State of Connecticut
Office of Policy and Management

November 10, 2015

Dear Governor Malloy:

Please accept the attached *Final Report on Connecticut's State Employees Retirement System and Teachers' Retirement System*, by Jean-Pierre Aubry and Alicia Munnell from the Center for Retirement Research at Boston College. This study is the product of an engagement by OPM over the last year, the purpose of which has been to identify historic weaknesses in our funding approach to these two largest pension systems, and to recommend improvements. In addition, please accept in this transmittal some specific recommendations for major changes to our pension systems.

I am happy to say that this engagement has been especially helpful. BC has completed a thoughtful and insightful review of the two major State pension plans. The study has generated some important data and has raised some timely observations about our current funding approach which demand our attention now in order to strengthen the long-term sustainability of the plans. Indeed, our discussion of their preliminary findings has prompted you to suggest some creative and unusual alternatives which are now among our recommendations. This in turn has developed into the specific recommendations that are included here.

Specifically, the BC report addresses the following three areas:

a) Identify factors that have led to today's unfunded liability.
b) Project the systems' finances going forward under current law.
c) Recommend alternatives to shore up the systems' finances and improve budget flexibility.

The headline of the report is that the combined systems, if funded under the current approach and if investment returns meet our assumptions, will require that our contributions double from about $2 ½ billion now to about $5 billion as we approach 2032. In my opinion, this scenario, while optimistic about investment returns, still presents the greatest long-term budget challenge facing the state. However, if investment returns fall short of our 8-8.5% expectations, the future becomes alarming. If investment returns over the next fifteen years are like those over the last fifteen years – 5 ½% per year on average – we face balloon payments totaling $13 billion in order to fully fund our pensions in 2032. This would be a catastrophic legacy to leave for our successors and our children.

We must take every responsible measure to avoid this outcome while maintaining our commitments to retirees.

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In discussing the funding of our State's pension systems, it is critical to keep some key facts in mind (see figures 13 and 34 of the report):

- Our pensions are, in fact, affordable. As of the last actuarial valuation, the average cost in SERS for active employees is 10.2% of payroll, compared to the national average of 13.6%. (For new, Tier 3 employees it is significantly lower still). For teachers, the cost of our pensions for active teachers is 9.7% of pay, compared to the national average of 13%.

- It is our unfunded liability that drives our costs – money we should have set aside and invested years ago for employees who are mostly retired today, but did not. In SERS, payment of unfunded liability amounts to 35.4% of active employee payroll. In TRS, that number is 19.9%.

- Because so much of our annual cost is for unfunded liability, any changes we make to benefits for new or active employees will only make a marginal change in our annual required contribution. This is why conversion to a defined contribution, 401K-type plan would not help control costs, as many have suggested. A new pension structure going forward would not wipe out the debts racked up over generations of state workers.

- Moreover, the Connecticut courts have held that pensions, once awarded at retirement, are the property of the pensioners. We cannot diminish or take those pensions away without compensating the pensioners who own them, any more than the state can take other property without compensation.

While our actions are limited by legal and other constraints, the BC study does identify a number of practical changes to our funding approach which will reduce the risks of catastrophic spikes in pension costs while maintaining our commitment to full-funding of our pensions. While these measures generally will require somewhat higher contributions in the near term, they tend to limit the amount of investment risk that the state holds, and limit significant future growth in state costs over the coming fifteen years.

Based on the report, I recommend the following changes be undertaken in order to strengthen the State's two largest pension systems:

1. Reduce the investment return assumptions. SERS is currently at 8%, and TRS has just this last week lowered their rate assumption from 8.5% to 8%. There is a significant annual cost to making this change, and it will result in a reduction of the widely-reported "funded ratio" of each fund. Nevertheless, we should work with each fund's governing board to identify an appropriate and aggressive schedule for reducing their

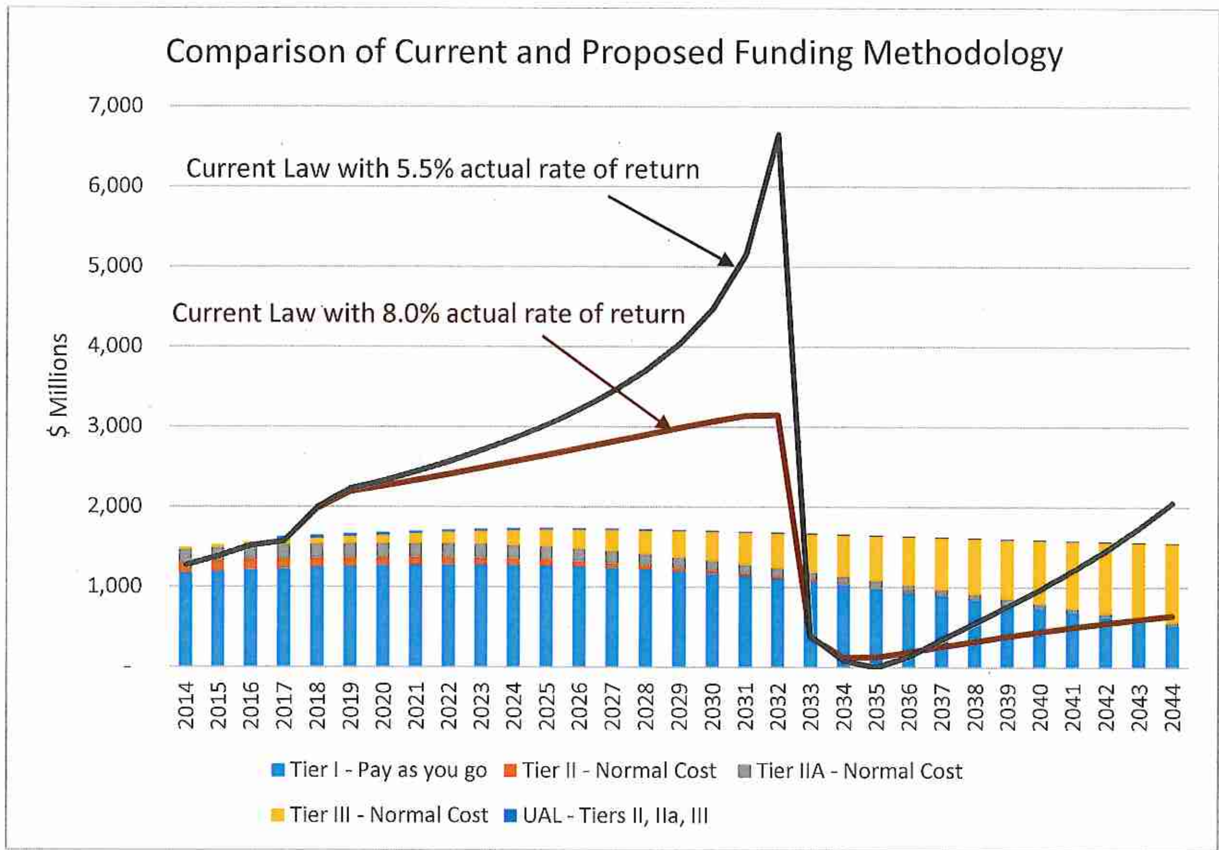
respective investment return assumptions down to 7%. Note that the average assumption for similar plans nationally is 7.7%.

2. Convert from "Level Percent of Payroll" to "Level Dollar" amortization. This change would eliminate a significant back-weighting feature of the systems' current methods of calculating annual contributions. As with changing the investment return assumptions, this change will have an immediate cost, and should be evaluated by each plan's actuary to establish a transition plan that balances affordability with the urgency of moving away from an actuarial approach that has contributed so significantly to our current unacceptable level of underfunding. Again, we should work with each fund's governing board to evaluate alternatives and implement the preferred option.

3. Establish policies under which the amortization of unfunded liabilities will convert from a closed period to a rolling period as the plan approaches full funding. There are a number of approaches that will produce a similar effect of reducing unmanageable spikes in contributions, while smoothing the drop-off in annual budget requirements that a closed period creates. While these changes are less critical in the short term, we should recommend that each fund's governing board consider a policy that would move away from single closed amortization periods over the next decade, eliminating the risk of contribution spikes in the final years of a fixed schedule.

4. Continue to control future State pension costs by avoiding retirement incentives, contribution holidays, or other similar damaging practices; and by increasing employee and non-state employer contributions to the funds. Increasing State employee contributions will require collective bargaining, and since the current SEBAC agreement on pensions runs through June 30, 2022, such changes may need to be deferred. Increases to non-state employer contributions to TRS would require legislative action.

5. Split the SERS system into two funds, one a closed plan for Tier 1 retirees for whom most of the unfunded liability applies, and one open plan for active employees, mostly from Tiers 2 and 3. The closed plan would then be funded on a pay-as-you-go basis with annual required appropriations sufficient to cover guaranteed benefit payments, while the open plan would continue to be pre-funded on an actuarial basis. This change would dramatically change our future payments to SERS, as shown in the graph below, based on our preliminary estimates of the impact of the proposed change:



This recommendation acknowledges the reality of our current SERS system: that our annual contributions to the system are not, in fact, invested for the future, but instead are paid out in benefits to existing retirees, mostly Tier 1 retirees. For example, in FY 15, our state contribution to SERS amounted to $1.38 billion, while our payments to Tier 1 retirees was to $1.19 billion. Furthermore, this approach has some important advantages. First, it reduces the extraordinary burden on the current generation of taxpayers to make up for a shortfall accumulated since 1939 in just 15 years. Second, it separates the affordable and sustainable pensions for current and future employees from the largely unfunded pensions for Tier 1 retirees. This makes the active system stronger and more transparent, while still honoring the binding commitments we have made to retirees. Third, this approach provides for a less risky, more stable pattern of state contributions over the coming decades, lending budget stability and predictability which the current system cannot.

This recommended split of the SERS system presents some significant legal, procedural, financial, and actuarial questions which will take some time to answer. These include:

- Should the division of the plan include an actual separation of the fund into two separate funds, or should the fund remain intact but require annual state

contributions based on an appropriated benefits portion and an actuarially prefunded portion?

- How shall the assets of the fund be applied against Tier 1 liability and the ongoing liabilities of the open plan? If all the assets are applied to the open plan, it would be funded at about 95%. This is the approach modelled in the chart above. On the other hand, Boston College estimates that the Tier 1 closed plan could be considered to be funded at 25.4%, while the open plan would be funded at 62.4%. It is clear that under any reasonable attribution of assets, the closed plan will be dramatically less well funded than the open plan, which is much better funded than the combined plan that exists today, which is funded just over 40%. Nevertheless, a specific allocation of assets must be established.

- Should the small number (less than 2,000 today) of active Tier 1 employees be part of the closed or the open plan?

- Should we consider a phased transition to a split plan, in order to ensure budget stability in the short-term?

- What are the consequences of splitting the SERS system to our current practices for establishing fringe benefit rates, and will such a change impact our ability to garner federal revenue to support our staff costs in areas such as Medicaid administration, unemployment administration, and other areas with significant federal support? Can we mitigate any risks to federal revenue through a redesign of our fringe benefit calculations?

- Which aspects of this plan require Retirement Commission approval, collective bargaining, or legislative action?

- Will such a split impact our credit rating or our compliance with Generally Accepted Accounting Principles?

In order to implement this recommendation, we should immediately undertake the following actions:

- Engage the Retirement Commission, SEBAC, the General Assembly, the Comptroller and the Treasurer in a detailed discussion of the plan, based on the research by BC. This engagement will likely produce additional issues to research and address.

- Identify and retain specialized counsel to identify legal requirements for implementation.

- In collaboration with the Retirement Commission, obtain detailed actuarial cost projections for various likely alternatives from the plan actuary.

These recommendations are a combination of common sense measures, actuarial refinements, and bold new thinking. They must be implemented over time, with care and flexibility. They must be implemented in consultation with the many constituencies of our pension systems – retirees, employees, teachers, legislators and taxpayers. Our pension reform efforts should build on the unprecedented commitments you have already made to full funding of our pensions each year, restraint in benefit levels for new employees we have already negotiated, and our commitment to defined benefit pensions as a just and sustainable model for retirement security for our employees.

Finally, these proposals and our efforts to date reflect balance between the inviolable trust we have with our retirees, and the obligation we have to residents and taxpayers to maintain cost-effective services over time.

I look forward to working to strengthen our pension systems in the coming months and years.

Yours,

Ben Barnes, Secretary

cc: Lieutenant Governor Nancy Wyman
Legislative Leaders
Chair, Teachers' Retirement Board
Chair, Retirement Commission
State Comptroller Lembo
Treasurer Nappier