2014 State Pension Funding Review

Analytical Services Division Conference Call
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Presented By:

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Loop Capital Markets

Today's Speakers

Chris Mier, Managing Director

Chris Mier has been Loop's Chief Strategist since 2002, having been a mutual fund municipal portfolio manager, trader, and credit analyst before joining Loop in 2000 as its Sales Manager.

Chris covers a wide variety of topics for Loop, including state economic, tax policy, and market dynamics. He also serves as the firm's economist.

Rachel Barkley, Vice President

Rachel Barkley joined Loop as a Vice President this summer after serving as a Senior Municipal Analyst at Morningstar, following stints at Fitch Ratings as a Public Finance Director, and at PFM. She has covered pensions extensively over the course of her career.

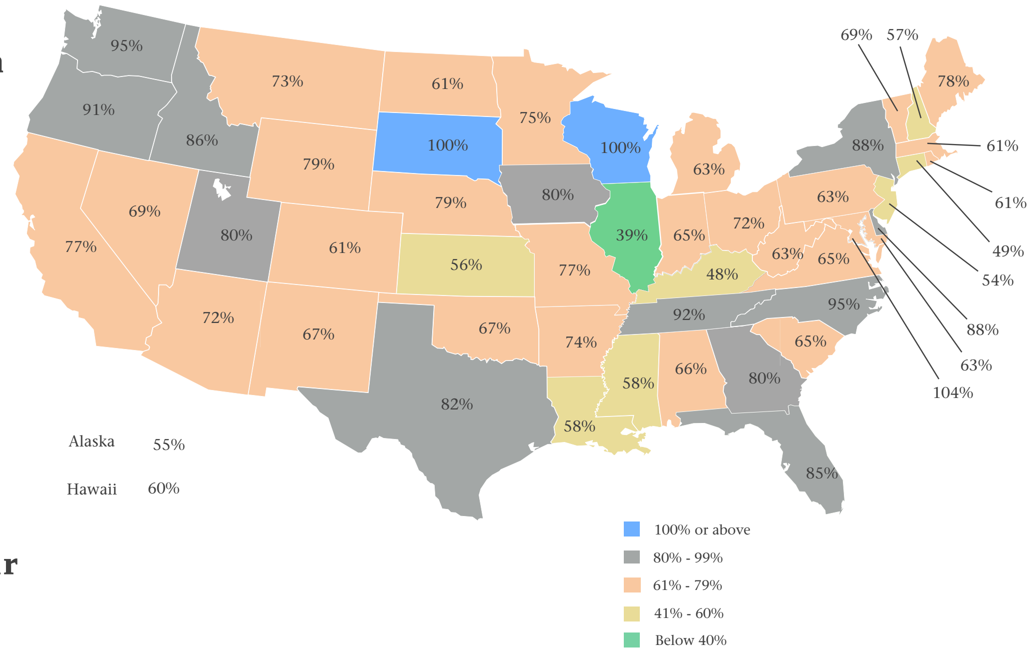
Rachel covers credit conditions, pension performance and financial developments in the state and local government sector for Loop. She also follows water and sewer, and other revenue bond areas.

The Loop Public Pension Data Base

- **Loop Capital has been collecting pension data since 2003.**
- **Our data base currently covers 247 individual state pension plans from all 50 states.**
- **Additionally, this year we continue to expand our coverage of local pension plans. We are now covering 84 local pension plans of 25 large cities and their communities.**
- **Our database contains data on:**
  - Actuarial Value of Assets (AVA)
  - Unfunded Actuarial Accrued Liability (UAAL)
  - Funded ratio
  - Annually Required Contribution (ARC)
  - Plan Type
  - Plan Assumptions
    - Investment return
    - Inflation
    - Wage growth
    - Cost of Living Adjustment (COLA)
    - UAAL amortization method and amortization period
    - Choice of smoothing treatment
- **Our data comes directly from the source documents of state and local units of government.**

- **The funded level is a valuable measure of the fiscal health of a plan at a point in time.**
  - **It helps determine who may be managing their pension liabilities well, and who has work to do.**
  - **By looking at trends over time, we can also track which municipalities are making progress in funding their pension liabilities and which are losing ground.**
- **On an aggregate level, pension funding levels appear to be stabilizing with minimal annual declines on both the state and local levels for fiscal 2013.**
- **Based on fiscal 2013 data, the aggregate funded ratio for the 247 state plans in our database fell to 73.1% for the year from 73.5% in fiscal 2012.**

Weighted Average Funded Levels- States



State Funded Levels: Top and Bottom Performers

- **Individual state performance is ‘sticky’.**
    - 4 of the 5 states with the lowest funded ratios were in the bottom quartile of states in 2005, with the exception of Kentucky.
    - 4 of the top 5 states were in the top quartile in 2005.
- **Finding common attributes among either the top 5 or the bottom 5 is difficult.**
- **Pension performance appears to be a very state-specific feature.**
- **Wisconsin and South Dakota continue to lead the pack with fully funded pension liabilities.**
- **Four additional states are also more than 90% funded.**
- **14 states have aggregate funded ratios above 80% while 20 have ratios of at least 75%.**

Top and Bottom 5 States Based on Funded Level (Fiscal 2013)

Top 5 States	Bottom 5 States
South Dakota (100%)	Alaska (55%)
Wisconsin (100%)	New Jersey (54%)
North Carolina (95%)	Connecticut (49%)
Washington (95%)	Kentucky (48%)
Tennessee (92%)	Illinois (39%)

State Funded Levels: Where Do We See Improvement?

- **Aggregate funded ratios for 19 states improved in fiscal 2013.**
  - Compares favorably to prior years :

    --5 states improved funded level in fiscal 2012

    - -14 states improved in fiscal 2011

- **States with the largest annual increases in funded level for fiscal 2013 are shown in the table to the right.**

- **While these states have unique attributes, there appear to be some common themes that describe them as a whole:**
  - Most of these states appear to be relatively fiscally conservative.
  - Some of these states were already funded above the 80% threshold, and were not distracted by the need to focus on damage control.
  - These states are generally smaller in population (Ohio is an exception).
  - These states are either "right-to-work" states, or have lower union concentration (again, Ohio is an exception).

States With Largest Annual Increase in Funded Levels		
	Fiscal 2013	**Fiscal 2012**
Montana	73%	64%
Oregon	91%	82%
South Dakota	100%	93%
Ohio	72%	65%
Indiana	65%	61%
New Mexico	67%	63%
Utah	80%	77%
Arkansas	74%	71%

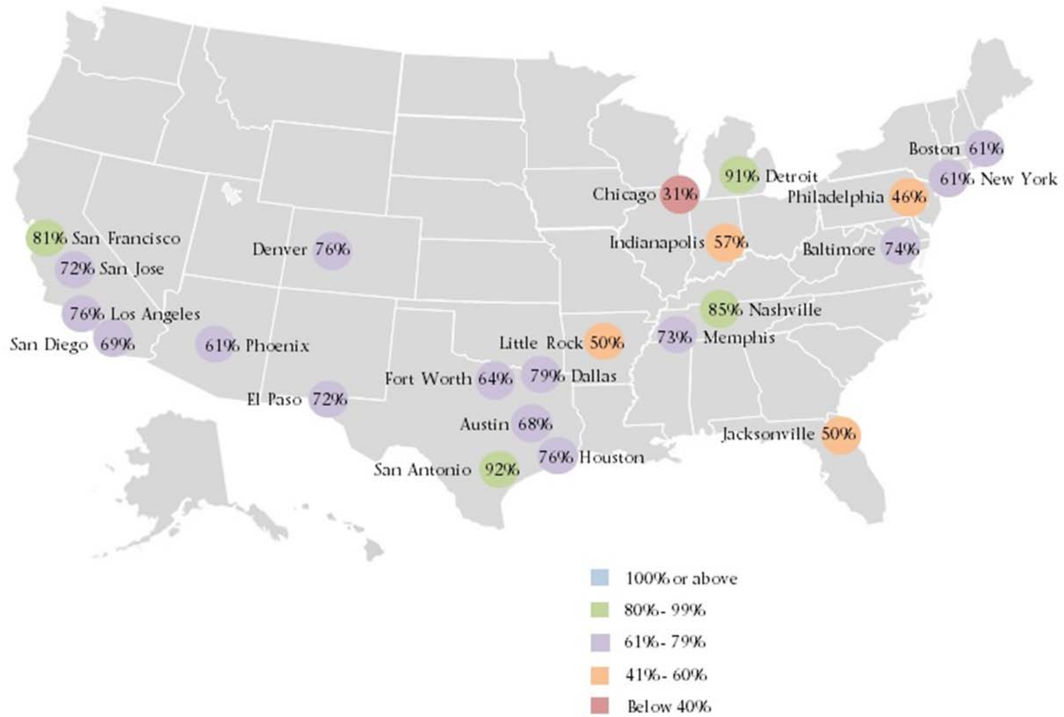
State Funded Levels: Where Do We See Weakening?

- **Aggregate funded ratios for 26 states declined in fiscal 2013.**
- **States with the worst declines in funded ratios are shown in the table to the right.**
- **It would seem that deterioration occurs under progressive and conservative administrations alike.**
- **Except for New York, states with funded ratios that have deteriorated the most in fiscal 2013 were weak pension performing states to begin with.**
- **These are mostly "older" states from the Northeast and Mid-Atlantic.**

States With Largest Annual Decline in Funded Levels

	Fiscal 2013	Fiscal 2012
New Jersey	54%	61%
Massachusetts	61%	66%
New York	88%	93%
Virginia	65%	70%
Michigan	63%	66%
Kansas	56%	59%
South Carolina	65%	68%
North Dakota	61%	63%

Local Funded Levels: Annual Review

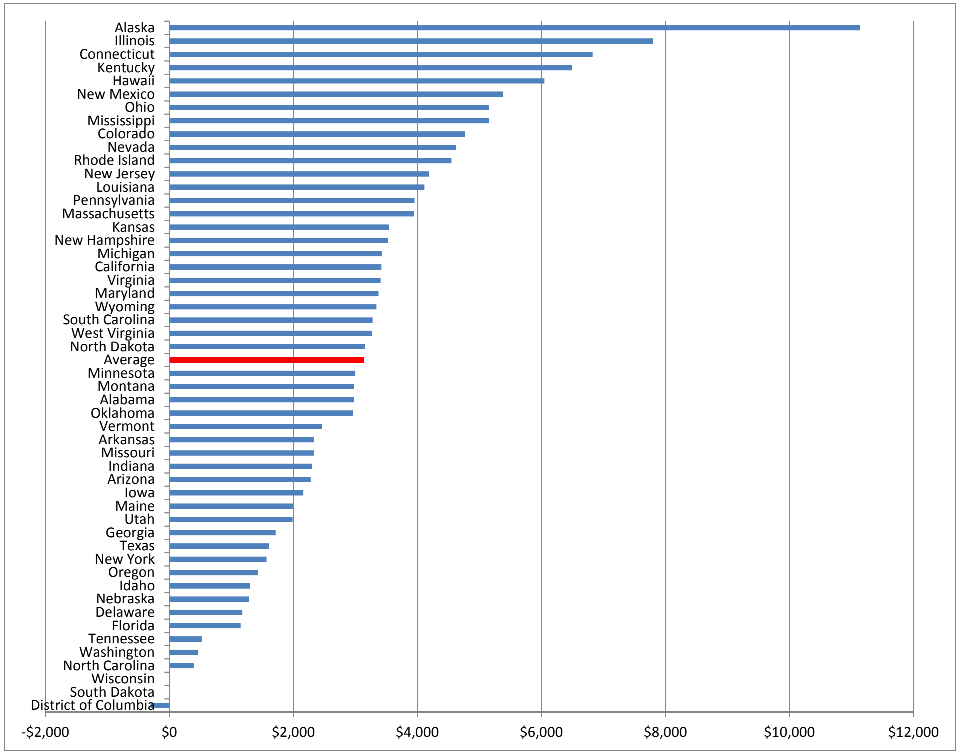


- **22 of the 25 cities analyzed have the majority of their pension obligations attached to city plans. The remaining three, Charlotte, Indianapolis, and Oklahoma City have been excluded from this portion of analysis.**

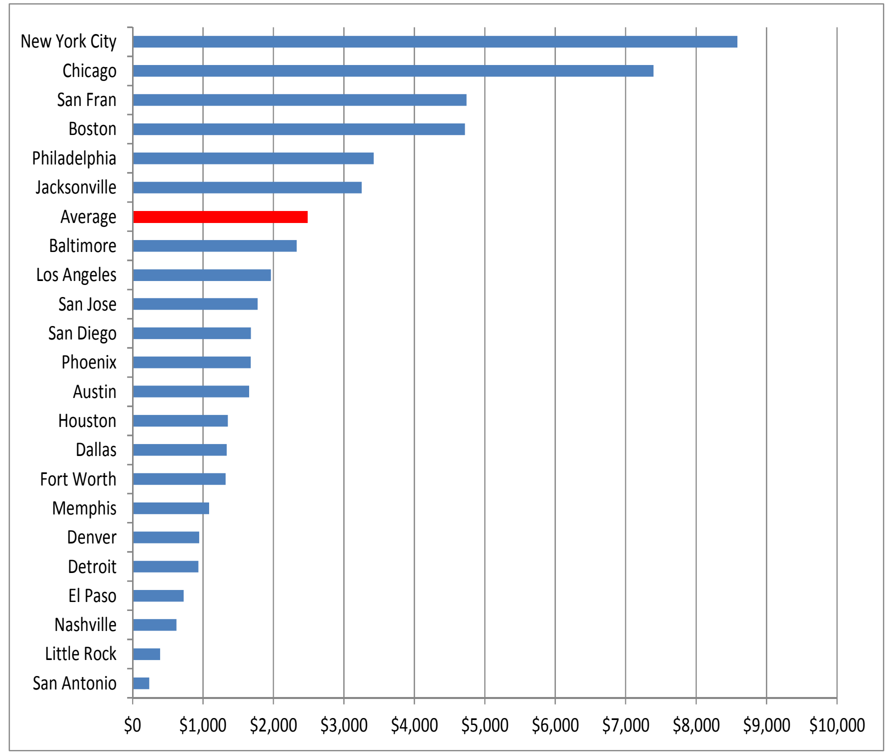
- **Local plans continue to have lower funded ratios than state plans. The aggregate funded ratio for local plans in our database fell to 65.3% for fiscal 2013 from 65.6% a year prior. This falls notably below the 73.1% and 73.5% state funded levels, respectively, for the same periods.**

Per Capita Pension Burden (UAAL)

Weighted UAAL Per Capita-States



2013 Weighted UAAL Per Capita-Locals



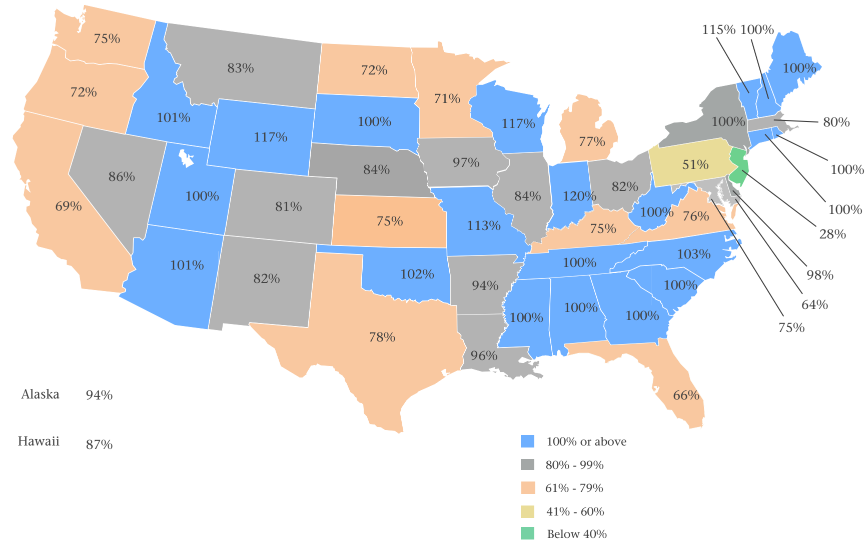
- **For both states and local governments, we feel that the UAAL per capita is an important measure of the pension burden.**
- **Pension burden per capita tends to be higher for states compared to local governments.**

Annual Funding Contributions

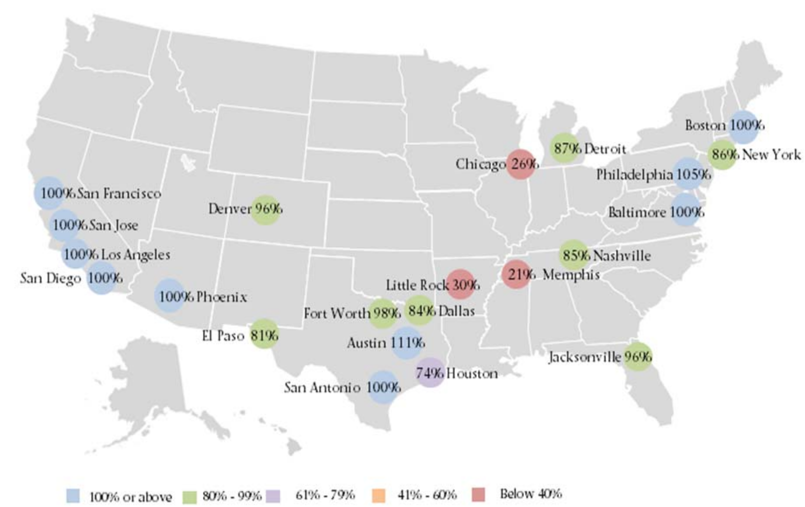
- **Slightly less than half of states and cities have demonstrated the commitment to pay 100% or more of their ARC.**
- **Many entities which systemically underfund their pension payments have state statutes determining their annual contributions which are not linked to the ARC.**
- **Other entities chose instead to pay down bonded debt, replenish reserve funds, restore program spending, cut taxes, or fund capital improvements.**
- **In aggregate, states made 80.7% of ARC payments for fiscal 2013 while locals contributed 93.8%. This is a slight improvement from 78.1% and 92.7% a year prior, respectively.**
- **ARCs continue to increase on both a state and local level. The overall value of ARC payments rose 10% this year for states and 7% for cities.**

Given the combination of increasing state and local revenues along with strong investment returns in recent years, entities who have not fully funded their ARC over the past few years have missed out on a prime opportunity to fund their pension plans.

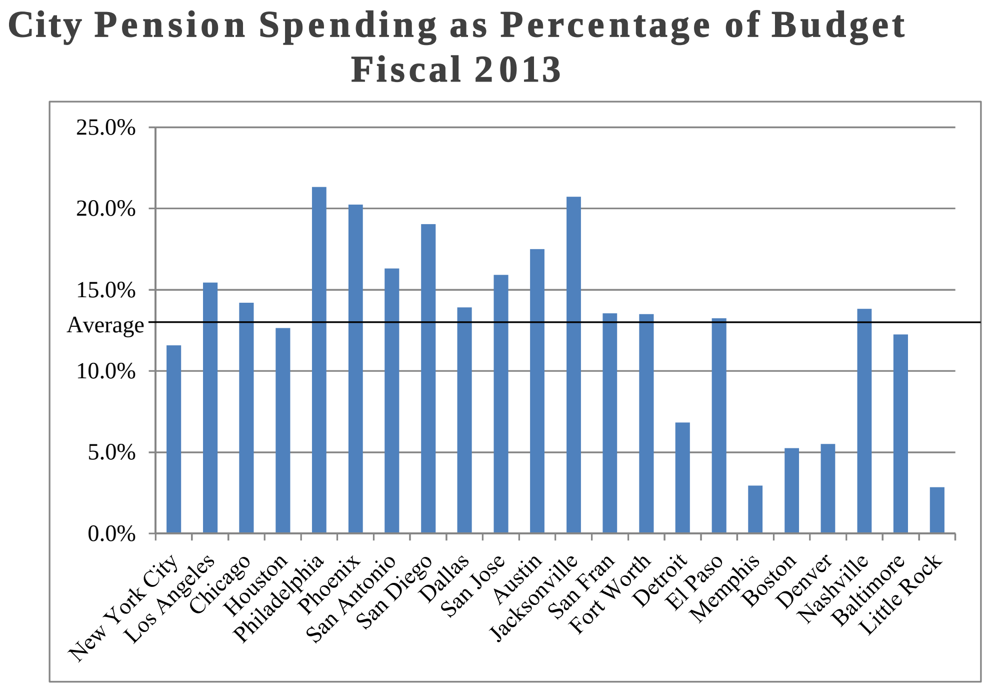
2013 ARC Percentage Paid-States



2013 ARC Percentage Paid-Locals



Budgetary Pressure



- **The impact pension payments have on an entity's budget is also an important factor when analyzing pensions.**
- **States on average contribute a moderate 4% of their budgets to pension spending.**
- **Local units, on the other hand, face more budget pressure from pension contributions. They account for an average of 12% of general fund spending.**
- **Two cities (Memphis and Little Rock) contribute 3% or less of general fund spending while three cities (Philadelphia, Jacksonville and Phoenix) have annual contributions in excess of over 20%.**
  - All five of these entities have funded levels below 75% and four of the five have funded levels below 60%.
  - Philadelphia and Phoenix are both contributing 100% of the ARC, while the remaining three are not.

Reforms and Legal Obstacles

States and local governments responded to pension crisis in 2009 and 2010 with a blizzard of reforms, creating optimism regarding pension reform progress. Since 2012 alone, 46 states have enacted a total of 447 bills regarding public pensions.

- **But legal battles have made pension reform difficult by postponing cost savings until litigation is resolved, and in rolling back some reforms.**
- **7 states have constitutional pension protections—Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York.**
- **All 7 of these states protect past benefits while the Alaska, Illinois and New York constitutions also protect future benefits for public employees, meaning the structure of an employees retirement benefits can never change from their first day.**
- **While 17 states have reduced, suspended, or dropped COLA from their plans, 12 have had to go to court over it. Other states have lost COLA litigation.**
- **Progress is difficult to gauge systemically because each state faces different degrees of statutory and/or constitutional pension protection, making pension reform progress a state-by-state skirmish.**

GASB Statements 67 and 68 Alter Reporting of Pension Activity

- **Goal of new standards is to improve the accounting and financial reporting of government pension plans.**
  - **Statement No. 67 revises existing financial reporting guidelines for most pension plans. Phase in period began June 2013.**
  - **Statement No. 68 revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits. Phase in period began June 2014.**
- **Key GASB Changes:**
  - **Elimination of Annual Required Contribution (ARC).**
  - **Net pension liability (NPL) will become the primary pension expense required by GASB.**
    - **Must be reported on balance sheet and be accompanied by funding projections.**
  - **Employers participating in a CSME plan must now report their portion of the plan's NPL, pension expense, and other metrics.**
  - **Entry age normal as a level percentage of payroll as the sole allocation method used for reporting purposes.**
  - **If a state or local government has not set aside enough money to cover projected future benefits, they have to use a combination of the historical rate of return and municipal borrowing rate.**
  - **Discontinued use of the smoothing period to determine asset levels, assets now valued at market.**
  - **Massive expansion of the note disclosure and required supplementary information sections.**

The new regulations take an "accounting-based" approach to evaluate a plan's ability to ensure the overall costs of providing current and future benefits are accounted for. This is in contrast to the old "funded-based" approach, which focused on annual contributions and relied heavily on various, often vague, actuarial assumptions.

GASB Statements 67 and 68 -- Positives

- **The GASB changes:**
  - **Will provide more information and detail on the components of pension related expenditures.**
  - **Require that actuarial data, like the ARC, will have to be disclosed, if used, in Supplemental Information. Anecdotally, there is no evidence to suggest that governments would stop calculating ARC.**
  - **Simplifies analysis since the only post-Statement 68 actuarial method allowed will be the entry age normal as a level percentage of payroll.**
  - **Analysts will be able to evaluate the impact of various factors (asset appreciation, annual contribution, change in benefits, accounting changes etc.) on pension plan performance.**
  - **Market value of assets will provide a more accurate funded ratios. The downside is that funded ratio will become more volatile. While it seems reasonable to assume that transition from smoothed valuation to market valuation may improve funded ratios as historical stock market gains are recognized, improvements in funded ratios could be modest.**

On balance, we believe that the new methodology will provide meaningful information to users, but at a cost of greater confusion and with a loss of historical data comparability.

GASB Statements 67 and 68 -- Negatives

- **The GASB changes:**
  - **Create a degree of confusion among many important constituencies—investment analysts, policy analysts, journalists, politicians, etc.**
  - **Create a break in data since the new statements will not require governments to provide revised historical data.**
  - **Provide no resolution regarding the controversy over the appropriate rate to discount liabilities.**
  - **Create the possibility that the discount rate used by a government can change from year to year, complicating time series analysis of funded ratios and other pertinent metrics.**
  - **Complicate both time series and cross-sectional data analysis (panel data) making comparative performance analysis between governments problematic. On the other hand, the existing methodology has its own share of problems due to different ways to calculate ARC, changing actuarial assumptions, smoothing of market returns, etc.**

It will take several years of using the new reporting system to generate sufficient amount of data to make meaningful comparisons.

Looking Forward

- The financial performance of public pensions has stabilized, but remains below investors' expectations in a handful of states.
- Local pension plans should be a focus of municipal analysts going forward, as we believe they will be a source of more event risk.
- Of particular concern are state and local entities that face a combination of low funded levels and above average budgetary pressure from pension contributions.
- Implementation of GASB regulations will produce both positives and negatives for pension analysis. However, we do think the inclusion of the pension liability on the balance sheet will further focus public scrutiny and awareness on pension liabilities.
- Upcoming Loop pension analysis efforts:
  - Overlapping Liability
  - Deep Dives Into Localities Facing Pension Stress

Questions

Analytical Services Division

Loop Capital Markets' Analytical Services Division (ASD), established in 2002, publishes a variety of reports that provide clients with relevant and timely information about the bond market and investor demand. The ASD is one of the largest analytics groups dedicated to investment banking, providing analytics and commentary on the economy, monetary policy, and a variety of public finance issues.

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