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Fitch: U.S. Public Pensions Highly Vulnerable to Market Correction

Fitch Ratings-New York-05 February 2024: Investment volatility has re-emerged as a key concern for defined benefit public pension plans since the pandemic began, signalling the risk that market corrections can set back progress in stabilizing funded ratios and trigger higher contributions, Fitch Ratings says.

Asset values surged in 2021 followed by sharp reversal in 2022 and a rebound in 2023. Based on audits of almost 100 major state pension plans, fiduciary plan assets rose a median of 24.4% in fiscal 2021, then fell 7% yoy in fiscal 2022. For major plans reporting fiscal 2023 audits to date, fiduciary plan assets are showing modest gains, near or just below the average investment return assumption (IRA) of about 6.9%.

While fiscal 2021 market returns were remarkably positive, recent market gyrations underscore the vulnerability of pensions to market shocks. We do not anticipate a market downturn similar to the Global Financial Crisis (GFC), when average returns fell 7.7% in 2008 and 17.9% in 2009, but a severe market correction would pressure funded ratios and require plans and governments to once again correct course to stabilize plans.

Since the GFC, plans and their sponsors have taken broad actions to improve pension sustainability. Most notable has been reducing the IRA, which now averages less than 6.9% compared with 8% during the GFC; Fitch views lower IRAs and the resulting higher liabilities as better reflecting the magnitude of the burden posed by pension commitments. Other plan changes include trimming benefits for new hires, shifting to more conservative mortality assumptions, tightening amortization practices and raising target contributions. Plan sponsors have also improved their contribution practices, with 36 states paying at least 100% of actuarial contributions in fiscal 2022, up from 25 in fiscal 2016. Nevertheless, to the extent that actual plan experience does not match expectations, governments need to make up the difference via higher future contributions, reducing expenditure flexibility and pressuring local and state budgets.

Pensions have also ramped up risk disclosure, including the risk of future market shock. For example, CalPERS, the largest public system, which provides pensions to the state and most local employers through hundreds of plans in its Public Employees Retirement Fund (PERF), has been a leader in risk disclosure through its Annual Review of Funding Levels and Risks report. The 2023 report, published last November, calculates the probability of its plans falling below 50% funded ratios at some point in the next 30 years, with the median probability at 22.8% for its miscellaneous plans (covering general employees), and 25.3% for its public safety plans.

Significant pension asset performance below target levels ultimately requires ongoing higher contributions by participating governments, and CalPERS already acknowledges that some “are under significant strain” in meeting this objective; CalPERS participants have no meaningful discretion to underpay. Current employer contribution rates as a percentage of payroll are sizable, and could go higher still; the average fiscal 2024 contribution rates are 26.4% for miscellaneous

plans and 51.3% for public safety plans. These rates are forecast to rise by fiscal 2029 to an average of 31.1% and 62.6%, respectively.

Since the GFC, CalPERS and the state have taken substantial steps to mitigate pension risks, including reducing benefits for recent hires and lowering discount rates. The PERF funded ratio is estimated at 72% as of June 30, 2023 based on a 6.8% IRA, compared with 69.8% a decade ago, when the IRA was 7.5%. Assuming future experience matches current assumptions, including consistent 6.8% returns, CalPERS estimates a 15%-20% funded ratio increase over 10 years.

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