The health of defined-benefit pension plans is a key issue to the tens of millions of Americans who are receiving or expecting to collect pension benefits. Some have said that the level of funding – specifically an 80% funded level – should be used as a general benchmark to determine whether pension plans are financially healthy. In reality, however, no single level of funding distinguishes a healthy plan from an unhealthy plan. In fact, plans should have as their objective accumulating assets equal to 100% of relevant pension obligations.

**Consequences of Underfunding**

The effects of poorly funded pension plans include plan sponsors (employers) being required to make larger future contribution to the fund, potential benefit cuts for participants, or situations where current pension benefits must be paid by future shareholders (or, in the case of public employee plans, taxpayers). These outcomes can be avoided through appropriate benefit, funding, and investment policies. A plan’s actuarial funding method should have a built-in mechanism for moving the plan to the target of 100% funding.

**Limitations of the Funded Ratio**

A plan’s funded ratio, which equals the value of assets in a pension plan divided by a measure of its obligations, is merely a financial snapshot of a plan’s status at a single moment. Many pensions hold stocks and other assets that can change in value – these assets rise during good economic times and drop in recessions. So too can the funded ratio change over time.

Besides fluctuating asset values, other circumstances that could lead to funded levels that are less than 100% at any point include benefit increases, volatile interest rates, and contributions to pension plans that are less than what are needed. Just as being more than 80% funded at one point in time does not assure a plan is adequately funded, a plan with a funded ratio below 80% should not necessarily be deemed unhealthy without further examination.

Although media reports, some policy-makers, and others perpetuate the myth that 80% funded signifies a healthy plan, there is no single threshold that assures a healthy plan. When assessing the fiscal soundness of a pension plan, many factors should be taken into account because each situation is unique.
Factors to Consider in Determining Health of Plans

Relative size of pension obligation
A large company or plan sponsor facing a sizable pension shortfall typically stands a much greater chance of fully funding its pension plan than a smaller sponsor with a similar pension shortfall.

Plan sponsor’s financial health
Companies, municipalities, or other plan sponsors that are financially healthy – as measured by level of debt, cash flow, or budget surplus – have greater capacities to shore up their lagging pension plans than those facing economic challenges.

Establishing and following a funding or contribution policy
The funding or contribution policy of a plan – whether it targets 100% funding in a reasonable time period and whether contributions actually are made according to the plan’s policy – need to be examined.

Investment strategy
Some plan sponsors actively take on higher investment risks than others and choose to contribute less because they anticipate future investment gains. In exchange, they must be willing and able to contribute more money when their fund’s investment targets are not met. For these sponsors, higher investment risks may be acceptable as long as they are willing and able to stick to their contribution plan.

Conclusion
There is no single pension plan funded level that determines whether a plan is healthy. The oft-used 80% funded target level is a myth that should not be perpetuated. There are many factors that must be considered in determining the health of a pension plan, including the size of the pension obligation, the plan sponsor’s financial health, and the plan’s contribution policy and investment strategy.

Additional Resources from the American Academy of Actuaries
The 80% Pension Funding Standard Myth (July 2012)