John Arnold Takes a Stand in Kentucky Pension Fight

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In Frankfort, Kentucky, the state legislature is currently debating the retirement future of its public workers. The six plans that make up the Kentucky Retirement Systems have $33 billion in underfunded liabilities, a situation that is putting a strain on state and municipal finances at a time when the state can least afford it. In early January the mayors of Kentucky's two largest cities, Louisville and Lexington, publicly called on the governor to support pension reform, arguing that the pension costs on their cities were "spiraling out of control." Among those advising Kentucky lawmakers is the Laura and John Arnold Foundation — the private foundation of former Enron trader turned hedge fund manager John Arnold and his wife. Kentucky is just one of many states where Arnold is seeking to play a role influencing the highly contentious pension debate, and not everyone is happy to see him.

Pension reform does not, on the surface, appear to be an obvious fit for the Arnolds. Their initial areas of philanthropic interest were penal reform and education according to Josh McGee, the Arnold Foundation's vice president for public accountability. As the couple started educating themselves on what they could do, however, they found an area where their investment could really have an impact — reforming the public pension system. Additionally the couple realized that as state and local budgets were forced to spend more covering pension debts the less money their would be in civic coffers for their other concerns — the so-called crowd-out effect. "The more they dug into it the more they realized this crowd-out effect was going to be a huge deal," says McGee.

The Arnold Foundation aims to tackle pension reform in two principal ways. The first, says McGee, is to "engage in a research agenda that would highlight success

stories and wins on pension reform, and knock down stumbling blocks to reform." The second is to provide education and technical assistance to those seeking to reform public pension funds; often this means advising and assisting state legislatures. The latter has raised the ire of some organized labor groups.

During the past two years the Arnold Foundation has started putting money and resources into pension reform at the state and municipal level — both by supporting and educating groups that are interested in changing the public retirement system, as they are doing in Kentucky, and by funding research. The Arnold Foundation advocates a move away from traditional defined benefit models toward pension plans that, it argues, are more sustainable — either some kind of defined contribution plan or a so-called cash balance plan, which represents each individual's savings in the fund as a cash balance available upon retirement. Last year the Arnold Foundation began a partnership with the Pew Charitable Trust, a Washington, D.C.–based not-for-profit, to further its reach. To date the two groups have given advice and assistance in 24 jurisdictions, and the Arnold Foundation has spent around $7 million on pension reform efforts in states such as Arizona, Colorado, Illinois, Montana, Nevada, Rhode Island and Kentucky.

Almost every state in the U.S. is tackling the challenge of how to afford the pension benefits promised to government employees, teachers, fire fighters, police officers and other municipal workers. As pension benefits grow and state and city budgets shrink, a state pension deficit problem has arisen that is akin to the sovereign debt issues in Europe. Industry experts estimate that U.S. public pensions could be underfunded by anywhere from $1 trillion to $3 trillion, depending on what accounting principals are used. The pension debate is a sensitive topic — people's livelihood and financial security are at stake.

Not surprisingly, the Arnold Foundation's efforts have received criticism. Labor groups have objected to what they see as a Houston, Texas-based billionaire weighing in on their pension issues. In California last year, labor groups reacted critically to the news that the Arnold Foundation had given a $150,000 grant to the California Foundation For Fiscal Responsibility, a 501(c)3 organization established to educate "the public and key decision makers about California public employee retirement benefit issues and developing fiscally responsible solutions that are fair to

employees, employers and taxpayers." This December a group representing public sector workers, called the Kentucky Public Pension Coalition, circulated a memo to its state legislature criticizing the actuarial assumptions the Arnold Foundation and Pew had used in their work in the state.

"The unholy alliance between Pew Center on the States and the Laura and John Arnold Foundation showcases how an ideologue like John Arnold can partner with a seemingly nonpartisan organization to push a sloppy policy proposal," says Steve Barger, coordinator for the Kentucky Public Pension Coalition and managing member of Steve Barger Consulting. "The Arnold Foundation has made no effort to hide their disdain for public employees — and that conviction is now coming out in the form of recommendations to eliminate the traditional defined benefit pension plans in Kentucky and other states."

Last week, Pew and the Arnold Foundation sent a letter to Kentucky's actuarial firm, Baltimore-based Bolton Partners, arguing that the analysis used to refute their proposals was flawed. In their consultation with the Kentucky legislature, Pew and the Arnold Foundation recommend that the state move its public pension funds to a so-called cash balance plan, which would be funded like a defined benefit plan but in which the "balance" of the retirement benefactors' pension would vary with the fortunes of the fund. They argue that the cash balance plan would put less debt on the state, provide more long-term retirement security for public workers and avoid future funding crises. The proposal was taken up by a legislative task force as a proposed reform.

Labor objected, with the Kentucky coalition calling the plan "poorly designed" in a white paper last year. The group pointed to actuarial studies that show the costs will be far higher, and the savings far less, then the Pew and the Arnold Foundation projections. The coalition argues that, rather then insulate the state against pension deficits ,the cash balance model actually helps lock in losses because it restricts the ability of the pension investments to make up those losses on any market rebound. The differences may appear to be points of actuarial minutiae, but the impacts are real and significant.

Though not at the core of the Kentucky debate, another key point of contention

between much of organized labor and Pew Center and Arnold Foundation's work is the so-called discount rate. Both the Arnold Foundation and Pew support mark-to-market accounting for pubic pension funds — this would require funds to use a much lower figure for the discount rate, making the pension funding issues greater. The Washington, D.C.–based National Conference on Public Employee Retirement Systems, the public pension fund trade association, is just one of many groups that objects to such assumptions. It argues that a higher discount rate should be used because states, unlike corporations, cannot go bankrupt.

"We are very disappointed with the Arnold Foundation," says Hank Kim, executive director and legal counsel for NCPERS. "They are coming in with preconceived notions of what the solutions are" and, to Kim's mind, faulty accounting assumptions. "If the Arnold Foundation and Pew would want to engage in a solutions orientated conversation we would be more then happy to have that conversation," he says.

The Pew Center and Arnold Fondation, however, see arguing over the discount rate as beside the point. Pew's Drain says that, even using pension funds' own accounting, the scale of the problem is immense. The Arnold Foundation's McGee agrees. He thinks the debate over the discount rate is unproductive. He would rather frame the conversation around risk. "The higher the discount rate the greater the risk of future underfunding," he says. "Real comprehensive pension reform is necessary to secure the benefits that workers have been promised. Pension reform can and should be pro-worker."

The tiny state of Rhode Island, population 1 million, is currently a test case for pension reform. Led by the then new state Treasurer Gina Raimondo, the local legislature in 2011 voted for comprehensive pension reforms to its $7.4 billion retirement system. Those reforms are currently being implemented, but they face opposition in the courts from organized labor groups that claim the reforms violate the contract clause of the state constitution. The case is expected to go to the state's supreme court, but Rhode Island's pension problems do not just exist at the state level. They are also a concern for the 36 locally administered municipal pension funds in the state, all of which have their own retirement funds and pension burdens. The Arnold Foundation and Pew Trust are currently, along with

Raimondo's office, providing counseling for how these municipalities can implement reform along the lines of what the state has done.

As a private foundation, the Arnold Foundation cannot contribute to political campaigns. But the deep-pocketed Arnolds can — and they do. John and Laura Arnold have given money to Raimondo's campaign as well as to Engage Rhode Island, a political action committee and 501(c) set up to support Rhode Island's pension reforms.

The Arnolds are not the only civic-minded billionaires who see pension reform as an increasingly vital problem to address. From Blackstone Group co-founder Peter Peterson to New York City Mayor Michael Bloomberg, some of the wealthiest Americans are beginning to pay increasing attention to this issue. Given the growing concern around budget deficits, and the increased awareness of what role pension funds play in that debate, organized labor — in Kentucky and the rest of the U.S. — is likely going to have to get used to billionaires brandishing checkbooks.