State of Connecticut

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COMPTROLLER

Hartford

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The Honorable Dannel P. Malloy
Governor of Connecticut
State Capitol
210 Capitol Avenue
Hartford, Connecticut 06106

Dear Governor Malloy,

First, I commend you for your continued focus on fixing our broken pension funding system. Under your leadership, arbitrary reductions to the state's actuarially required contribution (ARC) to the State Employees Retirement System (SERS) were eliminated and full ARC payments have been made each year since 2012, despite significant budgetary constraints.

However in spite of your efforts, historic underfunding, questionable actuarial assumptions and a substandard funding methodology continue to plague the system. The funding methodology and actuarial assumptions the state has relied on over the past two decades for its two largest pension funds, SERS and the Teachers' Retirement System (TRS) has resulted in inadequate contributions to the funds, leaving the state with rapidly rising ARCs and large unfunded liabilities. The increasing costs are placing a significant burden on the state budget. Pension costs are rising faster than state revenues, requiring cuts to other important services and tax increases to make the necessary payments. The state's negligent past actions now leave only 17 years on our current amortization schedule to pay down almost $15 billion in unfunded liability in SERS and more than $11 billion in TRS. Under a best case scenario, the state's combined ARCs to the funds will nearly double to almost $5 billion in 2032 and will be significantly higher if current assumptions are not met. As you have said, it is time for the state to reform our pension funding methodology in a way that will create more manageable and predictable payments in future years, while responsibly paying our past and present obligations. As we consider our options to reform our funding methodology we should focus our efforts on solutions that meet generally accepted actuarial best practices, retain market confidence in our state's financial position and create predictable payment schedules with a clear path to paying off our past obligations.

Recently, you proposed a solution to our current funding system for SERS that calls for separating Tier I retirees from the SERS plan and funding their benefits on a pay-as-you-go basis. The proposal has some significant strengths. It creates more manageable and predictable annual pension costs over the long-term. It also creates a well-funded retirement system for non-Tier I employees, which will have less demand for liquidity and will allow the Treasurer to more aggressively invest the assets to achieve higher returns. However, your proposal does raise important questions, some of which were highlighted by Secretary Barnes in a recent letter to you, including:

- What is the impact on federal and other fund fringe benefit recoveries?
- How will credit markets react to splitting Tier I members into a pay-as-you-go plan?
- Are there legal constraints on the method of separating the assets between the two groups?
- Will there be an impact on the pre-tax status of Tier I member pension contributions?
- What is the long-term cost to the state in foregone investment returns as a result of abandoning a prefunded strategy for Tier I employees and retirees?

Obtaining answers to some of the above questions may be challenging as there are few state-level examples to reference. In fact my office has only been able to find one state-level pension fund that has a pay-as-you-go portion, the Indiana Teachers' Retirement Fund. It includes a pay-as-you go system for a closed group of teachers who retired prior to 1996 and is bolstered by a dedicated revenue stream. Generally, states have moved away from pay-as-you-go funding systems as they are not actuarially sound and require greater contributions in the long run.[1]

In addition to the questions that have been raised about the impact of splitting Tier I retirees into a pay as you go system, the proposal to move to an open amortization period for the remaining tiers should also be thoroughly examined. The Government Finance Officers Association (GFOA) recommends defined benefit pension plans "Adopt a funding policy targeting a 100 percent ratio [that] provides for a stable amortization period over time."[2] GFOA cautions against using open amortization periods, stating "Public officials and retirement system trustees should exercise extreme caution when considering the use of open amortization since this method can delay full amortization indefinitely, and could even result in the amount to be amortized increasing rather than decreasing."[3] If we are not cautious, the use of an open amortization period could put the pension plans back on the same unsustainable funding path that we have experienced over the past two decades.

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[1] Philip Martin McCaulay, FSA,EA, FCA, MAAA. "Public Pension Plan Funding Policy", American Society of Actuaries. 2010. file:///C:/Users/JWOJCIK/Downloads/mono-2010-mrs10-mccaulay%20(1).pdf

[2] GASB. "Sustainable Funding Practices of Defined Benefit Pension Plans". October 2009. http://www.gfoa.org/sustainable-funding-practices-defined-benefit-pension-plans

[3] GASB

More traditional adjustments to our pension funding system have the potential to achieve the same goals as your recent proposal without creating the uncertainty inherent in the unorthodox approach of moving a portion of retirees to a pay-as-you-go plan or moving to an open amortization schedule.

As an alternative to your proposal, I would recommend:

- extending the current amortization period ;
- lowering investment return assumptions; and,
- changing the methodology for amortizing gains and losses based on variations between actual and assumed experience.[4]

The above approach has the potential to reduce the volatility of future ARC payments and create a more manageable schedule for paying down the unfunded liabilities while utilizing actuarial best practices currently in place in other states.

Moving from a percent of payroll payment schedule to a level dollar payment schedule as you have recommended will also help to more quickly pay down our unfunded liabilities and reduce future costs. A level dollar payment schedule is recommended by the Society of Actuaries for defined benefit plans and required for non-government plans under ERISA.[5]

We should also consider regular independent comprehensive audits of the plans' actuarial valuations to determine the reasonableness of the actuarial methods and assumptions being used. Such regular audits will help right the ship should the state begin to veer off course again. GASB recommends such audits every 5 to 8 years.[6]

The problems with our current funding systems are clear, but we must be very careful to avoid crafting a solution that creates additional unnecessary long-term costs to the state. A poorly crafted solution could result in lost federal revenue through reduced fringe benefit reimbursements, higher borrowing costs from a bond rating downgrade and higher total long-term contributions as a result of foregone investment returns. A traditional approach that is rooted in actuarial best practices will limit all of the above risks and should be our first option in tackling this problem.

Our state faces unsustainable future pension payments under our current system. I am in full agreement with your assessment of the problem and the need for action. I propose we engage the plans' actuaries to investigate the potential for a traditional solution to our current funding

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[4] One promising option would be to amortize annual actuarial gains and losses over a 20 or 25-year period. Such a policy would reduce annual fluctuations in contributions and avoid the inherent risks associated with a closed amortization period in which large losses near the end of the closed period require large increases in annual contributions to make for such losses in a condensed time frame.

[5] McCaulay

[6] GASB

problems that will meet generally accepted actuarial best practices, retain market confidence and create a predictable payment schedule that establishes a clear path to paying off our past obligations.

I thank you again for your leadership on this issue and look forward to working with you over the next several months to craft the best possible solution to the state's pension funding crisis.

Sincerely,

Kevin Lembo
Comptroller