Bond Case Briefs

Municipal Finance Law Since 1971

S&P: Chicago's Ratings Unaffected By City Council's Budget Approval.

CHICAGO (Standard & Poor's) Oct. 28, 2015 — Chicago's City Council today approved Mayor Rahm Emanuel's 2016 budget, ahead of its Dec. 31 due date, with minimal changes. Standard & Poor's Ratings Services' ratings are unaffected by the approval of this budget.

Despite Chicago's efforts to address its longer-term structural issues (starting with the approval of the 2016 budget), we still consider the city's financial problems substantial, particularly because we anticipate that the city's required pension contributions will continue to increase and place pressure on the city's budget–one of the primary drivers of our rating. In our view, the extent of the city's structural imbalance, when factoring in required pension contributions, will take multiple years to rectify.

Most notably, and as an important first step to address Chicago's longer-term pension costs, the city council approved the mayor's proposed property tax increase, which will be used to make over $300 million of additional payments on city's pension obligations. The budgeted pension contributions are based on the assumption that the state will approve a level of pension relief on the city's police and fire pension obligations. However, if the state ultimately rejects the revised payment plan, and if that decision occurs before the mayor's proposed tax rate is finalized, the city would have the option to further increase its property taxes by roughly $200 million in order to satisfy the higher pension contributions currently mandated under state law in 2016; although it is questionable whether the city would propose that option or approve it before the Dec. 31, 2015 budgetary deadline and the Dec. 29, 2015 tax levy deadline.

If the city does not or is not able to accommodate the currently mandated police and fire pension contributions in its budget, its intergovernmental revenues will be intercepted to cover the pension contributions. At this time, the likelihood of this scenario is uncertain, but the risk is partly reflected in our negative outlook, which takes into account the possibility of budgetary pressures from pension costs.

The 2016 budget adopted by the city council closes the roughly $233 million corporate fund budget gap and implements increased property taxes to bear the bulk of the city's rising pension obligations to its police and fire funds. The 2016 budget allocates $978 million in total pension contributions across all of its pension funds, a 78% increase from its $550 million total pension contributions in 2015.

The budgeted 2016 contributions meet current state requirements for the municipal and laborers plans, but they are below what current state statutes require on the police and fire plans and below actuarially determined amounts for all four of the plans. The city is assuming the state will approve SB777, which calls for a five-year step up to the amounts currently required under state law for the police and fire pension funds. Current state law calls for a roughly $550 million increase in the city's annual contributions to its police and fire plans starting in 2016; under SB777, the amount is $328 million. Under the adopted 2016 budget, the majority of the assumed $328 million police and fire contributions will be covered by $318 million of additional property taxes. The 2016 contributions to all four plans are well below the actuarially determined amount of $1.7 billion, according to the actuarial valuation dated Dec. 31, 2014.

While the actions taken in this budget to raise property taxes are intended to address the cost pressures in 2016, they may not be sufficient to mitigate the city's financial stress. The city's required pension contributions escalate each year, and each subsequent budget for the next five years will need to address these increased contributions. In our view, the city has historically been reluctant to raise taxes, which limits our view of its budgetary flexibility and management. While raising taxes is politically unpopular, we view property taxes as one of the more predictable and reliable choices of revenues. The phased-in approach to the pension contributions (which is also utilized in the city's municipal and laborers pension plans) provides for larger contributions, but they remain at levels lower than actuarially determined amounts. Overall, a phased-in approach could still be viewed as deferring payments because phased-in contributions would be less than the actuarially determined annual required contributions. Given the extent of city's contribution increases, these obligations will likely be an impediment to the city achieving significant future budget surpluses and improving its budgetary performance, which we currently view as very weak.

The city faces additional budgetary pressure if the state does not approve SB 777 and the city is required to make the pension contributions currently required under state law. In this scenario, the city's required pension contributions would increase by $200 million to $1.178 billion in 2016, putting even more stress on the city's budget.

The 2016 budget also assumes that the Illinois Supreme Court will uphold the 2014 state law reducing benefits under the city's municipal and laborers pension plans, which the Illinois Circuit Court previously struck down as in violation of the state constitution. While the city has budgeted for the increased contributions to those plans that accompanied the benefit reductions under the 2014 law, it is possible that the law may not survive court challenge. If the Illinois Supreme Court strikes down the law, the city's contributions to the municipal and laborers' pension plans would revert to the original, and lower, formula. In the short-term, this would benefit the city's budget, but it would have negative overall ramifications because it would set the stage for greater budgetary pressure in the medium to long term as pension plan assets are depleted.

Given the uncertainty regarding the reform of its police, fire, municipal, and laborers pension plans, we expect city management to consider contingency plans for addressing its pension contributions and liabilities. We expect the city to continue to address the structural cracks in its corporate fund budget, as exemplified by budget gaps, which the city forecasts will continue for the next two years, and to find additional solutions to manage its pension and debt obligations in a structurally sound way.

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

Standard & Poor's Ratings Services, part of McGraw Hill Financial (NYSE: MHFI), is the world's leading provider of independent credit risk research and benchmarks. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information and independent benchmarks that help to support the growth of transparent, liquid debt markets worldwide.

Primary Credit Analyst: Helen Samuelson, Chicago (1) 312-233-7011;
helen.samuelson@standardandpoors.com

Secondary Contacts: John A Kenward, Chicago (1) 312-233-7003;
john.kenward@standardandpoors.com

Jane H Ridley, Chicago (1) 312-233-7012;
jane.ridley@standardandpoors.com