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Market Declines Will Shake Up U.S. State Pension Funding Stability

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Market Declines Will Shake Up U.S. State Pension Funding Stability

A period of relative stability for U.S. states' pension plan investment performance looks set to end as market declines in 2008 will start to show up in the "funded ratio," a key measure of pension fund health, Standard & Poor's Ratings Services' analysis shows.

The market turmoil of the last year has created challenges for states on many fronts. But the latest data compiled by Standard & Poor's (see table 1), covering 2007, showed a third year of relative stability for major state pension plans. However, the funded ratio--or actuarial value of assets divided by the actuarial accrued liabilities (AAL)—can be expected, given market declines, to have moved to shakier ground by the time data for 2008 is available.

Pension liabilities and the costs associated with funding them on an annual basis are a key 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 a fixed debt repayment schedule, it can also be more volatile and could lead to fiscal stress if not managed, in our opinion.

In 2007 (the latest year with substantially complete data available), according to our analysis, the mean funded ratio for the principal state pensions was 83%, effectively back to the levels recorded in the early 1990s. Our 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; costs are shared with other plan participants.

We expect investment performance for public pension plans to be negative for 2008. Wilshire Associates reports the median performance for public pension funds for 2008 was minus 24.91%. The S&P 500 index fell by 38.5% in 2008. We will assess actual losses recorded by individual pension plans and the losses will be influenced by the reporting time horizon and asset allocation of each plan. While this is not positive news for state governments grappling with revenue shortfalls and spending pressures, the budget impact of these declines will not be immediate. Thus, we believe states will have some flexibility in planning for these increased costs. In our view, state governments have a history of funding increased contributions resulting from the investment losses sustained over time. In cases where funded ratios are weak and contribution rates place pressure on the budget, we factor this into the overall state rating.

Pension Hit Won't Be An Immediate Budget Hit

We believe that 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 the state's annual budget. The key issue for our credit analysis will be assessing the budget impact and affordability of higher pension contributions in the future.

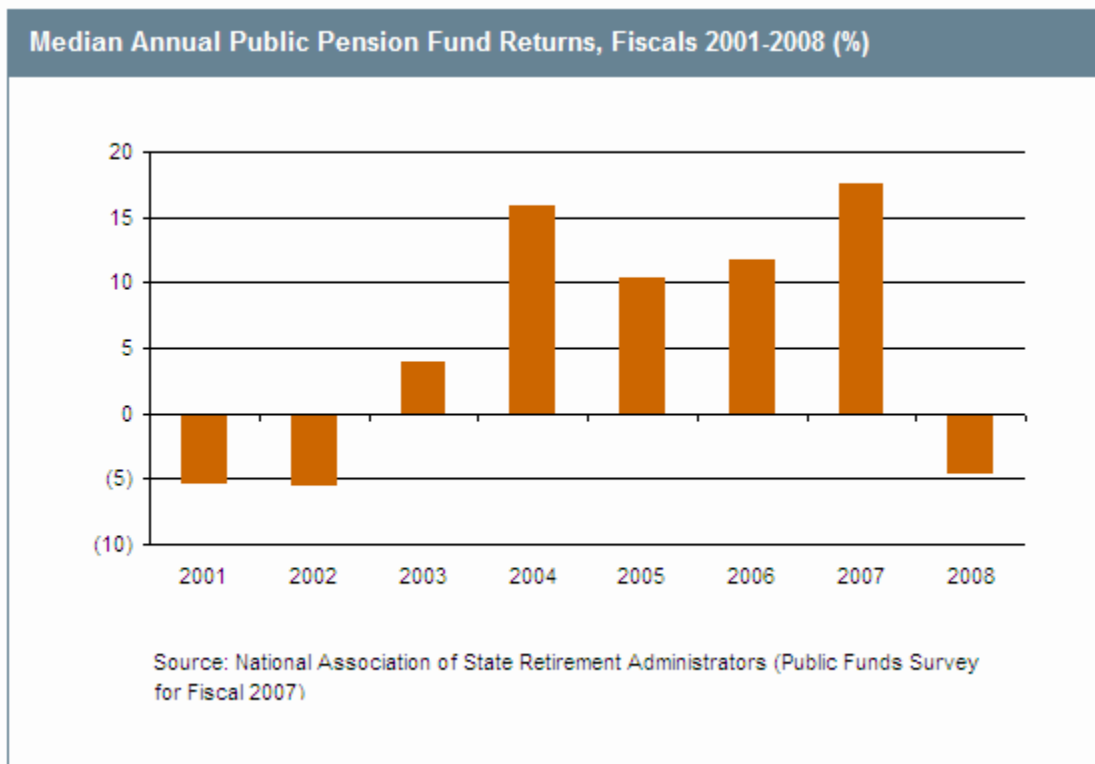
The funding and accounting treatment of public pension plans moderates the effect of investment market volatility on annual pension contributions made by governments. Actuarial smoothing methods allow investment losses and gains to be phased in over several years (unlike with corporate pension plans, 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. We believe this is important because weak investment results have historically correlated with weak state tax revenue performance, as is the case for 2008.

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 addition to falling asset values, in our opinion, a number of other factors led to rising liabilities, including members' increased longevity and the phasing in of previously granted benefit enhancements. Not surprisingly, 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 2007 (fiscal year end 2007 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: States Weather Credit-Market Disruptions, But Are Likely To Step Up Borrowing As Economy Slows," published July 14, 2008).

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.

Highlights of the data include:

- State debt rose slightly to \$359 billion in fiscal 2007 from \$344 billion in fiscal 2006.
- Unfunded pension liabilities decreased to \$368.5 million in 2007 compared with \$371 billion in 2006.
- Debt remained stable on a per capita basis at \$1,053 in fiscal 2007 compared to \$1,045 in fiscal 2006.
- The average UAAL per capita declined to \$1,458 in 2007 from \$1,664 in 2006
- In relation to the resources available to service these requirements, debt per capita and the per capita unfunded pension liability relative to income had a 50-state average of 6.6% compared with 5.5% in 2006.

(For a comparison with fiscal 2006's results, see "Market Volatility Could Shake Up State Pension Funding Stability," published Feb. 20, 2008.)

Pension Liabilities Will Need to Be Managed

Recent investment declines have cut across most asset classes and will 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.

State Retirement Systems And Debt Statistics: 2007

State	Funded Ratio (%)	Unfunded AAL (Mil. \$)	UAAL PC (\$)	Total Debt (Mil. \$)	Debt PC	PC debt + PCUL	PC debt + PCUL/PC Income (%)	GO Rating
Alabama	79.3	7,920	1,711	2,392	517	2,228	6.9	AA/Stable
Alaska	74.3	3,525	5,157	470	688	5,845	14.5	AA+/Stable
Arizona	79.7	7,958	1,255	3,500	552	1,808	5.5	AA/Stable
Arkansas	86.6	2,486	877	1,248	440	1,317	4.4	AA/Stable
California	87.9	47,800	1,308	57,433	1,571	2,879	6.9	A/Stable
Colorado	75.1	13,011	2,676	433	89	2,765	6.7	AA/Stable
Connecticut	62.6	14,833	4,235	13,083	3,736	7,971	14.7	AA/Stable
Delaware	103.7	(230)	(266)	1,848	2,137	1,871	4.6	AAA/Stable
Florida	105.6	(6,714)	(368)	18,300	1,003	635	1.7	AAA/Negative
Georgia	94.4	3,939	413	8,260	865	1,278	3.8	AAA/Stable
Hawaii	67.5	5,107	3,979	4,600	3,584	7,563	19.3	AA/Stable
Idaho	104.9	(514)	(343)	325	217	(126)	0.4	AA/Positive
Illinois	61.4	33,941	2,641	22,850	1,778	4,419	11.0	AA/Watch Neg
Indiana	66.2	10,558	1,664	3,100	489	2,152	6.4	AAA/Stable
Iowa	90.2	2,266	759	100	33	792	2.3	AAA/Stable
Kansas	70.8	5,552	2,000	3,100	1,117	3,117	8.5	AA+/Stable
Kentucky	70.3	11,912	2,808	5,115	1,206	4,014	12.9	AA-/Positive
Louisiana	69.8	10,036	2,338	3,400	792	3,130	9.0	A+/Stable
Maine	79.7	2,652	2,014	449	341	2,354	7.0	AA/Stable
Maryland	80.2	8,522	1,517	6,784	1,207	2,724	5.9	AAA/Stable
Massachusetts	75.7	12,947	2,007	27,400	4,248	6,256	12.7	AA/Stable
Michigan	88.2	7,590	754	6,625	658	1,411	4.0	AA-/Stable
Minnesota	81.1	7,396	1,423	4,500	866	2,289	5.6	AAA/Stable
Mississippi	73.7	7,071	2,423	3,920	1,343	3,766	13.1	AA/Stable
Missouri	84.1	6,972	1,186	1,760	299	1,485	4.3	AAA/Stable
Montana	85.6	1,145	1,195	208	217	1,412	4.4	AA/Stable
Nebraska	90.6	722	407	38	21	428	1.2	AA+/Stable
Nevada	77.2	6,313	2,461	3,830	1,493	3,954	9.8	AA+/Stable
New Hampshire	67.0	2,397	1,822	556	423	2,245	5.4	AA/Stable
New Jersey	76.0	27,579	3,175	27,500	3,166	6,341	12.9	AA/Stable
New Mexico	82.0	4,531	2,300	2,900	1,472	3,772	12.0	AA+/Stable
New York	101.5	(3,322)	(172)	44,600	2,311	2,139	4.5	AA/Stable

State Retirement Systems And Debt Statistics: 2007 (cont.)							
North Carolina	106.9	(3,547)	(391)	6,900	762	370	1.1 AAA/Stable
North Dakota	85.2	566	885	275	430	1,315	3.8 AA/Stable
Ohio	88.0	19,700	1,718	10,104	881	2,599	7.5 AA+/Stable
Oklahoma	59.5	9,906	2,738	1,650	456	3,195	9.4 AA+/Stable
Oregon	112.2	(6,457)	(1,723)	4,800	1,281	(442)	(1.3) AA/Stable
Pennsylvania	89.5	10,352	833	9,470	762	1,594	4.1 AA/Stable
Rhode Island	56.2	4,852	4,586	1,608	1,520	6,106	15.5 AA/Stable
South Carolina	69.7	10,225	2,320	2,638	598	2,918	9.4 AA+/Stable
South Dakota	97.1	192	242	137	172	414	1.2 AA/Stable
Tennessee	95.1	1,603	260	1,246	202	463	1.4 AA+/Stable
Texas	90.3	13,593	569	9,500	397	966	2.6 AA/Stable
Utah	100.3	(54)	(20)	1,556	588	568	1.8 AAA/Stable
Vermont	91.6	264	425	458	737	1,162	3.2 AA+/Stable
Virginia	82.3	10,301	1,336	5,130	665	2,001	4.8 AAA/Stable
Washington	73.3	6,549	1,012	12,298	1,901	2,914	7.2 AA+/Stable
West Virginia	68.8	3,609	1,992	1,265	698	2,690	9.1 AA-/Stable
Wisconsin	99.6	288	51	9,501	1,696	1,747	4.8 AA/Stable
Wyoming	94.0	362	691	0	0	691	1.6 AA+/Stable
Average	83.0	6,964	1,458	7,183	1,053	2,510	6.6
Median	82.1	5,329	1,322	3,250	749	2,190	5.5

The pension fund data for most states include the two principal state-sponsored retirement systems (i.e. public employees and teachers) or, in a few cases, a third large system. For 19 states, the data represent a single, all-inclusive system. PC - per capita. UAAL—Unfunded actuarial accrued liability. PCUL—Per capita unfunded liability.

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