Before the recent downturn in the economy, pension plans sponsored by state and local governments had done a pretty good job of setting aside money to “prefund” benefits that will be owed to current and future retirees. But since the recent drop in the stock market, many pensions find 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 they are? What’s the solution for filling the gap?

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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

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 will be manageable. On average, gaps can be filled in 30 years if total contributions increase by just 2.2% of payrolls.
- 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.”
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 need to be paid out in the form of pension benefits.

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 which will eventually pay out $100 billion in benefits, but which has $90 billion in assets on hand. The funding gap is $10 billion ($100 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 the two 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. Many experts find that a funding level of 80% or more is just fine for most public plans.

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 a number of years—governmental accounting standards permit a pay-down period of up to thirty years. 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 too. 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 85.3% in 2008.

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.

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. 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 2008, six out of ten pension plans received the full ARC or something close to it—but that means that contributions to four in ten plans were inadequate.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. For example, if the plan is able to continue to pay promised benefits and the plan sponsor (employer) 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 is a lack of funding discipline. Even before the stock market downturn, many of those plans that did not receive proper funding year to year were experiencing problems. 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.

For most states and localities, filling funding gaps will be manageable. Researchers at Boston College project that if total contributions increase by just 2.2 percent of payrolls, state and local governments can pay off the total unfunded liabilities in 30 years.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.⁹ Returning to the mortgage analogy, any balance on the mortgage does not vanish simply because you move out of your house—what is past 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 due to three reasons. First, maintaining two plans is more expensive than operating just one, because of the additional administrative costs associated with running a second

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traditional, group-based pensions (defined benefit plans) are associated with several economic efficiencies that defined contribution plans based on individual accounts cannot duplicate; forgoing these efficiencies drives up retirement plan costs. Finally, accounting rules may require plan sponsors to pay off the unfunded liability faster once a plan is closed to new hires.\textsuperscript{10} Accelerating pension contributions is generally unhelpful for states and localities looking for ways to manage through a difficult budgetary environment. Because of this, most states that have studied whether to freeze a pension and switch new hires to a defined contribution plan have found that continuing the group pension plan is in the best interest of the state, taxpayers, and employees.\textsuperscript{11}

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.\textsuperscript{12}

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.

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