

## Connecticut Post Employment Benefits Commission

### Outline of Report, as of June 23, 2010

- I. Executive Summary (write this last)
- II. Introduction
  - a. Purposes of Commission
    - i. **Identify the amount and extent of unfunded liabilities for pensions and other post-employment benefits;**
    - ii. **Compare and evaluate the advantages and disadvantages of various approaches for addressing unfunded pension liabilities and post-employment benefits; and**
    - iii. **Propose a short and long term plan or plans for addressing unfunded pension liabilities and post-employment benefits.**
  - b. Commission's approach
    - i. Research funding issues in Connecticut and nationwide
    - ii. Determine and evaluate possible solutions
    - iii. Report on all considerations, whether rejected or not
- III. Overview of Benefits/Plans
  - a. Pension
    - i. State Employees Retirement System – Covers about 95,000 state employees and elected officials
    - ii. Teachers Fund (include?) – Covers about 80,000 teachers, administrators, and professional employees at State schools of higher education; describe POB issuance and related changes
    - iii. Others?
  - b. OPEB
    - i. Covers 130,000 members of SERS, JFSMCCRS, JPERS, ARP, Teachers, and others.
  - c. SEBAC Agreement, including description of 2009 changes
- IV. Background: Actuarial liabilities and calculations (draft – Greg S)
  - a. How are actuarial liabilities measured?
    - i. Technical explanation: All benefits payable from a pension or OPEB plan to current plan participants, are projected and discounted. The actuary takes into account life expectancy and probabilities of various events (disability, termination), as well as projected future salaries and cost-of-living adjustments if appropriate.
  - b. Definitions:
    - i. Actuarial Accrued Liability (AAL): The Actuarial Accrued Liability is the portion deemed to have been already earned. For example, for a new employee the AAL = 0, but for a retiree, the AAL = the total present value of expected benefits.

- ii. Normal Cost (NC): The annual benefit accrual for plan participants who are still earning service towards benefits.
  - iii. Actuarial Value of Assets (AVA): The value of assets used to determine annual contributions. This value usually takes into account gradual recognition of investment gains and losses.
  - iv. Unfunded Actuarial Accrued Liability (UAAL) = AAL – AVA. Theoretically, the UAAL should be \$0, but this is never the case. Actuarial gains and losses cause the UAAL to fluctuate over time, often quite substantially.
- c. Pension/OPEB funding: Generally, monies are contributed to a fund each year as benefits are deemed to be earned. The value of benefits earned is the Normal Cost, as described above. The annual contribution is equal to the Normal Cost, adjusted up or down by a portion of the UAAL (i.e., amortization of unfunded or overfunded amount).

V. History of benefits and funding in Connecticut

- a. Inception of pension trust fund
  - i. Pay as you go funding until 1980's
    - 1. Implications
      - a. Current funding ratio
      - b. Amortization schedule
  - ii. History of UAAL and funding ratio
    - 1. <insert charts and tables here>
    - 2. Reasons for changes in funding
      - a. Early retirement incentives
      - b. Contributions less than actuarial cost
      - c. Info from Tom Woodruff

**Reasons for SERS Unfunded liabilities**

*Four factors have led to the increasing unfunded liabilities of SERS: long periods of not fully funding Tier I and to some extent Tier II; cyclical Retirement Incentive Plans (every five to six years); the chosen actuarial cost method which back-loads costs to the end of the amortization period; and investment losses. The actuaries "smoothed" the actuarial losses (and gains) by a method where 20% of the loss is included in the next year and 20% of the remaining loss in each of subsequent years (20% of the remaining 80% in year 2 or 16%, and so on until the amount approaches zero). This method results in losses (or gains) being spread over more than a decade after they have occurred.*

*The impact of the SERS smoothing methodology is illustrated by the "Historical Rates of Return" chart on Page 8.*

*The smoothing of investment losses in 2002 and 2003 and the 2003 Retirement Incentive Plan, along with the chosen actuarial cost method, have resulted in steadily increasing unfunded liabilities illustrated on page 10—even though the actuarially required contributions were made in each of those years.*

- b. Historical changes in benefits/tiers
  - i. SERS now has multiple tiers (I, II, IIA)
    - 1. Description of benefit changes and differences between tiers
    - 2. Timeline for tier inception
  - ii. Recent changes in OPEB
    - 1. <need description from SEBAC agreement>

VI. Where are we now?

- a. Unfunded liabilities and funding for Pension
  - i. In total
  - ii. By Tier

(from Tom Woodruff)

*The actuarial liability chart on page 9 shows total actuarial liabilities in June, 2008, \$19.2 Billion. Of that total \$14.3 billion is attributable to retirees, (most of whom were Tier I) and Tier I actives. The remaining liability is attributable to active Tier II members (\$4.0 billion) and active Tier II-A members (\$0.9 billion).*

- iii. Recent contributions into SERS Fund
- b. Unfunded liabilities and funding for OPEB
  - i. Most recent actuarial analysis
    - 1. Full funding scenario
    - 2. Paygo scenario
    - 3. Partial funding scenario
  - c. Outlook for future costs
    - i. Impact on benefit costs
      - 1. Changes in normal cost and projections of such

**(from Tom W)**

*The actuarial funding method currently being used by SERS is the projected unit credit cost method, often called the level percentage of payroll method. While it tends to back-end costs to later in the amortization schedule it is designed to produce contributions as a level percent of payroll if all actuarial assumptions are met.*

*Table IV-1 on page 26 shows the normal cost for SERS participants expressed as a percent of payroll. The table shows that while Tier I normal costs are in double digits, Tier II-A had a normal cost of only 4.7% of payroll as of the valuation date. The lower costs were due primarily due to reduced benefit levels for Tier II-A, a 2% of payroll contribution rate for Tier II-A participants, as well as the fact that the average Tier II-A participant is a number of years away from normal retirement.*

*According to the the SERS actuaries at the time, the normal cost for Tier II-A is expected to increase as that population ages but should settle somewhere between 7% and 8% of payroll. This forecast is supported by the fact that Tier II normal cost, with its older population, was 9.75% in 2008. The*

*difference between Tier II and II-A is the 2% employee contribution. When that is taken into account, Tier II normal cost, if it were contributory like Tier II-A, would be 7.75%--in the range of what the actuaries forecast for Tier II-A once the population ages. By comparison, the state's defined contribution retirement plan at its colleges and universities, the Alternate Retirement Plan, costs the state 8% of payroll.*

VII. Peer group comparison

a. Other states – <NASRA Public Fund Survey, 2008; Pew Charitable Trust>

i. Funding progress

1. Most recent NASRA Survey (2008) implies CT as 49<sup>TH</sup> out of 51 (including DC), with combined ratio (Teachers and SERS) of 58.5%
2. Individually, the plans were 115<sup>th</sup> and 121<sup>st</sup> out of 125 statewide plans

ii. Contributions

iii. Benefits <information available?>

b. Other local plans (Connecticut cities)

c. Other comparisons

i. Private sector

VIII. Possible Solutions discussed

a. State Pension Plan(s)

i. Funding Strategies

1. Require full funding of actuarial Plan cost, through collective bargaining agreement, statute, or policy
2. Pension Obligation Bond
  - a. Review cost and benefits
3. Review actuarial assumptions and methods, including cost method (Projected Unit Credit)
4. Review investment policies
5. Contribute to the Fund operating surpluses above a specified level
  - a. Other sources of funding?

ii. Benefit Provision changes

1. New tier of benefits involving revised defined benefit, defined contribution, or combination/hybrid
  - a. Is Defined Contribution an Option?

(from Paul M)

The Commission examined the possibility of moving existing and future retirement plan participants from the existing DB Plan to a DC Plan. Currently, the State offers an optional DC plan or Alternative

Retirement Program where the State deposits 8% of salary into an employee's account and the employee contributes up to 5% of his or her salary into such account. This program is in lieu of the traditional DB plan. The employee makes an irrevocable choice to enter this Plan upon the start of employment. This option has not been widely accepted by state workers and those who have chosen it have generally have had second thoughts given the poor equity results of recent years. It is however a choice and provides a portable benefit that appeals to certain employees. The question is to make a DC Plan for either new employees and/or existing workers mandatory.

The primary benefit for Connecticut in transitioning its workers and future workers into a DC Plan would be to cap the State's annual and future retirement costs. It would accomplish this by transferring 100% of existing investment risk from the State to the employee. As such the DC retirement plan would also be similar to most plans offered in the private sector. Although attractive from a budgetary point of view, there are reasons of fairness, social benefits and economics to maintain most, if not, all aspects of the current DB Plan for both the state and its workers.

First, the Plan's current unfunded actuarially accrued liability (UAAL) is largely attributable to the State not funding pension liabilities until the mid-1980's, early retirement incentives or RIPS and below plan investment performance. The UAAL associated with Tier II and Tier IIA workers is only a one-third of the overall UAAL due to plan modifications applicable to newer workers. It seems unfair to take away a valuable benefit from current workers due to a State decision not to fund prior obligations to Tier I employees. Why should recent employees subsidize a funding error made by the State?

Second, the existing DB Plan provides significant benefits to both the State and its employees including:

- Attracting and maintaining workers – in order to receive benefits significant service time is required and benefits build over time;
- Automatic Coverage – DB Plans do not require an employee to opt in;
- Protected Money – DB Plans maintain monies in a block and do not permit individual loans. DC Plans permit loans and hardship withdrawals;
- Professional Management – DB management protects against bad individual investment decisions and generally produce better outcomes at a lower cost for DB Plan participants.  
**Employees focusing on their jobs not their investment choices;**
- Lifetime Income – DB benefit plans provide retirees lifetime income without the possible financial risk of large individual withdrawals associated DC Plans;
- Special Protection for Spouses – ERISA requires that a joint life annuity be the default benefit option.

The Commission recommends that the existing DB Plan with the employee option of DC Plan be retained. We do however recommend that adjustments to the existing DB be considered to reduce the growing UAAL, which threatens the State's overall credit quality and crowds out discretionary spending. These adjustments include considering increasing employee contributions, identifying new funding sources, creating a new less generous Tier for future employees and work rule changes to control unintended pension benefits. The State's Actuarially Required Contribution (ARC) to the Plan is the fastest growing component of the State budget. The ARC was \$807 million for FY 2010 and is on track

for rapid growth in future years as weaker investment performance is factored in - absent any Plan changes.

2. Increase retirement age or provide incentives to retire later

These included increasing the pension vesting percentage in later years to perhaps 3%/year through ages 55 to 65. This would require a concurrent reduction in the vesting percentage for earlier years- perhaps 1.5% for the first 30 years of years. This could be applied to new hires with existing workers having the option of reducing current vested percentage for a higher future rate of vesting. This is the "Vermont Plan" that was just approved after negotiations with all parties.

3. Cap the Maximum Pension Benefit

Example: No pension should be higher than a certain percentage of an employee's average compensation over the past 5 years, say 80%.

4. Changes re number of years and ages for normal retirement; change benefit calculations re early retirement (i.e., reduction factors)

5. Altering pension formula going forward re percentage of salary for each year of service

6. Increased employee contributions going forward

7. Changes to COLA calculations

8. Changes re Disability Pensions (re: on and off-job disabilities)

9. Sharing of investment risks-losses, gains

Risk Sharing - Annual pension benefits could be subject to reduction if 5 year average investment returns are below assumed 8.25% assumptions. There would be limited potential on the upside if performance is better than expected. Perhaps pension benefits could be paid within a range of 80 to 110% of scheduled amounts

10. Review of annuity options for receiving benefits

11. Number of years for calculating average salary (e.g., 3 to 5 years, "indexed career average")

iii. Administrative

1. Seek to minimize the increase in or number of state employees
2. Changes to final average salary
  - a. "Spiking" Provisions
  - b. Review what is included in final salary (e.g., overtime, longevity)
3. Policies re "double-dipping"
4. Rules re: re-entering system

b. Other Post-Employment Benefits (OPEB)

i. Funding Strategies

1. Implement contributions to an OPEB Trust Fund
  - a. Full or partial funding the actuarial cost
2. Establish Voluntary Employees' Beneficiary Association (VEBA) trust—similar to the auto industry
3. Review actuarial assumptions and methods
4. Consider cost-benefits of OPEB Obligation Bonds

The concept is to fund the Trust with state General Obligation bond proceeds (perhaps \$1 billion net of issuance costs), which is equal to about 2 years of state OPEB expenditures for retirees and then cap future state contributions to the Trust including debt service on the bonds at a fixed percentage say 2% of total general fund revenues (\$400 million). Trust monies should be invested largely in fixed income securities to prevent against risk of loss and bad investment timing.

The State would be responsible for debt service on the bonds plus its annual requirement to the Trust. **The state's responsibility for retiree health care benefits would be capped and linked to state GF revenues.** This Trust would need to be maintained at a certain level so as to permit long term investing at a higher rate. If the Trust falls below the pre-determined actuarial level based upon an actuarial analysis then either active employee contributions will need to be increased or retirees will need to contribute a portion of the cost of their healthcare plans.

The Trust could be jointly managed by SEBAC and the State. This option has the benefit of capping the State's payments for OPEB and linking it to GF revenues, not healthcare cost increases. There would incentives for SEBAC to manage healthcare costs so as to prevent a reduction in benefits or cost increases.

The Chicago Transit Authority recently adopted such a plan for its workers. General Motors created a VEBA Trust with many these elements to manage its healthcare costs. In both cases substantial negotiations with all parties were required and it took time to reach an agreement.

i. Benefit provision changes

1. Changes to eligibility for retiree health insurance benefits (age and years of service-note recent agreement re "Rule of 75"); could tie to "Normal Retirement"

2. Limit Retiree Health Insurance to Long-Term State Employees

- Rule of 75 in new SEBAC agreement critical start
- Apply Rule of 75 to current terminated vested
- For new employees and employees with less than 10 years of service, must be eligible for full normal retirement to be eligible for retiree health benefits

3. Move Retirement Closer to Medicare Eligibility

- Tier II- (generally hired on or after July 1, 1984): For those with less than 20 years of service, move normal retirement age to 64 or 25 years and age 62; Move hazardous employees duty with less than 15 years of service to 22 years of service for retirement
- Tier IIa- (hired on or after July 1, 1997): Move normal retirement age to 65 (no matter how many years of service); Move hazardous duty employees with 23 years of service, but to 25 and age 52 for those with less than 10 years of service
- New employees or those with under five years of service: Normal retirement age tied to Medicare eligibility ; Early retirement at age 65; Hazardous duty personnel retirement: 25 years of service and age 55

**4. Reduce Growth in State Employee and Retiree Health Care Costs**

- i. System delivery reforms (e.g. medical homes, payment reforms, etc.)
- ii. Plan design changes
- iii. State's purchasing power
- iv. Create mechanism to ensure targets are met

5. Prorate employer contribution based on number of years of service (e.g., reductions for under 25 years of service)

- Premium Share:
  - Less than 5 years: State pays 50% early retirement insurance and Medicare supplement for employee only



- Less than 10 years: State pays 75% of early retirement insurance and Medicare supplement for employee only
- Less than 15 years: State pays 75% of early retirement insurance and Medicare supplement for employee and dependents
- Less than 20 years: State pays 90% of early retirement insurance and Medicare supplement for employee and dependents

6. Increase employee contribution going forward (note 3% contribution for newer employees in recent agreement)

- i. Build upon recent SEBAC agreement by the following employee contributions to trust (may need to align with ARC for each of these groups)

- Less than five years: 3.0%
- Less than 10 years: 2.5%
- Less than 15 years: 2.0%
- Less than 20 years: 1.5%
- Less than 25 years: 1.0%

Note: State match equal to or above total contribution (above and beyond pay-as-you-go)

- ii. Increase health care contributions for **all** active state workers to 5% of salary from current 3% requirement for recently hired for all tiers for their entire careers. Estimated incremental revenue of \$100 million to be deposited to OPEB Trust.

ii. Healthcare cost management

1. Cost containment approaches for State employee health plan, include reforms in federal health reform, including early retiree reinsurance, funding for medical homes, et.

2. Participation in federal early retirement subsidy program

c. Legal implications of benefit changes?

- i. Applicability of changes to future, recent or other current or terminated employees/retirees?

d. Bargaining issues?

IX. Conclusion & Recommendations (after further discussion)

a. Short term

i. Funding policies

- 1. Partially fund OPEB
- 2. Require full funding of actuarial cost

ii. Benefit provisions

1. OPEB

a.

b.

2. Pension

b. Long term

- i. Independent Analysis of any proposed legislation, work rule change or executive that potentially impacts the State's pension or OPEB liabilities either positive or negative would be required prior to any such approval or enactment. An oversight board (possibly comprised of Commission members) would have a budget to seek an independent assessment from outside experts. Such opinion must be provided within a specific number of days upon request so as not to unduly slow consideration of an action. Therefore, no more RIPs without an independent review of the costs prepared in advance; prohibit benefit upgrades if funding falls below certain levels
- ii. Requiring actuarial valuation when changing benefits or plan design or offering early retirement plans

X. Glossary of Terms (Acronyms)

AAL

AVA

POB

PUC

RIP

SEBAC

SERS

?

?

?

**STATE OF CONNECTICUT**  
**BY HER EXCELLENCY**  
**M. JODI RELL**  
**EXECUTIVE ORDER NO. 38**

**WHEREAS** the State of Connecticut provides its employees with pensions and other post-employment benefits such as health care; and

**WHEREAS** these benefits serve the public interest by attracting and retaining a workforce that protects the health and safety of the State; and

**WHEREAS** the most recent accounting reports that the State Employees Retirement System is \$9.3 billion under funded, and the State Employees Post Retirement Health and Life benefits ("OPEB") are \$24.6 billion under funded; and

**WHEREAS** the impact of the growth in pension and OPEB liabilities places additional strain on the State's budget resources as annual contributions comprise over \$1 billion of state funds, with the potential to be many times that amount; and

**WHEREAS** the unfunded liability is considered debt and thus has a negative impact for Connecticut with rating agencies; and

**WHEREAS** providing additional information, resources and potential short and long term plans to our elected officials will assist them in developing strategies for addressing post-employment liabilities; and

**WHEREAS** it is my goal as Governor to work with the business community, legislature and other elected officials to find an effective solution to the problem;

NOW, THEREFORE, I, M. JODI RELL, Governor of the State of Connecticut, by virtue of the authority vested in me by the Constitution and Statutes of the State do hereby ORDER AND DIRECT:

1. That there is established a State Post-Employment Benefits Commission.
2. That the Governor shall appoint representatives to the Commission consisting of representatives of the Office of the Treasurer, Office of the Comptroller, the Office of Policy and Management, the Office of Labor Relations, the State Employees Bargaining Agent Coalition, certified public accountants, certified actuaries, and members of the business community.
3. That the Governor shall appoint the Chairperson.
4. That all appointments should be made by February 15, 2010.
5. That on or before July 1, 2010, the Commission shall deliver a report to the Governor that:
  - a. Identifies the amount and extent of unfunded liabilities for pensions and other post-employment benefits;
  - b. Compares and evaluates the advantages and disadvantages of various approaches for addressing unfunded pension liabilities and post-employment benefits; and
  - c. Proposes a short and long term plan or plans for addressing unfunded pension liabilities and post-employment benefits.
6. That State departments and agencies shall cooperate and provide support to the Commission
7. That the Commission shall comply with applicable Freedom of Information laws, and that all meetings shall take place, whenever possible, in the Legislative Office Building.
8. That this Order shall take effect immediately.

Dated in Hartford, Connecticut, this 3<sup>rd</sup> day of February 2010.

M. Jodi Rell  
By Her Excellency's Command  
Susan Bysiewicz, Secretary of the State