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PUBLIC PENSION FUND LIABILITIES: A CREDIT RATING AGENCY PERSPECTIVE

Note: On occasion, ***DEBT LINE*** features guest speaker articles to provide its readers with perspectives on debt or investment topics. This month's newsletter features a reprint of a recent article from Standard & Poor's *RatingsDirect* publication that discusses the growing concern surrounding unfunded pension liabilities and their implications for government agencies, in particular, their credit ratings. The article is reprinted in its entirety (without adaptation, deletions, or changes) with permission of Standard & Poor's, a division of The McGraw-Hill Companies, Inc. The views and attributions expressed are those of the authors and do not necessarily reflect the views or opinions of the California Debt & Investment Advisory Commission.

Credit FAQ: Public Pension Funds

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Frequently Asked Questions

Concerns about the health and funding of public pension funds have been increasing. U.S. public pension funds, largely defined benefit plans, which were a major financial success story in the 20th century, have experienced significant declines in funding levels over the last several years. The principal effect of this malaise, increased annual contribution payments, has added to the budgetary pressures of the sponsors of the funds—state and local governments that created the funds and are responsible for maintaining their fiscal well-being.

Public pension funds, unlike private or corporate funds, are not regulated by the Employee Retirement Income Security Act of 1974 (ERISA) and therefore do not have the Pension Benefit Guaranty Corp. as a safety net to pay benefits in the event of system deficiencies. Public funds may ultimately turn only to the individual sponsors, whether it is a city, state, county, or authority.

Because of the recent troubling pension trends, Standard & Poor's Ratings Services has been asked a number of questions about the effects of these developments. Below are some of those frequently asked questions.

What is an unfunded pension liability, and what does it have to do with the creditworthiness of a state or local government?

An unfunded pension liability is more formally referred to as unfunded actuarial accrued liability (UAAL) in the financial statements of public pension funds and their sponsors. The UAAL is the difference between the retirement system's actuarial value of assets (AVA) and its actuarial accrued liability (AAL). For example, a system with an AVA of $9 billion and an AAL of $10 billion would have a UAAL of $1 billion (AAL-AVA). Another funding measure is the funded ratio, which is derived by dividing the AVA by the AAL. In the above example, the funded ratio would be 90% ($9 billion/$10 billion).

Standard & Poor's treats the UAAL as a long-term liability similar to bonded debt. This liability represents a portion of the compensation sponsors have promised their employees to be paid at a later date. Pension benefit payments may not have as high a legal lien position as other obligations such as debt service payments, but Standard & Poor's expects that these obligations will also be paid as they come due. We recognize that the UAAL is an estimate based on a great many assumptions, including demographic, economic and financial, and subject to change. Therefore, the UAAL may not be as absolute a number as the par amount of a fixed-rate bond, for example. However, the valuations that determine this liability are prepared under professional actuarial standards and represent the best current indication of such liability. When evaluating the relative debt burden of a state or local bond issuer, Standard & Poor's compares the burdens with, and without the UAAL to encompass a complete picture of total long-term obligations. Debt burden is obviously a critical factor in the rating analysis of general governments.

The news is full of articles about mushrooming pension liabilities—is there a real public pension fund crisis today?

There is a public pension fund crisis but the problem at this point affects the pension fund sponsors (employers) more than the retirement systems themselves. Pension liabilities have indeed exploded and funded ratios plunged. However, public funds, on average, should still be reasonably well funded and no worse than they were in the early 1990s when funding levels were generally considered adequate to good. Public pension fund members overall should still feel confident about the security of their retirement benefits in that the recent downward funding trend would have to continue, unaddressed, for a number of years before actual benefit payments would be in jeopardy. Further, in that actuarially funded pension plans are designed to be self-balancing, the pendulum will eventually swing back, increasing funding levels again through increased contributions if investment returns continue to be insufficient. The real pension crisis today, as evidenced by the ballooning liabilities, concerns the fiscal pressure these liabilities exert on employers in the form of dramatically increased contributions, at a time when they are facing other budgetary pressures. With most states, and state-dependent jurisdictions, facing relatively weak revenue outlooks and increasing expenditure pressures, higher pension contribution requirements are the last thing they need.

As recently as 2000, public pension funds were very healthy, what has happened to turn the tables?
Public pension funds significantly improved their funding status during the latter part of the 20th century and particularly in the last two decades. With an average funded ratio of only about 50% in the mid-1970s, this ratio increased to about 80% in 1990, and to more than 100% in 2000. Keep in mind that these ratios are averages and include funds significantly below and above the line. The funding gains were largely fueled by a shift in asset allocation strategies to an equity bias and away from fixed income, in addition to the above average returns driven by the equity bull markets, especially in the 1990s. Thus, by June 30, 2000, the fiscal year-end for most public pension funds, the retirement systems were substantially fully funded, and enjoying reduced contribution rates, or even contribution holidays (no required contributions). After fiscal 2000, investment returns plummeted largely due to the bear markets in equities (on average, public funds allocate about 40% to 45% of their assets to domestic equities). The S&P 500 index, a measure of this asset class, fell 16% in 2001 and another 19% in 2002, contributing to large actuarial losses for pension funds, even after the softening effects of actuarial smoothing. The decline in the S&P 500 for fiscal 2003 (1.6%) was not as severe as the previous two years, and many funds generated net positive returns. However, this performance was still not high enough to meet their actuarial investment return hurdle (generally about 8%), auguring another year of actuarial losses. As a result, average funded ratios continue to decline.

Why is Standard & Poor's concerned about the growing unfunded liabilities of public pension funds?
Standard & Poor's is concerned because it represents new long-term liabilities, which have the effect of driving up contribution expenses. Thus, the sponsor's cost structure is adversely affected, and recently the contribution rate increases have been dramatic, in many cases multiples of two or three times or more of the earlier rates. The increase in contribution rates is particularly dramatic for employers that previously were making no contributions (due to a funded ratio exceeding 100%) but now have to make large contributions again. New expense pressures of any kind are problematical for most employers given their current budgetary challenges. For example, most jurisdictions are facing rapidly growing health care and public safety costs, in addition to the new pension pressures. Through fiscals 2002 and 2003 most of the low hanging fruit has been picked in terms of expenditure cuts and revenue enhancements and employers are left with tougher options for budget balancing. Added cost pressures from pension liabilities are intensifying this fiscal stress.

How will the pension crisis affect ratings?
Managing unfunded liabilities has become another litmus test for plan sponsors. State and local governments must be on top of their pension situation as part of a sound and complete management strategy. They should demonstrate an understanding of the dynamics and prudent use of pension fund variables. For example, awarding enhanced retirement benefits today with markedly increased contribution rates in the future, in lieu of salary increases with immediate costs may be only expedient, and not the best long-term strategy. The same may go for early retirement incentives. While either or both approaches may be appropriate under certain circumstances, they may, on the other hand, fall into the category of one-shots, putting off the day of reckoning to future administrations or legislatures. Such actions may even raise the issue of intergenerational equity by pushing off costs of current services to a later generation of taxpayers.

Jurisdictions should take a measured approach to awarding benefit increases, which is coordinated with their long-term plan. Fair and equitable benefit packages coupled with the ability to sustain them should be the mark of good management. This is the type of strategy that will nourish strong credit ratings. A weak or ill-conceived strategy for setting and fulfilling pension benefits will only result in downward pressure on credit quality. Today's pension funding crisis should be faced directly and addressed through implementing appropriate actuarial procedures, which will most likely lead to higher contributions. Gimmicks and delays should be avoided. High credit quality depends on the prudent management of unfunded pension liabilities.

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