



Public Fund Survey Summary of Findings for FY 2010

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About the Public Fund Survey

The Public Fund Survey is an online compendium of key characteristics of most of the nation's largest public retirement systems. The Survey is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement.

Beginning with fiscal year 2001, the Survey contains data on public retirement systems that provide pension and other benefits for 13.2 million active (working) members and 7.1 million annuitants (those receiving a regular benefit, including retirees, disabilitants and beneficiaries). At the end of FY 10, systems in the Survey held assets of \$2.3 trillion. The membership and assets of systems included in the Survey comprise approximately 85 percent of the entire state and local government retirement system community.

The primary source of Survey data is public retirement system annual financial reports. Data also is culled from actuarial valuations, benefits guides, system websites, and input from system representatives. The Survey is updated continuously as new information, particularly annual financial reports, becomes available. This report focuses on fiscal year 2010.

A key objective of the Survey is to increase the transparency of the public pension community and understanding of public pension funding concepts by providing a factual and objective basis on which to discuss many issues related to retirement benefits for public employees. The Survey is found online at www.publicfundsurvey.org.

Executive Summary

As expected, public pension funding levels continued their decline in FY 10 following the sharp drop in global capital markets in 2008 and early 2009. At the end of FY 10, the aggregate public pension funding level was 77.0 percent, down from 79.8 percent in FY 09. The size of the decline was smaller in FY 10 compared to the year before, due chiefly to improving asset values and slowing (and, in some cases, reversing) rates of growth in liabilities.

Public pension fund investment returns were strong again in FY 10, with median returns increasing at a double-digit rate. The value of public pension trust fund assets, from which state and local government pension plans pay benefits, have rebounded sharply since their mid-2009 low, and these gains are helping to offset the effects of the market decline that took place from July 2008 until March 2009. Compared to March 2009, the aggregate value of public pension fund assets was higher at the end of 2010 by 35 percent. Because nearly all public pension plans recognize their investment gains and losses over several years, the full extent of the market drop—and subsequent increase—will be incorporated into public plan funding levels over several years.

Aggregate public pension funding levels are expected to continue to drift lower through FY 13. Once all of the investment losses of 2008-09 have been factored in to actuarial calculations, funding levels are expected to begin to improve. The funding experience of individual plans varies: some plans have improved their funding level via changes made to benefit levels that affect existing plan participants.

For many pension plans, the higher unfunded liabilities resulting from the market decline are increasing their Annual Required Contribution (ARC)—the sum of the cost of benefits accrued in the current year and the cost to amortize unfunded liabilities. Consistent payment of the ARC is intended to bring the plan to full funding by the end of the funding period. The overall ARC experience of plans in the Survey in FY 10 was roughly consistent with recent years: four of every ten plans in the Survey received less than 90 percent of their full required contribution. The average ARC paid since inception of the Public Fund Survey in FY 01 is 92 percent.

An April 2010 issue brief authored by the Center for Retirement Research at Boston College found that for the public pension community as a group, receiving the full ARC would require additional pension contributions of two percent of payroll, an amount that varies by plan.ⁱ

Continuing a trend that began in earnest in 2009 and continued in 2010, plan sponsors continued to make changes in 2011 to benefit levels, financing arrangements, or both, to ameliorate the effects of increased unfunded liabilities. In some cases, these changes affected new hires only; other changes affected existing plan participants. Legislatures in several more states reduced unfunded pension liabilities by postponing or reducing future cost-of-living adjustments for existing retired plan participants. This pattern of changes to pension benefits and financing arrangements is likely to continue in 2012.

Overview of the Public Pension Community

A 2007 study by the U.S. Government

Accountability Office reported that employees of state and local government comprise 12 percent of the nation's full-time workforce. These employees perform a broad range of functions in such fields as elementary and higher education, public safety, criminal justice, public health, transportation, infrastructure, conservation and management of natural resources, and others.

Retirement benefits play an important role in attracting and retaining qualified employees needed to perform essential public services. Pension plans provide stable and adequate income replacement in retirement for long-term workers, and ancillary casualty benefits related to disability and death before retirement. Unlike government programs funded out of general revenues, state and local government retirement systems generally are funded in advance, by investing employee and employer contributions during employees' working years. Most of these benefits are distributed in the form of a lifetime payout in retirement. This arrangement allows for long-term financing and the majority of revenues to be generated from investment earnings and employee contributions, while also ensuring retirees do not outlive their retirement assets.

The long-term nature of pension finance requires funding and asset allocations to be evaluated regularly to ensure that plans and benefits are sustainable over a long time horizon and continue to accommodate the changing needs of the workforce and policy goals of the sponsoring government.

As with virtually all investors, market volatility in recent years has affected public pension funds. Public pension plans are designed to withstand volatility: even after the market decline, through the use of strategies such as portfolio diversification, long investment and funding horizons, actuarial

smoothing of investment gains and losses, and pooling of assets, the vast majority of public pension plans remain able to pay promised benefits to retirees for decades into the future.

Following the steep market losses that took place from the second half of 2008 through early March 2009, by the end of 2010, the aggregate value of public pension fund assets increased by 35 percent. Although market gains have not fully offset all of the losses experienced during the decline, this sharp increase helps illustrate the importance of focusing on the long-term when investing and monitoring public pension fund assets. This volatility also demonstrates the value of phasing in investment gains and losses: to moderate volatility in funding levels and costs, making them more stable and predictable.

Most plans use a five-year smoothing period to phase in investment gains and losses. This phase-in period will extend through 2013 the time when the recent investment losses are incorporated into public pension funding levels. Plans that use smoothing periods longer than five years will take longer to recognize their losses, as will those whose actuarial valuation date lags their fiscal year-end date.

Effects of the 2008 Market Decline

The market decline increased unfunded pension liabilities—and the cost of amortizing them—for most states and cities that sponsor pension plans. The extent of the resulting increases in required contributions varies by plan and depends on several factors, especially the plan's funding condition prior to the market decline; the adequacy of contributions to the plan by employers and employees; and the plan's demographic composition. The cost to amortize unfunded liabilities is also affected by the plan's actuarial methods, assumptions, and past and future investment returns.

The higher costs resulting from the market decline have been calculated by plan actuaries and implemented for many plans. Largely as a result of the higher expected costs since 2009, many states, cities, and other pension plan sponsors have been making changes to contribution structures and rates, benefits, or both.

The Related Resources section and Appendix C provide information regarding many of the changes made to benefit levels and contributions. Authority to revise benefit and financing arrangements varies widely among states, depending on a combination of constitutional and statutory provisions and case laws. In some cases, policymakers may modify future benefit accrual patterns for existing plan participants. In other cases, once an employee has begun participating in the pension plan, the employee is entitled to continue to accrue benefits for the duration of her or his employment with the plan sponsor, with little or no change permitted.ⁱⁱ

Pensions and Retirement Security

The future retirement security of Americans employed outside the public sector appears increasingly uncertain. An editorial in the Wall Street Journal in 2010 stated: “The biggest, but most underreported, financial story in America is the looming retirement disaster. Eighty million baby boomers are approaching retirement and most have absolutely no idea what’s going to hit them.”ⁱⁱⁱ This growing retirement insecurity is due to a number of factors, including the fact that just one-half of the nation’s private sector workforce participates in an employer-sponsored retirement plan;^{iv} a long-term decline in private sector workforce participation in a traditional pension plan; and heavy reliance on a retirement plan model—defined contribution plans—that has been found to be undependable in its ability to provide reliable retirement income.

By contrast, some 87 percent of employees of state and local government participate in an employer-sponsored retirement benefit.^v Retirement plans in the public sector generally contain the following key characteristics:

- mandatory participation
- mandatory annuitization, meaning that retiring participants must take their benefit as a lifetime annuity
- pooled assets that are professionally invested
- adequate benefits that include coverage for death and disability
- cost-sharing of contributions by employees and employers.

These plan design features promote retirement security by a) ensuring that workers actually participate in the employer-sponsored retirement plan; b) increasing the number and percentage of retiring workers who cannot outlive their retirement assets; c) minimizing administrative and investment costs, keeping more assets in place to pay retirement benefits; and d) maintaining a stream of revenue to pension funds and defraying taxpayer costs.

According to one study, by pooling assets and risk and generating higher investment returns for all plan participants, defined benefit plans deliver the same retirement benefit at nearly one-half of the cost of a defined contribution plan.^{vi} Traditional pension plans also are designed to assist public employers to attract and retain workers needed to perform essential public services; to promote an orderly turnover of workers, particularly among those who have reached an age at which they may be unable to perform the duties required of their position; and to enhance the retirement security of a large segment of the nation’s workforce.

The Meaning and Implications of Actuarial Funding Ratios

The most recognized measure of a public retirement plan's ability to meet current and future obligations is its actuarial funding ratio, derived by dividing the actuarial value of a plan's assets by the value of its liabilities. Pension benefits for public employees usually are funded in advance, meaning that a significant portion of the assets needed to fund pension liabilities is accumulated during an employee's working life, which is paid during the participant's years in retirement.

Such "pre-funding" is one way of financing a pension benefit. The opposite of pre-funding is pay-as-you-go, an arrangement under which current benefit obligations are paid with the pension plan sponsor's current revenues. In most cases, a pay-as-you-go pension plan eventually becomes too expensive to support with only current receipts and contributions. By contrast, investment earnings account for most revenue generated by a pre-funded pension plan, reducing required contributions from employees and employers (taxpayers).

Funded status is a single-point measure of the degree to which a plan is on course to meet a distant goal. A pension plan whose assets equal its liabilities at one point in time, is funded at 100% and considered to be *fully funded*. A plan with assets less than its accrued liabilities at one point in time is considered *underfunded*.

Most public pension plans contain these key characteristics:

- ***Mandatory participation***
- ***Mandatory annuitization***
- ***Pooled assets that are professionally invested***
- ***Adequate benefits that include death and disability coverage***
- ***Cost-sharing of contributions by employees and employers.***

Underfunding is a matter of degree, not of kind: the status of a plan whose funding level declines from 101 percent in year one to 99 percent the following year, changes from overfunded to underfunded. Yet despite this diametric shift in terminology, the reality of the plan's funding condition has changed little. The fact that a plan is underfunded is not necessarily a sign of fiscal or actuarial distress; many pension plans remain underfunded for decades without causing fiscal stress for the plan sponsor or reducing benefits to current beneficiaries.

The critical factor in assessing the current and future health of a pension plan is whether or not funding its liabilities creates fiscal stress for the pension plan sponsor. Although a pension plan that is fully funded is preferable to one that is underfunded, other factors held equal, a plan's funded status is simply a snapshot in a long-term, continuous financial and actuarial process. A plan's funding level is akin to a single frame of a movie that spans decades.

Because the sponsors of public pensions (i.e., states, cities, etc.) are "going concerns," operating essentially as perpetual entities, there is nothing particularly important about a public pension plan being fully funded at any particular point. Likewise, the fact that a plan is underfunded does not necessarily present a fiscal or actuarial challenge to the plan sponsor.

Attaining full funding of a pension plan has been likened to a mortgage: at the end of the process, when fully paid, the mortgage would be considered fully funded. Although at any point during the 30-year mortgage, part of the outstanding obligation may be considered an unfunded liability, more relevant considerations are a) whether the mortgage holder has the resources to continue making payments until the obligation is resolved; and b) whether the obligation is indeed being amortized. The size of a mortgage-holder's outstanding

obligation reveals little about the holder’s financial condition. The length of the mortgage and the ability of its owner to amortize the obligation without financial hardship are more relevant indicators. Likewise, more pertinent considerations with regard to funding a public pension plan are the ability of the plan sponsor to continue to pay promised benefits and to make required contributions without causing fiscal stress, and whether the plan’s unfunded liability is being amortized.

All plans, underfunded and fully funded alike, that are open to newly hired workers, rely on future contributions and investment returns. A key difference between underfunded and fully funded plans is that underfunded plans require additional revenue to amortize the shortfall between assets and accrued liabilities. The degree of underfunding and its associated cost to the plan sponsor are key considerations in assessing a plan’s overall condition.

Other factors indicative of a pension plan’s health include the:

- length of the funding amortization period
- required current and future contribution rates
- plan’s demographics
- plan’s actuarial assumptions
- sustainability of the plan design
- plan’s governance structure
- fiscal health of the plan sponsor
- commitment of the plan sponsor to continue funding the plan

Information about these factors is provided in annual reports and other material published by most public retirement systems.

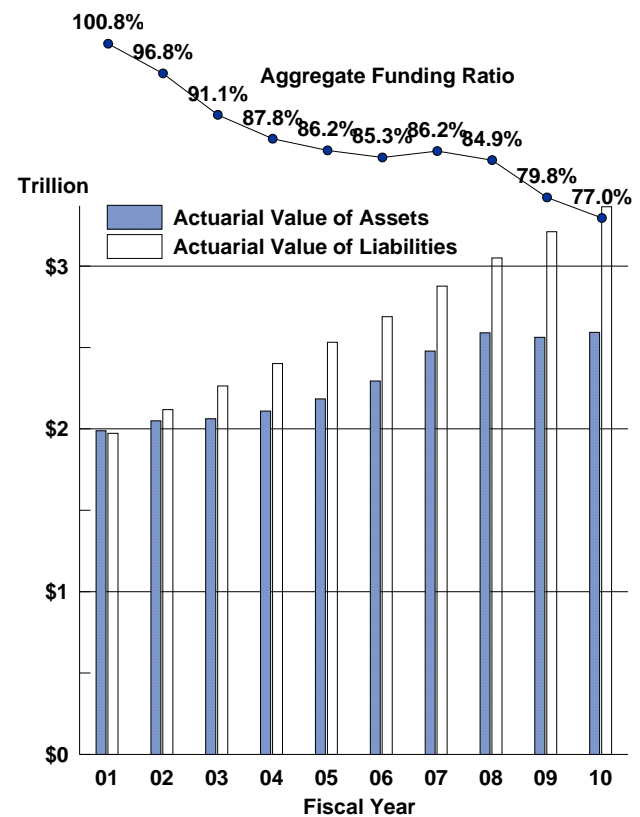
Recent Changes in Funding Levels

Figure A summarizes changes in aggregate assets and liabilities and the resulting actuarial funding ratio for plans in the Public Fund Survey. The

aggregate public pension funding level declined in FY 10 from 79.8 percent to 77.0 percent.

This decline continues a trend that began in FY 02 following the 2000-2002 drop in equity values. In addition to investment returns, rates of liability growth and changes to actuarial assumptions—particularly assumed rates of investment return—also have an effect on funding levels.

Figure A: Change in aggregate actuarial value of assets, liabilities, and funding levels, FY 01 to FY 10

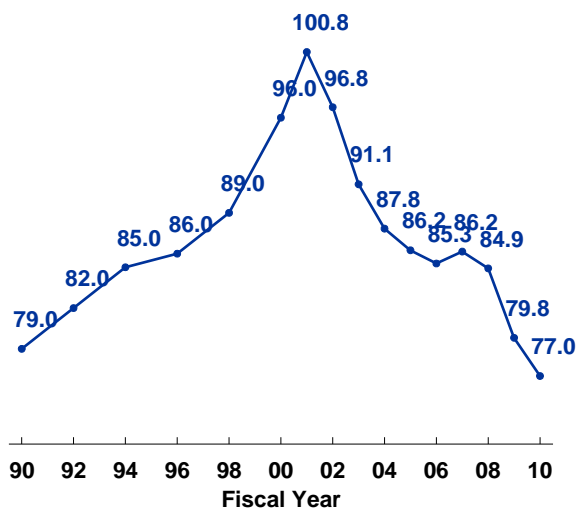


Public pensions are designed to absorb volatility in actuarial experience, including variations from expected levels of investment performance. This is achieved through the use of actuarial smoothing methods, which phase in investment gains and losses; funding amortization periods (that average approximately 25 years for plans in the Survey), which are timeframes during which unfunded liabilities are paid off; and through use of a stable discount rate that is based on historic and projected long-term investment returns.

Figure B shows the change in the aggregate public pension funding level since 1990. As a result chiefly of growth in equity values, funding levels improved sharply during the 1990s before beginning their decline in FY 02.

Other factors that affect a plan’s funding ratio include changes in actuarial assumptions, contribution levels, changes in benefits, and variations in a plan’s actuarial experience relative to expectations. One or more of these factors has played some role, to varying degrees, in the funding level of every public pension plan.

Figure B: Change in aggregate public pension funding level, FY 90 to FY 10

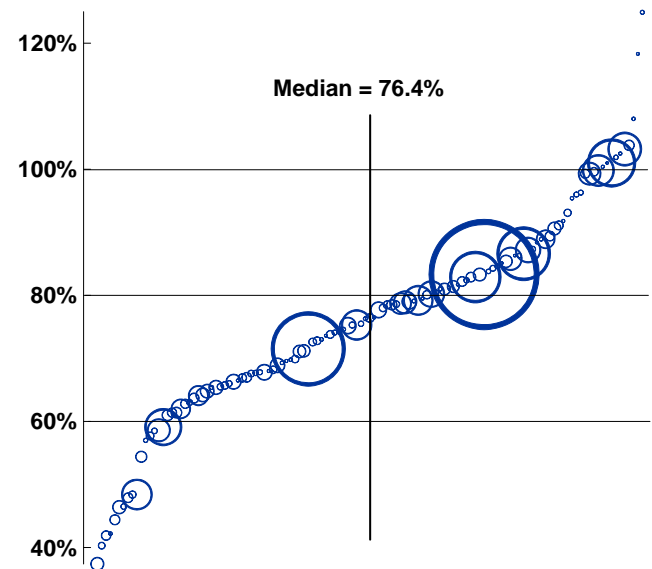


For several years, the Governmental Accounting Standards Board (GASB) has been reviewing its standards used to calculate and report public pension liabilities. This is known as GASB’s Post Employment Benefits project. In June 2011, GASB issued exposure drafts on the project. An exposure draft is a nearly-final decision of GASB’s views on accounting standards. When its final statements are issued in 2012, GASB’s accounting standards for public pensions and their sponsors are expected to contain a number of important changes, including the separation of pension accounting standards from those used for pension funding. A second anticipated effect of the proposed GASB changes,

which was discussed in a report published in November 2011 by the Center for Retirement Research at Boston College, estimated that on an accounting basis, aggregate public pension funding levels would be approximately 53 percent in FY 10 using the standards proposed in GASB’s Exposure Drafts, rather than 77 percent.^{vii}

Figure C plots funding levels of the 126 plans in the Survey, presented based on the size of each circle, which is roughly proportionate to the size of the plan’s liabilities: larger bubbles signify larger plans, and smaller bubbles indicate smaller plans.

Figure C: Distribution of actuarial funding levels for plans in the Public Fund Survey, based on latest available data



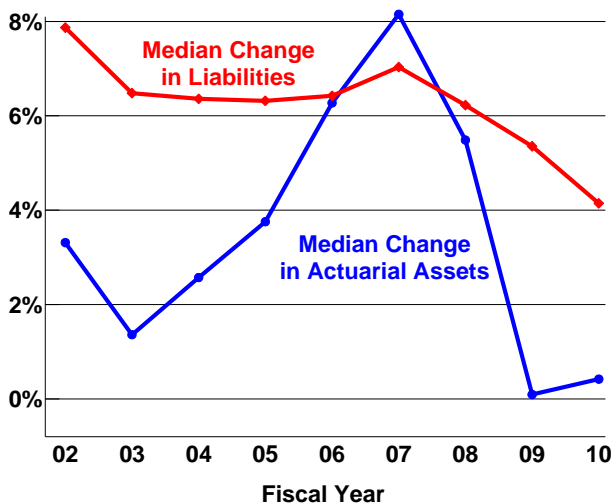
Although comparing public pension funding levels with other plans may be tempting, one should also be mindful of the limitations of such comparisons. Important differences can render comparisons misleading. Such differences include the:

- level of required employee and employer contributions;
- plan sponsor(s)’ commitment and ability to make required contributions;
- fiscal condition of the plan sponsor;
- plan’s demographic makeup;
- level of benefits provided by the plan;

- plan’s governance structure, including the ability (or inability) to modify the plan design and financing structure;
- plan sponsor’s level of support for the pension plan;
- plan’s amortization period(s);
- required benefit payments in the current and future years relative to the plan’s asset base; and
- the pension fund’s investment performance, risk tolerance, asset allocation, and expected investment return
- the plan’s actuarial methods and assumptions.

Analysis of a public pension plan’s financial or actuarial condition must take these and other factors into account; failure to do so creates a risk of misunderstanding or misrepresenting the plan’s true condition.

Figure D: Median change from prior year in actuarial value of assets and liabilities



For a plan’s funding level to improve, the rate of growth in assets must exceed the rate of growth in liabilities. Liability growth is affected by a variety of factors, including changes in salary and benefit levels, and demographic changes in plan participants, such as retirement and mortality rates. As Figure D shows, median actuarial liability growth in FY 10 exceeded median growth in

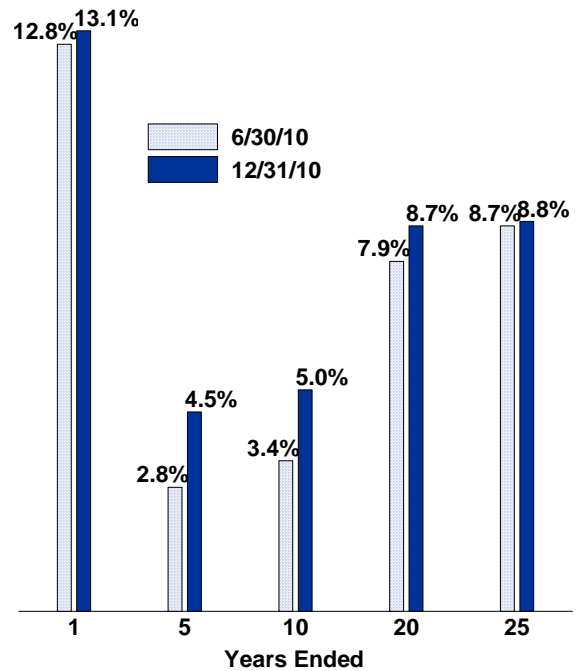
actuarial assets, which produced the predictable outcome of a lower funding level.

Liability growth has been trending significantly lower in recent years. This is due to such factors as lower salary growth, reduced employment levels, and approval of fewer discretionary cost-of-living adjustments. Some plans have actually reduced liabilities by modifying benefit levels. For example, in 2010 and 2011, several states have reduced future cost-of-living adjustment provisions for existing retired members, thereby lowering the plans’ unfunded liabilities (see Appendix C). With respect to assets, investment returns below assumed levels during the past decade have been the primary factor affecting the tepid growth in actuarial assets.

Investment Returns

Over time, investment earnings have a major effect on the cost and funding condition of a public pension plan: from 1982 through 2009, investment earnings accounted for 60 percent of all public pension revenue.^{viii}

Figure E: Median annual public pension fund investment returns (in percent) for years ended 6/30/10 and 12/31/10



Source: Callan Associates

Figure E plots median public pension fund investment returns for selected periods ended 6/30/10 and 12/31/10, which are the fiscal-year-end dates used by nearly all public pension funds.

Asset Allocation and Investment Expenses

Figure F compares average asset allocations for funds in the Public Fund Survey from FY 01 through FY 10. Since FY 01, the combined allocation to public equities and fixed income has declined from more than 90 percent to less than 80 percent in FY 10. In place of these reduced allocations, allocations to real estate and alternatives (chiefly private equity and hedge funds) have grown. This increased diversification reflects an effort by many funds to generate returns at lower levels of risk, or to increase projected returns at the same level of expected portfolio risk.

Figure F: Average asset allocation, FY 01 to FY 10, and FY 10 averages labeled

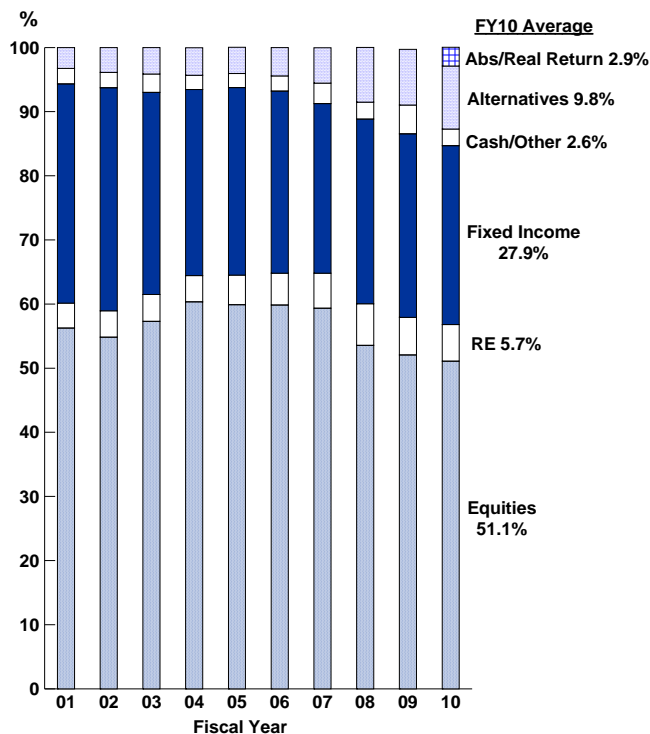
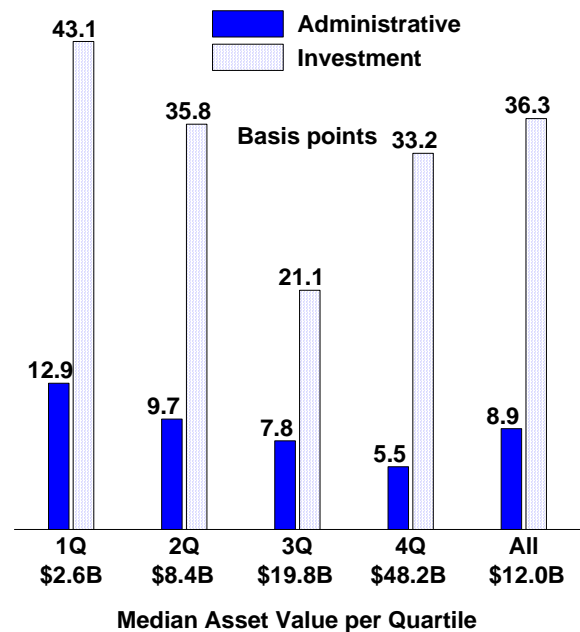


Figure G compares median administrative and investment expenses in FY 10, by quartile.

Larger funds generally are able to use their size to secure lower asset management fees than smaller funds. Perhaps because larger funds are more likely to be invested in alternative classes, which typically cost more to manage than other asset classes, expenses for the largest quartile are higher than those for the third quartile of funds.

The median cost to administer plans in the Survey is under 10 basis points, or 0.10 percent of assets. Combined with investment management costs, the total cost of administering a median public pension plan is less than 50 basis points, considerably less than the cost of alternative types of retirement plans.

Figure G: FY 10 median administrative and investment management expenses, by quartile

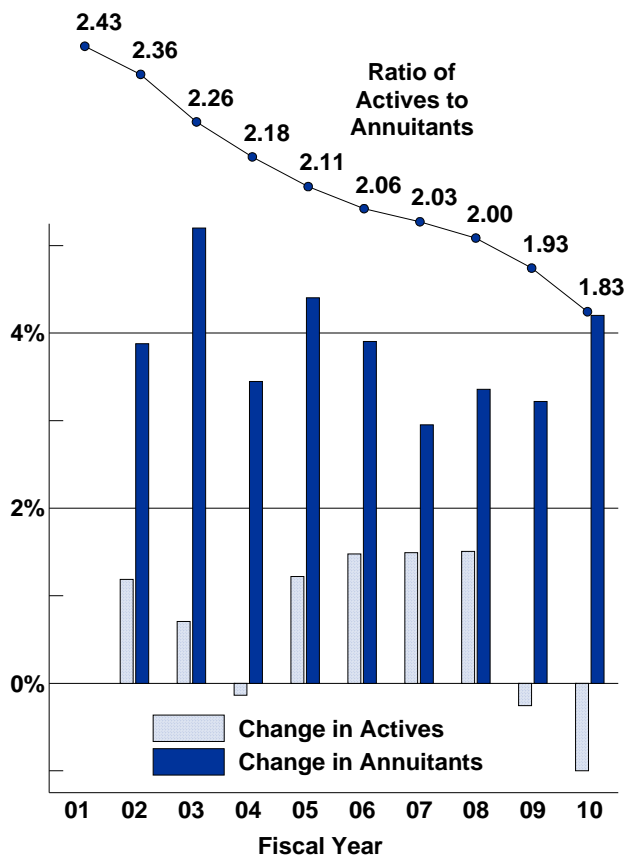


Membership Changes

The Survey tracks two groups of members: actives, who are currently working and receiving service credit in their retirement plan; and annuitants, which includes any member receiving a regular benefit from the system: retirees, beneficiaries and disabled.

Figure H summarizes the percentage changes from the prior year in these membership groups from FY 01 to FY 10. Perhaps the most striking trend displayed in this chart is the decline in the number of active members that has occurred in two consecutive periods. This decline is consistent with figures published by the U.S. Bureau of Labor Statistics that show a steady decline in the number of states and local government jobs, beginning in September 2008.^{ix} Meanwhile, the change in the number of annuitants continued apace in FY 10, increasing at the fastest rate since FY 05.

Figure H: Percentage change over prior year in active members and annuitants, FY 01 to FY 10, and change in ratio of actives to annuitants



By itself, a declining ratio of actives to annuitants is not an indication of public pension financial or actuarial distress. Most public pension plans have funding policies to fund the cost of their benefits in advance. However, to the extent that a plan is underfunded, meaning that all accrued future

benefits have not yet been funded, a low or declining ratio of actives to annuitants can complicate the plan's ability to move toward full funding. This is because amortizing unfunded liabilities over a smaller active payroll base, relative to the amount of benefits being distributed, becomes relatively more expensive.

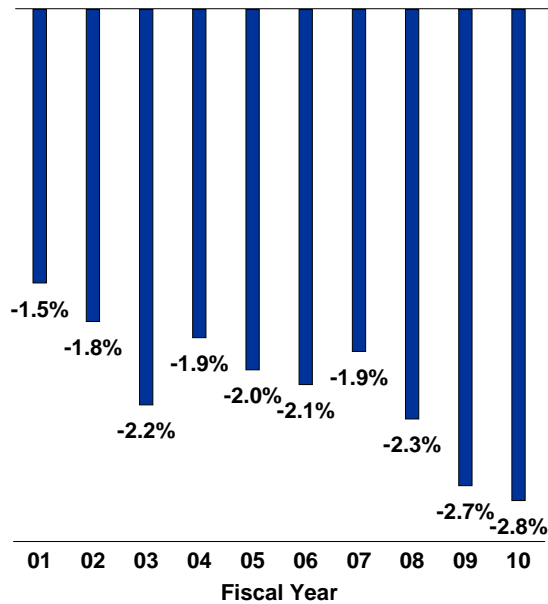
A declining ratio of actives to annuitants also can have financial and operational effects on a retirement system. For example, fewer active members create a larger negative cash flow (contributions minus benefit payments and administrative expenses). At a certain point, a negative external cash flow can require a pension fund to allocate a larger percentage of its assets to more liquid securities, or to make other adjustments to its asset allocation which may reduce long-term investment returns. As a group, annuitants tend to require more time and attention than actives from the retirement system staff. This is likely because annuitants are reliant, to some degree, on current income from the system, and are more attuned to the system's activities and operations.

Figure I displays the median external cash flow among systems in the Public Fund Survey. External cash flow is the difference between the contributions a retirement system receives in a year, and the fund's expenses, chiefly benefits and administrative costs. Of the 96 systems whose external cash flow was measured in FY 10, 90 (94 percent) had a negative external cash flow.

As a workforce ages, a pension plan eventually will distribute more in benefits than it takes in from contributions. Although the concept of a negative cash flow may provoke adverse connotations, paying out more in benefits than it receives in contributions is a normal development in the evolution of a pension plan: assets are accumulated through contributions and increased through investment earnings. As a plan's participants age,

the accumulated assets are distributed in the form of benefits.

Figure I: Median external cash flow for systems in the Public Fund Survey, FY 01 to FY 10



Contributions

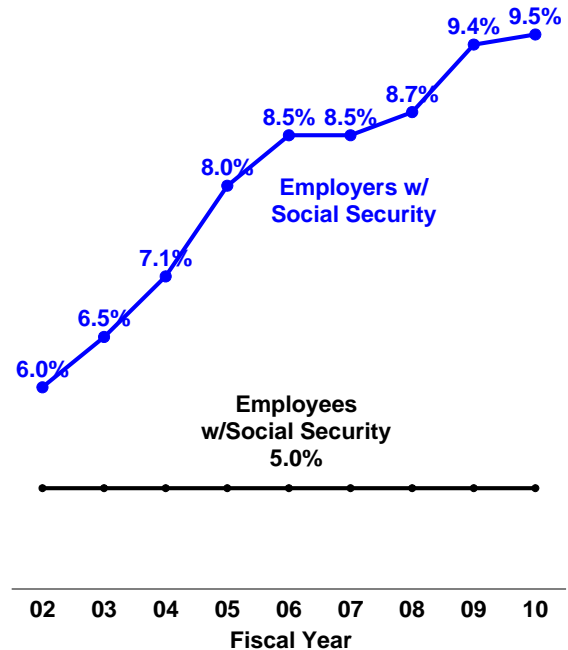
In addition to contributions from employers (taxpayers), nearly all employees of state and local government are required to contribute toward the cost of their retirement benefit.

Contribution rates for employees usually are set as a fixed percentage of pay; in some plans, employee contribution rates fluctuate. Employee contributions are a stable and reliable source of public pension fund revenue, providing a predictable stream of revenue that most plans use to fund current benefits. Figure J plots median contribution rates for employers and employees since FY 02 for general employees and school teachers who also participate in Social Security. This data does not reflect rates for public safety personnel, such as firefighters and police officers, or narrow employee groups, such as legislators or judges.

Median employer contribution rates for workers who participate in Social Security rose to 9.5 percent of pay and to 12.7 percent of pay for employers whose participants do not participate in

Social Security. The median employee contribution rates remained five percent of pay for Social Security-eligible workers, and eight percent for non-Social Security-eligible.

Figure J: Median employee and employer contribution rates as a percentage of pay, Social Security-eligible workers, FY 02 to FY 10



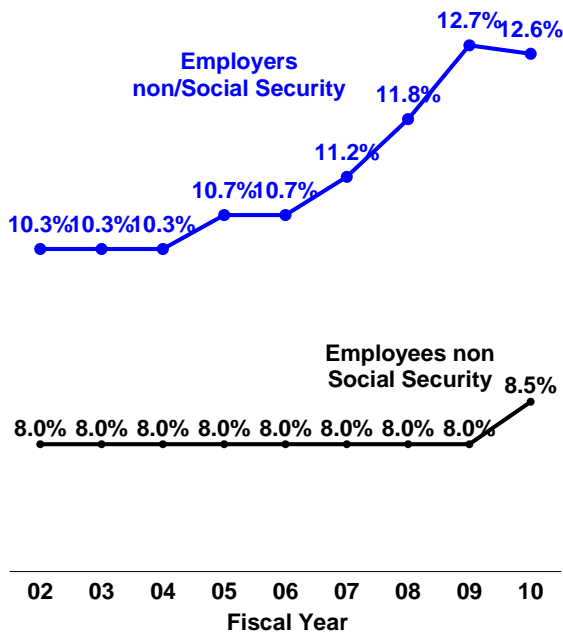
As shown in Appendix C, contribution rates for many public pension participants have increased since 2009. However, the number of plans where increases have occurred, and the size of the increases, have not been large enough to cause a change to the median employee contribution rate. Legislative schedules and the implementation date of higher contribution rates, which often coincide with the onset of new fiscal years, can slow the onset dates of higher rates. Higher contribution rates imposed recently on employees in many states may be reflected in findings for FY 11.

Approximately one-fourth of all employees of state and local government do not participate in Social Security, including 40 percent of public school teachers, a majority of firefighters and police officers, and most or substantially all public employees in seven states: Alaska, Colorado, Louisiana, Maine, Massachusetts, Ohio, and

Nevada. Contribution rates usually are higher for non-Social Security eligible employers and workers, as benefits usually are higher to offset the absence of Social Security. Employers and employees participating in non-Social Security plans each avoid the 6.2 percent contribution used to fund Social Security, but they are required to pay the 1.45 percent Medicare contribution.

Figure K plots median changes in employer and employee contribution rates since FY 02. For the first time during the measurement period, the median employee contribution rate rose, from 8.0 percent to 8.5 percent, reflecting increases in contribution rates for some plan participants.

Figure K: Median employee and employer contribution rates as a percentage of pay, non-Social Security-eligible workers, FY 02 to FY 10



As established by the Governmental Accounting Standards Board, a plan’s annual required contribution, or ARC, reflects the amount needed to fund benefits accrued in the current period (the normal cost) plus the amount needed to retire the plan’s unfunded liability over the plan’s funding period. The failure by some sponsors of public pension plans to make required contributions is a

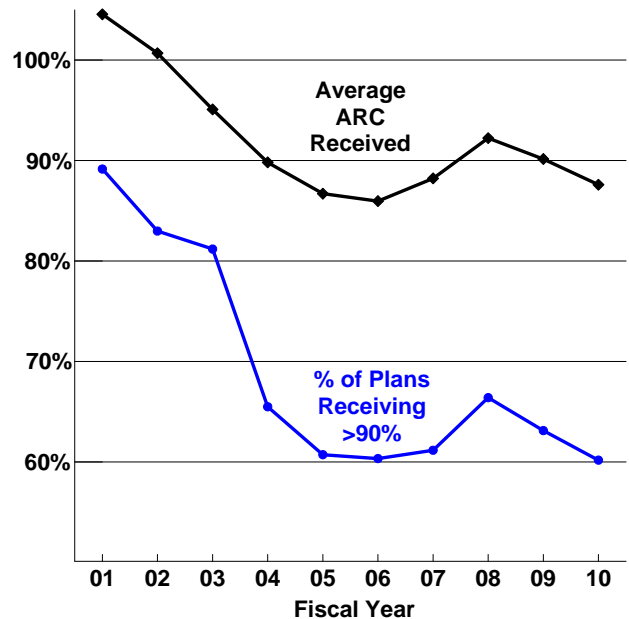
major factor contributing to unfunded liabilities for some public pension plans.

Methods for setting employer contribution rates vary; some plan sponsors set the rate on the basis of the Annual Required Contribution (ARC); others pay a fixed percentage of employee pay; and others base their contribution on how much is available or that can be wrung from the entity’s budget.

Although many plan sponsors consistently make their full ARC, some consistently fail to do so.

Figure L plots the ARC history for plans in the Survey on the basis of two measures: the overall average ARC paid, and the percentage of plans receiving at least 90 percent of the ARC. Each plan’s ARC experience is equally weighted, meaning that ARC experiences do not account for plan size or the size of required contributions.

Figure L: Average Annual Required Contribution received and percentage of plans receiving at least 90 percent of their ARC, FY 01 to 10



As Figure L shows, the overall average ARC received by public plan sponsors in FY 10 was 88 percent, within the range of levels in recent years. Similarly, the percentage of plan sponsors paying at

least 90 percent of their ARC also was consistent with recent experience.

Both rates, however, were lower for the second consecutive year, likely reflecting a combination of higher ARCs and the difficult fiscal conditions states and their political subdivisions have faced since the recession that began in late 2007.

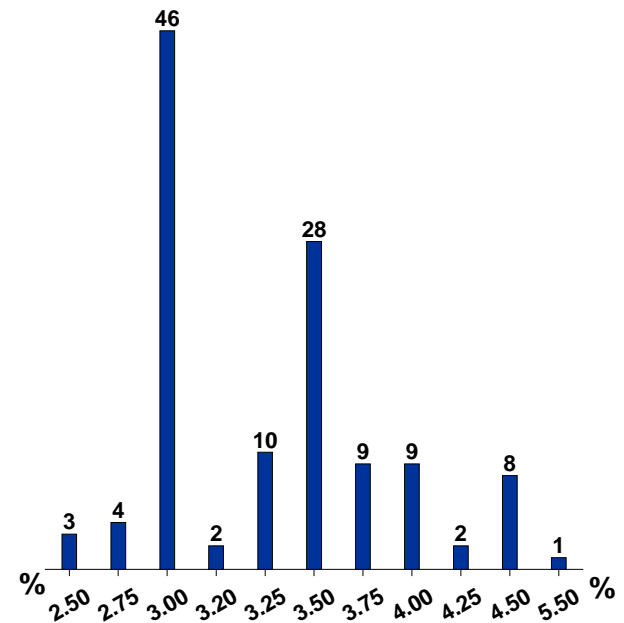
In a recent study of public pensions, the Government Accountability Office stated that many of the plan sponsors failing to pay their ARC also had plans in relatively poorer funding condition. “[T]he failure of some [plan sponsors] to consistently make the annual required contributions undermines [funding] progress and is cause for concern, particularly as state and local governments will likely face increasing fiscal pressure in the coming decades. While unfunded liabilities do not generally put benefits at risk in the near-term, they do shift costs and risks to the future.”^x

Assumptions for Inflation and Investment Return

Among the many actuarial assumptions used to calculate a plan’s liabilities, rates of general inflation and investment return exert a particularly strong effect on plan costs. The assumed inflation rate affects actual and projected wage growth, a major driver of benefit levels (and plan costs). Inflation also is one component of the investment return assumption; the other is the assumed real return, which is the investment return net of inflation.

Figure M plots the distribution of general inflation assumptions among plans in the Public Fund Survey based on the latest available data. (Four plans in the survey do not specify an assumption for general inflation.) Many plans have reduced their inflation assumptions in recent years, and the median assumption of 3.25 percent is lower compared to last year by 0.25 percent.

Figure M: Distribution of inflation assumptions as of December 2011



For the 25-year period ended June 2010, the average rate of inflation, based on the most-recognized inflation indicator published by the U.S. Bureau of Labor Statistics, was 2.95 percent.^{xi}

Figure N: Distribution of nominal investment return assumptions as of December 2011

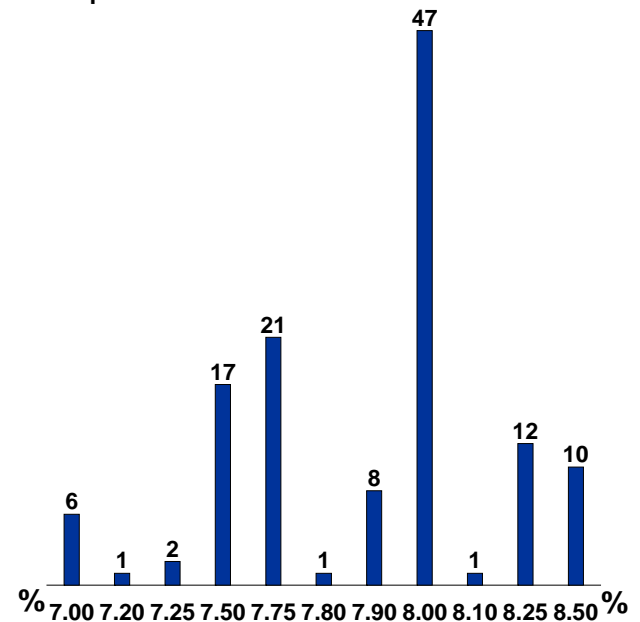
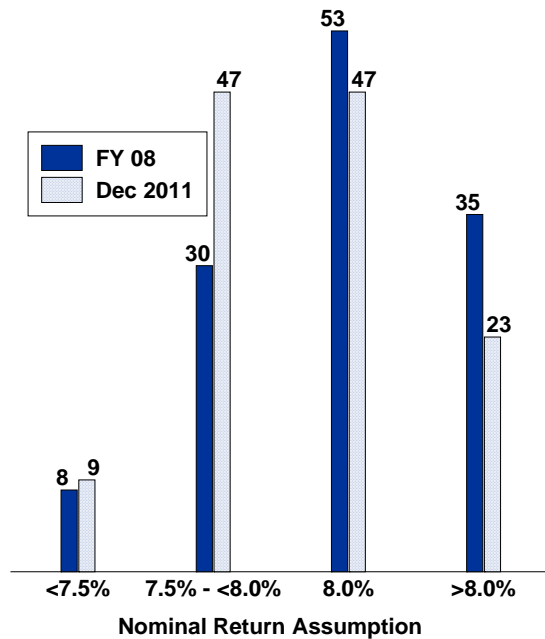


Figure N plots the distribution of nominal (non-inflation-adjusted) investment return assumptions, including all changes made through calendar year 2011. Many plans have reduced their investment

return assumption in recent years, although the median and modal assumption remains 8.0 percent.

Public pension plan investment return assumptions have received growing attention recently, especially in the wake of investment returns over the past decade that have fallen short of expectations. As shown in Figure O, some plans have reduced their investment return assumption since the end of FY 08.

Figure O: Changes in distribution of investment return assumptions as of December 2011



As the chart shows, the number of plans with assumed returns of 8.0 percent or higher has dropped from 88 of 126 plans at the end of FY 08, to 70 plans as of December 2011.

Conclusion

The decline in public pension funding levels, triggered chiefly by market declines in 2008-09, is expected to continue through 2013. This decline continues to serve as the primary catalyst for plan changes made by many states and other pension plan sponsors. These changes have retained the core elements of public pension plans and are intended to reduce employer (taxpayer) costs. Changes such as these are likely to continue to be made until state and local fiscal conditions improve.

Notwithstanding a difficult operating environment featuring struggling investment markets, criticism of public employees and their benefits, and a challenging fiscal condition facing states and cities, most public retirement systems strive to maintain sound management and governance practices, and seek opportunities to continuously improve in those areas.

End Notes

- ⁱ Center for Retirement Research, “The funding of state and local pensions: 2009-2013” April 2010
- ⁱⁱ Robert Klausner, for NCPERS, “State constitutional protections for public sector retirement benefits,” March 2007
- ⁱⁱⁱ Wall Street Journal, “A Nation of Helen Thomases,” June 11 2010
- ^{iv} US Bureau of Labor Statistics, “Retirement Benefits: Access, participation, and take-up rates,” March 2011
- ^v U.S. Bureau of Labor Statistics, National Compensation Survey, March 2010
- ^{vi} National Institute on Retirement Security (Almeida, Fornia), “A Better Bang for the Buck,” August 2008
- ^{vii} Center for Retirement Research at Boston College, “How Would GASB Proposals Affect State and Local Pension Reporting,” November 2011
- ^{viii} U.S. Census Bureau, “State and Local Government Employee Retirement Systems,” October 2011
- ^{ix} U.S. Bureau of Labor Statistics, “Current Employment Statistics Highlights,” November 2011
- ^x Government Accountability Office, “State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits,” January 2008
- ^{xi} Bureau of Labor Statistics, CPI-All Urban Consumers

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