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# Moody's pension calculation changes could hit Illinois hard

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Wall Street is turning up the heat on Illinois and Chicago for pension reform, turning a chasm of unfunded liabilities into a Grand Canyon-size problem.

Moody's Investors Service Inc., a major credit rating agency, plans a massive recalculation of the nation's public pension balance sheet, based in part on an investment outlook that's far more conservative than most such plans assume. At a time when many governments are struggling to meet existing pension obligations, the prospect of lower returns means they would have to come up with even more money to pay future benefits — debts that ultimately could fall on taxpayers.

The proposed shift would swell pension shortfalls by more than half for five major Illinois plans, taking the state's staggering $83 billion pension debt to nearly $135 billion. Unfunded liabilities would jump to nearly $47 billion at the 10 biggest Chicago-area public pension plans, from $27 billion in fiscal 2010, the latest data available for the plans.

While it's too early to say whether the nation's two other major credit rating companies will follow suit, Moody's is proposing what academic economists and other critics of the U.S. public pension system have advocated for years: a tougher appraisal of pension obligations to keep politicians from promising more than taxpayers can afford. Moody's proposal would go several steps beyond reforms recently adopted by the Governmental Accounting Standards Board.

"I have been saying if there was going to be discipline imposed on the states, it would be through the market, not a regulator," said Robert Novy-Marx, professor of finance at New York's University of Rochester, who writes frequently about public pension plan problems. "I don't care how long they drag their feet — the market will drag them along."

The new methodology is not expected to mean a slew of changes in credit ratings, although some cities might be reassessed if their recalculated pension liabilities are out of line with their rating, according to New York-based Moody's, which noted Chicago's rating already has been reduced because of pension liabilities.

Some question whether the proposal is realistic or meaningful in terms of ongoing efforts in Illinois and elsewhere to reduce pension benefits to avert a funding crisis.

"The fact remains we have a problem," said a spokesman for the Illinois Teachers Retirement System, whose current 8.5% rate of return assumption is under review by its board. "A new calculation of unfunded liabilities doesn't give us any solution to the problem. It's like stirring your coffee in a different direction."

The Illinois General Assembly failed to reach agreement on a pension-reform package before it adjourned last month, but negotiations continue between Gov. Pat Quinn and legislative leaders. Chicago Mayor Rahm Emanuel also is pushing for changes in state law that dictate the city's pension terms.

"This is a wake-up call for everybody," said a spokeswoman for the city's finance department. "It means it's even more important to find a legislative solution to the problem." A spokeswoman for the governor said: "We are making steady progress."

Instead of expecting investments to earn between 7.25% and 8.5% like most plans here and elsewhere now do, Moody's says it will use a return of 5.5% to judge and compare the financial soundness of state and city pension funds. According to Moody's, the more recent performance of investments and the outlook for an extended period of low interest rates make 5.5% more likely than the higher returns that plan sponsors justify on the basis of long-term past performance.

Moody's also plans to rely on current market values, rather than multiyear "smoothing" to value pension assets and mask poor investment performance in any one year by assuming it can be offset over the long term. The proposal is open for public comment until Aug. 31. Market participants can provide feedback to Moody's by sending comments to cpc@moodys.com.

*Paul Merrion is a reporter for Crain's Chicago Business, a sister publication of Pensions & Investments*

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