Five Public Pension And OPEB Credit Considerations To Watch In 2022

February 1, 2022

Key Takeaways

- Pension funding in the U.S. public finance sector improved after very strong market returns in 2021, although a decrease in contributions could negate some of this progress.
- High inflation could affect pensions long term but is unlikely to lead to significant short-term changes to liability or costs.
- Pension obligation bonds (POBs) will likely continue to increase if bond rates remain low, but anticipated rate hikes could disrupt issuance plans.
- Demographic impacts from the COVID-19 pandemic could be felt for some time, but despite increased mortality from the coronavirus, we expect limited pension funding relief.
- Environmental, social, and governance (ESG) considerations, including contribution and benefit reforms, will continue to affect pension management.

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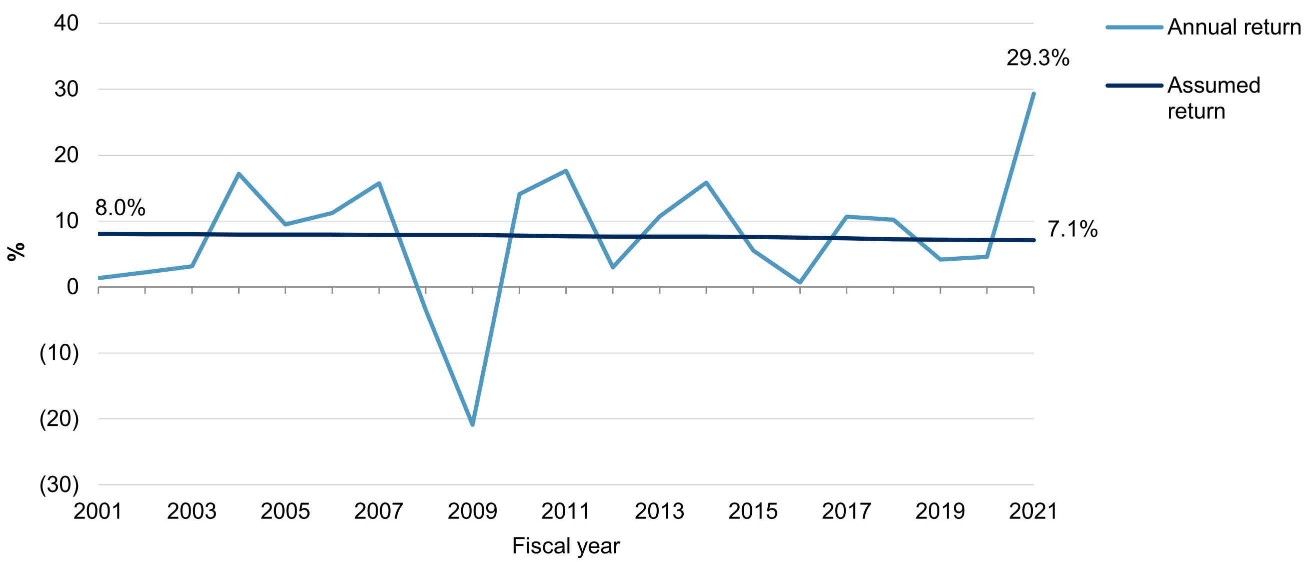
Market Returns Provide Some Relief, But Funding Challenges Remain

Public pension system funded ratios generally improved in fiscal 2021, often significantly, with market returns of near 30%, but S&P Global Ratings notes that large unfunded pension liabilities remain a significant pressure point for states and local governments around the country. Over the past 20 years, public pension assets added risk to their asset portfolios as inflation declined and managers sought yield, and we expect this trend will continue. We are also beginning to see new avenues of risk and yield-seeking through the addition of alternative investments, or investment vehicles such as cryptocurrencies, to the asset mix. Countering this trend, pension plans across the county are slowly adopting lower assumed returns, with the average falling to 7.1% in 2021 from 8.0% in 2001. We also expect this trend will continue as plan sponsors slowly adjust to higher expected contributions as a cost associated with reduced budgetary volatility. Chart 1 shows the abnormally positive 2021 returns as well as the slow but steady decrease in assumed returns. The chart also highlights the general volatility of year-over-year returns that can lead to contribution jumps for plan sponsors.

Chart 1

Market Returns In 2021 Beat The Assumption For The Average U.S. Public Pension Plan

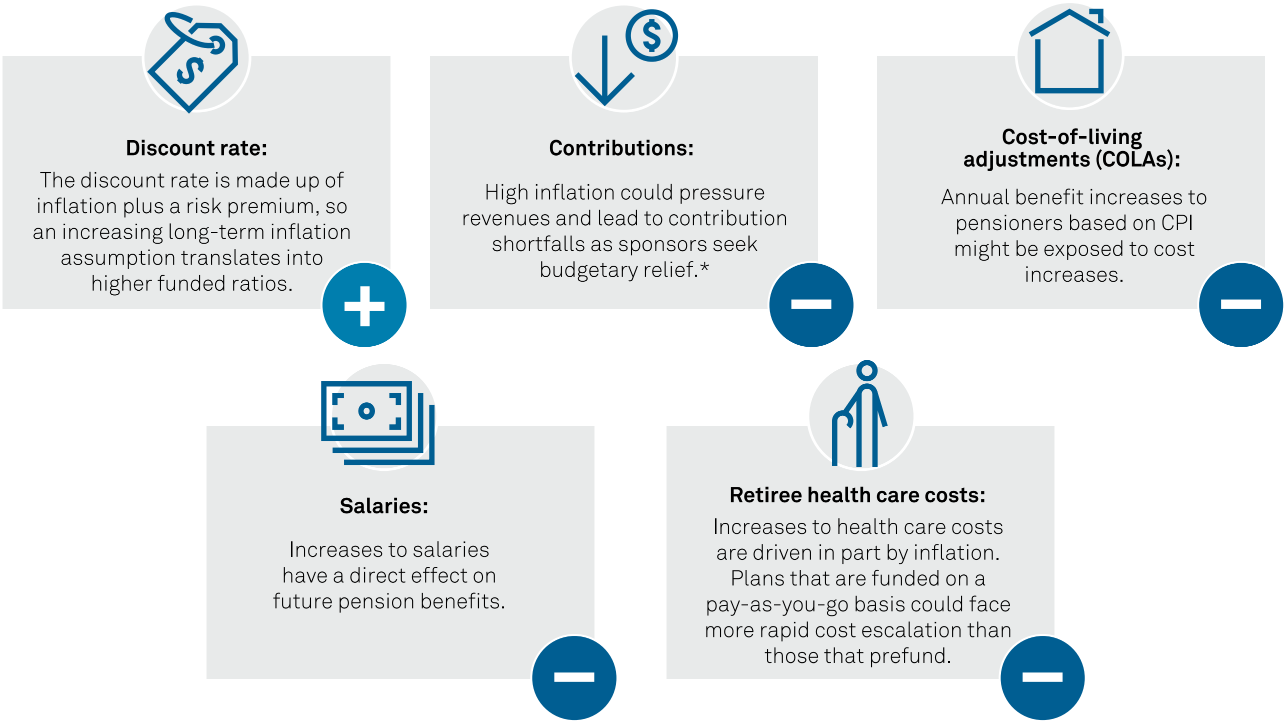


Source: Public Plans Database.

Increasing Inflation Could Affect Pension Costs

The U.S. Consumer Price Index (CPI) reached 7% in December 2021, as reported by the Bureau of Labor Statistics. Periodic market swings have limited effect on long-term actuarial assumptions, as shown in chart 2 by contrasting CPI with the long-term U.S. treasury rate and surveyed U.S. public pension inflation assumptions. Given the limited effect of short-term inflation on liabilities and annual costs, we do not expect a significant change in the credit implications of local government issuers with regard to pensions. However, if inflation remains significantly above trends, this could shift underlying actuarial assumptions in a way that affects pension liabilities and issuer creditworthiness.

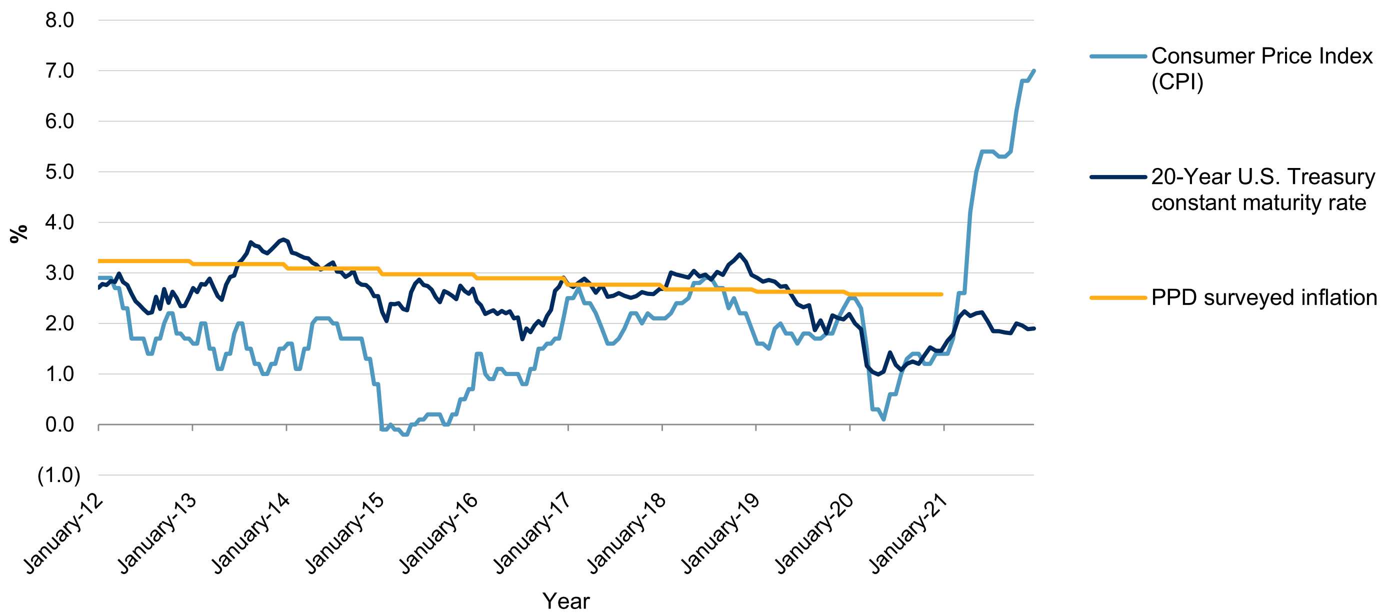
High Inflation, If Persistent, Could Lead To Assumption Changes That Underscore Pension Costs



*See “Outlook For U.S. States: Federal Funds Fuel Spending; Will Inflation Impede The Impact?” Jan. 4, 2022, and “Outlook For U.S. Local Governments: Risks Remain Despite Support From Stimulus,” Jan. 5, 2022, both on RatingsDirect.
Source: S&P Global Ratings.

Chart 2

High 2021 Inflation Could Affect Pension Costs If Sustained



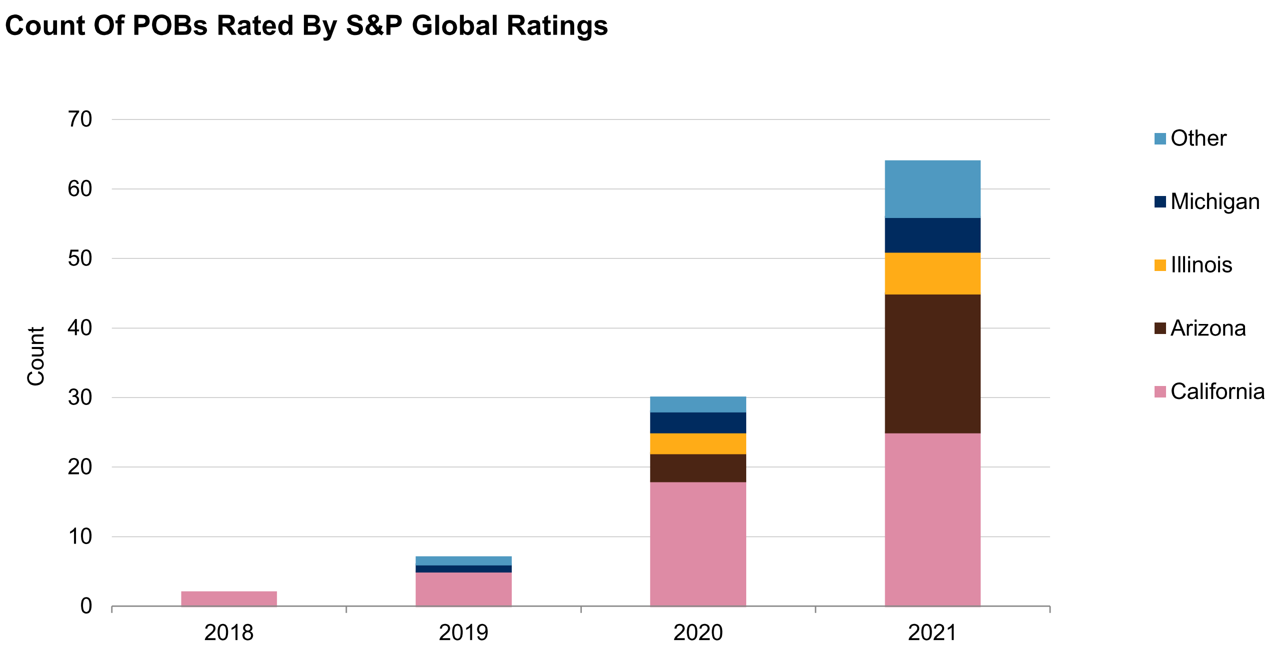
Sources: CPI from the Bureau of Labor Statistics. 20-year U.S. Treasury from the Federal Reserve Economic Data..
PPD surveyed inflation: Public Plans Database.

POBs Will Continue To Increase If Interest Rates Remain Low

POB and OPEB obligation bond (OOB) issuance has been accelerating in the U.S. for the past few years and is expected to continue if interest rates are low. However, low rates might be coming to an end because of inflation pressures, along with expected Federal Reserve quantitative tightening and interest rate hikes. In the meantime, a perception of the end of low interest rates could accelerate POB issuance. Aside from any arbitrage plays, we expect POBs will continue to be used as budget stabilizers for volatile or rapidly increasing amortizations.

S&P Global Ratings discusses its views on risks and opportunities associated with POBs in "Pension Obligation Bond Issuances Continue To Increase In 2021," published Oct. 14, 2021).

Chart 3



POBs--Pension obligation bonds.

A Demographic Impact Caused By The Pandemic, While Generally Limited, Could Be Felt For Some Time

Mortality rates have been unusually high

The Center for Disease Control and Prevention (CDC) measured a decline in life expectancy in 2020 of nearly two years, and this trend is expected to continue in 2021 as the COVID-19 pandemic lingers. Such a reduction to the actuarial assumption of life expectancy typically leads to expected savings for pension plans, particularly given the apparent disproportionate effect on older people who are more likely to be receiving benefits. However, a large change to the actuarial assumption is not expected since pandemic mortality levels are not likely to continue indefinitely. We expect actuaries to include all information about the pandemic, including eventual recovery and ongoing medical advancements, when recommending mortality assumptions and therefore the pandemic effects are likely to be somewhat muted regarding assumed life expectancy.

Payroll growth could be slower than expected

The National Association of State Retirement Administrators reports that, since February 2020, states and local governments have shed nearly 944,000 jobs (4.7%). Pensions that amortize their unfunded liabilities using a level percent-of-payroll methodology base contributions on an assumption of increasing payroll growth that is based in part on hiring. Therefore, this could lead to more deferred contributions than expected and slower funding progress, ultimately leading to increased cost growth, relative to the current baseline, in future years.

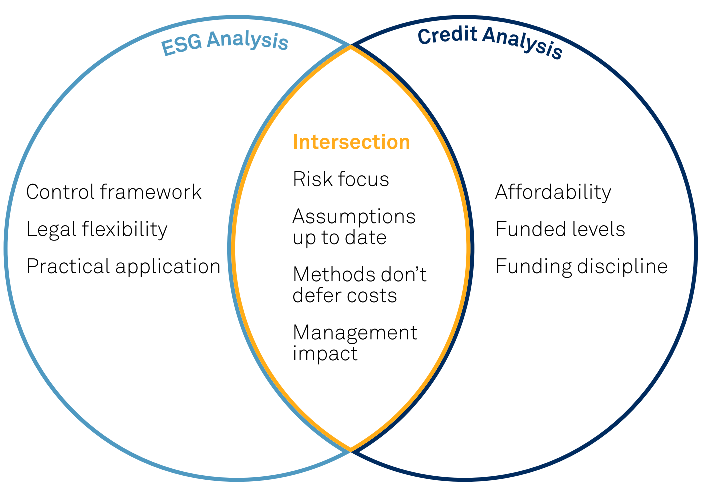
Delayed and early retirement

According to the Society of Actuaries, individuals who reach retirement age with less savings than planned could try to delay retirement. Others, however, might cite health or exposure concerns as a reason to retire early. There appears to much demographic volatility in the job market at all ages and we expect this uncertainty will continue in 2022.

ESG Considerations Will Continue To Influence Pension Management

ESG factors overlap credit rating analysis for pension and OPEB through a review of forward-looking plan governance and risk management (see "ESG Brief: ESG Pension And OPEB Analysis In U.S. Public Finance," published Oct. 7, 2021). In the intersection of ESG and credit analysis, we expect to continue to see management proactively addressing cost deferrals by updating assumptions and methods as well as instituting benefit reforms aimed at reducing long-term pension costs, including hybrid models that share risk among employees, employers, pensioners, and states. (See "Pension Spotlight: Risk Sharing Dilutes Pension Burden For Five States," published April 21, 2021.)

The Intersection Of ESG And Credit Analysis



Source: S&P Global Ratings.

Related Research

- Outlook For U.S. Local Governments: Risks Remain Despite Support From Stimulus, Jan. 5, 2022
- Outlook For U.S. States: Federal Funds Fuel Spending; Will Inflation Impede The Impact? Jan. 4, 2022
- Pension Obligation Bond Issuances Continue To Increase In 2021, Oct. 14, 2021
- ESG Brief: ESG Pension And OPEB Analysis In U.S. Public Finance, Oct. 7, 2021
- Pension Spotlight: Risk Sharing Dilutes Pension Burden For Five States, April 21, 2021

This report does not constitute a rating action.