Fitch Ratings: Kentucky Benefit Changes Unlikely to Affect Pension Burden Near Term

Fitch Ratings-New York-10 January 2019: As a new legislative session begins in Kentucky with pension changes likely up for debate, the commitment to address rising expenditure demands, particularly for pensions, remains a key determinant in the trajectory of the commonwealth's 'AA-'/Stable Outlook Issuer Default Rating (IDR), according to Fitch Ratings.

Kentucky has made fiscal progress in recent years, including raising additional revenues to support spending growth, which included full pension actuarial contributions. However, continued budget balancing challenges despite economic recovery indicate a structural problem that extends beyond the effects of economic cyclicality on Kentucky's financial operations. Pension benefit changes could be helpful in easing fiscal pressure over a very long timeframe, but are likely to have only a modest effect on the commonwealth's pension burden in the near term. Fitch's primary focus remains whether Kentucky can continue recent progress towards structural budget balance, including maintaining full pension funding.

Kentucky's governor called the legislature into special session in December to consider legislation that would largely re-enact provisions of a pension bill recently struck down by the commonwealth's Supreme Court. The court overturned the bill, SB 151, on procedural grounds and did not assess the legality of the benefit changes. The special session ended without a bill; however, leadership indicated plans to revisit the issue in the regular session that began this week. Even if the legislature and governor enact replacement legislation, Fitch anticipates further litigation. Given the modest savings anticipated, the proposed pension benefit changes, and any related litigation, would not affect the state's rating.

While Kentucky's somewhat elevated long-term liability burden, including net pension liabilities, is amongst the highest for U.S. states, Fitch considers the burden moderate and anticipates it will remain there for the foreseeable future. SB 151's legislative sponsor estimated it would generate roughly $300 million in savings over the next 30 years, less than 1% of the commonwealth's Fitch-adjusted net pension liability of approximately $40 billion. Assuming the legislature pursues similar provisions in a new bill, Fitch anticipates any beneficial effects to emerge slowly, as new hires with lower benefits gradually replace existing employees with higher benefits. These changes are unlikely to materially affect Fitch's view of Kentucky's long-term liability burden.

Fitch's primary rating sensitivity for Kentucky is the commonwealth's ability to maintain structural spending commitments, most notably for pensions, while continuing to reduce reliance on non-recurring budget measures. Over the past several biennia, Kentucky's budgets moved closer to addressing inadequate pension contributions, which had been one of the primary drivers of the state's elevated pension burden. For the biennium that began July 1, 2018, the commonwealth has budgeted full actuarial contributions for all systems, reaching an important fiscal milestone. To achieve this, the budget included significant spending cuts across most state agencies, tax changes resulting in a sizable net revenue increase, and several one-time fund transfers.

In addition to the benefit changes, SB 151 also established an ongoing statutory commitment for the commonwealth to make full pension system actuarial contributions, calculated using a more actuarially conservative level dollar amortization method. A replacement bill would likely include similar provisions.

Fitch views an ongoing statutory funding provision as a positive step, but not determinative in assessing Kentucky's commitment to meeting pension budgetary obligations. As demonstrated most explicitly in New Jersey several years ago, future legislatures and governors generally have discretion to revise statutory multi-year budgetary commitments to pensions.

Instead, Fitch will focus on the state's actual budgetary practices and performance over the next several years to assess Kentucky's ability to meet rising spending demands. The 2019 – 2020 biennial budget includes approximately $500 million in one-time fund transfers that likely will be challenging to address in the next budget even if the economy continues to grow at the current pace. The challenge would be exacerbated by any downturn in the economy and revenues. Kentucky's ability to manage rising spending demands while reducing reliance on one-time items will continue to drive Fitch's assessment of the commonwealth's financial resilience as the next, inevitable, recession draws closer.

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