Local Government Pension Analysis
Special Report

Fitch Ratings continues to review and refine its approach to analyzing the impact of pension liabilities on local government ratings. As one element in our analysis of a government's overall credit profile, our goal is to identify cases where pension-related risks are outsized.

**Continued Budgetary Pressure:** Fitch expects pensions to pose a continued and in some cases rising source of budgetary pressure for local governments, although the vast majority of governments will be able to absorb the impact of higher contributions. The situations that pose the greatest concern remain those in which the plan's funded ratio is exceptionally low and contribution levels are already high relative to the budget and rising.

**Pension-Related Risks Vary:** The level of risk posed by pension liabilities varies enormously among the more than 1,000 local governments Fitch rates. Because of the wide variation among the financial situations of local governments and the ways their pension benefits are managed, Fitch evaluates each government's pension situation individually.

**Impending GASB changes:** New GASB standards will take effect beginning in fiscal 2014 (for pension plans) and fiscal 2015 (for employers). Fitch believes the new standards are a step in the right direction toward better transparency and comparability of government pension liabilities. We expect the information not only to give analysts and other users a more consistent and robust view of pension liabilities, but also provide additional information to governmental employers to make decisions about funding and benefit levels going forward.

**Part of Overall Analysis:** A local government's pension situation is included as an element in our analysis of its debt burden, financial operations, and, when plans are locally-administered, management.

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**Related Research**

- Improving Comparability of State Liabilities (March 2012)
- The Reporting of U.S. State and Local Government Pension Obligations (February 2011)
- Enhancing the Analysis of U.S. State and Local Government Pension Obligations (February 2011)
- Fitch Downgrades Chicago, IL's GO Bonds to 'AA-': Outlook Revised to Stable (October 2010)
- Fitch Rates City of Chicago, IL's GO Bonds & Tender Notes 'AA'; Downgrades Outstanding GOs (August 2010)
- Fitch Downgrades Chicago Board of Ed (IL) ULTGOs to 'A' from 'A+': Outlook Negative (October 2012)
- Fitch Rates Chicago Board of Ed (IL) ULTGOs Series C,D,E,F & G 'A+'; Downgrades Outstanding GOs (October 2010)
- Fitch Rates Providence RI's GO Bonds 'BBB'; Outlook Negative (February 2013)

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Pension-Related Risks Vary

Pension contributions remain a source of budgetary pressure for local governments that provide defined benefits to retirees, whether by their own system or through a statewide plan. There is wide variation among the financial situations of local governments and the ways their pension benefits are managed. Fitch expects pensions to pose a continued and in some cases rising source of budgetary pressure for local governments in general, although the vast majority of governments will be able to absorb the impact of higher contributions. The situations that pose the greatest concern remain those in which the plan’s funded ratio is exceptionally low and contribution levels are already high relative to the budget and rising.

Fitch evaluates each government’s pension situation individually, taking into account recent historical trends and forecast data (currently only infrequently available) to understand the current and future burden that contributions may pose. Wide-ranging reforms have been undertaken since the downturn, and Fitch reviews the impact the reforms may have on the ability of the local government to sustain its pension commitments. However, in most cases, pension reforms have only affected new hires, in which case the budget benefits accrue only gradually. Where reforms have included current employees or retirees, such as reductions of COLAs or increased contributions, more substantial and immediate reductions in current funding requirements and unfunded liabilities have resulted. However, in some situations these changes are being litigated. The outcome of such litigation may have significant ramifications for reforms going forward.

Impending GASB Changes

New GASB standards will take effect beginning in fiscal 2014 (for pension plans) and fiscal 2015 (for employers). Fitch believes the new standards are a step in the right direction toward better transparency and comparability of government pension liabilities. The new standards will also require forward-looking information, now available infrequently, on a consistent basis. We expect the information not only to give analysts a more consistent and meaningful view of pension liabilities and future funding levels, but also to enhance governmental employers’ ability to make decisions about funding and benefit levels going forward.

Many local governments participate in cost-sharing multiemployer (CSME) plans that are controlled and administered by the state or another unit of government rather than the local entity. Under current GASB standards, information for individual CSME plan participants is limited. Other local governments sponsor their own plans and thus report a full array of financial and actuarial data. Fitch relies on all available data, including CSME plans’ system-

Related Criteria

Tax-Supported Rating Criteria (August 2012)
U.S. Local Government Tax-Supported Rating Criteria (August 2012)
wide data, in its evaluation of the pension burden on local governments. The new GASB standards will enhance pension data, regardless of whether the local government is a CSME plan participant or sponsors its own plans.

Fitch believes the new GASB standards will result in the reporting of moderately weaker funded ratios and more limited ability to spread the cost of addressing the liability over time. This in turn should increase public pressure on decision-makers to reform pensions in order to improve plans’ affordability, which we view positively.

**Pensions in Relation to Overall Credit Factors**

A local government’s pension situation is included as an element in our analysis of its debt burden, financial operations and, for locally-controlled plans, management.

**Debt Burden**

Unfunded pension liabilities, like outstanding bonded debt, represent a future claim on government resources, and thus Fitch incorporates a local government’s pension burden when assigning credit ratings. Fitch recognizes that a government’s unfunded pension liability, unlike most bonded debt, is subject to a degree of adjustment through future actuarial assumption changes, benefit revisions, and contribution policy choices. Moreover, the lack of consistently available data across plans to which local governments belong — from a CSME plan with no specific breakout of liability data by participating government, to an agent multiemployer (AME) or single employer (SE) plan with a full array of available data — poses an analytical challenge for evaluating local governments.

Fitch reviews the plans to which a local government contributes, regardless of plan type, focusing on the funded ratio (adjusted to a 7% return/discount rate assumption) and contribution trends over time and whether plan assumptions — such as the investment return assumption — appear reasonable.

Fitch expects that GASB’s enhanced pension reporting standards will result in considerably more data to evaluate local governments’ pension burden in the context of other long-term liabilities. This is particularly true for local governments whose primary pension obligation is to a CSME plan. In addition to the contribution data that is currently available, the share of a CSME plan’s liability corresponding to each local government’s obligation will be available for the first time.

Fitch does not expect these enhancements to result in a significant level of rating changes, as we believe the overall CSME plan information already provides sufficient basis for analytical judgment and evaluation of pension risks to participating governments. Fitch believes the figures to be required under the new GASB standards will be far more reliable and consistent for local governments than an estimate based on current, limited information.
Financial Operations

Fitch’s analysis of the impact of pension obligations on financial operations looks at the history of actual contributions, whether the payments are actuarially or statutorily based (for CSME plans, we look at what the plan requires of its participants), any projections provided by the entity, and the implications of the funded ratio on potential future contributions. We consider management’s ongoing efforts to incorporate increasing pension payments into a balanced budget. While for local governments we do not aggregate debt and pension liabilities in our burden ratio, we do look at total carrying costs as a percent of governmental spending.

For each rated entity, Fitch calculates the sum of debt service, the actuarially required contribution for pensions (or the payment made to the CSME plan), and the actual payment for other post-employment benefits (realizing this is a more flexible obligation than pensions) and divides it by governmental fund spending net of capital projects funds. This calculation yields a wide range of results and can be done across all entities, regardless of types of plans in which the government participates. Some governments, for example school districts in states in which the state itself assumes the pension liability, may have carrying costs of 5% or even less of spending; others are as high as 30%.

High and rising carrying costs of liabilities are worrisome because they limit flexibility to address other spending priorities. In cases in which the plan’s funded ratio is falling, budgeting in the near term will likely become more challenging even if the full contribution is being made. More concerning still are those cases in which pension contributions are already below an actuarially determined level, either because the contribution is statutorily or contractually fixed (and the sponsoring government has delayed taking corrective action), or because the participating government itself has chosen not to fully fund its annual required contribution.

Management

The ability to manage pension costs, as well as all other cost pressures, is a factor in our analysis of management. We believe management of pension benefits and funding frameworks is particularly meaningful in our analysis when the government has some level of authority over both sides of the equation — determining benefits and paying for them, as is typically the case in SE and AME plans. Fitch recognizes that state constitutions and statutes in some cases preclude meaningful flexibility in altering benefits, but we continue to see a surprising number of plan changes even within those constraints. The level of rigor with which management attempts to increase plan affordability has varied greatly, and where this level is high, liabilities have often changed accordingly. Other governments have chosen to postpone difficult decisions.

Fitch’s ratings have reflected the degree to which local governments have an ability and willingness to pursue possible changes in order to make their pension burdens more sustainable. In cases where pension reforms are being legally challenged, we recognize management’s efforts to make the reforms but view implementation as a risk. Most participants in CSME plans have no meaningful ability to implement pension reform and are subject to policy choices made by the sponsoring state government. Participants in AME and SE plans may have much broader ability to pursue and implement reforms. The collective bargaining context of each government is also a factor in the ability to make meaningful changes.

Not all pension reforms are beneficial to all participants, and some may result in near-term increases in contributions. As an example of the latter, lowering the investment return assumption results in a higher unfunded ratio and higher contributions to amortize a liability, all else being equal. Fitch views such reforms in a positive light despite the immediate near-term
impact on metrics because they represent a more realistic approach to addressing a long-term problem. Other reforms to statewide CSME systems may result in a shifting of responsibility for unfunded pension liabilities to the local level from the state, posing additional stress on the local government to rapidly absorb a higher contribution level.

Examples

The examples below demonstrate the various approaches Fitch has taken to analyze pension funding issues. For more information on the rated entities, see the links in Related Research on page 1.

City of Chicago and Chicago Board of Education, IL

Over the past two years Fitch has twice downgraded ratings on both the city of Chicago (to ‘AA–’ from ‘AA+’) and the Chicago Board of Education (to ‘A’/Negative from ‘AA–’) in part due to weakness in pension funding and lack of action to address it. Both have large unfunded liabilities and are significantly underfunding the ARC. Although other factors contributed to the downgrades, we cited pensions as a large and growing concern.

City of Providence, RI

Despite efforts the city of Providence has made to reduce future liabilities, its ‘BBB’ rating is on Rating Outlook Negative. The city council approved the Pension Protection Act a year ago, eliminating and partially freezing certain cost-of-living adjustments. However, the agreement requires approval by the state Superior Court.

The divergent approaches to pension obligations by the states of Illinois and Rhode Island provide some context to our level of concern for the local credits mentioned above; while Illinois has thus far not made adjustments to its own plans, Rhode Island has been aggressive in improving the affordability of theirs.

Looking Forward

Pension obligations can result in large and growing expenses for local governments, particularly when insufficiently addressed in the past. Fitch will continue to refine and enhance its analysis of the impact of pension obligations on local government credit quality. GASB changes will aid that process by increasing the comparability of disclosure and providing valuable forward-looking information.
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