

Declining Funding Ratios of City and County Pension Systems: Impact on Private Equity Fund Financing

September 7, 2022 Todd Cabbage, Chris Kang, Ellen McGinnis

PRACTICES Fund Finance, Finance, Corporate

Funding ratios for city- and county-sponsored pension funds have suffered a 15.7% decrease from FYE 2021 measurements as a result of global market fluctuations, dropping to an estimated average of 73.3% as of June 30, 2022.¹ Funding ratios are an important metric for determining the creditworthiness of governmental pension plans when they invest in private equity funds that obtain subscription-secured credit facilities, so it is important for lenders and funds to have protocols in place to monitor the impact of market conditions on these underlying metrics.

Governmental pension plans ("**GPPs**")² frequently invest in private equity funds given the expected long-term returns, and many private equity funds utilize subscription-secured, revolving credit facilities (i.e., revolving credit facilities secured by the investor capital commitments, "**subscription facilities**") to, among other things, provide convenient liquidity for investments. Borrowing availability for subscription facilities is generally based on the creditworthiness of certain identified borrowing-base-eligible investors, and, with respect to GPPs, the funding ratio is a metric used along with ratings criteria to determine whether the investor has met the applicable underwriting requirement for inclusion as an "included investor" in the borrowing base. Generally, GPPs may be included in a borrowing base so long as the rating of the governmental entity responsible for funding the plan is BBB-³ / Baa3⁴ or higher and its funding ratio is at least 80-90%. If its rating is higher, a funding ratio at the lower end of the scale, or no minimum at all, may be acceptable. If, during the term of a facility, these applicable thresholds are not met, such investors may be excluded from the borrowing base, which may negatively impact borrowing availability and trigger a mandatory prepayment requirement to the extent loans have been advanced based on the creditworthiness of such investor.

The June 2022 estimate for city and county GPPs is below the 80% level often cited as a threshold for financial health in the context of a subscription facility. In general, the funding ratio represents the funded status of a plan, expressed as a ratio determined by the actuarial value (or fair value) of the pension plan's assets over the pension plan's actuarial accrued liabilities. Funding ratios for GPPs are typically reported in publicly available annual comprehensive financial reports. While reports indicate that funding ratios for city- and county-sponsored pension plans have declined, similar estimates for state-sponsored and corporate-sponsored pension plans remain well above the 80% threshold.

Of course, lenders do not determine the creditworthiness of an investor based on an average of similar investors, and this news should be analyzed in context. Many cities and counties maintain a rating higher than BBB- / Baa3, reducing reliance on the funding ratio, and many also maintain a higher funding ratio. Further, the funding ratio for any particular GPP typically changes slowly over time. Therefore, depending on additional factors, such as diversity of a borrowing base, lenders may be satisfied to designate city or county GPPs with funding ratios somewhat below 80% as included investors, as the typical subscription facility has only a two-to-three-year term.

While any particular subscription facility may not be impacted as a result of the declining funding ratio of these GPPs, reported lower funding ratios are a reminder that, in a volatile market with changing interest rates and other market fluctuations, some investors may struggle to satisfy financially driven credit requirements, such as funding ratio thresholds. Lenders should continue to vigilantly monitor investor creditworthiness, and sponsors should be aware of duties to report events negatively impacting the borrowing base, especially during turbulent times.

For further information, please contact a member of the Haynes Boone [Fund Finance Practice Group](#).

¹Figures are from Wilshire Advisors LLC estimates, from a survey of 107 pension plans, as reported by the Wall Street Journal on August 26, 2022.

²We recognize that most governmental pension plans are aggregated in pension “systems;” therefore the credit analysis must take into account multiple plans in a system that acts as a single entity when making investments in private equity funds.

³Standard and Poor’s rating.

⁴Moody’s rating.