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S&P: Pension Shortfalls Pressure Private and Public Sectors.

As life expectancy in the U.S. reaches new highs, with Americans born this year forecast to live to almost 79–five years longer than those born in 1980–the severe underfunding of pensions in the private and public sectors is taking on ever-greater importance.

Simply put, many older Americans will be hard-pressed to afford their golden years, in light of this underfunding and the budgetary pressures on Medicare and Social Security. With real median household income on the decline since 1999, Baby Boomers are right to be concerned that their retirement savings will be eroded by inflation, depleted by poor investment performance, or not last as long as they do.

At the same time, about half of American households age 55 and older have no retirement savings, according to a report in May from the U.S. Government Accountability Office (GAO). And many households without retirement savings have few other resources, such as defined-benefit (DB) plans or other savings to tap into for retirement, the GAO's analysis of the 2013 Survey of Consumer Finances showed.

Meanwhile, the average U.S. life expectancy has risen to 79 years (76 for men and 82 for women). Still, the official age of "full retirement" for Social Security has been raised only to 67, from 65, depending on when beneficiaries were born. So, post-employment medical costs have skyrocketed, along with the costs of prescription drugs and elder care.

Pension funding across all sectors benefited from sharp gains in stocks and a strengthening of the U.S. economic recovery in 2013, with underfunding among companies in the S&P 500 Index dropping by $224 billion. However, despite continued–albeit moderated–gains in stocks, strong corporate earnings, and companies holding record amounts of cash, corporate pensions and other post-employment benefits (OPEBs) remain severely short. At the end of last year, corporate pension underfunding had ballooned to $389 billion, almost 10% more than in 2011 and the second-highest level ever, below the 2012 record of $452 billion (see "Pension Funding Ratios Continue To Weigh On U.S. Corporate Credit Metrics," published June 9, 2015, on RatingsDirect).

Growing Obligations

Even as companies last year increased the assets they set aside for pensions and OPEBs, obligations grew faster. Combined, S&P 500 companies set aside assets amounting to $1.75 trillion, a 3.5% increase from year-end 2013. But obligations grew 11.3%, to a record $2.34 trillion, pushing combined underfunding to $584.7 billion, from $405.7 billion a year earlier.

The problem is not limited to the U.S.: In Europe, there has been a deterioration in the funding of corporate defined-benefit pension plans, especially for those companies that were already materially underfunded with DB plan deficits of more than 10%-15%. As the European Central Bank (ECB) tries to stimulate economic growth in the region with asset purchases of €60 billion per month, DB plan deficits could weigh on borrowers' credit quality in the next two years unless companies take extra care regarding risk management (see "Quantitative Easing Benefits Few European Corporate

Defined-Benefit Pension Plans," Feb. 26, 2015).

All told, the funding position of the top 50 European companies we rate that are the most-exposed–with DB pension plan deficits greater than 10% of adjusted debt and with outstanding adjusted debt greater than €1 billion–had pension fund liabilities totaling €527 billion at the end of 2013. With plan assets of €356 billion, this means that, on average, they had a funding deficit of just over 30%.

Nonetheless, the private sector remains in better shape to meet pension obligations than the public sector does, mostly because of stricter funding regulations and the massive shifts over the past 20 years from traditional defined-benefit plans to enhanced 401(k)-type saving accounts.

The federal government projects that the Social Security Trust Fund will be able to pay full retirement and disability benefits only through 2033, and Congress has considered various measures to strengthen the system, especially, perhaps, because older Americans represent a significant voting bloc. Meanwhile, most states have pursued strategies to reform and strengthen their employee pension systems, although the effects of these initiatives will likely be gradual.

At any rate, there is little doubt that GDP growth of, say, 5% annually for the next generation would go a long way toward easing any worries about pension funding. But it is increasingly unlikely that we will see economic expansion of even 3% this year, still well short of the five-year average annual growth rate following past U.S. recessions (going back 50 years) of 4.6%. Even if, as we expect, the economy makes a comeback in the second half, in our May report we forecast 2015 GDP growth of just 2.4%–the same as in 2014 and down from our 2.8% forecast in April.

This below-trend growth–combined with inflation running below the Federal Reserve's 2% target–will likely keep the U.S. central bank's normalization of monetary policy on a slow track. We expect the Fed to raise rates in September, for the first time in nearly a decade, but minutes from the last Federal Open Market Committee meeting noted that a number of members are worried that weakness might persist.

States Suffer

Against this backdrop, a majority of states face budget gaps in either fiscal 2015 or fiscal 2016, or both. However, while we view the majority of these gaps as manageable and no immediate threat to a state's credit quality, they could test states' pension funding commitments (see "U.S. State Pension Roundup: Recent Court Rulings And Reform Slowdowns Make Active Management Essential," June 18, 2015). Still, given states' generally strong credit profiles, and the long-term nature of pension obligations, we do not see these liabilities as immediately jeopardizing state governments' capacity to pay their debts, but believe they can weaken a state's relative credit profile if left unmanaged.

Among states, levels of pension funding vary widely, playing a significant role in relative creditworthiness. Funded levels now average 71.16%, according to our annual survey for 2015 (based on 2013 valuations), essentially the same as in 2012. And more states (26) either maintained or increased their funded ratio. However, there remains a sizable and growing gap between well- and less-funded plans, and the fact that 24 states' funding ratios declined is notable.

For the most part, states have demonstrated a commitment to manage their long-term liabilities, including pensions. And there has seemingly been an increased focus and vigilance among policymakers, employees, taxpayers, and the media about the need to continue to do so. Testament to this is the unprecedented level of pension reform in the past few years. Since 2009, all 50 states and the Commonwealth of Puerto Rico have enacted some type of pension reform, according to the

National Conference of State Legislatures. Whereas pensions for public workers were once considered sacrosanct, governments and employees alike may be softening this stance, as lawmakers face the dilemma of maintaining current benefits for both those retired and in the active workforce and restoring much needed services–or tax relief–to taxpayers. Either way, state reform efforts have slowed, and may continue to wane, in part because of recent court rulings against such efforts and perhaps due to reform fatigue.

In the end, many Americans are being, or soon will be, forced to make some difficult choices about the cost and timing of their retirement. And, as a society, we need to look at the extent to which employers and the government should be responsible for retirees' incomes and health care.

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