Chicago's Massive Pension Problem Triggers Downgrade – But Chicago is Not Detroit

On March 4, Moody's downgraded the city of Chicago again, lowering the general obligation (G.O.) rating of the city to Baa1 from A3, and maintained its negative outlook on the city. Moody's downgrade was prompted by "the city's massive and growing unfunded pension liabilities, which threaten the city's fiscal solvency absent major revenue and other budgetary adjustments adopted in the near term and sustained for years to come." Chicago's G.O. bonds are now rated Baa1/A+/A-, having been downgraded multiple notches by all three rating agencies over the past 18 months.

The key drivers of Chicago's weakening credit ratings are:

- Unfunded pension liabilities that total more than $20 billion (more than eight times the city's annual general operating revenues) that leave Chicago's pensions funded at an aggregate level of approximately 35%.
- Annual pension funding shortfalls (the difference between what is actually paid and what should be paid to eventually fully fund pensions) that have now grown to over $1 billion.
- Changes in state statutes that will result in an increase of $600 million in the city's annual pension funding requirement for fiscal year 2015.
- City management's reluctance to take material steps to create a more balanced long-term structural budget, despite Chicago's broad powers to adjust taxes and fees to generate additional revenues.

While Chicago's pension situation is difficult, the challenges facing the city are only part of the story. Chicago is the third largest city in the United States and has one of the largest and most diverse economic bases in the nation. By dollar value, Chicago also has the third largest tax base among U.S. cities, behind only New York and Los Angeles. Chicago is the headquarters location for numerous Fortune 500 companies and also has a strong tourism economy. From a standpoint of economic resources, Chicago appears to have the foundation in place to maintain high credit quality over the long term. *In our view, the ultimate path of*

Chicago's credit will develop in the coming years and will be largely a function of the political will of the city and state to take action to establish a sound, long-term financial footing for the city. In the near-term, we believe Chicago has ample financial resources to ensure that G.O. bondholders get repaid as scheduled.

Reacting to media discussion of Chicago as "the next Detroit," S&P published a thoughtful analysis in late February of the differences between the two cities. In its summary, the agency noted that it "believed that Chicago's growing economy and taxing flexibility provide it with the resources to avoid a fate similar to Detroit." While Chicago is somewhat limited in its ability to act on pensions due to the overriding authority of state statute, the city does have the tools and resources to stabilize its financial position. In the case of Detroit, economic decline had gutted the city's tax base and left it with few resources with which to address its growing budget problems. The table below shows a synopsis of S&P's comparative analysis of the two cities.

Chicago and Detroit - U.S. Local Governments: Key Rating Factors

Factor	Chicago	Detroit
Economy	Strong	Very Weak
Management	Strong	Very Weak
Budgetary Flexibility	Adequate	Very Weak
Budgetary Performance	Very Weak	Very Weak
Liquidity	Very Strong	Very Weak
Debt and Contingent Liabilities	Very Weak	Very Weak
Institutional Framework	Weak	Strong

Sources: *"Will Chicago Suffer Detroit's Fate?"* S&P, Feb. 27, 2014.

Underlying S&P's factor ratings for the two cities are the following specific characteristics:

1. **Economy** – Detroit is the poster child for urban blight, population loss and an inability of a city to maintain services to its residents due to financial and management constraints. Two of the city's three marquis corporate citizens (GM and Chrysler) were taken into federal receivership during the financial crisis. In contrast, Chicago has an expanding economy that shows solid measures of per capita and household income, as well as strong per capita tax base values. Chicago is a national and regional economic center and the location of more than 400 major corporate headquarters.

2. **Management** –Detroit has a long history of frequent management turnover, political gridlock and financial mismanagement. Chicago, by comparison, benefited from the stability of the Daly administration and continues to demonstrate strong management under the Emanuel administration.

3. **Budgetary Flexibility** – For more than a decade, Detroit carried fund deficits that were the result of declining revenues. The city covered its deficits with state emergency aid and borrowing. Prior to filing for Chapter 9 protection, Detroit simply ran out of funds to maintain payments due to pensioners, creditors and employees. Chicago still maintains some ability to manage its budget since it maintains healthy general reserves. However, the city is constrained by its expenditures on public safety, which are being pressured by rising debt repayment and pension funding costs.
4. **Budgetary Performance** – Detroit has historically had poor budget performance and net deficits. Chicago faces the challenge of balancing revenues that have not returned to pre-recession levels against budget demands that continue to grow rapidly. Chicago balanced its budget in recent years through the use of one-time measures including underfunding pension payments and transfers among funds. Even so, Chicago posted a substantial net deficit (funded from reserves) in FY2012 and is expected to post another shortfall when FY2013 financial reports are released.
5. **Liquidity** – Detroit has run budget deficits for many years, leaving the city with large accumulated deficits and the need to rely on cash flow borrowing to meet payment obligations. Although they have declined in recent years, Chicago still maintained a healthy general reserve of approximately 13% of annual governmental fund expenditures at the end of fiscal year 2012 (FYE2012).
6. **Debt and Contingent Liabilities** – Prior to its filing, Detroit's carrying charges for fixed costs (debt and pensions) were 14% of governmental expenditures with long-term obligations totaling approximately $18.5 billion compared to governmental revenues of $1.5 billion. Chicago's fixed cost charges in FY2012 amounted to approximately 12% of the city's total governmental expenditures. Total long-term obligations at FYE2012 totaled approximately $32 billion as compared to total governmental revenues of $5.8 billion.
7. **Institutional Framework** – Detroit's assessment reflects the strong oversight exercised by the State of Michigan. Chicago, by comparison, lacks a rigorous state oversight and reporting regime. Chicago also suffers from the fact that pension policy for the city is set at the state level.

Chicago's pension problem mirrors, to some degree, the problems faced by the State of Illinois, and the city's current rating difficulties are due in some part to the state. Much of the anticipated pressure on the city's budget from rising pension funding costs in the next three fiscal years could be alleviated by thoughtful legislation at the state level. We are encouraged by the fact that Illinois finally passed state-level pension funding legislation, and we expect that the state will act on the city's situation before it becomes a budget crisis. Longer term, however, the city and state will have to work together to craft an approach that allows the city some freedom to re-establish a structurally sound budget without simply pushing pension funding off to future years.

Brian Tournier
Director of Research
Ascent Investment Partners