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Five U.S. State And Local Government Pension And OPEB Trends To Watch For In 2021 And Beyond

January 25, 2021

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Key Takeaways

- Pension contribution deferrals are likely to increase among some U.S. local governments experiencing severe budgetary stress.
- Declining government payrolls and early retirements will contribute to shortfalls in required plan contributions and demographic changes could increase costs.
- As interest rates remain low, safer investment options may appear less attractive for pension funds needing to meet targeted returns.
- Governments struggling with budgetary stress may find certain pension reform initiatives, like pension obligation bonds (POBs), could be helpful for long-term system health but do not necessarily solve near-term credit pressures.
- We expect governments and asset managers will be increasingly guided by environmental, social, and governance (ESG) factors in making investment decisions.

U.S. public pension and other postemployment benefit (OPEB) plans face new challenges as the country recovers from the sudden-stop recession and mitigates health and safety risks associated with the pandemic. However, some of the challenges facing these plans are not unlike those that occurred following the Great Recession. S&P Global Ratings expects similar recessionary policy responses to address these risks and management of related costs to have near-term credit implications. Even small changes to pension contributions can have a significant effect on costs and funding levels over the long term.

Pressures brought on by COVID-19 and the recession will continue to weigh on state and local government credit quality (see "Outlook For U.S. States: Symptoms Persist, But A Shot In The Arm Could Lead To Growth," published Jan. 5, 2021, and "Outlook For U.S. Local Governments: Revenue Pressures Mount And Choices Get Harder," Jan. 6, 2021, on RatingsDirect). During times of slow revenue growth, governments are likely to consider deferring costs, including those to retirement plans. These types of actions risk trading long-term funding stability for near-term budgetary relief. Market returns (measured for the year ended June 30, 2020) were stronger than initially anticipated and staved off potentially significant declines in funded positions. Nonetheless, returns were still weak compared to assumptions and likely to result in lower funded ratios.

In 2021 and as we look forward to the next fiscal year, we believe there are four key trends related to pension and OPEB liabilities that could have implications for future government costs: contribution deferrals, reductions in government employee payrolls, a period of low interest rates, and pension and OPEB benefit reforms. The fifth trend reflects our belief that environmental, social, and governance (ESG) factors likely will have a greater influence over asset allocation and investment decisions.

Contribution Deferrals To Relieve Budgetary Stress

The most direct form of contribution deferral is paying less than what is required. To address budgetary shortfalls, we observed some governments delaying planned contribution increases or contributing less than was required in fiscal years 2020 and 2021. We expect these direct deferrals to continue in the near term, along with other indirect actions to defer costs. These indirect actions may include extending amortization periods, smoothing out asset volatility over longer periods, or backloading contribution schedules.

Chart 1

Percentage Of Unfunded Liabilities Remaining Under Different Amortization Methods: Period

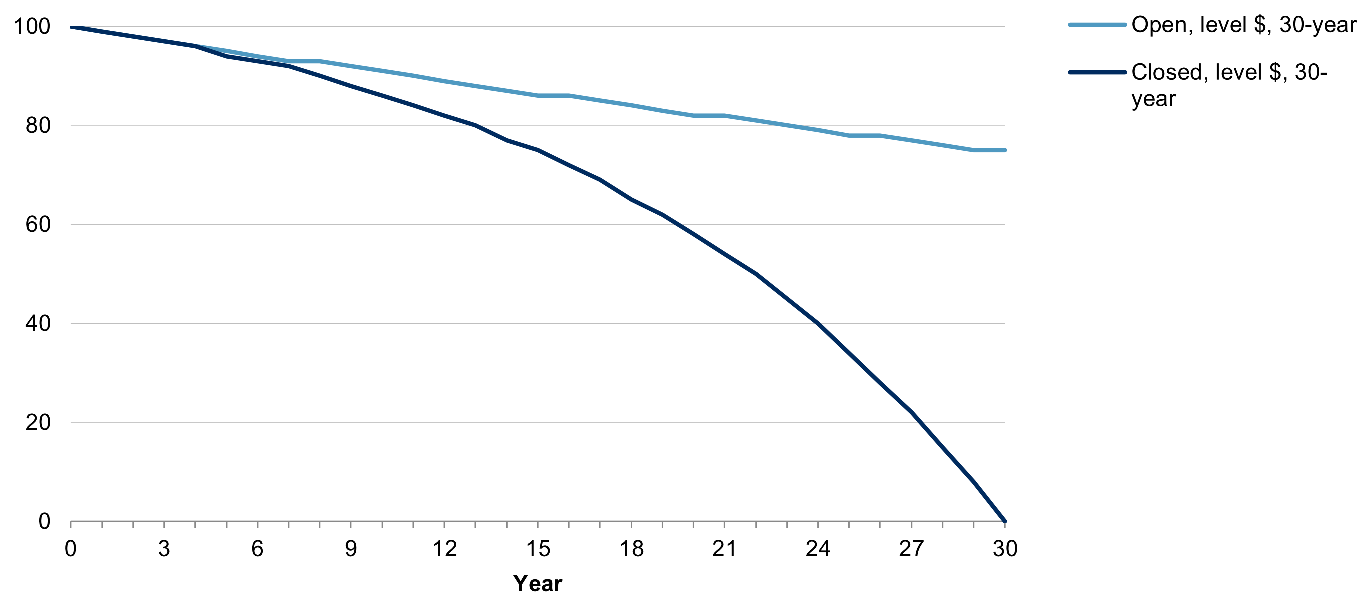
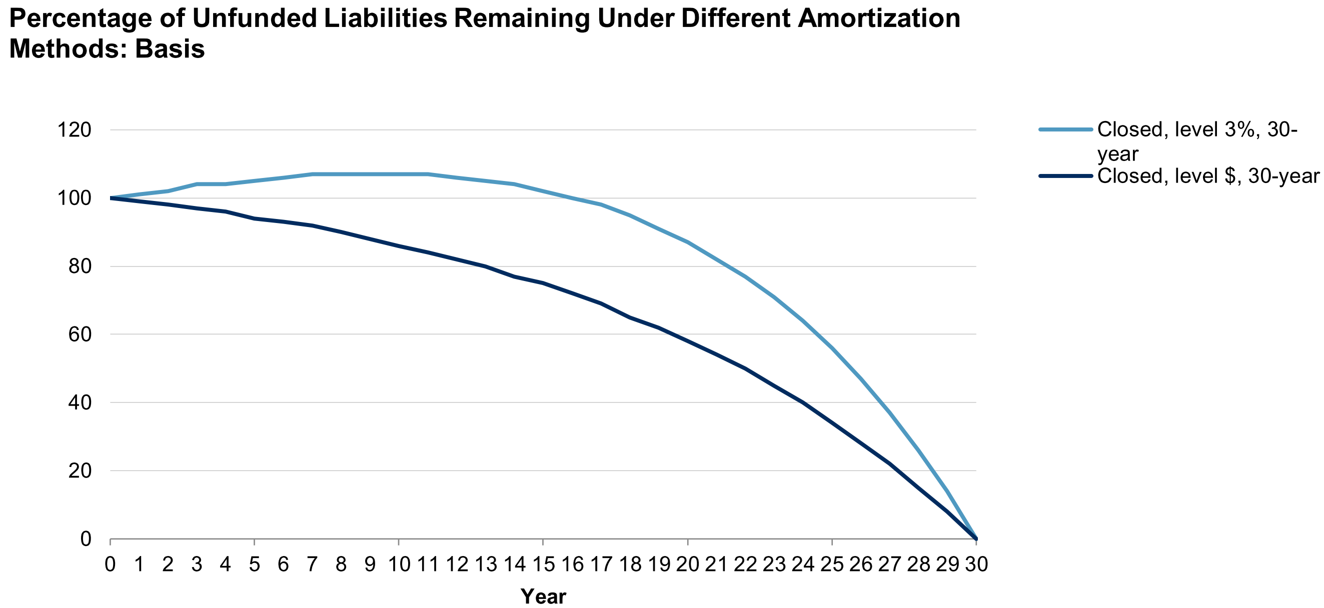


Chart 2

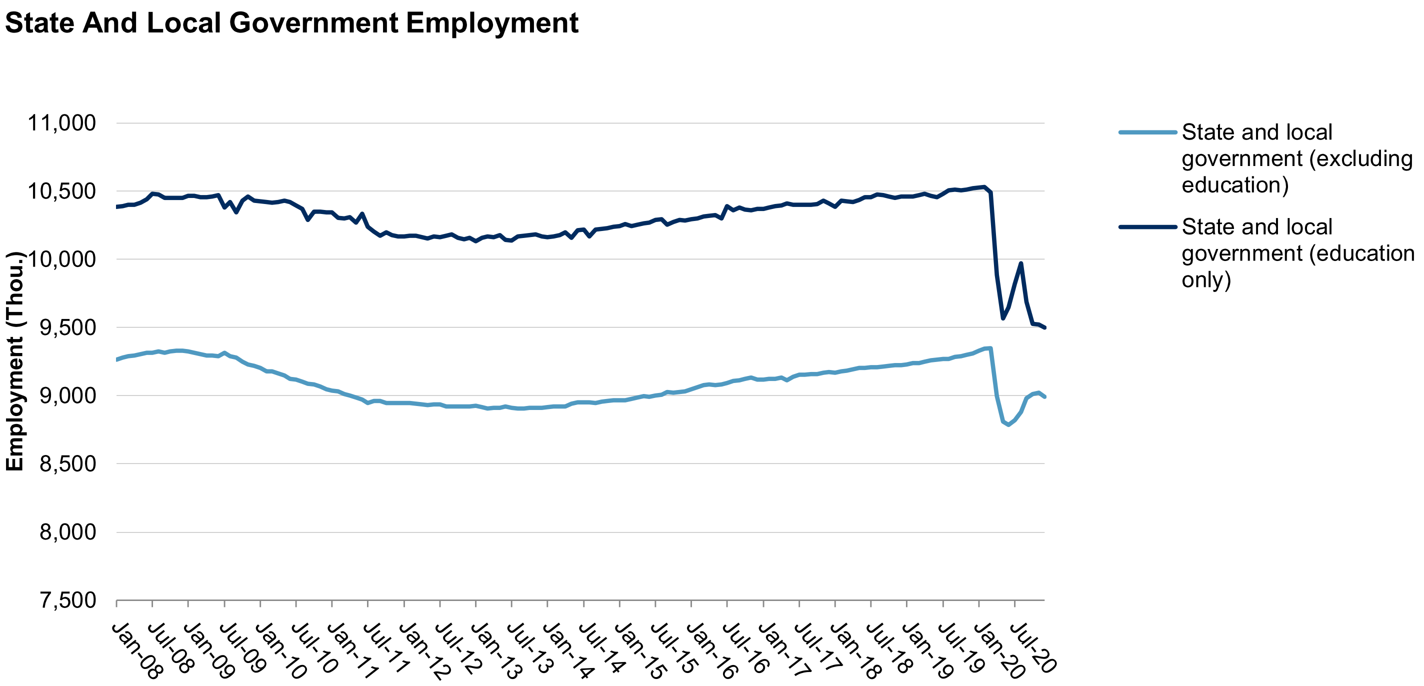


Under different amortization methods, payments might not cover the interest on the unfunded liability and allow it to grow for years before very large projected contributions kick in to make up for smaller payments in earlier years (see charts 1 and 2). Over the long term, we have observed that this kind of contribution scenario of deferred but escalating payments can lead to pronounced and unabated budgetary stress as the amortization progresses (see "The Increasing Cost Of Governmental Pensions: Discount Rate And Contribution Practices," Sept. 27, 2018).

Reductions In Government Employee Payrolls Will Increase Contributions

We have observed that actual government payroll growth in the previous decade has often fallen below annual growth assumptions, creating negative amortization and digging a deeper hole to be addressed with future contributions. Similar to the last recession, state and local governments have started to reduce headcount to find budgetary relief (see "Sudden-Stop Recession Pressures U.S. States' Funding For Pension And Other Retirement Liabilities," Aug. 3, 2020).

Chart 3



BLS data is preliminary for November and December 2020. Sources: Bureau of Labor and Statistics (BLS); S&P Global Ratings.

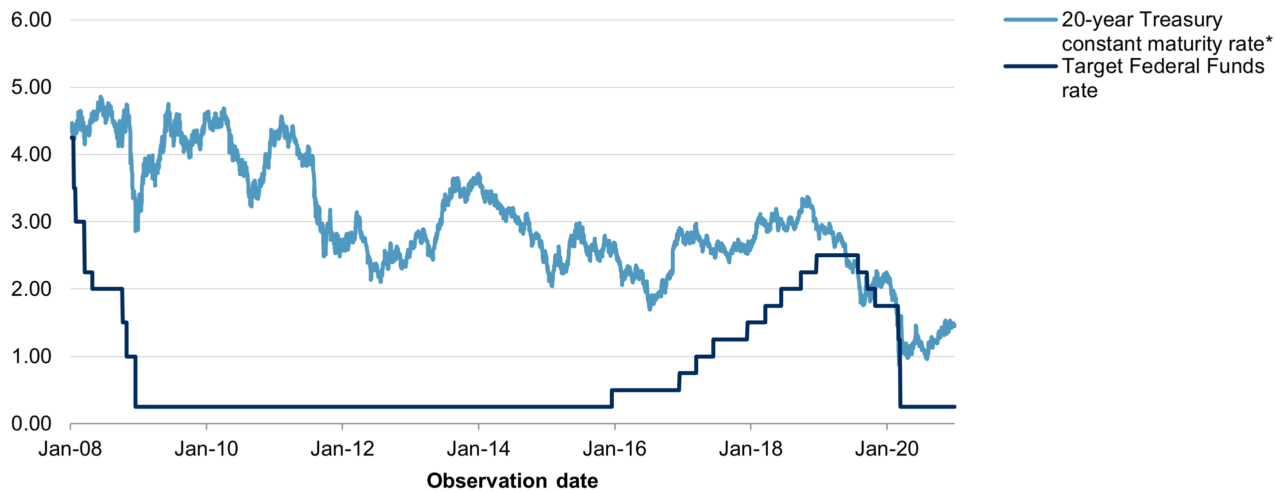
Declining headcount and correlated payrolls will undermine plan contributions as fewer active employees contribute to plan assets and payroll-driven employer contributions lag earlier estimates. Employer contributions can fall short of estimates due to slow payroll growth if the amortization is built around a growth assumption. The contribution shortfalls are likely to augment liquidity pressures for some plans, particularly those with low funded ratios and already weak demographics (see "Pension Brief: Liquidity Is a Rising Concern for U.S. Public Pensions in down Markets," March 24, 2020). The effects of the reduced plan inflows are compounded by increased outflows for a greater number of retirees and beneficiaries. As a result, employers face greater strains to maintain plan funding.

Low Interest Rates Are Here To Stay

Prior to the COVID-19-induced recession, the Federal Reserve lowered the federal funds rate three times in 2019, the first time it did so since 2008 following a period of increases during 2015-2018. In response to the anticipated economic effects of mitigating health safety risks associate with the pandemic, the fund funds rate was further reduced almost to zero in March 2020.

Chart 4

U.S Interest Rates: 20-Year Treasury And Target Federal Funds Rate



For FOMC's target federal funds rate or range, the chart depicts the top of the FOMC's target range for any given period. *20-Year Treasury constant maturity rate, percentage, daily, not seasonally adjusted.

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

As interest rates remain low, so do bond yields, making safer investment options less attractive for pension funds needing to meet targeted returns. Over the past three years, we have observed more than half of states' largest plans lowering their rate of return assumptions. While these lower return assumptions correlate to reduced risk, they also increase required contributions, adding to budgetary pressure. During this time of more difficult budgeting decisions, we expect governments and plan sponsors will be less likely to further lower plan discount rates and absorb higher costs.

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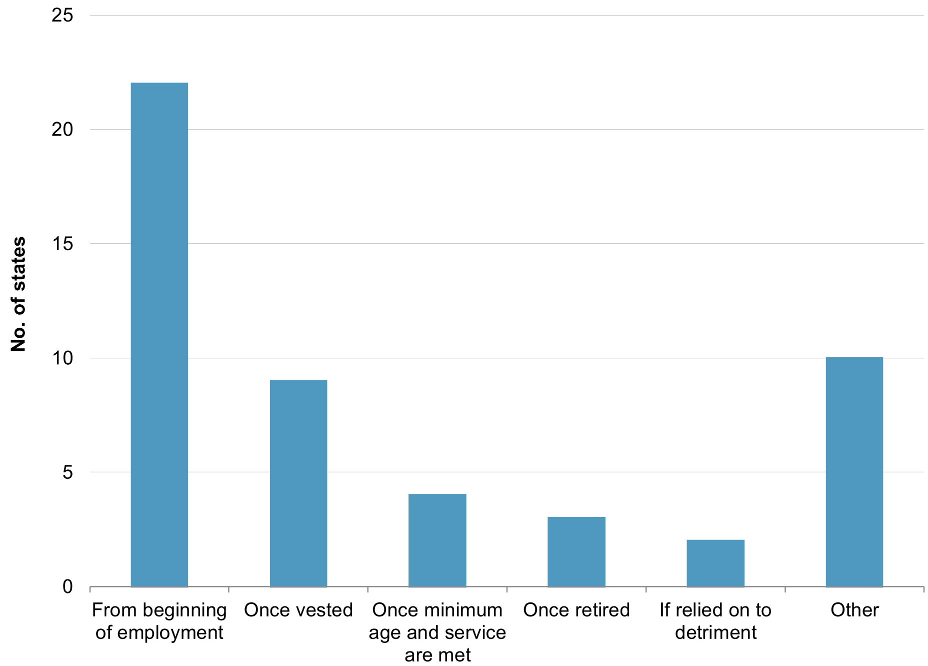
Pension And OPEB Benefit Reforms Should Address Long-Term Costs

Following the Great Recession, a shallow economic recovery weighed heavily on required pension contributions. To reduce costs, many governments enacted pension benefit reforms to decelerate rising costs. Retiree benefit reforms cover a broad category of actions: e.g., benefit changes including cost-of-living (COLA) reductions, modifications to plan design and structure, and adjusting retirement eligibility and compensation.

Governments struggling with budgetary stress and imbalance may find certain pension reform initiatives could be helpful for long-term system health but do not necessarily solve near-term credit pressures (see "Recent U.S. State Pension Reform: Balancing Long-Term Strategy And Budget Reality," Feb. 9, 2018). Pension reforms typically face significant legal obstacles and years to implement, delaying any positive effects. In addition, states that have already enacted significant reform may find it more difficult to do so again and may face practical or political constraints on their ability to do so.

Chart 5

Legal Protections For Accrued Pension Benefits



Source: The Pew Charitable Trusts, "Legal Protections for State Pension and Retiree Health Benefits," May 2019.

OPEB liabilities are often a secondary priority in comparison to the enormity of some pension burdens around the country, but present a problem that must eventually be addressed. While pension benefits typically can only be reformed for new entrants, reforming retiree health care benefits can be more flexible for current participants, depending on the state's legal framework and political environment. Ohio recently changed its benefit structure from a coverage model to that of a stipend, along with other changes that extended the life of its health care trust fund by eight years. (For more information see, "OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility," May 22, 2019, and "Pension Spotlight: Ohio," Jan. 7, 2021.)

With record low interest rates, pension plan sponsors are likely to turn to pension obligation bonds (POBs) for a variety of reasons other than financing pension benefits through debt issuance. POBs may be used to smooth increasing payments or alter the length of the payment schedule and possibly defer costs to future years (For more information, see "Pension Brief: POBs See Increasing Activity in Low-Interest-Rate Environment," Oct. 14, 2020). More bespoke actions, like asset transfers, might also gain traction as entities look to mitigate expanding unfunded liabilities (see "Pension Brief: Are Asset Transfers A Gimmick or A Sound Fiscal Strategy?" Feb. 19, 2019).

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ESG Factors Influencing Asset Allocation And Investment Decisions

In addition to evaluating budgetary pressures of pension and OPEB contributions, S&P Global Ratings considers how long-term ESG factors may affect funding practices and future costs. An increasing focus on these risks is likely to affect asset management decisions and potential portfolio returns. Following current market trends, we expect governments and asset managers will be increasingly guided by ESG factors in making investment decisions. The table below lists some recent ESG actions by public pension funds.

Some Recent ESG Actions Affecting Public Pension Funds

Fund or organization	Action
CALPERS (the largest public pension fund)	Investment strategy ensures ESG risk considerations are integrated into its decision-making process; such decisions may center on divesting from certain industries and holding companies to a higher social standard.
The New York State Comptroller	Recently announced plans to transition its pension portfolio to net zero greenhouse gas emissions by 2040.
The Diversity Disclosure Initiative (headed by the Illinois and Connecticut state treasurers)	Called on public companies to disclose racial, ethnic, and gender data about their boards of directors.

ESG--Environmental, social, and governance factors.

Regarding diversity, investors are increasingly leveraging their ownership interests to push companies toward greater transparency and accountability. As corporates and financial institutions' social record faces closer scrutiny from stakeholders, S&P Global Ratings foresees a widening competitive gap between companies that adopt effective strategies for workforce diversity and those that do not. Not only are there compelling social reasons for companies to look at their business practices, but it also makes financial sense as well.

An S&P Global Ratings study concluded that firms with high gender diversity on their board of directors were more profitable and larger than firms with low gender diversity. Over the study period, data showed female CEOs saw a 20% increase in stock price momentum and female CFOs saw a 6% increase in profitability and 8% larger stock returns (see "When Women Lead, Firms Win," published Oct. 16, 2019). Additionally, the results of a 2019 McKinsey study showed that the profitability of companies in the top quartile for ethnic diversity were 36% higher than for those in the bottom quartile.

The issue of racial inequality is not new, but the groundswell of reactions by the corporate sector is. In this year and beyond, we expect public pension funds to take on a greater role evaluating ESG risks in their portfolios. Only time will tell if the elevation of social factors rises to the same level as environment and governance. However, pension fund managers ignoring these risks could see negative effects on their market returns.

For more information, see "Why Corporations' Responses To George Floyd Protests Matter," July 23, 2020, and "Diversity And Inclusion As A Social Imperative," Aug. 3, 2020.

Related Research

- Outlook For U.S. States: Symptoms Persist, But A Shot In The Arm Could Lead To Growth, Jan. 5, 2021

- Outlook For U.S. Local Governments: Revenue Pressures Mount And Choices Get Harder, Jan. 6, 2021
- Sudden-Stop Recession Pressures U.S. States' Funding For Pension And Other Retirement Liabilities, Aug. 3, 2020
- Mounting Pressures Threaten Stability Of 20 Largest U.S. Cities' Pension Funding, Oct, 20 2020
- Pension Brief: POBs See Increasing Activity in Low-Interest-Rate Environment, Oct. 14, 2020
- Pension Brief: Liquidity Is a Rising Concern for U.S. Public Pensions in down Markets, March 24, 2020
- When Women Lead, Firms Win, Oct. 16, 2019
- Pension Brief: Are Asset Transfers A Gimmick or A Sound Fiscal Strategy?, Feb. 19, 2019
- The Increasing Cost Of Governmental Pensions: Discount Rate And Contribution Practices, Sept. 27, 2018
- OPEB Brief: Risks Weigh On Credit Even Where There Is Legal Flexibility, May 22, 2019
- Recent U.S. State Pension Reform: Balancing Long-Term Strategy And Budget Reality, Feb. 9, 2018

This report does not constitute a rating action.