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Statement of the Shadow Financial Regulatory Committee

The Crises in State and Municipal Pension Funds

February 14, 2011

The massive underfunded pension funds of states and municipalities and the precarious status of the budgets of these entities have received wide publicity recently.

Many, if not most, state and municipal pension funds are defined-benefit plans. In a defined-benefit plan, the employee receives a predetermined benefit upon retirement. An employee is entitled to a benefit after working a number of years, and the benefit is typically calculated as a percentage of an average of the compensation over the last year or last several years of work. Some of these plans also incorporate a cost-of-living adjustment during retirement. The ultimate benefits are defined and do not vary with the value of the assets in the pension plan. Often, however, the pension contributions of state and municipalities are not sufficient to cover the costs of the promised benefits, resulting in what are referred to as "underfunded" plans.

Three factors have contributed to this underfunding. First, elected officials found it politically expedient to promise very generous benefits to their current employees, reasoning that such benefits would only have to be paid in the distant future, when the officials were no longer in office. If these pension plans were private pension plans, an increase in benefits would require an increase in funding, although the increased funding would typically be spread over a number of years. As state and municipal plans are not bound by

the same rules as private pension plans, these plans have been able to defer an immediate increase in funding until a future date. Over time, these deferrals have led to substantial underfunding.

Second, some states and municipalities are determining the present value of their pension liabilities by assuming unreasonably high discount rates. As the discount rate increases, the present value of the pension liability decreases. If the returns realized by a plan are less than the assumed rate, the shortfall in funding will be substantially greater than predicted.

Third, state and municipalities may be able to borrow from their pension plans. In contrast, the Employee Retirement Income Security Act (ERISA) imposes significant restrictions on the ability of a corporation to borrow money from its pension funds. A state or municipality is not subject to provisions of ERISA. Any such borrowings to finance current expenditures represent a future liability to the state or municipality and exacerbate potential underfunding of liabilities.

In the future, state and municipal pensions should be subject to comparable funding requirements and self-dealing restrictions as private pension funds. If states and municipalities had been subject to these requirements, most of their plans would not be in the severe financial conditions in which they now find themselves. Further, the sooner these measures are adopted the sooner state and local pension fund managers will be subject to market discipline that will require them to begin to address the growing underfunding problem.