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Low interest rates squeezing pension funds

Public, private plans scramble to make up widening shortfalls

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Thanks to stock market gyrations and the lowest interest rates in 60 years, millions of Americans are struggling to keep their retirement savings intact and secure their future.

And it's not any easier for managers of their pension funds.

Both groups share a mounting problem. The plunge in interest rates engineered to save the U.S. economy and banking system has left them with a giant money hole to fill. Much like a retiree trying to live off the income from Treasury bonds, when interest rates fall, you need a lot more bonds to generate the same level of income.

The same principal has left the nation's public and private pension funds badly underfunded.

"We are actually more underfunded than we were at the end of 2008 because of the drop in interest rates since then," said John Ehrhardt, who tracks fund performance for benefits consultant Milliman.

That's a sharp reversal from just a few years ago, when pension funds managed by the nation's largest corporations were fully funded, holding roughly $1 in assets for every $1 of future obligations to pay benefits.

When the financial markets tanked in 2008, stock market losses wiped out trillions of dollars in assets of both individual retirement accounts and pension funds. The market's rebound since then has helped make up some of those lost assets. But lower interest rates have made it more costly to meet future liabilities. In just the last year alone, the ratio of assets to liabilities of the 100 largest private pension funds has fallen from 82 cents on the dollar to just 73 cents.

So companies are scrambling to find ways to fill the funding gap.

"It's unlikely for most funds that investment return alone is going to do the trick," said Alan Glickstein, a benefits consultant at Towers Watson.

That means setting aside additional contributions from corporate profits. Ehrhardt says those contributions are at the highest levels in 10 years – close to $50 billion last year – and could hit $75 billion for 2010.

The ratio of assets to liabilities is a rough guide to a fund's ability to cover future benefits, but other factors come into play. A pension plan for a company with rising profits and relatively few retirees for each active worker is better positioned than an older company with a large retiree pool and a shrinking work force. That's why pension plans for airlines are among those under the most pressure: the assets backing Delta Air Lines' plan covered just 44.8 percent of liabilities, while American Airlines' coverage ratio was 58.7 percent, according to a recent survey by Pensions & Investment.

When pension funds face financial pressure, they have limited options. By law, benefits already accrued can't be cut. Closing the plan to new employees or freezing benefits for all members can bring only limited savings because the plan now has to keep paying retirees without new money coming in.

Companies are also barred from terminating their plan unless it can show there are enough assets in the plan to pay retirees their full benefits. If a company with an underfunded plan goes broke, the assets of the company can be tapped to make up the shortfall. And if all else failed, private pensions are backed by a federally administered insurance plan managed by the Pension Benefit Guarantee Corp. (PBGC).

"Realistically speaking pension benefits are secured three ways: the assets in the plan, and the assets of the plan sponsor, and essentially the federal government if the other two are not sufficient," said Glickstein.

Managers of public pension funds, which aren't protected by the PBGC, are having an even tougher time filling the widening gap between assets and liabilities. That's because tax revenues, the main source of funding for most state pension funds, have fallen sharply since the recession began in December 2007.

Though the largest states, such as California and New York, face the biggest budget gaps, the pension squeeze is even worse for a handful of smaller states. That's because the size of their pension fund shortfall is much larger in relation to the size of their economies.

"If it takes up a large amount of their (Gross Domestic Product). Essentially they are going to have to grow their way out of this," said Pamela Villarreal, a senior analyst at the National Center for Policy Analysis (NCPA). "It's just not feasibly."

Connecticut, for example, which has only 27 cents set aside for every dollar of pension liabilities, will have to close a funding gap that represents roughly a third of its GDP, according to an NCPA analysis. The shortfall for Kentucky, which is only 37 percent funded, amounts to 36 percent of GDP. Hawaii, which has set aside only 31 cents per dollar of pension obligations, has to come up with an amount equal to 37 percent of GDP, according to NCPA figures.

States have limited ability to borrow money to shore up pension funds; when they do, they simply defer the day of reckoning. The drop in tax revenues is also forcing layoffs at state and local governments across the country.

That has put public pensions in a harsh political spotlight. Taxpayers, already stretched by stagnant wages, falling home prices and high unemployment, are balking at making up the shortfall for public employee pensions.

Diana Frey, a city worker in Cincinnati for the past 18 years, is among those facing cuts in future benefits. Though she contributes roughly a quarter of her paycheck to the fund, the city is considering a variety of cuts that would force her to work longer or live on less when she retires.

Since 2000, the number of workers covered by the pension plan has dropped from 2,500 to just 862 workers.

“But there are no less road miles in the city of Cincinnati,” said Frey, who works in the city's sewer department. “We have cut back so severely, yet we're still required to maintain this level of service and maintain the public safety."

Those staffing cuts exacerbate the pension funding gap.

Frey says municipal workers recognize that asking to divert more taxes to fund public pension shortfalls is a tough sell with voters.

“We do get it,” she said. “But we’re not the greedy ungratefuls that the private sector thinks that we are. We’re the people that, when you call 911, we’ll come out to your call. Or when you trash needs collecting, or you go a health center, we’re the people who take care of you.”