BUDGET/ECONOMY/TAXES

Making a dent in our pension liabilities: A new solution

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The General Assembly has authorized the creation of the Connecticut Pension Sustainability Commission which is tasked in 2018 to evaluate a potentially significant solution for funding State's pension liabilities: the in-kind contribution of the state's real assets.

Connecticut has $33.8 billion in underfunded pensions and our five largest cities owe another $2.1 billion. These liabilities, coupled with other legacy obligations like retiree health care and bond debt service, are the source of the "crowding out" problem with the state's budget – as well as municipal budgets – that makes our structural deficits so maddeningly difficult to reverse.

Connecticut carries about $18 billion of real assets, valued at cost, on its balance sheet. An in-kind contribution of even a fraction of these assets, at their fair market value, could make a meaningful dent in our pension liabilities.

Government-owned assets as obligation payments?

The use of real assets as a form of payment was the key to settling the City of Detroit's Chapter 9 bankruptcy in 2013-2104. During that bankruptcy case, I served as financial advisor to several European banks that had financed a $1.4 billion contribution to Detroit's grossly underfunded pension.

These creditors accepted the transfer of certain valuable real estate along Detroit's waterfront and downtown area, including the Joe Louis Arena and the Detroit Windsor Tunnel.

As the new owners of city assets, the creditors' long-term recovery would be dependent on their willingness to invest new money to maximize the economic utility of these assets. Judge Steven Rhodes specifically cited this creative alignment of the city's redevelopment with creditor recovery as an important feature of the city's successful exit from bankruptcy.

My experience with Detroit showcased how real assets could be used as a form of recovery to satisfy legacy obligations. The Legacy Obligation Trust ("LOT") model, as described below, was the catalyst for our state legislature to create the Connecticut Pension Sustainability Commission in the budget passed in October 2017.

The Legacy Obligation Trust model

The basic construct is that a government makes a contribution of real assets (known as an "in-kind contribution" – a fancy way of saying "not cash") to a trust for the benefit of one or more underfunded pensions. The trust issues Certificates of Trust, much like shares of stock, and divides them among the various pension funds the government unit sponsors. The government unit gets an immediate credit against its unfunded liability based on the valuation of the assets contributed to the trust. The pension's funded ratio goes up, which has the added benefit of reducing the "catch-up" payment the sponsoring government unit must make and thus has an immediate and positive cash flow impact on the its budget.

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The Pension Sustainability Commission's feasibility evaluation of the LOT model would likely include (1) an analysis of all state-owned assets, which include raw land, buildings, airports, roads, health care facilities, and other categories and (2) identifying a subset of those assets that (a) the state does not need to own to deliver government service *AND* (b) has market development potential.

The fair market value of this subset of assets would have to be determined by independent valuation experts and then the state would select which assets should be contributed to the LOT.

Economic vs. political utility

An underlying presumption of this construct is that a government will generally seek to maximize political utility rather than economic utility in the management of its owned real assets.

Transferring an asset to an independently and professionally managed LOT can minimize the political dynamic that can lead to inefficient management. The independent manager will function almost like an outsourced economic development officer for the government but the incentive structure will be tied to the change in the economic value of the assets contributed to the trust within the confines of the trust's charter.

The LOT manager would be empowered to sell or lease the assets and even contribute the asset to a joint venture in exchange for equity. Of course, the governance rules for the manager and an oversight function must be established from the outset to ensure full transparency and fair, arms-length, market-driven management.

Assumption of growth

Each year, the assets in the LOT would have to be valued and, hopefully, would increase in value based on the efforts of the LOT manager. As the LOT value increases, it further offsets the pension liability without any additional cash investment by the State. In other words, the State benefits when there are policies in place that stimulate the value of the LOT assets located in Connecticut. This gives the legislature incentive to foster such economic policies that lead to jobs, population increases, and enhanced tax revenues from new growth rather than increased tax rates. To be fair, asset valuations can decline – just as the equity and bond assets in the pension fund can decline, too. Hence, the Pension Sustainability Commission must weigh all of these factors – and many others – during its task this year.

Have government assets ever been used to pay pension liabilities before?

In 2017, the City of Hartford received a $5 million credit against its pension liability when it transferred the title of Batterson Park to the City's pension fund. This one action helped the city narrow its cash budget deficit and demonstrates that an in-kind contribution of real assets can successfully be used to offset pension liability.

The LOT model would pick up on this concept and provide the overlay process of an economic development plan as well as dedicated professional management to ensure that the value is maintained and enhanced: vacant land cannot produce cash flow unless it is entitled and developed through a sale, lease, or joint venture.

As an aside, if Connecticut chooses to pursue the LOT model, state assets that are located in the City of Hartford and contributed to the trust create an opportunity to add them back to the city's grand list and improve the property tax base.

On a much larger scale, I offer an example from the Land Down Under: Australia's third largest state, Queensland, experienced a fiscal budget deficit in 2009 in the wake of the global recession. Rating agency downgrades followed rising deficits that ultimately prompted Queensland to announce it would seek to sell or lease major government-owned assets in response to the crisis.

After strenuous public objection to the outright privatization of assets, Queensland contributed the state-owned Queensland Motorways Ltd., a 70-kilometer state-owned toll road, to the pension fund. Queensland received an AU$3 billion credit against its underfunded pension. The pension fund hired professional infrastructure managers who improved operations and expanded the toll road.

In less than five years, the pension sold the toll road to the private sector for AU$7 billion. In short, Queensland unlocked AU$7 billion of hidden equity value sitting on its balance sheet for the benefit of the pensions.

Out-of-the-box thinking

There is not a reasonable way to cut, tax, or grow our way out of Connecticut's pension problem. Evaluating extraordinary solutions and then having the courage to implement may be our best hope.

The blue-ribbon Commission on Fiscal Stability and Economic Growth has already heard testimony on the use of out-of-the-box approaches to Connecticut's pension challenges, including the use of in-kind contributions of assets. As the Pension Sustainability Commission begins its work to consider the use of in-kind asset contribution to relieve pension liability, it can consider how to align the interests of economic development, job creation, and satisfying the legacy obligations Connecticut owes to its retirees who have made our state a wonderful place to live.

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