Thoughts on the Status of State and Local Plans

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Good news, worrisome things, and who knows.

Our **2013 update** on the funded status of state and local pension plans made me think more broadly about the progress of these plans. My thoughts fell into three buckets: good news, worrisome things, and some issues up in the air.

As background, state and local plan funded levels held steady at 72 percent from 2012 to 2013. This result is surprising in view of a 19-percent increase in the stock market, but actuarial smoothed assets increased by only 2 percent and CalPERS, one of the largest plans in the country, re-estimated its funded status – discussed below.

On the positive side:

- Pension costs remain about 5 percent of state and local own-source revenues. Despite some caveats (States and localities are not paying all they should and the costs are calculated using the long-run expected return), that is good news.

- States and localities have started to increase the percent paid of their Annual Required Contribution (ARC), now 83 percent.
- Plan sponsors are gradually reducing the interest rate used to calculate liabilities from the historical average of 8 percent to 7.7 percent.
- Some sponsors have cut back on excessive cost-of-living increases, moving from fixed-rate to Consumer Price Index-linked adjustments.
- Funding will improve in 2014 either as 2009 rotates out of actuarial values of assets or as plans move to valuing assets at market under the new GASB rules.
- Recent changes in plan structure have emphasized hybrids or cash balance, not pure defined contribution plans.

On the other hand, several things make me worry:

- State and local plans continue to hold two thirds of their portfolios in equities.
- While some bad actors are trying to correct their ways, others – such as New Jersey – are acting worse.
- Cutting future benefits for current employees remains an obstacle, resulting in draconian cuts falling on new hires, which makes it hard to attract talented workers.
- Nasty surprises, such as CalPERS' new numbers that reduced its reported funded ratio, undermine confidence in reports.
- One quarter of plans use backloaded amortization and will never reach funding even if they pay the full ARC and earn the expected return.
- For some large cities – Chicago, Philadelphia, and New York City (even though NYC pensions are well funded) – pension costs create serious budget pressures.

And “who knows?”:

- How will the new GASB standards, which take effect in 2014, affect reported numbers? Plans will move to the market value of assets, but how many will use the new blended rate to calculate liabilities?
- How will Rhode Island’s efforts to cut future benefits for current workers play out? Will the reforms enacted in 2011, having emerged from mediation relatively unscathed only to be defeated (by a hair!!), survive the court challenge?
- What happens if/when the stock market tanks again?

On balance, the progress in state and local pensions since the financial crisis remains a mixed story. Funding behavior has improved, even though it is not yet visible in the numbers. But plan sponsors need the freedom to change future benefits for current employees – most importantly by tapering in some increase in the retirement age. These are the good times; plans need to take advantage of them.