FitchRatings Public Finance

Special Report

U.S. State and Local Government Pensions

One Size Does Not Fit All

Analysts

Amy Laskey
+ 1 212 908-0568
amy.laskey@fitchratings.com

Richard Raphael
+1 212 908-0506
richard.raphael@fitchratings.com

Laura Porter
+1 212 908-1575
laura.porter@fitchratings.com

Douglas Offerman
+1 212 908-0889
douglas.offerman@fitchratings.com

Related Research

Applicable Criteria
- *Tax-Supported Rating Criteria, Aug. 16, 2010*
- *U.S. State Government Tax-Supported Rating Criteria, Oct. 8, 2010*
- *U.S. Local Government Tax-Supported Rating Criteria, Oct. 8, 2010*

Summary

Fitch Ratings recognizes that there has been much public debate around the impact on U.S. state and local government finances of pensions and other benefit obligations. Fitch notes that there is cause for near-term concern about a number of public sector defined benefit pension plans and recognizes the considerable pressure that these obligations will place on many government budgets in the coming years. However, given wide variations in the financial condition of and management approach to individual plans, blanket conclusions are problematic. Each plan and each government's situation is its own story, and Fitch believes that it is important to evaluate them as such.

The analysis of long-term obligations, including pensions, is an important part of Fitch's rating review for state and local government credits. Fitch has downgraded a number of credits due in part to pension funding issues and will continue to take such action as warranted.

The steep market decline of late 2008 and early 2009 has presented governments with both long- and short-term challenges: assets available to make future payments are reduced and annual required contributions (ARCs) are rising considerably at the same time that government revenues to fund them have dropped and demand for overall government services has risen. Although investment returns have rebounded somewhat, many plans' actuarial valuations will continue to weaken as losses are smoothed in over multiple years, and market values are still well below pre-financial crisis levels.

Fitch believes that the vast majority of governments will withstand the substantial pressures they face from their pension obligations, although for many governments this will mean taking difficult steps to adjust contributions and/or benefits to ensure adequate pension funding. For governments with poorly funded systems, the need to take these steps is pressing. However, since governments and their tax bases are long-term in nature, officials in most cases have some time to fully implement changes to control their long-term liabilities. Similarly, the beneficial impact of any adjustments on funding levels and contributions will accrue over an extended period.

Historical Context

In considering the current status of state and local government pension plans and the expectations for future management actions, a historical context may be helpful. Prior to the latest recession, public pension obligations represented a growing source of fiscal pressure due to the same broad demographic factors affecting other cost trends in the U.S., such as healthcare spending and Social Security outlays. Nonetheless, public pension plans were generally well funded and cost trends were more manageable as a result of decades of progress toward advanced funding of future benefits and strong investment returns that lowered the growth rate of ARCs. The main driver of the current level of pension funding pressure is market losses in late 2008 and early 2009, which represent a major setback toward the prefunding of retirement obligations. In some cases, this compounds a fundamental problem caused by consistent underfunding of actuarially required pension payments.

A March 2010 report by Wilshire Consulting (*2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*) indicates that 125 state plans had an average funded ratio (assets to liabilities) of 87% in 2007 on an actuarial basis, where market gains and losses are smoothed in over a number of years. On a market value basis (without smoothing), the ratio was even higher at 96%. The estimated average actuarial funded ratio dropped slightly to 84% in 2008 but remained solid. Behind this aggregate figure was wide variation in the ratios of individual plans. According to an often-cited February 2010 study by the Pew Center on the States (*The Trillion Dollar Gap*), 11 states reported funded levels above 90%, whereas 10 were less than 70% funded in 2008. The Wilshire report indicated that the estimated average actuarial funded ratio dropped to 75% in 2009, even as the estimated market value funded ratio dropped to 65%.

Specific examples of the wide variations in pension situations include North Carolina's Teachers' and State Employees' Retirement System, which was funded at 95.9% as of Dec. 31, 2009, down from 104.9% two years earlier due to market losses but nonetheless very well funded. The state and other member governments have a demonstrated commitment to fully funding their ARC. In stark contrast, the state of Illinois' five retirement systems combined had a funded ratio of 50.6% as of June 30, 2009, down from 63.6% two years earlier. The state had consistently underfunded its ARCs even prior to the market downturn and its fiscal crisis. This poor funding history is one among a number of reasons that Illinois' credit rating, at 'A', is among the lowest of the states.

A Look Ahead

The systems that pose the greatest risks are those with significant unfunded liabilities for which the government's annual payments have been significantly less than an actuarially determined ARC over multiple years. Plans with relatively low funded ratios prior to the market downturn — below 70% — will likely be in a weak position as market losses are fully reflected. However, for some plans that appear relatively poorly funded, ARC payments continue to be made and the government is on a path to 100% funding over a reasonable period (e.g. 20 years) without undue financial pressure. In other cases, the funded level is high but the ARC is growing to a nearly unsustainable proportion of overall resources, crowding out spending for essential operating purposes or forcing tax increases on an already stressed base.

In analyzing state and local government pension obligations and the impact on overall credit quality, key factors that Fitch reviews include the size of the resource base from which funding is derived, the amount of the government's budget needed to make pension payments, and officials' willingness and ability to make hard choices to bring assets and liabilities into better balance. These factors are not positive for all governments, and more will see rating declines as options become even more limited as time passes.

Much has been made about public pension funds' "aggressive" discount rate assumptions, which average 8%. Fitch agrees that, given the recent market downturn and prospects for lower returns going forward, this figure is likely optimistic, and to enhance analytical efforts, Fitch is in the process of estimating the size of plans' liabilities under various alternative discount rate assumptions. Such adjustments will clearly reduce estimated funded ratios and raise contributions for most plans and make the dimensions of the problem more pronounced. They will also allow Fitch to compare liabilities among plans on a more equivalent basis, pending expected pension accounting revisions by the Governmental Accounting Standards Board (GASB).

However, to assume that pension fund returns are going to hover close to Treasuries going forward seems unrealistic given the long duration of pension liabilities that are paid by governments and the fact that governments can confidently be expected to exist for the long term. Therefore, it is appropriate for these entities to invest in a diversified, long-term portfolio and assume a historically justifiable return on investments.

Although a pressing need remains to set many pension systems on a more sustainable footing, what Fitch has observed over a long period is generally responsible financial management actions by state and local governments, and Fitch believes officials will work in the near term to improve funded ratios. The significant powers of most state and local governments, which are not subject to the same competitive pressures as corporations, to control their revenue and spending should not be overlooked in this discussion.

There has already been significant activity on government pensions to lower benefits or improve funding. According to the Pew Center on the States, in 2010 (through October), 19 states made broad-based changes, including two that increased contributions, 10 that reduced benefits, and seven that did both. Negative public sentiment toward government spending and tax increases is likely to put further pressure on officials to develop solutions. In some cases, particularly for benefit reductions to retirees, these changes are being litigated, which Fitch believes over time will lead to increased clarity as to officials' flexibility to alter pension plans.

Fitch will provide additional, more detailed commentary on U.S. state and local pension issues in the coming weeks. These will include a more detailed analysis of current public pension accounting and GASB's proposed changes, to be followed by a revised framework for enhancing the analysis of pension liabilities.