U.S. Public Pension Fiscal 2023 Update: Funded Ratios Stable, Inflation Retreats, And POB Issuance Stops

July 11, 2023

Key Takeaways

- U.S. pension funded ratios are likely to remain stable or slightly improve for fiscal 2023, as the market recovers from earlier losses.
- High inflation continues to ease toward previous lows, though volatility could affect pension funding if sponsors experience budgetary stress.
- Pension obligation bond (POB) issuances have completely dropped off this year on the expectation that volatile interest rates may come down in the near future.

Funded Ratios Hold Stable

We expect asset performance to drive slight improvement to U.S. public pension-funded ratios for the fiscal year ended June 30, 2023 (July 1, 2022–June 30, 2023). U.S. pension plans, on average, assume annual asset returns of 7%, and if this assumption is not met, it equates to a loss compared with planned inflows that may lead to escalating contributions and credit stress. After a slow start to the fiscal year, we estimate that a typical public pension plan will have experienced a return of around 9% for fiscal 2023 (see methodology sidebar below), which equates to a 2% gain for the year above the 7% return assumption.

We expect fiscal 2024 funded ratios to be near 70% barring an unusual market movement. For illustration purposes, we looked forward to fiscal 2024 using three funded ratio scenarios (see chart 1). The first scenario shows how unlikely it is that we will soon see funded ratios as high as the 82% we saw in our 2021 state survey (see "Market Swings Could Signal Contribution Volatility For U.S. State Pensions And OPEBs," published Aug. 3, 2022). The second shows how the funded ratio might shift given another 9% return for fiscal 2024, similar to this year. The third scenario is a reminder that pension assets must hit their 7% return assumption to maintain their funded ratio. It’s important to note that reported funded ratios may have been calculated up to a year before the date they’re reported.
Inflation Is Returning To Lower Long-Term Rates

The effective federal funds rate has been rapidly increasing, to 5.07% in June 2023 from 0.08% in March 2022, as reported by the Federal Reserve Bank of New York, an indication that we haven't seen the last of volatile interest rates. At the same time, the U.S. Consumer Price Index (CPI) decreased to levels not seen since April 2021. The CPI reached 4.0% at the end of June 2023 from 9.0% in June 2022. This inflation dynamic is meaningfully different from the preceding decade (2010-2020), and high inflation can have contrasting effects on a pension plan. For example, a general expectation of persistently higher long-term inflation could improve funded ratios by driving up the assumed asset return and therefore discount rate. On the other hand, even in the short-term, higher rates could boost pensionable salaries and cost-of-living adjustments (COLAs) for pensioners, both of which increase pension liabilities. For more on how inflation can affect pension plans, including budgetary stress of plan sponsors, please see "Five U.S. Public Pension And OPEB Credit Points To Watch In 2023," published Jan. 31, 2023.

To help gauge where long-term inflation assumptions are trending around the country, we compared surveyed assumptions to current interest rates. We contrasted CPI, the long-term U.S. Treasury rate, and the surveyed average U.S. public pension inflation assumption from the Public Plans Database (see chart 2). CPI has come back from the 2022 spike, even crossing below the long-term Treasury rate, and our economic forecast predicts continued decreases to CPI (see "Economic Outlook U.S. Q3 2023: A Sticky Slowdown Means Higher For Longer," published June 26, 2023). We expect to see minimal push, if any, by U.S. pension plans to increase the long-term inflation assumption that underscores many of the actuarial assumptions used to measure pension liability.
It May Take Time Before POB Issuance Resumes

POB issuance has come to a halt as governments wait for a lower and less-volatile interest rate environment to develop. As recently as 2021, POB issuance had been rapidly increasing due primarily to interest rates that had been at historic lows for years. We noted in our 2021 POB survey that high issuance could be spurred in part by anticipation of the end of record-low rates and now, in contrast, we see low issuance that could be spurred by the anticipation of the end of high interest rates. In our recent economic report cited above, our economists forecast CPI growth of 4.3% for 2023 to come down to under 3.0% in 2024 and nearly 2.0% by 2026. If interest rates follow our economic forecast, it may still take time before we see a return of POBs due to the time-intensive government process of issuance. If and when POB issuance resumes, we could then see some pent-up demand that had been holding off during the recent market volatility.
Market timing is one of the biggest risks with POBs

When assessing the expected cost savings (returns vs. expectations) from POBs in general, more precision than the year of issuance may be needed as market movements can vary widely even within a given year. To show this, we provided an illustration of returns versus expectations for a hypothetical POB issued at various times in fiscal 2023 (see table 1). We estimated the actual cumulative return through June 30, 2023, for a typical U.S. pension plan. Then using the median assumed annual return of 7% for U.S. public pensions, we calculated the return expected to have been achieved as of June 30, 2023, so that their difference may illustrate the high return volatility within a single year of issuance.

Table 1

<table>
<thead>
<tr>
<th>%</th>
<th>Issuance month</th>
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<tbody>
<tr>
<td></td>
<td>3/31/2023</td>
</tr>
<tr>
<td>Actual cumulative return</td>
<td>3.60</td>
</tr>
<tr>
<td>Expected return (7% per year)</td>
<td>1.70</td>
</tr>
<tr>
<td>Actual minus expectation</td>
<td>1.90</td>
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Depending on the quarter, a hypothetical POB issued during fiscal 2023 could range from slightly positive to very positive, and such variance may occur in any given year possibly swinging from negative to positive, and likewise. This can have an outsized impact on costs for a substantial pension trust deposit such as a POB and, if timed poorly, could have negative credit implications as fixed costs rise. Whether or not investment return benchmarks can be realized in the long term, and issuances therefore deemed at or above expectations, it’s important to note that there is more to a POB than its use as a vehicle for market returns. For example, a restructured contribution schedule might be beneficial to an issuer looking to restructure inconsistent expected annual costs. For our views on risks and opportunities associated with POBs, please see "U.S. Pension Obligation Bond Issuance Recedes In 2022 As Interest Rates Rise," published Oct. 10, 2022.

Methodology

Public Plans Database: The typical public pension plan allocated 32% of its target portfolio to "risk mitigation" using bonds, hedge funds, and cash, and 68% of its target portfolio for "return seeking," which takes on higher levels of risk. To approximate annual returns for the risk-mitigation category, we used the S&P Investment Grade Corporate Bond Index and to approximate returns for the return-seeking category, we used the S&P 500 Index.

This report does not constitute a rating action.