Pension Brief: The Future Of U.S. Public Pensions After The Sudden-Stop Recession

May 6, 2020

Key Takeaways

- U.S. public pension funds in aggregate lost approximately $850 billion in the first quarter of 2020.
- A Q2 2020 return of nearly 30% is needed for government-sponsored pension systems to maintain the 73% average funded ratio from a year ago.
- Should experience mirror that of the recent Great Recession, adjustments to reduce plan costs and increase contributions are likely.

Escalating pension obligations caused by the sudden-stop recession are likely to be felt for years by U.S. state and local governments. In the public sector, market returns are built into the funding model and thus make up a large part of pension plan inflows. Should market returns remain below past peaks, the effect of poor returns will result in an increase in employer contributions. To understand the future of U.S. public pensions, we consider the recession impact over three periods:

- Immediate: liquidity
- Near-to-mid-term: funded level signifies the scope of impact
- Long-term: contribution and benefit adjustments over time address plan funding

Immediate: Liquidity

Like municipal budgets themselves, a pension plan’s liquidity position mitigates near-term shocks. Pension asset portfolios that do not hold enough cash to cover benefits could have to sell return-seeking assets at inopportune times. (See "Pension Brief: Liquidity Is A Rising Concern For U.S. Public Pensions In Down Markets," published March 24, 2020 on RatingsDirect.)
Near- To Mid-Term: Funded Levels

We estimate that U.S. public pension funds lost approximately $850 billion in aggregate in the first quarter of 2020. Many public sector pension plans measure their assets in June and are recognized on employer financial statements the following year. Though markets have seen some gains in April, funded ratios are likely to decline in the near future.

The Federal Reserve estimates U.S. public sector pension assets to be $4.8 trillion as of Dec. 31, 2019, allocated between market risk-mitigating (cash, fixed costs, and hedge funds) and return-seeking investments (all others). Chart 2, below, shows the fiscal year 2018 target allocation for the largest pension plan in each state. Approximate aggregate returns for July 2019 through March 2020 are shown below.

Approximate Aggregate Returns (%), July 2019 – March 2020

<table>
<thead>
<tr>
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<th>Risk-mitigating*</th>
<th>Return-seeking§</th>
<th>Combined</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019 Q3 return</td>
<td>2.50</td>
<td>(0.80)</td>
<td>0.20</td>
</tr>
<tr>
<td>2019 Q4 return</td>
<td>0.80</td>
<td>9.90</td>
<td>7.00</td>
</tr>
<tr>
<td>2020 Q1 return</td>
<td>(4.60)</td>
<td>(23.50)</td>
<td>(17.70)</td>
</tr>
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Average target allocation for U.S. pensions†

|                | 31.00 | 69.00 | 100.00 |

* Risk-mitigating results approximated using the S&P 20-Year Municipal Bond Index. § Return-seeking results approximated using the S&P 500 Index. † According to the Boston College Public Plans Database.

In the most recent state and 15-largest-city surveys, S&P Global Ratings found the average funded ratio to be 73%. For the market to counter the sudden-stop recession and maintain the 73% average funded ratio, 2020 Q2 would need to return nearly 30%. This 30% return for the quarter would bring the annual return back from its current minus-12% up to the average assumed rate of 7.25%. If returns stagnate, we estimate the funded ratio for the average state and local government pension plan could decrease to 60% from 73%.
This projected funded ratio formula can be applied for each individual plan with its own estimated asset return and liability discount rate.

\[
\text{Projected Funded Ratio} = \frac{\text{Assets} \times (1 - 12\%)}{\text{Liabilities} \times (1 + 7.25\%)}
\]

**Long-Term: Maintaining Sustainable Funding**

Pension plan sponsors and administrators are likely entering into a period of fiscal stress. To alleviate budgetary pressures, adjustments to reduce plan costs and contribution increases are likely to be considered. Though employer audits may not show the impact of the sudden-stop recession for months, experience from the Great Recession of 2008 gives a sense of what's to come.

Mechanisms such as the typical five-year asset smoothing or "collars" that limit rapid contribution increases are part of most funding policies. This does not reduce losses, but only delays contributions and budgetary adjustments to make up for market losses. Even though smoothing defers contributions, the effects of the market downturn will be immediately recognized in reported liabilities. Funded ratios reported under GASB 67 are based on a market value of assets, without smoothing, unlike what was reported following the last recession.

Benefit tiers, employee contribution increases, and cost of living reductions are all options used to reduce contributions. Additional actions may be limited since many of these levers have already been pulled. A report by the National Association of State Retirement Administrators notes that in the 10 years after the Great Recession, many of these options were utilized. Benefit changes may affect employee hiring and retention efforts, if they haven't already.
Plans that have either taken actions in the past to reduce contributions or lacked action when actuarial recommendations increased are seeing increased stress now. With tightening budgets and operating cost pressures, pension contributions may be an outlet for temporary budget relief at the risk of plan funding. Changes to pension contributions and plan design, if under consideration, will continue to be an important credit factor in assessing structural balance. S&P Global Ratings monitors the credit effects of pension funded and liquidity levels throughout all economic cycles. The current sudden-stop recession will affect many aspects of pension system management, and while deferring costs in the near term may provide budgetary flexibility and be a liquidity management tool, it will increase long-term pension costs. We will evaluate the measures taken to balance near-term budgetary savings with implications for long-term costs and how those decisions drive credit outcomes.

Chart 2

2018 Target Allocation Of Largest State Pension Plans

Source: 2018 CAFRs for North Carolina, Vermont, and Washington. Boston College Public Plans Database for all others. Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

Related Research
- Pension Brief: Liquidity Is A Rising Concern For U.S. Public Pensions In Down Markets, March 24, 2020
- U.S. State Pension Reforms Partly Mitigate The Effects Of The Next Recession, Sept. 26, 2019
- Fifteen Largest U.S. City Pensions See Modest Gains In 2018, But Recession Risk And Rising OPEB Cost Challenges Persist, Sept. 23, 2019
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