S&P Global
Ratings

Recent Pension Funding Gains For Largest U.S. Cities Expected To Be Short-Lived

September 26, 2022

Key Takeaways

- Outsized fiscal 2021 investment returns increased funded ratios for the 20 largest U.S. cities, to a median of 78.5% from a median of 71.5%, though much of these funding gains will likely be negated in fiscal 2022.

- Increasing inflation pressures in the near term could lead to less budgetary flexibility for these cities to address rising contributions.

- Available reserve levels might indicate an ability to absorb increasing current and future pension and other postemployment benefits (OPEB) costs.

- Fourteen of the 20 cities met our minimum funding progress (MFP) metric for at least one of their two largest pensions in fiscal 2021, indicating they made meaningful contributions toward achieving full funding for those plans. Fifteen cities achieved at least static funding.

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While local pension funds in the U.S. saw extraordinary investment returns in 2021, S&P Global Ratings anticipates that market declines in 2022 and the threat of a recession will likely lead to the need for increased future contributions, in most cases. Market return volatility can also expose riskier assumptions, particularly a plan's assumed rate of return, potentially leading to rising costs. Many of the largest local pension plans across the U.S. have lowered their assumed rates of return in recent years, but this decision may lag current average market return rates. We believe the cities with high fixed costs and limited budgetary flexibility will likely face the most budgetary pressure heading into 2023. For more information on the impact of 2022 market returns on U.S. public finance (USPF) issuers, see "Pension Brief: 2022's Down Markets Reverse 2021's Unprecedented Gains For U.S. Public Pension Plans," published June 8, 2022, on RatingsDirect.

The Effects Of High Recent Inflation Are Largely Negative For Local Pensions

Broad-based inflation increases during 2022 led to weakening economic conditions and lower market returns. As noted, we believe positive market returns from 2021 have been, or will be erased in 2022. While our pension guidelines are long-term and based on long-term inflation

assumptions, near-term inflation can lead to increased pension costs due to salary increases, cost-of-living adjustments (COLAs), and weakened pension funding. The assumed return and discount rates incorporate long-term inflation forecasts and are not affected by relatively brief market swings. However, plans that have either taken actions to reduce contributions or expand benefits due to strong fiscal 2021 returns are likely to experience increased stress following negative asset returns in 2022 that are well below the assumed rate. Staffing shortages and multiyear labor contract negotiations can also lead to higher personnel costs that might pressure budgets and increase pension costs for the 20 largest cities in the country. For more information on how economic volatility could affect local governments in the U.S., see "Looking Forward: How Economic Volatility Could Affect U.S. State And Local Government Ratings," published Aug. 4, 2022.

There are many ways the 20 cities in our survey could choose to deal with increasing pension costs, including utilizing available reserves, implementing cost-cutting measures in the budget, or potentially increasing revenues. However, if pension contributions are reduced to provide budget relief, pension funding could be negatively affected. One way we can assess each city's ability to incorporate increasing pension costs is to compare its budgetary flexibility to its current annual pension costs (pension actuarially determined contribution [ADC]/total governmental funds [TGF] expenditures). Overall, increasing inflation pressures in the near term will likely lead to less budgetary flexibility to address rising contributions for the 20 largest cities. We view greater budgetary flexibility (as measured by available reserves as a percentage of operating expenditures) favorably in our local government criteria. Higher reserve positions allow cities to incorporate growing costs more easily and weather periods of expenditure increases, including pension costs, or revenue declines. However, if cities utilize reserves to support pension costs, we expect it would be limited as the reduction in flexibility could also pose budgetary challenges. San Jose, Los Angeles, and Chicago each have the highest current pension costs of the surveyed cities, though they have budgetary flexibility that we view as strong-to-very strong, which could help incorporate expected increasing annual costs following declining asset returns in 2022. While greater budgetary flexibility is likely more important when assessing current or near-term pension costs, it is important to incorporate the long-term unfunded liability for a more holistic view of what could pressure each cities financial position or future financial performance.

By comparing each cities' current pension costs and net pension liabilities (each viewed as a percentage of each city's most recent TGF expenditures) on the chart below, we can assess whether each city is facing greater near-term or longer-term pension pressures. As shown below, over half of the surveyed cities have net pension liabilities that are less than their most recent TGF expenditures and half have current pension costs less than 10% of their most recent TGF expenditures. Chicago continues to be an outlier with the highest current pension costs and net pension liabilities of the surveyed cities. Three cities, Indianapolis, San Francisco, and Washington, D.C., have net pension assets, meaning more assets in the pension trust than liability. Many of the cities with the largest net pension liabilities compared with their governmental funds expenditures, such as Dallas, Jacksonville, and Fort Worth, also have relatively high current pension costs and are not meeting our MFP guideline in Chart 2, indicating slower progress towards full funding compared to other surveyed cities. Changes to pension contributions and funding discipline will remain important credit factors in assessing structural balance for each of the largest cities.

Plans that have either taken actions to reduce contributions or expand benefits due to strong fiscal 2021 returns are likely to experience increased stress following negative asset returns in 2022.

Chart 1

## Current Pension Costs vs. Long-Term Costs Represented By Unfunded Pension Liability
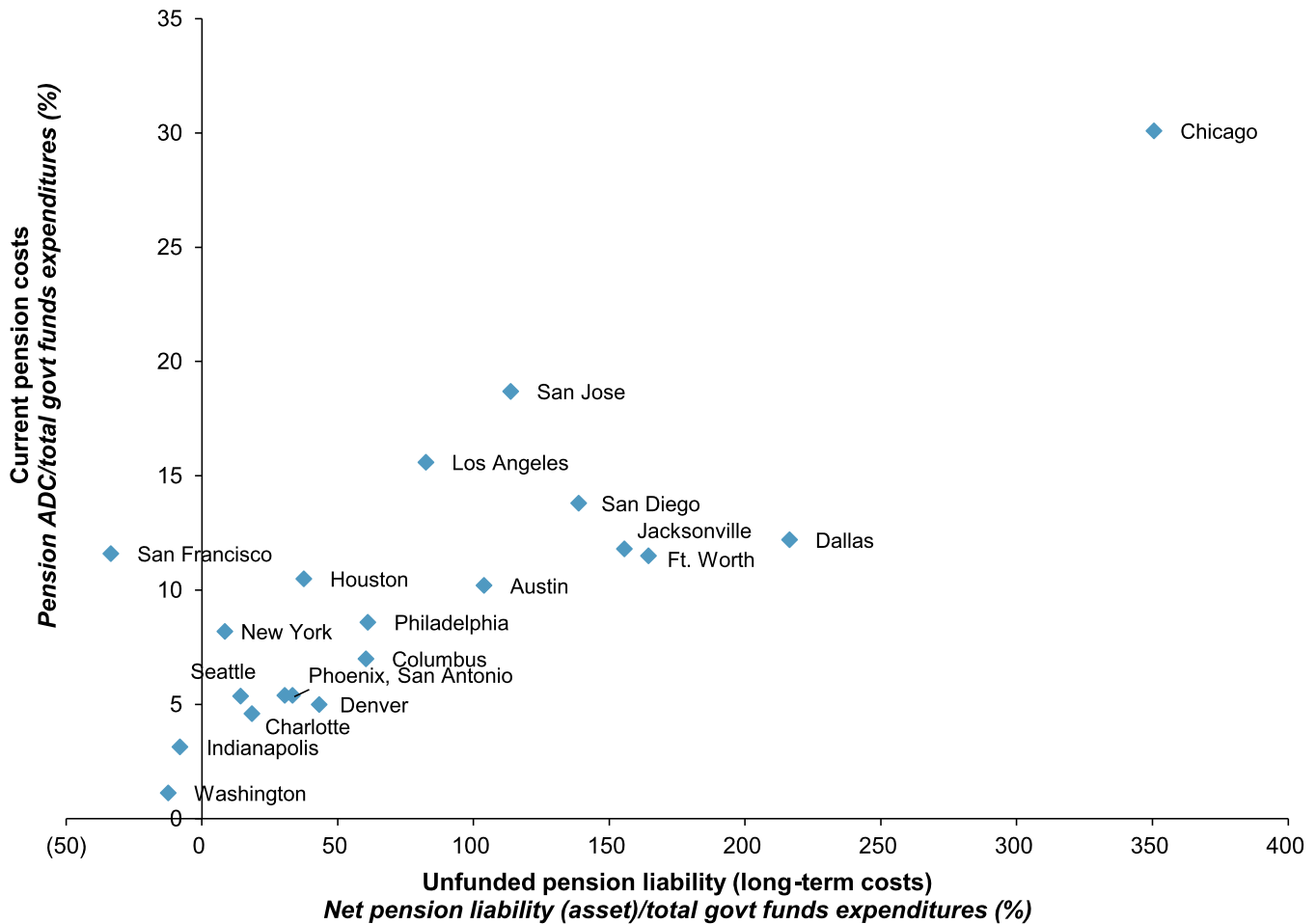
Fiscal 2021 Annual Survey Results

The funded ratios for the 35 plans in this year's survey improved, with the overall median increasing to 78.5% from 71.5%. For plans with available fiscal 2021 data, funded levels reflect the outsized investment returns in 2021. However, we expect the pension funding impact from these returns will largely reverse in our fiscal 2022 annual survey based on year-to-date market declines.

Chart 2

Top Plans' Latest Funded Ratios
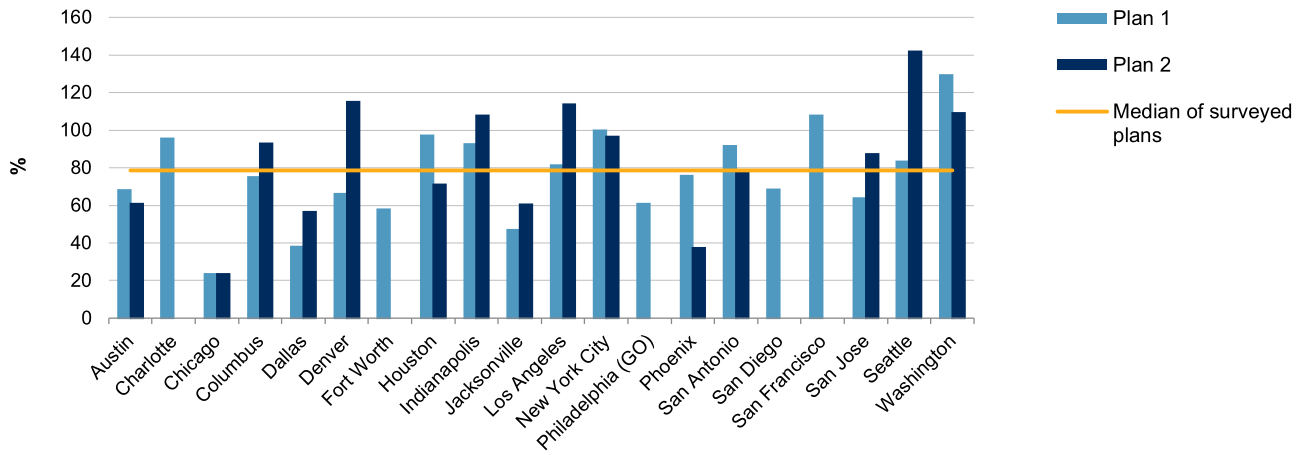
Source: S&P Global Ratings.

Funded ratio based on the most recently available data as reported in the city's audit or plan comprehensive annual financial report.

With rising inflation and increasing recessionary pressure, cities might hold back on making changes to assumptions or voluntarily increasing contributions during the next year, which could delay some cities' efforts to improve pension funding. S&P Global Ratings recently published discount rate guidance of 6.0% to represent our view of market volatility sufficiently contained for a typical pension plan. Find out more about our pension and OPEB credit analyses guidelines in our Credit FAQ: "How Do U.S. Pension/OPEB Credit Analysis Guidelines Stand Up Amid High Inflation And Lower 2022 Market Returns?," published Aug. 23, 2022.

The funded ratio is highly dependent on the assumed market return, which is typically also the discount rate used to measure liabilities in the U.S. public sector, but not in cases where funding discipline is lacking. The average rate of expected asset return in the sample is about 7.0%, ranging from 6.5% to 8.0%. The average of the discount rates is about 6.8%, ranging from 5.3% to 7.5%. The difference between the discount and expected asset return rates is the result of five of the 35 plans in the sample having contributions meaningfully below the actuarial recommendation.

As of the latest data, S&P Global Ratings views contributions to 13 of the 35 plans in this year's survey as insufficient to maintain current funded ratios, as contributions were below static funding. Given the recessionary environment and resulting revenue and expenditure pressures, we expect that funding discipline is unlikely to improve over the next few years. S&P Global Ratings measures contribution sufficiency based on a combination of an assessment of the forward-looking actuarial recommendation and our backward-looking static and MFP metrics, which look at contributions made in the most recent year. These metrics measure whether a given pension plan is maintaining current funding levels or making material progress toward full funding. MFP is our guideline that indicates a likely positive view of funding discipline. If a city falls below static funding, the funded ratio is expected to fall, leading to higher future contribution costs. The yellow line in the graph below represents our MFP guideline of 100%. Each city's MFP metric is listed below for their top one or two plans.

Funding Progress Compared With MFP Guideline (Top Plans)
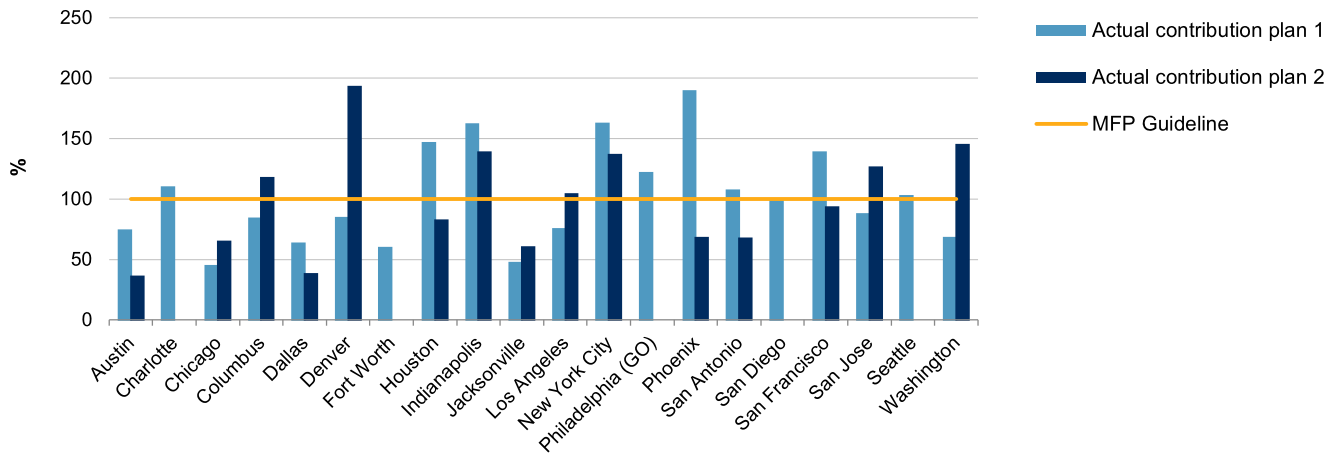
Source: S&P Global Ratings.

MFP: Minimum funding progress. Ratios reflect the two largest plans for each city in the most recent year.

What To Watch In The Coming Year

With pension contributions increasing materially over the past decade for the surveyed cities, management of pension liabilities will be important for ongoing fiscal health, particularly in the current economic environment. Increasing pension contribution costs will compete with growing expenditures and potentially tighter operating margins if revenues weaken or decline. In addition, the need to address actuarial assumptions will also place pressure on pension contribution costs. Many of the cities in our survey have made, or were in the process of making, changes to improve pension funding heading into the pandemic and current economic uncertainty. How these largest cities will balance potential budgetary pressures with ongoing pension reforms will remain S&P Global Ratings' focus in the coming year.

Recent reforms for the 20 largest cities include Austin, Texas, making changes to its police pension plan via the state legislature, including adding a new benefit tier and increasing both employer and employee contributions as per an actuarially determined funding model. Philadelphia has gradually lowered its discount rate in recent years. Most recently, the Philadelphia Board of Pensions and Retirement voted to lower the rate to 7.45%, effective July 1, 2022, and further to 7.40% beginning on July 1, 2023. Phoenix has adopted a formalized pension funding policy to address its large unfunded liabilities. In March 2022, Seattle lowered the discount rate for its employee retirement system to 6.75% from 7.50%. Other cities, including Denver, have also lowered their plan discount rates in recent years, but most still use rates that are well above our 6.0% guideline, which could lead to future contribution volatility.

We continue to see municipalities issue pension obligation bonds (POBs) to address growing pension liabilities and rising contributions costs, though this trend has slowed in 2022. POBs are particularly attractive in a relatively low interest rate environment, though we continue to watch

for issuance in the current high-rate environment. Although none of the 20 largest cities surveyed has issued POBs in recent years, officials in some cities might see POBs as an opportunity to control or adjust fixed-cost payment schedules. For more information on our latest view of POBs, see "Pension Obligation Bond Issuances Continue To Increase In 2021," published Oct. 14, 2021.

Focused Review: Selected Cities With Stories To Tell From 2021

Austin

Large pension obligations and associated fixed costs pose a challenge to Austin's overall credit quality. An independent board of trustees administers each of the city's three defined-benefit pension plans, and state law governs benefit and contribution provisions, though the Texas Legislature can make amendments. For all three systems, enabling legislation determines minimum contributions. While contribution requirements are not actuarially determined, state law requires that a qualified actuary approve each plan's adopted benefits.

During the 2021 state legislative session, Austin made changes to its police pension plan. Most notably, changes defined in House Bill 4368 reduced the plan funding period to 30 years from infinite. It also added a new benefit tier, shifted to an actuarially determined funding model, added legacy-liability payments, increased member and employer contributions, and changed the governance structure. The police plan's net pension liability decreased materially for 2021 as a result of reforms allowing for the use of the fund's assumed rate of return of 7.25%, compared with a blended 4.10% in 2019. City officials are also working on similar reforms for the employees' plan during the state's legislative session in 2023. If the proposed changes pass, they will go into effect in January 2024.

Los Angeles

We have noted in recent reports that Los Angeles' large pension and OPEB obligations pose a significant near-term budgetary pressure. The city's combined required pension and actual OPEB contributions totaled 19.9% of total governmental fund expenditures in fiscal 2021. The city has made changes to its assumed discount rates in recent years, most recently when the discount rate was lowered to 7.00% from 7.25% for the Los Angeles Fire and Police Pension Plan (LAFPP) and Los Angeles City Employees' Retirement System (LACERS) plans, effective for fiscal 2022, though this rate remains well above our guidance of 6.0%. The change in assumed discount rates will lead to progress toward funding Los Angeles' pension liabilities, but will increase medium-term pension costs. The city's rapid amortization assumptions, including a closed amortization period, compare favorably with most other large cities in our survey.

Los Angeles has been funding its OPEB annual required contribution for at least the past 20 years. Its LACERS OPEB and LAFPP OPEB plans are 94.6% and 64.7% funded, respectively. We note that though the city has made changes that could lower pension and OPEB costs in the long term--including creating new tiers for new civilian and sworn hires, and requiring employees to contribute more to retiree health care or have their benefits frozen--the city still projects its contributions toward these fixed costs will rise in the near term due to amortization of investment losses.

San Jose

San Jose reported strong pension fund returns for fiscal 2021, but faces a high current pension cost and its long-term pension costs are higher than the average of the 20 cities in our survey. The city's combined required pension and actual OPEB contributions totaled 23.2% of total governmental fund expenditures in fiscal 2021. Other than Chicago, San Jose's required contribution was a greater portion of its expenditures than any other city on our list. Conversely, the city has one of the largest available reserve positions of the cities in our survey, at 30% of fiscal 2021 expenditures. We understand San Jose is considering issuing POBs to improve the funding levels in its pension plans. The city's two largest plans are funded at 64% and 87%, respectively. We note in recent credit reports that San Jose's pension and OPEB liabilities pose a challenge for the city, but that strong asset performance in fiscal 2021 (over 26% for both plans in 2021) has provided near-term budgetary relief. The city's five-year financial forecast incorporates declining projected pension costs, following strong asset returns in 2021, because the effects of the strong fund performance are smoothed in over five years. We note in our latest report that if future pension fund performance gives up the gains from fiscal 2021, then pension contributions might not decline as assumed in the forecast, reopening budgetary gaps.

Appendix 1

Appendix 1

Key Metrics And Pension Plan List

City	Per capita net pension and OPEB liability ($)	Weighted funded ratio % (largest two plans)	Most recent year fixed costs % expenditures	Plan 1	Plan 2
Austin	6,665	66.3	23.0	City of Austin Employees' Retirement System	Austin Police Officers' Retirement & Pension Fund
Charlotte	477	95.5	21.1	Local Governmental Employees' Retirement System	N/A
Chicago	13,238	23.5	43.4	Municipal Employees' Annuity and Benefit Fund	Policemen's Annuity and Benefit Fund
Columbus	1,348	89.9	19.5	Ohio Police & Fire Pension Fund	Ohio Public Employees' Retirement System
Dallas	4,576	49.9	30.6	Dallas Police and Fire Pension System (Combined Plan)	Employees' Retirement Fund (ERF)
Denver	1,637	88.6	13.4	Denver Employee Retirement Plan	Fire and Police Pension Association
Fort Worth	3,648	58.0	25.3	Employee's Retirement Fund of the City of Fort Worth	N/A
Houston	1,701	86.1	25	Houston Police Officers' Pension System	Houston Municipal Employees Pension System

Appendix 1

Key Metrics And Pension Plan List (cont.)

City	Per capita net pension and OPEB liability ($)	Weighted funded ratio % (largest two plans)	Most recent year fixed costs % expenditures	Plan 1	Plan 2
Indianapolis	154	97.1	20.4	Indiana Public Employees' Retirement Fund	Indiana 1977 Police Officers' and Firefighters' Retirement Fund
Jacksonville	3,211	53.1	20.8	Police and Fire Pension Plan	General Employees' Retirement Plan
Los Angeles	3,452	92.9	25.9	Los Angeles City Employees' Retirement System	Los Angeles Fire and Police Pension Plan
New York	15,340	98.5	23.3	New York City Teachers Retirement System	New York City Police Pension Fund
Philadelphia	4,324	60.8	14.1	Philadelphia Municipal Pension Fund	N/A
Phoenix	751	75.7	11.9	City of Phoenix Employees' Retirement System	Public Safety Personnel Retirement System
San Antonio	1,184	86.9	18.9	Fire and Police Pension Fund	Texas Municipal Retirement System
San Diego	2,826	69.0	23.4	San Diego City Employees' Retirement System	N/A
San Francisco	1,344	107.8	22.2	San Francisco City and County Employees Retirement System	N/A
San Jose	3,030	76.5	28.1	Federated City Employees Retirement System	Police and Fire Department Retirement Plan
Seattle	1,444	126.5	10.5	Seattle City Employees' Retirement System	Law Enforcement Officers' and Fire Fighters' Retirement System
Washington, D.C.	(3,305)	123.2	10.9	Police Officers and Firefighters Retirement Fund	Teachers Retirement Fund

N/A: Not applicable.

Appendix 2

Issuer List

City	GO Rating	Rating Date	Primary Analyst	Email
Austin	AAA/Stable	8/25/2022	Stephen Doyle	stephen.doyle@spglobal.com
Charlotte	AAA/Stable	10/25/2021	Nora Wittstruck	nora.wittstruck@spglobal.com

Issuer List (cont.)

City	GO Rating	Rating Date	Primary Analyst	Email
Chicago	BBB+/Stable	11/3/2021	Jane Ridley	jane.ridley@spglobal.com
Columbus	AAA/Stable	4/18/2022	Randy Layman	randy.layman@spglobal.com
Dallas	AA-/Stable	11/15/2021	Andy Hobbs	andy.hobbs@spglobal.com
Denver	AAA/Stable	4/7/2022	Jane Ridley	jane.ridley@spglobal.com
Fort Worth	AA/Stable	5/26/2021	Kristin Button	kristin.button@spglobal.com
Houston	AA/Stable	8/9/2019	Andy Hobbs	andy.hobbs@spglobal.com
Indianapolis	AA+/Positive	2/1/2022	Anna Uboytseva	anna.uboytseva@spglobal.com
Jacksonville	AA/Stable	8/19/2022	Krystal Tena	krystal.tena@spglobal.com
Los Angeles	AA/Stable	8/31/2022	Tim Tung	tim.tung@spglobal.com
New York	AA/Stable	8/12/2022	Nora Wittstruck	nora.wittstruck@spglobal.com
Philadelphia	A/Stable	9/29/2021	Cora Bruemmer	core.bruemmer@spglobal.com
Phoenix	AA+/Stable	4/15/2022	Alyssa Farrell	alyssa.farrell@spglobal.com
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