



STATE & CITY PENSION FUNDING: A CONTRARIAN VIEW

UNFUNDED PENSION LIABILITIES DO NOT MEAN INSOLVENCY

State and city pension funds are **not** insolvent. Pension funding for states and cities is under a microscope these days, with predictions that unfunded liabilities are going to lead to wide scale defaults and bankruptcies of municipal debt. These predictions are overblown, by people who have not followed state and city fiscal trends over decades, through 6 recessions, as I have. Here are some facts that informed investors need to know about public pension funding:

FACT: In the 1950s through 1970s, pension funding levels were the same or lower than today's levels, without rampant municipal bond defaults or bankruptcies;

FACT: The Pew Center on States, authors of a definitive study on pension funding and a major critic of unfunded liabilities, points out that average state pension funding was at 84% in 2008, higher than the average in the 1970s, and a "relatively positive outcome, because most experts advise at least an 80 percent funding level"

FACT: Even states with some of the weakest pension funding rates, like New Jersey, had enough assets at the end of 2009 to cover their pension costs by **10 times or more.**

This last point is crucial, because pension funding is not well understood by the general public. An unfunded pension liability will not, by itself, lead to immediate financial crisis or insolvency, except in the extremely rare case where a municipality has not set aside any reserves at all for paying retirement costs. That is not to say that pension funding is not a problem; clearly, states and cities need to take action on pension funding to avoid rapidly rising costs that will need to be paid by future generations. It does mean, however, that unfunded pension liabilities have occurred in the past and will again occur in the future. And it is clear from an historical review that unfunded liabilities do not mean budgetary insolvency and default.

THE MYTH OF FULLY FUNDED PENSION FUNDS

Uninformed observers, citing unfunded pension liabilities as the "bubble" that will lead to the next bond market crisis, would have you believe that a fully funded pension plan is required for fiscal solvency and financial stability. James Spiotto, a lawyer at Chapman & Cutler and a widely respected authority on municipal bankruptcy, pointed out that average state pension funding ratios have grown and declined over time. Funding levels were as low as 50% in the 1970s, 80% in the 1980s, and only reached 100% in the mid- 1990s after stock market returns averaged 28% per year.

Simply put, pension funds are created to set aside employee and employer deposits and invest them in order to accumulate monies to pay future retirement benefits. Pension funding levels will therefore be affected by changes in employee and employer deposits, as well as changes in investment earnings on those funds. Stock prices and earnings go up and down over time; bond prices and interest rates do as well. Since investment earnings will fluctuate, by definition pension funding ratios will fluctuate as well. Therefore, just the existence of an unfunded pension liability does not result in immediate stress.

To further my point, the Pew study points out that the benchmark of 80% has been identified by the Government Accountability Office and other experts as the threshold for adequate pension funding. Pension funding is a way to smooth out the amount of money that states need to pay to meet future benefit costs—the more that you accumulate now will reduce the amounts a state will need to pay in the future. While pension funding levels are important, it is more important to see the direction of pension funding levels. Clearly, pension



funding levels in the last decade have been declining, because of weaker investment earnings in the last 10 years, as well as reduced contributions by state employers. Clearly, pension payments need to increase for states which have reduced their contributions; failure to do so will result in further depletion of reserves and will cause annual contributions to rise dramatically. Just as importantly, investment earnings on accumulated funds need to rebound. But reaching a “full funding” ratio of 100% in the short run is not only unlikely, it is also not necessary for states to regain fiscal stability after the current recession ends.

NOT ALL STATE PENSION PLANS ARE DRASTICALLY UNDERFUNDED

Another myth, buried within observers’ calamitous claims that pension funding is about to create national insolvency at the state level, is that all state pension funds are on the brink of disaster. As Pew points out, the average funding level for states remains above 80% currently. There are still state pension plans that are 100% funded (FL, NY, WA & WI). There are another eight with funding levels over 90% (DE,GA,ID,NE,NC,TN,TX). And over the last 5 years, 21 states have made annual contributions that were 100% or more of what was needed to move their plans toward fully funded status.

On the other hand, there are a number of states whose plans, while not insolvent, are in danger of depleting reserves over the next 10 years unless contributions are raised or investment earnings stage a strong rebound. Pew reports that ten states have funding levels below 70% (CO,CT,HI,IL,KS,KY,MA,NH,OK & WV). Six states have reduced their annual payments into their plans to below 60% of what is needed to keep funding levels stable. One of the worst offenders in this regard is the State of New Jersey, which only contributed 33% of what was necessary to stabilize declining reserves in its pension funds. A review of New Jersey reveals some of the factors that led to pension underfunding; further analysis shows what state fiscal actions could have averted the decline and serves as a possible guide for the future.

CASE STUDY: NEW JERSEY

New Jersey’s underfunding of its pension contributions is not new; it goes back to at least 2001-2002 when the state had actually achieved a 100% funding level for its pensions. (See chart below). In fact, the fully funded status was cited as the reason for reduced contributions. Underfunding, however, continued through 3 different administrations, both Republican and Democrat, even after actuarial funding levels dropped below 100% in 2003. One point to note: despite a long history of reducing payments below that needed to maintain stable pension funding levels, and seeing reserves reduced to \$69 billion in 2009 (from \$85.4 billion at the start of the decade), ending reserves still covered that year’s pension payments to retirees by 10.37 times)

Besides increasing benefit terms to retirees over the years, the other contributor to New Jersey’s low funding ratio was erratic investment performance, led by large investment losses in 2001, 2002, 2008 & 2009. These losses offset over 75% of the investment gains of \$35.6 billion from 2003 through 2007 when stock markets were in their heyday.

Most pension funds, both governmental and corporate, invest heavily in stocks for the long run. Many funds, both public and private, invest as much as 60-65% of their holdings in equities. Over the long run, this has been beneficial: average annual returns for the S&P 500 basket of stocks averaged 9.61% annually over the last 25 years. New Jersey’s problem (as well as most domestic U.S. pension funds) is that annual returns for the S&P 500 yielded **-1.75%** annually over the last ten years.



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New Jersey Pension Funding History									
(\$ in millions)									
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenue	-\$6,617	-\$4,584	\$3,237	\$11,075	\$8,469	\$10,758	\$15,499	\$2,432	-\$8,528
Employee Contributions	\$922	\$929	\$928	\$927	\$1,060	\$1,615	\$1,446	\$1,506	\$1,622
Employer Contributions	\$265	\$294	\$304	\$1,502	\$1,448	\$1,932	\$2,237	\$2,450	\$1,799
Net Investment Income	-\$7,804	-\$5,807	\$2,005	\$8,646	\$5,961	\$7,211	\$11,816	-\$1,524	-\$11,949
Expenses	\$3,878	\$4,379	\$5,023	\$5,465	\$5,929	\$6,383	\$6,105	\$6,614	\$7,084
Benefits	\$3,614	\$4,115	\$4,759	\$5,201	\$5,665	\$6,119	\$5,841	\$6,350	\$6,820
Refunds, Expenses & Other	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264
Net Pension Annual Surplus/(Deficit)	-\$10,495	-\$8,963	-\$1,786	\$5,874	\$2,540	\$4,375	\$9,394	-\$4,182	-\$15,612
Beginning Assets	\$85,488	\$76,052	\$67,122	\$65,541	\$71,649	\$74,732	\$79,817	\$89,745	\$85,837
Ending Assets	\$76,052	\$67,122	\$65,541	\$71,649	\$74,732	\$79,817	\$89,745	\$85,837	\$69,904
Actuarial Funding Level	109.2	101.4%	93.7%	87.2%	81.6%	77.5%	76.0%	72.6%	N/A
Coverage of Actual Benefits Paid by Ending Reserves (Reserves/Benefits)	19.92	15.61	13.29	13.58	13.12	13.03	15.31	13.59	10.37

Source: State of New Jersey Financial Statements

One can see the enormous difference that weak investment performance caused to New Jersey by recalculating the funds' investment performance as if they had invested their assets in only fixed income investments. If New Jersey had regularly invested its assets in 10 year Treasury bonds at the average annual rates from 2001 through 2009, the funds' ending assets could have increased by over 34%, without increasing its poor levels of annual contributions. Total income and cash flow would have exceeded pension benefits to retirees in every year except 2009.

New Jersey Pension Funding History									
(\$ in millions)									
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenue	\$5,659	\$5,869	\$4,818	\$6,300	\$6,364	\$7,559	\$8,021	\$8,324	\$5,968
Employee Contributions	\$922	\$929	\$928	\$927	\$1,060	\$1,615	\$1,446	\$1,506	\$1,622
Employer Contributions	\$265	\$294	\$304	\$1,502	\$1,448	\$1,932	\$2,237	\$2,450	\$1,799
Net Investment Income	\$4,472	\$4,646	\$3,586	\$3,871	\$3,856	\$4,012	\$4,338	\$4,368	\$2,547
Expenses	\$3,878	\$4,379	\$5,023	\$5,465	\$5,929	\$6,383	\$6,105	\$6,614	\$7,084
Benefits	\$3,614	\$4,115	\$4,759	\$5,201	\$5,665	\$6,119	\$5,841	\$6,350	\$6,820
Refunds, Expenses & Other	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264
Net Pension Annual Surplus/(Deficit)	\$1,781	\$1,490	-\$205	\$835	\$435	\$1,176	\$1,916	\$1,710	-\$1,116
Beginning Assets	\$85,488	\$87,269	\$88,909	\$88,850	\$89,950	\$90,519	\$91,840	\$93,874	\$95,682
Ending Assets	\$87,269	\$88,909	\$88,850	\$89,950	\$90,519	\$91,840	\$93,874	\$95,682	\$94,669
Coverage of Actual Benefits Paid by Ending Reserves (Reserves/Benefits)	22.50	20.30	17.69	16.46	15.27	14.39	15.38	14.47	13.36

Source: Herbert J. Sims Calculations

Finally, you can see the difference in the State's projected pension fund reserves if the State had only made additional contributions of \$1 billion annually and invested their assets in the aforementioned Treasury bonds. The contributions would still have been less than what actuaries would have recommended to eventually achieve full funding, but the growth of reserves would have been sufficient to keep funding levels from declining. In order to return to stable pension funding, the State of New Jersey needs to commit to prudent annual funding of its contributions and hope for a return to historical levels of investment performance. Failure to do so will result in further depletion of pension reserves, and rapidly rising annual payments by the state to meet growing benefit demands by current and future retirees.



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New Jersey Pension Funding History									
(\$ in millions)									
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Revenue	\$6,726	\$7,000	\$5,996	\$7,512	\$7,638	\$8,879	\$9,408	\$9,777	\$7,323
Employee Contributions	\$922	\$929	\$928	\$927	\$1,060	\$1,615	\$1,446	\$1,506	\$1,622
Employer Contributions	\$1,265	\$1,294	\$1,304	\$2,502	\$2,448	\$2,932	\$3,237	\$3,450	\$2,799
Net Investment Income	\$4,539	\$4,777	\$3,764	\$4,083	\$4,130	\$4,332	\$4,725	\$4,821	\$2,902
Expenses	\$3,878	\$4,379	\$5,023	\$5,465	\$5,929	\$6,383	\$6,105	\$6,614	\$7,084
Benefits	\$3,614	\$4,115	\$4,759	\$5,201	\$5,665	\$6,119	\$5,841	\$6,350	\$6,820
Refunds, Expenses & Other	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264	\$264
Net Pension Annual Surplus/(Deficit)	\$2,848	\$2,621	\$973	\$2,047	\$1,709	\$2,496	\$3,303	\$3,163	\$239
Beginning Assets	\$85,488	\$88,294	\$91,015	\$92,068	\$94,335	\$96,121	\$98,719	\$102,108	\$105,330
Ending Assets	\$88,294	\$91,015	\$92,068	\$94,335	\$96,121	\$98,719	\$102,108	\$105,330	\$105,608
Coverage of Actual Benefits Paid by Ending Reserves (Reserves/Benefits)	22.77	20.78	18.33	17.26	16.21	15.47	16.73	15.93	14.91

Source: Herbert J. Sims Calculations

WHAT DOES THE FUTURE HOLD FOR PENSION FUNDING?

While lower than average pension funding levels are not equivalent to insolvency, they are clearly a challenge that must be addressed to avoid continued declines in pension reserves. Full funding is an ideal goal, but not required to maintain stable pension reserves. There are strategies which states and local governments can implement to ameliorate pension pressures.

- While it may be legally hard to retroactively change benefit terms for existing retirees, pension benefit terms can be made less generous for newer employees so that pension reserves can be preserved for their retirement.
- Shifting to defined contribution plans, which limit retirement benefits to contributions and investment earnings, would also stem the growing tide of benefit obligations in the future.
- Finally, states and local governments can increase their own contributions, as well as revisiting the contribution rates of employees; this was an option used by New Jersey in 2007, when it raised the rates of employee contributions in its State Employees and Teachers Retirement Funds from 5% to 5.5%.

Finally, states will have to come to grips with a different but related problem: Other Post Employment Benefits (OPEBs). These are benefits separate from pension costs, whereby governments may have promised to cover other retiree costs like medical insurance. These liabilities are currently smaller than regular pension costs but are growing more rapidly. In addition, many states have not created reserve funds for these items, so that they are basically pay-as-you-go expenses in the annual state operating budget. Clearly, these commitments have to be addressed as well. However, states may have more flexibility in revising the terms of these obligations to make them more affordable if they were granted after employment ended, and were not part of an employment contract prior to retirement. Vesting of these benefits will be a key to their treatment in future years.

In conclusion, pension funding is a financial challenge but not an immediate threat to insolvency for state and local governments. They face long-term funding pressure, but it is not a problem that must be totally solved this year or next. The long-term decisions and commitments which must be made to keep pension funding stable should be balanced between those already retired and those who continue to work and contribute to their retirement.

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