BUILD AMERICA MUTUAL

WHITE PAPER

PUBLIC PENSION RISK SERIES

STATE AND LOCAL RESPONSES TO LABOR MARKET VOLATILITY

Will the Tight Labor Market Increase Pension Risk?

Post-COVID turnover in the state and local workforce, including elevated numbers of retirements and resignations, is forcing municipal bond analysts to rethink their assessment of pension risk — the possibility that pension and other postemployment benefit costs grow so much that they impair a bond issuer's ability to pay its debts.

Pension actuaries use assumptions about employee demographics when they forecast a pension plan's long-term liabilities as part of an annual valuation. When the actual decisions made by employers differ from those assumptions, the plan's funded ratio can also shift – for example, if governments provide outsized salary increases or make benefit changes to maintain service levels and/or avoid remaining-employee burnout.

The MissionSquare Research Institute survey, "State and Local Workforce 2022" included some concerning insights. Of governments surveyed:

69% reported that voluntary, non-retirement resignations increased in the last year when compared to 2020, and 60% reported increased retirements;

53% reported that employees had accelerated their retirement;

41% anticipate the largest number of retirements in the next few years;

51% reported uncompetitive compensation as one of the top reasons for employees separating; and

86% reported having a competitive compensation package as an important workforce issue.

These survey findings suggest that the demographics of the public-sector workforce are likely to change, even as many state and local governments consider increasing wages and improving other benefits to attract and retain employees (especially in positions that are hard to fill). Like many issues in municipal credit analysis, understanding the impact of these changes on pension risk requires careful analysis at the individual issuer level, within an overall framework.

Demographic shifts are shrinking the active workforce. The MissionSquare survey suggests that the rates of retirement in the public sector are accelerating and may continue to do so in the next few years. If this occurs, it will exacerbate a 20-year trend in which the number of public sector retirees has grown faster than the number of active employees (as reported in the NASRA Public Fund Survey, October 2022). This means that retirees may make up an ever-greater portion of pension plan populations in the coming years, which will impact pension risk across several parameters:

(i) In many cases, inadequate contributions have caused pensions to not be completely funded over employees' working lifetimes. The result is that current pension contributions are paying for both current employee benefit accruals and benefits already promised to retirees. This adds to pension-related budget pressure.

(ii) Most public sector pension plans require employee contributions. The less significant the plan's active employee population, the less significant the employee contribution funding source.

(iii) Retirees are frequently "held harmless" from cost-saving pension reforms. The greater the plan's retiree population, the less-effective pension benefit reforms will be when attempting to reduce unfunded liabilities.

At BAM, we assess a pension plan's demographic-related risks in the context of the funding ratio: Well-funded plans face lower risks from plan demographics, because they are less likely to require sharply greater contributions from a government's current budget. But with poor investment performance in fiscal 2022 basically erasing the excellent performance in fiscal 2021, funding ratios are likely to fall, and demographic risk may be significant if current trends continue.

HIGHER WAGES INCREASE SHORT- AND LONG-TERM BUDGET PRESSURE

Survey data suggests that state and local employers are either offering, or considering offering, higher wages to attract and retain workers (particularly for hard-to-fill positions). Those moves impact pension risk because the typical public sector pension benefit is calculated based on wages: If wage increases are greater than assumed by the actuary, pensions will be projected to be greater, resulting in higher pension liabilities and associated costs to pay for them.

But analysts can't generalize across issuers: Employers who boost compensation through one-time bonuses may see less of an impact because those bonuses may or may not be counted as pensionable compensation in a given pension plan. Similarly, the impact of higher wages on pension risk will differ based on whether the plan is a cost-sharing plan (for which there is one actuarial contribution calculation for the entire plan, and individual employers are billed based on a plan-wide percentage of payroll), or a plan where the pension contribution is calculated specifically for an individual employer:

COST-SHARING PLAN: Each participating employer's annual pension contribution is calculated as a plan-wide rate, times the individual employer's pensionable payroll. Unless there are widespread above-assumed wage increases among the participating employers, it is unlikely that the contribution rate will rise materially based on the wage increases of a few employers. In other words, the impact of a participating employer's above-assumed wage increase on the contribution rate is spread among all participating employers in the plan. However, the payroll of the high-wage-increase employers may rise significantly, and their billed contributions will rise as well. For example, if the "extra" wage increases are $100,000 and the contribution rate is 10%, the wage bump is really costing $110,000. This would serve to increase budget pressure and pension risk.

EMPLOYER-SPECIFIC PENSION CONTRIBUTIONS: Employers with such pension plans will bear the full weight of above-assumed wage increases. Not only will wages be higher, but the employer will have to fund the full impact on the wage increases on plan liabilities. So, the impact of above-assumed wage increases on pension risk is greater when contributions are calculated for the specific employer.

BENEFIT DESIGN STRATEGIES CAN HAVE MEASURABLE FINANCIAL CONSEQUENCES

Employers have historically used enhanced retirement benefits as part of a strategy to attract and retain employees. Examples include:

- **ELIMINATING** a less-generous pension benefit tier and placing employees in a more-generous benefit tier
- **PLACING** employees currently in a defined contribution plan into a defined benefit plan
- **MAKING** it easier to become eligible for retiree health benefits

Any design change that makes benefits more generous would have an immediate impact on benefit liabilities, increase the budgetary requirements to pay for them, and increase pension risk.

Of course, not all employers will experience demographic shifts or feel the need to raise wages. There are also plenty of non-remunerative steps that can improve labor relations, such as offering better work-life balance and career paths. But the fact is, higher wages and better benefits are important, and can directly affect pension risk: Municipal credit analysts who include those trends when analyzing credit risk will be able to spot potential changes to a plan's funding status and contribution needs before they show up in the annual financial reports.

ABOUT THE AUTHOR

Les Richmond
ASA, EA, MAAA, FCA
Vice President and Actuary
lrichmond@buildamerica.com

Les Richmond evaluates municipal pension and other postemployment benefit (OPEB) plans and liabilities as part of BAM's credit underwriting process for municipal bond issuers. He reviews approximately 500 plans per year and is an expert on public pension policies and funding trends across the U.S.

Mr. Richmond is an advisor to the Government Finance Officers Association's Committee on Retirement Benefits and Administration (CORBA) and was a member of the Advisory Committee to the National League of Cities' Public Sector Retirement Initiative. He is an Associate of the Society of Actuaries, an Enrolled Actuary, a member of the American Academy of Actuaries, and a Fellow of the Conference of Consulting Actuaries. He is a member of the National Federation of Municipal Analysts and the Municipal Analysts Group of New York. He holds a B.A. in Mathematics from Rutgers College.

BUILD AMERICA MUTUAL ASSURANCE COMPANY

CORPORATE HEADQUARTERS
200 Liberty Street, 27th Floor
New York, New York 10281
212.235.2500
800.993.1500

SAN FRANCISCO
101 California Street, 29th Floor
San Francisco, California 94111
415.858.1000

WWW.BUILDAMERICA.COM

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