

Pension Funding And Policy Challenges Loom For U.S. States

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Pension Funding And Policy Challenges Loom For U.S. States

(Editor's Note: Standard & Poor's has adjusted the pension information for Washington. In the original version of this report published June 30, 2010 we followed our practice from prior reports and included only Washington's Public Employees Retirement System (PERS) Plan 1 and the Teachers Retirement System (TRS) Plan 1. With the release of Washington's fiscal 2008 audit, the state changed accounting methods and began reporting actuarial information for the PERS Plan 2/3 and TRS Plan 2/3. Disclosure for PERS Plan 2/3 and TRS Plan 2/3 includes data associated with both Plan 2 (a defined benefit plan) and the defined benefit portion of PERS Plan 3 and TRS Plan 3 (each, a combined defined benefit/defined contribution plan). Including PERS Plan 2/3 and TRS Plan 2/3 produces a funded ratio of 88% compared to the previously reported 73.5%. The table has been adjusted to reflect this change.)

The decline in public pension fund assets that started in fiscal 2008 is now contributing to significant budget challenges for U.S. states as many of them are faced with having to increase their pension contributions even as federal stimulus funding dries up and before meaningful revenue recovery has taken hold. Our observations show that many states are re-thinking core services, programs, and benefit levels—including pensions.

Historically, this has been a common government response in a difficult budget climate and we believe that for the most part states will move relatively slowly and incrementally in dealing with pension funding. We plan to analyze their overall success in managing pensions and reducing long-term liabilities in conjunction with future investment performance and their demonstrated commitment to funding required pension contribution increases.

There are other policy challenges that we believe will serve to keep public pension liabilities and sustainability in the forefront for governments and investors alike. The first relates to assumed investment earnings relative to performance. Second, we believe the recent "preliminary views" released by the Governmental Accounting Standards Board (GASB) will cause lively debate about pension accounting and financial reporting and, possibly, funding.

Survey: Funded Ratio Has Decreased

The latest complete data compiled by Standard & Poor's Ratings Services (see table), covering 2008, show that the funded ratio—or actuarial value of assets divided by the actuarial accrued liabilities (AAL)—has weakened considerably after a period of stability through 2007. Based on our review of the information released so far for 2009 (not available for all states), we think it could look considerably worse. Actual losses recorded by state plans will be partially determined by the reporting time horizon, asset allocation, and level of contribution.

Pension liabilities and the costs associated with funding them on an annual basis remain an important credit factor in our review of state governments. Standard & Poor's views pension obligations as long-term liabilities that must be funded over time. While the funding schedule can be more flexible than that for a fixed-debt repayment, it can also be more volatile and may cause fiscal stress if not managed, in our opinion.

In 2008, according to our analysis, the mean funded ratio for the principal state pensions was 80%, below the 83% recorded for 2007 and far below the 100% recorded in 2000. Our annual survey includes the principal state pension

funds, which generally encompass retirement plans both for public employees (including employees from both the state and municipal jurisdictions) and teachers. However, in some cases, a state could simply have one large plan covering all government workers. In other cases, it could sponsor a third significant plan. States generally aren't directly responsible for the full liabilities of these pension systems; typically, costs are shared with other plan participants.

We will assess actual losses recorded by individual pension plans, which losses will be influenced by the reporting time horizon and asset allocation of each plan. While the pension funding declines were not an immediate budget issue for state and local governments due to actuarial smoothing of losses and gains, that is about to change. Though states have had time to plan for these cost increases, we believe that the current economic environment will create funding challenges for some. Funded ratios and contribution rates are a significant part of our credit analysis for states, so when these factors are weak they may serve to limit the rating.

Pension Hit Was Delayed

We believe it is important to keep in mind that volatility of assets in public pension funds does not immediately equate to a like amount of volatility in a state's annual budget. The key issue for our credit analysis regarding pensions and state budgets is to assess the budget impact and affordability of higher pension contributions.

The funding and accounting treatment of public pension plans moderates the effect of investment market volatility on annual pension contributions. Actuarial smoothing methods allow investment losses and gains to be phased in over several years (unlike with corporate pension plans, where federal law restricts smoothing). About 88% of public pension plans have a smoothing period of four years or longer, with five years being the most common. This smoothing allows governments time to adjust budgets over several years rather than absorb the pension fund losses in one year. The losses from 2008 are now translating to real budget pressure for states. We believe this will continue for a while.

Focus On Sustainability

We have observed a range of state actions over the past several years centered on managing long term retirement costs and improving funding levels. To date, these actions have incrementally controlled costs or improved funding but have not dramatically changed benefit levels or funded status, especially when contrasted with asset performance. We have seen state governments focus attention on a broad range of changes including contribution rate increases, benefit levels, vesting, and age and service requirements. We believe that these actions could provide opportunity for cost containment over time. Post retirement benefits are long term liabilities that will not be fully resolved in short term. Over the long term, state governments do have a track record of making adjustments and improving funding ratios. Prior to GASB accounting changes in the 1980s, many public sector pension plans had very weak funded ratios and limited asset accumulation relative to current levels.

Accounting And Reporting Changes

On June 16, GASB released "Preliminary Views: Pension Accounting and Financial Reporting by Employers." It has been over a decade since GASB revised its financial accounting and reporting for public pensions (Statements No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans";

and No. 27, "Accounting for Pensions by State and Local Governmental Employers"). A research project on the topic was initiated in 2006 and GASB determined that changes were necessary to improve the transparency, consistency, and comparability of reported pension information. There are a range of issues being considered including how pension benefits are earned, who is responsible for the obligations, how a liability would be measured, pension plan assumptions, and the frequency and timing of actuarial valuations. Also under consideration is how a government in a cost-sharing multiple-employer pension plan would report a liability related to its proportionate share of the cumulative unfunded liability of all participating governments. We believe that significant changes could be on the horizon related to accounting and reporting and perhaps how a government funds its pension obligations.

State Pension Funding History

State pension funding ratios made what we consider strong gains in the 1990s, averaging more than 100% by 2000, compared with roughly 80% a decade earlier. Above-average investment returns, particularly from equities, contributed to this rapid increase. From 1990 to 2000, the average annual increase of the S&P 500 Index of domestic equities was 15%, compared with an average actuarial return assumption of about 8%. Public pension fund investment allocations to domestic equity rose to about 60% (from 40%) over the same period. This combination of factors, coupled with strong fixed-income returns, enabled public funds to exceed their investment return assumptions and achieve the actuarial gains that led to the dramatically improved funded ratios.

In the first part of this decade, however, the funded ratio trend shifted quite rapidly when public pension funds suffered a number of setbacks. In terms of investment yields, the S&P 500 fell 16% in fiscal 2001 and was down 19% in fiscal 2002. In our opinion, in addition to falling asset values, a number of other factors led to rising liabilities, including members' increased longevity and the phasing in of previously granted benefit enhancements. The combination of falling assets and rising liabilities caused average state pension funding levels to fall from their peak in 2000.

Pension Liabilities And State Debt

The table below contains selected pension and debt information for each state. The data are mostly as of 2008 (fiscal year end 2008 for debt data), which is the most recent year with substantially complete data available. The pension data are combined for the principal, state-sponsored, defined-benefit pension funds: generally the public employees retirement system, including state and local employees in most cases, plus the teachers retirement system. In some cases, a state may have just one combined system for all employees, while others may have a third significant system that is included in several cases

State sponsors have varying degrees of responsibility for funding pension plans. For example, in the case of multi-employer agent systems, the state would make contributions to plans that include its employees only, with local agencies contributing to their respective plans. For multi-employer cost-sharing systems, which can include a number of local jurisdictions like school districts with contributions from both employers and employees, the state may be a nonemployer contributor. Therefore, with some exceptions, states are generally not directly responsible for the full liabilities of these pension systems.

When evaluating the debt structure of state and local governments, Standard & Poor's does not include the

unfunded actuarial accrued liabilities (UAAL) with other debt in its presentation of tax-supported debt statistics. Comparisons are difficult due to the significant variation in how these liabilities are calculated. Because it is a long-term obligation that must be funded over time, however, we include the UAAL factors in the analysis as an additional long-term liability (see "Criteria: GO Debt," published Oct. 12, 2006, and "U.S. Public Finance Report Card: 2009 State Debt Review: Significant Challenges Lie Ahead," published Dec. 16, 2009).

We have reported state debt and unfunded pension liabilities in recent years in order to give a comparative framework for these liabilities. The pension information includes the systems' funded ratio for each state and the UAAL; the UAAL is also expressed on a per capita basis. Tax-supported debt is shown for each state in total as well as on a per capita basis. Pension and debt figures are combined on a per capita basis and then expressed as a percent of per capita income as a measure of resources to meet these obligations.

In an effort to enhance comparability of our ratings and provide taxable investors with a way to assess debt relative to sovereign peers outside the U.S., Standard & Poor's added a new debt ratio to its debt analysis: tax-supported debt to gross state product. We have included a ratio of tax supported debt and UAAL relative to gross state product.

Highlights of the data include:

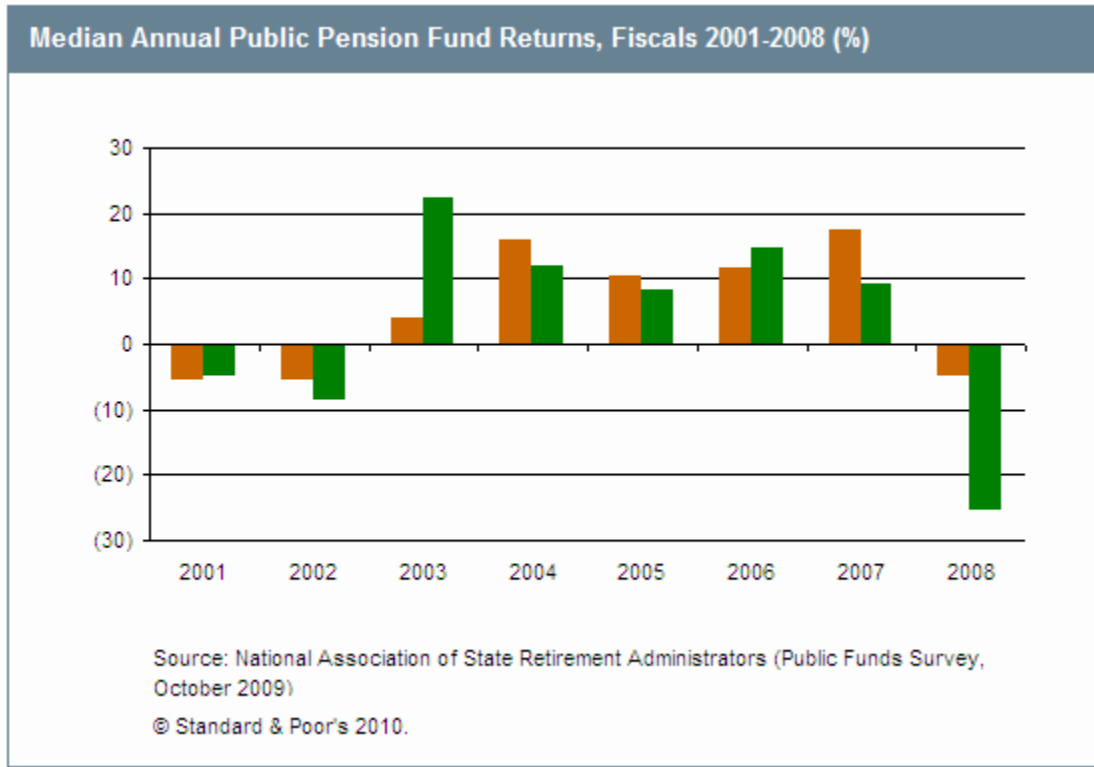
- State debt rose slightly to \$396 billion in fiscal 2008 from \$359 billion in fiscal 2007, a 10.3% increase;
- Unfunded pension liabilities increased to \$457.1 billion in fiscal 2008 from \$368.5 billion in 2007 (a 24% increase);
- Debt remained stable on a per capita basis at \$1,141 in fiscal 2008 compared to \$1,053 in fiscal 2007;
- The average UAAL per capita increased to \$1,809 in 2008 from \$1,458 in 2007; and
- In relation to the resources available to service these requirements, debt per capita and the per capita unfunded pension liability relative to personal income had a 50-state average of 7.5%, compared to 6.6% in 2007.

(For a comparison with fiscal 2007's results, see "Market Declines Will Shake Up U.S. State Pension Funding Stability," published Feb. 26, 2009)

Pension Liabilities Will Need to Be Managed

Recent investment declines have cut across most asset classes and will likely present challenges for public pension plan managers in the coming years, we believe. Most governments have a track record of absorbing increased contributions due to the phased-in nature of these increases. We expect that the funding trends and annual costs of servicing this liability relative to a government's resources will be important elements of our credit review in the future. However, if governments consistently ignore postretirement benefits and underfund contributions in the hope that future economic growth will bolster their finances sufficiently, they could be setting themselves up for greater hardship, in our view.

Chart 1



State Retirement Systems And Debt Statistics: 2008

State	Funded Ratio	\$					%		GO Rating
		UAAL (Mil.)	UAAL PC	Debt (Mil.)	Debt PC	Debt PC+UAAL PC	(Debt PC+UAAL PC)/Income PC	(Debt PC+UAAL PC)/GSP PC	
Alabama	77.0	9,165	1,966	3,368	722	2,688	8.0	7.4	AA/Stable
Alaska	75.6	3,505	5,107	1,076	1,568	6,675	15.4	9.6	AA+/Stable
Arizona	79.8	8,329	1,281	4,470	688	1,969	6.0	5.1	AA-/Negative
Arkansas	86.5	2,692	943	1,240	434	1,377	4.4	4.0	AA/Stable
California	87.0	57,784	1,572	60,394	1,643	3,215	7.5	6.4	A-/Negative
Colorado	69.7	16,756	3,392	1,290	261	3,653	8.6	7.3	AA/Stable
Connecticut	59.8	16,520	4,718	15,883	4,536	9,255	16.5	15.0	AA/Stable
Delaware	103.1	(202)	(231)	2,294	2,627	2,396	5.9	3.4	AAA/Stable
Florida	105.3	(6,633)	(362)	20,329	1,109	747	1.9	1.8	AAA/Negative
Georgia	91.4	6,443	665	8,388	866	1,531	4.5	3.7	AAA/Stable
Hawaii	68.8	5,168	4,012	4,480	3,478	7,490	18.5	15.1	AA/Stable
Idaho	92.8	810	531	423	278	809	2.5	2.3	AA/Stable
Illinois	53.4	43,048	3,337	23,302	1,806	5,143	12.1	10.5	A+/Watch Neg
Indiana	64.8	10,161	1,594	2,974	466	2,060	6.0	5.2	AAA/Stable
Iowa	89.1	2,665	888	261	87	974	2.7	2.2	AAA/Stable
Kansas	58.8	8,280	2,955	3,200	1,142	4,097	10.8	9.4	AA+/Stable
Kentucky	66.7	14,291	3,347	5,164	1,210	4,557	14.3	12.4	AA-/Stable
Louisiana	69.2	10,978	2,489	2,800	635	3,124	8.6	6.2	AA-/Stable

State Retirement Systems And Debt Statistics: 2008 (cont.)									
Maine	79.7	2,782	2,113	476	362	2,475	7.0	6.6	AA/Negative
Maryland	78.2	9,981	1,772	7,584	1,346	3,118	6.5	6.4	AAA/Stable
Massachusetts	79.2	11,729	1,805	26,138	4,022	5,828	11.5	10.4	AA/Stable
Michigan	83.5	11,294	1,129	6,583	658	1,787	5.1	4.7	AA-/Stable
Minnesota	78.3	8,685	1,664	4,655	892	2,555	6.0	5.1	AAA/Stable
Mississippi	72.9	7,720	2,627	4,345	1,479	4,106	13.9	13.1	AA/Stable
Missouri	83.8	7,604	1,286	3,924	664	1,950	5.5	4.8	AAA/Stable
Montana	83.9	1,391	1,438	202	209	1,647	4.8	4.4	AA/Stable
Nebraska	90.6	722	405	11	6	411	1.1	0.9	AA+/Stable
Nevada	76.1	6,611	2,543	3,800	1,461	4,004	9.9	7.9	AA+/Stable
New Hampshire	67.8	2,519	1,914	683	519	2,433	5.7	5.3	AA/Stable
New Jersey	73.0	32,811	3,779	29,680	3,418	7,197	14.1	13.2	AA/Stable
New Mexico	82.7	4,620	2,328	1,247	628	2,956	9.2	7.3	AA+/Stable
New York	107.1	(15,905)	(816)	50,486	2,590	1,774	3.7	3.0	AA/Stable
North Carolina	99.3	391	42	6,735	730	773	2.2	1.8	AAA/Stable
North Dakota	86.5	549	856	251	391	1,247	3.2	2.6	AA+/Stable
Ohio	77.8	38,848	3,382	9,750	849	4,231	11.9	10.3	AA+/Negative
Oklahoma	58.2	11,501	3,158	1,894	520	3,678	10.0	9.1	AA+/Stable
Oregon	80.2	10,739	2,833	6,092	1,607	4,441	12.4	10.4	AA/Stable
Pennsylvania	87.0	13,725	1,103	9,296	747	1,849	4.6	4.2	AA/Stable
Rhode Island	60.9	4,332	4,123	1,651	1,571	5,694	13.9	12.6	AA/Negative
South Carolina	69.3	10,964	2,447	2,426	542	2,989	9.4	8.6	AA+/Stable
South Dakota	97.2	193	239	149	185	425	1.1	0.9	AA/Stable
Tennessee	95.1	1,603	258	1,421	229	487	1.4	1.2	AA+/Stable
Texas	90.9	13,415	551	11,100	456	1,008	2.6	2.0	AA+/Stable
Utah	86.6	3,075	1,124	2,600	950	2,074	6.8	5.2	AAA/Stable
Vermont	86.5	467	751	439	707	1,458	3.7	3.6	AA+/Stable
Virginia	84.0	10,006	1,288	6,590	848	2,136	5.0	4.2	AAA/Stable
Washington	88.0	5,843	892	13,798	2,107	2,999	7.1	6.1	AA+/Stable
West Virginia	62.4	4,873	2,685	1,283	707	3,393	11.0	10.0	AA/Stable
Wisconsin	99.7	253	45	9,970	1,772	1,816	4.9	4.3	AA/Stable
Wyoming	78.6	1,316	2,471	44	83	2,554	5.1	3.9	AA+/Stable
Average	80.5	8,688	1,809	7,733	1,136	2,945	7.5	6.4	
Median	80.0	6,527	1,629	3,584	739	2,514	6.3	5.3	

UAAL-unfunded actuarial accrued liabilities; PC-per capita; GSP-gross state product.

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