

## HISTORY OF SERS AND TRS FUNDING

The main reasons for the poor funding status of the State Employees Retirement System are that it began offering benefits before 1939, but operated entirely on a pay as you go basis until 1973, when a phase-in to actuarial funding began. The first full ARC payment was made in 1987. Between 1989 and 2009, five retirement incentive programs (RIPs) were adopted, however, no adjustment was made in the state's funding plan to account for the actuarial cost of these RIPs. The state's actuarially required contribution (ARC) was also routinely reduced between 1993 and 2000 and was further reduced by over \$300 million between FY 2009 and 2011.

In an effort to reduce the cost of the system, new less-generous tiers were established in 1984 (tier 2), 1997 (tier 2A), 2011 (tier 3), and 2017 (tier 4). In addition, there is an increasingly less-generous formula for retiree COLAs for employees who retire after June 30, 1999, October 2, 2011, and June 30, 2022. Finally, changes to the normal retirement age, early retirement penalty, and employee contributions that applied to existing employees were adopted in 2011 and 2017.

As noted above, funding for the system began to transition from pay-as-you-go to a pre-funding model starting in 1973, with the first full ARC contribution being made in 1987. Since then, in 1995 the actuarial method was changed from entry age normal to projected unit credit and a new 40-year amortization schedule was adopted. That amortization schedule was rebased in 1996 and 1997. In 2009, the return assumption was reduced from 8.5% to 8.25%, and then further reduced to 8.0% in 2013. In 2017, a major modernization of the funding approach was adopted which included returning to entry age normal, reducing the return assumption to 6.9%, transitioning from level percent of payroll to level dollar amortization over a five year period, extending the amortization period to 2047 for approximately 4/5ths of the outstanding liability and layering future gains and losses over separate 25-year periods. This approach was widely viewed as positive by ratings agencies, and stress testing performed by the Pew Charitable Trust has shown that the state faces very little risk of insolvency in the SERS plan due to market variations.

In 2019, Governor Lamont proposed combining the transitional and statutory amortization bases that are to be paid-off by 2047 as well as the adoption of market performance risk-sharing features for future retiree's COLAs.

The reasons for the poor funding status of the Teachers' Retirement System, like SERS, include late adoption of actuarial prefunding, consistent underpayment by previous legislatures of the statutorily required annual contribution and optimistic return assumptions. TRS began promising benefits in 1917, but was funded on a pay as you go basis until 1980, and full funding of the ARC was not achieved until 2006. While the full calculated ARC has been paid since then, the return assumption was 8.5% until 2017 when it was reduced to 8.0%. Changes in retiree COLA formula were adopted for members who retire after 1992 and will be further reduced for members who joined the system after 2007. Member contributions were increased in 1992 and 2018.

In order to improve the funding of the system, the state issued \$2.2 billion in Pension Obligation Bonds in 2008, those bonds contained a covenant that pledged that the state would make the ARC payments under the amortization scheme that was adopted at the time.

In 2019, Governor Lamont proposed that the state make a number of changes that mirror the 2017 actuarial changes made to SERS. Those include: reducing the return assumption to 6.9%, extending the amortization period to 30 years, transitional from level percent to level dollar amortization over five years, and layering future gains and losses over new 25 year periods. In order to ensure that adequate provision has been made to holders of the 2008 pension obligation bonds, the Governor and Treasurer have proposed the establishment of a Teachers' Retirement Fund Bonds Special Capital Reserve Fund, which would contain a reserve that would be available to support the cost of principal and interest payable to bond holders in the unlikely event that the state did not otherwise make such funding available. Initially, the Special Capital Reserve Fund would be funded via a General Fund appropriation which is possible due to the projected FY 2019 surplus. The state would also pledge lottery revenue to refill the fund should the balance in the fund ever fall below the necessary level.

#### CONTRIBUTION OF AN ASSET

In February 2019, Governor Lamont proposed that unfunded liabilities in both the Teachers' Retirement Fund and the State Employees' Retirement Fund be treated in a similar fashion. For SERS, the unfunded liability as of June 30, 2016 would be funded over a 30-year period ending in FY 2047 and for TRS, the liability as of June 30, 2018 would be funded over a 30-year period ending in 2049. In both systems, future gains and losses would be amortized over new 25-year periods. If we assume that any potential asset contribution would therefore be treated as an actuarial gain in the year in which that asset was contributed, the impact on annually recommended contributions, at an assumed 6.9% discount rate for 25 years, is equal to approximately 8.5% of the value of the asset contributed. For example, if either fund were to receive an asset valued at \$100 million, the State's contribution toward the unfunded liability in that fund would be expected to decrease by approximately \$8.5 million per year for the next 25 years.

Two other factors will influence the estimate provided above. First, SERS is in the middle of a transition from level percent of payroll to level dollar amortization and TRS would begin that transition under the Governor's proposed budget. That means that, if the asset transfer were to be made before the change in amortization method was complete, the impact of an asset transfer would be somewhat smaller than the figure noted above prior to the end of the transition period and somewhat higher thereafter. Second, while the General Fund supports 100% of the unfunded liability for TRS, it only supports approximately 72% of the cost of SERS (the remainder being attributable to positions funded by non-General Fund sources), so the General Fund impact of a \$100 million asset transfer to SERS would be expected to be about \$6 million per year.