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Analysis of California Pensions Finds Half-Trillion-Dollar Gap

By MARY WILLIAMS WALSH

An independent analysis of California's three big pension funds has found a hidden shortfall of more than half a trillion dollars, several times the amount reported by the funds and more than six times the value of the state's outstanding bonds.

The analysis was commissioned by Gov. [Arnold Schwarzenegger](#), who has been pressing the State Legislature to focus on the rising cost of public pensions.

Graduate students at Stanford applied fair-value accounting principles to California's pension funds, using a method recently devised by [two economists working in Illinois](#), Joshua D. Rauh of [Northwestern University](#) and Robert Novy-Marx of the [University of Chicago](#).

The Stanford group's finding does not suggest that California has to come up with half a trillion dollars all at once; pensions are paid slowly over time. But the possibility that the state's public pension funds are much deeper in the hole than reported could help explain why the required contributions to the funds have been rising every year, contributing to California's annual budget drama.

The finding also raises vexing legal issues, because public debts in California are supposed to be approved by the voters. The voters have, in fact, duly authorized all of the state's general obligation bonds, but the much larger pension debt is appearing out of nowhere.

The researchers offered six recommendations for closing the gap between what is owed to the state's retirees and how much has been set aside, including less volatile investments and a revamped benefit structure.

Governor Schwarzenegger issued [a statement](#) on Monday, warning that unless state lawmakers tackled pension reform, "increasingly large portions of state funding for programs Californians hold dear, such as schools, parks and health care, will be diverted to pay for this debt."

Mr. Schwarzenegger pointed out that he proposed pension initiatives a year ago, but lawmakers never followed through.

"We cannot wait any longer," he said. "Without reform, pension debt will only grow."

The Stanford project focused on California's big state-run employees' pension fund, known as Calpers; a second large fund for teachers, known as Calstrs, and the [University of California Retirement System](#). The three funds serve more than 2.6 million public employees and retirees.

Smaller public pension funds in California, run by cities and some counties, were not included in the analysis.

Public pension funds in all states and cities normally report their financial status with numbers prepared by actuaries, who keep track of assets and liabilities while calculating required contributions every year.

Increasingly, though, economists and other authorities say that the actuarial numbers give an unacceptably distorted picture.

That is because pension actuaries are trying to plan a budget of smooth, predictable contributions over the years, regardless of market volatility. Their job is not to provide a current financial picture.

Companies are no longer allowed to use actuarial numbers when reporting their pension values to the [Securities and Exchange Commission](#). For governments, the board that issues accounting rules has been contemplating whether to change its pension standard, but while it deliberates, economists like Mr. Rauh and Mr. Novy-Marx are recalculating public pension numbers on their own.

The primary complaint about the method used by states and cities is how they gauge the value of the pensions they owe in the future in today's dollars — a widely accepted financial calculation known as discounting.

Currently, governments discount pension values by using the return they expect their pension investments to earn over the long term. For most public pension funds, that means about 8 percent. In California, the teachers' fund uses 8 percent, Calpers uses 7.75 percent, and the University fund uses 7.5 percent.

The Stanford team found fault with that approach. The researchers wrote that in today's economic climate, such rates are associated with more speculative securities that carry some degree of risk, like those of emerging markets. Pensions, by contrast, are constitutionally protected and therefore the payments to public employees and retirees should carry almost no risk.

After the researchers applied a risk-free rate of 4.14 percent, equivalent to the yield on a 10-year Treasury note, the present value of the promised benefits ballooned. The researchers came up with a \$425 billion shortfall for the three funds.

As of July 1, 2008, the funds officially reported they were \$55 billion short. They have not issued financial statements since then, but have said informally that they lost a total of \$110 billion.

The researchers concluded that their estimate of the gap would also have grown by roughly \$110 billion, to more than half a trillion, today. Their full report is expected to be released this week on the Stanford Institute for Economic Policy Research Web site.

Calpers **challenged the research**, saying it was "out of sync with governmental accounting rules and actuarial standards of practice."

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