PENSION FUNDING REFORM

Kevin Lembo Office of the State Comptroller

WHAT IS THE PROBLEM?

Connecticut's unfunded pension liabilities are a crushing debt that increasingly crowd out other state budget priorities and remain a top concern for businesses when deciding whether to invest here and hire more workers.

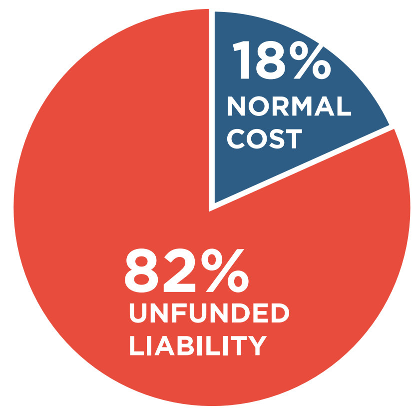
In addition to the contributions that employees make (dependent on their tier), the state makes a payment each year to the pension fund. That payment is known as the "Actuarial Determined Employer Contribution" (or ADEC).

There are two components to the state's annual payment: First, there is the "normal cost" which is what must be set aside now to pay future benefits earned by employees this year. The second component is the "Actuarial Accrued Liability" – or the "unfunded pension liability" – which is the gap between the value of the assets currently in the state's pension fund vs. the full future cost of paying benefits that have been earned. The Actuarial Accrued Liability are essentially catch up payments for benefits earned by past employee service that were not fully funded at the time.

At the risk of oversimplifying the definition of the unfunded pension liability, it's akin to the cost of back payments owed on a mortgage.

SERS PAYMENT FY 2017

UNFUNDED LIABILITY VS. NORMAL COST



HOW DID WE GET HERE?

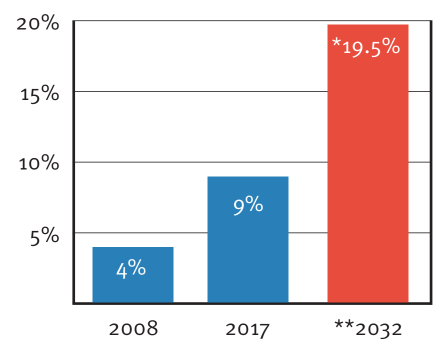
In 1992, the state created a plan to pay its unfunded pension obligations by 2032. The payment plan was flat and predictable — like a fixed-rate mortgage. In the mid-1990s, however — when the state enjoyed consistent surpluses — government decision-makers negotiated an agreement to lower the annual pension fund contributions. But this meant payments would sharply increase in the distant future, like a balloon mortgage.

That distant future is now. The balloon payments have arrived and are scheduled to get precipitously bigger each year. The cost of paying for benefits earned this year (again, the "normal costs") is slightly under $300 million. When combined with the cost of those decades of deferred payments and other shortfalls, however, the cost for us in 2016 was more than $1.5 billion.

That annual payment could grow from $1.5 billion to nearly $6 billion in a single year by 2032!

Compounding the problem is that Connecticut has, for many years, relied on a rosy assumption about how much the pension fund's investments will grow each year (8 percent, when a lower assumption is more realistic and responsible).

TOTAL PENSION CONTRIBUTIONS AS % OF TOTAL GENERAL FUND SPEND



*BOSTON COLLEGE ESTIMATE BASED ON CONSISTENT 5.5% RETURN ON INVESTMENT

**ASSUMES ANNUAL GENERAL FUND EXPENDITURE GROWTH OF 3%.

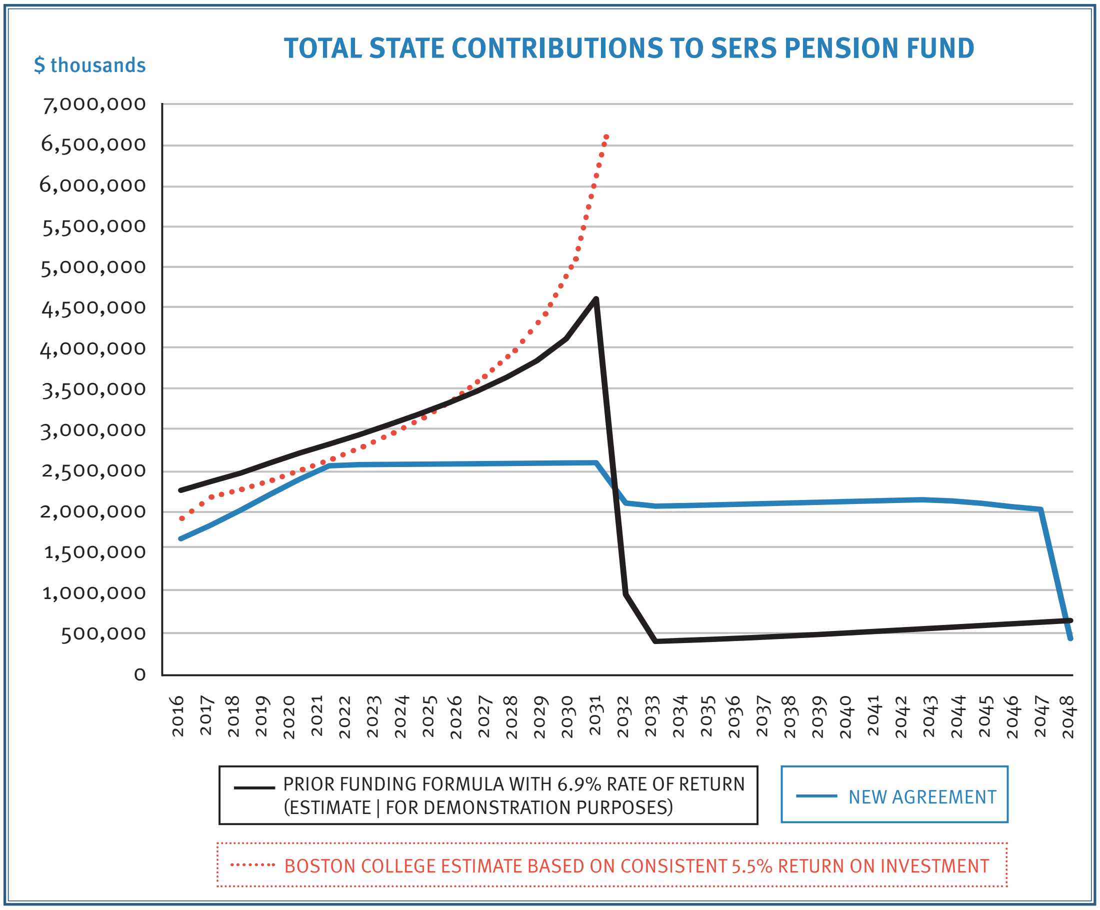
WHAT DOES THE AGREEMENT BETWEEN SEBAC AND GOVERNOR MALLOY ACHIEVE?

The agreement includes a great deal of the components that both I and Treasurer Nappier advocated for. It replaces the sharp and volatile rising balloon payments with flat, stable and predictable annual contributions. It achieves this by lengthening the payment plan for a portion of the unfunded liabilities from 15 years to 30, allowing us to pay slightly more in the beginning – but maintaining that manageable amount over the years, rather than face consistently rising payments.

It also adopts a more conservative and realistic assumption about how much the pension fund investments will perform in the financial markets each year.

DOESN'T THIS "KICK THE CAN DOWN THE ROAD?"

The can has already been kicked down the road and now we're staring down the barrel of a $6-billion balloon payment. It's simply unsustainable and irresponsible for us to ignore it. The responsible solution, for our generation and the next, is to create a responsible and disciplined flat payment plan. That means a reasonable lengthening of the payment plan, but making it more predictable and manageable over the years. Unfunded liability associated with service prior to 1985 remains on the original amortization schedule and is planned to be paid off by 2032, generating significant budget relief in subsequent years.



IS A 6.9-PERCENT GROWTH RATE A REASONABLE ASSUMPTION?

A 6.9-percent investment return assumption – aside from being far lower than the current 8-percent assumption – is one of the lowest in the country for a state pension plan, according to the National Association of State Retirement Administrators (the average is 7.62 percent). Moreover, the State Employees Retirement Commission sets the investment return assumption and has the ability to make future adjustment should the 6.9% prove unachievable.

A NEW REPORT JUST REVEALED THAT THE STATE'S UNFUNDED PENSION LIABILITY HAS GROWN DUE TO THIS AGREEMENT. HAS THIS AGREEMENT CREATED A BIGGER LIABILITY?

The state's liability didn't magically grow because of this agreement. Simply by lowering the state's investment growth assumptions – transparently acknowledging that the state's pension fund investment returns will likely be lower – the state is acknowledging reality, not making it worse.

Because of this agreement, the state isn't growing the liability, but more honestly reporting the true scope of the problem.

THIS AGREEMENT DOESN'T ADDRESS BENEFIT DESIGN. SHOULDN'T ANY AGREEMENT ADDRESS BOTH ISSUES?

Should overtime be included in pension calculations – and should employees contribute more to the pension plan? These are fair questions, but I strongly caution against rejecting this agreement on the basis that it doesn't address benefit design. If the state eliminated the pension system, and every Connecticut employee left tomorrow, the state would still owe these billions in unfunded pension costs. Why oppose this agreement when a separate conversation can be had about benefit design?

And let's be honest: Rejecting this agreement would also fail to address benefit design – while also eliminating any chance for pension payment reform! Rejecting this agreement would be the worst case scenario.

FINAL NOTES:

The credit rating agencies endorse this action (Moody's called it a "credit positive"). The business community has demanded action. I urge support for this agreement because it will steer the state from financial devastation, and will establish the predictability that businesses and residents deserve.

MOVING FORWARD

If you would like more information or wish to discuss this issue further, please contact our legislative liaison, Genevieve Ballinger via email, Genevieve.Ballinger@ct.gov, or telephone, 860.702.3668.