BAM CREDIT INSIGHTS

Pension Disclosure Standards Face New Test

By Les Richmond

This article was originally published as a commentary in The Bond Buyer on April 23, 2025. Subscribers can access it here.

Public pension disclosure and transparency has improved dramatically since the Global Financial Crisis, thanks to the combined focus of credit analysts, accounting rule makers, and securities regulators. In the coming year, we'll find out if they've done enough to protect municipal bond investors.

Before the recent market volatility, it was tempting to assess the current state of municipal issuer pension risk (the risk that the costs of pension and other postemployment benefits can rise to such a degree as to impair a bond issuer's ability to pay debt service) as fairly rosy. According to a recently published survey by the National Conference on Public Employee Retirement Systems, the average U.S. public sector pension plan's assets totaled 83.1% of liabilities, a five-year high for the funded ratio.

But those disclosure statements are not keeping up with today's fast-moving market environment. In assessing pension risk for individual bond issuers, the most recent financial statement available for much of 2025 will be from fiscal year ends from June 2024 or earlier. Subsequent market activity is already forcing retirement system managers to re-visit their investment and funding strategies, which could lead to changes in how pensions are funded and managed.

My role at BAM Mutual, a municipal bond insurer, is to assess pension risk for every bond we consider for insurance. I have analyzed state and local pension funds in nearly every state in the U.S. This article will include my observations based on these analyses and examine the trends that may emerge in 2025.

Potential market volatility

According to the NCPERS survey, fiscal year ends June 30, 2023 and 2024 saw overall pension fund investment returns of 7.30% and 9.47%, respectively, driving the national improvement in funded ratios thru 2024. The median investment return assumed by actuaries when determining pension liabilities was about 7.0% for the past couple of years.

Of course, events are occurring all the time that might be a source of investment performance volatility which could lead to increased pension risk. Should financial markets continue experiencing a downturn in 2025, one bond issuer reaction that analysts should be on the lookout for is the issuer paying pension contributions less than the actuarially determined contribution (ADC). Underinvesting in pension contributions today increases future pension-related fiscal requirements, and a prolonged practice of shortchanging pension contributions can cause the shortfalls to snowball to an unsustainable level. The NCPERS survey revealed that plans that received the ADC in the most recent fiscal year have an average funded ratio around 20 points higher than plans that were paid less than the ADC.

The market may not learn about pension underpayments for months or even years after the most recent fiscal year end. But it's possible to identify issuers that are vulnerable to fiscal stress following a market downturn. At BAM, we do this by calculating how much of an issuer's budget would be consumed by the impact of a hypothetical 10% pension fund asset loss by:

1. Quantifying the dollar cost of a 10% decline in the market value of all disclosed end-of-year pension and other postemployment benefit (OPEB) assets
2. Assuming the issuer will amortize that loss over a reasonable period, and calculating the annual contribution increase necessary to achieve that
3. Dividing that increase by the issuer's annual budget.

At BAM, we assume that if item 3, the estimated budget consumption, is more than 3%, the issuer is moderately vulnerable to the risk of contribution underpayment in the event of a market downturn; if more than 5%, that vulnerability is elevated. Note that this only works for single and agent multiple employer plans whose specific assets and liabilities are disclosed in the issuer's annual financial statement. The calculation can be done for cost-sharing plans (typically statewide plans covering large employee groups such as teachers), but it's more complicated because the impact of the 10% decline in market value must first be calculated for the entire plan and then allocated to the issuer.

Shifts in demographic and economic risks

Under BAM's pension risk methodology, we judge pension fund demographic risk in the context of the funded ratio. We look at the pension plan's population and calculate an active-to-retiree ratio: The greater the ratio, the "younger" the plan population. The "younger" the plan population, the longer the time horizon to pay down unfunded liabilities. For decades, most plans have seen decreasing active-to-retiree ratios. As I have analyzed various pension funds throughout the country, in many cases I have observed a slowdown or reversal of this trend based on 2024 plan population data. There are probably many drivers of this phenomenon, such as high rates of backfilling vacant positions.

The demographic stabilization, combined with positive news on funded ratios, could lead credit analysts to conclude that demographic pension risks are decreasing thru 2024. However, the impact of potential actions to reduce the Federal government's budget deficit (and the trickle-down effect of cuts to Federal spending for local governments), was not reflected in fiscal 2024 financial statements. Investors can monitor local news headlines to understand how individual issuers are responding and what that could mean for their pension liabilities.

Should an issuer decide on staff downsizing as a way to offset the impact of revenue cuts, the impact on pension risk will be dependent on the demographics of the terminated staff. At one extreme, pension liabilities of non-vested plan members leaving the workforce will decrease to zero, and the plan will benefit from past employer contributions applicable to them, helping cover benefits for remaining plan members. At the other extreme, retirement-eligible plan members who take advantage of an early retirement incentive or subsidy may drive a pension liability increase when they leave the workforce.

A brief word about early retirement incentives: credit analysts should proceed with caution when making judgements about their impact on municipal issuers' budgets. The ultimate financial success of a retirement incentive is often highly dependent on how many positions are backfilled, and this may not be known for many months after the incentive offer. This is particularly true for school districts, as class sizes are often affected, resulting in taxpayer backlash.

Should inflation remain elevated or accelerate, the decisions issuers make about how to respond will have other immediate impacts on pension risks. Most responses to inflation will raise pension liabilities by increasing costs – either in the form of wages for current employees or cost of living adjustments for retirees – faster than projected by actuaries.

In conclusion

Although national survey data may point to an overall pension risk stabilization or improvement thru fiscal 2024, market volatility and issuer decisions since then can have an impact of pension risk that would not be obvious from the most recent issuer financial statements. A deep dive into individual issuer circumstances is necessary to get a handle on their specific pension risk factors.

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