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Five U.S. State And Local Government Pension And OPEB Trends To Watch For In 2020 And Beyond

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Key Takeaways

- As interest rates remain low, safer investment options may seem less attractive for U.S. pension funds needing to meet targeted returns.
- Pension reforms and efforts to improve funding discipline will continue, while weak funded plans are likely to consider new ways to solve funding challenges.
- Many state and local governments failed to make meaningful progress on their aggregate pension and OPEB liabilities last year.
- Changing demographics and workforce trends pose multiple risks to pension funding.
- As rising medical costs continue to outpace general price inflation, OPEB spending will likely grow as a significant cost pressure.

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Despite progress over the past decade reducing budgetary risk from pension and other postemployment benefits (OPEBs), many U.S. state and local governments continue to face rising costs to fund these long-term obligations. As S&P Global Ratings looks forward to a new year, we believe there are five key trends related to pension and OPEB obligations that could have implications for future government costs: a new period of lower interest rates, continued efforts to reform pension plans, retirement obligation affordability being a key source of credit stress, changing demographic and workforce trends, and heightened scrutiny around retiree health care plans.

S&P Global Ratings incorporates a forward-looking view of retirement obligations as part of its assessment of a state or local government's general creditworthiness. On Oct. 7. 2019, we published a "guidance" document, "Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings." This document lays out our views of risk associated with various pension metrics, including assumptions in the measurement of liability and methods used to fund that liability over time. In the guidance, we introduce a couple of new measures we will be citing in our reports based on the previous year's total contributions:

- Static funding is an amount that, if contributed every year, would neither reduce nor improve the funded ratio; and

- Minimum funding progress (MFP) metric is an amount in addition to static funding that we consider enough to achieve full funding over a reasonable time.

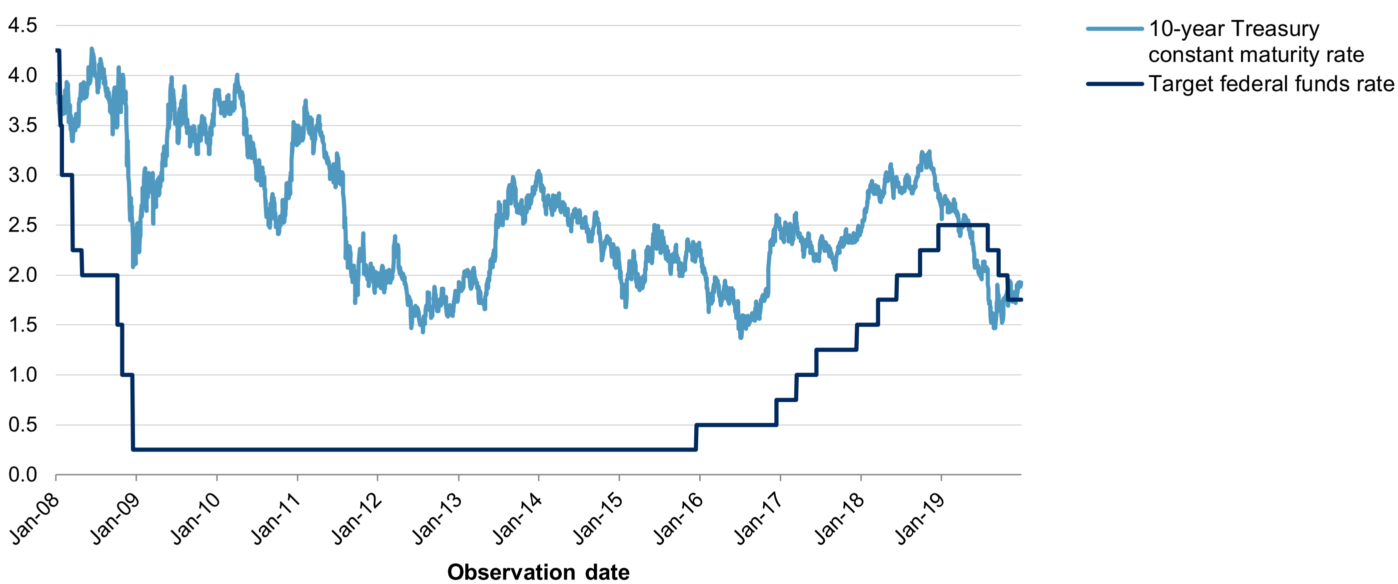
Low Interest Rates And Market Volatility Increase Risk For Public Pension Plans

The lower-for-longer economic forecast, coupled with the living-for-longer demographic trend, has made pension plans credit drivers for some state and local governments. This low growth encourages maintenance of lower interest rates, making retirement assets less likely to grow at target rates of return (see "U.S. State Sector 2020 Outlook: Finding Balance in Today's Lower-for-Longer Economy," published Jan. 6, 2020).

Over the past year, the Federal Reserve lowered the federal funds rate three times, the first time it did so since 2008 following a period of increases during 2015-2018. As interest rates remain low, so do bond yields, making safer investment options less attractive for pension funds needing to meet targeted returns.

Chart 1

U.S. Interest Rates: 10-Year Treasury And Target Federal Funds Rates



*For FOMC's target federal funds rate or range, the chart depcits the top of the FOMC's target range for any given period. **10-Year Treasury Constant Maturity Rate, Percent, Daily, Not Seasonally Adjusted.

Sources: Federal Reserve System; S&P Global Ratings.

During a period of market volatility over the past two years, nearly half of states' largest plans prudently lowered their rate of return assumptions. While lower return assumptions reduce risk, they also increase required contributions, adding to budgetary pressure. We expect this trend of lowering discount rates to continue, and should investment returns remain below target, somewhat weaker reported state pension funded ratios are likely.

Pension Reforms Continue, Partly Mitigating The Effects Of The Next Recession

A history of reforms since the last recession has led to a majority of plans retaining sufficient assets to withstand a market shock. (see "U.S. State Pension Reforms Partly Mitigate The Effects Of The Next Recession," published Sept. 26, 2019). State and local governments are expected to continue discussions around pension reforms to control costs and manage risk. While large-scale benefit reform unlikely, plans will probably continue reducing assumed rates of return and making other assumption changes, while weak funded plans are likely to consider new ways to solve funding challenges.

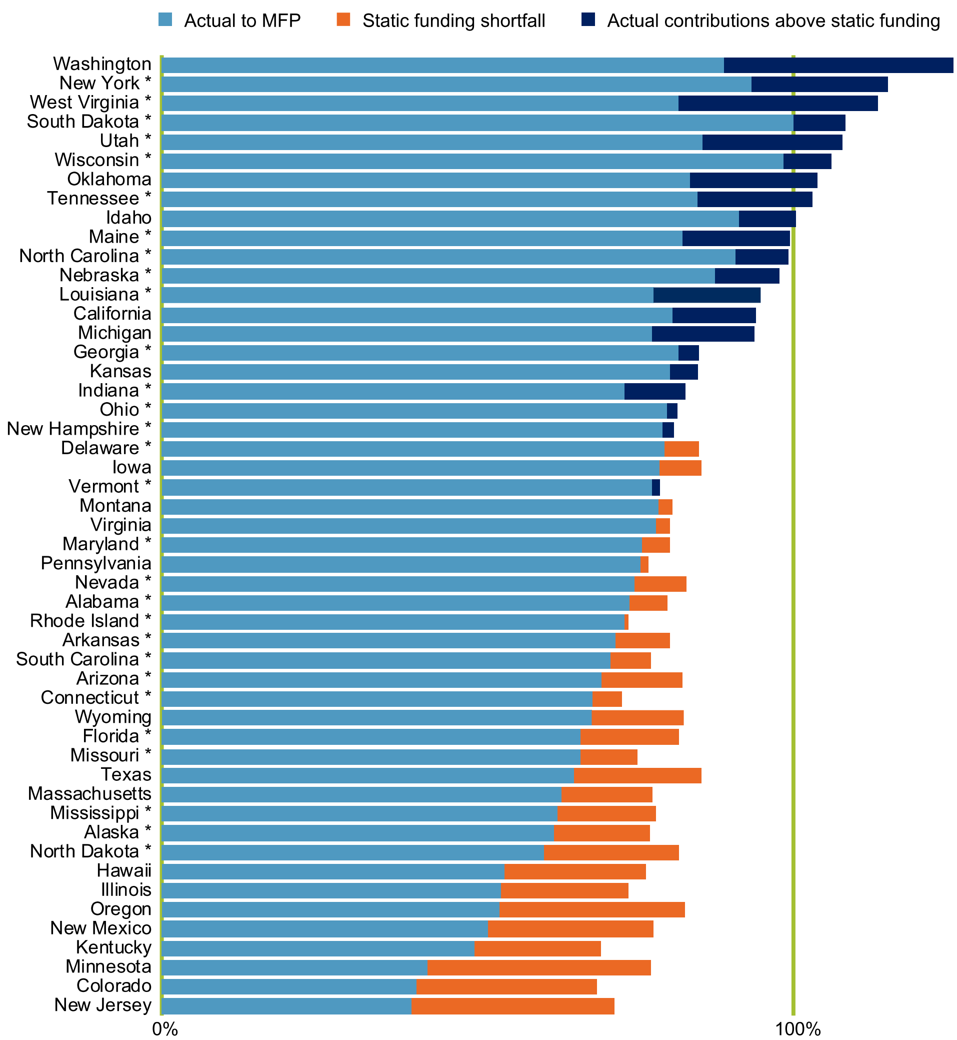
Consideration of asset transfers to pension plans will likely be part of the reform conversations. While not a new concept, the way these solutions are valued and influence funding discipline can have varying effects on the overall health of a pension system and long-term fiscal sustainability (see "Pension Brief: Are Asset Transfers A Gimmick Or A Sound Fiscal Strategy?" published Feb. 19, 2019). New Jersey has already dedicated lottery proceeds to improve funding, and conversations around other transfers have occurred in Connecticut and Illinois (see "Illinois Budget Proposal Places Risky Bets On Asset Transfers And Graduated Income Tax," published Feb. 22, 2019).

Affordability Of Retirement Obligations Remains A Long-Term Source Of Credit Stress

Regardless of widespread efforts to improve funding discipline, many state and local governments are failing to make meaningful progress on their aggregate pension and OPEB liabilities. For fiscal 2018, 60% of states and six pension plans among the 15 largest cities experienced a static funding shortfall. Chart 2 shows the contribution shortfall for state pension plans. In our opinion, making at least minimum funding progress reduces the likelihood of future cost acceleration through a more effective payment structure and one that is ultimately less costly over the long run. As government entities continue to underfund plans based on these metrics, future costs may accelerate and pressure budgets.

Chart 2

State Plan Aggregate Actual Contribution Funding Progress



*These states typically fully meet required contributions with an actuarial basis. Source: S&P Global Ratings.

Improvements to overall funding and funding discipline in 2019 falling short of our MFP metric indicate that pension and OPEB pressures are likely to remain in place for state and local governments for the near future. Pensions and OPEBs are just two of the fixed costs affecting state budget decisions. Management continues to play a critical role in maintaining balanced operations and credit stability.

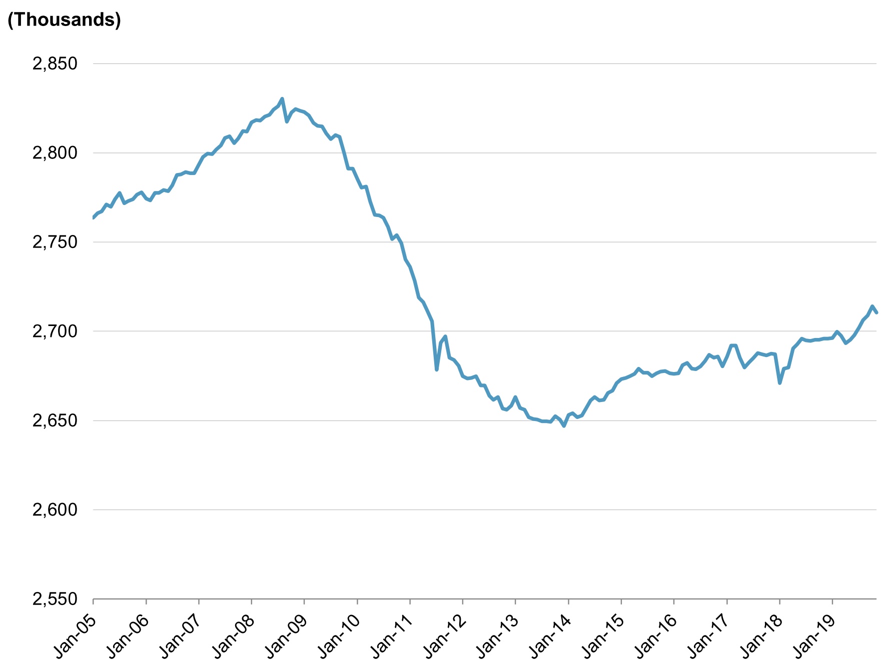
For more information on how we view static funding and MFP across U.S. states and the 15 largest cities, see our reports titled "U.S. State Pension Reforms Partly Mitigate The Effects Of The Next Recession" (published Sept. 26, 2019) and "Fifteen Largest U.S. City Pensions See Modest Gains In 2018, But Recession Risk And Rising OPEB Cost Challenges Persist" (published Sept. 23, 2019).

Demographic Trends And A Changing Public Workforce Affect Funding

As baby boomers continue to reach retirement age and state government payrolls remain well below their prerecession levels, there are reduced plan inflows as fewer active members make annual contributions. This continuing trend places a greater strain on employers, as well as asset returns, to maintain plan funding.

Chart 3

State Government Employees
(excluding education employees)



Bureau of Labor Statistics (BLS) data is preliminary for October and November 2019. Sources: BLS; S&P Global Ratings.

This trend is particularly concerning for plans with high payroll growth assumptions. Every year that payroll growth is not realized leads to a contribution shortfall from expectations and adds unfunded liabilities. We have seen amortization methods reduce such risk of acceleration in states such as Kentucky and Connecticut and expect this trend to continue (see "The Increasing Cost of Governmental Pensions: Discount Rate and Contribution Practices," Sept. 27, 2018).

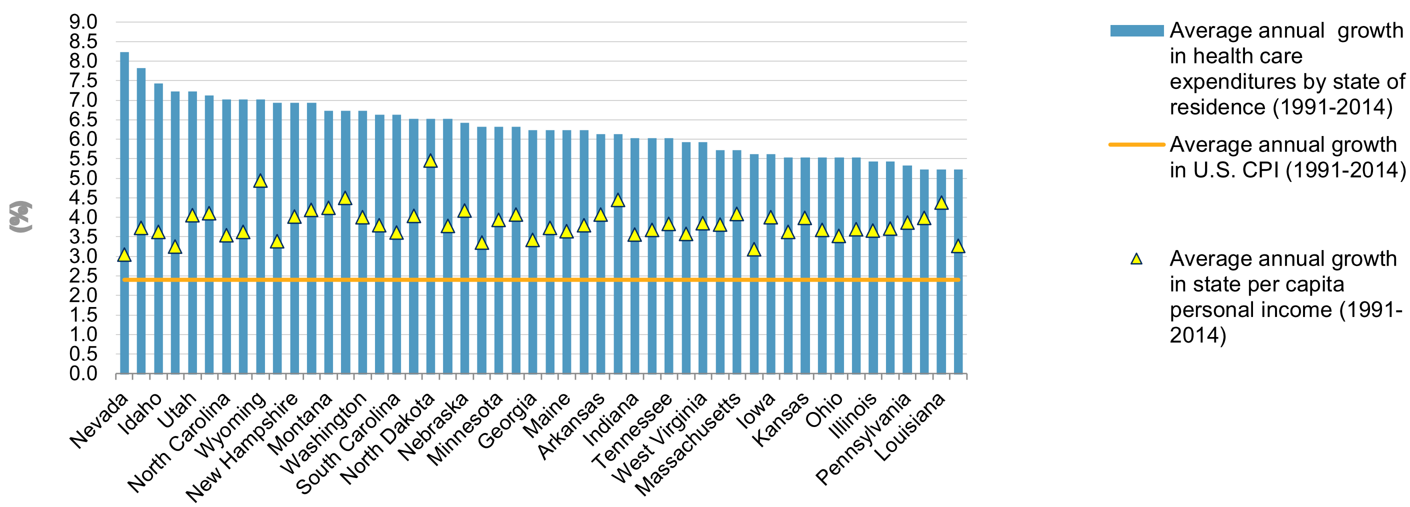
Retiree Health Care Costs And Benefits Face Heightened Scrutiny

Consistent with past years, most governments continue to fund their OPEB liabilities on a pay-as-you-go basis in which annual funding is equal to the benefits distributed. The history of failing to prefund OPEB obligations has led to a steep rise in reported liabilities. In our opinion, scrutiny of these benefits will continue amid national conversations about the future of health care and as liabilities are reported on a government's financial statements (see "Retiree Medical Benefits Generate Unique Cost Drivers And Risks For U.S. States," Sept. 17, 2019).

In spite of OPEBs having generally fewer legal protections than pensions, benefit changes face significant political and social resistance (see "OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility," May 22, 2019). Consequentially, we consider OPEB contributions a fixed cost, absent a credible plan to manage risks. Since pay-as-you-go contributions typically represent a modest amount of a government's budget, future risk is often masked (see "U.S. States Are Slow To Reform OPEBs As Decline In Liabilities Masks Increased Risk," Dec. 3, 2019). However, as rising medical costs continue to outpace general price inflation, OPEB spending will likely be a more significant cost pressure. With OPEBs under more spotlight in the future, legal flexibility to reduce benefits is likely to be tested.

Chart 4

Growth In Health Care Expenditures Compared To Personal Income Per Capita And CPI (1991-2014)



Sources: The Henry J. Kaiser Family Foundation "Average Annual Percent Growth in Health Care Expenditures by State of Residence" Timeframe: 1991-2014. Bureau of Labor Statistics "Historical Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, all items, index averages." Bureau of Economic Analysis "SAINC1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income."