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Is it time to stop worrying about pensions?

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6–8 minutes

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Welcome back to *Route Fifty's* Public Finance Update! I'm Liz Farmer and this week I'm writing about the latest public pension plan numbers—which are the best they've been since the Great Recession and the Financial Crisis slashed assets by one-third between 2007 and 2009.

Nationally, pensions now have 77% of the assets they need to meet all their future unfunded liabilities, and the Equable Institute, a bipartisan non-profit that promotes public sector retirement security, predicts that will rise to 78% this year. It's the highest funded ratio for pensions since 2009.

What's more, funding discipline has improved over the last decade. Data collected by the Boston College Center for Retirement Research shows that more governments have been paying their full pension bill. Last year, 98% of the average pension bill was paid, compared with just 81% back in 2011. Some would also say that those bills are more realistic than they were before the Great Recession as many pension plans have shifted their investment return assumptions downward from 8% in 2009 to a median of 7% today.

Future liability growth has also been tamed as thousands of governments have enacted pension reforms and cuts to create different benefits for new employees.

Even New Jersey, which was sued by the Securities and Exchange Commission in 2010 for not disclosing its pension liabilities to investors, won its first credit rating upgrade in 30 years from Fitch Ratings last year in part for "simultaneously addressing [its] high debt and pension liabilities."

Bond buyers have also collectively turned down the heat. Pensions, the No. 1 issue for municipal bond analysts surveyed by Hilltop Securities in 2019, slipped to No. 4 last year.

These trends beg the question: Is it time to stop worrying about pensions?

“Pensions are not flashing red at the magnitude they maybe once were,” said Tom Kozlik, the analyst who runs the survey. “But it's absolutely not the time to no longer care about pensions just because the overall funding levels are a little stronger.”

While the surface optics look much better than a decade ago, Kozlik and others warn that now is not the time to relax about the health of public pensions. The rising costs for retiree benefits —including retiree health care—and a more volatile investment environment mean that pensions will remain a fiscal pressure on state and local governments budgets for the foreseeable future.

Rising Retirement Costs

A big reason pensions are healthier is because states and localities have been putting more money into them. It’s a vastly improved funding discipline compared to the 1990s and 2000s, when governments would take “pension holidays” and skip payments. But improved funding discipline comes at an incredible cost.

In the early 2000s, annual pension payments represented just under 7% of payroll. By 2014 it more than doubled to 14%, and today, pension payments are equal to 22% of payroll.

“That’s still a massive amount of money that has to be set aside for state or local budgets every year,” said Kozlik. “To me that’s almost more worrisome.”

What’s more, pensions are just one part of retiree benefits—health care is another. Retiree health care benefits, or other post-employment benefits (OPEB), don’t have the same constitutional protections as pensions, and most governments don’t pre-fund those benefits. One study by the Reason Foundation put state and local government OPEB liabilities at $1.2 trillion—nearly as much public pension unfunded liabilities.

“OPEB is a shoe that hasn't dropped yet,” said Vijay Kapoor, a pension consultant who helped mediate reforms in various cities including New Orleans and Lexington, Kentucky. “I think we are at a point where policymakers at least generally understand issues of pensions, but we’re still in the infancy of trying to figure out what to do with retiree health care.”

Increasing Investment Return Volatility

The Equable Institute highlights what it calls “converging pressures of risk addiction, market uncertainty and increasing politicization of asset management activities" as reasons to keep the spotlight on pensions.

Equable's latest pension report points to pension funds' increasing share of alternative investments, such as hedge funds and private equity, which have less transparency in how they are valued. As opposed to market-based stocks, alternative investment values are reported by asset managers. In 2022, as much as one-third of the $4.8 trillion in pension assets were based entirely on this valuation approach, according to Equable.

"If [the valuations aren't accurate], pension funds are likely over-estimating the total value of their assets and, in turn, are setting contribution rates too low to achieve their funding goals," the report said.

Executive Director Anthony Randazzo added that the trend toward lower investment return assumptions, also called discount rates, hasn't gone far enough. But some places have managed it well.

He points to the New York Common Fund as one plan that has been able to step down its return assumptions from 8% in 2010 to 5.9% today through a disciplined contribution schedule. Michigan has also made several changes to its teachers' pension plan in recent years that include reducing its return assumptions. Notably, the state created a new defined benefit plan for teachers hired as of February 2018 that uses a maximum 6% assumed rate of return.

"That gives the legacy system time to buy down its assumed rate of return over time without a big contribution rate shock," Randazzo said.

Ultimately, no matter how good (or poor) the national pension numbers are, the real fiscal picture of pensions is a crazy quilt of plans that run the gamut from being near insolvent to consistently well funded and managed. Over the last decade, many plans have made moves to become well funded, which has helped the overall picture. But observers note that the high interest rate environment that has helped boost returns, along with the end of federal pandemic relief funds, could also be providing a temporary lift to pension plan health.

"The places that took action are in better shape, so we're in that period right now where they are reaping the benefits of the actions they took," said Kapoor. "But those may not last forever."