

Although it is generally preferable for a pension plan to be “fully funded,” it is not unusual for funding gaps to emerge, especially during economic downturns. Putting the gap in context is the key...

- A funding gap (or “unfunded liability”) occurs when the benefits owed to current and future retirees exceeds the amount of money the plan has socked away to meet these obligations.
- Funding gaps do need to be filled—but they can be filled gradually, over time.
- For most states, filling funding gaps is manageable. In fact, in response to the financial crisis, states have already made significant pension reforms, and forecasts show that in most cases, these reforms will fully fill the funding gaps over time.
- Closing down a pension plan to newly hired employees will not eliminate a funding gap. Rather, it may be even harder to close the gap, once a plan is “frozen.”

Before the economic downturn started in 2008, pension plans sponsored by state and local governments had done a pretty good job of setting aside money to “pre-fund” benefits that will be owed to current and future retirees. But since the unprecedented 2008-2009 drop in the stock market, many pensions have found themselves facing a funding gap.

A funding gap occurs when the benefits owed to current and future retirees exceeds the amount of money the plan has socked away to meet these obligations. This fact sheet provides some basic information about pension funding gaps, which are also referred to as “unfunded liabilities.” What are they? How much of a problem are they? What’s the solution for filling the gap?

▶ UNDERSTANDING PENSION FUNDING GAPS

A funding gap occurs when there is a mismatch between a plan’s obligations and its assets.

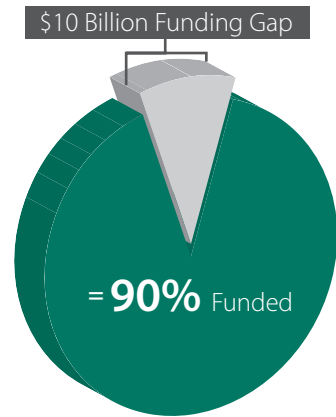
A pension plan’s obligations are the dollar value of the benefits that have been promised by the plan, and earned by employees and retirees.

A pension plan’s assets consist of financial holdings—cash, stocks, bonds, and other securities—that have been accumulated by the plan over the years. Pension plans are pre-funded, which means that regular contributions for each worker are made into a retirement fund during the



course of that worker’s career. State and local pension plans are usually funded by employer contributions and contributions from employees themselves. These contributions are invested to generate returns, or investment earnings. Investment earnings can be continually reinvested into the pension fund, until such time as the funds are needed to be paid out in the form of pension benefits.

\$100 Billion Pension Plan



When a pension plan’s obligations exceed its assets, the plan can be described as having a funding gap or an “unfunded liability.” To illustrate, imagine a pension plan that will eventually pay out \$100 billion in benefits, but only has \$90 billion in assets on hand. The funding gap, or unfunded liability, is \$10 billion ($\$100 \text{ billion} - \90 billion). That seems like a lot of money. But is this pension plan really in trouble?

Sometimes it can be helpful to look at a pension’s funding status in percentage terms. A plan’s “funding ratio” is calculated by dividing the plan’s assets by its obligations. In this case, the plan’s \$90 billion in assets is divided by the \$100 billion in obligations. This plan can be described as 90% funded. In effect, for each dollar in future benefits to be paid, the plan has 90 cents on hand. That sounds a lot more manageable than a plan with a “\$10 billion unfunded liability.” But both descriptions accurately portray the same plan. Putting some perspective around these

numbers is critical to understanding just how much of a problem a funding gap poses.

Another point to remember is that a funding gap does not need to be closed in a single year, but the payments can be spread out (or “amortized”) over many years, according to governmental accounting standards.² In this way, many observers liken an unfunded liability to a mortgage, which is paid off over time.

▶ WHERE DO FUNDING GAPS COME FROM?

Sharp, unexpected downturns in financial markets can create funding gaps. That’s because when the stock market drops, the value of the assets held by the plan drops, as well. The economic downturn of 2008 and 2009 included unprecedented losses in the stock market. Because public pension funds are invested in the market, these plans—like all investors—saw substantial losses in their assets. According to the National Association of State Retirement Administrators, the aggregate funding levels of the nation’s largest public pension plans fell from 86.7% in 2007 to 73.5% in 2012.³

Funding gaps can also develop when contributions coming into the plan are insufficient to cover promised benefits. The amount necessary to be contributed to the pension fund each year is generally determined through an actuarial analysis. The plan actuary determines the cost associated with new benefits earned in that year (normal cost) plus any additional amount that might be required to make up for shortfalls that have developed in the past. This amount is called the “Annual Required Contribution” or ARC, and this is what the plan sponsor should pay in order to maintain a healthy plan.⁴

It is important that the full amount of the ARC be contributed to the pension trust each year. If not, the plan can develop a funding gap. And if full payments are missed repeatedly, the gap will only grow with each passing year. States and localities have generally done a respectable job with pre-funding.⁵ But there have been exceptions, and some governmental employers have failed to contribute the full amount of their ARC each year. According to the National Association of State Retirement

Administrators, in 2012, more than six out of ten pension plans received the full ARC or something close to it—even as employer contribution rates have had to rise in response to the financial crisis.⁶

FUNDING GAPS CAN BE ADDRESSED OVER TIME WITH A DISCIPLINED APPROACH



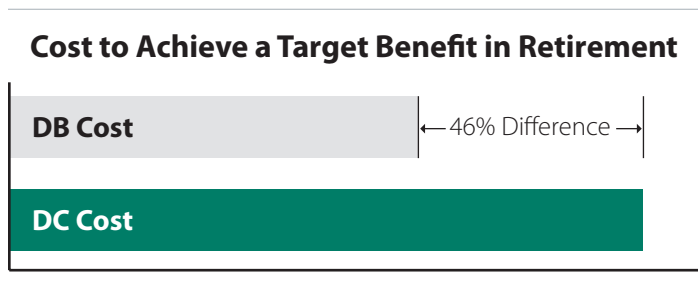
While achieving full funding of a pension plan may be ideal, a funding gap may not be so problematic, depending on the characteristics of the plan and plan sponsor (employer). For example, if the plan is able to continue to pay promised benefits and the plan sponsor can make its required contributions without causing fiscal stress, then the funding gap can be closed gradually over time, by making regular payments to the plan.⁷ Actuaries describe this process as “amortizing the unfunded liability.” This is similar to the process of paying down a mortgage. As long as payments are being made in full and on schedule, the plan will be on a course toward full funding and the existence of a funding gap may not be considered problematic at all.

It’s important to distinguish between plans whose funding gaps are the result of recent market conditions and those where there has been a lack of funding discipline. Addressing the funding gap should be more manageable for those plans where employers were disciplined about funding—the downturn may be a temporary set-back, and restoring the plan to full funding may require only modest adjustments to the plan. Plans whose sponsors were undisciplined about funding will have greater challenges in recovering, and unfortunately, fewer tools at their disposal to address the issue. In fact, many of these plans were experiencing problems even before the stock market downturn, due to the lack of proper funding.

In addition, many state and local governments have been evaluating the need for, and even implementing, adjustments to their pension systems to ensure that they will be on a strong footing for the long-term. The actions taken by states to date have been quite substantive and varied, including increased employee contributions and lower benefit levels. Boston College finds that for most states, the reforms already implemented should fully offset the effects of the economic downturn, ensuring the plans’ long term sustainability.⁸

CLOSING THE PENSION PLAN TO NEW HIRES WON’T ELIMINATE THE FUNDING GAP

The only way to eliminate an unfunded liability is to pay it off. While it may be tempting to completely close down a pension plan to new hires due to its unfunded liabilities, this action does nothing to close the plan’s funding gap. This is because, whether a pension plan is open or closed, the obligation to pay for benefits earned in the past will remain. Returning to the mortgage analogy, any balance on the mortgage does not vanish simply because you move out of your house—what is owed remains owed.



Furthermore, “freezing” a pension plan and moving new hires to a new defined contribution plan, like a 401(k) or 403(b) plan can actually increase costs to the state. This is

because of the additional administrative costs associated with running a second retirement plan. Second, traditional, group-based pensions (defined benefit plans) are associated with several economic efficiencies that defined contribution plans cannot duplicate; forgoing these efficiencies drives up retirement plan costs. Finally, appropriate funding stewardship may require plan sponsors to pay off the unfunded liability faster once a plan is closed to new hires.⁹ Accelerating pension contributions is generally unhelpful for states and localities looking for ways to manage through a difficult budgetary environment.

Preventing funding gaps from occurring and closing gaps that do emerge is hard work, and requires a disciplined approach to pension fund stewardship. The good news for employers, employees, and taxpayers is that a well-managed group pension plan is the most economical way to achieve retirement security.

The economic efficiencies embedded in group pension plans are substantial, and stem from the pooled, professionally managed nature of these plans. A recent analysis of the cost to achieve a target retirement benefit under a group pension structure, as compared with a defined contribution plan based on individual accounts, found that a group pension can do the job at almost half the cost of the defined contribution plan.¹⁰

Time and again, states that have carefully studied the issue have concluded that, even in tough economic times, continuing to provide retirement benefits via cost-effective group pension plans meets the joint interests of fiscal responsibility for employers and taxpayers, and retirement security for employees. This is why the vast majority of states have chosen to stay within the DB structure, even as they implement pension reforms to ensure their long-term sustainability.¹¹

¹ National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Public Pension Basics*. Washington, DC: National Institute on Retirement Security.

² Governmental Accounting Standards Board. 2012. *Summary of Statement No. 67: Financial Reporting for Public Pension Plans*. Norwalk, CT: GASB

³ Brainard, K. 2013. *Public Fund Survey Summary of Findings for 2012*. National Association of State Retirement Administrators.

⁴ National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Public Pension Basics*. Washington, DC: National Institute on Retirement Security.

⁵ National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Public Pension Basics*. Washington, DC: National Institute on Retirement Security.

⁶ Brainard, K. 2013. *Public Fund Survey Summary of Findings for 2012*. National Association of State Retirement Administrators.

⁷ Brainard, K. 2009. *Public Fund Survey Summary of Findings for 2008*. National Association of State Retirement Administrators.

⁸ Munnell, A.H., J.P. Aubrey, A. Belbase, and J. Hurwitz. 2013. *State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

⁹ Boivie, I., and Almeida, B. 2008. *Look Before You Leap: The Unintended Consequences of Pension Freezes*. Washington, DC: National Institute on Retirement Security.

¹⁰ Almeida, B., and Fornia, W. 2008. *A Better Bang for the Buck: The Economic Efficiencies of DB Plans*. Washington, DC: National Institute on Retirement Security.

¹¹ Boivie, I., and C. Weller. 2012. *The Great Recession: Pressures on Public Pensions, Employment Relations and Reforms*. Washington, DC: National Institute on Retirement Security.