As Public Pension Plan Funding Continues to Decline, Employers Explore Other Options

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Background

Public pension systems are increasingly underfunded. Data released in 2017 indicates that the median state funding ratio (the percentage of assets that a state has available for future payments to retirees) fell to 71.1 percent in 2016, down from 74.5 percent in 2015. In total, the funding ratio of 43 states declined from 2015 to 2016. This news comes despite the fact that states are committing increasingly large sums of money to public pension obligations. For example, Michigan contributed $2 billion to fund the pension benefits of its largest public pension system in 2015, but that system's unfunded liabilities grew nonetheless.

Underfunded public pensions can affect public employers, their employees, and ultimately, taxpayers and legislatures. One important consequence currently affects public employers. Many public pension systems report that more than 80 percent of current pension spending now goes to catch up on past underfunding. As a result, governmental employers frequently feel pressure to limit wage increases and cut other expenses, such as infrastructure and public safety. How a governmental employer that participates in a public pension plan can react to this financial pressure is dictated in part by whether the employer (1) participates in a multiple employer public pension plan or (2) sponsors a single employer pension plan.

Legal Issues Facing Employers

1. Multiple Employer Public Pension Plans

Governmental employers that participate in multiple employer public defined benefit plans are required to make periodic funding contributions to the plan. Because of the underfunding issues that are described above, many employers are facing significant increases in their required pension plan funding contributions. Some employers are beginning to explore options for reducing or curtailing their pension plan liability. The options that are available to an employer depend on state law, as well as the applicable plan document.

One option that a governmental employer might consider is to withdraw from participation in a public pension plan. Most pension plans require that a withdrawing employer must contribute to the plan a share of the plan's unfunded liability (the "withdrawal liability"). The manner in which the withdrawal liability is calculated is typically described in the plan document. Additionally, many plans require approval of the withdrawal from the employer's Board, from a legislative body, or from voters.

Some public pension plans allow a participating employer to freeze participation in the pension plan, so that no new employees will be eligible to participate in the plan. The plan may provide that an accelerated amortization schedule applies to an employer who elects to freeze its participation, which could increase the amount of the employer's funding contributions in the short run. Additionally, some plans offer the option to participate in a "hybrid plan." A hybrid plan combines aspects of a defined benefit plan and a defined contribution plan, and typically requires lower funding contributions than a traditional defined benefit plan.

2. Single Employer Public Pension Plans

Governmental employers that sponsor single employer pension plans often experience the same underfunding issues that multiple employer governmental pension plans are facing. Employers might consider whether to freeze or terminate their defined benefit plans, and instead offer benefits under a defined contribution plan. Any changes to the benefits that are offered under governmental pension plans must comply with state law. For example, many states have constitutional provisions or statutes that prohibit the reduction of retirement benefits under a public pension plan. What constitutes a "reduction" of retirement benefits varies from state to state.

Options

Most public pension systems provide options for participating employers to terminate or modify their participation in the system. Those options may seem confusing in light of the legal issues that are described above. Foster Swift has helped many governmental employers with these legal issues. For example, we have helped employers to withdraw from public pension systems, negotiate withdrawal liability, and establish defined contribution plans. Additionally, we have helped employers to successfully freeze or terminate their defined benefit plans in accordance with relevant law. Please contact an attorney in our employee benefits group if you would like to discuss these issues.