Municipal Pension Funding Increased in Recent Years, but Challenges Remain

Forward-looking metrics can help cities navigate economic uncertainty

Overview

The Pew Charitable Trusts has examined funding data for 100 pension plans in 33 cities from 2015 to 2017. The analysis found a $145 billion shortfall in 2017 between assets on hand and the liabilities for promised benefits, representing an aggregate funded ratio of 68%, only slightly below the overall state pension plan funded ratio of 69%. This is a $1 billion improvement from 2015, due in part to strong investment returns.

However, fiscal health varies widely across jurisdictions, and a quarter of the cities in the study continue to report significant funding challenges. Pew found that Chicago; Charleston, West Virginia; Pittsburgh; Providence, Rhode Island; Portland, Oregon; Philadelphia; Phoenix; and New Orleans were less than 50% funded, putting them at significant risk of fiscal distress heading into a recession fueled by the COVID-19 pandemic. Additionally, Charlotte, North Carolina, reported a funding decline of more than 10 percentage points, from 98% to 87%. Only 10 cities in the study - Charlotte, North Carolina; Indianapolis; Los Angeles; Memphis, Tennessee; Milwaukee; Minneapolis; Nashville, Tennessee; San Francisco; Seattle; and St. Louis - had funded levels above 80%.

Forward-looking metrics

Although the funded ratio provides a point-in-time assessment of financial position, Pew also analyzed the cities through the lens of two forward-looking metrics.

Net amortization

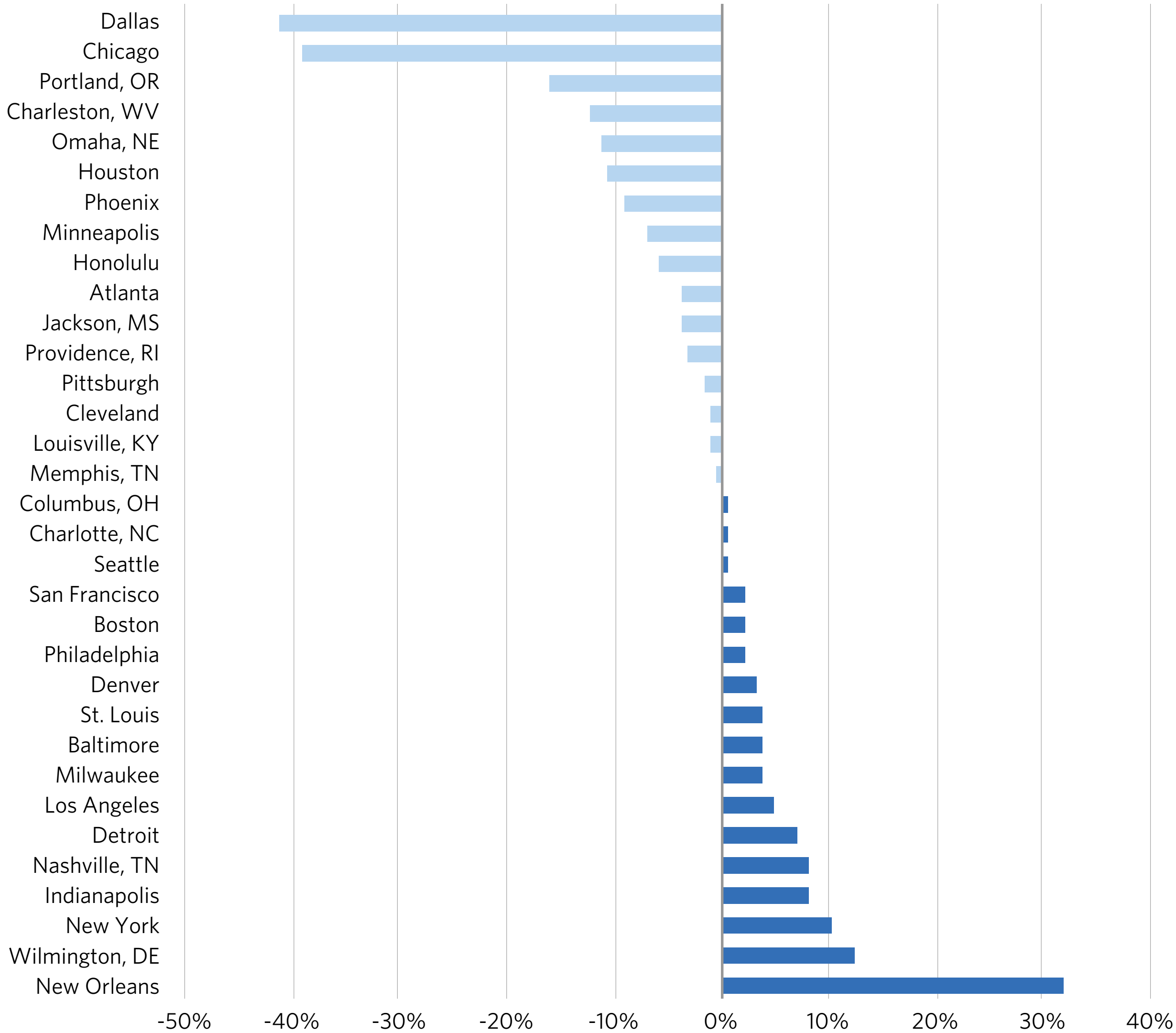
The first metric is net amortization, which measures whether total contributions to a public retirement system are sufficient to reduce unfunded liabilities if all actuarial assumptions—primarily investment expectations—are met for that year. Plans with positive net amortization are expected to retire pension debt over time and therefore improve their funded status.

Pew reviewed the three-year average for net amortization. This figure provides a more complete picture of contribution adequacy given the impact of volatile investment performance and demographic experience on plan assets. In total, the 33 cities in Pew's analysis achieved positive amortization (104% of the benchmark) from 2015 to 2017. However, individually, more than half of the cities had negative amortization. Notably, Chicago and Dallas contributed less than 50% of the benchmark. In contrast, New Orleans contributed 174%, or $132 million, which was well over the city's benchmark over the time period. For cities that are poorly funded, net amortization can indicate that they are on a path toward sustainably funding their pension plans. For example, New Orleans and Philadelphia have both increased their contributions significantly in recent years to achieve positive net amortization and decrease unfunded liabilities. On the other hand, better funded cities that fell short of the benchmark may face growing pension debt absent a policy change or adjustment.

Figure 1

Net Amortization as a Share of Payroll: Three-Year Average, 2015-17

16 cities had negative amortization



Sources: City and plan comprehensive annual financial reports, actuarial valuations, and documents and responses by city or plan officials

Operating cash flow

The second forward-looking metric is operating cash flow, which measures the difference between expenses—primarily benefit payments to retirees—and employer and employee contributions, divided by the value of assets. This measure, which is typically negative for a mature pension plan, is used to assess a pension fund's dependence on investment earnings to maintain asset levels by identifying the rate of return required to ensure that asset balances do not decline. In particular, cash flow ratios below minus 5% serve as an early warning sign that plans may be at risk of asset depletion if long-term investment returns don't meet expectations. Pew's analysis found a 1 in 4 chance that long-term pension fund returns will be 5% or lower.

Nine cities fell below the minus 5% operating cash flow threshold in 2017. Although this finding does not necessarily signal a cause for alarm, it could indicate a need for corrective action. For example, Chicago, Detroit, and Providence all reported negative operating cash flows below the minus 5% threshold, as well as sizable funding gaps. This finding suggests that these cities need to increase contributions to avoid the possibility of asset depletion and, potentially, insolvency. As shown in Figure 2, viewing the cities' operating cash flow over a three-year period provides further insight. Nearly all of the cities—with the exception of Wilmington, Delaware; Boston; and Indianapolis—had negative operating cash flow. Pew found that the average operating cash flow ratio was minus 2.3%, with wide variation among the cities when reviewed on an individual basis. Over the three-year period, five cities were below the minus 5% threshold. Chicago stands out with an average operating cash flow of almost minus 9%.

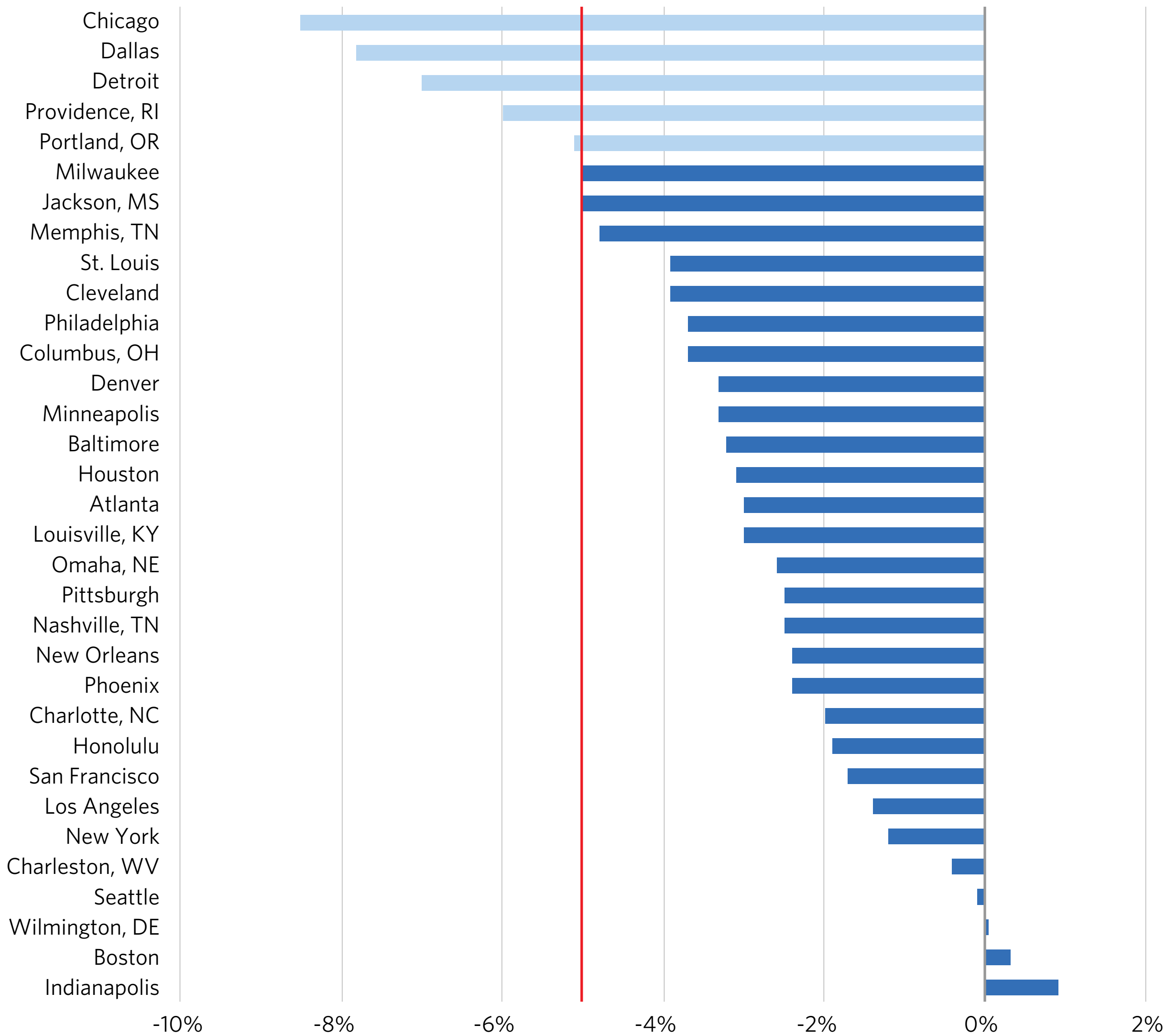
Conclusion

Municipal governments are navigating unprecedented economic circumstances and levels of uncertainty. Although the latest comprehensive data precedes the current challenges from COVID-19, how cities have managed their long-term liabilities in the past will affect how they can respond now. Large revenue declines and related budget challenges may accelerate existing funding issues or erase gains made in prior years. Under these conditions, it is increasingly important that policymakers have the tools to understand the health of their pension systems and make informed decisions to adequately fund the promises made to their workers. Forward-looking metrics such as net amortization and the operating cash flow ratio can help policymakers and the public assess the financial health of their public pension plans and, when necessary, consider corrective action to avoid fiscal distress.

Figure 2

Operating Cash Flow to Assets: Three-Year Average, 2015-17

Five cities had cash flow below minus 5%



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For further information, please visit:
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