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Fitch: US Public Pension Amortization Practices Remain a Problem.

Fitch Ratings-New York-29 August 2016: The chances of a near-term improvement in funded ratios for many state-wide pension systems are remote, Fitch Ratings says, even as annual pension contributions made by state governments continue to rise. In particular, state systems that employ 30-year rolling amortization or similar methods to calculate their annual required contributions (ARC) are at greater risk of having pension sustainability problems over the long run.

Actual pension contributions have risen rapidly in recent years as governments have attempted to stem the erosion of their systems' funded ratios and catch up with rising ARCs, the contribution benchmark calculated by actuaries as necessary to eliminate the unfunded pension liability over time. The average actual contribution in fiscal 2014 is roughly 89% greater than in 2008, the year the global financial crisis began, while the ARC has risen an average of 72% since then.

However, actual contributions remain inadequate relative to the ARC. Based on Fitch's last state pension update, a little more than half of major state-wide systems received an annual contribution in fiscal 2014 at or above their ARC. The remaining systems received lower contributions. A shortfall in actual contributions, relative to the ARC, deprives a system of investable resources, increases its unfunded liability and elevates the future ARC that will be calculated at subsequent funding valuations.

Inadequate contributions relative to the ARC are not the only weak contribution practice. In many cases, a system's ARC itself is a poor benchmark of contribution adequacy. The ARC is a product of multiple, separate assumptions reflecting the disparate policy priorities of each system. These priorities include cost stability, equity and certainty of achieving full funding. For many systems, progress in achieving full funding is sacrificed for short-term cost stability. This is particularly true for major systems employing 30-year rolling amortization or other amortization assumptions that create a similar outcome.

Under a 30-year rolling amortization, the ARC is an inadequate measure of contribution sufficiency because at each successive annual funding valuation the ARC is recalculated based on a new 30-year open period, much like refinancing a home mortgage loan year after year. The resulting ARC is likely to provide a higher degree of contribution stability at a lower cost than if it were calculated based on more conservative, alternative methods, such as a consistently fixed, closed-period amortization, various layered amortization approaches, or even a shorter rolling period, such as over 20-years.

For systems using a 30-year rolling amortization, the resulting ARC may too low to cover the cost of new benefits each year plus the accrued interest on the pre-existing unfunded liability — hence the unfunded liability can rise each year, even when the full ARC is paid and other assumptions are achieved. Many governments using 30-year rolling amortization while consistently paying their full ARC each year have still seen their funded ratios languish well below prerecession levels.

Implementation of GASB 67 and 68 standards, which created a new, parallel "accounting" valuation for financial reporting purposes, has not altered the challenges associated with weak pension funding practices. Although similar assumptions inform both funding and accounting valuations for the pension liability, the funding valuation remains how systems arrive at an ARC, the rough equivalent of the actuarially determined employer contribution (ADEC) under the new standards.

Given legal protections that limit the near-term positive impact of reforms and other trends affecting pensions, we expect liabilities will remain elevated and ARC increases to continue. Most governments have been able to absorb higher pension contributions, and Fitch expects this to remain the case, especially as past reforms begin to have an impact. In a smaller number of cases, pensions may result in downward rating pressure, particularly as past contribution shortfalls and limited reforms continue to drive the unfunded liability and ARC higher, reducing expenditure flexibility and straining operations.

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