ESG Brief: ESG Pension And OPEB Analysis In U.S. Public Finance

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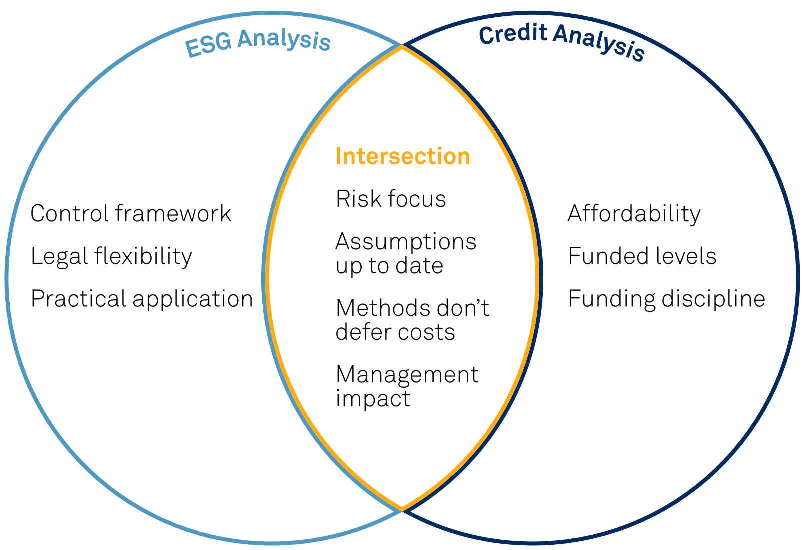
Environmental, social, and governance (ESG) is integral to our public finance credit analysis and we continue to amplify our transparency efforts for market participants. This brief aims to identify when our view of pension analytics and governance as part of ESG intersects with credit rating analysis.

Chart 1

The Intersection Of ESG And Credit Analysis



Source: S&P Global Ratings.
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Credit rating analysis for pension and OPEB is built around cash flows, both current and future, and how contribution costs could negatively affect an issuer's willingness and ability to meet its debt obligations and operational expenditures. In our view, ESG factors begin to overlap with our credit rating analysis for pension and OPEB when prioritization of plan contributions, through forward-looking plan governance decisions, is viewed through the lens of risk management, culture, and oversight.

Chart 2

What We're Watching

Control Framework
Who sets contribution level?
Who sets benefit level?

Legal Flexibility
Change funding methods
Reduce benefits

Practical Application
Risk focus
Adjust assumptions

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Control Framework

A regulating entity such as the state, for smaller government plans, or the pension board, for cost-sharing multiple-employer (CSME) plans, may limit an issuer's ability to control its own contribution requirements and plan decisions, although the effect could be positive or negative. In some instances, if the plan receives supplemental contributions during periods of economic stress or smaller issuers gain access to higher-level expertise that otherwise would be inaccessible or too costly to employ, we may view that positively from a governance perspective. However, for small governments participating in a CSME plan, there is often an inability to participate in plan decision making, which could lead to less risk mitigation planning to address escalating contributions in long-term financial forecasts. Highly rated entities often plan for volatility and possible cost escalation.

Legal Flexibility

An issuer's ability to modify benefits, funding methods, or plan assumptions to mitigate risks is considered in both an ESG-focused assessment of governance and the overall credit rating analysis. For example, in the state of New York, local governments do not have authority to prefund OPEB benefits in an irrevocable trust, limiting their ability to mitigate risk from rising costs. In Illinois, the state minimum pension contribution typically adhered to by local governments within the state achieves only 90% funding and is in excess of the 20 years we believe is likely to lead to material funding progress, which indicates weak funding discipline and could increase an entity's exposure to financial pressure going forward. Issuers not constrained by such limitations and practices are better positioned to manage pension and OPEB risks. We would view favorably the incorporation of conservative financial forecasts (such as rising or volatile health care claims costs within OPEB projections) and development of strategies to maintain budgetary balance through raised revenue or expenditure reductions to accommodate an increasing fixed cost burden.

Practical Application

When local plan control exists, we assess management's risk focus on whether techniques are considered to address cost escalation. In some instances, changes to funding methods can lead to rapidly increasing costs, such as when plans that defer costs through high annual contribution increases are updated to a level-dollar amortization that addresses costs sooner. If a government is not planning for pending increases, an entity may experience accumulated future fiscal stress absent significant budgetary adjustments to incorporate the higher amounts. Similarly, while some issuers may manage down unfunded liabilities and contribution requirements by relying on higher assumed investment returns and corresponding discount rates, we view these decisions as adding to credit risk as they can lead to volatile and increasing contributions should actual results fall short of assumptions.

Related Research

- ESG Brief: Emerging Themes In U.S. Public Finance, June 3, 2021
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- Guidance | Criteria | Governments | U.S. Public Finance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Credit FAQ: Pension And OPEB Guidance In U.S. Public Finance Credit Analysis, July 21, 2020

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