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Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria

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Pension and other postemployment benefit (OPEB) obligations are measured under many sets of assumptions and methods and reported according to different sets of standards. Thus, various metrics can be used to evaluate the financial health of a pension or OPEB plan and its plan sponsor. This article will explain some of the metrics Standard & Poor's Ratings Services uses under our recently released U.S. local government general obligation (GO) criteria to further evaluate the risks posed by these liabilities. According to the criteria, the primary focus of our analysis of a local government's pension or OPEB liability is not that the liability will grow or the funded ratio will fall, but whether it requires significant—or significantly increasing--contributions over the medium term. Limited resources or no credible plan for how to pay for these benefits could exacerbate the situation.

Our credit analyses evaluate a local government's near- to medium-term budget stress caused by payments of pension or OPEB contributions and management's actions to reduce that stress. We recognize that most local governments participate in multiple-employer, cost-sharing, state-run pension or OPEB plans, leaving them with few, if any, options to lower the underfunded liability and control the growth rate of their contributions. This focuses our attention on the contributions themselves and the local government's strategy for how to fund them, rather than the size of the unfunded liabilities.

Under Standard & Poor's new local government GO criteria, we make a negative qualitative adjustment to a local government's debt and contingent liabilities score if it has "an unaddressed exposure to large unfunded pension or OPEB obligations, leading to accelerating payment obligations over the medium term that represent significant budget pressure. If there is a plan to address the obligations, the final score worsens by one point; otherwise, the score worsens by two points." (See table 14 of the local GO criteria.) For us to determine whether to apply the adjustment, we consider the variables raised by the criteria:

- Magnitude,
- Timeframe,
- Trends, and
- Managerial actions.

We assess each of these variables to determine the credit impact these obligations can have.

The primary source of quantitative data for this portion of a Standard & Poor's GO credit analysis will be financial statements; the secondary source will be actuarial valuation reports.

Magnitude

Current budget impacts can be measured with a carrying charge. For our purposes, a local government's combined pension and OPEB carrying charge is the sum of its required pension contribution(s)(1), and OPEB contribution(s)(2),

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measured as a percentage of its total governmental funds expenditures. Note that if a local government sponsors or participates in more than one pension plan or more than one OPEB plan, the required contributions to all plans will be summed for this calculation. In this way, we can determine the total portion of the most recent annual budget dedicated to pension and OPEB costs.

Under our new local GO criteria, we would consider a combined pension and OPEB carrying charge approaching or exceeding 10% elevated, leading to further review. A carrying charge at this level warrants further review, in our view, because it could be a marker of significant budget pressure in the medium term, if not currently. However, we will consider whether the carrying charges are elevated because a local government is intentionally overfunding the actuarially required amounts (in the case of a pension plan) in an effort to accelerate the pre-funding of its liabilities. We recognize that substantial flexibility to increase revenues or decrease nonpension- and OPEB-related expenditures could allow a local government to absorb carrying charges of 10% or higher into its budget without undue stress and, conversely, that limited flexibility could indicate carrying charges below 10% would cause stress. As such, Standard & Poor's will analyze the magnitude of each local government's carrying charge in relation to the magnitude of its fiscal flexibility, as well.

We also review OPEB carrying charges separately from pensions. These benefits, unlike pensions, typically do not vest and, thus, are not pre-funded because they can be taken away or modified if state laws do not expressly prohibit this or they are not contractual. Under our new local GO criteria, OPEB carrying charges exceeding 5% and limited flexibility to change or amend these benefits could also be a marker of significant budget pressure in the medium term, warranting consideration of the negative adjustment to the debt score, if the government does not have resource flexibility. We will consider whether the OPEB carrying charge is elevated because a local government is funding more than its pay-as-you-go-cost in an effort to pre-fund the liability. The size of the OPEB carrying charges will also be evaluated relative to the ability and political will to adjust the benefits, control costs, adjust other expenditures, or raise additional revenues to avoid budget pressure in the medium term.

We assess medium-term carrying charge growth by reviewing the magnitude of the obligations and--for pension plans--the funded ratios. OPEB plans are typically unfunded if the benefits do not vest and can be reduced or altered. Therefore, a local government that sponsors or participates in an OPEB plan that is entirely unfunded or has a low funded ratio will not necessarily receive a negative adjustment to its debt and contingent liabilities score because it may not lead to medium-term budget stress.

We start by reviewing the largest pension plan the government sponsors and/or participates in because, generally speaking, larger obligations require larger contributions and, consequently, pose greater credit risk than smaller ones. For example, the nominal amount of an actuarially required contribution for a 90% funded multibillion-dollar liability will be much larger than the contribution for a plan with a $500,000 liability that is 60% funded. However, a plan that has an extremely low funded ratio, such as 40%, regardless of how large or small its liability, bears further review as it could lead to increasing contributions in the medium term.

The liability we review is determined by the type of plan the local government sponsors and/or participates in. For those in multiple-employer cost-sharing plans, a low funded percentage of the overall plan will lead to increased contributions for all, as opposed to specific governments participating in the plan. As such, we will review the overall

funded ratio for that type of plan to try to determine if it will lead to increasing contributions. In an agent multiple-employer or single-employer plan, we will review the liability specific to the local government we are rating. In addition, Standard & Poor's will analyze other plans if it appears the magnitude of their corresponding contributions could substantially increase in the medium term, thereby causing financial pressure for the local government.

Future carrying charges can increase rapidly when a pension plan is underfunded. If a low funded ratio hasn't already led to increased contributions, it is likely in the medium term. If contributions are increasing, local governments could be forced to pay them in ways that weaken credit quality, such as using operating reserves. To assess whether a plan is underfunded, Standard & Poor's will look at its actuarial funded ratio(3), which indicates the sufficiency of the assets set aside in a trust to fund the liabilities due. While the ideal pension plan actuarial funded ratio is 100%, an actuarial funded ratio of 80% or greater, in our opinion, represents adequate progress toward funding future liabilities. We recognize that pension liabilities are long-term obligations and that funded levels may fluctuate over time. If the actuarial funded ratio(s) of the pension plan(s) a local government participates in or sponsors is less than 80%, this could represent evidence of future carrying charge growth and will be an area of analytic focus.

Timeframe

Our analyses, using the new local government criteria, seek to be forward-looking and identify projected continued credit strength or deterioration. Therefore, we will be analyzing budget impacts from growing pension or OPEB funding requirements over the medium term, which we consider the next two to three years. This is consistent with our treatment of significant additional debt plans over the medium term, given both pension/OPEB and debt payments are fixed costs that can cause budgetary stress.

Trends

We analyze trends in funded ratios and contributions, both required and actual, to identify impending budget stress caused by pension or OPEB obligations. We believe that a decreasing trend in funded ratios or in the percentage of required contributions actually contributed will likely lead to an increase in contributions and potential budget stress in the future.

Given that our analysis focuses on the medium term, we are particularly interested in the speed at which the required contributions are increasing. Rapidly increasing required contributions pose greater budget stress than modest increases for which the local government can prepare. A minor drop in the funded ratio may necessitate a small increase in contributions over the long term, while a major drop may require substantially higher contributions as early as the next fiscal year and for several years to come, depending on investment performance and asset-smoothing methods.

In addition to measuring what a local government should be contributing to its pension plan(s) (according to its actuary or legislation), Standard & Poor's evaluates what a local government actually has been contributing to its pension plan(s). Contributing less than required generally leads to larger contributions down the road, and the smaller the percentage of required contributions that is actually contributed, the sooner the increased contributions will be

required. Standard & Poor's collects data on all contributions actually made to all plans a local government participates in or sponsors. The degree to which a local government contributes less than its full required contribution(s) could be an indication of either short-term cash flow issues or management's willingness to defer difficult decisions, both of which could be credit concerns. Certain states allow local governments participating in their multiple-employer plans to contribute less than the required amount in certain years without further penalties. While states may allow these options, we will review each local government's reasons for taking advantage of such an option. A declining trend in the percentage of the required contribution actually contributed typically has credit implications because it most likely means either the pension costs are unaffordable for the local government or it chooses to prioritize spending elsewhere in the budget.

Managerial Actions

If the magnitude of and trend in pension or OPEB metrics indicates a current or potential material budget impact, we evaluate whether management is taking action to handle or prepare for it. If a local government has taken action or developed a plan that we believe is credible and will address its exposure to increased pension or OPEB funding requirements, the debt score will only worsen by one point. On the contrary, if no plan exists or, in our view, it is weak or unrealistic, the local government's debt score will worsen by two points.

In assessing a managerial plan, we first identify the type of plan(s) a local government's employees participate in: cost-sharing multiple-employer state plans, agent multiple-employer state plans, or single-employer plans. In a cost-sharing plan, a local government has no control over benefit levels, plan assumptions, or contributions because all three are decided at the state level. In this case, we would evaluate management's awareness of--and ability to react to--future contribution increases communicated at the state level. Options may include cutting operating expenditures, using dedicated reserves, or proposing a levy increase to voters. In an agent multiple-employer plan, the local government has control over benefit levels and may reduce the liability and, consequently, required contributions, by lowering them. In a single-employer plan, the local government can change assumptions, benefit levels, or contribution levels.

Viable managerial actions depend on the level of control a local government has over assumptions, benefits, and contribution levels. Examples of such actions include:

- Reducing benefits for current retirees, current employees, or new employees
- Cost-control initiatives;
- Increasing employee contributions;
- Establishing and beginning to fund a revocable or irrevocable OPEB trust;
- Identifying a new revenue stream, portion of an existing revenue stream, or portion of year-end surpluses to fund increasing contributions; and
- Closing an existing plan to new employees.

In our opinion, the more significant the payment obligation, the more significant and timely management's response needs to be. For example, we would likely consider increasing contributions significantly for a very poorly funded plan a credible action, while increasing them only slightly may not be. Another example is the choice of the type of OPEB

trust to establish and fund. In our opinion, an irrevocable trust reduces credit risk more than a revocable trust because the funds are secured only for paying OPEB benefits. Funds in a revocable OPEB trust may be released for other uses, so management's intentions must also be discussed for Standard & Poor's to gain comfort that the funds will remain set aside for OPEB benefits alone.

Market Analysis Versus Credit Analysis: Standard & Poor's View

We assess magnitude, timeframe, trends, and managerial actions to factor the risks posed by underfunding pension and OPEB plans into our credit analyses. We are not, however, currently calculating an alternative estimate of pension liabilities or contributions. Given the sheer number of assumptions and methods involved, we believe that a revised estimate of the calculations using the few assumptions and methods that we could feasibly alter for comparative purposes would be at the expense of accuracy.

Our analysis seeks to be forward-looking and identify budget stress from large pension or OPEB obligations over the medium term. Pension and OPEB obligations are a key part of a local government's debt and contingent liabilities score. As mentioned in our recently published view on how the implementation of GASB Statement Nos. 67 and 68 will affect our credit analyses (see "Credit FAQ: Standard & Poor's Approach to Pension Liabilities In Light Of GASB 67 and 68," published July 16, 2013), we view them as long-term liabilities that must be funded over time. While the funding schedule can be more flexible than for a fixed-debt repayment, it can also be more volatile and cause fiscal stress if not properly managed. Therefore, our focus is on the obligations' near-term affordability and management's ability to fund this liability on an ongoing basis.

Notes

(1) A required pension contribution, for our purposes, means a contribution that is either statutorily, contractually, or actuarially required. A contractually required contribution is an amount, typically a percentage of covered payroll, agreed upon in a contract, or collective bargaining agreement, that must be contributed to a pension plan on an annual basis. An actuarially required contribution is the sum of a plan's normal cost (present value of benefits earned during the current year) and an amortization of its unfunded actuarial accrued liability. A statutorily required contribution is an amount, typically a percentage of covered payroll, written into state statutes that must be contributed to a pension plan on an annual basis.

(2) A required OPEB contribution, for our purposes, means the contribution a local government is requiring of itself to contribute on an annual basis, be that its pay-as-you-go cost, actuarially required amount, some combination of the two.

(3) A plan's actuarial funded ratio is the ratio of its actuarial value of assets to its actuarial accrued liabilities. Note that a new metric(s) may be used to assess funded status once the actuarial funded ratio is no longer reported under the new GASB Statement Nos. 67 and 68.

Related Criteria And Research

Related Criteria

USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013

Related Research

Credit FAQ: Standard & Poor's Approach to Pension Liabilities In Light Of GASB 67 and 68, July 16, 2013

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