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US public pension funds take on more risk

By Dan McCrum in New York

US public pension funds have used loose regulation to camouflage their liabilities and take on risks as they have matured, according to a new study by academics from Yale and Maastricht universities.

US corporate pension plans, as well as corporate and public plans in Canada and Europe, responded to rising numbers of retirees and falling interest rates over the last 20 years by reducing investment risks, the study finds.

But US public funds have moved in the opposite direction: increasing allocations to risky investments such as stocks, private equity and alternatives even as their proportion of retired members increased.

Martijn Cremers, professor at the Yale school of management, said that the behaviour was because of the "perverse incentives" of regulations that allow US public plans to calculate liabilities based on expectations for investment returns, typically 7.5 to 8 per cent a year.

An individual typically takes less investment risk as they get older and economic theory suggests a pension fund should do the same as it matures – as the ratio of retirees to active workers rises.

However, the rules give the plans an incentive to take more risk to maintain high returns targets and so camouflage rising liabilities, Prof Cremers said. "All the current fund boards, politicians and even taxpayers have an incentive to kick the can down the road."

For instance, Calpers, the largest US public pension plan, this year cut its assumed rate of return from 7.75 per cent to 7.5 per cent. The fund's actuary had recommended a cut to 7.25 per cent.

Official estimates for US public pension shortfalls range from $500bn to $1tn. Critics have suggested the true number is closer to $2.5tn.

Regulations for US corporate plans, and for European and Canadian plans, calculate

liabilities based on the prevailing level of bond yields.

In 1990, 10-year Treasury bonds paid more than 8 per cent, but have since fallen to below 2 per cent. As interest rates fall, the size of a pension plan's ultimate liability rises.

But rather than lower expectations which might raise contribution requirements, public pension funds have increased allocations to risky assets: from 53 per cent of total assets in 1992, to almost 75 per cent now.

The Governmental Accounting Standards Board (GASB) is in the final stages of writing new standards for public pension fund reporting. These aim "to make financial reporting of these public pensions more transparent, comparable and useful to citizens, legislators, and financial analysts", GASB said.

Final standards are expected within months, however GASB is expected to force funds to lower the discount rate for only a portion of their liabilities.

The study is based on numbers reported to the CEM Benchmarking database, covering 804 defined benefit pension plans which captures about 40 per cent of US pension assets and the majority of Canadian pension funds. In Europe, it covers mostly UK and Dutch funds.

Prof Cremers will present the findings in Washington at a University of Notre Dame and Nasdaq conference on financial regulation next month. He due to take up a position at the school's Mendoza College of Business.

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