



# ISSUE BRIEF

## STABILITY IN OVERALL PENSION PLAN FUNDING MASKS A GROWING DIVIDE

October 2018

## Foreword

**F**requently, when the funding status and costs of state and local pensions are described in policy discussions, media coverage, and other related settings, all public plans tend to be clumped together and generalizations are made about public plans as if they were monolithic. But all state and local plans are not in the same fiscal positions, do not face the same challenges, and do not have the same funding histories.

To provide additional, needed context, this brief, *Stability in Overall Pension Plan Funding Masks a Growing Divide*, by Jean-Pierre Aubry, Caroline V. Crawford, and Kevin Wandrei, separates the 180 plans of the *Public Plans Database* (PPD) into three equal cohorts - the top, middle, and bottom third of plans in terms of funded status. These groups had aggregate funded ratios of 90 percent, 73 percent, and 55 percent, respectively, in FY17. While the normal costs for all of these groups did not vary that much, there was divergence among the three regarding the percent of required contributions paid. In FY17, for the top third 95 percent of their required contributions were paid, with the middle third having 80 percent paid, and the remaining plans having 74 percent paid. Looking over the longer term, with one exception in the early 2000s, between 2001-2017, plans that are more well-funded had a larger portion of their required contributions paid, as would be expected. Also, over this same 17 year period, all plans, regardless of their cohort, have underperformed relative to their actuarial investment assumptions, with underperformance being greater for the lower-funded plans. It should be noted that a market correction would set back plan funding, for all plans, by many years.

Readers should take note of this brief's conclusions. The well-funded plans in the PPD likely will continue to be on a sustainable course, with continued adequate funding from plan sponsors. Those in the middle third need to adopt more rigorous and consistent funding approaches, while the remaining plans have hard decisions ahead of them that may entail going beyond the reform options generally adopted by many plans over the past decade.

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Joshua M. Franzel, PhD  
President/CEO  
Center for State and Local Government Excellence

# Stability In Overall Pension Plan Funding Masks a Growing Divide

BY JEAN-PIERRE AUBRY, CAROLINE V. CRAWFORD, AND KEVIN WANDREI\*

## Introduction

In fiscal year 2017, the aggregate funded ratio for state and local pension plans under traditional government accounting rules was 72 percent, largely unchanged from the past several years. However, this stability belies growing disparities in individual plan funding. While plans with extremely low funded ratios garner most of the public spotlight, a sizable share of plans are well-funded and financially stable. As such, much can be learned from analyzing trends for specific groups of plans that underlie the aggregate story.

The discussion proceeds as follows. The first section provides an update of the aggregate funded level for 2017 based on the most recent reports from the 180 plans in the *Public Plans Database*.<sup>1</sup> The second section divides the sample of plans into thirds based on their 2017 funded ratio, and traces the history of funding for each group. The data show that the average funded ratios for each third were relatively similar in 2001, but have diverged since. The third section investigates potential reasons for this divergence by reviewing each group's benefit levels, funding discipline, and investment returns from 2001-2017. The fourth section projects future funded levels in aggregate. The final section concludes that the top third of plans should remain on track if they maintain their current course while the bottom third will likely

need to make major changes. One concern that all plans share is the possibility of a market downturn, which could set back funding for several years.

## Funded Status in 2017

Prior to 2014, most public pension plans used the traditional Governmental Accounting Standards Board rules (GASB 25) to report assets and liabilities both for accounting and funding purposes. New GASB rules introduced in 2014 (GASB 67) included significant changes to the measures of assets and liabilities for accounting purposes only. This *brief* focuses on the traditional GASB 25 standards because plans still use them for funding, and they allow for continuity with historical trends.<sup>2</sup>

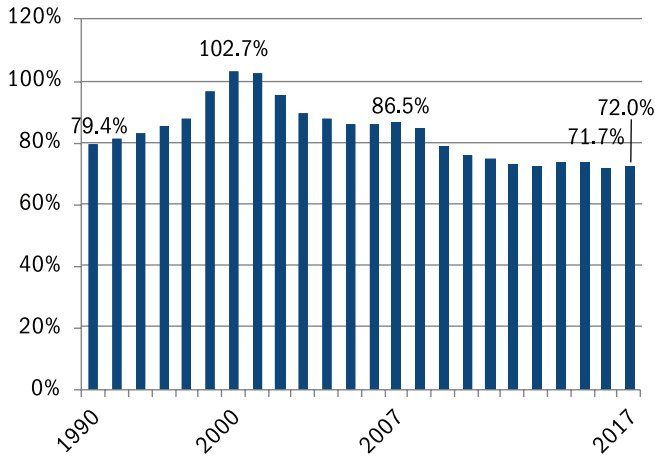
As of 2017, state and local plans were 72 percent funded in aggregate – virtually unchanged since 2016 (see Figure 1).<sup>3</sup> This lack of improvement in funded levels is a result of similar growth in both assets and liabilities. Between 2016 and 2017, actuarial assets grew by 5.1 percent – from \$3.46 trillion to \$3.64 trillion – while actuarial liabilities grew by 4.8 percent – from \$4.83 trillion to \$5.07 trillion.

The relatively slow growth in assets in 2017 is due to the impact of actuarial smoothing, which typically averages market performance over a 5-year period. So, while investment returns were strong in 2017 (12.6 percent), the smoothing method reflects a combination of three very strong years and two weak years (see Figure 2). In contrast, the growth in liability values is based on the discount rate used by plans, which generally changes little from year to year.<sup>4</sup>

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\*Jean-Pierre Aubry is associate director of state and local research at the Center for Retirement Research at Boston College (CRR). Caroline V. Crawford is assistant director of state and local research at the CRR. Kevin Wandrei is a research associate at the CRR. The authors thank David Blitzstein, Keith Brainard, and Joshua Franzel for helpful comments.

**Figure 1. State and Local Pension Funded Ratios, FY 1990-2017**



Note: The 2017 funded ratio involves projections for 18 percent of PPD plans, representing 26 percent of liabilities.

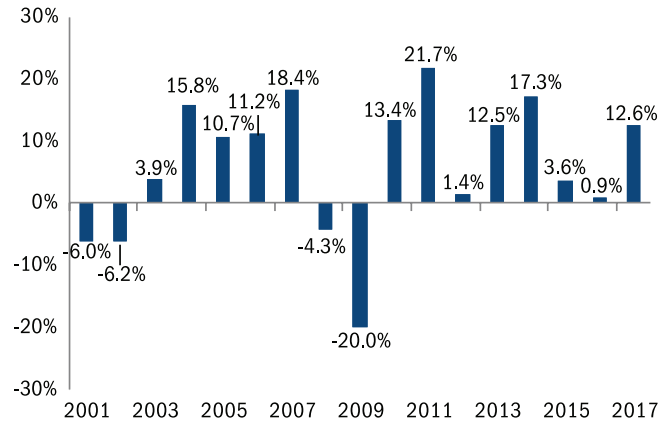
Sources: 2017 actuarial valuations (AVs); Public Plans Database (PPD) (2001-2017); and Zorn (1990-2000).

## How Do Funded Ratios Vary Among Plans?

While the aggregate funded ratio provides a useful measure of the public pension landscape at large, it can obscure variations in funding at the plan level. Figure 3 shows the distribution of 2017 funded ratios for the 180 plans in the PPD. To better assess any underlying trends, this analysis divides the universe of PPD plans into three equal groups based on their 2017 funded status. The funded-ratio boundaries for the three groups were 16 to 67 percent for the bottom third, 68 to 80 percent for the middle third, and 81 to 111 percent for the top third. The average 2017 funded ratio for each group was 55 percent for the bottom third, 73 percent for the middle third, and 90 percent for the top third.

The analysis begins by tracking the average funded ratio for each group back to 2001 (see Figure 4). While the bottom third has been consistently less funded throughout the period, all three groups were

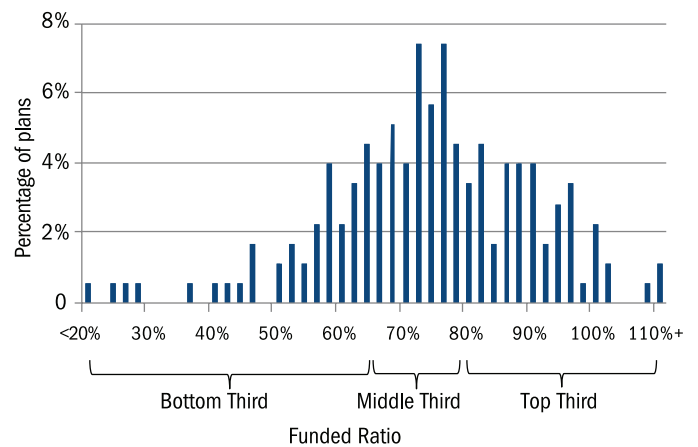
**Figure 2. Returns for State and Local Plans, FY 2001-2017**



Source: PPD (2001-2017).

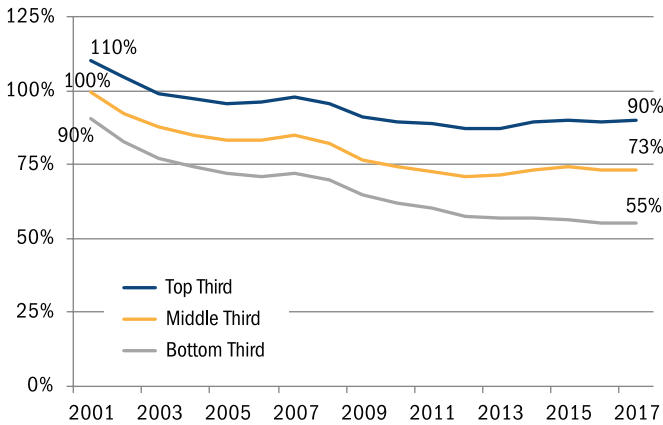
at or above 90 percent in 2001. However, over time, the funded status of the three groups has grown apart. Much of this divergence has occurred since the financial crisis as the worst-funded group has continued to deteriorate while the other two groups have stabilized. As a result, the gap between the top and bottom group in 2017 was 35 percentage points.

**Figure 3. Distribution of 2017 Funded Status**



Sources: PPD (2017).

**Figure 4. Average Funded Ratios by 2017 Funded Status, 2001-2017**



Sources: PPD (2001-2017).

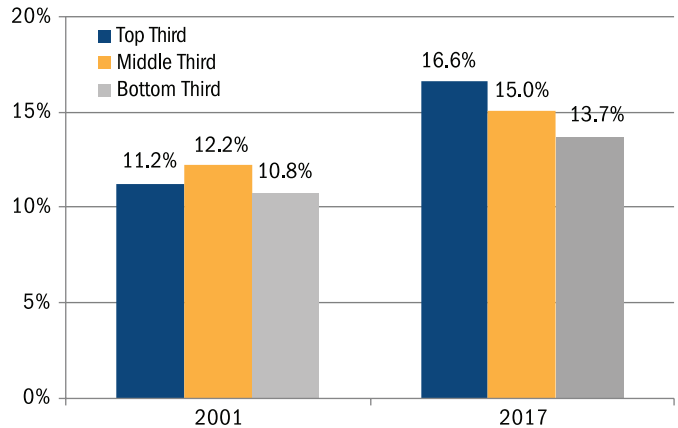
## What Explains the Widening Gap?

To better understand what factors underlie the divergence in funded status, we look at three key elements: benefit levels, funding discipline, and investment returns.

To assess retirement benefits, the analysis examines the average normal cost as a percentage of payroll for each group. The normal cost measures the present value of retirement benefits earned by active workers in a given year, and is often used as a single measure to compare the complicated benefit provisions offered by plans. Figure 5 shows that the normal costs for the three groups are relatively similar and that the worst-funded plans generally had the lowest normal cost. These results suggest that differences in benefit levels are not driving the widening gap in funded status among the three groups.

Past research by the Center has demonstrated that both inadequate contributions by government sponsors and poor investment performance of plans have contributed significantly to unfunded liability growth for public plans.<sup>5</sup> To investigate the adequacy of contributions made to plans, the analysis compares annual government contributions with the amount needed to both fund accruing benefits and pay off

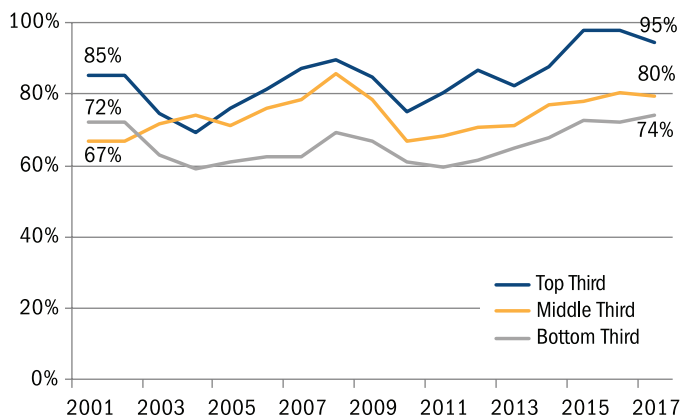
**Figure 5. Average Total Normal Cost as a Percentage of Payroll by 2017 Funded Status, 2001 and 2017**



Note: To standardize across the varying discount rates, reported normal costs were revalued at a 7.5-percent discount rate based on an actuarial rule-of-thumb that assumes a 1-percentage point change in the discount rate equates to a 22-percent change in normal costs.

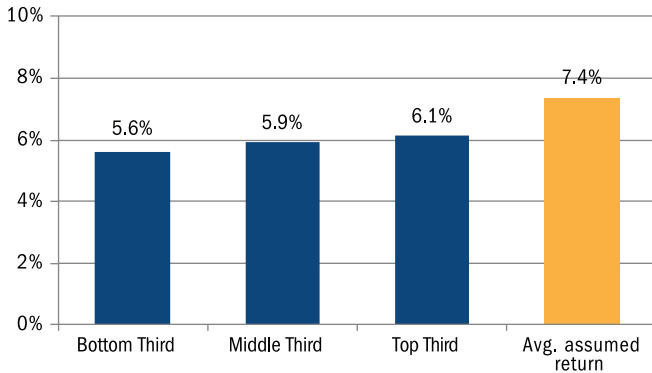
Source: PPD (2001-2017).

**Figure 6. Percentage of Required Contribution Received\* by 2017 Funded Status, 2001-2017**



\*The required contribution used here recalculates each plan's reported required contribution using a level-dollar amortization method over a 30-year period, holding all other factors constant. Sources: 2017 AVs; and PPD (2001-2017).

**Figure 7.** Average Annualized Return by 2017 Funded Status, and Assumed Return, 2001-2017



Sources: PPD (2001–2017).

the existing unfunded liability within 30 years in level dollar payments.<sup>6</sup> From 2001-2017, the average contribution for all three groups was less than this funding benchmark, with the best-funded group receiving 80-90 percent of the benchmark in most years, and the worst-funded receiving 60-70 percent in most years (see Figure 6).<sup>7</sup>

The analysis next turns to a comparison of investment returns. Figure 7 shows the average annualized return from 2001-2017 for each group compared to the average assumed investment return. Two key takeaways emerge. First, all groups underperformed the assumed return.<sup>8</sup> As a result, because contributions are based on the assumption that plans realize their assumed return, even plans that have been dutiful in paying down unfunded liabilities have seen a drop in funded status. Second, the worst-funded plans fell short of the assumed return by more than the best-funded plans. Based on simple projections, if the worst funded plans had achieved returns similar to the best-funded group, their funded ratio would be about 11 percentage points higher – eliminating about one-third of the gap in funding between the two groups.<sup>9</sup>

In summary, the data show that the worst-funded plans have not provided higher levels of benefits over the past 17 years. However, contributions to the worst-funded plans have fallen well short of what is required

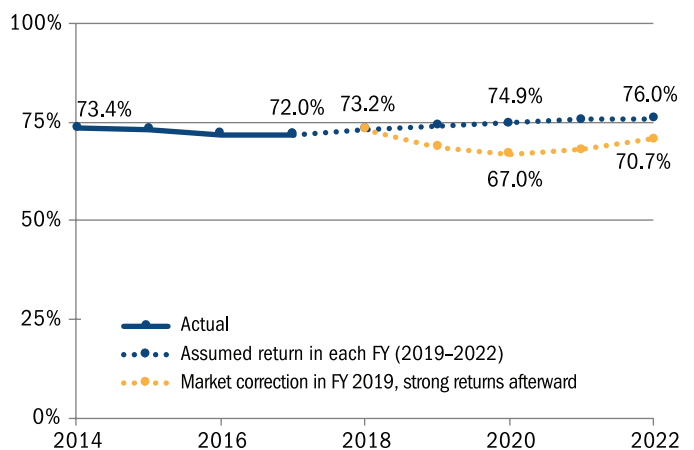
to maintain reasonable funded levels. And average investment returns for the worst-funded plans lag behind the other groups.

## Looking Forward

The performance of the stock market in 2018 has likely improved the funded status for most plans relative to their reported levels in 2017. A projection of plan funded status, incorporating realized stock market returns, shows a one-percentage-point increase in the funded levels from 2017 to 2018 – from 72 percent to 73 percent.<sup>10</sup>

However, the extended period of relatively strong market performance has some experts worried about a market correction in the near future – the stock market is near historic highs with a price-to-earnings ratio of about 1.5 times the historic average, and the yield curve continues to flatten as short-term rates increase.<sup>11</sup> To better understand how a significant market correction might impact plan funding, funded ratios from 2019 to 2022 are projected under two

**Figure 8.** State and Local Pension Funded Ratios, Actual and Projected, 2014-2022



Note: FY 2018 funded ratios are estimated based on the actual performance of the Wilshire 5000.

Sources: PPD (2014-2017); and authors' calculations (2018-2022).

scenarios: 1) plans earn exactly their assumed return in each year; and 2) plans experience a negative return of 15 percent in 2019 and then relatively strong returns in the following years to ensure that the annualized return from 2019-2022 is equal to the assumed return (see Figure 8).<sup>12</sup>

If plans earn their assumed return in each of the next four years, the funded ratio will climb slowly to 76 percent by 2022. However, if a downturn results in a negative 15-percent return in 2019, the aggregate funded ratio will be only 71 percent in 2022 – even with strong returns from 2020 to 2022. Two factors exacerbate the impact that negative returns have on the funded ratio. First, the initial impact of a market loss is felt twofold because the actuarial assets drop *and* liabilities continue to grow. Second, because of actuarial smoothing of market gains and losses, a loss in 2019 is incrementally recognized in the actuarial assets over several years (typically five). The incremental recognition of losses limits improvement in the funded ratio in spite of strong returns afterward. In that way, a one-time market downturn has lingering impacts on plan funding.

## Conclusion

The 2017 funded ratios reported by public pension plans resulted in little change in their average funded status under the traditional GASB standards. However, separating the public pension universe into three groups by their 2017 funded status makes clear that underlying trends for each group have not been uniform. The top third of plans now has an average funded ratio of 90 percent and should remain on track with continued maintenance. The average funded ratio for the middle third of plans has remained relatively steady around 70 percent since the crisis, and these plans can improve by adopting more stringent funding methods. However, the average funded ratio for the bottom third of plans is currently 55 percent and has continued to decline in the wake of the crisis. These worst-off plans will likely require intervention beyond traditional reforms to change the trajectory of their funded status.

Looking forward, the 2018 funded levels for plans will likely increase from 2017 levels due to the relatively strong market performance from July 2017 to June 2018. However, if a market downturn occurs, it could set back plan funding for several years.



## Endnotes

- 1 This sample covers approximately 95 percent of public pension membership and assets nationwide. The sample of plans is a carry-over from the Public Fund Survey (PFS), which was constructed with an eye toward the largest state-administered plans in each state, but also includes some large local plans such as New York City ERS and Chicago Teachers.
- 2 For an update of the funded status based on the new GASB standards, see Appendix A.
- 3 For the funded ratios of individual plans, access the PPD's Interactive Data Browser, available at: <http://publicplansdata.org/public-plans-database/browse-data>
- 4 The annual growth in actuarially accrued liabilities is roughly equal to the interest on last year's liability + normal cost (the present value of newly accrued benefits) – benefits paid (accrued benefits that are no longer due). Because benefit payments are generally larger than normal costs, the annual growth in liabilities is usually lower than the discount rate. Rather than use market interest rates that may fluctuate significantly, public plans use their assumed long-term investment return as the interest rate to value their liabilities.
- 5 See Munnell, Aubry, and Cafarelli (2015).
- 6 See Aubry, Crawford, and Munnell (2018). Most plans use a “level-percentage-of-pay” method for amortizing their unfunded liabilities in order to keep contributions at a set percentage of government payroll – which is consistent with public sector budgeting objectives. However, this method generally results in a schedule of smaller amortization payments in earlier years and larger payments later. For long amortization periods (20-30 years), the backloaded payment schedule allows the UAAL to grow in the early years. An alternative approach is a “level-dollar” amortization method that schedules equal dollar payments, which are designed to reduce the unfunded liability each year. For any amortization period, the level-dollar approach will reduce the UAAL more quickly than the “level-percentage-of-pay” approach.
- 7 For many state and local plans, government pension contributions are made according to a fixed statutory contribution rate (or dollar level) rather than the actuarially determined contribution. For others, statutory caps limit the allowable increase in the employer contribution from year to year. These statutory limitations are often why governments contribute less than the required contribution to their pension plan. For example, in 2006, 71 percent of plans with a statutory limitation did not pay their full required contribution compared to only 26 percent of plans without a statutory limitation.
- 8 The average assumed return for each group differed by less than one-tenth of a percentage point.
- 9 The projection assumes that plans in the worst-funded group achieve the average returns of plans in the best-funded group while leaving the cash flows and liabilities of the worst-funded group unchanged. This simplified projection does not account for the impact of actuarial asset smoothing (delayed accounting of annual investment gains and losses) or the likelihood that a plan's contributions would decrease in response to better returns.
- 10 The projection begins with the assets, liabilities, and cash flows reported in the 2017 PPD data. The investment return for public plans in 2018 is based on the actual performance of the Wilshire 5000 Index and a historical market beta of 0.75 for public plan portfolios. Liabilities are assumed to grow at a 5-percent rate annually. Cash flows (the difference between contributions and benefits) are assumed to grow at an annual rate of 2.7 percent, based on the five-year geometric mean of aggregate cash flow growth between 2012 and 2017 (U.S. Census Bureau, 2012 and 2017).
- 11 Leinz (2018). At the end of 2017, when market indicators were similar to today, Vanguard predicted a 70-percent likelihood of a market correction in 2018.
- 12 The negative 15-percent return for public plans in 2019 is based on a 20-percent decline in the Wilshire 5000 – halfway between a standard 10-percent correction and the roughly 30-percent drop during the financial crisis – and a historical market beta of about 0.75 for public pension portfolios. For a discussion of the exact definitions of market corrections, market reversals, and bear markets, see Constable (2016).
- 12 Given the assumed negative 15-percent portfolio return in 2019, the annualized portfolio return from 2020 to 2022 would equal about 16 percent to achieve a 7.5-percent return from 2019 to 2022.
- 13 For multiple employer agency plans that do not report a funded ratio under the new rules, the funded ratio is calculated by dividing the net market assets reported on the pension fund's balance sheet by the plan's actuarially accrued liability.



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## Appendix

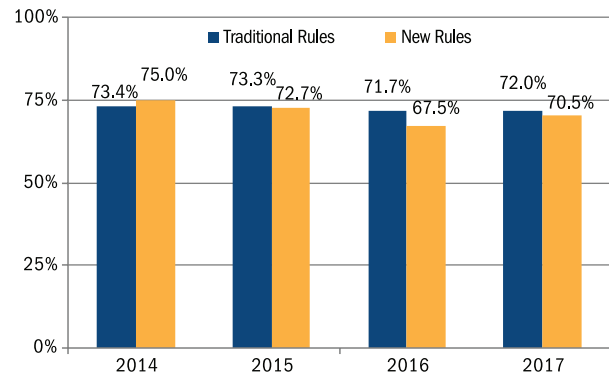
### Appendix. Aggregate Funded Status Under New GASB Standards

The new GASB 67 standards introduced two significant changes to the reporting of pension assets and liabilities. First, they require plans to report assets at market value rather than actuarially smoothed. Second, they require plans to value liabilities using a blended rate that reflects: 1) the plan's assumed return for the portion of benefits projected to be covered by plan assets and contributions; and 2) the yield on high-grade municipal bonds for any portion of benefits that is to be covered by other resources.

The majority of plans use their assumed return for valuing all liabilities, as they anticipate having sufficient assets and contributions to cover benefits. Table A1 lists the plans that currently use a blended discount rate that is more than 1 percentage point below their assumed return.

Figure A1 shows the funded status under both traditional and new GASB standards from 2014 to 2018. While the funded status under both methods is relatively similar, the ratio under the new rules is slightly more volatile due to fluctuations in market assets.<sup>13</sup>

**Figure A1.** Funded Ratios under Traditional and New GASB Rules, FY 2014-2018



Sources: 2017 AVs; and PPD (2017).

**Table A1.** Plans Adopting a Significantly Lower GASB 67 Blended Discount Rate, FY 2017

Plan	Actuarial assets (\$000s)	Discount Rate		Funded status	
		Traditional (GASB 25)	New (GASB 67)	Traditional (GASB 25)	New (GASB 67)
New Jersey PERS	\$33,401,414	7.0 %	5.0 %	57.3 %	36.8 %
New Jersey Teachers	26,549,410	7.0	4.3	42.1	25.4
Texas ERS	26,371,827	8.0	5.4	70.1	54.7
Colorado School	23,263,344	7.3	5.3	56.3	43.1
Minnesota Teachers	21,062,789	8.5	5.1	76.8	51.6
Kentucky Teachers	18,514,638	7.5	4.5	56.4	39.8
Colorado State	14,026,332	7.3	5.3	54.6	42.6
New Mexico Educational	12,507,831	7.3	5.9	62.9	53.0
Minnesota State Employees	12,364,957	8.0	5.4	85.2	62.7
Cook County ERS	9,488,223	7.5	4.6	56.7	39.2
North Dakota PERS	2,633,199	7.8	6.4	70.7	62.6
Dallas Police and Fire	2,157,800	7.3	4.1	49.4	25.5
Birmingham RRS	1,016,438	7.5	4.1	75.5	48.5
Texas LECOS	923,990	8.0	3.5	66.0	42.7
Charlotte Firefighters' RS	520,579	7.5	5.2	86.2	71.2

Sources: 2017 AVs; and PPD (2017).



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