

Improved U.S. State Pension Funding Levels Could Be On The Horizon

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Although U.S. state pension funding levels fell slightly in fiscal 2005, signs are pointing to a possible easing of pressures related to prior escalations in contribution rates. There is also reason to believe that funded ratios could stabilize and improve over the medium term if investment returns and liability growth meet expectations.

According to Standard & Poor's Ratings Services' current survey of fiscal 2005 data, the mean funded ratio for the principal state pensions was 81.8%, compared with 83.5% in fiscal 2004. The funded ratio, or actuarial value of assets divided by the actuarial accrued liabilities (AAL), is one measure of the health of a pension fund. For public pension funds, this measure has fallen dramatically from 2000, when average levels exceeded 100%. Above-average investment returns generated by pension funds over the past few years, however, could make this latest decline in funded ratios an only temporary setback.

The fiscal 2005 survey includes the principal state pension funds, which are generally composed of two major plans: (1) a public employees retirement system, including employees from both the state and municipal jurisdictions, and (2) a teachers retirement system. In some cases, a state could simply have one large plan covering all government workers; in other cases, it may sponsor a third significant plan. The pension liability statistics cited in this report are largely as of fiscal 2005, the latest year with substantially complete data available.

Rating Perspective

The status of an employer's pension plans is an important factor in Standard & Poor's state ratings analysis. States face a variety of ongoing and chronic cost pressures that at any point could weaken their ability to meet bond debt service requirements—and potentially have a negative effect on credit. Pension obligations, which are debt-like in nature, fall into this category. Therefore, pension liabilities—which include ongoing, annual servicing requirements

in the form of contributions from employers—must be managed in a way that does not adversely affect the state’s credit profile.

State Pension Funding History

State pension funding ratios made strong gains in the 1990s, averaging more than 100% by 2000 compared with roughly 80% a decade earlier. Above-average investment returns, particularly from equities, contributed to this rapid increase. From 1990-2000, the average annual increase of the S&P 500 Index of domestic equities was 15% compared with an average actuarial return assumption of about 8%. Public pension fund allocations to domestic equity rose to about 60% from 40% over the same time period. This combination of factors, coupled with strong fixed-income returns, enabled public funds to exceed their investment return assumptions and achieve the actuarial gains that led to the dramatically improved funded ratios.

In the first part of this decade, however, the funded ratio climate shifted quite rapidly when pension funds suffered a number of setbacks. In terms of investment yields, the S&P 500 fell 16% in fiscal 2001 and another 19% in fiscal 2002. In addition, and in conjunction with falling asset values, a number of factors led to upward pressure on liabilities, including demographic changes such as members living longer and the phasing in of previously granted benefit enhancements. Not surprisingly, the combination of these negative effects on assets and liabilities resulted in average state pension funding levels falling to 83.5% as of June 30, 2004, from their previous high point four years earlier. The fiscal 2005 survey reports a further decline in funded ratios to 81.8% despite solid investment returns on a market value basis. One possible explanation for this occurrence is that in fiscal 2005, with the five-year smoothing of asset values used by most public funds, the earlier investment losses of 2001 and 2002 were still acting as a brake on the actuarial value of assets.

Contribution Rates Are Easing

Another important measure related to public pension funds is reflected in the trend in employer contribution rates (employee rates tend to remain at a fixed level), which can cause budget pressures. A collection of U.S. Census data on public pension funds compiled by the National Association of State Retirement Administrators (NASRA) suggests that the rapid increase in employer rates experienced earlier in the decade may have been reversed in 2005. According to NASRA’s findings, average employer contribution rates fell between fiscals 1998 and 2002, then subsequently rose by almost 50% in fiscals 2003 and 2004 following the effectiveness of actuarial losses. Despite large investment losses in 2001 and 2002, employer contribution rates fell in those years due to the lags (such as asset smoothing and other factors) built into the actuarial models. The jump in rates in 2003 and 2004—even though investment returns improved—again reflected the effects of actuarial assumptions and methods. The NASRA data show employer rates easing again in 2005, however, declining by about 7%. This provides a degree of budgetary relief.

Pension Liabilities And Debt

The table below displays selected pension and debt information for each state. The data are mainly as of fiscal 2005, which is the most recent year with substantially complete data available. The pension data are combined for the principal, state-sponsored, defined-benefit pension funds: generally the public employees retirement system, including state and local employees in most cases, plus the teachers

retirement system. In some cases, a state may have just one combined system for all employees, while others may have a third significant system that is included in several cases. State sponsors have varying degrees of responsibility in relation to the funding of these pension plans. For example, in the case of multi-employer agent systems, the state would make contributions to plans that include its employees only, with local agencies contributing to their respective plans. For multi-employer cost-sharing systems, which can include a number of local jurisdictions like school districts with contributions from both employers and employees, the state may be a nonemployer contributor. Therefore, with some exceptions, states are generally not directly responsible for the full liabilities of these pension systems.

The pension information includes the systems' funded ratio for each state and the unfunded AAL (UAAL); the UAAL is also expressed on a per capita basis. Tax-supported debt is shown for each state in total as well as on a per capita basis. Pension and debt figures are combined on a per capita basis and then expressed as a percent of per capita income as a measure of resources to meet these obligations.

Compared with fiscal 2000, when an average state pension fund had little or no unfunded liabilities (with the exception of certain historically weak plans), the gross UAAL had increased to about \$330 billion as of fiscal 2005 from \$284 billion in 2004. On a state-by-state basis, the mean UAAL per capita equaled \$1,378 in 2005, compared with \$1,183 the prior year. State debt rose to \$313.5 billion in 2005 from \$288 billion in 2004, while 2005 mean state debt was \$933 per capita, compared with \$867 a year earlier. When evaluating the debt structure of state and local governments, Standard & Poor's does not add the UAAL in with other debt in its presentation of debt statistics. Because of its debt-like aspect, however, the UAAL factors into the analysis as an additional long-term liability. The total per capita UAAL and tax-supported debt mean for this survey was \$2,310, up from the prior-year level of \$2,050. In relation to the resources available to service these requirements, this measure divided by per capita income had a mean of 6.8% in 2005 compared with 6.3% in 2004.

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State Retirement System And Debt Statistics: 2005

<i>State</i>	<i>GO rating</i>	<i>Funded ratio (%)</i>	<i>UAAL (mil \$)</i>	<i>UAAL PC (\$)</i>	<i>Total debt (mil \$)</i>	<i>Debt PC (\$)</i>	<i>Debt PC + PCUL (\$)</i>	<i>PC income (\$)</i>	<i>Debt PC + PCUL/PC income (%)</i>
Alabama	AA	83.4	4,827	1,059	2,245	493	1,552	29,136	5.3
Alaska	AA	63.9	4,123	6,212	1,327	2,000	8,212	35,612	23.1
Arizona	AA (ICR)	85.2	4,251	716	2,975	501	1,217	30,267	4.0
Arkansas	AA	80.8	3,191	1,148	607	218	1,367	26,874	5.1
California	A+	86.7	46,932	1,299	53,212	1,473	2,772	37,036	7.5
Colorado	AA- (lease)	73.2	12,448	2,668	61	13	2,681	37,946	7.1
Connecticut	AA	58.3	14,801	4,217	9,900	2,820	7,037	47,819	14.7
Delaware	AAA	101.6	(87)	(104)	1,830	2,169	2,066	35,861	5.8
Florida	AAA	107.3	(7,614)	(428)	17,455	981	553	33,219	1.7
Georgia	AAA	100.1	(79)	(9)	6,882	759	750	31,121	2.4
Hawaii	AA	68.6	4,071	3,193	4,253	3,335	6,528	34,539	18.9
Idaho	AA- (lease)	93.5	570	399	212	148	547	28,158	1.9
Illinois	AA	58.4	31,340	2,455	25,566	2,003	4,459	36,120	12.3
Indiana	AA+ (ICR)	66.5	8,384	1,337	2,376	379	1,716	31,276	5.5
Iowa	AA+ (ICR)	88.7	2,289	772	359	121	893	32,315	2.8
Kansas	AA+ (ICR)	68.8	5,152	1,877	460	168	2,045	32,836	6.2
Kentucky	AA- (ICR)	78.9	7,239	1,735	3,423	820	2,555	28,513	9.0
Louisiana	A	63.5	10,791	2,385	3,311	732	3,117	24,820	12.6
Maine	AA-	76.0	2,802	2,120	753	570	2,690	31,252	8.6
Maryland	AAA	88.7	4,315	771	5,892	1,052	1,823	41,760	4.4
Massachusetts	AA	73.0	12,945	2,023	16,050	2,508	4,531	44,289	10.2
Michigan	AA	79.4	12,498	1,235	5,826	576	1,811	33,116	5.5
Minnesota	AAA	87.3	4,317	841	3,565	695	1,536	37,373	4.1
Mississippi	AA	72.4	6,546	2,241	3,099	1,061	3,302	25,318	13.0
Missouri	AAA	83.2	6,378	1,100	2,634	454	1,554	31,899	4.9
Montana	AA-	78.3	1,570	1,678	213	228	1,906	29,387	6.5
Nebraska	AA+ (ICR)	85.6	899	511	43	24	536	33,616	1.6
Nevada	AA+	75.6	5,722	2,370	975	404	2,773	35,883	7.7
New Hampshire	AA	66.4	2,011	1,535	532	406	1,941	38,408	5.1
New Jersey	AA	87.0	11,980	1,374	24,410	2,800	4,174	43,771	9.5
New Mexico	AA+	81.2	4,047	2,099	1,970	1,022	3,120	27,644	11.3
New York	AA	99.7	561	29	40,128	2,084	2,113	40,507	5.2
North Carolina	AAA	106.5	(3,046)	(351)	6,438	741	391	30,553	1.3
North Dakota	AA (ICR)	81.3	621	975	245	385	1,360	31,395	4.3
Ohio	AA+	79.7	29,793	2,599	8,470	739	3,338	32,478	10.3

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State Retirement System And Debt Statistics: 2005 (cont. 'd)

<i>State</i>	<i>GO rating</i>	<i>Funded ratio (%)</i>	<i>UAAL (mil \$)</i>	<i>UAAL PC (\$)</i>	<i>Total debt (mil \$)</i>	<i>Debt PC (\$)</i>	<i>Debt PC + PCUL (\$)</i>	<i>PC income (\$)</i>	<i>Debt PC + PCUL/PC income (%)</i>
Oklahoma	AA	56.9	9,933	2,800	1,031	291	3,090	29,330	10.5
Oregon	AA-	104.2	(2,089)	(574)	5,492	1,508	935	32,103	2.9
Pennsylvania	AA	86.6	12,065	971	10,102	813	1,783	34,897	5.1
Rhode Island	AA	59.4	3,786	3,518	1,601	1,488	5,005	36,153	13.8
South Carolina	AA+	80.3	5,115	1,202	2,631	618	1,820	28,352	6.4
South Dakota	AA (ICR)	96.6	191	246	189	244	489	31,614	1.5
Tennessee	AA+	98.7	366	61	1,213	203	265	31,107	0.9
Texas	AA	88.5	14,330	627	4,604	201	828	32,462	2.6
Utah	AAA	92.2	1,101	446	1,862	754	1,200	28,061	4.3
Vermont	AA+	93.8	164	263	489	785	1,048	33,327	3.1
Virginia	AAA	90.3	4,267	564	5,748	760	1,323	38,390	3.4
Washington	AA	73.8	6,441	1,012	10,583	1,663	2,676	35,409	7.6
West Virginia	AA-	47.1	5,660	3,115	1,542	849	3,964	27,215	14.6
Wisconsin	AA-	99.5	372	67	8,725	1,576	1,643	33,565	4.9
Wyoming	AA (ICR)	95.1	248	487	0	0	487	36,778	1.3
Mean		81.8	6,371	1,378	6,270	933	2,310	33,418	6.8
Median		82.3	4,259	1,124	2,633	740	1,822	32,657	5.4

Note: The pension fund data for most states include the two principal state-sponsored retirement systems (i.e. public employees and teachers) or, in a few cases, a third large system. For 19 states, the data represent a single, all-inclusive system. UAAL—Unfunded actuarial accrued liability. UAAL PC—Unfunded actuarial accrued liability per capita. Debt PC—Debt per capita. PCUL—Per capita unfunded liability. ICR—Issuer credit rating.

(To compare the above data with results from last year, please see “Rising U.S. State Unfunded Pension Liabilities Are Causing Budgetary Stress.”)

OPEB Liabilities: Another Retirement Issue

The funding of other postemployment benefits (OPEB) is another factor related to the total long-term liability landscape facing state and local governments that has received a higher profile lately. This is due to the imminent implementation of new GASB 45 accounting rules for OPEB reporting and the rapidly increasing costs related to medical inflation rates. OPEB benefits, largely attributable to retiree health care, have traditionally been accounted for on a pay-as-you-go basis. Now, under GASB 45, they will be treated on an accrual basis, similar to pension liabilities.

GASB 45 will bring greater transparency to the financial disclosure surrounding retiree health care. Employers will be required to have an actuarial valuation completed to determine the OPEB liability and the annual required contribution. The new reporting will provide important information on future cash flow requirements for the employer. For governments with fiscal years that end in June, reporting under this statement will be required beginning in fiscal 2008.

Although GASB 45 does not change the nature of these pre-existing retiree health care liabilities, it is causing states, as employers, to focus on this issue and develop plans for managing these obligations under the new reporting environment. Management will have to ascertain whether or not it can either: (1) prefund these liabilities, in the same manner that pension obligations are treated, from both economic and political viewpoints; (2) continue down the pay-as-you-go path; or (3) arrive at some middle ground. The GASB 45 analysis by employers may include options to lower plan liabilities by

changing benefit levels, among other alternatives. The majority of employers are still in the development stages of determining what their exact OPEB liability is—as well as what their options are to mitigate its effects.

Standard & Poor's believes that, with or without the prefunding of OPEB liabilities, most employers will be able to continue to meet their ongoing OPEB cost requirements without any near-term effect on credit quality.

Pension Liability Outlook

If we look at prospective public pension funding levels from the standpoint of one key variable—investment return performance—recent investment results would suggest that the funding climate should improve. With actual market returns exceeding investment return assumptions, on average, for the past three fiscal years, we should see an increase in the actuarial value of assets in fiscal 2006. If the growth in benefit liabilities does not exceed expectations, the trend in funded ratios should stabilize or even begin to rise modestly. Because about 60% of large public funds use five-year smoothing to value assets, the investment losses from 2002 will still be taking their toll on the June 30, 2006, actuarial valuations. It is only after fiscal 2006 that funds will be fully out of the woods from this drag on assets.

The risks to stabilization or improvement in pension funding in fiscal 2007 and beyond include the list of usual suspects affecting assets and liabilities. On the asset side, of course, is the uncertainty of future investment returns. Any shortfall compared with the assumed rate will create additional actuarial losses. Assets would also be adversely affected if less than the full annual required contributions are made. Regarding investment returns, some systems have lowered their investment rate of return assumption, either toward or below 8%, with the effect of increasing liabilities. On the liability side, any benefit increases would increase liabilities. Demographic changes could boost liabilities to the extent that longevity continues to increase and as known or anticipated mortality experience is reflected in the actuarial models.

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