Pension Funding: Current Issues and Trends

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Retirement security, important for all Americans, has been especially important in attracting and retaining public servants. Public employees generally have accepted lower wages in exchange for more generous retirement benefits.

In the aftermath of the economic downturn of 2008-2009, there has been considerable focus on the unfunded pension liabilities of state and local governments. The extent of public pension liabilities varies widely among the states and local governments.

Why has pension funding slipped?

- The economic downturns of 2001 and 2008 hurt funding levels of all public and private retirement plans
- Plan sponsors sometimes have not paid the full annual required contribution
- The experience of the pension plan did not match its assumptions.
- Some pension plans made changes that exacerbated their funding problems
  - lowering the retirement age
  - authorizing, but not funding, retroactive benefit enhancements

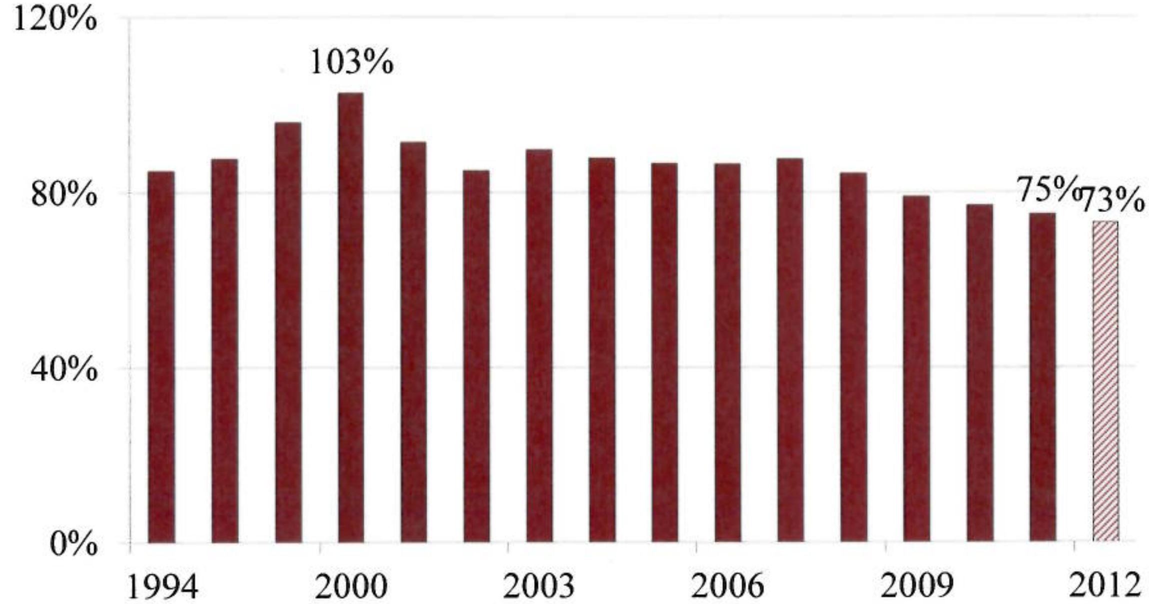
Defined benefit pension plan funding is based on assumptions developed and certified by enrolled actuaries. There are two types of assumptions: demographic and economic. Demographic assumptions include projected behaviors such as salary growth, mortality, and length of service. Economic assumptions include inflation and investment returns.

Pension plans are typically funded through a combination of employer and employee contributions and earnings from investments. Public pension plans hold more than $3 trillion in assets in trust on behalf of more than 15 million working and 8 million retired state and local government employees and their surviving family members.

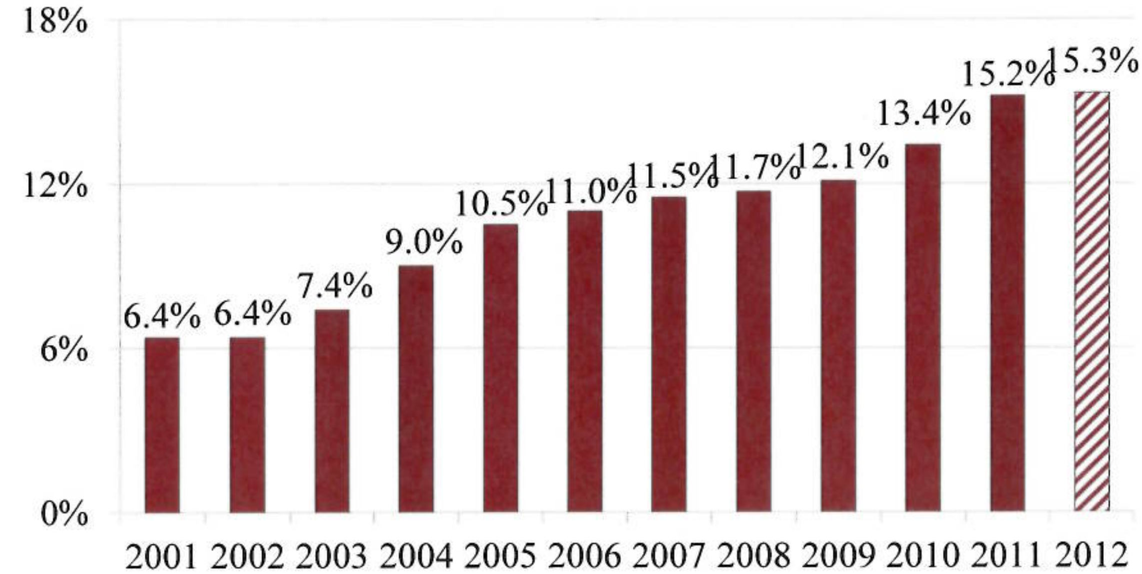
Putting pension funding issues into perspective

- There were serious pension funding problems in the past – "pay as you go" was relatively common in the 1970s
- Governmental Accounting Standards Board disclosure requirements (1986) stimulated better funding
- Most plans were fully funded by 2000
- The last decade hit pension plans hard -- two recessions and more retirees to support
- In 2012, 33 percent of plans were over 80% funded
- 22 percent were less than 60 percent funded in 2012
- Average funded ratio in 2012 was 73%

State and Local Funded Ratios, 1994-2012[1]



Annual Required Contribution as a Percentage of Payroll, 2001-2012[2]



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1 Note: 2012 is Alicia Munnell's estimate.

Sources: Various 2012 actuarial valuations; *Public Plans Database*. 2001-2011. Center for Retirement Research at Boston College and Center for State and Local Government Excellence; and Paul Zorn. 1994-2000. *Survey of State and Local Government Retirement Systems: Survey Report for Members of the Public Pension Coordinating Council*. Government Finance Officers Association.

2 Note: 2012 is Alicia Munnell's estimate.

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Although pension costs have grown, they remain a relatively small percentage of state and local government revenues. On average, pension costs have grown from 3.6 percent of budget in 2000 to 4.6 percent in 2010, according to the Center for Retirement Research at Boston College.

Pension funding policies

If local governments follow prudent funding policies, pension funding is likely to stabilize in the years ahead. A variety of state and local laws and policies guide pension funding decisions and practices. Many states and local governments have passed legislation that stipulates how pensions should be funded. Others have policies that address how pension assets are to be invested or if pension reserves must be maintained.

Generally speaking, well-funded pension plans take a long-term approach to estimating investment returns, adjust their demographic and other assumptions as needed, and have employers that consistently pay their annual required contribution in full. A clear pension funding policy is important because it:

- Lays out a plan to fund pensions;
- Provides guidance in making annual budget decisions;
- Demonstrates prudent financial management practices;
- Reassures bond rating agencies; and
- Shows employees and the public how pensions will be funded.

2013 Pension Funding Task force recommendations

Ten national associations representing state and local governments served on a Pension Funding Task Force over the past two years. The task force recommends that pension funding policies be based on the following five general policy objectives:

1. Have a pension funding policy that is based on an actuarially determined contribution.
2. Build funding discipline into the policy to ensure that promised benefits can be paid.
3. Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers who receives services.
4. Make employer costs a consistent percentage of payroll.
5. Require clear reporting to show how and when pension plans will be fully funded.

The task force also recommends that the pension funding policy address at least the following three core elements of pension funding in a manner consistent with the policy objectives:

- Actuarial cost method,
- Asset smoothing method, and
- Amortization policy.

All of these elements are important in determining whether or not a pension plan can achieve its funding goals. For example, the actuarial cost method allocates the pension costs (and contributions) over an employee's working career so that the individual's benefit is fully funded by the time he or she is expected to retire. The Governmental Accounting Standards Board, which sets accounting standards, will require that pension plans use the Entry Age Normal (EAN) cost method to calculate pension liabilities for pension plan fiscal years ending on or after June 30, 2014. The EAN cost method also is well suited to meeting funding policy objectives.

Why some pension plans are better funded than others?

- Consistent funding of the annual required contribution (ARC)
- Have appropriate full-retirement ages
- Are realistic about investment assumptions
- Accumulate funding reserves
- Do not allow extraordinary income to be included in pension formulas
- Take a long term view; no contribution "holidays" in good times
- Use long-term financial modeling to analyze pension benefits
- Have annual briefings from the plan sponsor and actuary

Pension Reform Lessons

- Pensions are part of a broad human resources strategy
- Keep recruitment and retention in mind when making changes
- Use good data from high quality experts; changing independent actuaries periodically can provide a fresh set of eyes
- Share information with all stakeholders and create an atmosphere that supports compromise and better outcomes
- Careful planning and thorough evaluation of proposed changes is essential
- Include pension administrators when crafting new policies and consider implementation with policy changes
- Plan design changes can pay big dividends over time
- Recognize the importance of investment education
- Appreciate the importance of a strong board; provide training to elected officials and pension trustees
- Communicate! Keep employees and the public fully informed.

Center for State and Local Government Excellence http://slge.org. Future of Retirement Summit video and proceedings (April 2013), the Public Plans Database, and recent publications:

- The Funding of State and Local Pensions, 2012-2016 (June 2012)
- Gauging the Burden of Public Pensions on Cities, (October 2013)
- State and Local Government Workforce: 2013 Trends (May 2013)
- Pension Funding: A Guide for Elected Officials (March 2013)
- State & Local Pensions: An Overview of Funding Issues and Challenges (January 2013)
- Locally-Administered Pension Plans, 2007-2011 (January 2013)