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Fitch: US Public Pensions Unlikely to Face UK Pension-Style Crisis

Fitch Ratings-New York-14 October 2022: U.S. state and local pensions are unlikely to face the sudden liquidity crisis that U.K. corporate pensions are confronting given their different approaches to valuing liabilities and the resulting differences in investment strategies, Fitch Ratings says. However, U.S. public pension funds' investment return assumptions incentivize higher yielding asset investments, posing the risk of deeper losses in a market downturn.

State and local government pensions discount their liabilities using the same fixed long-term investment return rate that they assume for their assets, whereas U.K. corporate pensions discount their liabilities using variable, market-based rates. To avoid having market rate variability affect U.K. pension liabilities, and thus their parent corporations' balance sheets, U.K. pensions engage in liability-driven investing (LDI) strategies that use leverage, an approach not commonly used by U.S. plans. LDI strategies typically rely on interest rate derivatives that involve long-dated U.K. bonds to match their long-term obligations.

The rapid spike in gilt yields following the U.K.'s 'mini-budget' on Sept. 23 led to sharp declines in the notional value of these interest rate derivatives, requiring collateral calls on U.K. pensions. The scale of the collateral requirements triggered a rapid liquidation of assets as pension funds scrambled to find the necessary cash, creating fears that pension assets intended to support benefits could be at risk or that plans would need liquidity injections from their parent corporations.

The investment return assumption used by U.S. state and local government pensions is a fixed rate, but this presents its own set of risks, most notably incentivizing the search for higher yield, exposing assets to higher volatility. Fitch views this as a central concern for state and local pensions, particularly as investment return assumptions remained unrealistically high, despite incremental decreases during a decade of low inflation and variable returns.

U.S. state and local pensions will see weaker asset performance as higher inflation, geopolitical uncertainty, and higher interest rates are priced into asset values. Fitch's latest Global Economic Outlook anticipates a mild U.S. recession next year, with deeper recessions in some parts of the globe.

U.S. public pension assets are dominated by public equities and alternatives, which constituted 47% and 19% of holdings in 2021, respectively, according to the Public Plan Database, leaving plans vulnerable to sharper swings in value. Fixed income holdings, which have historically produced more stable returns, stood at 21.4% of pension holdings in 2021.

As asset weakness weighs on funded ratios and gets smoothed into funded ratios, it will ultimately put upward pressure on pension contributions. The period since the pandemic began illustrates the asset volatility that plans face. Milliman, the actuarial firm, reports in its Public Pension Funding Index that the ratio of public pension assets to liabilities rose to 85% as of June 2021 from 70.7% a year earlier and fell back to 74% as of June 2022.

While they do not appear to employ derivatives on the scale seen in UK pensions, U.S. state and local plan assets often have direct derivatives exposure, typically used for hedging foreign currency and interest rate risks and reported at fair value. While plans disclosure of asset allocations, derivatives exposure and related risks has improved in recent years, details on allocations vary widely.

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