[Bond Case Briefs]

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[Fitch: Path to Impactful U.S. Public Pension Reforms Paved by Court Decisions.]

Fitch Ratings-New York-21 June 2018: The legal backdrop for U.S. state and local pensions has played a key role in reforms adopted by some states in 2018, although pensions in general still face an uphill climb to improve their funding levels, according to Fitch Ratings.

Worries over the long-term sustainability of pension obligations and the rising budgetary burden of annual contributions remain front and center for states in 2018. Many states' legislatures passed, and governors signed, reforms in 2018 legislative action to date, with some of the most interesting emerging in Colorado, Minnesota and Illinois. For these states, past state court decisions validating or rejecting earlier reform efforts, particularly on cost-of-living adjustments (COLAs), delineated how far their 2018 reform packages could go. However, as seen with other states like Ohio, the presence of legal flexibility and the identified need for further reform is not always enough to sway legislatures to act.

Colorado and Minnesota both adopted comprehensive reforms in 2018 covering their major statewide plans following long roads to building consensus. In Colorado, SB 18-200 temporarily freezes COLAs for current retirees, delays COLAs for new retirees, caps all future COLAs at 1.5% annually instead of the previous 2%, modifies age and salary requirements for future employees, and expands eligibility for its defined contribution plan, among other changes. It also raises employee and employer contributions and requires an annual lump sum, $225 million state contribution for 30 years.

Similarly, Minnesota H.F. 3053/S.F. 2620 adjusts COLAs downward for current and future retirees depending on the plan. For most, future COLAs are held between 1% and 1.5% annually, with COLAs for future retirees delayed until normal retirement age. The reform package also lowers the state plans' funding discount rates to 7.5% (from as high as 8.5% before the reform), modifies actuarial assumptions and raises age and salary requirements. The Minnesota bill also raises employee and employer contributions, with most of the higher contributions borne by employers.

The Colorado and Minnesota bills were not the first rounds of reform adopted by the two states since the great recession exposed their pensions' funding weaknesses. Insofar as both bills reduce COLA provisions for existing retirees, they capitalize on court rulings (Justus vs. State of Colorado, in 2014 and Swanson v. Minnesota, in 2011) that validated past statutory changes lowering promised benefits.

In both of those decisions, less generous COLA provisions in the states' reforms were challenged and ultimately upheld, with courts viewing COLAs as being outside the contractual (in Colorado) or contract-like (in Minnesota) protections afforded to their core pension benefits. Reducing or eliminating COLAs, including for retirees and current employees, is one of the few pension reforms that can materially lower the accrued liability immediately. The net effect for both Colorado (not rated by Fitch) and Minnesota (IDR AAA/Stable) was to give them more tools for managing their accrued pension burdens without having to rely solely on raising employer contributions, shifting more of the contribution burden to employees, or waiting for newer, lower benefit tiers to achieve savings. The benefit for both states is also likely to be felt by local governments, schools and other public entities participating as employers in the state-administered plans.

Illinois also adopted pension measures in 2018, although the context of these actions is different and the trade-off of savings vs. costs remains uncertain. As part of its fiscal 2019 budget, Illinois among other pension changes established two buyout programs that sunset in fiscal 2021, targeting budget savings by lowering accrued liabilities associated with employees hired before 2011. The first offers retiring state, university and teacher plan members an upfront payment equal to 70% of the difference between their promised 3% COLA and a reduced 1.5% COLA; the second provides a 60% lump sum to vested, inactive members of the same plans in exchange for all future benefits. Assuming that approximately 20%-25% of eligible members participate in the buyouts, lower accrued liabilities could lower state contributions approximately $400 million, a figure that will be partly offset by debt service on state GO bonds to be issued to fund the buyouts. Notably, the timing of rollout will be lengthy and the precise fiscal impact will only be known upon conclusion of the program and could vary significantly from the initial estimates.

Like Colorado and Minnesota, Illinois' more limited 2018 actions were informed by past court precedent. A 2015 state Supreme Court ruling (In re: Pension Reform Litigation) rejected a 2014 pension reform law (Public Act 98-599) that lowered benefits for employees hired before 2011 as violating the explicit contractual protection of retirement benefits embedded in Illinois' 1970 constitution. The high hurdle imposed by this constitutional provision has left Illinois with few and costly options for reducing accrued benefits.

Fitch notes that the contractual constraints faces by Illinois (IDR BBB/Negative) would have been less likely to emerge as a fiscal problem had the state not consistently avoided making full actuarial contributions for its pensions. The state has yet to rectify this longstanding problem, which Fitch considers a form of deficit financing.

Reform efforts stalled in some other states in 2018, regardless of the degree to which their legal environment supports changes to accrued benefits. This speaks to the political challenge of making changes to pensions.

In Ohio (IDR AA+/Stable), a bill (HB 413) that would lower COLAs in the Ohio Public Employees Retirement System (OPERS) from 3% to the annual change in CPI capped at 2.5%, among other adjustments, never received a vote in committee after several hearings and has been shelved, according to press reports. The bill would have improved the plan's funded status while making it likelier that the statutorily fixed contributions OPERS receives would be sufficient to support funding progress under more adverse future circumstances.

Ohio's pension plans have generally benefited from strong contribution practices and the willingness of both the legislature and pension boards to revisit decisions on benefits, assumptions and funding practices. Like a handful of other states, Ohio protects accrued benefits as property rights, rather than as contracts, and thus has greater discretion in theory to adopt reforms affecting accrued benefits of current members and retirees.

As examples of this leeway, 2012 reforms narrowed age and service requirements for OPERS benefits, including for some current employees, and COLA changes have been a part of reforms for several other Ohio statewide systems in recent years. However, even with a demonstrated record of trimming existing benefits, Fitch views more significant benefit rollbacks in Ohio beyond the recent examples as being politically unpalatable, leaving participating Ohio governments obligated to covering the unfunded liability over time.

Even with recent reform efforts like the aforementioned legislated changes, Fitch believes funding improvement for many major pensions may not materialize any time soon. Funding discount rates upon which accrued liabilities and actuarial contributions are based for virtually all major plans remain above the 6% level that Fitch views as reasonable. Although the average funding discount rate for major plans has fallen steadily since 2009, when it was 8%, Fitch calculates it at about 7.4% as of fiscal 2017. Demographic pressures likewise mean more retirees than ever are drawing benefits from funds, making improved funded ratios harder to achieve. Finally, the current economic expansion, even with recent gains, has been weaker than past expansions, and arguably is closer to its end than its beginning. This means pensions may soon be absorbing another round of recessionary weakness that further raises contribution pressure, without having fully recovered from the last downturn.

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