Analysis of Changes to Contribution Policy for the
Connecticut State Employees' Retirement System (SERS)

The information below is provided in response to requests for analysis and is based on the information contained in the December 8th Memorandum of Understanding ("MOU") between the State and SEBAC.

The SERS funding policy contained in the MOU calls for:

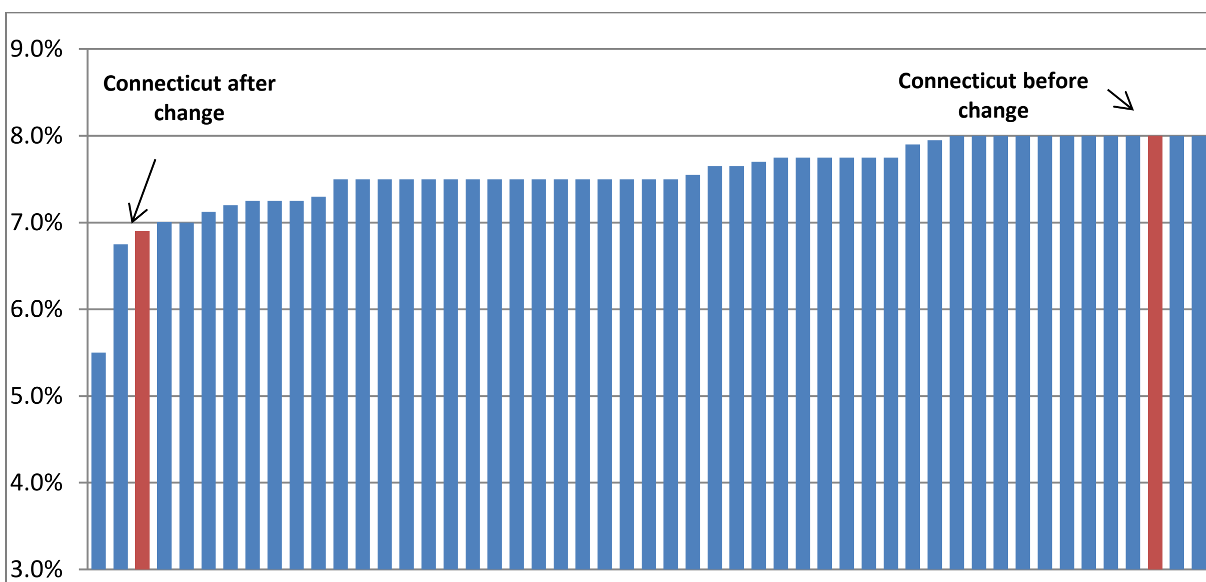
1) using a more conservative assumption for the rate of return on investments (reduced from 8% to 6.9%);
2) ramping up state contributions over a five-year period (with average annual growth in contributions of 7.3% and a projected total increase of $526 million in plan funding by 2022);
3) moving to a fixed payment schedule in 2022 after the 5-year phase in;
4) adopting a specific policy to pay down any future unfunded liabilities; and
5) accounting for pension contributions between the pre- and post-1984 benefit tiers separately.

The proposed changes represent a reasonable and sustainable approach to managing Connecticut's pension liabilities; an analysis by Moody's[1] reached a similar conclusion. The use of a more conservative return assumption and $526 million increase in plan funding over five years will help to make state pension costs more fiscally sustainable over time. While the proposal does result in an extension in the projected date for full funding, the state can evaluate progress in 2022 after the ramp up period is complete. The following analysis provides considerations on each of the five points summarized above.

1. Using a More Conservative Assumption for the Rate of Return

- The reduction in the assumed rate of return from 8% to 6.9% is a positive step in terms of making plan assumptions more conservative and reducing cost uncertainty going forward. Connecticut's return assumption would move from being one of the highest in the country to one of the lowest (figure 1), and more in line with recent estimates of expected returns for US Public Pension plans.[2]
- A lower assumed rate of return would require higher payments in the short-term but reduce the risk of insufficient investment returns and make costs more predictable in the long-term.
- Changing the rate of return assumption doesn't change the underlying economics of the pension plan—benefit payments will need to be made either way.

Figure 1: Assumed Rate of Return on State Employee Pension Investments



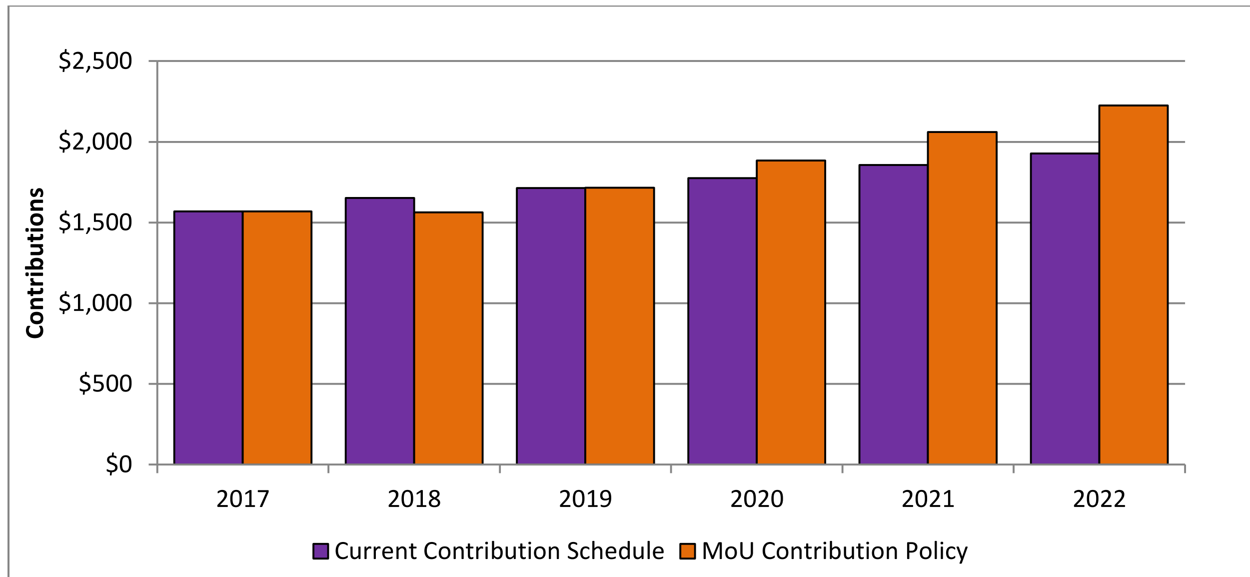
Based on information from state pension plan actuarial valuations and financial reports.

[1] Moody's Investor Services, "Connecticut Restructures Pension Contributions, a Credit Positive," 12/15/16.
[2] Wilshire Consulting, "2015 Report on State Retirement Systems: Funding Levels and Asset Allocation," 2/25/15.

2. Ramping Up Employer Contributions Over A 5-Year Period

- Annual contributions to SERS would increase to a total of $2.2 billion by 2022 (figure 2) before leveling out as part of the new contribution policy.
- From 2017 to 2022, the new policy would put more than half a billion additional dollars into the state pension plan.
- Annual contributions increase on average by 7.3% through 2022 due to the phase-in of the new contribution policies.

Figure 2: Connecticut SERS Contributions from 2017 to 2022 under Current and New MOU Policy



Dollar figures are in millions. Numbers are from actuarial exhibits attached to the Memorandum of Understanding as provided by the Office of Policy and Management.

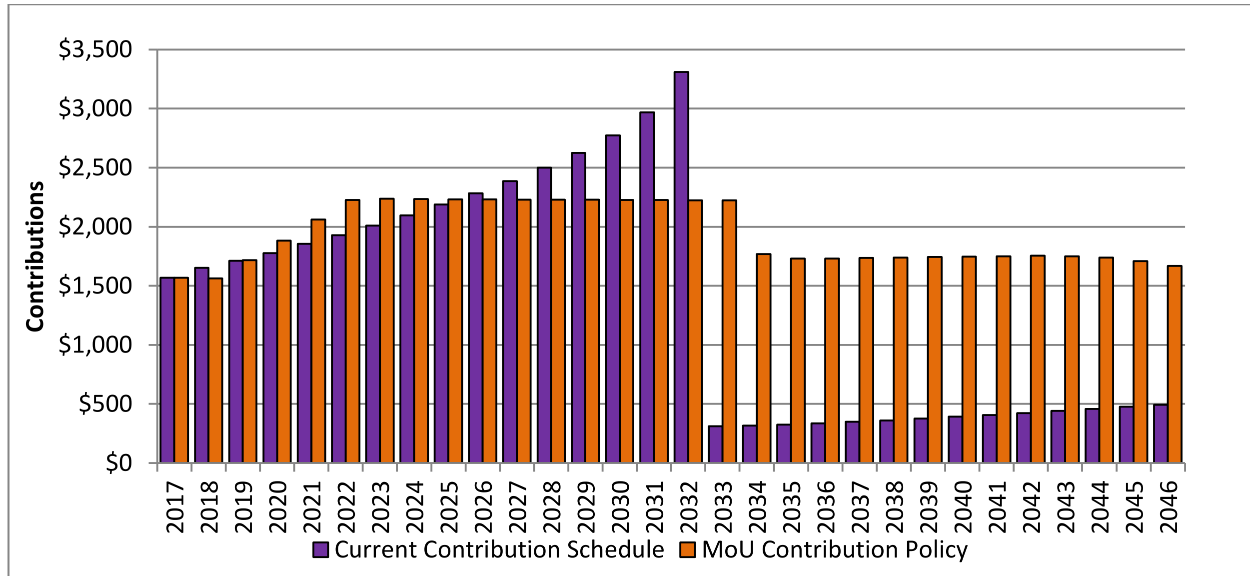
3. Adopting a Fixed Payment Schedule in 2022 After the 5-Year Phase in

- From 2022 to 2033, payments under the MOU plan would be relatively stable at about $2.2 billion. With current policy, payments were scheduled to rise from $1.9 billion in 2022 to $3.3 billion in 2032 before dropping to about $300 million in 2033 (figure 3).
- By 2034, the statutory unfunded liability for the pre-1984 benefits would be paid off under the MOU plan, dropping payments to $1.8 billion from $2.2 billion.
- The changes extend the funding of the unfunded liabilities accrued since 1984 over 30 years while current policy was scheduled to pay those debts off by 2032.
- The changes are designed to make pension costs more predictable by switching from a funding plan with payments that are projected to grow faster than revenue[3] to fixed pension debt payments (*level dollar*).
- All of these projections assume things will go exactly as planned while actual experience over the next 20 years will reflect gains and losses from investment performance and other actuarial factors.

[3] Many states, including Connecticut, set pension debt payments as a *level percentage of payroll* such that the employers costs will grow at the same rate as salary is expected to (currently 3.75 percent expected growth in Connecticut. That pushes pension costs out to future decades and leads to rapid increases in costs in the latter years of a debt payment schedule.

- We recommend that the state review funding progress in 2022 after the five year ramp up period is complete, also taking into account the fiscal health and funding requirement for the Teachers Employee Retirement System (TERS). The review should consider funding policies that would put more money into the plan between 2023 and 2032 while keeping the core policy changes from the MOU.[4]

Figure 3: Connecticut SERS Contributions from 2017 to 2046 under Current and New MOU Policy



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4. Adopting a Reasonable Policy to Pay For Future Unfunded Liabilities

- Current policy required all future investment shortfalls or other actuarial losses to be paid for by 2032. As a result, a recession in 2030 or 2031 would require all of the losses to be made up in a relatively short timeframe. This policy would lead to unpredictable and potentially unsustainable costs.
- An analysis by the State Comptroller found that a loss of 15% of plan assets in five years before the state's pension debt was scheduled to be fully paid off could lead to a more than 250% increase in employer contributions over that time period.[5]
- Rather than require all pension debt be paid for in a single payment schedule (*closed amortization)*, the changes would have future unfunded liabilities paid off under a separate 25-year debt payment schedule (*layered amortization*).
- Having separate payment schedules for future losses will make costs more predictable and sustainable while maintaining a commitment to funding the state's pension promises.

[4] For example, if experience calls for additional funding, the state could consider adding an inflationary component to the fixed payment schedule (*level dollar real*) that would increase funding while still keeping cost growth at or below revenue growth.
[5] Comptroller Kevin Lembo, "An Evidence-Based Approach to Pension Funding Reform". http://andr.ct.aft.org/files/lembo_pensiondocuments.pdf, pg. 21-22.

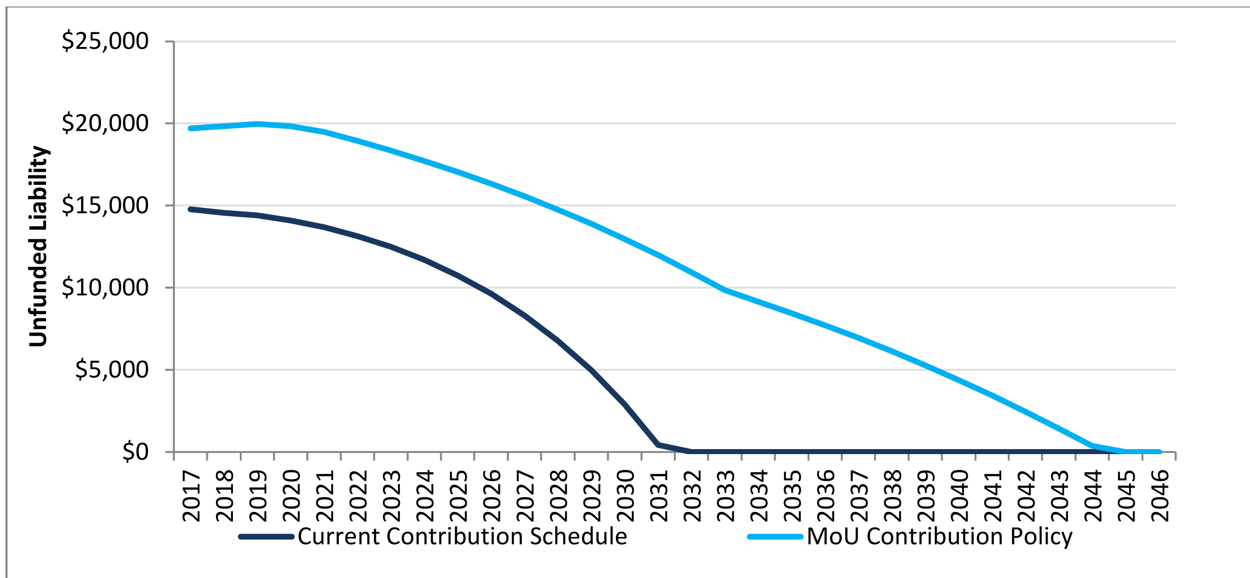
5. Accounting for both the Pre-1984 and Post-1984 Unfunded Liabilities

- The changes maintain the state's commitment to funding the pension debt incurred before 1984 by June 30, 2032. Other unfunded liabilities already on the books would be fully funded by June 30, 2047.
- The core goal of a funding policy is to fully fund all unfunded liabilities within a reasonable time frame while keeping costs sustainable. Meeting other policy goals regarding when to pay for specific unfunded liabilities can also be built into a contribution policy.

Conclusion

The changes to Connecticut's pension funding policies would result in an immediate increase in the reported unfunded liability due to more conservative assumptions. The new policy would increase contributions through 2022 by a total of $526 million and make progress on reducing the state's pension debt. Extending the payment period for the state's pension debt will result in lower funding levels in the interim years and increase the total amount needed to pay for pensions. The funding changes as a whole, including the move to level dollar, the reduction in the return assumption, and the adoption of layered amortization, will make the state's pension payments more predictable over time while still making progress on improving the state's pension funding levels (see figure 4).

Figure 4: Connecticut SERS UAAL under Current vs. New MOU Contribution Policies



Dollar figures are in millions. Projected unfunded liability based on actuarial model developed by the Terry Group.

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