

Five U.S. Public Pension And OPEB Points To Watch In 2024

January 29, 2024

Key Takeaways

- We expect U.S. public pension funded ratios will improve in fiscal 2024 due to positive market results in the first half.
- U.S. public pensions face growing risks because discount rates used to measure the funded ratio are based on increasingly diverse and opaque asset allocations.
- Inflation affects many pension factors, and the Consumer Price Index (CPI) has crossed below long-term rates.
- Pension obligation bond (POB) issuance could make a comeback, although not until rates fall further.
- An aging population exacerbates contribution risk stemming from market volatility.

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Funded Ratios Will Likely Rise Slightly In Fiscal 2024

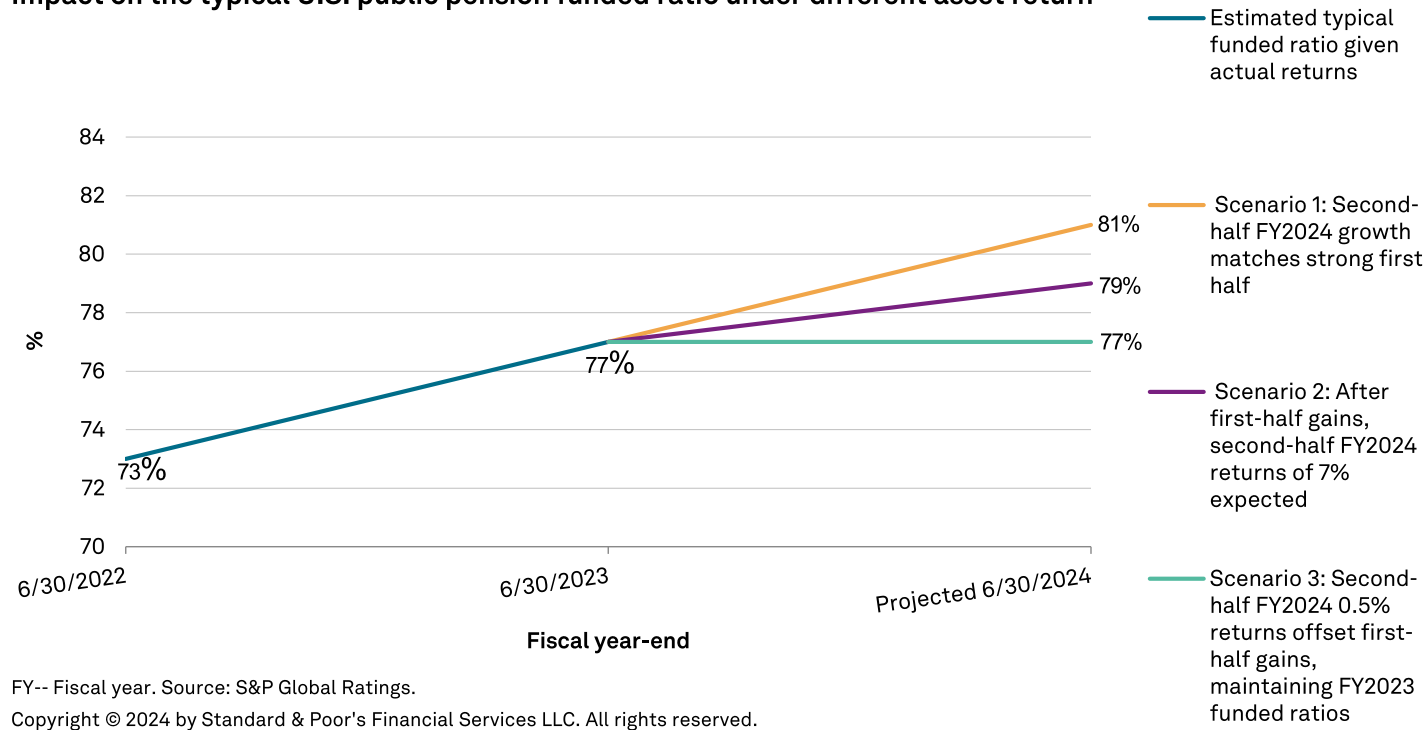
S&P Global Ratings expects asset performance to spur a slight improvement in U.S. public pension funded ratios for the fiscal year ended June 30, 2024 (fiscal 2024) thanks to positive returns in the first half of the year. U.S. pension plans, on average, assume annual asset returns of 7% and returns above or below this assumption equate to a "gain" or "loss" compared with planned inflows that might affect contributions and credit stress. We estimate that a typical public pension plan will have experienced a gain due to a return of about 6.5% for the first half of fiscal 2024 (13% annualized), which is 3.0% above the half-year assumption of 3.5% (annualized to 7.0%).

We started with a 73% funded ratio calculated as of fiscal year ended June 30, 2022, in our state and largest city surveys (see "U.S. State Pension And OPEBs: Funding Progress Is Likely To Pick Up In 2023 After Slipping In 2022," Sept. 7, 2023, and "Pension Funded Ratios Fall For Most U.S. Big Cities On Weakened Investment Returns," Oct. 19, 2023, both on RatingsDirect). We note that the pension funded ratios in any given fiscal year are typically represented in issuer audits the following year, so we expect our 2024 surveys will reflect the slight improvement estimated in chart 1 as of fiscal year ended 2023. We projected to fiscal year-end 2024 using three funded ratio

scenarios. The first scenario shows continued growth for the second half of the fiscal year at the same pace as the first half. The second projects earnings at the expected rate for the rest of the fiscal year. And the third scenario projects assets at 0.5% for the second half to achieve an annual return of 7.0% and maintain funded ratios.

Chart 1

Impact on the typical U.S. public pension funded ratio under different asset return



Asset Allocations Increase Risk Through Less Transparent Investments

Even as assumed real return (total market return less inflation) modestly fell over the past five years, we see a possible increase of market risk within already risky target portfolios given increasing private equity and other opaque alternative investments. In chart 2, overlaid by the line showing assumed real return, we have four portfolio risk categories (see sidebar) making up the average U.S. pension trust over the past 20 years, from bottom to top. We see risk increasing not only from various "other" investments, but also within the equity and risk mitigator categories. In the chart, outlined in black, we see an increase in certain risky asset classes to 51% in 2022 from 26% in 2017.

Portfolio Risk Categories

Cash:

- Cash and cash equivalent coverage has been fairly consistent.

Risk mitigators:

- Within the "fixed income" category, Pionline.com noted that private debt allocation in state pension funds has increased by 70% since 2017, with growth expected to continue (see "Private credit attracts billions from U.S. pension funds," Dec. 18, 2023, Pensions & Investments online site).
- Hedge funds, built around mitigating risk with assumed returns often comparable to that of fixed income, include portfolio management risk and possible opacity. Risk is increased as the relative allocation has grown within this category.

Equities:

- Private equity is generally riskier and less liquid, with possibly complex fee arrangements, and its share of equities within pension asset portfolios is growing rapidly.

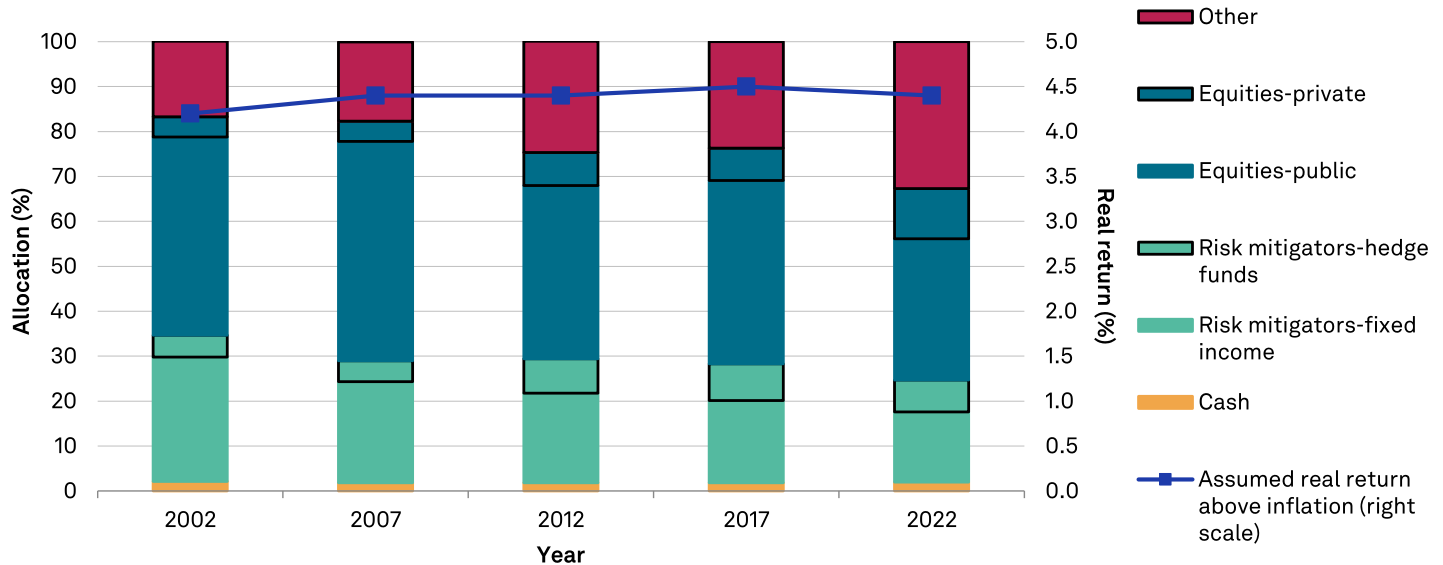
Other:

- This category has increased over the years, as fixed income has declined, which adds valuation risk to opaque and often illiquid alternative investments.
- Included within "other" are commodities and real estate, along with other miscellaneous asset categories not listed above.

Chart 2

Increasing asset complexity driving pension return assumptions

U.S. public pension asset allocations and assumed real return above inflation



Source: S&P Global Ratings using data from the Public Plans Database.

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The real return assumption grew from 2002 to 2017 (see chart 2), but decreased slightly in the past five years likely reflecting the 2022 inflation spike. We expect that inflation will decrease this year, which could lead to lower yields and higher market risk within U.S. pension asset portfolios if fixed income allocations are decreased to meet return assumptions. This could lead to contribution volatility and budgetary stress during rapid market movements.

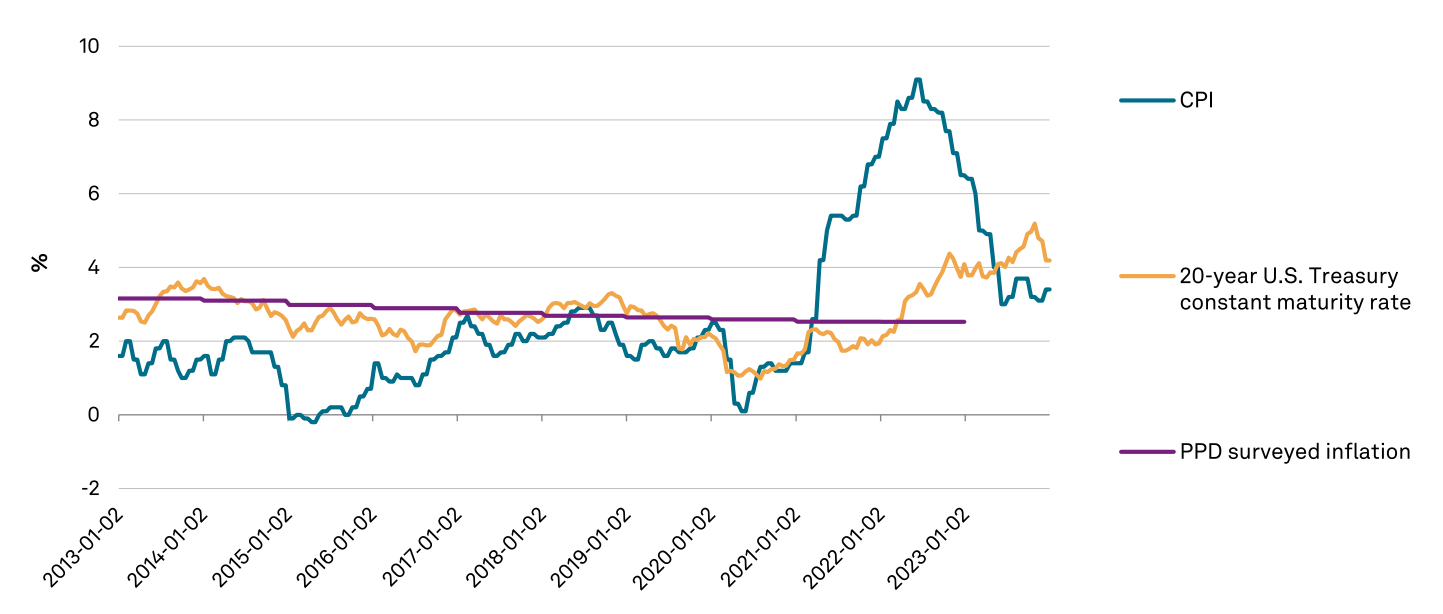
Recent Inflation Volatility Affects Pensions In Multiple Ways

After spiking to over 9% in June 2022, the U.S. CPI fell to as low as 3.0% in June 2023. Although CPI has since risen to 3.4% in December 2023, it is on par with the 40-year average of 2.8% that ended 2020 following the previous rate spike in the late 1970s.

Chart 3 contrasts CPI, the long-term U.S. Treasury rate, and the surveyed average U.S. public pension inflation assumption from the Public Plans Database. Since surveyed inflation more closely reflects the long-term U.S. Treasury rate, we are monitoring forward-looking expectations to see if long-term rates come down or if CPI is expected to continue its volatility. S&P Global Ratings will continue to monitor contribution sufficiency and funding discipline to assess the risk of funding deterioration that could lead to budget gaps over time. Furthermore, inflation underlies many aspects of pension and retiree medical (other postemployment benefit [OPEB]) costs, in addition to budgetary concerns for plan sponsors.

Chart 3

CPI versus Treasury rate, and average U.S. public pension inflation assumption



Sources: Consumer Price Index (CPI), Bureau of Labor Statistics, 20-Year Treasury. Federal Reserve Economic Data (FRED). PPD Surveyed Inflation: Public Plans Database.
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How inflation affects pensions

POB

Evaporated during the recent interest-rate spike, but pent-up demand could see resurgence. Contribution volatility risk is heightened with increased market exposure.

OPEB

As most retiree medical plans are funded on a pay-as-you-go basis, medical cost volatility is passed directly onto issuers. Processing lags could mean high interest rates are still felt in 2024.

Assumed return/ discount rate

Falling inflation could increase market risk exposure and contribution volatility, as higher real return would be needed to meet the return assumption.

Other effects

Lagging salary growth and inflation-linked cost-of-living adjustments, combined with lower future inflation expectation, could compound funding stress.

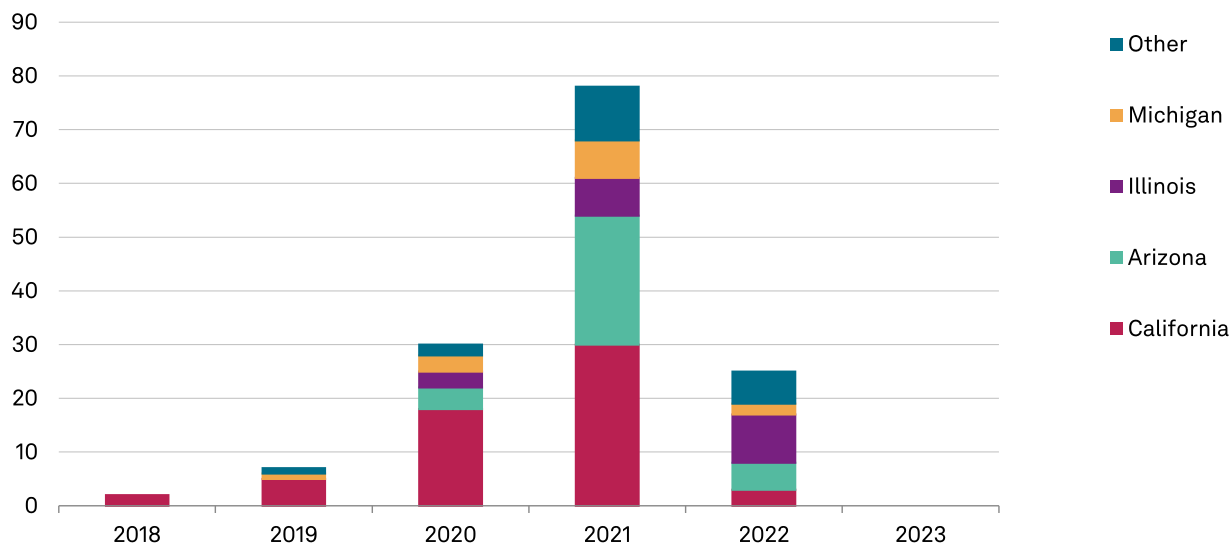
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POB Issuance May Come Back With Low Rates

POB and OPEB obligation bond issuance halted in the U.S. in 2023 primarily due to high interest rates compared to recent history. While CPI has come down, issuers could still consider interest rates high, discouraging them from issuing obligation bonds. Furthermore, given that POBs typically require time and cost, issuers might wait for the current volatile market to settle convincingly before beginning the issuance process. For additional information, including market timing risk associated with obligation bonds, see "U.S. Public Pension Fiscal 2023 Update: Funded Ratios Stable, Inflation Retreats, And POB Issuance Stops," July 11, 2023.

Chart 4

S&P Global Ratings rated pension obligation bonds by state



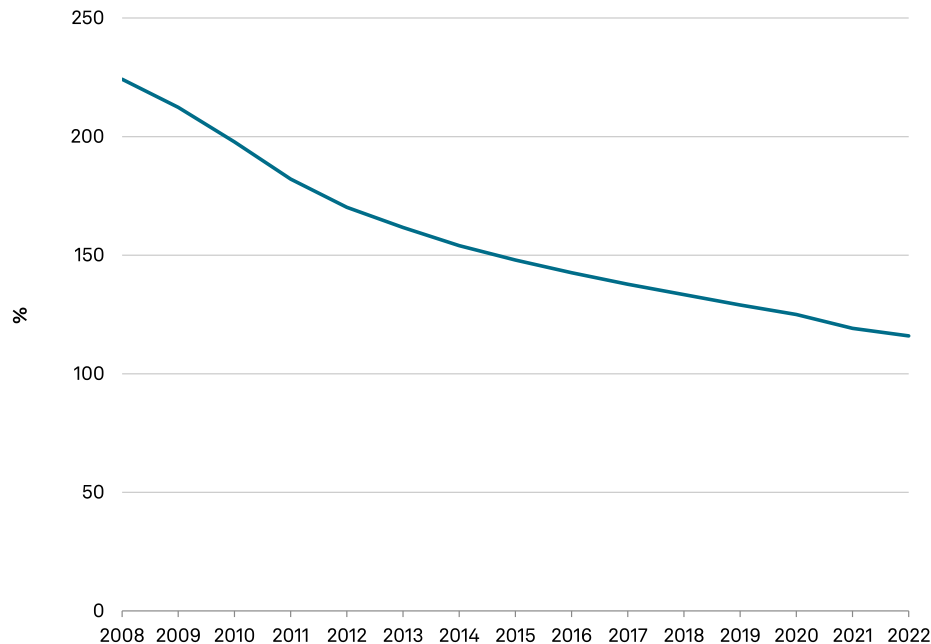
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Aging Demographics Magnify Market Risk

Baby boomers continue to reach retirement age, and budgetary concerns have often slowed hiring and reduced their replacement. As a result, pension plans have experienced a shift to fewer active employees who make contributions compared with pensioners who draw benefits from them. Aging demographics can not only increase budgetary stress for states and local governments, but also compound market risk exposure for employers because of the loss of plan contributors to help offset the budgetary impact of negative market movements (see chart 5). Issuers with plans that take on high levels of market risk within their asset portfolios could see magnified contribution volatility risk as a result of an aging population.

Chart 5

As baby-boomers retire, fewer active participants support beneficiaries
Active-to-beneficiary ratio



Source: S&P Global Ratings using data from the Public Plans Database.
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Related Research

- Pension Funded Ratios Fall For Most U.S. Big Cities On Weakened Investment Returns, Oct. 19, 2023
- U.S. State Pension And OPEBs: Funding Progress Is Likely To Pick Up In 2023 After Slipping In 2022, Sept. 7, 2023
- U.S. Public Pension Fiscal 2023 Update: Funded Ratios Stable, Inflation Retreats, And POB Issuance Stops, July 11, 2023

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