THE BOND BUYER

The coronavirus pandemic and public pension risk: Learning from history

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The first bear market in U.S. stocks in more than a decade is almost certain to cast a long shadow over U.S. public pension funds' investment earnings and increase the risk that the growing cost of retirement benefits will negatively impact municipal bond issuers' credit strength.

The ultimate impact of the bear market on pension risks is likely to vary widely among issuers, making granular analysis more important and valuable. Each plan's pre-crisis funding level and investment choices will play a role in determining the outcome, as will the potential for COVID-related revenue losses and the issuer's actions in response

BAM's approach to pension and other post-employment 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.

To the extent that asset values do not recover by the next fiscal year end, governments will report higher levels of unfunded liabilities and lower funding ratios (assets divided by liabilities). Actuarial asset losses are measured against the assumed investment return: so, if a plan with an assumed return of 7% posts actual losses of 10% in the fiscal year ending June 30, 2020, then the actuarial asset loss (that needs to be paid for by future contributions) is -17%.

In addition to asset losses, unfunded liabilities can increase due to plan liability increases: possibilities in the current environment include higher health care costs driving increasing OPEB liabilities, and public sector unions possibly pushing for enhanced line-of-duty death or disability benefits.

The level of unfunded liability is an indicator of risk, and to the extent it increases, future contributions will probably have to increase, pressuring budgets that also need to allocate dollars to debt service.

Contribution requirements will increase, but governments will likely be slow to increase pension contributions — forcing necessary contributions to be even larger in the long term. Even before the pandemic, some state and local governments were already faced with difficult choices between pension funding and service delivery. A steep decline in plan assets would only exacerbate that situation.

And, depending on the timing and strength of the economic recovery, some employers may decide to reduce, defer or skip pension contributions. This is exactly what occurred during and for a few years following the Great Recession, and overall U.S. pension funding ratios had not yet fully recovered to the 2007 level even before the pandemic. Kicking the can down the road in this fashion defers the contributions to future budgets, which raises an issuer's fixed costs and reduces their financial flexibility. These items indicate increasing credit risk in almost all cases.

The mechanics for determining the actuarially determined contribution (ADC) may mitigate the budget impact of sharp investment losses. Since there can be a timing difference between the year in which the actuarial valuation is performed (e.g. the July 1, 2020 actuarial valuation, the first major valuation date that will reflect any pandemic-related asset losses), and the year for which the ADC applies (e.g. the fiscal year beginning July 1, 2021 or even July 1, 2022), the budget impact of any asset losses will be delayed — possibly until the economy is clearly recovering from the negative impacts of COVID-related mitigation efforts, and governmental revenues begin to recover.

In addition, when actuaries determine actuarial contribution rates, they usually employ a smoothing methodology on the assets to decrease funding volatility. So, the impact of any pandemic-related asset losses will probably be phased into ADC calculations over a period of time, usually five years. This means that ADCs will probably march upward, even if assets recover in succeeding fiscal years. This phenomenon was clear following the 2008-09 Great Recession, when many plans' pension contribution rates continued to rise despite the fact that plan assets were performing well.

Plan insolvency risk may rise. Each year, as part of the exercise to determine the discount rate for pension and OPEB financial reporting purposes, actuaries 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 assets decline or funding policies change (e.g., by skipping or reducing contributions) as a result of the pandemic, 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. Experiencing an actual depletion date can have a severe impact on a government's finances, because a sudden transition to a pay-as-you-go plan may result in costs (e.g., retirees' benefit payments) that far exceed recent employer contributions. Any increase in likelihood, or acceleration, of asset depletion, is a risk increase.

If issuers react to the actuarial projection of a depletion date by adjusting their pension contributions, those additional resources can offset some or all of the increased risk.

Plan sponsor actions can affect pension/OPEB credit risk. As noted, 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). Plan sponsors adjusted the asset allocations in their pension plans to be more or less aggressive. There was also an uptick in pension/OPEB reforms. 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, and so is unknown absent specifics and actuarial analyses.

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Evaluating the impact of these factors will be complicated 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 losses are not likely to be filed until late this year, after the plans' next actuarial valuation date, and the full implications of the selloff and revenue losses we've witnessed since March 1 may not be fully incorporated into public financial statements for years to come. Investors and analysts should prepare now for pension risks to become even more central to municipal bond credit analysis.

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