

The Basics of Funding

The following principles apply to both pensions and post-employment health care benefits, based on a general consensus of experts in the field:

- The long-term costs of retiree benefits are based on a passel of variables, the future values of which are unknown. Actuaries try to pin down these variables through the use of best or at least reasonable “assumptions” and a professional methodology developed to manage multiple uncertainties. If all the actuaries’ projections were correct over time, governments funded benefits earned by employees every year and no new benefits were added, then pensions and retiree health benefits would be fully funded by the end of the amortization period.
 - When a state has an unfunded actuarial liability, it is often because over time those “ifs” did not happen. To pay for the unfunded liability, governments add another chunk of money to their annual contribution to spread the unpaid costs over the amortization period, which is usually 30 years. Generally, when funding ratios decline, employer contributions need to increase.
 - Overly optimistic assumptions, benefit increases and underfunded contributions all put greater demands on future government payments.
 - Inaccurate assumptions also can result in a situation where funding levels rise unexpectedly. This occurred in the late 1990s when most investments earned higher than anticipated returns, which prompted some governments to skip the ARC payment during a so-called funding holiday.
- However, as the recession in the early half of this decade demonstrated, bad years often follow good ones and the contribution holidays aggravated the impact of market losses.
- In a mature pension plan that is reasonably well funded, most of the total additions to plan assets each year will come from investment returns of assets that have been set aside over decades. In a poorly funded plan (pensions or OPEB), more future money comes from direct state contributions and from the same state coffers that fund education, economic development and health care.
 - A poorly funded plan or one that is moving in the wrong direction may also eventually cause trouble for an organization’s credit rating. This could increase the cost of borrowing money, which will make it more expensive for governments to pay for infrastructure improvements such as bridges and roads that typically are supported through borrowing.
 - Although states aspire to having fully funded pensions, it is important to recognize that “underfunding is a matter of degree,” said Keith Brainard, research director for the National Association of State Retirement Administrators (NASRA).²³ The important point is not whether states have reached 98 percent or 101 percent funding; it is the direction in which they are heading and the distance they have to travel to get there.