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Fitch: Kentucky Pension Proposal Will Require Funding Certainty.

Fitch Ratings-New York-30 October 2017: A wide ranging proposal to address Kentucky's underfunded pension plans could gradually improve the commonwealth's credit as large and growing pension obligations have been one of its key rating challenges, Fitch Ratings says. However, the proposal faces likely legal, and possibly legislative, challenges before becoming law. Kentucky's recurring funding of pension contributions also remains uncertain.

The governor's proposal is complex and the budgetary costs have yet to be formally estimated. The wide-ranging plan includes moving some new employees to defined contribution or hybrid plans, changing age and service requirements, and other reforms similar to those adopted in other states. The proposal would also statutorily require the commonwealth to make the actuarially required contributions (ARC) to the plans each year over the coming 30 years.

Republican leadership of the commonwealth's house and senate announced the plan with the governor last week but several Democrats and various employee and retiree groups have already gone public with their opposition. If the proposal passes the legislature with benefit cuts it would likely spur legal challenges.

Kentucky's ratio of long-term liabilities to personal income, which includes both net tax-supported debt and net pension liabilities, is among the highest of US states. Using recent data and applying Fitch's 6% investment return assumption, this metric for Kentucky measures 24%.

Setting Kentucky's pensions on a more sustainable path ultimately depends on the commonwealth consistently making ARC over time. The commonwealth has historically not met the full ARC for its two primary pensions systems, Kentucky Employee Retirement Systems Non-Hazardous Plan (KERS-NH) and the Teachers Retirement System (TRS). Recent legislative action corrected this situation for KERS-NH and the ARC was fully funded in the current biennial budget, ending on June 30, 2018, along with an additional $126 million to help address the sizable unfunded liability. For TRS the current biennial budget includes appropriations for 94% of the ARC with nearly $1 billion in additional funding. However, that funding is heavily reliant on nonrecurring revenue.

Fitch anticipates the governor will call a special session this year to consider the proposal and it may be more likely to be adopted as Kentucky's pension funding pressures are among the worst of any US state. KERS-NH reported a funded ratio of just 16% as of its 2016 valuation, the weakest of the commonwealth's plans. Fitch considers a plan at this level at risk of converting to a pay as you go system. We calculate converting KERS-NH to pay as you go would mean a 60% increase, or approximately $300 million, in budgetary demands for benefits paid by that system.

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