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U.S. States Weigh Risk Reduction In Managing Pension And OPEB Liabilities

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Key Takeaways

- The average U.S. state funded ratio decreased for fiscal 2020 to 68.9% from 70.9% primarily due to market returns during the pandemic-induced recession; however, we expect funded levels will improve for many plans in fiscal 2021 given generally strong market returns to date.
- Fourteen U.S. states met our minimum funding progress metric for pensions, indicating they made meaningful contributions toward full funding.
- States continue to reduce market risk exposure in their target portfolios, leading to lower discount rates and higher reported liabilities.
- State retirement plans benefited indirectly from historic levels of federal aid during the pandemic, but large unfunded liabilities persist.
- Retiree health care plans remain substantially underfunded because most states direct limited resources to other priorities.

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The COVID-19 pandemic created uncertainty across U.S. states' budgetary landscapes in fiscal 2020, disrupting progress made in the preceding economic expansion to fund retiree pension and medical benefits. As revenue forecasts plummeted, states scrambled to manage their budgets with lower-than-anticipated resources. Most states, in a financial pinch, prioritized contributions to pension plans over other postemployment benefits (OPEB) plans, given the typically stronger legal protections for pension benefits. While some uncertainty persists, pandemic-driven budgetary challenges have generally settled in 2021 thanks to significant federal aid, vaccine rollout, and an uptick in economic activity.

S&P Global Ratings anticipates this return to stability will allow states to refocus attention on addressing their growing unfunded retirement liabilities. We expect states' reduced appetite for risk over the past decade will continue, translating into further reductions in the discount rate for pensions over time. Although we expect most states will continue to direct limited resources to priorities other than OPEBs, those with large unfunded retiree medical liabilities could face more pressure to act as the budgetary impact increases. In our view, contribution volatility poses greater risk to states with high fixed costs and limited budgetary flexibility.

Fiscal 2020 Annual Survey Results Of State Pension And OPEB Funding

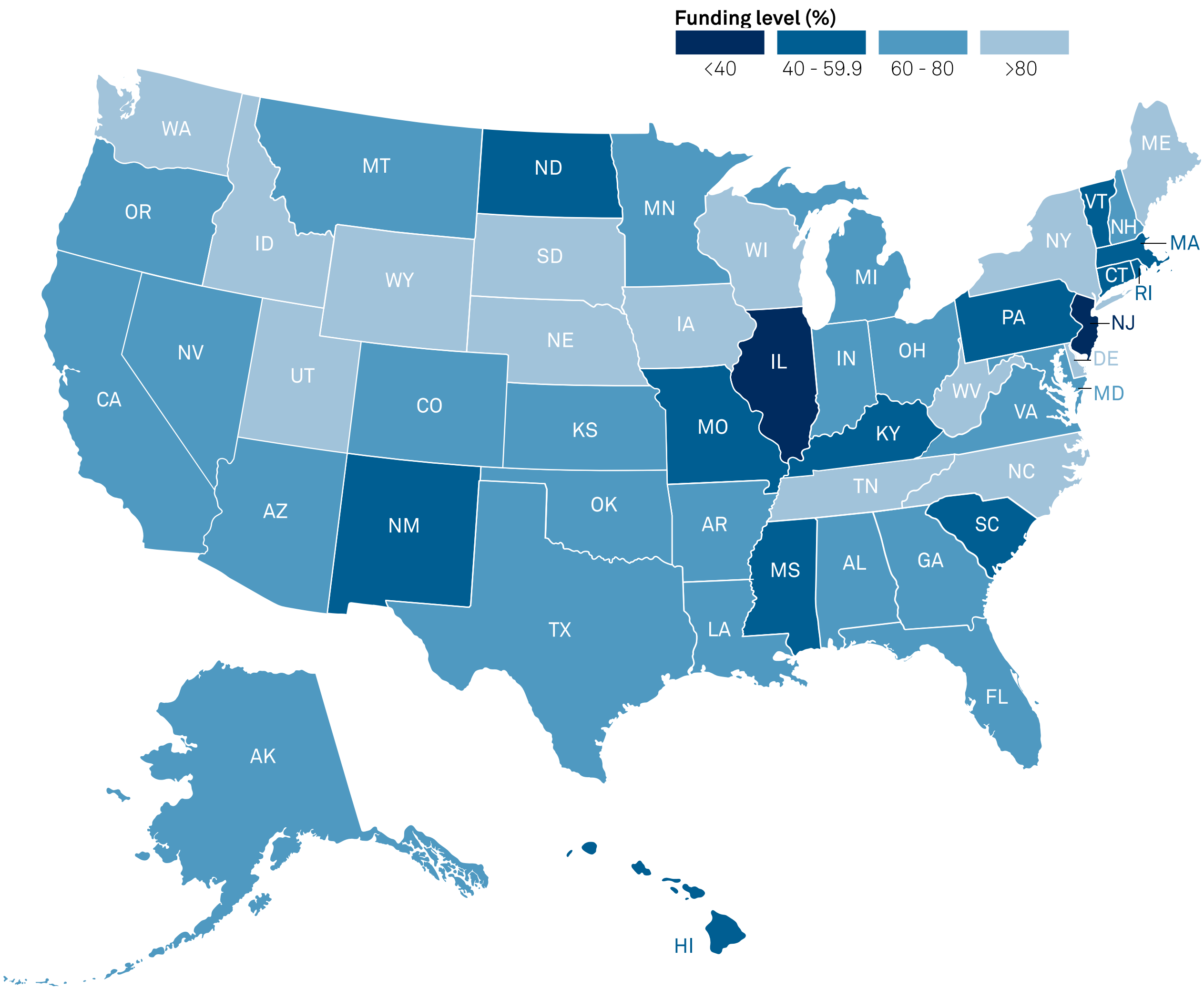
Overall, in fiscal 2020, states' pension funded levels declined slightly and retiree health care liabilities continued to grow.

Pension funded levels decreased slightly in fiscal 2020 due to the pandemic-induced recession, with expected improvement in fiscal 2021.

S&P Global Ratings' annual state pension survey found most state pension systems reported a slight dip in funded levels in fiscal 2020, mainly due to weaker investment returns as of June 30, 2020, stemming from the pandemic-induced recession. The fiscal 2020 median reported funded ratio of 68.9% for states was down slightly compared with 70.9% in fiscal 2019, and 72.5% in fiscal 2018 (see table for state-by-state details). Despite the slight decline in funded ratios, and in part contributing to them, some states continued to focus on improving funding discipline through more conservative market return assumptions with the intent to decrease contribution volatility. We estimate reported funded levels for many pension plans will improve in fiscal 2021 given generally strong market returns to date.

Chart 1

Aggregate U.S. State Funded Ratios For 2020 - Pension



Source: S&P Global Ratings.

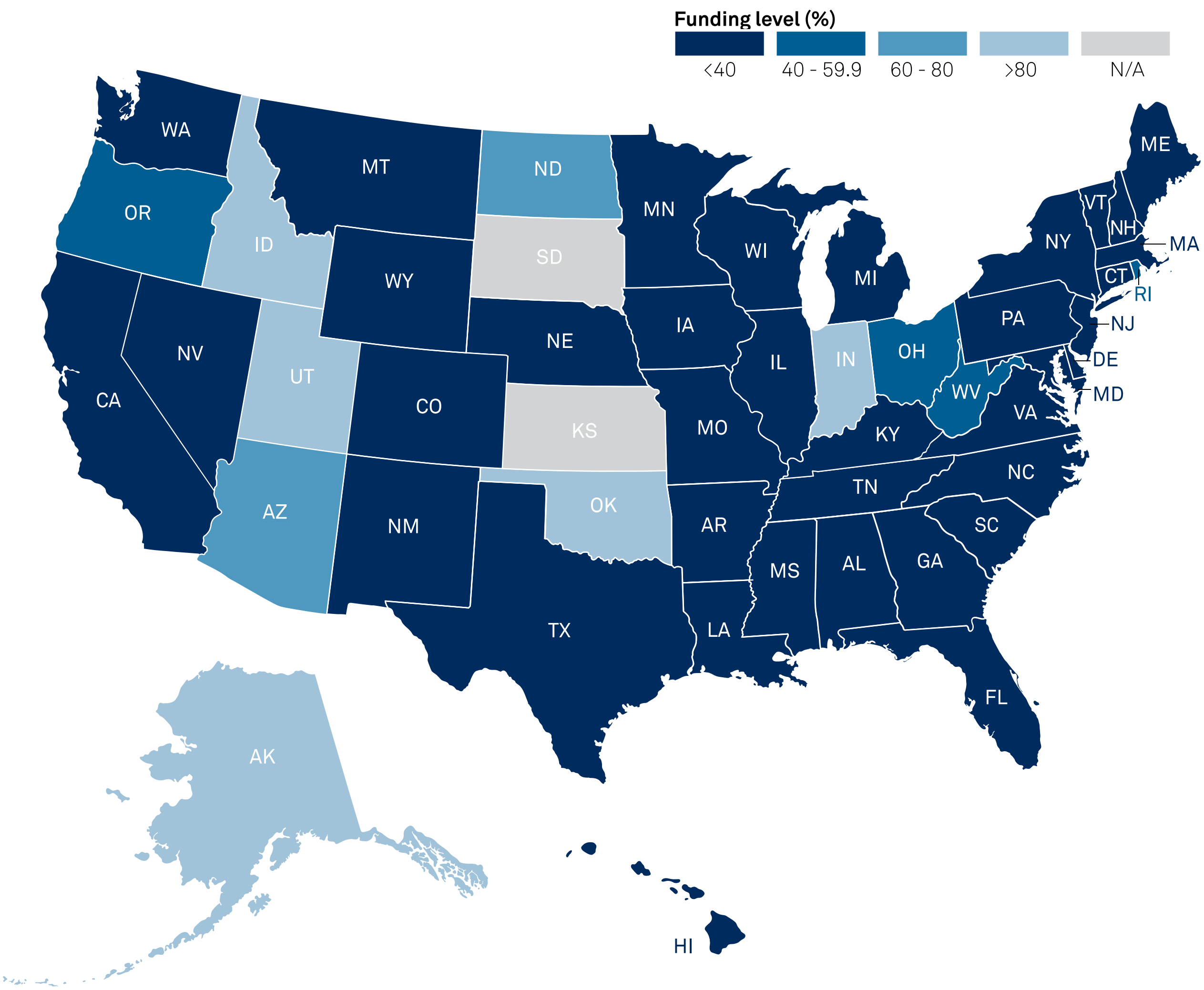
The OPEB funding survey results show growth in unfunded retiree health care liabilities.

Our survey found that states continued to sharply underfund their OPEB plans as reported aggregate unfunded liabilities ticked upward in fiscal 2020. Across the 48 states that report a liability for retiree medical benefits, the aggregate proportionate share of the net OPEB liability (NOL) rose by 5.2% to $557 billion. Among the states with funded ratios below 40%, 29 were below 10% funded, with 13 states having no prefunding at all.

During the economic expansion preceding the pandemic few states pursued and implemented reforms aimed at reducing growing unfunded OPEB liabilities as they diverted finite resources elsewhere. This trend continued during the pandemic and we expect it will persist even as budgets stabilize because states have historically underfunded their OPEBs. Therefore, we expect annual OPEB costs will increase absent meaningful efforts to prefund or reduce these liabilities. Our credit analysis for states with large unfunded liabilities includes legal and practical flexibility for reducing costs; we typically view states with limited flexibility and no progress toward prefunding to be lacking a meaningful funding plan.

Chart 2

Aggregate U.S. State Funded Ratios For 2020 - OPEB



Note: Kansas and South Dakota do not report even an implicit liability for retiree health care benefits so are excluded from this chart.
Source: S&P Global Ratings.

Pension And OPEB Affordability Is A Key Factor In A State's Creditworthiness

We consider pension and OPEB affordability a key credit risk for state credit quality. We factor this view into our analysis by considering contribution direction and sufficiency. In addition to analysis of the actuarial contribution, if one is made, we consider two funding metrics based on contributions made in the previous year:

- Static funding: An amount that if contributed every year, would neither reduce nor improve the funded ratio; and
- Minimum funding progress (MFP): An amount that includes an addition to static funding that we consider reasonable progress for a given year.

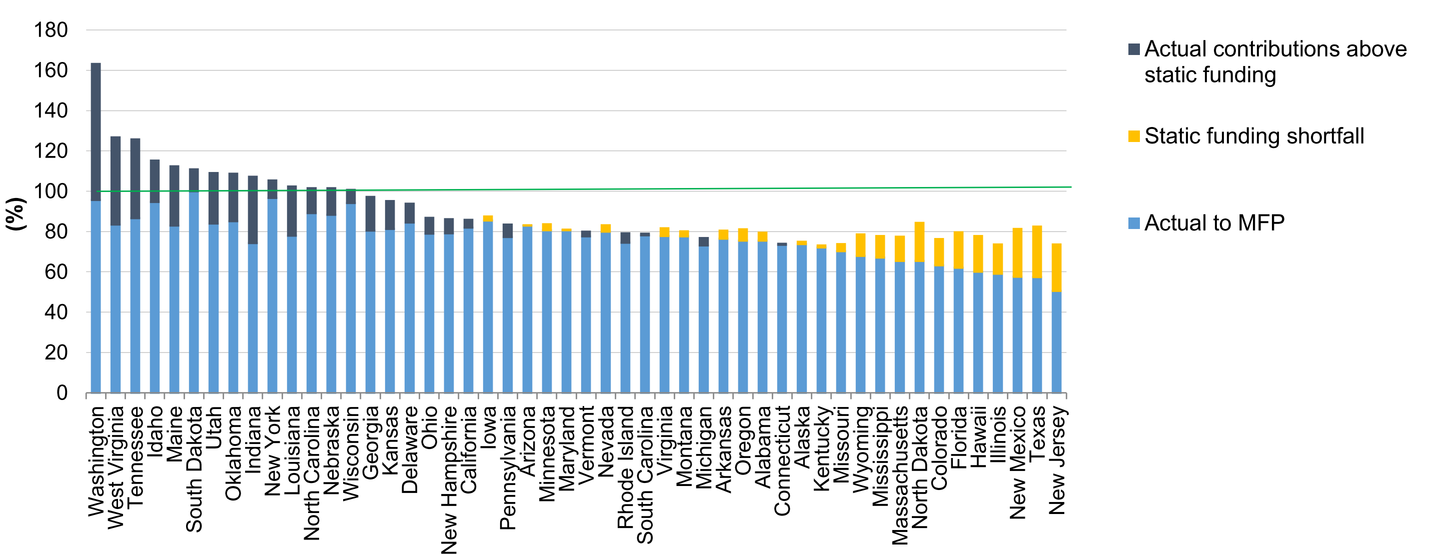
Chart 3 compares total annual plan contributions to these metrics for pension plans. The chart reveals that, on the whole, plan contributions for 14 states met or exceeded our minimum funding progress guideline for the most recently reported year, a decline from 15 the previous year. States that consistently show strong progress in meeting our MFP metric are also typically those with the highest funded ratios.

Typically, states that consistently meet our MFP metric also have the highest funded ratios.

In fiscal 2020, 26 states met the static funding threshold, up from 24 the previous year. Even for states that maintain a track record of funding at actuarially determined levels, total plan contributions can still fall short of levels necessary to make progress on paying down the long-term liability for a given year. This typically happens when the methods used to calculate actuarially determined contributions assume significant growth in payroll over a long amortization.

Chart 3

State Pension Plan Aggregate Actual Contribution Funding Progress



MFP--Minimum funding progress.

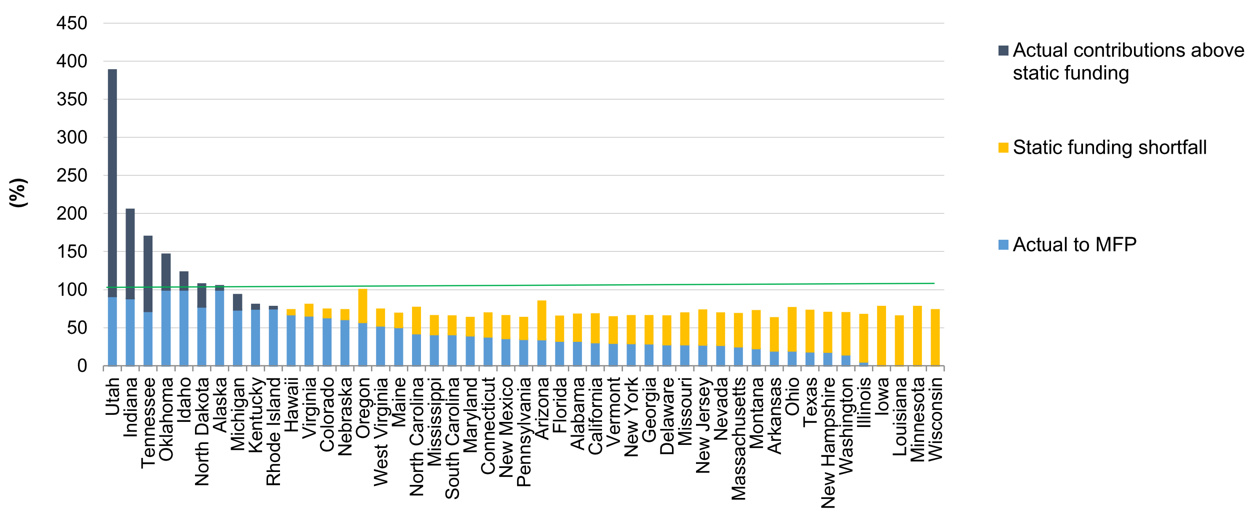
Most states continue to fund their OPEB liabilities on a pay-as-you-go (paygo) basis in which annual funding is equal to the benefits distributed; assets are not set aside in advance to pay benefits in the future. Our survey found that combined annual plan contributions do not cover static funding for nearly 80% of the states surveyed. States in which funding consistently falls below static funding levels will likely report escalating unfunded OPEB liabilities in future years if benefit reforms are not implemented. Of the 10 states that reached static funding levels, seven (15% of the states surveyed) met our MFP guideline, indicating a wide gap between the few states that fund OPEB benefits and the majority that don't.

Chart 4 compares total annual plan contributions to the static funding and MFP metrics above for OPEB plans. OPEB plan funding shows a stark contrast to funding for state pension plans. In our view, the strict legal requirements for funding many pension plans, which do not exist for most OPEB plans, are largely responsible for this funding differential.

While we recognize it will likely be difficult for states to divert scarce resources to unfunded retiree health care liabilities, we believe that, on the whole, a continued lack of funding OPEB obligations indicates poor plan management, which exposes state governments to rising unfunded liabilities, fixed costs, and budgetary pressure over time. States contributing more than a paygo amount toward these obligations are likely to reduce contributions for budgetary relief. If legally permissible, benefit design changes might also be considered to reduce annual costs.

Chart 4

State OPEB Plan Aggregate Actual Contribution Funding Progress



Note: Kansas and South Dakota do not report even an implicit liability for retiree health care benefits. California's trial courts plan is excluded from our calculation of static funding and minimum funding progress because the state does not disclose schedule of changes to the net OPEB liability (NOL) for the 50 trial courts reported as a part of the primary government in its annual comprehensive financial report. Wyoming is exlcuded from our calculation of static funding and minimum funding progress because a schedule of changes to the NOL was not publicly available. OPEB--Other postemployment benefits. MFP--Mimimum funding progress.

States' Declining Market Risk Tolerance Could Lead To Improved Funding Progress

We expect that states' reduced appetite for market and contribution volatility risks over the past decade will continue, translating into further reductions in the discount rate for pensions over time. Although future reductions in plan discount rates will likely lower corresponding funded ratios and increase cost, we expect overall funding discipline will improve as risk exposure is reduced, for plans that receive contributions based on actuarial recommendations. We believe many plans will choose to pursue incremental discount rate reductions at a pace that allows states budgets to absorb the increase in required contributions. Several states have even tied discount rate reductions to market gains to soften the blow of cost increases; as a result, we anticipate some states might decrease their discount rates to less aggressive levels following high investment returns achieved in fiscal 2021.

We believe this improvement in funding discipline, although it worsens some metrics initially, would positively affect funded levels in the future, if maintained. In our view, changes to actuarial assumptions that might reduce funded ratios generally show a more conservative assessment of market risk tolerance for individual states, thus better enabling them to make funding progress. States that have proactively reduced pension plan discount rates, increased liquidity, and adopted other conservative assumptions have better positioned themselves to manage contribution volatility. This stands in contrast to OPEB plans in which states have made little progress toward benefit reforms or contribution increases.

Although Significant Federal Aid For Pandemic Recovery Prohibits Pension Paydown, Plans Benefit Indirectly

On March 11, 2021, the federal government approved unprecedented levels of aid to state governments to quell the far-reaching economic and financial effects of the pandemic. While allocations from the American Rescue Plan Act (ARP) are allowed for a variety of uses including capital projects for water, sewer, and broadband infrastructure, states are expressly prohibited from depositing these dollars into their pension funds. Despite this restriction, we believe state retirement plans still indirectly benefit from the influx of ARP funding since these dollars have provided stability to revenue-pressured budgets and enabled states to continue making full and timely contributions to their pension plans. For more information on states' fiscal 2022 budgets, see "Federal Aid Helps Lift The Cloud Over U.S. State Budgets," published on April 29, 2021, on RatingsDirect.

In our view, federal aid has supported some states with significant fixed costs by increasing those states' budgetary flexibility to offset other pandemic-related operating costs and direct excess general fund resources toward management of long-term liabilities. For example, Connecticut--which we consider to have a high fixed-cost burden--benefitted from better-than projected revenue across all state sources and directed amounts in excess of its 15% statutory budget reserve fund cap to reduce the long-term pension liability in its State Employee Retirement Fund. With ARP and other federal pandemic relief funds expected through the fiscal 2022-2023 biennium, Connecticut projects an operating surplus and could make another supplemental contribution to pay down its unfunded pension liabilities. (For more information on Connecticut's credit profile, see our most recent analysis published May 13, 2021.)

Although utilization patterns will differ across states, ARP dollars may be spent through Dec. 31, 2024. We expect states that choose to use this one-time funding for recurring needs could face a structural challenge when ARP funds are exhausted, thereby pressuring fixed costs such as pensions and further challenging funding progress for OPEBs, which do not typically have the same legal protections.

States Pension And OPEB Liabilities And Ratios -- Fiscal 2020

	Proportionate state NPL (mil. $)	Aggregate pension funded ratio (%)	State NPL per capita ($)	Proportionate state NOL (mil. $)	Aggregate OPEB funded ratio (%)	State NOL per capita ($)
Alabama	3,801	66.5	772	2,692	13.8	547
Alaska	5,351	65.5	7,319	(544)	100.0	(745)
Arizona	5,772	67.3	778	1,178	66.7	159
Arkansas	2,300	80.0	759	2,844	0.0	938
California	69,152	71.0	1,757	93,513	1.9	2,375
Colorado	11,034	63.8	1,900	368	24.5	63
Connecticut	41,899	43.1	11,779	23,345	5.1	6,563
Delaware	1,712	85.1	1,735	9,360	4.3	9,486
Florida	9,356	74.5	430	14,418	0.4	663
Georgia	8,486	77.1	792	6,175	33.3	577
Hawaii	7,899	54.9	5,614	9,421	17.2	6,696
Idaho	591	89.1	323	(108)	88.1	(59)
Illinois	152,651	37.5	12,127	60,179	0.1	4,781
Indiana	11,407	64.0	1,689	54	81.1	8
Iowa	1,295	82.9	409	288	0.0	91
Kansas	10,245	66.3	3,516	0.0	N/A	0.0
Kentucky	26,518	44.6	5,923	3,009	36.3	672
Louisiana	7,571	63.6	1,630	7,798	0.0	1,679
Maine	2,668	81.2	1,976	2,190	14.8	1,622
Maryland	22,205	69.9	3,667	17,257	2.0	2,850
Massachusetts	47,366	56.3	6,871	20,691	6.4	3,002
Michigan	19,612	60.4	1,968	6,461	37.9	648
Minnesota	2,800	79.5	495	631	0.0	112
Mississippi	3,467	59.1	1,169	178	0.1	60
Missouri	7,359	55.5	1,196	2,988	5.1	486
Montana	3,037	67.9	2,811	74	0.0	69
Nebraska	340	86.6	175	15	0.0	8
Nevada	2,339	77.1	745	810	0.0	258
New Hampshire	942	65.6	689	1,886	0.4	1,380
New Jersey	96,860	38.4	10,905	65,492	0.2	7,373
New Mexico	9,620	50.0	4,567	1,045	16.4	496

States Pension And OPEB Liabilities And Ratios -- Fiscal 2020 (cont.)

	Proportionate state NPL (mil. $)	Aggregate pension funded ratio (%)	State NPL per capita ($)	Proportionate state NOL (mil. $)	Aggregate OPEB funded ratio (%)	State NOL per capita ($)
New York	13,201	90.2	683	77,776	0.0	4,022
North Carolina	2,800	86.7	264	5,368	7.8	506
North Dakota	1,643	55.4	2,147	42	63.4	55
Ohio	4,608	79.1	394	3,325	59.9	284
Oklahoma	3,349	73.9	841	(39)	100.0	(10)
Oregon	4,860	75.8	1,146	72	47.5	17
Pennsylvania	43,121	57.1	3,373	20,739	2.7	1,622
Rhode Island	3,492	54.2	3,303	367	49.5	347
South Carolina	14,176	51.7	2,717	13,818	8.4	2,648
South Dakota	(1)	100.0	(1)	-	N/A	0
Tennessee	960	92.0	139	1,641	18.5	238
Texas	76,262	67.5	2,597	68,208	2.2	2,323
Utah	737	91.7	227	19	94.3	6
Vermont	3,044	56.1	4,883	2,670	2.4	4,284
Virginia	8,525	71.8	992	1,505	32.3	175
Washington	575	95.3	75	5,800	0.0	754
West Virginia	3,457	80.8	1,937	1,281	43.5	718
Wisconsin	(893)	103.0	(153)	683	0.0	117
Wyoming	426	80.3	731.6	382	0.0	656
Median	4,734	69.0	1,413	2,038	5.1	527
Average	15,600	70	2,456	11,147	21.8	1,432

NPL--Net pension liability. NOL--Net OPEB liability. OPEB--Other postemployment benefits. N/A--Not applicable. Note: For most plans, data aligns with a state's 2020 fiscal year. For some plans, data aligns with a state's 2019 or 2021 fiscal years depending on data availability. Plans with calendar year-end reporting periods are incorporated within a state's respective fiscal year (for example, reports ended Dec. 31, 2019, are counted within a state's 2020 fiscal year). We exclude various OPEB plans that do not offer medical benefits. The majority of these benefits resulted in relatively small liabilities but these benefits are sizable for some states, such as Michigan. Kansas, and South Dakota, which do not report even an implicit liability for retiree health care benefits.

Survey Methodology

We derived our calculation of pension liabilities from pension and state annual comprehensive financial reports (ACFRs) reporting under Governmental Accounting Standards Board (GASB) 67 and 68 standards, GASB 67 consultant reports, and GASB 68 allocation reports currently available to us. We derived our calculation of OPEB liabilities from the most recent state ACFR, benefit plan ACFR, and benefit plan actuarial report currently available to us. In most cases, this corresponded with the state's 2020 fiscal year. For some plans, data aligns with the state's 2019 or 2021 fiscal years depending on data availability. Some states do not perform actuarial valuations for OPEBs as often as they do for pensions, so results may be measured as of an earlier year.

We have combined information across multiple pension plans for each state to calculate a state's aggregated plan net position to the total pension liability (pension funded ratio) and funding progress measures. The largest pension plan for a state is measured by its share of the state's aggregated net pension liability (NPL). We use cost-sharing, multiple-employer pension plan ACFRs or GASB 67 reports released within the state's fiscal year and use the state's proportionate share of plan liabilities to calculate its NPL. Given varying reporting dates between some plan ACFRs and state government ACFRs, we use plan reports measured within the respective state's fiscal 2020, except where noted.

We have combined multiple OPEB plans for each state into one combined funded figure. Our survey includes those OPEB plans that states disclose as a state obligation. We use the combined OPEB for multiple-employer plans when both state and local governments participate but we also disclose the state's combined NOL in our publishing table, which incorporates the state's reported proportionate share of the unfunded liability. For cost-sharing, multiple-employer plans where the state's proportionate share was not publicly available, we assumed the state has sole responsibility for the liability. Some states provide a general fund contribution to local teacher OPEB plans, and for these we have also included teacher OPEB. In most cases, we have not included public university systems' OPEBs, unless a state considers these a direct state responsibility or if they are not reported separately from the state's cost-sharing, multiple-employer plan.

All states have released an ACFR using GASB 68 reporting standards, which incorporates disclosure on the state's proportionate share of cost-sharing pension plans. To estimate respective shares of the pertinent cost-sharing plans' NPL, we use the reported proportionate share disclosed in the states' most recent ACFRs or plan GASB 68 allocation reports. Although most state ACFRs report their proportionate share of respective cost-sharing plan NPLs with a one-year lag, we assume the reported percentage share is applied to fiscal 2020 plan NPLs. In deriving the estimated state portion of the liability for some cost-sharing, multiple-employer plans, we include a portion of plan liabilities in addition to those reported in the state's ACFR if we expect the state will likely continue to make pension contributions on behalf of other plan employers, even if such contributions are not legally required or do not flow directly to the plan.

Most states' single or agent employer plans are relatively small and updated GASB reported information is available only as of fiscal 2019 in their fiscal 2020 ACFRs. Given the relative size of these plans, if updated information is not available for fiscal 2020, we carry forward fiscal 2019 NPLs to fiscal 2020 to maintain relative comparability between years.

At the time of this report, a 2020 state ACFR was unavailable for California and Iowa. For Iowa, however, a preliminary version of the ACFR was released and is incorporated into this report. For states with plan reporting periods that align with a calendar year-end, we used reports ended Dec. 31, 2019.

Charts 3 and 4 use the following calculation across all state plans to estimate annual plan funding progress: Total employer and employee plan contributions ÷ the sum of service cost + total interest cost x (1 - average plan funded ratio) + (beginning plan NPL ÷ 30). (See "U.S. State Ratings Methodology," published Oct. 17, 2016, paragraph 71, table 27, and glossary.) If the aggregate beginning unfunded pension or OPEB liability across plans is negative, beginning plan NPL ÷ 30 would be treated as zero. Likewise, for funded ratios at or above 100% in fiscal 2020, the interest cost factor would be zero.

Related Research

- Federal Aid Helps Lift The Cloud Over U.S. State Budgets, April 29, 2021
- Pension Spotlight: Risk Sharing Dilutes Pension Burden For Five States, April 21, 2021
- State, Local Government, School District, And Charter School Sector Views Revised Back To Stable, March 24, 2021
- Five U.S. State And Local Government Pension And OPEB Trends To Watch For In 2021 And Beyond, Jan. 25, 2021
- Guidance: Assessing U.S. Public Finance Pension and Other Post Employment Obligations for GO Debt, Local Governments GO Ratings, and State Ratings, Oct. 7, 2019 (updated July 21, 2020)
- Retiree Medical Benefits Generate Unique Cost Drivers And Risks For U.S. States, Sept. 17, 2019
- OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility, May 22, 2019

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