

## Special Report

# U.S. State and Local Government Pensions

## One Size Does Not Fit All

### Analysts

Amy Laskey  
+1 212 908-0568  
[amy.laskey@fitchratings.com](mailto:amy.laskey@fitchratings.com)

Richard Raphael  
+1 212 908-0506  
[richard.raaphael@fitchratings.com](mailto:richard.raaphael@fitchratings.com)

Laura Porter  
+1 212 908-1575  
[laura.porter@fitchratings.com](mailto:laura.porter@fitchratings.com)

Douglas Offerman  
+1 212 908-0889  
[douglas.offerman@fitchratings.com](mailto:douglas.offerman@fitchratings.com)

### Related Research

#### Applicable Criteria

- [Tax-Supported Rating Criteria, Aug. 16, 2010](#)
- [U.S. State Government Tax-Supported Rating Criteria, Oct. 8, 2010](#)
- [U.S. Local Government Tax-Supported Rating Criteria, Oct. 8, 2010](#)

### Summary

Fitch Ratings recognizes that there has been much public debate around the impact on U.S. state and local government finances of pensions and other benefit obligations. Fitch notes that there is cause for near-term concern about a number of public sector defined benefit pension plans and recognizes the considerable pressure that these obligations will place on many government budgets in the coming years. However, given wide variations in the financial condition of and management approach to individual plans, blanket conclusions are problematic. Each plan and each government's situation is its own story, and Fitch believes that it is important to evaluate them as such.

The analysis of long-term obligations, including pensions, is an important part of Fitch's rating review for state and local government credits. Fitch has downgraded a number of credits due in part to pension funding issues and will continue to take such action as warranted.

The steep market decline of late 2008 and early 2009 has presented governments with both long- and short-term challenges: assets available to make future payments are reduced and annual required contributions (ARCs) are rising considerably at the same time that government revenues to fund them have dropped and demand for overall government services has risen. Although investment returns have rebounded somewhat, many plans' actuarial valuations will continue to weaken as losses are smoothed in over multiple years, and market values are still well below pre-financial crisis levels.

Fitch believes that the vast majority of governments will withstand the substantial pressures they face from their pension obligations, although for many governments this will mean taking difficult steps to adjust contributions and/or benefits to ensure adequate pension funding. For governments with poorly funded systems, the need to take these steps is pressing. However, since governments and their tax bases are long-term in nature, officials in most cases have some time to fully implement changes to control their long-term liabilities. Similarly, the beneficial impact of any adjustments on funding levels and contributions will accrue over an extended period.

### Historical Context

In considering the current status of state and local government pension plans and the expectations for future management actions, a historical context may be helpful. Prior to the latest recession, public pension obligations represented a growing source of fiscal pressure due to the same broad demographic factors affecting other cost trends in the U.S., such as healthcare spending and Social Security outlays. Nonetheless, public pension plans were generally well funded and cost trends were more manageable as a result of decades of progress toward advanced funding of future benefits and strong investment returns that lowered the growth rate of ARCs. The main driver of the current level of pension funding pressure is market losses in late 2008 and early 2009, which represent a major setback toward the prefunding of retirement obligations. In some cases, this compounds a fundamental problem caused by consistent underfunding of actuarially required pension payments.

A March 2010 report by Wilshire Consulting (*2010 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*) indicates that 125 state plans had an average funded ratio (assets to liabilities) of 87% in 2007 on an actuarial basis, where market gains and losses are smoothed in over a number of years. On a market value basis (without smoothing), the ratio was even higher at 96%. The estimated average actuarial funded ratio dropped slightly to 84% in 2008 but remained solid. Behind this aggregate figure was wide variation in the ratios of individual plans. According to an often-cited February 2010 study by the Pew Center on the States (*The Trillion Dollar Gap*), 11 states reported funded levels above 90%, whereas 10 were less than 70% funded in 2008. The Wilshire report indicated that the estimated average actuarial funded ratio dropped to 75% in 2009, even as the estimated market value funded ratio dropped to 65%.

Specific examples of the wide variations in pension situations include North Carolina's Teachers' and State Employees' Retirement System, which was funded at 95.9% as of Dec. 31, 2009, down from 104.9% two years earlier due to market losses but nonetheless very well funded. The state and other member governments have a demonstrated commitment to fully funding their ARC. In stark contrast, the state of Illinois' five retirement systems combined had a funded ratio of 50.6% as of June 30, 2009, down from 63.6% two years earlier. The state had consistently underfunded its ARCs even prior to the market downturn and its fiscal crisis. This poor funding history is one among a number of reasons that Illinois' credit rating, at 'A', is among the lowest of the states.

### A Look Ahead

The systems that pose the greatest risks are those with significant unfunded liabilities for which the government's annual payments have been significantly less than an actuarially determined ARC over multiple years. Plans with relatively low funded ratios prior to the market downturn — below 70% — will likely be in a weak position as market losses are fully reflected. However, for some plans that appear relatively poorly funded, ARC payments continue to be made and the government is on a path to 100% funding over a reasonable period (e.g. 20 years) without undue financial pressure. In other cases, the funded level is high but the ARC is growing to a nearly unsustainable proportion of overall resources, crowding out spending for essential operating purposes or forcing tax increases on an already stressed base.

In analyzing state and local government pension obligations and the impact on overall credit quality, key factors that Fitch reviews include the size of the resource base from which funding is derived, the amount of the government's budget needed to make pension payments, and officials' willingness and ability to make hard choices to bring assets and liabilities into better balance. These factors are not positive for all governments, and more will see rating declines as options become even more limited as time passes.

Much has been made about public pension funds' "aggressive" discount rate assumptions, which average 8%. Fitch agrees that, given the recent market downturn and prospects for lower returns going forward, this figure is likely optimistic, and to enhance analytical efforts, Fitch is in the process of estimating the size of plans' liabilities under various alternative discount rate assumptions. Such adjustments will clearly reduce estimated funded ratios and raise contributions for most plans and make the dimensions of the problem more pronounced. They will also allow Fitch to compare liabilities among plans on a more equivalent basis, pending expected pension accounting revisions by the Governmental Accounting Standards Board (GASB).

However, to assume that pension fund returns are going to hover close to Treasuries

going forward seems unrealistic given the long duration of pension liabilities that are paid by governments and the fact that governments can confidently be expected to exist for the long term. Therefore, it is appropriate for these entities to invest in a diversified, long-term portfolio and assume a historically justifiable return on investments.

Although a pressing need remains to set many pension systems on a more sustainable footing, what Fitch has observed over a long period is generally responsible financial management actions by state and local governments, and Fitch believes officials will work in the near term to improve funded ratios. The significant powers of most state and local governments, which are not subject to the same competitive pressures as corporations, to control their revenue and spending should not be overlooked in this discussion.

There has already been significant activity on government pensions to lower benefits or improve funding. According to the Pew Center on the States, in 2010 (through October), 19 states made broad-based changes, including two that increased contributions, 10 that reduced benefits, and seven that did both. Negative public sentiment toward government spending and tax increases is likely to put further pressure on officials to develop solutions. In some cases, particularly for benefit reductions to retirees, these changes are being litigated, which Fitch believes over time will lead to increased clarity as to officials' flexibility to alter pension plans.

Fitch will provide additional, more detailed commentary on U.S. state and local pension issues in the coming weeks. These will include a more detailed analysis of current public pension accounting and GASB's proposed changes, to be followed by a revised framework for enhancing the analysis of pension liabilities.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT [WWW.FITCHRATINGS.COM](http://WWW.FITCHRATINGS.COM). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2011 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.