BAM BUILD AMERICA MUTUAL | CREDIT INSIGHTS

It's Time to Talk About Pension Risks Again

By Les Richmond, ASA, EA, MAAA, FCA
VP and Pension Actuary, Build America Mutual

Municipal bond investors are paying more attention to the credit risks posed by public pension and other retirement liabilities. Municipal finance officers should prepare to address those questions when they apply for bond ratings and sell new issues and may want to consider bond insurance or other forms of credit enhancement to help enhance investor confidence.

Pension risks have been an important consideration for investors and rating agencies for more than a decade, but the COVID pandemic shifted the municipal bond market's focus to more pressing questions, like the potential for defaults due to temporary disruptions in cash flows from sales taxes and other revenue sources during the initial lockdown period. Now that economic activity has largely resumed, investors and analysts are taking another look at longer-term issues, and the volatile stock market performance since the pandemic is raising concerns.

The returns on assets invested in public sector pension funds play a powerful role in determining pension risk — the possibility that pension costs can grow to such a degree as to impair a bond issuer's ability to pay its debts. On the heels of fiscal year 2021, in which pension asset performance was superb, fiscal 2022 was a down year that erased much of the fiscal 2021 gains, and 2023's performance has been so-so.

Those results increase the risk that the growing cost of retirement benefits will negatively impact municipal bond issuers' credit strength. The ultimate impact of the subpar asset returns on pension risks is likely to vary widely among issuers, making transparent and active communication by issuers more important and valuable. Each plan's funding level, investment choices and materiality of pension costs to the issuer's overall budget will play a role in determining the degree to which pension risk changes, as will the issuer's actions in response.

BAM's approach to pension and other postemployment benefits (OPEB) analysis focuses on the risk that retirement costs could consume resources that are otherwise necessary to fund operations and debt service, with stress scenarios that incorporate the following observations from past economic downturns:

Positive returns are not necessarily enough to avoid an increase in unfunded pension liabilities. Actuarial asset losses are measured against the assumed investment return: so if a plan with an assumed return of 7% posts a gain of 5%, it is still falling behind on an actuarial basis. The impact from actual losses can be severe. If instead there is a 10% investment loss in the fiscal year ending June 30, 2023 there would be an actuarial asset loss of -17%.
In addition to asset losses, unfunded liabilities can increase due to plan liability increases: Inflation-driven wage growth, retiree pension cost-of-living adjustments which increase pension liabilities, and higher health care costs driving increasing OPEB liabilities can all have an impact.

Governments may find it hard to quickly increase pension contributions to match higher actuarial requirements – forcing even larger forecast contributions in the long term. Pension funding contributions and wages compete for the same budget dollars, and some state and local governments are already faced with difficult choices between pension funding and service delivery. Subpar investment performance by pension plan assets would only exacerbate that situation.

Plan insolvency risk may rise. Actuaries annually project plan assets and liabilities far into the future to determine whether plan assets are always expected to be available to pay benefits. If they're not, the point at which assets run out is called the "depletion date."

If pension assets underperform or funding policies change, plans that currently project a depletion date may find that event happening earlier; other plans not currently projecting a depletion date may now find that they have one. That can have a severe impact on a government's finances, because at asset depletion the transition to paying retiree benefits directly may require a sudden increase in expenses. Any increase in likelihood, or acceleration, of asset depletion, is a risk increase.

Plan sponsor actions can affect pension/OPEB credit risk. State and local governments took a number of actions in response to revenue declines during and following the 2008-09 Great Recession, such as workforce downsizing and salary freezes (or cuts). There was also an uptick in pension/OPEB reforms, and efforts to increase contribution rates once the economy began to recover. All of these actions can possibly have a material impact on pension/OPEB plan liabilities. However, the range of possible impacts is wide and individualized to the issuer level – disclosure remains key.

***

Investor and rating agency questions about pension risks are likely to be exacerbated by a lack of real-time financial information, which can lead to uncertainty, volatility, and elevated "headline risk." The first financial statements quantifying the investment-related actuarial losses are not likely to be filed until late this year, and the full implications may not be fully incorporated into public financial statements for years to come. Public-sector finance officers should prepare now for pension risks to become even more central to municipal bond credit analysis.

Les Richmond is Vice President and Pension Actuary for Build America Mutual and serves as an advisor to the Government Finance Officer's Association's Committee on Retirement and Benefits Administration.

June 9. 2023