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Pension Brief: Single-Employer Pension Plans Are Straining Illinois Municipalities' Credit Quality

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Key Takeaways

- Weak statutory funding requirements below actuarial recommendations postpone meaningful funding progress for many local governments' individual pension plans.
- Limited revenue-raising flexibility and weak demographic trends will likely compound pension pressures for poorly funded local plans.
- The consolidation of downstate and suburban public safety plans likely will provide some savings to these plans, but minimal help to address near-term cost pressures and could add contribution volatility risk.
- Although carve-outs in the statutory funding requirements have been made to provide Chicago with budgetary relief, the city faces budgetary pressure from its large unfunded liabilities, and costs are expected to escalate.

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Throughout Illinois, pension plans have made little funding progress in recent years and their costs have been rising, pressuring municipalities' budgets. (For more information on these pressures, see "Pension Spotlight: Illinois," published March 30, 2021, on RatingsDirect.) Cities throughout the state use single-employer pension plans for their public safety officers. S&P Global Ratings believes these plans can strain creditworthiness due to poor funding discipline in the past, inability to reform benefits, weak statutory funding requirements, weak demographic trends, and limited revenue-raising flexibility or political unwillingness to raise revenue.

Weak State Minimum Funding Requirements Lead Municipalities To Defer Costs

As poorly funded pension plans were catching national attention following recessions in 2000 and 2008, Illinois legislators passed minimum funding requirements for pension plans throughout the state. These requirements differ for the statewide plans, downstate and suburban public safety plans, and the Chicago pension plans. However, they all set a 90% funding goal that S&P Global Ratings views as adding credit risk compared with plans designed to achieve 100% funding. In addition, state law allows unfunded liabilities to be amortized as a level percentage of assumed payroll growth rather than on a level-dollar basis. Many municipalities use this level percentage amortization method along with elevated payroll growth assumptions to limit forecast annual costs, but this practice has a risk of payroll growth falling short of the assumed growth rate. If payroll growth falls short, payments are deferred and larger future contributions will be required. Plan requirements also allow pension plans to use a projected unit credit cost methodology that backloads employee costs toward the later years of their employment.

In addition to laws allowing pension plan costs to be deferred and underfunded, the state constitution also prohibits the reform of future benefit accruals for existing employees. Article XIII, Section 5, of the state's 1970 constitution, characterizes pension membership as "an enforceable contractual relationship" and declares categorically that pension benefits "shall not be diminished or impaired." Efforts to reform benefits throughout the state have been overturned by the Illinois Supreme Court because it upheld a strict reading of this pension protection clause. Because the benefits cannot be modified without a constitutional amendment, the associated large unfunded liabilities will continue burdening governing bodies' budgets and balance sheets.

Like the statewide plans, single-employer plans in Illinois do get some relief from benefit tiers, with the lower benefits for officers hired after Jan. 1, 2011. As newer-tier employees take on a larger portion of plan membership, growth in liabilities should level off. It will be years before the newer-tier retirees exceed the number of higher-benefit retirees and material savings are realized.

Recent Slower Economic Growth And Aging Populations Exacerbate Deferred Cost Pressures

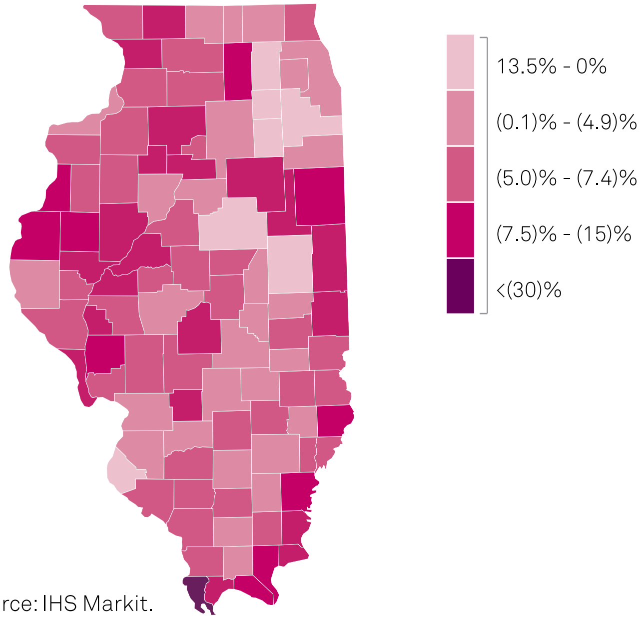
The risks associated with the methods and assumptions in use by many Illinois municipalities could be partially mitigated by expanding economies and payrolls. However, economic growth has been slow and local government payroll headcounts have been declining throughout the state. With population and government employment declining, we believe it is highly unlikely growth alone will help with the funding pressures. Between 2015 and 2020, Illinois' gross state product increased 8.6% and between 2020 and 2025 it is projected to increase 31.2%. Across all 50 states, gross state product has increased and is projected to increase 14.8% and 34.7% over these periods, respectively, according to IHS Markit data.

With population and payroll headcount declines, we expect escalating funding pressure.

As population declines and technological advances continue in the government space, municipalities are unlikely to hire more employees. Between 2013 and 2019, local payroll headcounts declined by 7.0% and they are down 10.2% from their 2009 pre-Great Recession peak, according to data from the Bureau of Labor Statistics. In our opinion, shrinking government employment increases the risk that payroll growth assumptions used in pension assumptions will not be met, leading to pension costs possibly escalating faster than anticipated, and causing pension contributions to consume a larger percentage of the budget and intensify liquidity pressures (see "Five U.S. State And Local Government Pension And OPEB Trends To Watch For In 2021 And Beyond," Jan. 25, 2021).

Only seven of the 102 counties in the state have a 2020 population estimate above their 2010 census figures and 62 have estimated declines of at least 5.0% over this period. Compounding these declines is the high risk of exposure to aging demographics. Projections from IHS Markit indicate that in Illinois, 86 counties will see their share of population 65 and older increase at a rate faster than the nation through 2026. This is likely to cause decelerating economic growth and increase fiscal pressures (for more information, see "Increasing Generational Dependency Poses Long-Term Social Risks To U.S. States' Fiscal And Economic Stability," Feb. 24, 2020).

Illinois County Population Changes 2010-2020



Source: IHS Markit.

How Illinois Single-Employer Public Safety Plans Differ From State Plans

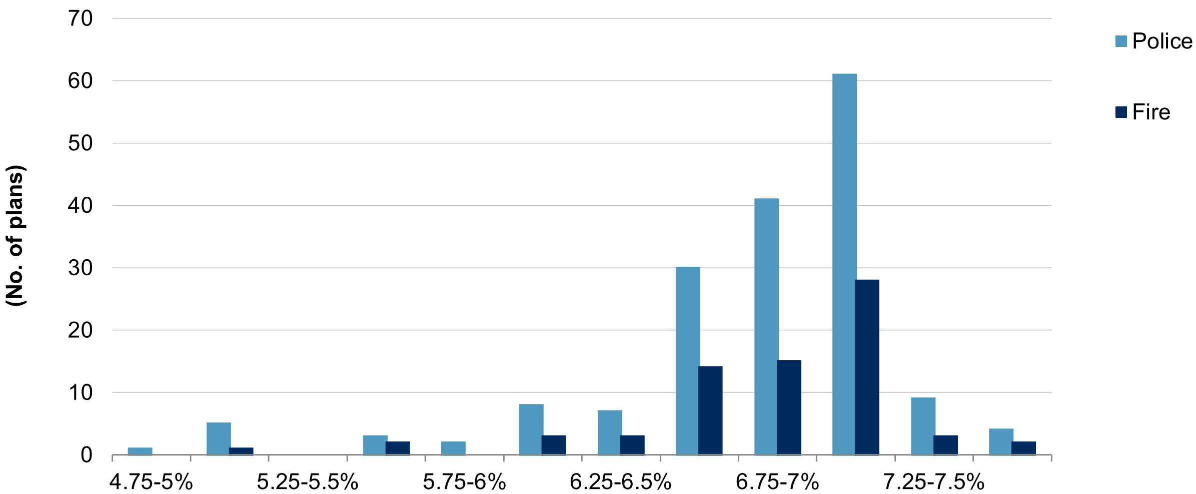
The state is now transitioning approximately $15 billion in assets of municipalities' existing single-employer police and firefighter pension plans to the newly created Illinois Police Officers' Pension Investment Fund (IPOPIF) and Illinois Firefighters' Pension Investment Fund (IFPIF). The new funds are expected to lower costs through greater economies of scale and improve investing options for many smaller plans. However, consolidation will likely reduce municipalities' ability to customize their market risk exposure to their individual circumstances. Of significance, existing single-employer municipal public safety pension funds with less than $10 million in assets that are currently subject to investment restrictions will no longer be constrained by these limitations. We believe this consolidation will provide some cost savings through the elimination of redundancies, but contribution increases will still be required for many plans.

Currently each of the 649 police and firefighter pension plans in the state each use different methodologies and assumptions. One aspect that differs for many plans is the assumed discount rate. We believe an investment rate of return assumption higher than 6.0% corresponds to more volatile investments needed to achieve the high expected returns. Should returns fall short of these assumptions in a given year, higher contributions in subsequent years will need to make up for the lower-than-assumed returns. These unanticipated contribution increases can lead to budgetary stress.

As the public safety plans merge, the new funds will use a blended approach to manage risk differently for plans based on the size of their assets and individual risk tolerances. This blended approach may utilize different discount rates for each municipality. Plans that experience an increase to their discount rates will show immediate funded ratio improvement while taking on additional volatility risk. See chart 1 for the discount rates used in plans for which we have data.

Chart 1

Illinois Municipalities' Police And Fire Pension Funds Discount Rate Distribution
S&P Global Ratings universe



Source: Issuers' financial reports.

Numerous Illinois public safety plans in our rated universe contribute to a 100% funded goal and use an entry age normal cost methodology. Even when plans use assumptions or methods more stringent than the statutory minimum requirements, it often does not offset the cost deferrals other less stringent allowable assumptions create. Only 6% of public safety plans' most recent contributions in our rated universe were sufficient to meet our minimum funding progress metric and almost two-thirds of public safety plans' most recent contributions were short of static funding--indicating these plans' unfunded liabilities will rise if all else is held equal.

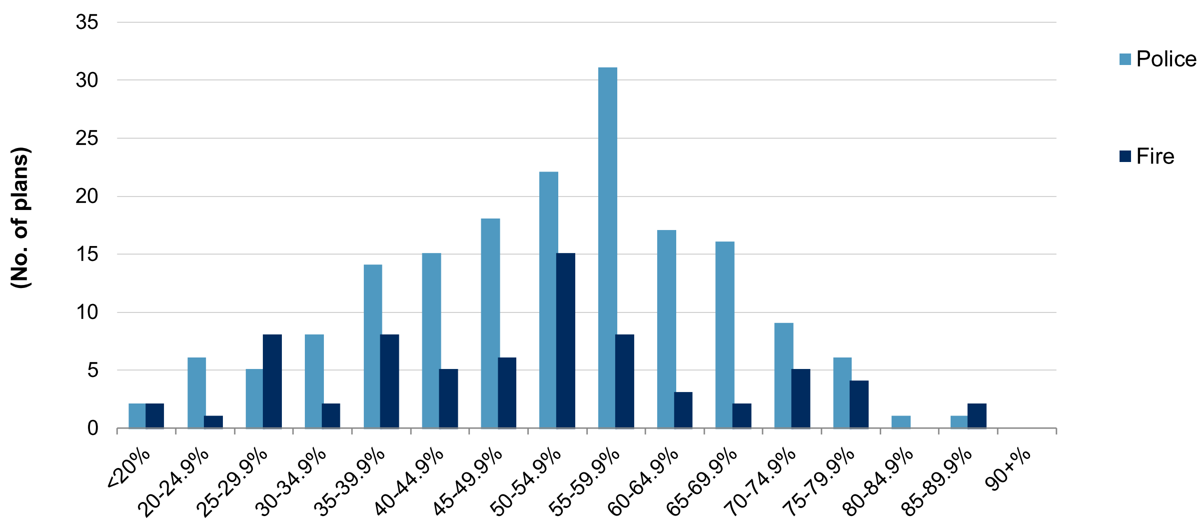
Recent contributions to public safety plans have been insufficient to generate funding progress, suggesting that unfunded liabilities will rise.

Of the 250 city and village public safety plans S&P Global Ratings has data for, the average funded ratio was only 52%, using the most recent data available. With a requirement to reach 90% funded ratios by 2040 and the most recent contributions for most plans being insufficient to generate funding progress, contributions will need to increase to achieve this goal. We expect municipalities with limited revenue-raising flexibility, weak demographic trends, and poorly funded pension plans will face acute budgetary pressure in the coming years.

The funded ratios in chart 2 are based on discount rates, which vary from plan to plan as they accept different amounts of portfolio risk. As these plans are consolidated, funded ratios will decline for those with discount rates larger than the consolidated plans' discount rates and ratios will improve for those with the lower rates. Correspondingly, the consolidation will lead to changes in current asset allocations. Asset allocation changes could widen plans' exposure to riskier investments, which would increase the likelihood of more contribution volatility.

Chart 2

Illinois Municipalities' Police And Fire Funded Ratio Distribution
S&P Global Ratings universe



Source: Issuers' financial reports.

For Illinois municipalities with stronger economic growth, wealthier tax bases, greater revenue-raising flexibility, conservative actuarial assumptions and methods, and strong funding discipline in the past, increasing pension costs will likely be manageable. However, this does not apply to many municipalities where pension costs are already pressuring an above-average percentage of issuers we rate. Of the rated Illinois municipalities, we lowered the general obligation ratings on 18.5% during calendar years 2019 and 2020 compared with downgrades to only 4.9% of rated municipalities across the U.S. During this period, 61% of the 44 Illinois municipalities downgrades were at least partially due to large net pension liabilities or deteriorating financial profiles caused by poorly funded pension plans.

Illinois municipalities are seeing rating pressure from high pension liabilities and costs.

The minimum funding requirement law that went into effect in 2011 also includes a provision that allows pension funds to petition the state comptroller to withhold funds owed to entities from the state if contributions fall short of the statutory funding requirements (for more information, see "Pension Pressures For Illinois Municipalities Could Become An Imminent Budgetary Challenge Under The State's Revenue Intercept Law," published May 14, 2018). The intercept of state funding can severely hinder budgetary flexibility and leave officials with limited options aside from cutting essential services. These effects result in many pension plans being reluctant to petition the state comptroller even if pension contributions are short of the statutory minimum requirements. As a result, the intercept has been petitioned only by pension boards from Harvey, North Chicago, and East St. Louis since it went into effect.

When municipalities are unable to make the statutory minimum contributions to their pension plans, there are usually budgetary pressures and likely structural budgetary imbalances. Under our criteria, a structural imbalance caps a rating at 'BBB+'. In our rated universe, we currently apply a structural imbalance adjustment to 7.0% of our ratings on Illinois municipalities; in contrast, we apply this adjustment to only 1.2% of ratings on municipalities countrywide . Many of the structural imbalances in Illinois stem from pension funding pressures. As contributions for pensions increase, the likelihood of a larger percentage of the budget being dedicated to fixed costs increases. If fixed costs rise as a percentage of the budget and officials are unable or unwilling to adjust, the possibility of budgets becoming structurally imbalanced and pressuring the creditworthiness of issuers will increase.

House Bill 308, which was introduced in January 2021, amends the target date for downstate and suburban public safety plans to reach the 90% funded goal to 2050 from 2040. The bill was not brought to a vote during the spring legislative session, but legislators are considering extending the amortization of the unfunded pension liabilities for public safety plans. Extending the amortization period for these plans to reach the funding goal might provide budgetary relief in the near term. However, this relief will come at the expense of rising unfunded liabilities that will need to be paid with larger contributions in future years for plans that continue to use assumptions and methodologies that defer costs.

Chicago's Unique, Yet Poorly Funded, Pension Plans

Chicago has its own pension systems and the Illinois pension code has several unique carve-outs for the city. After many years of working on pension reform, the city pursued and won state legislative backing for Chicago's police and firefighter plans to achieve a 90% funded ratio by 2055, and similar legislation was passed for Chicago's laborers' and municipal employees' plans to achieve a 90% funded ratio by 2058.The contributions required for the city to meet these funding goals would have been a significant jump from the previous contribution levels, so a ramp-up period for contributions through 2022 was enacted. After 2022, Chicago must make contributions sufficient to cover the plans' net employer normal cost plus an amount sufficient to amortize the unfunded liabilities to 90% by the target dates.

In 2019, contributions for each of the four city plans were short of static funding. Over the ramp-up period, contributions will be short of actuarial recommendations. After 2022, the contributions have a high probability of continuing to defer progress on funding levels due to the lengthy 30-plus year amortization period on the unfunded liabilities, particularly given payments are deferred by the use of a level percentage of assumed payroll growth methodology. Despite the strength of Chicago's economy and its role as a regional hub, costs associated with the city's poorly funded pension plans will continue to pressure the city's creditworthiness and would be compounded if plan assumptions fail to materialize.

The state made the carve-outs to help Chicago with budgetary pressure from its pension plans, but it has also passed laws related to pensions that add costs and budgetary pressures to the city. Although Chicago has worked to prepare for the pension cost ramp-up, recent legislation has demonstrated state lawmakers can pass laws creating more benefit costs for the city, adding another layer of potential pressure. In 2021, legislators passed House Bill 2451, raising the cost of living adjustments for some firefighters in Chicago and adding to the city's unfunded liabilities. The cost is expected to be $18 million annually, which we do not consider to be a major burden on the city's $4 billion budget. However, this type of mandate demonstrates the impact state actions can have even with Chicago maintaining its own pension funds.

Teachers at Chicago public schools and teachers employed by charter schools operating in the city are covered by the Public School Teachers' Pension and Retirement Fund of Chicago, a defined-benefit system. This plan also has unique carve-outs in the Illinois pension code. It is poorly funded and the burden that this overlapping unfunded liability places on the city compounds the tax pressures on residents and businesses.

Retiree Medical Benefit Liabilities Loom And Reforms Face Significant Barriers

With the state's aging demographics and declining population trends and little being set aside for other postemployment benefits (OPEB), these costs likely will escalate for issuers in the state. OPEB is provided on a single-employer basis, with the benefits provided varying from issuer to issuer. Even for municipalities that do not make contributions for retiree health care premiums but allow retirees to remain on the city or village health care plan, costs are likely to increase and experience volatility due to current health care trends.

The state has made efforts to reduce these benefits in the past. However, court rulings have determined OPEB to be constitutionally protected, like pensions. The state has enacted minimum funding requirements for many pension plans, but it does not have funding requirements for its OPEB liabilities.

Chicago has made reforms to its OPEB that were challenged under the state constitution's pension protection clause. Before the merits of the case were discussed, a settlement was agreed upon. The terms of the settlement were adopted by the legislature and made part of the Illinois pension code. Other municipalities in the state would be unlikely to use a similar avenue for reforming their OPEB and most attempts would likely be barred under the pension protection clause. Moreover, retirees have challenged Chicago's attempts to change its OPEB plans and this is still in litigation.

According to the courts, OPEB is constitutionally protected.

This report does not constitute a rating action.