A fact sheet from Pew

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Risk Reporting Practices Across Pension Plans

States have adopted stress testing as they face an uncertain economy

Overview

State retirement systems began the 2022 fiscal year in their best condition since the Great Recession due to higher-than-expected investment returns and increased employer contributions, which helped boost assets and pay down debt. Yet recent market volatility—including an estimated loss of 8%, or roughly $300 billion, on plan investments for the fiscal year—combined with the possibility of an economic recession in the near future is a reminder that pension plans and government budgets remain vulnerable to risk. Comprehensive risk reporting can help states estimate the impact of market corrections on pension plan balance sheets and employer costs, which in turn can help them to manage the risk that future investment returns will fall short of plan assumptions.

Pension risk reporting refers to forward-looking assessments such as stress tests that measure funding levels and required annual contributions under a range of economic scenarios. These assessments can help plan sponsors and fiduciaries understand the potential impact of swings in the financial markets or a recession in order to better plan for the long term and manage costs. Adoption of risk reporting has grown significantly over the past decade, with 25 states now conducting some kind of routine, forward-looking assessment of investment risk and potential budget impacts, compared with only seven states in 2012.

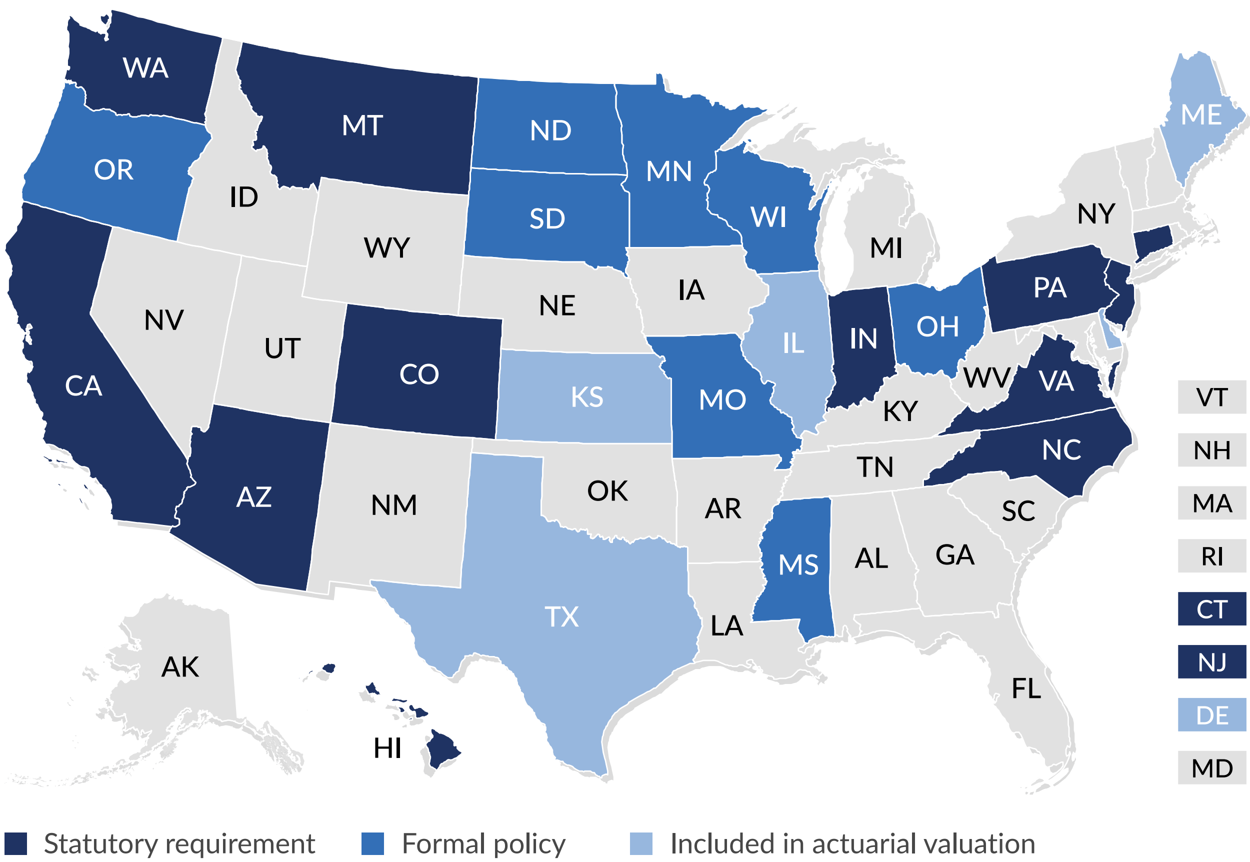
Growing attention from actuaries, policymakers, and third parties, including Pew, has contributed to these increases in pension risk reporting. In particular, the Actuarial Standards Board adopted new guidelines in 2017 requiring disclosures of the risk that the actual outcomes for pension funding might differ from plan assumptions. Around the same time, Pew released a framework for risk reporting that established specific guidelines designed to help policymakers evaluate the impact of risk on plan funding levels and government budgets. Finally, policymakers in several states have shown support for pension stress tests and other risk assessments by enacting statutory risk reporting requirements.

Risk reporting has proved integral to the success of high-performing retirement systems and has helped inform improvements for underfunded plans. As plans face potential cost increases due to inflation, shocks in the financial markets, and other uncertainties, stress tests and other risk assessments could help policymakers tasked with balancing pension promises alongside other critical government services.

Figure 1

State Risk Reporting Practices

25 states conduct forward-looking assessments of investment risk on pension plan funding levels and contributions



Source: Pew analysis of plan actuarial and financial reports

50-state review of pension risk reporting

In 2017, new standards governing risk disclosures for pension plans required routine plan valuations to disclose and assess risks that might affect funding levels and required contributions. To identify risk reporting practices across the 50 states, Pew reviewed these disclosures, as well as other plan financial and actuarial reports, board materials, and additional documents, for 100 state pension plans.[1]

Pew's minimum standard for pension risk reporting includes forward-looking and quantitative analysis of investment risk—that is, the risk that investment returns will deviate from assumptions—in plan financial and actuarial reporting. These analyses should provide sufficient detail to measure the effects of investment risk on required contributions as well as funding levels. Such assessments may range from simplified projections included in actuarial valuations to more detailed, stand-alone stress test reports.

Beyond this minimum standard, risk assessments should also seek to produce policy-relevant analysis, or information about investment risk that is useful to the governmental plan sponsor. Such analysis might consist of metrics that provide early warning indicators of fiscal distress, assessments demonstrating the potential impacts of plan costs on government budgets, or analyses of provisions designed to share risk between sponsoring governments and plan participants. More robust assessments can also go beyond assessing investment risk—which has the greatest effect on plan funding levels and costs—to evaluate the risk that actual contributions will fall short of assumptions. They can also look at other significant risks such as unexpected changes affecting participant mortality and longevity, inflationary pressures, and the potential impacts of climate change on plan investments.

Finally, risk reporting should be routine and transparent, meaning assessments are regularly conducted and made publicly available. To ensure that risk assessments met this condition, Pew reviewed only public materials published on plans' and states' websites when evaluating state risk reporting practices.

Progress and state examples

The first states to adopt risk reporting requirements were Washington and California in 2007 and 2011, respectively. Several states implemented similar practices in the decade following these initial adoptions, and 2017 marked a sea change in risk reporting adoption among state pension plans, with increased interest from plan sponsors, boards, and actuaries.

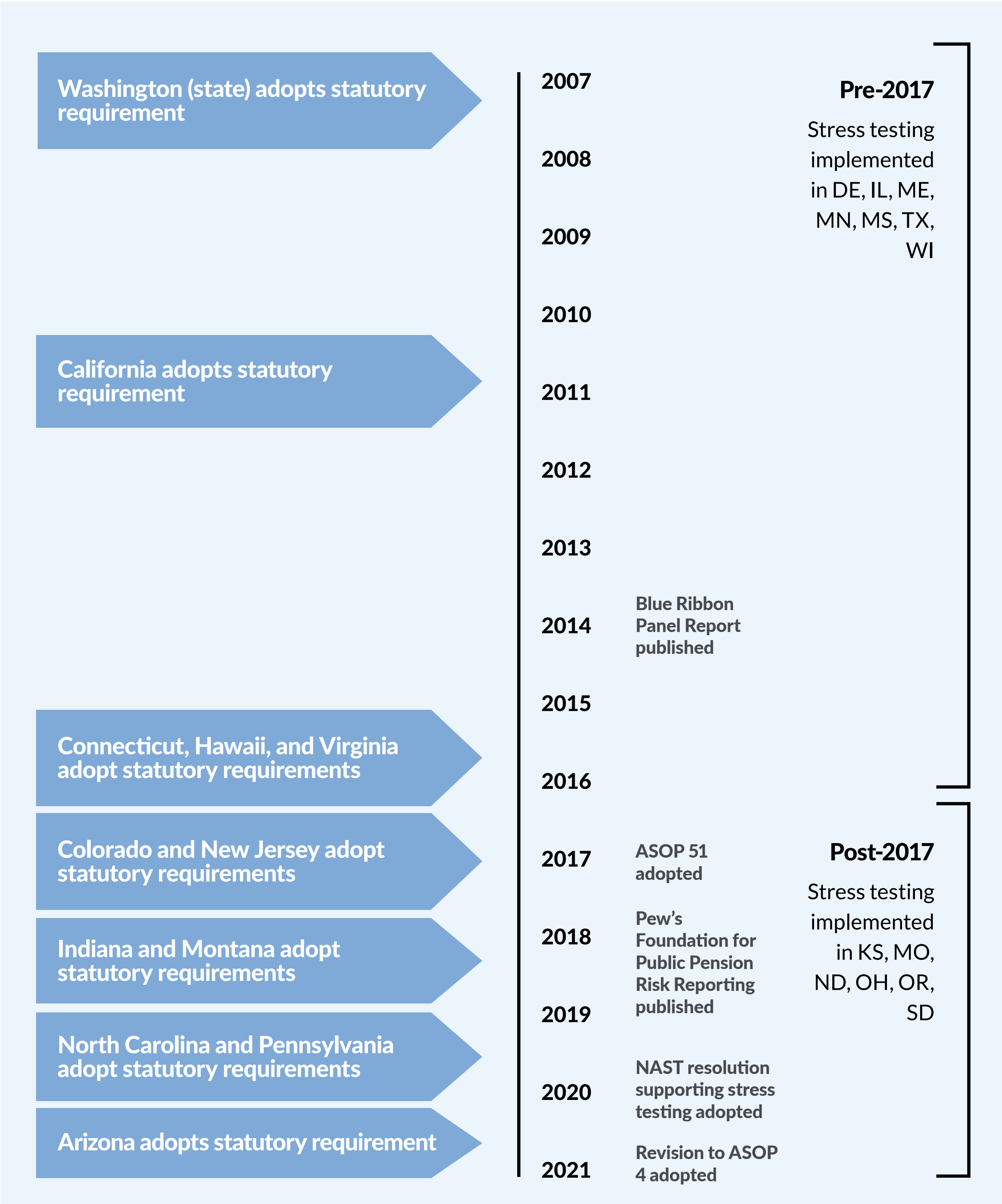
To date, Pew has identified risk reporting practices in 25 states:

- 12 have implemented statutory stress testing requirements.
- Eight require regular risk assessments as part of a formal policy established by a board of trustees or legislative oversight body.
- Five have incorporated forward-looking assessments into their annual actuarial valuations.

Figure 2

Timeline of Risk Reporting Adoption Among State Pension Plans

Implementation has grown significantly since 2017



Source: Pew analysis of plan actuarial and financial reports

Model retirement systems, such as those in South Dakota and Wisconsin, demonstrate how risk reporting can help policymakers assess current policies and inform targeted changes before problems threaten plan funding or government budgets. In South Dakota, a risk analysis conducted after the onset of the COVID-19 pandemic helped plan administrators assess whether existing policies were sufficient to manage market volatility and inform timely decision-making. Similarly, regular risk reporting in Wisconsin helps policymakers assess how adjustable benefit increases will respond to different market conditions and plan funding levels, showing the implications for both fiscal sustainability and retirement security. Washington state offers another example of a well-funded retirement system where risk reporting has been used by policymakers for over a decade, with a focus on helping analyze what different demographic and investment trends could mean for the state's budget.[2]

Risk reporting has also helped states with underfunded pension plans identify warning signs of distress, consider early interventions, or ensure that prior reforms are successful. In Colorado, after stress tests showed a risk of insolvency despite previous reforms, plan administrators and state policymakers worked to address plan shortcomings.[3] Similar assessments in Connecticut showed a risk of sharp increases in required pension contributions in the event of a future market downturn, informing the creation of a funding policy with more predictable costs.[4] More recently, projections assessing the pandemic's effects on New Jersey's pensions encouraged policymakers to pay required contributions in full, rather than postponing or reducing payments in response to expected revenue constraints.[5]

Finally, some states have begun looking beyond assessments of investment risk to begin evaluating the potential effects of climate change on plan assets and funding levels. Following legislation enacted in 2018, Maryland became the first state to begin publishing scenario analyses evaluating the potential effects of climate-related financial risks as part of an annual assessment of risks affecting the state's pension plans. Similar legislation was also adopted in California, and legislators in Colorado and Minnesota have recently considered proposals for climate risk assessments of state pension plans.

Approaches to risk reporting implementation

Pew's analysis indicates that 20 states have implemented pension risk reporting requirements through statute or formal policy. Such requirements can help clarify reports' content, frequency, and core audience. In the absence of such formal requirements, these details are left to the discretion of plan administrators and actuaries, and may not include analyses that are accessible or relevant to the governmental plan sponsors who are responsible for meeting pension obligations alongside the provision of other critical government services.

Another consideration for risk reporting is that results are shared with key stakeholders, including governmental plan sponsors. Formal policies by plan boards can outline requirements for the frequency and content of stress tests; however, these may leave the plan sponsor out of critical discussions of risk affecting funded levels and required contributions. Adopting a statutory requirement for risk reporting through legislation allows the plan sponsor to clarify the types of risk to be assessed and ensures that findings are shared with stakeholders and decision-makers beyond the plan board of trustees.

Pew has identified three elements that are essential to a risk reporting requirement that is adopted either through statute or formalized policy. These elements ensure that assessments are routine and transparent, forward-looking and quantitative, and that analysis provides policy-relevant information to governmental plan sponsors and budgetary decision-makers.

Figure 3

Essential Elements of Risk Reporting Policy

Routine & transparent	Forward-looking	Policy-relevant
Stress testing is done on a regular basis and published in a public-facing manner	Assesses the effects of low or volatile investment returns on plan funding levels and contributions	Includes analysis of potential plan costs in a budgetary context
Target audience includes plan fiduciaries and governmental plan sponsors	Provides a framework that can be tailored to reflect plan circumstances and relevant economic scenarios	Designed to inform long-term decision-making

All pension plans are different, and each state has its own approach to codifying reporting practices. While actuaries have raised the bar for risk reporting by requiring new disclosures for valuations, these reports are targeted to plan fiduciaries and do not necessarily reflect the concerns of plan sponsors and other stakeholders. For this reason, a statutory reporting requirement that builds on the analysis done by plan actuaries can ensure that risk assessments are useful to policymakers beyond the pension boardroom. Although there is no uniform approach to implementing such requirements, Pew has drafted model legislative text, included in the accompanying methodology document, that offers an example of a standardized policy containing the essential risk reporting elements outlined above.

Conclusion

Despite the progress made in pension funding over the past decade, states continue to face significant volatility and uncertainty in the financial markets, just as they did during the Great Recession. Although states are now better positioned to weather future risks, tools such as risk reporting will remain vital in helping plan administrators and budgetary decision-makers navigate uncertainty and ensure fiscal sustainability in the decades to come. Implementing statutory requirements for pension risk reporting—in particular, requirements that provide for regular, transparent, and forward-looking assessments of investment risk—can help plan sponsors balance adequate and predictable pension funding alongside other critical government services throughout good financial times and bad.

Endnotes

1 This review excluded asset-liability studies, which are produced by plan investment consultants and assess a range of investment return outcomes. These studies are designed to evaluate asset allocation policies and return assumptions and are not part of the formal risk assessments performed separately by plan actuaries.

2 Washington State Legislature, "Commentary on Risk," accessed Aug. 29, 2022, https://leg.wa.gov/osa/pensionfunding/Pages/CommentaryOnRisk.aspx.

3 G. Mennis, T. Dawson, and S. Fehr, "Financial 'Stress Test' of Colorado Pension System Spurs Reform," The Pew Charitable Trusts, July 26, 2018, https://www.pewtrusts.org/en/research-and-analysis/articles/2018/07/26/financial-stress-test-of-colorado-pension-system-spurs-reform.

4 G. Mennis and M. Lowenthal, "Stress Testing in Connecticut Shows Reforms Stabilizing State Pension System," The Pew Charitable Trusts, Jan. 30, 2019, https://www.pewtrusts.org/en/research-and-analysis/articles/2019/01/30/stress-testing-in-connecticut-shows-reforms-stabilizing-state-pension-system.

5 D. Draine, C. Hall, and E. Wei, "New Jersey to Make Largest Pension Contribution in State History," The Pew Charitable Trusts, Oct. 1, 2020, https://www.pewtrusts.org/en/research-and-analysis/articles/2020/10/01/new-jersey-to-make-largest-pension-contribution-in-state-history.

For further information, please visit: pewtrusts.org/pensions

The Pew Charitable Trusts

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