S&P Global Ratings

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Summary:

Detroit; General Obligation

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Long Term Rating	BB/Positive	Upgraded

Rating Action

S&P Global Ratings raised its rating on Detroit, Mich.'s unlimited-tax general obligation (GO) debt to 'BB' from 'BB-'. The outlook is positive.

The upgrade reflects Detroit's growing revenues and improved budget position, sustained reserves, and overall increasing flexibility with substantial federal funds and a bolstered retiree protection fund (RPF). The city remains, in our view, on a trajectory to meet increasing pension costs in the near and long term within a balanced budget framework, and if it does so, we could raise the rating. We feel the city has strong fiscal discipline and flexibility that can keep it on track should it experience economic slowdowns or higher-than-forecasted pension increases.

Credit overview

Detroit's financial standing has recovered strongly from the pandemic, outpacing that of the local economy. The city was able to sustain its reserves and offset severe revenue losses through quick cost reductions and use of CARES Act funds. Management expects to close the pandemic-induced revenue gap this year and its proposed fiscal 2023 budget is balanced without use of fund balance or stimulus funds for operations. Budget stabilization was aided largely by strong recovery in onsite wagering taxes and collection of the state's new internet gaming and sports betting tax. Detroit has also increased its RPF substantially, which will provide a smoother ramp-up and buffer against the uncertainty of future pension costs. The city's allocation of $827 million in American Rescue Plan Act (ARPA) funds adds stability in that it will accelerate projects to improve the tax base and community well-being while preserving fund balance and resources that otherwise may have funded these. None of the funds are being used as revenue replacement or for recurring expenses.

Detroit's pension outlook will soon become clearer as both its legacy and hybrid plans shift to actuarial based funding requirements in fiscal 2024. While recent plan experience and the increased RPF point to an increasingly affordable transition, we still consider there to be a pending funding gap that constitutes a structural imbalance, as if the city were annually paying full costs as other cities do, it would likely have a budget gap. Under our criteria, this limits the management assessment to weak and caps the rating. However, as the funding policy is set and payment schedules established (and with the fully funded RPF), if we feel the budget is likely to accommodate increasing costs in unison with a gradual use of the RPF, we may consider removing our structural imbalance consideration. Aside from the forthcoming pension performance and resolution, we view the key near-term credit pressure being the many economic headwinds that could disrupt an already slower employment recovery.

The 'BB' rating additionally reflects our view of Detroit's:

- Economic stature as the anchor and cultural center for a large regional economy, but a declining-to-stagnant population with below-average income earning power and who face high unemployment;
- Limited revenue-raising ability and profile that is sensitive to economic fluctuation, a risk magnified by a tax base with above-average reliance on the automotive industry that over time has proven vulnerable to economic retraction;
- Use of fund balance and one-time funds in fiscal years 2020 and 2021 to plug budget holes from pandemic-based revenue losses, yet projected return to balance in fiscal years 2022 and 2023, while available reserves were largely left intact at above 50% of expenditures and should remain very strong and the RPF grew to $370 million (and is projected to add another $90 million next year);
- Very strong liquidity, with strong cash flow and strong market access;
- A strong institutional framework score and strong fiscal discipline supported by policies, transparency, and action, but our view of a long-term structural imbalance in the form of pension deferrals that other cities do not benefit from, which limits our management assessment to weak under the criteria;
- Very weak debt and contingent liability profile, with high debt, a large pension obligation, and already high and growing combined debt and pension carrying charges that can pressure long-term financial flexibility; but no OPEB (other postemployment benefit) liability, which is a strength.

Environmental, social, and governance

We view Detroit as facing elevated social risks, specifically social capital risks. Commuting patterns changed significantly through the pandemic and more than 30% of nonresidents continue to work remotely. This translates to revenue losses directly from refunds, but also slowed recovery of jobs that rely on a regular course of business and leisure activity in the city. Detroit's population trend remains a risk, as do its high poverty levels, as these can limit revenue-raising abilities and increase service needs. The city's leadership views building up its residential tax base as fundamental to its future and invests significant resources in these efforts. Successes to date are reflected in increasing property values, improved public safety metrics, and reduced poverty rates; and substantial new job creation within the city likely reflects the private sector's recognition of an increasingly skilled labor force. Detroit reduced its poverty rate by nearly 9% from 2014 to 2019, lowering it to 31%, but 2020 Census figures show an increase to 35%.

We see governance as a strength, with strong fiscal controls, formal long-term forecasting, well-framed policies that are consistently met, and commitment to long-term goals that keeps the city's rebound moving forward. We do not consider there to be high environmental risk. Detroit is building a sustainability plan and continues to seek solutions to fight flooding of the Detroit River in certain pockets of the city. It also anticipates that federal infrastructure act funding will yield substantial investment in lead pipe removal, road repair, and broadband expansion.

Positive Outlook

Upside scenario

We could raise the rating over the next one-to-two years if the city sustains budgetary balance, including increasing pension contributions and not relying on reserves, and if we feel it is likely to continue to do so without deferring expenses or depleting the RPF at a rate that puts future budgets at increased risk. We anticipate portions of fund balance will be spent on planned nonrecurring expenses, but maintenance of very strong reserves will continue to be a key credit factor with the revenue profile and weaker tax base. Continued economic growth will also weigh on possible positive rating movement.

Return to stable scenario

We could revise the outlook to stable if economic and revenue recovery subside and the city is unable to offset this with enough expenditure controls to stave off deficit spending. We could also do so if pension experience or new pension funding policies result in much higher required costs that we feel are likely to disrupt budget balance or significantly increase draws on the RPF or use of reserves.

Credit Opinion

Recovering employment base with weak underlying fundamentals, but likely to improve with substantial ongoing investment

Detroit anchors the Detroit-Warren-Dearborn metropolitan statistical area (MSA), which we consider to be broad and diverse, and supports about 45% of jobs and 49% of the population in the state. The city's projected per capita effective buying incomes are at 51.6% of national levels and per capita market value is $36,470. According to Claritas, Detroit's 2020 population was 655,610, essentially flat from 2019 and 2018, a marked improvement relative to historical trends. U.S. Census data, however, show 639,111 for 2020, down 4.6% from the Bureau's 2019 estimate. City leadership is working with government officials to review the accuracy of these Census results, given their implications for future revenues. If there was indeed material loss of residents, this could slow growth. Somewhat tempering these weak fundamentals is a revenue profile reaching beyond city boundaries, with substantial operating revenues coming from statewide sales taxes, nonresident commuter income taxes, and visitors to casinos (and more recently, anyone in the state partaking in internet gambling).

The pandemic had an outsized effect on lower wage-earners and the leisure and entertainment industry continues to bear the brunt. Resident employment has recovered over 80% of pandemic losses, but total employment in the city has only recovered 60%. City unemployment remained between 8% and 12% through 2021, close to the pre-pandemic mark of 9.7%. It stood above 20% from April through December 2020. Forecasts from the University of Michigan Research Seminar in Quantitative Economics (UM-RSQE), which support budget assumptions, point to full resident and city employment recovery by the end of 2022 and early 2023, respectively, much of this reflecting blue-collar job growth. General Motors, Ford, and Stellantis have recently embarked on more than $5.4 billion in investments that could create more than 11,000 jobs within the city, and there are several other major investments in plants just outside it that could employ residents. In total, more than 20,000 new jobs are expected to be created in Detroit over the next few years. Many of these jobs reflect automakers' increasing shift to electric vehicles (EVs), from which we feel this region is strategically positioned to benefit. Recovery could be disrupted by many headwinds, however, including supply-chain disruptions, inflation, rising gas prices, and potentially increasing costs for EV battery manufacturing.

Any prolonged weakness in Detroit's commercial real estate could become a pressure, particularly in office real estate, as Detroit has an above-average reliance on commercial property (52%) and its ten largest payers, mostly commercial, make up 26% of the base. Rocket Companies, the parent company to Rocket Mortgage, is the largest employer in the city (18,600 employees) and owns significant real estate. We understand it is making a push to return workers to offices, which could have a positive effect on the recovery trajectory.

Detroit continues to prioritize investing in its residents and ARPA funds will accelerate this. The focus is on continued blight and abandoned building removal, streetscaping, and beautification projects, all of which have proven to increase home values and public safety, along with people projects such as paying for job training and degree attainment, improving internet access, and facilitating record expungements, which help better position residents for jobs. Detroit Public Schools should also benefit greatly from nearly $800 million in stimulus funds. Faith in the school district is likely to remain a key factor in rebuilding the base.

Unfunded pension obligation and application of structural imbalance cap

Detroit's Plan of Adjustment (POA) provided the city a ten-year pension holiday (on its legacy plans) so it could focus on stabilizing the tax base, solidifying the budget, and building up reserves. To prepare for a return to full actuarial determined pension funding in fiscal 2024, the city has been annually increasing its budget allotment for pensions, depositing revenues not required to be paid to the actual pension plan into a voluntary RPF. This would allow it to meet required payments through a combination of increasing payments from the budget and draws on the RPF. Management originally targeted to grow the RPF to $335 million in deposits (plus investments) by the start of fiscal year 2024, but with significant increases in cost projections and recognizing the strain this could place on the budget, the city has been making unscheduled, one-time deposits to bolster the RPF and now projects it will grow to $460 million. Despite not being required to pay full pension payments, we still consider there to be a large pending funding gap that constitutes a structural imbalance, as if the city were paying a full amount annually from the budget there would likely be a substantial deficit (full cost estimates ranged between $120 million and $200 million this year and last, versus the fiscal 2023 budget allotment of $60 million). Under our criteria, the existence of a structural imbalance caps the rating.

Improving budgetary performance ahead of a pension picture that will soon become clearer

Detroit is poised to return to operating balance this year and maintain it going into fiscal 2023, a significant feat considering that recurring revenues were down more than $300 million across fiscal years 2020 and 2021 (compared to pre-pandemic projections and excluding one-time sources).

The original fiscal 2022 budget assumed using $60 million of fund balance to plug revenue shortfalls, and about $27 million in CARES Act funds to reduce transportation subsidies. After budget adoption, the state legislature approved and implemented a new internet gaming and sports betting tax. Knowing this would bring in significant new revenue (all online wagering must go through one of the city's three casinos or a tribal casino, allowing the city to collect from users across the state), Detroit reversed its pandemic staffing reductions, increasing spending estimates by $41 million (3.9%). The new revenues plus various one-time sources are now forecasted to result in an increase in fund balance, as opposed to a use of it. The new online wagering tax is estimated to generate $71 million this year, more than offsetting income tax losses due to remote workers. This is in addition to onsite wagering taxes that are forecasted to increase $68 million, or 61%, over last year.

The mayor's proposed fiscal 2023 general fund operating budget totals $1.15 billion, up 8.7% over the original 2022 budget, and assumes no use of fund balance or ARPA funds for operations; scheduled increases in pension, debt, and labor costs; and a return to full general fund subsidies of the transportation fund. The continued restoration of full staffing levels accounts for almost half of the increase. The city's three police unions are the only ones up for negotiation this year and the budget accommodates various outcomes. Income taxes account for 28% of budgeted revenues and are forecasted to increase 10% over the current year. The budget assumes a $45.2 million loss from 30% of nonremote workers continuing to work remotely, in comparison to a $53.2 million projected loss this year, based on 40% remote work through March 2022 and declining to 30% by June. Other large tax sources are wagering (23%), state revenue sharing (18%), and property taxes (11%). It is uncertain how the 2020 Census results may affect the city's revenue sharing, but we feel its projections will likely prove conservative.

The city's proposed four-year plan shows operational balance through fiscal 2026. It uses a new forecasted legacy pension contribution of $130 million, which, after considering draws on the RPF, would make for an affordable ramp-up schedule of $13 million for fiscal 2024 then around $5 million a year thereafter. The 2024 jump would be partly offset by a decline in debt service. The cost projections have fluctuated significantly over the last several years, though--just last year, it was $200 million, with forecasted ramp-ups of $19 million in fiscal 2024 and a $42 million one from 2026 to 2027--and could still swing again in the event of weaker returns or more aggressive funding policies. The investment board controls investment decisions and the pension board will set assumptions and amortization schedules, leaving the city without direct control. At the same time, we feel the city is generally highly conservative with budget estimates, leaving cushion to accommodate unfavorable outcomes. Revenue estimates, for example, do not account for economic development projects and job creation underway. The budget assumes full staffing (though there are several hundred vacancies) and we feel the city could scale back spending quickly if needed, through both efficiency measures and head count, as it has demonstrated over time, and still maintain full services.

Fiscal 2021 audited results netted a $107.9 million general fund surplus, but when factoring out various one-time items, adding back expenditures charged to CARES Act funding, and adding in the recurring RPF contribution, we estimate the net operating result as closer to a $72 million deficit, or negative 7% of expenditures, which was much better than a previously anticipated $190 million deficit (similarly adjusted). This was down from an adjusted $34 million (negative 3.4%) deficit in fiscal 2020, reflecting a full-year pandemic implication.

Strong flexibility and very strong liquidity, with sustained reserves and steady cash flow

The city ended fiscal 2021 with a $509.1 million combined assigned and unassigned general fund balance, equal to 53% of adjusted expenditures, up from $418.9 million in fiscal 2019. Preliminary fiscal 2022 projections show this could fall to $398 million by this summer, largely due to a supplemental deposit to the RPF, which effectively shifts funds from available to restricted. The fiscal 2023 budget assumes another $30 million use of funds for supplemental RPF deposits and assigns more than $65 million of funds to be spent on one-time expenditures, most significantly, blight removal and capital projects, though we have observed this type of spending of assigned fund balance often occurs over longer periods of time. The strong budget flexibility assessment reflects our view of a limited ability to raise revenues given both the economic limitations and all major taxes being levied at maximum amounts.

Within the available reserve, the city assigns funds to its rainy day, or budget reserve, which the state mandates to be kept above 5%. This allocation totaled $107.3 million (11.2%) in 2021 and the city plans to add another $30 million into this allocation in fiscal 2023.

Detroit consistently has very strong liquidity, closing fiscal 2021 with more than $1.3 billion in total government cash. It collects most major revenue streams either monthly or bimonthly, supporting steady cash flow throughout the year. It did not need to cash-flow borrow through the pandemic.

The city issued GO debt in 2020 and 2021 at competitive rates and with no additional enhancements, signaling strong market access, which we expect to continue. During and after the bankruptcy, most debt was issued through the Michigan Finance Authority and carried added revenue pledges with intercept features.

Strong financial oversight practices and demonstrated ability to adjust

We consider Detroit to have good financial policies and practices under our financial management assessment methodology, although the management assessment remains weak as it is constrained by our view of the budget gap that would exist without the pension holiday. Still, the city remains committed to balanced budgets, long-term planning, and transparency, which has persisted through multiple transitions in the CFO position.

Detroit performs a formal historical trend analysis--encompassing both revenues and expenditures--that is updated annually and has a biannual revenue-estimating conference to helps it stay on track with projections and remain disciplined in budgeting. Budget-to-actual results are provided to the Financial Review Commission (FRC) and city council monthly, and a new investment policy requires quarterly reporting to city council on investment holdings. The city has a comprehensive debt policy that provides parameters for the issuance and use of debt, as well as limitations/ranges to limit debt burdens on the budget and residents' tax bills. There is also a policy to remain in compliance with the requirements of the Home Rule City Act to keep a budget reserve of at least 5% of appropriations.

In accordance with the Home Rule City Act, Detroit annually updates a four-year financial projection, and it also has a five-year capital plan that must be updated biennially. By way of administrative order, the city reviews policies annually unless the CFO determines a review is not necessary.

Financial Review Commission and the Home Rule City Act

The FRC continues to waive oversight and we do not anticipate it reversing course. If it determines that Detroit is in a deficit or at increased financial risk, it could rescind its waiver and return to full oversight (for a minimum of three years). This would create additional layers of budget and contract approval and more reporting, though officials would still maintain control and run day-to-day operations. Regardless of the presence of the FRC, Detroit is subject to provisions of the Home Rule City Act (amended in 2014).

Very weak debt and contingent liability profile, with high obligations and high fixed costs compared to the budget

Detroit has approximately $3.1 billion in direct debt outstanding, with about 40% amortizing in ten years. Excluding water, sewer, and utility user tax-secured debt, we calculate net direct debt as approximately $2 billion, of which $1.5 billion is GO supported. The city retains $75 million in unused voter-authorized neighborhood improvement bonds capacity (2020 election) and $71 million in unused voter-authorized capital improvement bonds capacity (2004 and 2009 elections). This unlimited-tax debt capacity should allow it to finance initiatives over the next few years while keeping its debt millage flat. If it continues to attain voter approval for its capital plan, it can use the debt millage for these types of costs instead of fitting them into the budget or using reserves--or potentially worse, deferring them. The city does not have direct-purchase debt nor do we consider there to be contingent liability risk.

Debt service expenses (total governmental funds) have grown from 8% to 12% over the last three years. This is slightly above the city's target of 10% or less, yet below its 15% cap, as defined in the city's formal debt affordability metrics. Debt as percentage of market value and as a percentage of total governmental funds revenues are also near defined target levels. The debt assessment is ultimately weakened, though, by high overall net debt above 15% of market value (which includes overlapping debt) and our view of the city's large pension obligation.

Large unfunded pension liability remains a pressure

Detroit has high pension liabilities with costs that account for a high portion of spending and will be increasing, with the size of increases to become clearer soon. As anticipated, funded levels for the city's legacy plans declined through much of the last decade, but after strong recent results last year are likely to improve to levels not far from 2014.

The city has the following pension plans (measured liabilities as of June 30, 2020):

- General Retirement System (GRS) Component II (single-employer defined-benefit legacy plan), 59.2% funded with a net pension liability (NPL) of $1.1 billion;
- Police and Fire Retirement System (PFRS) Component II (single-employer defined-benefit legacy plan), 66.8% funded with a NPL of $1.2 billion;
- GRS Component I (hybrid), 90.6% funded with a NPL of $15.8 million; and
- PFRS Component I (hybrid), 117.9% funded with a net asset of $28 million.

The general fund contributed $31 million toward the hybrid plans in fiscal 2021, or 3.1% of adjusted general fund expenditures. While not cash transactions, the 2021 budget included a $50 million RPF contribution (the recurring/growing amount, separate from one-time contributions), well short of the projected legacy plan ADC. Adding a forecasted $73 million general fund legacy contribution in 2024 to the current $30 million hybrid plan contribution that began in 2014, general fund pension costs could grow to more than 10%. A full ADC of $130 million would push this adjusted carrying charge to over 15%.

Detroit froze both its plans effective July 1, 2014. Active and retired employees continue to receive benefits, but at a reduced level, accrued up until this date under the old plan (legacy plan), and benefits accrued thereafter are dictated by the new hybrid GRS and PFRS plans. The POA outlined how the two legacy plans would be funded, including contributions from the library fund, Great Lakes Water Authority, Foundation for Detroit's Future, and Detroit Institute of Arts, and from bond proceeds in escrow. Overall, these annual contributions were expected to be below what actuarially sound levels would be.

The POA dictates actuarial assumptions through fiscal 2024, including a level-dollar, 30-year amortization, and a 6.75% discount rate, at which point a funding policy will be determined by the pension boards and the investment committees. Contributions to the hybrid plans were also set by the POA and will be actuarially determined started with fiscal 2024. The POA required the city contribute 5% of compensation to the GRS plan and between 11.2% and 12.25% to the PFRS plan, but the city anticipates these rates could decrease under an actuarial approach and provide some savings that can be put toward the legacy plan costs. We consider this plan to have many positive features, notably eliminating COLAs, increasing employee contributions, and even reducing benefits if certain funded ratios are not met.

As part to the bankruptcy and POA, the city effectively eliminated its entire other postemployment benefit liability, leaving only a minimal supplemental death benefit plan. Not having such a liability is a strength compared to most large cities.

Strong institutional framework

The institutional framework score for Michigan municipalities with a population greater than 600,000 is strong.

Detroit, MI -- Key Credit Metrics

	Most recent	Historical information		
		2021	2020	2019
Very weak economy				
Projected per capita EBI % of U.S.	52			
Market value per capita ($)	36,470			
Population	655,610		655,610	655,651
County unemployment rate(%)			13.8	5.1
Market value ($000)	23,909,798	23,271,928	21,062,160	15,963,524
Ten largest taxpayers % of taxable value	26.0			
Adequate budgetary performance				
Operating fund result % of expenditures		(2.3)	1.1	4.7
Total governmental fund result % of expenditures		(8.8)	(11.8)	8.0
Strong budgetary flexibility				
Available reserves % of operating expenditures		53.3	45.1	41.2
Total available reserves ($000)		509,121	433,363	418,878
Very strong liquidity				
Total government cash % of governmental fund expenditures		92	61	56
Total government cash % of governmental fund debt service		769	602	675
Weak management				
Financial Management Assessment	Good			
Very weak debt & long-term liabilities				
Debt service % of governmental fund expenditures		11.9	10.1	8.3
Net direct debt % of governmental fund revenue	149			
Overall net debt % of market value	15.5			
Direct debt 10-year amortization (%)	40			
Required pension contribution % of governmental fund expenditures		6.5	6.4	8.2
OPEB actual contribution % of governmental fund expenditures		0.0	0.0	0.0
Strong institutional framework				

EBI--Effective buying income. OPEB--Other postemployment benefits.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March

2, 2022