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Retiree pension benefits represent long-term obligations of state and local governments and as such, are a component of an issuer’s debt profile. Little attention was given to these liabilities in the years leading up to the Great Recession and rightfully so, since in 2001, funding of state plans appeared robust with an average funded ratio (plan assets divided by promised payouts) of nearly 100%. Consecutive years of negative market returns starting in 2008 battered investment portfolios, while escalating future obligations for many issuers exposed generous promises and lax funding discipline. In 2010, the Pew Center for the States published *The Trillion Dollar Gap*, an influential study that raised concerns regarding the magnitude of retiree benefits and predicted the gap between plan assets and liabilities would soon exceed \$1.0 trillion. In an unexpected outcome following the pandemic, Pew released a brief last month that estimates state pension plans will post the strongest funded levels since 2008, due to record investment returns in 2021 and widespread policy reforms implemented over the past decade.

The declining health of state plans uncovered during the financial crisis caught the attention of a host of stakeholders and ultimately led to meaningful pension reform. Over the past decade, nearly every state has enacted some type of policy modification. These legislative changes call for higher employee contributions, reductions or

eliminations of Cost-of-Living Adjustments (COLAs), increased retirement ages and other measures, all with the sole mission of reducing future liabilities. In exchange for concessions by retirees and active employees, policymakers have instituted funding mandates to ensure annual government contributions are sufficient to meet upcoming benefits. Pew reports that states have increased annual pension contributions by 8% since 2010 or double the rate of revenue growth. These positive funding developments demonstrate the recognition by both employers and employees that retirement obligations should be addressed in a responsible and timely manner.

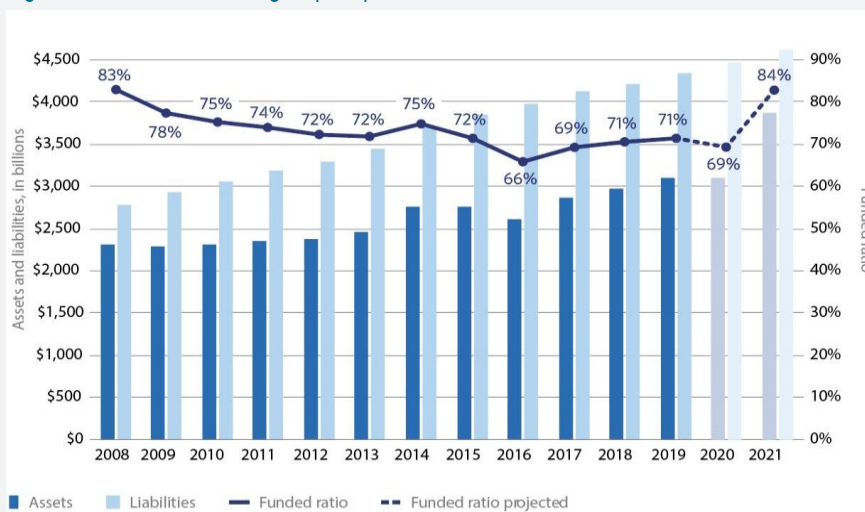
The Pew article reports portfolio returns in fiscal 2021 (ending June 30 for most) exceeded 25% on average and resulted in income gains of more than \$500 billion above target. The excess earnings lowered aggregate unfunded liabilities below \$1.0 trillion for the first time since 2014 and translate into an estimated funded ratio of 84% for 2021, the highest level since 2008.

Asset returns are a vital component of pension system revenues. Based on a historical study by the National Association of State Retirement Administrators (NASRA), investment earnings provide 60% of annual cash receipts, with employee and employer contributions accounting for the remainder.

Of equal importance are the return assumptions adopted by administrators to value assets, liabilities and ultimately, annual funding requirements. Due to the prevalence of low interest rates since the Great Recession, NASRA reports states have gradually lowered return assumptions to 7.2% in 2019 from 8.05% in 2002. Despite longer-dated historical returns above 7.2%, the prudent decision to moderate expectations continues throughout the sector with New York, California and others announcing planned reductions in discount rates over the next few years.

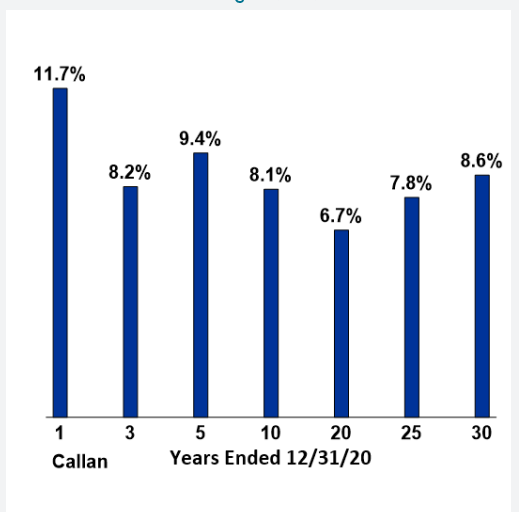
Retiree benefits influence an issuer’s debt profile and overall fiscal health. We review the retirement systems of all issuers in our portfolio in the normal course of our ongoing surveillance. Our evaluation considers the level of participation in a pension plan, funded ratio, size of unfunded liabilities, history and ability of servicing annual contributions, as well as reform legislation. Record investment returns have significantly improved the funded status of state systems and stabilized the claim on resources over the near term. The economic recovery following the pandemic, along with balance sheets strengthened by significant federal aid should enable states to maintain reasonable funding of pension obligations in coming years.

Figure 1: The Pension Funding Gap Projected to Reach Lowest Level in Over a Decade



Source: Pew Charitable Trusts “The State Pension Funding Gap” September 2021

Figure 2: Median Public Pension Annualized Investment Returns for Period Ending 12/31/2020



Source: NASRA Issue Brief, February 2021

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