Connecticut at Forefront of Pension Innovation

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The governor is pursuing a new approach to funding the state's main pension plans.

Who would have thought it? Connecticut is on the cutting edge of pension innovation on two fronts: 1) it is one of a handful of states leading the charge to set up a state-run, auto-IRA program for its uncovered private sector workers; and 2) the governor has proposed an innovative plan to address its seriously underfunded pension plans. Since the state initiatives for the uncovered have received a lot of publicity, this blog post focuses on the second innovation.

Connecticut's two largest retirement systems are the State Employees Retirement System (SERS), and the Teachers' Retirement System (TRS). Over the past decade, despite a concerted effort by the State, the funded status for both these systems declined by about 20 percentage points and, as of 2014, stood at 42 percent for SERS and 59 percent for TRS – among the lowest in the nation. The State requested that the Center for Retirement Research provide an assessment of both SERS and TRS.

.The assessment showed that these plans were **behind the eight ball** from the beginning. They had promised benefits from 1939 but did not begin to fund their plans until the 1970s and 1980s.

Once Connecticut did start funding its plans, it did not do a very good job. A systematic analysis of actuarial valuations showed that the state consistently made inadequate contributions to both plans. These inadequate contributions were a combination of using a lax methodology for determining the annual required contribution and then failing to pay even that modest amount. In addition, actual investment returns fell short of the assumed rate after 2000.

As a result of significant underfunding, the majority of pension costs for the State going forward is due to the unfunded liability. These payments are very large and have the potential to crowd out other essential spending. Hence, Connecticut was interested in alternatives.

The **two main options** were to: 1) replace the 2032 full-funding date with a reasonable rolling amortization period; or 2) separately finance benefits for members hired before pre-funding began in the 1970s and 1980s. The rationale for both approaches is that the existing unfunded liability was accumulated over multiple generations and is primarily for the benefits of members hired before the state started to fund its pensions; it is not fair to place the entire burden of paying off these benefits on a single generation.

Under either approach, the state would improve the funding process going forward by switching to a level-dollar approach to amortize the unfunded liability and by reducing the assumed rate of return used to discount promised benefits.

The Governor has proposed to pay the benefits for Tier 1 retirees in SERS on a pay-as-you go basis. Tier I benefits were replaced by less generous Tier II benefits in 1985 for new hires, and 93 percent of the Tier 1 participants are retired, so Tier 1 retirees form an easily identifiable group.

A pay-as-you-go approach for benefits that arose before the state started to fund has a number of advantages. First, it stretches out payments over the longest period possible, providing the greatest generational equity. Second, it changes a malleable obligation into a fixed one; whereas the State faces no sanction for not making its full annual required contribution to the pension fund, the benefit payments must be paid each year by law. Third, pay-as-you-go makes the payment schedule fairly predictable, as it is unaffected by future changes in interest rates and/or investment returns. Finally, separately financing benefits for members hired before pre-funding also clarifies that the cost of benefits for current workers is modest.

While the proposal to pay retirees on a pay-as-you-go basis has created a political firestorm and the details need to be worked out, the approach makes enormous sense and could be very useful to other states that started the funding game with a large unfunded liability.