

Executive Summary

In October of 2017, the State Legislature established the Pension Sustainability Commission with the express mandate to investigate the feasibility of donating state capital assets to the SERS and TRS pension funds to mitigate the impact of unfunded liabilities on the state budget. This report represents the Commission's best efforts to provide guidance and recommendations on this concept, in spite of significant constraints.

Although the Commission was given a one-year term to perform its labors beginning on January 1, 2018, the slow appointment process resulted in a late start in July of 2018. An abbreviated working window, combined with the absence of necessary resources to validate some aspects of the concept, have frustrated the Commission's ability to reach closure on several aspects of the concept. One of the recommendations offered to the Legislature in this report is to extend the Commission's mandate, beyond the current temporary status, so as to provide the opportunity to complete its work – assuming the necessary resources are also provided.

Statutory Mandate

The Connecticut Pension Sustainability Commission was established to study the feasibility of placing state capital assets in a trust and maximizing those assets for the sole benefit of the state pension system. Specifically, the Commission was charged with:

- Performing a preliminary inventory of state capital assets for the purpose of determining the extent and suitability of those assets for inclusion in such a trust;
- Studying the potential impact that the inclusion and maximization of such state capital assets in such a trust may have on the unfunded liability of the state pension system;
- Making recommendations on the appropriateness of placing state capital assets in a trust and maximizing those assets for the benefit of the pension system;
- Examining the state facility plan prepared pursuant to section 4b-23 of the general statutes and the inventories of state real property submitted pursuant to section 4-67g of the general statutes;
- Making recommendations for any legislative or administrative action, as deemed appropriate, necessary for establishing a process to (A) create and manage such a trust and (B) identify state capital assets for inclusion in such a trust.

The statute stipulated that Commission members would be appointed by Constitutional Officers and Legislative Leadership, some members to have specific backgrounds such as: experience in banking and private sector financial management, and a state employee collective bargaining unit that benefits from the state pension system.

The Commission's final report was to be delivered to the Legislature's Finance, Revenue & Bonding Committee as of January 1, 2019. However, a temporary extension was sought and granted by the Speaker of the House so that the Commission could complete its report.

Background

The State of Connecticut has experienced serial budget deficits dating back more than a decade. Analysis of these deficits indicate that escalating fixed costs have contributed significantly to the imbalance, specifically required annual payouts to retired teachers and state workers. This growing obligation has crowded out spending for other governmental programs and created uncertainty and concern for businesses and credit markets, conceivably depressing economic vitality. [charts]

The cause of these burgeoning pension costs is primarily the failure by the State to make annual contributions to the pension funds and Other Post-Employment Benefits (OPEB) in anticipation of actuarially-projected future obligations – typically described today as the “unfunded liabilities.” Costs are also unusually high because of terms in the union contracts signed by both parties as well as now clearly inflated expected rates of return on State pension investments. [charts]

The State has struggled to find a path to a balanced budget with these increasing fixed costs. Early in 2017, an information forum sponsored by members of the Finance, Revenue & Bonding Committee included a presentation posing the opportunity to consider a new concept, implemented overseas but not in the U.S., what subsequently came to be called the Legacy Obligation Trust, or LOT. It was this concept, viewed as a potential means to mitigate state pension unfunded liabilities, which led to the Legislature’s decision to create the Pension Sustainability Commission, specifically tasked with proving out the concept (NOT tasked with all aspects of pension sustainability, despite the expectations of many!).

Commission Information Gathering Process

At the beginning of the Commission’s tenure, the focus of invited presenters was on the background and causes of the State’s fiscal condition and deficit history. Presenters included Ben Barnes, Secretary of the Office of Policy & Management, and Jim Millstein, Principal of Millstein & Co (presentations in Appendices). This report contains a number of charts and other data-derived documents which illustrate the sources and consequences of both the current and future budget situations. It’s important to note that, as dire as the budget deficit situation is as of this date, escalating fixed costs related to the Teachers Pension will lead to even more significant deficits, unless addressed by Connecticut’s government in some fashion. The presentations also noted efforts to date intended to address the deficit situation. Presenters included Jim Smith and Bob Patricelli, the Chairs of the former Connecticut Commission on Fiscal Stability and Economic Growth, which had previously considered transfer of the CT Lottery to the pension funds (Report in Appendices).

Subsequent presentations focused on examples of initiatives similar to the LOT concept instituted overseas (Queensland Motorways,...) as well as New Jersey’s experience in seeking to use its state lottery to reduce budget deficits there. [some details on other examples] The Commission also entertained consideration of other potential solutions [such as...]

Lastly, but very importantly, the Commission examined the consequences of doing nothing, leaving the State in the untenable circumstances of increasing budget deficits on State services and the local economy. [charts]

Commission Deliberative Process

Early on in the Commission's discussions, it was agreed that the process would be best served by a better understanding of several key areas: accounting/actuarial benefits; the state capital real estate asset universe (including the CT Lottery) for potential donation to the funds; legal issues; and economic opportunity considerations. Working groups (Membership in Appendices), comprised of Commission members, were created to "drill down" on these subjects and then report back to the full Commission on issues, insights and recommendations. The group entrusted with evaluating the State capital asset opportunity was particularly important. Much discussion centered on the critical issue of whether there were sufficient "eligible" assets to justify the creation of an independent LOT manager structure to implement the concept. Unfortunately, the short timeframe for the workgroups' deliberations and the aforementioned lack of resources made it virtually impossible to reach conclusions on several of the essential issues.

The Legacy Obligation Trust Concept

The Legacy Obligation Trust concept is predicated on the assumption that governmental entities own a multitude of capital assets but typically do a mediocre job of managing such assets to optimize value, primarily because that's not their priority. The concept involves the governmental unit making an in-kind contribution of real assets -- such as land, buildings, infrastructure or enterprises -- to a professionally and independently managed trust. The trust "manager's" responsibility would be to manage such donated assets to maximize value for the express benefit of one or more underfunded pension funds. In return, the manager would be compensated for the additional value created.

Importantly, the LOT concept was not intended to be a "silver bullet" for the pension sustainability problem. Rather, it might serve, at best, as a contributory means to mitigate the pension crisis by increasing funded ratios and restoring confidence in the State's fiscal stability.

Several potential benefits would accrue from such a trust, specifically:

- The government unit would receive an immediate credit against its unfunded liability based on fair market valuation of the assets contributed to the trust;
- The pension or OPEB funded ratios would increase, potentially improving the credit agencies' assessment of the governmental unit;
- The pension funds would receive an immediate, positive cash flow impact on the governmental unit's budget, as the "catch up" payment for the underfunding is reduced.

An adjunct to the LOT concept is the potential creation of Certificates of Trust (COTs), an instrument which would potentially increase the liquidity of donated assets by establishing a public market for such certificates, suitable for investment by public and private sector portfolio investors.

Modified LOT “Hybrid” Concept

Then State Treasurer Nappier and staff presented an alternative approach to the LOT concept, embedding the manager’s role within the Office of the Treasurer. As stated in the presentation, “A prudent transfer of State assets that can be developed and improved within the confines and authorities of current pension fund governance.” Components of the plan:

1. Monetize CT Lottery revenues and transfer other state capital assets to the TRF in order to mitigate the impact of moving to a more realistic investment return assumption of 7.5% (from 8%). Assets would be invested consistent with the Investment Policy Statement, including asset allocations, approved by the Investment Advisory Council, and the requirements of pension fund governance.
2. Pay off the Pension Obligation Bonds (POBs) in Fiscal Year 2026 (the first full fiscal year they can be redeemed), thereby allowing for more options for responsible recalculation of future contributions.
3. Following payoff of the POBs, re-amortize the TRF’s remaining unfunded liability and further reduce the investment return assumption to 7%, consistent with capital market expectations.

This proposal would potentially: generate net General Fund savings of \$440 million from FY 2020 through 2025; bring General Fund costs roughly in line with budgetary funding “constraint;” and improve TRF cash flow by \$560 million.

After Fiscal Year 2025, the State would be in a position to pay off the POBs for roughly \$1.9 billion, using the estimated State ADEC and the POB debt service payment for that year, subsequently Saving \$2.25 billion in debt service through FY 2032.

Conclusions

1. Virtually all DOT and DEEP capital assets are **not** appropriate for donation to the pension funds and can’t be considered. However, improvements of such real estate assets to generate revenue which can benefit transportation and environmental investment priorities should be considered.
2. Donating the CT Lottery to the pension funds (securitization) is not as sensible as donating only the proceeds of the Lottery.
3. Donations of capital real estate assets pose challenges for pension fund liquidity and portfolio balance. Managing the trust within the aegis of the Treasurer’s Office may mitigate these concerns.
4. The Commission had insufficient time and resources to perform the inventory analysis as mandated by statute and can’t conclusively determine whether there are sufficient capital assets to justify the trust concept. However, it did establish a set of asset selection criteria to be considered when evaluating the suitability of specific capital state assets for donation.

Recommendations

1. The Legislature should recommission the group to continue its work through conclusion, for a period of not less than one year.
2. The Legislature should appropriate \$100,000 so that necessary validation by third-party experts can be accomplished.
3. The reconstituted Commission should focus on an in-depth analysis of capital real estate assets to determine eligibility and relative “attractiveness” for donation, taking into account potential value and obstacles. The analysis effort should yield a decision as to whether there are sufficient eligible assets to justify the creation of a LOT-like management entity.
4. The Commission should focus on a LOT-like concept based on the “hybrid” approach championed by former Treasurer Nappier.
5. The Legislature and the Governor should consider donating the proceeds of the CT Lottery (not the Lottery asset itself) to the Teachers Pension Fund for a period of six years, or until the bond can be reamortized without violation of the bond covenants. The method of donation should be based on the model proposed by former Treasurer Nappier.