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Moody's to Factor Pension Gaps in States' Ratings

By MARY WILLIAMS WALSH

Moody's Investors Service has begun to recalculate the states' debt burdens in a way that includes unfunded pensions, something states and others have ardently resisted until now.

States do not now show their pension obligations — funded or not — on their audited financial statements. The board that issues accounting rules does not require them to. And while it has been working on possible changes to the pension accounting rules, investors have grown increasingly nervous about **municipal bonds**.

Moody's new approach may now turn the tide in favor of more disclosure. The ratings agency said that in the future, it will add states' unfunded pension obligations together with the value of their bonds, and consider the totals when rating their credit. The new approach will be more comparable to how the agency rates corporate debt and sovereign debt. Moody's did not indicate whether states' credit ratings may rise or fall.

Under its new method, Moody's found that the states with the biggest total indebtedness included Connecticut, Hawaii, Illinois, Kentucky, Massachusetts, Mississippi, New Jersey and Rhode Island. Puerto Rico also ranked high on the scale because its pension fund for public workers is so depleted

that it has virtually become a pay-as-you-go plan, meaning each year's payments to retirees are essentially coming out of the budget each year.

Other big states that have had trouble balancing their budgets lately, like New York and California, tended to fare better in the new rankings. That is because Moody's counted only the unfunded portion of states' pension obligations. New York and California have tended to put more money into their state pension funds over the years, so they have somewhat smaller shortfalls.

In the past, Moody's looked at a state's level of bonded debt alone when assessing its creditworthiness. Pensions were considered "soft debt" and were considered separately from the bonds, using a different method.

"A more standard analysis would view both of these as liabilities that need to be paid and put stress on your operating budgets," said Robert Kurtter, managing director for public finance at Moody's.

In making the change, Moody's sidestepped a bitter, continuing debate about whether states and cities were accurately measuring their total pension obligations in the first place. In adding together the value of the states' bonds and their unfunded pensions, Moody's is using the pension values reported by the states. The shortfalls reported by the states greatly understate the scale of the problem, according to a number of independent researchers.

"Analysts and investors have to work with the information we have and draw their own conclusions about what the information shows," Mr. Kurtter said.

In a report that is being made available to clients on Thursday, Moody's acknowledges the controversy, pointing out that governments and corporations use very different methods to measure their total pension obligations. The government method allows public pension funds to credit themselves for the investment income, and the contributions, that they expect to receive in the future. It has come under intense criticism since 2008 because the expected investment returns have not materialized. Some states have not made the required contributions either.

Moody's noted in its report that it was going to keep using the states' own numbers, but said that if they were calculated differently, it "would likely lead to higher underfunded liabilities than are currently disclosed."

After adding up the values of each state's bonds and its unfunded pensions, Moody's compared the totals to each state's available resources, something it did in the past only for each state's bonds. It found that some relatively low-tax states, like Colorado and Illinois, had very high total debts compared with their revenue, suggesting that their finances could be improved by collecting more taxes.

But some states that are heavily indebted, like New Jersey, also have among the highest tax rates, suggesting other types of action may be needed to reduce their debt burdens.

Moody's also ranked total indebtedness on the basis of each state's total economic output and its population. It did not factor state promises for retiree health care into its analysis, on the thinking that pensions are a fixed debt like bonds, but retiree health plans can usually be renegotiated.

Mr. Kurtter said Moody's was not suggesting that any state was in such serious trouble that it was about to default on its bonds, something considered extremely unlikely by many analysts.

Some state officials have complained about a recent tendency to focus on total pension obligations, calling it a scare tactic by union opponents who want to abolish traditional pensions and make all state workers save for their own retirements.

Mr. Kurtter said Moody's had decided it was important to consider total unfunded pension obligations because they could contribute to current budget woes.

"These are really reflections of the budget stress that states and local governments are now feeling," he said. A company with too much debt could close its doors, he said, but governments do not have that option.

“They have a tax base. They have contractually obligated themselves to make these payments. These are part of the ongoing budget stress,” he said. “It ultimately all comes back to being an operating cost. Addressing those problems is really what’s happening today.”



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