

Pension Funded Ratios Fall For Most U.S. Big Cities On Weakened Investment Returns

October 19, 2023

Key Takeaways

- The median pension funded ratio for the 20 largest U.S. cities decreased during fiscal 2022, mainly due to investment returns falling from 2021 highs.
- While some losses from 2022's volatile markets could recover slightly in fiscal 2023, S&P Global is forecasting relatively slow growth over the next few years and S&P Global Ratings believes it is unlikely that funded ratios will return to near-2021 levels in the near term.
- Our view that funded ratios will not return to 2021 levels is further supported by the fact that in fiscal 2022 fewer cities met our minimum funding progress (MFP) metric for at least one of their two largest pension plans than in the prior year.
- Most cities do not prioritize pre-funding their other postemployment benefits (OPEB) liabilities, which could lead to future cost pressure.

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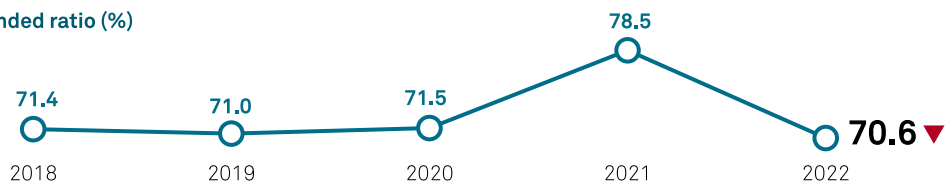
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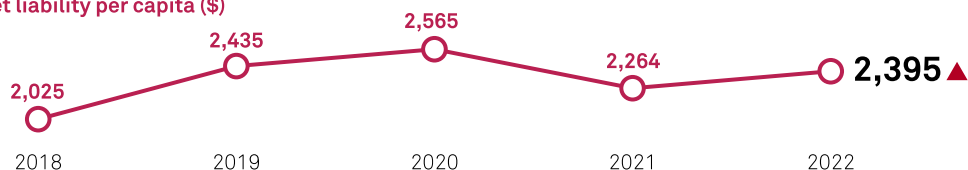
Chart 1

20 largest cities' pension medians fiscal 2022

Funded ratio (%)



Net liability per capita (\$)



Source: Published annual comprehensive financial reports.
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Note: 2022 funded ratio reflects the median of those plans for which 2022 data was available.

Market Returns Will Not Be Enough To Improve Long-Term Plan Funding

The largest one or two applicable pension plans in each of the 20 largest U.S. cities account for most of those cities' pension liabilities. S&P Global Ratings has evaluated these plans through their fiscal 2022 reporting periods and finds that funded ratios decreased from the fiscal 2021 reporting periods as investments gave back some of their extraordinary earnings from 2021.

Volatile market returns over the past five years have caused temporary swings in the funded ratios of the biggest plans in the 20 largest cities, but overall plan contributions have remained stable. Absent changes to contributions or benefits, cities are reliant on market performance for funding sustainability and, if market performance does not meet actuarial assumptions, they are exposed to larger unfunded liabilities and future costs. For issuers with inflexible benefits and inadequate funding, cost deferrals, such as extending amortization schedules, are commonly used to provide budget flexibility. Cost deferrals in any form, however, could lead to intergenerational inequity, with benefits supported by a generation that is not expected to see such benefits themselves, and to attraction and retention issues for employers. The imbalance could also lead to budgetary stress if higher salaries are needed to maintain the workforce.

With market performance improving in 2023 compared to the prior year, we expect a portion of 2022's investment losses to be recovered. However, we do not expect that funded ratios will return to 2021 levels any time soon, as S&P Global is forecasting slower economic growth over the next few years. Large swings in market returns underscore the importance of a long-term, and volatility-based, view of the assumed rate of return and discount rate. S&P Global Ratings' discount rate guideline for a typical target asset portfolio that manages cost volatility risk is 6.00%, and so we typically view plans with a higher assumed return and discount rate as taking on greater risk than they can safely absorb in a periodic negative market shock. All of the largest 20 cities' top plans have a discount rate higher than our guideline, though each has different demographic and plan characteristics that could cause us to take a more neutral view on the budgetary risk posed by their pension assets. While reducing the assumed return and discount rate will reduce a plan's funded status, it also reduces the risk of future cost volatility.

Cities with the largest shortfalls in contributions compared to MFP have accumulated large unfunded liabilities, which shows the effect of deferring pension costs for short-term budgetary relief.

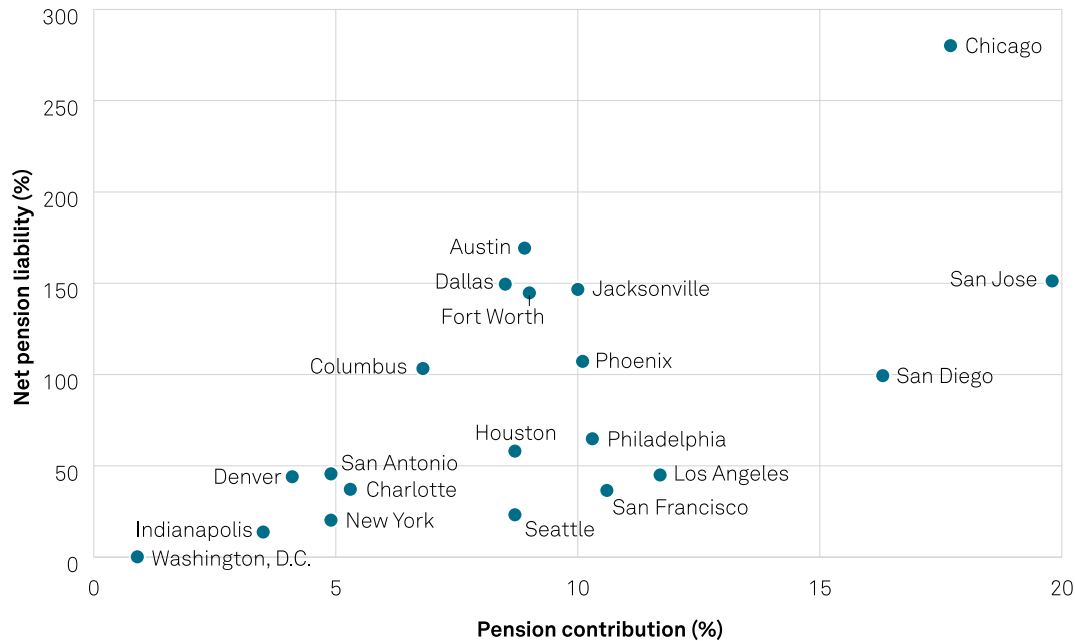
Short-term savings lead to long-term costs

To illustrate the short-term versus long-term nature of cities' pension pressures, in chart 2 we compare current pension costs (that is, a city's total contributions compared with its total governmental fund [TGF] expenditures) to long-term pension costs (that is, a city's net pension liability [NPL] compared to its TGF expenditures). For plans that are fully funded, long-term costs consist only of service costs, while plans with unfunded liabilities will need to pay for service costs and interest on the unfunded liabilities in addition to paying them down. Cities with large long-term cost pressures, such as Chicago and Austin, have had unfunded liabilities accumulate over many years without materially increasing contributions and will eventually face cost pressures that will translate into near-term budgetary pressure.

Chart 2

2022 net pension liability vs. pension costs for the two largest plans per city

As a % of total governmental funds expenditures



Source: S&P Global Ratings.

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Inflation remains a pressure on pension plans in the U.S. and its impact can vary based on plan design, investment makeup, and funding levels. Although our pension guidelines are long term and based on long-term inflation assumptions, in the near term inflation can exert pressure on pension plans by increasing their future liabilities because rising interest rates can affect the value of fixed-income investments and cost-of-living adjustments (COLAs). While interest rate hikes and higher inflation could continue through 2023, we expect them to begin to ease in 2024. For more information on how continued inflation could affect pension funding for local governments in the U.S., see "U.S. Public Pension Fiscal 2023 Update: Funded Ratios Stable, Inflation Retreats, and POB Issuance Stops," published July 11, 2023 on RatingsDirect.

Funding deferrals continue as 2022 contributions did not make progress toward full funding

S&P Global Ratings measures contribution sufficiency based on an assessment of the forward-looking actuarial recommendation and backward-looking MFP metric. Although many plans' contributions have remained stable relative to our MFP metric, a few have fallen behind compared to last year, as funding progress can be deferred by changes in assumptions and contribution methods, increases in unfunded liabilities, and budgetary decisions.

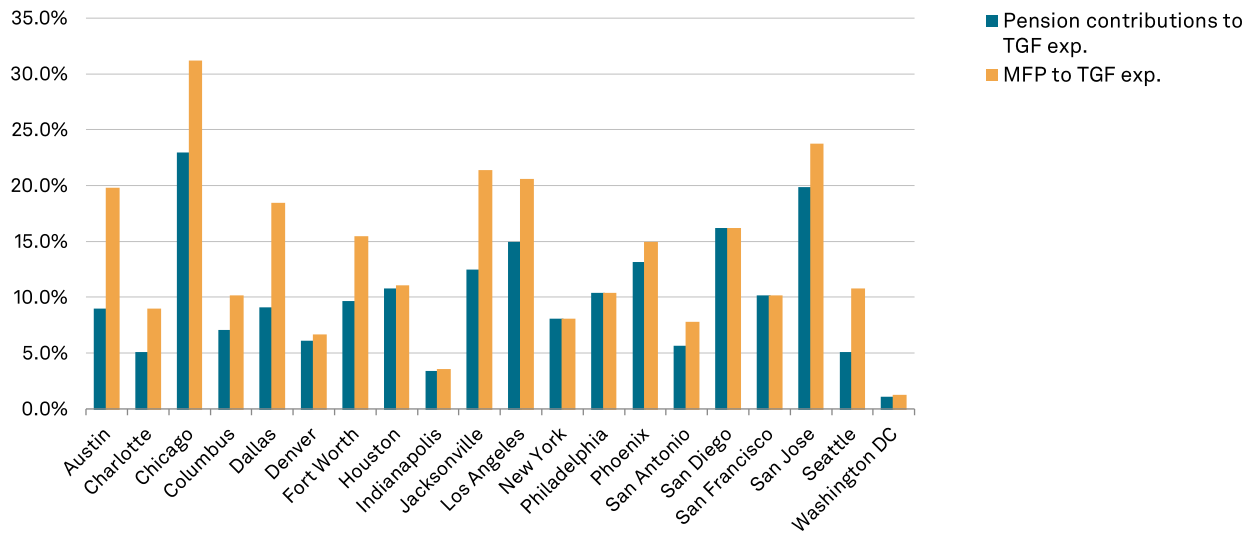
Eight of the 20 largest cities did not meet our MFP metric in at least one of their plans in the most recent audit, compared with six last year. We view contributions to 13 of the 37 plans we reviewed in this analysis as insufficient to maintain current funded ratios (that is, contributions were less than static funding), the same number as last year.

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In chart 3, the blue bar represents the percentage of a city's budget dedicated to pension contributions in the most recent audit, while the orange bar represents what that percentage would look like if the city were contributing the MFP. For issuers that are significantly below MFP, this chart shows the impact on budgetary pressure if they were making what we consider to be material progress in paying down unfunded pension liabilities. As chart 3 shows, cities with the largest shortfalls in contributions compared to MFP have accumulated large unfunded liabilities, which shows the effect of deferring pension costs for short-term budgetary relief.

Chart 3

Fiscal 2022 total pension contributions compared to MFP



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Note: TGF expenditures have been adjusted to include the increased contribution expenses in our MFP to TGF expenditure calculations.

Our static funding metric measures whether a given pension plan is maintaining current funding levels but not making progress in funding its liability, while our MFP metric measures whether a plan is making material progress in paying down its unfunded liability. It is important to note that these metrics look only at the most recent year. Within our analysis, we compare the actuarial funding plan against our guidelines. For example, we consider a long level-percent amortization as deferring costs and as potentially leading to negative funding progress, particularly if the associated payroll growth assumption is high. When assessing the actuarial recommendation and contribution affordability, we incorporate each sponsor's specific budgetary characteristics.

Other postemployment benefits (OPEB)

Three of the cities covered by this report contributed at least the actuarial recommendation toward their largest OPEB liability last year. Of these, Phoenix is an outlier because for the past five years it has contributed above this amount toward its Medical Expense Reimbursement Plan, which has a liability of \$178 million as of the June 30, 2022, measurement date and is

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approximately 53% funded, compared with approximately 46% five years ago. Cities in some states are limited in their ability to fund their OPEB liability; for example, in New York and New Jersey, municipalities are statutorily not permitted to prefund their OPEB liabilities and therefore retiree medical plans must be funded on a pay-as-you-go basis.

We could view pension and OPEB liabilities as a risk management, culture, and oversight risk. Examples include cities in states that have a limited ability to plan for future OPEB costs and states that use statutory funding requirements that defer costs, because costs might be manageable in the near term but will eventually pressure budgets.

How Funding Choices Affect Short And Long-Term Costs: A Look At Selected U.S. Cities

Cities that have consistently met MFP have shown funding progress

New York, Indianapolis, and Philadelphia have made contributions at least equal to MFP in at least one of their largest pension plans.

New York

In the past few years, the city has exceeded MFP in its Teachers' Retirement System. With the funding practices in its Police Pension Fund and Teachers Retirement System, funded ratios have remained mostly stable, while contributions have consumed a smaller portion of TGF expenditures, which we expect will continue. However, the city's OPEB plans typically have much more volatility and are a constraint on creditworthiness. The city recently attempted to address its large unfunded net OPEB liability by shifting employees to Medicare Advantage and discontinuing its senior care plan. However, following a lawsuit this attempt was halted. We understand that the city is appealing the decision and, in the interim, continues to make payments under its current OPEB plan. We anticipate that OPEB costs will pressure the city's budget and overall creditworthiness, although its pension contribution practices should continue to minimize this.

Indianapolis

Even with negative returns in fiscal 2022, the Indiana Public Retirement System remains above 80% funded, and we expect that funded ratios will continue to improve if contributions continue to exceed MFP, as the plan uses a conservative level-dollar amortization method and a 6.25% discount rate, only slightly above our 6.00% guidance. Pension contributions decreased as a percentage of TGF expenditures from 2018 to 2021 as a result of funding progress from recent contributions and market returns. We note that the city's 2022 audit is not yet available to compare contributions to 2022 TGF expenditures but, given that contributions for the top two plans increased by only 1.8% from the previous year, we do not believe they have consumed a materially larger percentage. Pension contributions make up a low portion of the city's budget and should not see material increases as a percentage of budget if the plan continues to meet MFP and actuarial assumptions.

Philadelphia

Philadelphia's large unfunded pension liability and weak funding levels have historically been

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considered a credit pressure for the city. While Philadelphia has contributed more than its yearly actuarial recommendation to the plan for more than 10 years, its funding progress is slow because its funded levels were so low historically. The city has worked to improve its pension funding, exceeding MFP for the past five audited fiscal years and lowering its discount rate by 0.05% annually. The city's discount rate was at 7.35% effective July 1, 2023; however, we still view this as aggressive and as potentially leading to cost volatility and escalation due to market movements. Should the city continue its current funding practices and be able to address any assumption shortfalls, we expect that funding progress will continue. However, pension liabilities remain a weakness in the city's overall credit quality as large contributions are required to pay down unfunded liabilities and pension contributions already make up the largest line item in the city's budget. For more information on Philadelphia pensions, see our latest report on the city, published July 7, 2023.

Falling short of MFP means cost increases or funding deterioration

Jacksonville and Chicago have a history of contributions routinely falling short of MFP, and pensions are a pressure on their overall creditworthiness.

Jacksonville

Jacksonville's Police and Fire Plan remains less than 60% funded and its unfunded liabilities have continued to grow. The city has not met MFP in either of its largest plans since 2018. In addition, yearly contributions have continued to increase in recent years as police and firefighters' pay raises have led to increased liabilities. In 2016, voters approved the extending of a half-cent sales tax, originally approved to provide financing for infrastructure projects, to contribute to the city's unfunded pension liability. This is expected to begin in 2026, three years earlier than originally anticipated due to strong sales tax receipts, and is currently expected to yield \$130 million per year. While sales tax revenue performance has remained robust, however, we view it as inherently volatile. We note that in 2017 the city closed its police and fire plan to new entrants.

Chicago

Chicago follows a statutory pension funding code and its pensions remain poorly funded, with a timeline to reach adequate funding status that is beyond our 20-year guideline for amortization length, leading to more exposure to market volatility and other potential assumption shortfalls. Despite the city's recent trend of increasing contributions, funded ratios have seen minimal improvement, though contributions will continue to increase under the statutory funding requirements. While the city contributed above its statutory requirement (though below the actuarial recommendation) in 2022, its funded percentage decreased due to negative investment returns. After making \$242 million in pension contributions above the state requirement in 2023, the city appears to be coming closer to the actuarial recommendation and should meet static funding if such practices are continued. However, we expect contributions will remain below MFP given the large unfunded liabilities and weak assumptions and methods, such as a level-percent-of-payroll amortization with a 3.5% yearly payroll growth assumption that we believe will defer costs. In addition, the decision to overfund the pension payments is made annually and can vary depending on choices made by the city's leadership, which has deferred funding plans in the past.

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Table 1

Key credit metrics and pension plan list

	Per capita net pension and OPEB liability	Weighted funded ratio % (largest two plans)	Most recent year fixed costs % expenditures	Plan 1	Plan 2
Austin	\$7,889	58.49%	23.30%	City of Austin Employees' Retirement System	Austin Police Officers' Retirement & Pension Fund
Charlotte	\$969	84.07%	28.40%	Local Governmental Employees' Retirement System	
Chicago	\$11,067	21.07%	31.50%	Municipal Employees' Annuity and Benefit Fund	Policemen's Annuity and Benefit Fund
Columbus	\$2,382	68.56%	19.40%	Ohio Police & Fire Pension Fund	Ohio Public Employees' Retirement System
Dallas	\$3,111	60.94%	27.20%	Dallas Police and Fire Pension System (Combined Plan)	Employees' Retirement Fund (ERF)
Denver	\$1,845	66.04%	14.50%	Denver Employee Retirement Plan	Fire and Police Pension Association
Fort Worth	\$3,235	57.85%	23.20%	Employee's Retirement Fund of the City of Fort Worth	
Houston	\$1,934	82.25%	22.60%	Houston Police Officers' Pension System	Houston Municipal Employees Pension System
Indianapolis	\$488	91.10%	20.60%	Indiana Public Employees' Retirement Fund	Indiana 1977 Police Officers' and Firefighters' Retirement Fund
Jacksonville	\$3,406	47.49%	21.20%	Police and Fire Pension Plan	General Employees' Retirement Plan
Los Angeles	\$1,343	91.50%	23.00%	Los Angeles City Employees' Retirement System	Los Angeles Fire and Police Pension Plan
NYC	\$13,702	82.58%	21.10%	New York City Teachers Retirement System	New York City Police Pension Fund
Philadelphia	\$4,778	56.08%	14.70%	Philadelphia Municipal Pension Fund	
Phoenix	\$2,407	56.12%	20.50%	City of Phoenix Employees' Retirement System	Public Safety Personnel Retirement System
San Antonio	\$1,215	81.04%	18.30%	Fire and Police Pension Fund	Texas Municipal Retirement System
San Diego	\$2,134	78.18%	22.20%	San Diego City Employees' Retirement System	
San Francisco	\$7,347	92.34%	21.40%	San Francisco City and County Employees Retirement System	

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Table 1

Key credit metrics and pension plan list (cont.)

San Jose	\$3,626	68.95%	28.40%	Federated City Employees Retirement System	Police and Fire Department Retirement Plan
Seattle	\$1,376	80.14%	9.20%	Seattle City Employees' Retirement System	Law Enforcement Officers' and Fire Fighters' Retirement System
Washington DC	\$292	99.62%	6.80%	Police Officers and Firefighters Retirement Fund	Teachers Retirement Fund

Table 2

Issuer list

City	GO rating	Rating date	Primary analyst	Email
Austin	AAA/Stable	8/28/2023	Stephen Doyle	Stephen.doyle@spglobal.com
Charlotte	AAA/Stable	6/23/2023	Christian Richards	Christian.richards@spglobal.com
Chicago	BBB+/Positive	11/10/2022	Jane Ridley	Jane.ridley@spglobal.com
Columbus	AAA/Stable	4/17/2023	Randy Layman	Randy.layman@spglobal.com
Dallas	AA-/Stable	3/13/2023	Stephen Doyle	Stephen.doyle@spglobal.com
Denver	AAA/Stable	7/13/2023	Jane Ridley	Jane.ridley@spglobal.com
Fort Worth	AA/Stable	5/2/2023	Kristin Button	Kristin.button@spglobal.com
Houston	AA/Stable	9/28/2022	Stephen Doyle	Stephen.doyle@spglobal.com
Indianapolis	AA+/Positive	6/2/2023	Anna Uboytseva	Anna.uboytseva@spglobal.com
Jacksonville	AA/Stable	8/17/2023	Krystal Tena	Krystal.tena@spglobal.com
Los Angeles	AA/Stable	8/31/2022	Treasure Walker	Treasure.walker@spglobal.com
NYC	AA/Stable	8/4/2023	Felix Winnekens	Felix.winnkens@spglobal.com
Philadelphia	A/Positive	4/20/2023	Cora Bruemmer	Cora.bruemmer@spglobal.com
Phoenix	AA+/Stable	4/15/2022	Daniel Golliday	Daniel.Golliday@spglobal.com
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San Francisco	AAA/Stable	3/17/2023	Li Yang	li.yang@spglobal.com
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Washington DC	AA+/Stable	2/27/2023	Christian Richards	Christian.richards@spglobal.com

This report does not constitute a rating action.

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