State and Local Pension Plans: Coping with Funding Challenges

By Randy Myers

Strictly by the numbers, pension plans sponsored by state and local governments do not look to be in great shape. Many plan sponsors have not been making full annual contributions to the plans, and partly as a result the average funded ratio for those plans has fallen to 71 percent from 90 percent since 2004. Many plans are paring benefits, too. Since 2008, a total of 19 states have increased the amount that current employees must contribute to their plans, and six have boosted contribution rates for new employees. A number of others have increased eligibility requirements, lengthened vesting periods and reduced benefits, especially for new employees. Some also have decreased cost-of-living adjustments for retirees.

These changes impact a broad swath of the U.S. population. In an address at the 2014 SVIA Fall Forum, Joshua Franzel, vice president of research for the Center for State and Local Government Excellence, noted that in addition to 50 state governments, the U.S. is home to about 90,000 local governments. In 2012, those entities had approximately 14.4 million full-time employees. They sponsored approximately 4,000 retirement plans covering 19.6 million active and inactive members and 9 million retirees.

Defined benefit plans are much more popular in the public sector than they are in the private sector, Franzel noted. About 86 percent of state workers have access to a defined benefit plan while only 43 percent have access to a defined contribution plan. Among local government workers, the numbers are 82 percent and 30 percent, respectively. This is important because about 30 percent of state and local workers do not participate in Social Security. Assets in government-sponsored defined benefit plans totaled $4.8 trillion in the second quarter of this year, or nearly nine times the $538 billion in government-sponsored defined contribution plans.

Despite the decline in the funded status of their defined benefit plans, and in some cases reductions in what they deliver, government workers remain fairly upbeat about their benefits. In a 2014 survey, Franzel noted, more than 80 percent of government workers said they were somewhat or very confident about their retirement plan benefits.

The role of stable value

Among state and local governments that do offer defined contribution plans, 82 percent include a stable value fund as an investment option, according to a recent survey by the National Association of Governmental Defined Contribution Administrators. "Practically every other plan has a similar protected account, so it's almost a 100 percent penetration rate," said Roderick Crane, managing director, governmental and religious markets, for TIAA-CREF Financial Services, a retirement plan provider. Crane joined Franzel in addressing the SVIA Fall Forum, along with John Saeli, vice president for market development and government affairs at ICMA-RC, another retirement plan provider. Crane said the type of stable value product used in state and government retirement plans can vary depending upon the type of plan sponsor. In the higher education and K-12 school space served by TIAA-CREF, he said, most plans offer an insurance-company product, either a general account offering or a 403(b)-qualified stable value product. But increasingly, he noted, plan consultants and advisors are pushing for greater use of "regular" types of stable value products such as "collective investment trust vehicles or GIC-type arrangements or custom stable value (funds)." He said that reflected a preference among plans for portability of assets and for not being tied to a single record keeper.

When choosing stable value funds, Crane said, plan sponsors are concerned "first, second and third" with the crediting rate, although, as noted, the portability of assets is becoming increasingly important, too. Sponsors also are interested in investment flexibility, low expenses, and the financial strength of the institution backing the stable value fund. Where they use collective funds, he said, they favor a shorter rather than longer put period—the length of time they may have to wait to receive their assets at contract value after exiting a fund.

Saeli noted that participants in government-sponsored defined contribution plans tend to allocate a higher percentage of their assets to stable value funds—about 30 percent of their deferrals—than do their counterparts in private-sector plans. "I think that's partly because public-sector employees have a little more aversion to risk than what we see in the private sector," he said.

Stable value allocations also may be higher in part because relatively few state or local governments—only about 10 percent—automatically enroll employees in their defined contribution plans, Crane observed.

In the private sector, automatic enrollment has helped to steer a high percentage of plan assets into target-date funds, which many plans use as their qualified default investment alternative when bringing employees aboard. Government plans have largely shied away from auto enrollment because the Pension Protection Act of 2006, which established a safe harbor for the practice, does not override the rules that prohibit many state and local governments from garnishing the wages of their employees.

Nonetheless, Crane said, increasing numbers of government plans are now designating target-date funds as their default investment option, too, and that is tending to reduce the use of stable value funds among younger plan participants.

Although there are more defined benefit plans than defined contribution plans in the government sector, Crane noted that the number of defined contribution plans is growing, which presents an opportunity for the stable value industry to grow, too.