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Fitch: Reversal of Pension Benefit Actions Could Pressure State Liabilities

Fitch Ratings-New York-21 October 2024: Recently adopted and proposed modifications to state pension benefits could slow pension funding progress and pressure long-term liability burdens over time, according to Fitch Ratings. Enacted and proposed actions that offer more generous benefits will lead to higher required contributions and liabilities in the short term and could affect long-term credit stability if states adopt additional rollbacks to the early 2010s pension benefit revisions over the next few years.

Many states revised government pension benefits following the Global Financial Crisis, which saw average state pension fund returns plummet 7.7% in 2008 and 17.9% in 2009. Changes included higher employee contributions, increased retirement eligibility age and service requirements, modifications to benefit calculations, shifts to defined-contribution or hybrid plans, and reductions or suspensions of cost-of-living adjustments (COLAs). These measures have resulted in compounded savings, improving pension funded ratios and reducing growth of actuarially determined employer contributions.

Recent events prompted the reconsideration of these decade-old pension actions. Pandemic disruptions and an aging workforce led to a surge in public sector retirements, and a sharp rise in inflation in 2021 and 2022 eroded retirees' purchasing power, particularly for plans that had curtailed COLA-linked automatic benefit increases. A tight labor market and flexible remote and hybrid working arrangements in the private sector have challenged public sector job recruitment and retention. Pension funded statuses have improved due in part to healthy long-term investment returns and, in some states, substantial supplemental pension contributions.

New York rolled back several changes over the past three budgets for workers hired after April 1, 2012, known as Tier 6. The legislature reduced the minimum vesting period from 10 years to five, costing the state and local governments $61 million annually, and changed the final average salary calculation period from five years to three, increasing annual contributions by $377 million. These changes increase the net present value of state and local pension benefits by over $4.3 billion, but Fitch expects that New York's long-term liability burden will remain low due to the state's history of conservative pension funding practices.

Rhode Island's fiscal 2025 budget included enhancements to retiree benefits to counteract inflation. Pension benefits are now based on the highest three consecutive years of earnings instead of five. The state also repealed the suspension of full annual COLAs for state employees who retired before 2012 and lowered the funding threshold for reinstating COLAs to 75% from 80% for those who retired after July 1, 2012. These changes will increase Rhode Island's required state pension contributions by $27.5 million in fiscal 2025 and add about $434 million to the state and local unfunded pension liability, increasing the state's long-term liability metrics in the near term. However, we expect the long-term liability burden to resume a general downward trend, absent additional legislative actions.

In Illinois, pension changes have been proposed over concerns about whether Tier 2 benefits meet IRS safe harbor requirements for a Federal Insurance Contributions Act tax exemption. While policies addressing this issue might not affect Illinois' credit quality, broader enhancements to Tier 2 benefits, applicable to employees hired after Jan. 1, 2011, could raise liabilities and negatively affect the state's credit rating.

Benefit enhancements have been proposed in at least two states where past reforms have meaningfully supported credit quality. New Jersey's legislature has repeatedly introduced bills in recent years that would revisit the 2011 suspension of COLAs until an 80% funded ratio is achieved. In Alaska, legislative proposals would reopen its long-closed pension plans. Both states have elevated pension liability burdens relative to state medians, but credit concerns have been partly mitigated by state policy actions to curtail liability growth.

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