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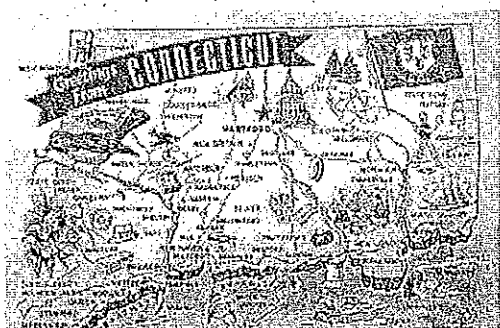
Has Connecticut Found A Solution To Underfunded Public Pensions?



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Public pensions are underfunded.

Okay. I know, I know. We've all seen this headline before. Ad nauseum. To add to that, nothing seems to improve. Another year goes by and state employee pensions are still underfunded. The numbers don't lie: at the

close of 2016, the cumulative pension funding deficit stood at \$1.4 trillion—the 15th annual increase in pension debt since 2000. It's not like the states aren't trying to make up the shortfalls. In fact, contributions to pensions from state taxpayers *doubled* since 2000. Apparently, to no avail. It's like listening to an endless repeating loop of hold music. Your ears stop listening after a while.

The State of the State: Connecticut

Well, not everyone's ears. State policy makers living with the implications of these deficits (often not of their own making) are listening carefully to proposed solutions. One state that is paying particularly close attention is Connecticut.

Connecticut faces some considerable challenges. By the close of 2017, job growth recovered only 82.3% of the jobs lost in the Great Recession of 2008. Connecticut faces population outmigration, the loss of at least one major corporate employer (General Electric), and the near bankruptcy of Hartford, the state's capital. But

the greatest long-term structural risk to the state's financial stability is the growing pension funding gap.

It was a key factor in the recent rating downgrades on the outstanding \$25.5 billion net general obligation and state-backed debt at the close of 2017 (itself up 26.4% from fiscal year 2012). Moody's dropped its Aa3 rating to A1, Standard & Poor's from AA to A+, and Fitch from AA- to A+.

Talk about kicking a guy when he's down.

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But the dour pension numbers bear out why the rating action was inevitable. The state sponsors five pension plans: State Employees Retirement System (SERS), Teachers Retirement System (TRS), Judges' Family Support Retirement System (JFS), Probate Judges Retirement System (JRS) and Municipal Employees' Retirement System (MERS).

The three that are of most concern are SERS, TRS and JFS. The most recent numbers show why. At the close of fiscal year 2016, SERS had a \$22.9 billion funding gap, TRS \$14.2 billion and JRS \$0.24 billion. Correspondingly, funded ratios for SERS, TRS and JRS (fiscal year 2016) were 31.69%, 52.26% and 43.76%, respectively with a combined net pension liability of \$37.3 billion. While the state is meeting its obligated payments to the plans, it is not making any additional payments towards reducing that liability.

A History

The problems started from the get-go. TRS offered benefits to members as far back as 1917; SERS began prior to 1939. At that time, benefits were paid from the annual budget. No money was saved to pay for future retiree benefits. These legacy costs just ran up unabated for decades until true actuarially-based

prefunding began, first for SERS (1972) and later for TRS (1980). By then, it was too little too late to true-up those years where there were no contributions.

Literally compounding the problem, the *real* rate of return on investments in the pensions underperformed the *assumed* rate of return over that time. The combination of unfunded legacy costs and underperforming investments saddled both systems with the massive unfunded liabilities current policy makers are now struggling to resolve.

But wait, there's more. The state's Other Post-Employment Benefits Plan (OPEB) is also underfunded. Predominantly covering pensioners' health care costs in the Teachers Plan and the State Employee Plan, its liability totals \$20.7 billion.

That puts the combined pension, OPEB and debt service payments at nearly 30% of state revenues, among the highest fixed cost ratio in the nation. Totaling up all three, the long-term liability per capita is close to \$21,500 for every man, woman, and child in the Nutmeg State.

The Standard Solutions

Connecticut is exploring a number of approaches that other state and municipal pension funds with underfunding issues have used, such as increasing employee contributions, changing the formula for cost-of-living adjustments, adopting a cap on pensionable compensation for new hires, and offering new hires a defined contribution plan, cash balance plan or a "DB-DC" hybrid plan. Some have been implemented.

A Fresh Approach

As pension solutions go, those are all pretty standard stuff. But the other approach Connecticut is considering is truly fresh. The state's inventory of real assets on its books, such as office buildings, parking lots, raw land or highway right-of-ways, identifies nearly 7,000 properties. An initial estimate is that these assets could have an overall value in the billions. If the state were to include certain state enterprises, such as toll-roads, that number could reach even higher.

A question arose: In lieu of cash, can the state donate any of these real assets as an in-kind contribution to its pension funds?

At first blush, the potential positive outcomes seem to make this very compelling. Obviously some of these assets don't qualify—the state isn't transferring any of its public parks any time soon! However, many of those assets that might qualify have been on the state's balance sheet for years. Correspondingly, book values are far below current market values. Transferring those assets from the state's balance sheet to the pension funds investment portfolio recategorizes their value from book to current market. That's an immediate mutual gain to the pensions and the state: the pensions get a boost in asset values and the state gets a lower pension liability with no cash outlay.

Theory to Reality

Transferring billions in state assets isn't something one does in haste. It is a complex venture with a host of political, financial and operational considerations. To analyze all aspects of the policy and make recommendations as to how to proceed, the Connecticut General Assembly created the Connecticut Pension Sustainability Commission.

The Chair of the 13-member Committee is State Representative Jonathan Steinberg (D-Westport, 136th District-CT). He is clear-eyed and unflinching about the serious problem the state faces with the growing pension underfunding. As a four-term legislator, he is keenly aware that reducing the liability is a top priority if the state is to extricate itself from its persistent budget problems. The pension underfunding burdens the state with underlying, long-term structural financial issues that need to be addressed in a systemic way. He is direct: short-term fixes or deferrals don't provide true solutions—and that includes further spending cuts and tax increases.

With options limited, the asset contribution proposal has his full attention. Acknowledging there are a myriad of factors that have to be balanced, Representative Steinberg put three at the top of the list: identify the highest

opportunity assets, determine the value of those assets, and establish what organizational structure might be best for the pensions to hold those assets.

Identifying Assets

To appropriately identify the highest opportunity assets, the optimal framework focuses on assets that maximize value for the pension as well as lower costs for the state. Key targets are property or land that is currently underutilized but, if transitioned to its highest and best use, could increase in value considerably.

Equally interesting are state enterprises. Often affiliated with infrastructure projects, such as toll roads or parking garages, these offer generally stable, long-term cash flows and potential asset appreciation consistent with the long-term liabilities of the pensions. This has considerable precedent. In Europe, it is common for public pensions to own interests in as well as fund improvements or expansions to state infrastructure enterprises.

Valuation

This is not the first time public assets have needed objective valuations for transfer or sale; there are numerous experts, best practices, market standard methodologies, and metrics to guide in that process. Wisely recognizing that valuation is critical to accurate accounting as well as maintaining the legislature's role in due diligence and oversight for the public, the Chair is holding hearings and inviting experts to offer their views. Michael Bennon of the Global Project Center at Stanford University is one such expert, with successful experience internationally in public asset valuation and transfer. Models exist based on completed transactions that maximized values for all stakeholders. Even so, it's always challenging, he noted in his testimony to the Committee. "There will always be 'ex-post' reports," says Bennon, which only "adds to the difficulty of valuing these assets." Apparently, even in pension asset valuations, there are armchair quarter backs.

Organizational Structure

Since the pensions can't hold physical assets directly, determining the pensions' ownership in any separate entity holding transferred assets has to be vetted. One structure being actively considered is putting assets in a separate trust. The trust would be a private entity, hiring private managers to run the business or develop the property. While Representative Steinberg noted that a trust structure where there would be shared risk was appealing, "the criteria we might use to determine what to donate to an independent trust is still very much open for conversation."

A High Impact Ancillary Benefit

Given the pressures on the state budget and the pensions, nearly everyone is focused on the immediate impact the transfer would have there. Overlooked is the enormous economic stimulus this transfer policy could have around the state.

Conversion to highest and best use of property or raw land opens up opportunity for renovation, refurbishment, retrofitting, and expanded development. For example, an office building can be repurposed to address needs in high impact sectors such as affordable housing, business incubators, senior care, or satellite medical centers. Clean energy and LEED certification are a component of retrofits, which could include matching Federal or foundation grant dollars for solar panels and microgrids. Not only does this create construction jobs immediately, but also permanent jobs working in the completed repurposed buildings.

A National Following

Other states and cities facing pension shortfalls are quickly picking up on the implications of this. Calls have come in from numerous state officials making inquiries about the process Connecticut is considering. Since every state and city has some assets on the balance sheet that are either underutilized, can be combined, or simply cost more to own than an alternative, having a mechanism to transfer those to the pension is potentially truly a win-win.

Time Line

While the committee's report is due January 1, 2019, it might take as long as two years to put everything in place before the state can even begin to create a schedule of asset transfers and start to execute on the plan. For those impatient for a solution, that may sound like a long time given liabilities are accruing at millions of dollars a day. But considering it took nearly 100 years to get to where things are now, two more years isn't unreasonable considering the solution could have a dramatic corrective impact.

What legislators and public administrators understand is that, with skeptical capital markets and an equally skeptical public, a careful, prudent approach rebuilds confidence and demonstrates that policymakers are serious in their intent to fix the problem.

Moreover, because this is as much a political process as a financial one, there will always be disagreements as to whether the actions are sufficient or right. However, tangible actions towards a solution—albeit initially modest—is a far better alternative than stagnation. It is a sign that the state of Connecticut is transitioning towards stabilization.

My heartfelt thanks to Les Richmond, ASA, EA, MAAA, FCA, Vice President and Actuary at Build America Mutual Assurance Company for his invaluable guidance and endless patience in walking me through the intricacies of the pension section of Connecticut's Comprehensive Annual Financial Report for 2017.

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