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Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress

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U.S. state budgetary stress continues to rise due to increasing pension fund contribution demands at a time when costs are also escalating in other areas, such as education and Medicaid. Higher pension liabilities are pressuring the creditworthiness of these states despite their overall strong revenue performance.

One measure of the health of a pension fund is the funded ratio, which for state pension funds has fallen dramatically since 2000. If pension investment return assumptions are met over the near-term, funded ratios may begin to stabilize or improve in fiscal 2006 and beyond. The risks to such a scenario, in addition to the potential for investment return shortfalls, include a number of factors that affect funding, such as changes in actuarial assumptions, benefit levels and demographics.

The pension liability data collected in this report for the major state pension funds are mainly for fiscal 2004, which is the latest year that substantially complete data are available. The total debt figures for the states are enumerated to give a more complete picture of long-term liabilities.

State Pension Funding: Recent History

The funded ratio is the actuarial value of assets (AVA) divided by actuarial accrued liabilities (AAL). The defined benefit plan actuarial model is designed to move the ratio towards 100% or full funding: the higher the ratio the more assets there are to cover liabilities. State pension funds made strong funding gains in the 1990s, and reached average funded ratios of more than 100% by 2000 (compared with approximately 80% a decade earlier). This rapid increase in funding was aided by above average investment returns, particularly from equities. From 1990 to 2000 (fiscal years ended in June) 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% for the period. Public pension fund allocations to domestic equity rose from about 40% to 60% during the decade. This combination of factors, plus the fact that fixed income returns were also strong, enabled public funds to exceed their investment return assumptions and achieve the actuarial gains that improved funded ratios.

The funded ratio climate shifted quite rapidly in the first part of this decade when pension funds suffered a number of setbacks. In terms of investment yields, the S&P 500 fell 16% in fiscal 2001 and another 19% in fiscal 2002. Also, in conjunction with falling asset values, upward pressure on liabilities resulted from a number of factors, including demographic changes, such as plan members living longer, and previously granted benefit enhancements, which were beginning to take hold. It is not surprising that because of the combined effect of this double-whammy, falling assets/rising liabilities, average state pension funding levels, as of June 30, 2004, had fallen to approximately 84% from their previous apex four years earlier.

Although this new funding level approximated the funding landscape of the mid-1990s, the critical difference is the effect the trend has had on contribution rates. When funded ratios are increasing, the actuarial model exerts downward pressure on contribution rates (less needed to pay the UAAL portion -- UAAL equals AVA minus AAL -- of the total contribution rate). With declining funded ratios, the effect is the reverse. Indeed, in the past several years, state and local employer contribution rates have risen dramatically, in many cases by a factor of two or more times the rates in effect in 2000.

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Pension Liability And Debt

The state retirement systems table looks at selected pension and debt information for each state as of June 30, 2004, the most recent date for which substantially complete data are 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, monolithic system, while others may have a third, significant system that is included in several cases. State sponsors have varying degrees of responsibility in relation to the funding of these pension plans. For multi-employer, agent plans, for example, the state would make contributions to the plans, which include its employees only, with local agencies funding their respective shares. For multi-employer, cost-sharing plans, which would include a number of local jurisdictions such as school districts, the state may be a nonemployer contributor. Thus, the states are generally not directly responsible for the full liabilities of these pension systems, with some exceptions.

The pension information includes the systems' funded ratio for each state and the unfunded AAL. Also, the UAAL is expressed on a per capita basis. In addition, 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.

Compared with fiscal 2000, when an average state pension fund had little or no unfunded liabilities, with the exception of certain historically weak plans, the gross UAAL had mushroomed to about \$284 billion as of June 30, 2004. On a state-by-state basis, the mean UAAL per capita was \$1,183. State debt, which more than doubled in absolute terms between 2000 and 2004, totaled \$288 billion at June 30, 2004, slightly higher than the gross UAAL. On a per capita basis, the state debt mean is \$867. When evaluating the debt structure of state (and local) governments, Standard & Poor's does not currently add the UAAL in with other debt in its presentation of debt statistics but, because of the debt-like aspects of the UAAL, factors it into the analysis as another, long-term contingent liability. The total per capita UAAL and tax-supported debt mean was \$2,050. In relation to the resources available to service these requirements, this measure divided by per capita income had a mean of 6.3%.

2004 State Retirement System And Debt Statistics									
State	GO rating	Funded ratio (%)	Unfunded AAL (\$ Mil.)	UAAL/ PC (\$ Mil.)	Total debt (\$ Mil.)	Debt PC (\$)	PC debt + PCUL (\$)	PC income (\$)	PC debt + PCUL/ PC income (%)
Alabama	AA	89.7	2,724	601	642	142	743	27,630	2.7
Alaska	AA	81.9	1,978	3,020	1,354	2,067	5,087	34,085	14.9
Arizona*	AA (ICR)	96.0	1,180	205	2,895	504	709	28,609	2.5
Arkansas	AA	85.4	2,197	798	533	194	992	25,724	3.9
California	A	85.3	48,860	1,361	51,213	2,854	4,215	35,172	12.0

Colorado	AA- (lease)	70.5	12,775	2,777	42	9	2,786	36,109	7.7
Connecticut	AA	59.9	12,114	3,457	9,391	2,680	6,137	45,506	13.5
Delaware	AAA	97.4	142	171	1,130	1,361	1,533	35,559	4.3
Florida	AAA	112.1	(11,522)	(662)	16,892	971	309	31,460	1.0
Georgia*	AAA	101.0	(526)	(60)	7,453	844	785	30,074	2.6
Hawaii	AA-	71.7	3,474	2,751	3,412	2,702	5,452	32,606	16.7
Idaho	AA- (lease)	91.8	671	482	219	157	639	26,839	2.4
Illinois	AA	59.9	27,855	2,191	25,232	1,985	4,175	34,725	12.0
Indiana*	AA+ (ICR)	66.4	8,135	1,304	2,494	400	1,704	30,070	5.7
Iowa	AA+ (ICR)	88.6	2,176	737	395	134	870	30,970	2.8
Kansas	AA+ (ICR)	69.8	4,743	1,734	479	175	1,909	31,003	6.2
Kentucky	AA- (ICR)	86.3	4,350	1,049	3,225	778	1,827	27,151	6.7
Louisiana	A	61.9	10,798	2,391	2,841	629	3,020	27,219	11.1
Maine	AA-	68.5	2,987	2,268	641	487	2,755	29,973	9.2
Maryland	AAA	92.7	2,589	466	5,536	996	1,462	39,629	3.7
Massachusetts	AA	75.9	10,479	1,633	15,602	2,431	4,064	42,102	9.7
Michigan	AA	83.9	9,388	928	5,405	534	1,463	32,052	4.6
Minnesota	AAA	89.3	3,480	682	3,589	704	1,386	36,173	3.8
Mississippi	AA	74.9	5,744	1,979	3,080	1,061	3,040	24,379	12.5
Missouri	AAA	82.6	6,219	1,081	2,611	454	1,534	30,516	5.0
Montana	AA-	80.5	1,340	1,446	220	237	1,683	27,666	6.1
Nebraska	NR	87.2	750	429	55	31	461	32,276	1.4
Nevada	AA	78.7	4,555	1,951	1,107	474	2,425	33,783	7.2
New Hampshire	AA	72.0	1,406	1,082	522	402	1,483	36,676	4.0
New Jersey	AA	87.0	11,979	1,377	19,012	2,186	3,563	41,636	8.6
New Mexico	AA+	83.8	3,122	1,641	1,623	853	2,493	26,154	9.5
New York	AA	99.7	561	29	39,805	2,070	2,099	38,333	5.5
North Carolina	AAA	108.1	(3,556)	(416)	5,496	643	227	29,303	0.8
North Dakota	AA (ICR)	86.0	430	678	97	153	831	29,247	2.8
Ohio*	AA+	79.2	28,225	2,463	9,325	814	3,277	31,135	10.5
Oklahoma	AA	57.0	9,122	2,589	1,014	288	2,876	27,819	10.3
Oregon*	AA-	95.1	2,200	612	2,949	820	1,432	30,584	4.3
Pennsylvania	AA	92.8	6,099	492	7,006	565	1,056	33,257	3.2
Rhode Island	AA	59.4	3,785	3,501	1,454	1,345	4,846	34,180	14.2
South Carolina*	AA+	82.8	4,201	1,001	2,556	609	1,610	27,153	5.9
South Dakota	NR	97.7	115	149	189	245	394	30,617	1.3
Tennessee*	AA	98.6	370	63	1,224	207	270	29,806	0.9
Texas	AA	92.7	8,508	378	2,530	112	491	30,697	1.6
Utah	AAA	92.4	1,004	420	1,846	773	1,193	26,946	4.4
Vermont	AA+	93.4	167	269	445	717	986	31,737	3.1
Virginia*	AAA	96.4	1,455	195	5,456	731	926	36,175	2.6
Washington	AA	84.4	3,446	555	8,079	1,302	1,858	35,017	5.3

West Virginia	AA-	43.9	5,788	3,189	1,623	894	4,083	25,681	15.9
Wisconsin	AA-	99.4	413	75	8,109	1,472	1,547	32,063	4.8
Wyoming	AA (ICR)	85.0	832	1,641	66	130	1,771	34,199	5.2
Mean		83.5	5,387	1,183	5,762	867	2,050	31,950	6.3
Median		85.4	3,055	964	2,543	674	1,578	31,069	5.1

Note: 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. AAL--Actuarial accrued liabilities. PC--Per capita. PCUL--Per capital unfunded liabilities. ICR--issuer credit rating. NR--Not rated. * Includes 2003 data.

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OPEB Liabilities Add Further Strain

A third issue related to long-term liabilities facing state (and local) governments is the onset of new accounting rules for reporting on other postemployment benefits (OPEB). These benefits, largely attributable to retiree healthcare, have traditionally been accounted for on a PAYGO basis and will now have to be treated on an accrual basis, like pension liabilities.

The new OPEB accounting statement, GASB 45, will bring greater transparency to the financial disclosure surrounding retiree healthcare. Employers will be required to have an actuarial valuation completed to determine the OPEB liability and the annual required contribution. The new reporting will provide important information on future cash flow requirements for the employer. For governments with June fiscal year-ends, reporting under this statement will be required beginning in fiscal 2008.

Although GASB 45 does not change the nature of these pre-existing retiree healthcare liabilities, it will cause states as employers to focus on this issue and their plans for managing these obligations. In most cases, this reckoning will be the first time the full ramifications are laid bare. Management will have to ascertain whether or not they can either: 1) prefund these liabilities, in the same manner that pension obligations are treated, from both economic and political viewpoints; 2) continue down the PAYGO path; or 3) arrive at some middle ground. The GASB 45 analysis by employers may include options to lower the liability of the plan by changing benefit levels, among other alternatives.

Early valuation results point to two significant trends:

- OPEB liabilities are going to be very large in some cases; and
- They will vary widely from state to state depending on the generosity of the plan features and the duration of promised benefits.

For example, if an OPEB plan includes the prospect of lifetime retiree healthcare benefits, this feature will have a magnifying effect on total liabilities compared with a benefit structure under which payments end at age 65.

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Pension Liability Outlook

If we look at prospective public pension funding levels from the standpoint of one key variable, investment return performance, recent investment results would suggest that the climate could improve. With public pension funds on average exceeding their investment return assumptions for both fiscals 2004 and 2005, we should be looking at market value increases for pension assets. However, on an actuarial basis, public funds will probably continue to experience modest declines in both assets and funding ratios for fiscal 2005. Because about 60% of large public funds use five-year smoothing to value assets, based on the universe of the National Association of State Retirement Administrators, the large investment losses felt in 2001 and 2002 were still taking their toll on those systems in the June 30, 2005 actuarial valuations. It is only after fiscal 2006 that these funds will be fully out of the woods from these losses (13% of the NASRA sample had smoothing periods of more than five years, and 27% had less). If funds produce adequate investment returns in fiscal 2006, then we may see funded ratios begin to stabilize. Also, because of the systemic delays in the implementation of increased contribution rates resulting from falling funded ratios (usually implemented one to two or more years after the date of the actuarial valuations are completed), contribution rate pressures will continue to be felt after fiscal 2006.

The risks to any stabilization of pension funding in fiscal 2006 and beyond include the list of usual suspects affecting assets and liabilities. On the asset side of the ledger, of course, is the future investment rate of return. Although we are almost three-quarters into fiscal 2006, the final results are far from certain. Any shortfall compared with the assumed rate will create additional actuarial losses. Assets would also be adversely affected if less than the full required contributions are made. On the flip side of investment returns, some systems are lowering their assumptions for this variable, either towards or below 8%, again with the effect of increasing liabilities. Also on the liability side, any benefit increases, a trend that appears to have waned, given the current climate, would increase liabilities. Demographic changes will continue to boost liabilities as longevity increases, and as known and anticipated mortality experience is reflected in the actuarial models.

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Pensions Rating Perspective

As part of Standard & Poor's state ratings analysis, the status of an employer's pension plans is an important factor. Any competing obligations that could weaken the ability of the employer to meet bond debt service requirements may be a negative credit issue. Pension obligations, which are debt-like in nature, fall into this category. Thus, pension liabilities, which include ongoing, annual servicing requirements in the form of contributions from employers, must be managed so as to not adversely affect the employer's credit profile. To the extent that pension, and OPEB, funding problems act to decrease a state's financial position or flexibility, and these issues are not addressed, they could exert downward pressure on the state creditworthiness at least over the intermediate term.

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