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California (State of)

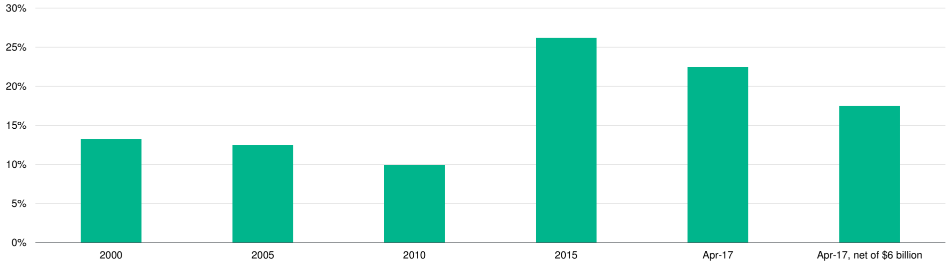
Improved Liquidity Position Enables More Aggressive Fiscal 2018 Pension Payment

California (Aa3 stable) Governor Jerry Brown's proposal to roughly double the state's fiscal 2018 pension contribution to $12 billion, released in a revised state budget last month, continues to move through the legislative process. The governor's proposal is a credit positive development because it suggests the state will aggressively counter a projected rise in its unfunded pension liabilities.

If approved by the Legislature, the state will pay a one-time $6 billion above required funding into its largest pension fund, the California Public Employees' Retirement System (CalPERS, Aa2 stable), for the fiscal year that begins July 1. Under plan assumptions, the extra payment would be akin to an early principal repayment that will reduce future interest costs on unfunded liabilities. Unfunded pension liabilities function similarly to debt under actuarial funding, because they accrue implied compound interest at the assumed rate of investment return on plan assets (currently 7.375% and eventually falling to 7.0% for the state's fiscal 2020 contributions to CalPERS).

To finance the supplemental pension contribution in fiscal 2018, California plans to borrow $6 billion from a short-term savings account, called the Surplus Money Investment Fund (SMIF). The proposal envisions that the state would repay the loan to the SMIF over 8 to 10 years at an interest rate that will likely be tied to market rates for two-year US Treasuries. The state has substantially improved its liquidity position since 2010, with total borrowable funds, including the SMIF, exceeding 20% of general fund revenues as of April 2017. Even after the supplemental pension contribution, California’s available liquidity will remain healthier than in recent years (see Exhibit 1).

Exhibit 1
California’s Available Liquidity Will Remain Strong, Even After $6 Billion Supplemental Pension Payment
Unused, available borrowable resources as % of general fund revenues



Note: All years reflect actuals except for 2017, which reflects enacted budget revenues and April actual borrowable resources
Source: State of California

Under the governor's proposal and pension plan assumptions, the state would achieve $11 billion in net pension cost savings over 20 years by making the more aggressive fiscal 2018 prepayment. Similar to a pension obligation bond issuance, the proposal anticipates an interest rate arbitrage gain by paying less interest to the SMIF than CalPERS can return by investing the $6 billion. However, CalPERS invests heavily in volatile asset classes, such as public equities, in order to justify its 7% return assumption. As such, investment losses could very well follow the state's supplemental payment and reduce the annual anticipated savings.

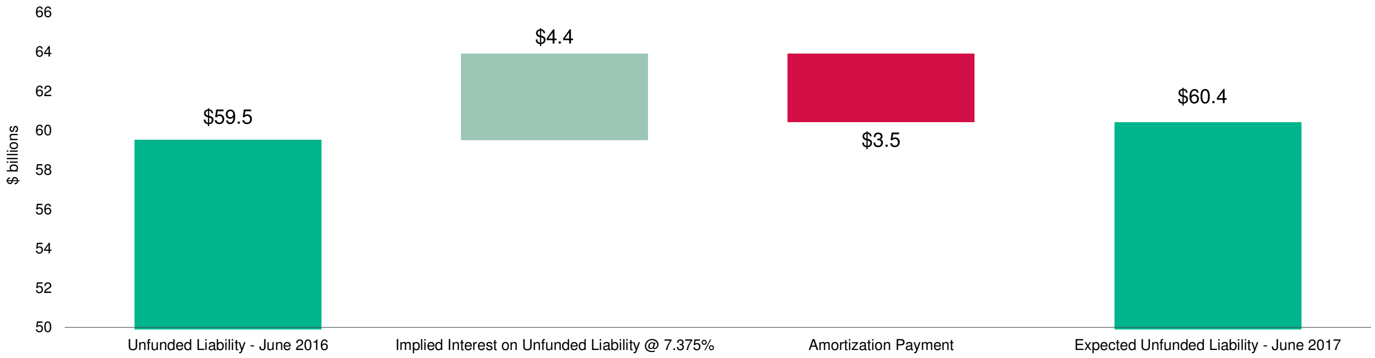
Unlike a pension bond, the governor's proposal would effectively borrow from the state's own savings and at a lower rate than if it issued taxable bonds to fund the additional pension contribution. Further, it could defer repayment of the SMIF loan without triggering a default on bonded debt.

California's baseline CalPERS pension contribution requirement falls below our "tread water" indicator by roughly $900 million in the fiscal year ending June 30, 2017. The "tread water" indicator measures the contribution required to prevent unfunded liabilities from growing in nominal dollars, if all actuarial assumptions are met in a given year. After covering its portion of current year benefit accruals, called "normal cost," the state's required fiscal 2017 pension contribution includes an amortization payment of $3.5 billion toward its $59.5 billion reported unfunded liability. Since the implied interest accrual on its unfunded liability is $4.4 billion, roughly $900 million greater than the amortization payment, we would expect its unfunded liability to grow by the size of the "tread water" gap if plan assumptions hold, to $60.4 billion (see Exhibit 2).

Exhibit 2

California's Required Contribution to CalPERS Does Not "Tread Water" because it Leads to Growing Unfunded Liabilities Under Plan Assumptions

Implied interest accrual of $4.4 billion exceeds scheduled amortization payment of $3.5 billion in fiscal 2017



Note: For simplicity, the expected unfunded liability in the exhibit does not reflect the scheduled reduction in CalPERS' reported discount rate to 7.25% for the state's June 2017 valuation.
Source: State of California CalPERS actuarial valuation

The additional $6 billion contribution proposal is the state's latest move to mitigate the negative effects of the back-loaded actuarial contribution requirements calculated by CalPERS, albeit for only one year in this instance. On previous occasions, the governor has advocated for a more aggressive discount rate reduction on the part of CalPERS, in the hopes of more quickly increasing ongoing funding requirements and reducing investment risk-taking.

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