

It's important to remember that even in the midst of all the bad economic news, there are some bright spots when it comes to public pensions....

- Group-based pension plans weathered the economic storm better than individual account plans. This continued a long trend of pensions outperforming individual accounts.
- Most states had done a good job of building up their pension plan reserves when the economy was in better shape. When the recession hit, pension plans had enough on hand to continue paying benefits—in most cases, for many years to come.
- In response to the financial crisis, states have already made significant pension reforms. Forecasts show that in most cases, these reforms should fully offset the effects of the economic downturn.
- Pensions are keeping the promise. They provide a critical lifeline for middle-class American seniors.

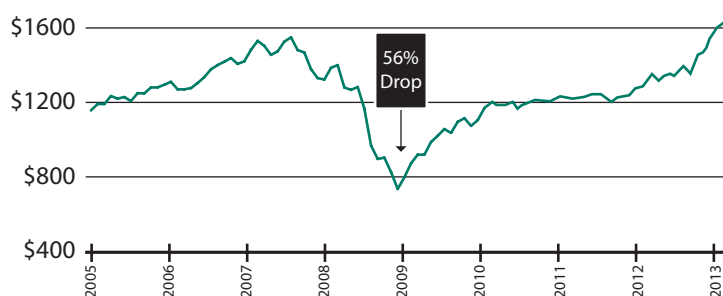
The recent economic downturn has negatively impacted Americans on many fronts. The unprecedented stock market decline of 2008–2009 hurt investors of all stripes—from large financial institutions, to pension funds, to individual families. Soon, the economy slowed to a halt, and even more Americans felt the pain as unemployment began to rise and states struggled to balance their budgets.

You may have wondered—what do these trends mean for my retirement? How have these trends impacted my pension plan? This fact sheet provides some basic information that might help.

HISTORIC MARKET DECLINE AND RECESSION

The stock market decline that began in the fall of 2007 and lasted through the spring of 2009 was unprecedented in recent history. The Standard & Poor's 500 Index (a measure of the stock market value of 500 of the largest companies in the U.S.) fell from a high of 1565 in October 2007 to just 676 in March 2009. **That's a 56% drop!**

Figure 1. Performance of the Standard & Poor 500 Index



According to The Wall Street Journal, the wealth of American families in 2008 plunged 18%, or \$11 trillion during the market meltdown. The decline marked the biggest loss since the government began keeping track after World War II.¹

Although the market has rebounded since then, it will still take time for households and institutional investors alike to fully recover. Furthermore, the stock market crash was only the prelude to a long, deep recession that brought pain to every element of our economy—businesses, workers, and state and local governments.

THE IMPACT OF THE STOCK MARKET DROP ON PENSIONS

Pre-funded pension plans (whether in the public or private sector) work like this: over the course of an employee's career, funds are set aside (by the employer, the employee, or both) and contributed to a group pension fund. These monies are invested by professionals in a range of assets—stocks, bonds, real estate, etc.—with the goal that by the time an employee retires, the initial contributions to the plan will have grown enough to pay benefits for the rest of the retiree's days.

Like all investors, pension plans were hurt in the stock market crash. According to figures from the Federal Reserve, public pensions saw their holdings fall in value by \$889 billion between 2007 and 2008.² Since that time, as the stock market has rebounded, so has the value of public pension funds—as of June 2013, their aggregate value was nearly \$3 trillion.³ But those gains have not fully made up for the huge prior losses.

One measure of a pension plan's financial health is its funding ratio—that is the ratio of assets held by the plan to the value of benefits it is obligated to pay in the future. For example, if a fund is holding exactly the same amount of assets that it needs to pay all current and future benefits, the plan is 100% funded. If the plan has fewer assets, the funding ratio will be less than 100%. According to the National Association of State Retirement Administrators, the recent stock market decline has caused the aggregate funding ratio of the nation's largest public pension plans to fall from 86.7% in 2007 to 73.5% in 2012.⁴



One bright spot is that most states had done a good job of building up their pension reserves back when the economy was in better shape. Like the ant in Aesop's famous fable, states have socked away an average of about 87 cents for every dollar in future benefits they will need to pay before the recession hit.⁵ This pre-funding strategy was in place to ensure that if (or when) the economy hit a rough patch (taking state budgets down with it), pension plans could keep on paying benefits as they come due.⁶

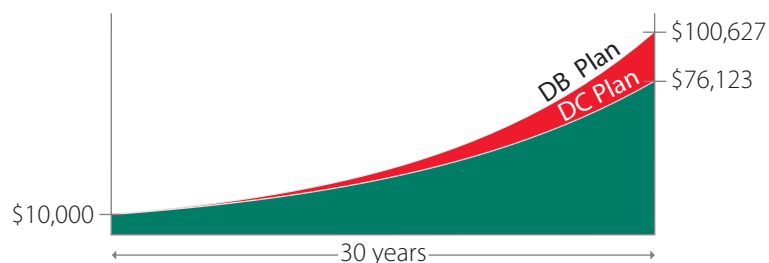


This pre-funding strategy has been a success—even during the worst days of the economic crisis, retirees have been able to count on their pension check arriving, just as always. Most public pensions have enough on hand to keep paying benefits for decades.⁷

The other bit of good news is that group pension plans (also called “defined benefit” pensions) weathered the financial storm better than other investors, particularly, individual investors in so-called “defined contribution” plans. A recent analysis by the consulting firm Towers Watson found that defined benefit pensions outperformed defined contribution plans in 2011,⁸ continuing a long-term trend of superior investment returns dating back to at least 1995.

That doesn't mean pensions are totally out of the woods though. Just as the stock market has yet to return many investors to their pre-crash levels, so pension funds have some work to do in recovering from the economic storm. Pensions might need additional contributions from employers, employees, or both. If employers and/or employees can't afford these additional contributions, pensions may need to make adjustments to the benefits they will pay in the future

Figure 2. **How \$10,000 Invested Grows Over 30 Years**



For some public pension plans, the recovery process will be made more difficult by the tough shape of state budgets.

THE ECONOMIC CRISIS AND STATE BUDGETS

The economic crisis has negatively impacted state budgets across the country in major ways. According to the National Conference on State Legislatures, states had a cumulative gap of \$107 billion in their 2012 budgets and a gap of \$55 billion in 2013, both of which they have managed to close.⁹ States have implemented various changes in order to balance their budgets, including furloughs and layoffs for state employees.¹⁰ However, significant challenges remain.

As a result, many state and local governments have been evaluating the need for, and even implementing, adjustments to their pension systems to ensure that they will be on a strong footing for the long-term. Fortunately, because most states acted like Aesop's "ants" before the economic winter, there is ample time to make any additional modifications that may be prudent. But like the fabled "grasshopper," other states may have a harder time. The small number of states that were less diligent about pre-funding their pension plans will need to grapple with tough choices sooner and may have fewer options to manage through the tough times.

The good news is that legislatures around the country are, by and large, taking a careful approach to examining benefit levels and financing structures to ensure that pension plans will have what they need to be sustainable over time. While public pension systems have a long term horizon that allows for a patient approach, the uniqueness in plan design, benefit structure, and governance arrangements may dictate different responses among different systems.¹¹

According to the National Conference on State Legislatures, the actions taken by states to date have been quite substantive and varied. Five states enacted significant pension reforms in 2013, 10 states enacted reforms in 2012, 32 states enacted reforms in 2011, and 21 did in 2010. In 2013, 4 states increased employee contributions, 4 states increased employer contributions, and 4 states implemented higher age or service requirements. Between 2009 and 2012, 30 states increased employee contributions and 32 states implemented higher age or service requirements.¹² Boston College finds that for most states, the reforms already implemented should fully offset the effects of the economic downturn.¹³

Although a small number of states have moved to restructure retirement benefits entirely, the vast majority have chosen to remain within the traditional defined benefit (DB) structure, acknowledging that these pension plans have a track record of simultaneously meeting the goals of employers, due to their recruitment and retention effects, and the goals of employees, due to the economic security they offer.¹⁴

DESPITE TOUGH TIMES, PENSIONS ARE KEEPING THE PROMISE OF RETIREMENT SECURITY

The Great Recession has presented some funding challenges to public pensions. However, the evidence suggests that employees and retirees who can count on group-based, defined benefit pensions are in the best position to weather tough economic storms.

Employees and retirees with pensions can count on a stable and secure retirement income that isn't subject to the volatility of Wall Street. This is possible because group pension plans can do something individual account plans cannot—provide better time diversification of financial market risks. This means that, because pension plans invest for very long time horizons, they are able to diversify their portfolios across broad time periods, and can better withstand market swings. Economists have shown that because of this ability, group pension plans can more effectively capture the excess returns that come from investing in stocks over long periods of time—to the benefit of employees, employers, and taxpayers.

The economic crisis has taught Americans many lessons about getting back to basics. Recent research reaffirms the importance of the traditional “three-legged stool” approach to retirement. A combination of Social Security and a group based defined benefit pension, supplemented with individual savings in a defined contribution plan or on their own, affords ordinary Americans the greatest chance to maintain their middle-class standard of living into retirement.¹⁵

Earned pension benefits are a critical lifeline to America's middle class seniors. More than 4.5 million retired public employees and nearly 10 million retired private sector employees rely on a pension to make ends meet. Keeping these vital systems healthy should be a high priority for decision-makers at every level, so that pensions can continue to keep the promise for future generations.

¹ Kalita, M. 2009. Americans see 18% of wealth vanish. *The Wall Street Journal*. March 13.

² Board of Governors, Federal Reserve System. 2010. *Flow of Funds Accounts of the United States*. Washington, DC: Board of Governors.

³ Lambert, L. 2013. U.S. public pension investments jump, costs surge too. *Reuters*, September 23.

⁴ Brainard, K. 2013. *Public Fund Survey Summary of Findings for 2012*. National Association of State Retirement Administrators.

⁵ Brainard, K. 2012. *Public Fund Survey Summary of Findings for 2012*. National Association of State Retirement Administrators.

⁶ Standard and Poor's. 2009. *No Immediate Pension Hardship For State And Local Governments*. Standard and Poor's, June.

⁷ Brainard, K. 2009. *Public Fund Survey Summary of Findings for 2008*. National Association of State Retirement Administrators.

⁸ Towers Watson. 2013. *Defined Benefit Plans Outperform Defined Contribution Plans Again*. July.

⁹ Oliff, P., C. Mai, and V. Palacios. 2012. *States Continue to Feel Recession's Impact*. Washington, DC: Center on Budget and Policy Priorities.

¹⁰ National Conference of State Legislatures. *Actions & Proposals to Balance the FY 2010 Budget: State Employee Actions, Furloughs and Layoffs*. Washington, DC: National Conference of State Legislatures.

¹¹ Brainard, K. 2009. *Public Fund Survey Summary of Findings for 2008*. National Association of State Retirement Administrators.

¹² Martel, L. and Rivale, T. 2013. *State Retirement Reform Legislation: NCSL Legislative Summit*. Washington, DC: National Conference of State Legislatures.

¹³ Munnell, A.H., J.P. Aubrey, A. Belbase, and J. Hurwitz. 2013. *State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

¹⁴ Boivie, I., and C. Weller. 2012. *The Great Recession: Pressures on Public Pensions, Employment Relations and Reforms*. Washington, DC: National Institute on Retirement Security.

¹⁵ National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Why Do Pensions Matter?* Washington, DC: National Institute on Retirement Security.

¹⁶ Porell, F., and Oakley, D. 2012. *The Pension Factor 2012: The Role of Defined Benefit Pensions in Reducing Elder Hardships*. Washington, DC: National Institute on Retirement Security.