Demystifying the ‘Unfunded Liability’

**Audience:** NERS members and citizens

**Description:** Clarification of the difference between the Norfolk Employees’ Retirement System’s (NERS) assets and the value of benefits already accrued or the ‘unfunded liability’.

**DISCLAIMER:** This pamphlet summarizes parts of Chapter 37 of the Code of the City of Norfolk. This summary is intended to provide simplified and meaningful information that is relevant to the average member. Any information that is inconsistent with, or contradicts, Chapter 37 must be disregarded.

The NERS “Know 2 Ask” series provides basic information needed to empower you to ask important retirement-related questions. Knowing who and what to ask is key.
Plan Funding Overview

Funding for NERS, like other retirement plans, is based on a Money In must equal Money Out formula, where the left side (plan income) must balance with the right side (plan benefits and expenses):

\[ C + I = B + E \]

Left Side = Right Side

- \( C \) = Contributions (employer and employee)
- \( I \) = Investment Income
- \( B \) = Benefits Paid
- \( E \) = Expenses (administrative)

Each year NERS hires an actuary to estimate the true cost of the plan and determine the contributions needed to meet that cost. The actuary estimates each member’s individual pension benefit — making certain assumptions about life expectancy, wage increases, plan investment returns, years of life after retirement, inflation, and many other factors.

Simply put, there is no way for these assumptions to be completely accurate. The unfunded pension liability, which is more formally referred to as the unfunded actuarial accrued liability (UAAL) in financial statements — comes about because past assumptions have not been met.

Each year, as the local government plan sponsor, the City is required to fund both benefits currently being accrued and to eliminate any shortfall called unfunded accrued liability.

Unfunded Liability Facts

Simply having an unfunded liability does not mean that a pension plan is unable to pay the benefits it is presently obligated or to meet current cash flow requirements.
The City does not have to take drastic and immediate actions to reduce or pay off the plan’s unfunded actuarial liability. It is being “paid down” in the same way you pay down your home mortgage. The annual contributions contain a payment toward this unfunded liability.

The health of a public retirement plan is not determined by the unfunded liability. The health of the plan has more to do with the City’s ability and willingness to make the minimum required contribution on an annual basis.

**Know the Details**

- **NERS PRESENTLY HAS A FUNDED RATIO OF 73% (AT 6/30/2020)**
  - This means that the actuarial value of the retirement system’s assets is 73% of the projected amount needed to pay for current or future benefits for retirees, beneficiaries and members.
  - It is important to note that an unfunded pension liability is not an exact dollar amount; it is an estimate based on a number of assumptions — demographic and economic — and is, therefore, subject to fluctuation. As a result, the funded ratio is a better measure of a plan’s financial status.
  - Despite the unfunded liability, retirement benefits for NERS members, retirees and beneficiaries are secure and cashflow is available to pay NERS current liabilities.
  - The City of Norfolk’s employer contribution rates are calculated to reflect the cost of benefits as they accrue, as well as pay down existing unfunded liabilities.
The NERS members’ mandatory five percent (5%) contributions (City Code Sec. 37-103.1) are calculated based upon a member’s individual earnable compensation.

Return on investments is the money (return) that NERS earns from an investment during a certain timeframe. Return on investments is a percentage that identifies the amount of money earned (return) related to total value of the assets (money) that was invested.

Key Takeaways

An unfunded pension liability is the difference between the NERS assets and the value of benefits currently due or due at some point in the future.

The unfunded liability represents the actuarial value of NERS benefits that have been earned in the past, but not yet funded.

The fact that a retirement system has an unfunded liability does not mean the plan is underfunded. Further, this liability does not mean that NERS is not able to pay its current retirees and beneficiaries or its future members. NERS is financially sound and its assets are secure and safe.

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