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Kentucky's Cautionary Tale About Underfunding Pensions.

With the worst-funded pension system in the country, Kentucky offers a glimpse of what could be in store for other states.

Pensions will be a contentious topic again this year, with many states still struggling to find an affordable way to fund these promises to retirees. In Kentucky, which has the worst-funded state pension in the country, some officials are worried the plan has already reached the point of no return.

Kentucky's largest retirement plan has been in slow and steady decline for years. Lately, it's faced poor stock market returns and an increasing need to cash out investments or move money into low-risk, low-return bonds in order to make retiree payments. All that has led to an increase in the pension system's unfunded liabilities to just over $10 billion.

The state legislature has passed several laws over the years aimed at reining in skyrocketing bills. But despite their efforts, the situation is getting worse.

The debate in Kentucky about what to do next offers a glimpse of what could be in store for other state pension systems that have a history of poor government funding.

In 2013, a new law created a hybrid cash balance plan for new employees, which is similar to a defined-benefit plan but carries less risk for the state. It also essentially eliminated retiree cost-o--living increases and required the state to make its full actuarial payments immediately — something it hadn't done regularly since the 1990s.

But some are worried the changes came too late.

Over the past year, the plan lost nearly a third of its assets, dropping to $2.3 billion in 2015 from $3.1 billion in 2014. It now has just 19 percent of the assets it needs to meet its total pension liabilities over the next three decades.

"We understood that there was going to be several years of decline even after the latest reforms," said Jim Carroll, cofounder of Kentucky Government Retirees, an advocacy group. "What [lawmakers] haven't realized now is how deep and fast that trough has occurred."

As in many states, lawmakers have tried to reverse the plan's downward course for years. They cut retirees' health benefits in 2004 and eliminated pension spiking, which offered higher benefits for workers whose earnings increased at the tail end of their career, in 2008. But it was only the most recent legislation in 2013 that forced the state to make its full pension payments. As a result, Kentucky's employer contribution (which comes from money from the state's General Fund, among other places) leapt to $521 million last year. That represents more than twice what it contributed in 2012 and one-third of the total payroll costs for state employees.

Kentucky's not alone.

Both Illinois and New Jersey have repeatedly failed to make their full pension payments because of budget constraints. This year, at least Connecticut and Pennsylvania lawmakers are debating major overhauls of their pension systems. All of these states — plus Kentucky– have been slapped with credit rating downgrades in the last few years, either as a result of inaction on pensions or because of the financial pressures that unfunded liabilities are putting on their budgets. But none have yet reached the cash flow situation that Kentucky is facing.

Gov. Matt Bevin, just over a month into his new job, said this week in his State of the State address that he'll order independent audits of every state pension system so he can propose "substantive structural changes" next year. He's already called for eventually replacing the current system with a 401(k) retirement plan for new employees and letting current public employees transfer their traditional pensions to a 401(k) if they want. Until then, his latest budget would put $130.7 million from the General Fund toward the state employees' pension, which is slightly more than what's required.

Carroll said his organization was still vetting the governor's full proposal but called it "encouraging" that Bevin was making funding a priority. The 401(k) aspect of his proposal, however, has already incurred opposition from pension advocates.

The situation calls for negotiation and creativity, pension consultants say, but most of the ideas have been tried before. Some have proposed issuing bonds instead of using more General Fund money to infuse cash into the pension fund over time. But a similar bond proposal for the Kentucky Teachers' Retirement System failed last year, and neither the legislature nor Bevin have shown much of an appetite for bonds.

Without decisive action, Kentucky will likely face even tougher budget choices down the line.

The struggling territory of Puerto Rico, for example, has recently started defaulting on some of its debt in order to pay its legally required obligations, including pensions. Some cities have been able to file for bankruptcy to overhaul their pensions, but territories and states can't go that far.

"States can become structurally bankrupt where it's very difficult — if not impossible — to make up the gap," said Daniel Liljenquist, a former Utah lawmaker and a board member of the Retirement Security Initiative, a newly-formed group promoting sustainable retirement policies. "I think at that point you do have to go back and renegotiate with your retirees."

That option isn't palatable yet in Kentucky. Pension advocates are quick to point out that retirees have already given up some of their health benefits and their cost-of-living raises.

"My advice to [retirees] has been don't spend any more money," said Carroll. "This is a [pension] plan that will fail if nobody acts."

*This story has been updated.

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