



POLICY MATTERS

Using Information and Ideas to Transform Public Policy

The Unfunded Liability and What it Means

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The oft cited and growing unfunded liability of the pension portion of the New Hampshire Retirement System (NHRS), pegged at the end of last fiscal year at \$3.7 billion, has been the driving force behind pension reform in Concord. This shortfall is not just a result of poor investment returns from the recent recession, rather it is systemic. Every year, for the past ten years, the dollar value of the unfunded liability has increased. Even in years with double digit investment returns, liabilities continued to out pace the growth of assets.

To understand what the unfunded liability is, we need to take a basic look at how the System functions on a financial basis.

According to the 2010 Comprehensive Annual Report (CAFR) of the NHRS, the pension component of the System took in just over \$1 billion in contributions and investment income and paid out roughly \$530 million in benefits and refunds. If the System operated on a pay as you go basis, it would be in great shape.

However, the NHRS does not function on pay as you go basis; rather it has assets, made up of employee contributions, employer contributions and investment income. Contributions are made to this pool by employees as a percentage of their salary at a rate set in state law. Employers then add a percentage of their employees' salaries, as determined by the actuaries of the System. These funds are then invested, which are now projected by the System to earn 7.75% a year.

Once employees retire, this pool is drawn on to pay their pensions. Money contributed to the pool today does not directly pay for current retirees; rather, the money for current retirees was added while they were working. The System functions in this regard as a 401(k) does. Unlike a 401(k) however, the state guarantees retirees a pension amount based on their length of service and their average final compensation, not on the dollar amount of the assets. As of the end of fiscal year 2010 these assets totaled \$5.23 billion dollars.

All values in millions of dollars ⁱ	FY 2001	FY 2002	FY 2003	FY 2004	FY 2005
Pension Assets	\$3,265	\$3,443	\$3,500	\$3,576	\$3,611
Pension Liability	\$3,843	\$4,196	\$4,669	\$5,030	\$5,991
Unfunded Liability	\$578	\$753	\$1,169	\$1,454	\$2,011
	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Pension Assets	\$3,928	\$4,862	\$5,302	\$4,937	\$5,234
Pension Liability	\$6,402	\$7,260	\$7,821	\$8,475	\$8,954

Unfunded Liability	\$2,049	\$2,397	\$2,519	\$3,538	\$3,720
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Operating on the basis of guaranteeing a payout, the System also carries liabilities in addition to assets. Liabilities for the System are not the same as the commonly held notion of the term. Instead liabilities are the value of assets needed today for with assumptions being made for, among other things, inflation, wage growth, future contributions, the rate of return on investments and the value of future benefits of members in the System.

<i>Today's Liabilities + Assumptions of Future Revenue and Payouts = Total Funds Needed to Pay Future Benefits</i>
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At the end of fiscal year 2010, the liabilities of the System totaled \$8.95 billion dollars. The difference between these two numbers is how the value of the unfunded liability is calculated. Currently the System has \$3.7 billion unfunded liability, and with the reduction in the expected rate of return from 8.5% to 7.75%, this number will likely increase.

Even without the recent economic downturn, the increases in the assets of the System have historically been far outweighed by the increases in the liabilities. Over the past 10 years assets have grown by just over 60% while liabilities have increased by 133%. This is not just as a result of the recession. Over the past 20 years assets have increased 288% and liabilities nearly 435%. In fact, every year, for the past 10 years, the unfunded liability has grown.

The Breakout by Group:

The New Hampshire Retirement System sorts employees into four categories: Employees, which includes local, county and state employees, Teachers, Police, which includes local, county, state as well as corrections and Fire. Teachers and Employees operate under one set of Pension guidelines as Group I and Police and Fire operate under another set of guidelines as Group II.

The NHRS also breaks out the unfunded liability by into the constituent categories of the System:

The Unfunded Liability (UL)ⁱⁱ

	Employees (Group I)	Teachers (Group I)	Police (Group II)	Fire (Group II)	Group I Average	Group II Average
Percentage of the UL Responsibility by Category	33.88%	40.41%	17.15%	8.55%	74.29%	25.70%
Membership of the NHRS by Category	50.91%	36.35%	8.99%	3.74%	87.27%	12.73%
Unfunded Liability Portion per Member	\$31,813	\$53,143	\$91,150	\$109,220	\$40,698	\$96,462

As shown in the chart above, there is not a correlation between the percentage of the unfunded liability by group and weighted membership for some of the categories. If the unfunded liability were equitably distributed among the groups, the "Membership of the NHRS by Category" field

should be the same as the “Unfunded Liability by Category” field. They do not match however, with exception of Teachers, which is only four percentage points off. Group I Employees as a category account for 33.88% of the unfunded liability, yet in terms of their total membership in the System, they make up roughly half of those in the retirement system. Group II Fire on the other hand is responsible for 8.55% of the unfunded liability, yet in terms of their numbers in the System; they only make up 3.74%.

Thus, Group II Police and Fire account for a disproportionate share of the unfunded liability relative to their membership numbers in the System. Group II members are weighing more heavily on the System by a factor of well over 2 to 1 over their Group I counterparts. Going a step further, one Fire Fighter in the System has the same financial impact on the System of three Employees. This is not to say that Group II members alone are causing the issues facing the NHRS, but the data shows that they have a deeper financial impact on the System than Group I members.

Changes to the System: Rate of Return and Legislative Reforms:ⁱⁱⁱ

When the retirement system changed their assumption on the rate of return on investments from 8.5% to 7.75% and the rate of wage growth from 4.5% to 3.75% in May, the liabilities will grow with the next valuation of the System. Part of that expected future revenue (investment income) is can no longer be counted on, so the needed present day value of the assets needs to be higher in order to payout the future benefits. Therefore, in order to keep the equation on page two of this paper balanced, the shortfall in future anticipated investment revenue must be offset by a corresponding increase in the liabilities. The unfunded liability will likely grow with the change; however this is highly dependent on the returns of the System over the past fiscal year and the extent of the normal increase in liabilities. Even though assumptions made by the System such as future pension amounts, contributions and total cost change slightly under the pension reforms, they are dwarfed by the financial impact of changing the rate of return.

Among other changes made by the legislature to the System this past session, Group I employees (Employees and Teachers) will now contribute 7% of their salary up from 5% and retire at 65 rather than 60. For Police members contributions rates go up to 11.55% of their salary and Fire 11.80%, up from 9.3% for both and retire at 50 rather than 45.

Contribution rates will take effect as of July 1, 2011 and the retirement ages will be phased in for Group II and for new hires of Group I only.

Group II has higher contribution rates because of their younger retirement age, shorter service and the fact that they don't pay into, nor receive Social Security benefits.

While it will take some time to see these reforms take effect, it is a step in the right direction. With the changes in contribution rates taking effect next month, the funding of the System should improve, but the extent of which it is working will not be know for sure until the release of the CAFR for Fiscal 2012.

ⁱ NHRS Comprehensive Annual Reports, 2001-2010

ⁱⁱ http://www.nhrs.org/documents/GRS_Fiscal_Analysis_SB3_2288.pdf Pg 15

ⁱⁱⁱ SB3, the original pension reform bill was vetoed by Gov. Lynch on June 15th. In response, the House rolled the language of SB3 into HB2, the budget companion bill that contains enabling legislation.