How Adopting a Defined Contribution Retirement Plan for New Hires in Addition to the 2016 SEBAC Agreement Would Change Employer Contributions in Connecticut

Prepared for: State Sen. Len Fasano,
Connecticut Senate President Pro Tempore

Prepared by: Anthony Randazzo, Managing Director, Pension Integrity Project
Daniel Takash, Policy Analyst, Pension Integrity Project

Re: Modeling Results of Additional Changes to Pending SEBAC Agreement

Thank you for the opportunity to comment on the December 2016 State Employees Bargaining Agent Coalition (SEBAC) agreement and its changes to funding policy for the State Employees Retirement System (SERS).

At the request of your staff, we modeled a number of additional changes to SERS that could be added on top of the SEBAC agreement funding policy changes to test how they would change contribution rates. The Pension Integrity Project at Reason Foundation is a 501(c)3 non-profit research organization dedicated to providing independent technical assistance to stakeholders seeking meaningful changes to improve the solvency of public sector retirement systems. In this capacity, last year we built an independent model of SERS based on the actuarial assumptions used by the plan and publicly available data.

The results of our analysis using this model are shown below. Specifically, we analyzed the following changes, which we refer to as the “Alternative Scenario”:

1. Adopt the December 2016 SEBAC Agreement: This includes lowering the assumed rate of return to 6.9%, adopting a “level-dollar” method for amortizing unfunded liabilities, and adopting a series of changes to stretch out portions of the existing unfunded liability.
2. Adopt a defined contribution retirement plan for new hires as of July 1, 2017: This includes an employer contribution of 7% of payroll, and no additional changes to the amortization schedule or funding policy.
3. Increase all non-hazardous employee contributions to 4% of compensation.
4. Change the cost-of-living adjustment (COLA) formula to match inflation up to a maximum increase of 2% annually.

Disclaimer: These results are provided directly to you in summary, but should be considered in the context of the various underlying assumptions and methods used to build the forecasts. Our modeling of and commentary on this scenario should not imply the Pension Integrity Project necessarily recommends any given proposed change. We believe there are many paths to meaningful pension reform, and that any proposed reform should be measured against the objectives of ensuring retirement security, long-term plan solvency, and reduction in contribution rate volatility, and reduction in taxpayer risks.

Table 1 shows the expected difference in nominal dollar employer contributions based on adopting only the SEBAC agreement versus adopting all four elements listed above.

Table 1: Actuarially Determined Employer Contribution for SERS (nominal dollars)
SEBAC Agreement Only vs. Alternative Scenario including a DC Plan for New Hires

Contribution Year	SEBAC Agreement Scenario	Alternative Scenario: (SEBAC + Adopt DC Plan + 2% Max COLA + 4% Non-Haz Rate)	Savings/(Cost)
Year One: FYE 2018	$2,032.9 Million	$1,939.3 Million	**$93.6 Million**
Year Two: FYE 2019	$2,031.5 Million	$1,936.9 Million	**$94.6 Million**
Five Years: 2018-2022	$10,211.3 Million	$9,730.7 Million	**$478.6 Million**
20 Years: 2018-2037	$39,933.3 Million	$37,770.5 Million	**$2,162.8 Million**

Source: Reason Foundation Analysis of CT SERS Valuation Reports and SEBAC Agreement.

Comparative Note: Our baseline figures differ somewhat from the numbers provided by the Connecticut Office of Fiscal Analysis (OFA) on January 24, 2017 (particularly with respect to the baseline total dollar figures for years 1 and 2). However, *these differences are not meaningful* in the context of comparing what additional costs or savings would result from adopting the additional changes in the "Alternative Scenario."[1]

Table 2 shows the same two scenarios, but with total employer contributions measured as a percentage of total payroll.

Table 2: Actuarially Determined Employer Contribution for SERS, as % of Payroll
SEBAC Agreement Only vs. Alternative Scenario including a DC Plan for New Hires

Contribution Year(s)	SEBAC Agreement Scenario	Alternative Scenario: (SEBAC + Adopt DC Plan + 2% Max COLA + 4% Non-Haz Rate)	Savings/(Cost)
Year One: FYE 2018	54.19%	51.70%	2.49%
Year Two: FYE 2019	52.20%	49.77%	2.43%
Five Year Average	50.51%	48.13%	2.38%
20 Year Average	36.69%	34.70%	1.99%

Source: Reason Foundation Analysis of CT SERS Valuation Reports and SEBAC Agreement.

[1] Any analysis of the SEBAC changes necessarily has to make certain assumptions about the application of the funding policy changes that have yet to be determined and applied by the SERS plan actuary — this is the primary source of difference. There may be further differences in the construction of the baseline model, but without additional time to calibrate to the specific methods they have applied we cannot further refine our figures at this time. However, even if our baseline model were refined to match the OFA forecast dollar for dollar, the savings/cost analysis results would be similar to what is presented here because all changes in the Alternative Scenario are changes to normal cost. Therefore, we do not believe the difference in our baseline scenario relative to OFA meaningfully influences the conclusions of our analysis.

Savings/Cost analysis for the proposed additional pension reforms:

- *Creating a DC Only Plan:* Adopting a defined contribution retirement plan with a 7% employer rate would produce a normal cost savings relative to the expected employer contribution to normal cost.
- *Employee Rate Increase*: Increasing the employee contribution necessarily reduces the actuarially determined employer contribution rate by a comparable amount.
- *Changing the COLA Formula:* Adopting a COLA design for SERS with a 2% maximum benefit adjustment would produce a slight savings to normal cost. Actuaries currently assume that COLAs for Tier III will average 2.3% annually in retirement and adjust normal cost accordingly. The required normal cost rate would fall based on this change, producing savings.

Liability analysis for the proposed additional pension reforms:

- *Creating a DC Only Plan:* Generally speaking, the primary fiscal benefits from adopting a defined contribution retirement plan are realized when the remaining defined benefit plan does not perform as expected based on actuarial assumptions.
    - For example, if SERS continues to earn average annual returns that are between 5% and 6%, then each new employee hired into the SERS DC plan would represent a reduction in the expected growth in pension obligations exposed to those underperforming investment returns.
- *Changing the COLA Formula:* Historically, SERS employees have not regularly had COLA benefit increases that reached the maximum of allowable under the COLA formulas, but the existing formulas expose SERS to certain long-term risks. Changing the formula to have a maximum 2% COLA would not only allow for lower normal cost contributions, but also put a lower ceiling on the growth in expected accrued liabilities, which are also be exposed to the existing actuarial assumptions.

Conclusion:

It is our assessment that the pending SEBAC agreement does not constitute comprehensive pension reform. While certain elements are meaningful steps towards sound funding policy--including changing the assumed return and adopting a level-dollar method for amortizing unfunded liabilities--other elements will increase long-term pension costs, namely the extension of the amortization schedule.

Collectively, *the SEBAC agreement's funding policy changes are not enough to ensure long-term solvency for SERS*. For Connecticut to adopt meaningful long-term reform, the state should consider adopting plan design changes for new hires, consider further funding policy changes, and consider governance reforms, in addition to the SEBAC agreement.

Please contact us with any questions at:

- anthony.randazzo@reason.org
- daniel.takash@reason.org