

What is the source of the 80-percent threshold as a healthy or minimum funding level for public pension plans?

Prepared by Keith Brainard and Paul Zorn, January 2012

Recently, some have challenged the idea that an 80 percent funding level is a healthy level for public pension plans and have asked about the origins of such statements.ⁱ Based on our research, the use of 80 percent as a healthy or minimum public pension funding level seems to have its genesis in corporate plans, for which it was a statutory threshold. This standard was also applied to private sector multiemployer plans.

However, there may be some confusion about the context in which the funding ratio is being used, since it could be considered in two different contexts. The first is the context of the funding ratio as the funding target, or the ultimate funding goal. Public pension plans generally have a funding policy targeting full funding, i.e., a 100 percent funding level. This is recommended by the Government Finance Officers Association (GFOA) in their Best Practice, “Sustainable Funding Practices of Defined Benefit Pension Plans.”ⁱⁱ

The second context is the funding ratio as a general indicator of a pension plan’s health at a specific point in time, possibly pointing to the need for corrective action. This is the context in which the 80-percent threshold is used by the federal government for private sector pension plans. For example, as explained in a 2008 U.S. Government Accountability Office report:

The Pension Protection Act of 2006 provided that large private sector pension plans will be considered at risk of defaulting on their liabilities if they have less than 80 percent funded ratios under standard actuarial assumptions and less than 70 percent funded ratios under certain additional ‘worst-case’ actuarial assumptions. When private sector plans default on their liabilities, the Pension Benefit Guaranty Corporation becomes liable for benefits. These funding standards will be phased in, becoming fully effective in 2011, and at-risk plans are required to use stricter actuarial assumptions that will result in them having to make larger plan contributions. Pub. L. No. 109-280, sec. 112(a), § 430(i), 120 Stat. 780, 839-42.ⁱⁱⁱ

In addition, the 80-percent threshold is used by credit rating agencies as a general indicator of a public plans financial health. For example, in their 2011 report “Enhancing the Analysis of U.S. State and Local Government Pension Obligations,” Fitch Ratings says it “generally considers a funded ratio of 70% or above to be adequate and less than 60% to be weak,” but also goes on to say that the funded ratio is “only one of many factors” used in the analysis of a government’s pension obligations.^{iv}

Also, in Standard & Poor’s report, “U.S. State Ratings Methodology,” the funding ratio is one of four factors used to evaluate pension liabilities. The other factors are pension funding levels (pertaining to the plan sponsor’s history of paying the Annual Required Contribution); unfunded pension liabilities per capita; and unfunded pension liabilities relative to personal income. S&P assigns a “strong” rating for funding levels above 90 percent; a rating of “above average” for levels between 80 percent and 90 percent; “below average” for funded levels 60 percent to 80 percent; and “weak” below 60 percent.^v

As explained in the *Public Fund Survey Summary of Findings for FY 2010*, by Keith Brainard:

Funded status is a single-point measure of the degree to which a plan is on course to meet a distant goal. ... The fact that a plan is underfunded is not necessarily a sign of fiscal or actuarial

distress; many pension plans remain underfunded for decades without causing fiscal stress for the plan sponsor or requiring benefits to be reduced.

The critical factor in assessing the current and future health of a pension plan is whether or not funding its liabilities creates fiscal stress for the pension plan sponsor. Although a pension plan that is fully funded is preferable to one that is underfunded, other factors held equal, a plan's funded status is simply a snapshot in a long-term, continuous financial and actuarial process, akin to a single frame of a movie that spans decades.^{vi}

ⁱ For example see Girard Miller, "[Pension Puffery](#)," *Governing Magazine*, January 2012.

ⁱⁱ Government Finance Officers Association, Best Practice, Sustainable Funding Practices of Defined Benefit Pension Plans, 2009. (http://www.gfoa.org/index.php?option=com_content&task=view&id=1627)

ⁱⁱⁱ U.S. Government Accountability Office, "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits," January 2008. (<http://www.gao.gov/new.items/d08223.pdf>)

^{iv} Fitch Ratings, "Enhancing the Analysis of U.S. State and Local Government Pension Obligations," 2011. (Note: Fitch would base its measure of funded ratio on a 7% discount rate, so their 70% funded ratio would be higher using a higher discount rate.) <http://www.nasra.org/resources/Fitch1102.pdf>.

^v Standard & Poor's, "U.S. State Ratings Methodology, January 3, 2011. (<http://www.nasra.org/resources/StateRatingsMethodology.pdf>)

^{vi} Keith Brainard, Public Fund Survey Summary of Findings for FY 2010, National Association of State Retirement Administrators, December 2011. (<http://www.publicfundsurvey.org/www/publicfundsurvey/SummaryofFindingsFY10public.pdf>)

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