# Bond Case Briefs

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## Fitch Ratings: Connecticut Teacher Pension Changes Costly, But Lower Fiscal Risks

Fitch Ratings-New York-28 February 2019: Connecticut is considering several proposals as part of its fiscal 2020-2021 biennial budget to contain the rising cost of pensions on state finances. Fitch Ratings views the proposed changes as meriting careful consideration in the context of the overall budget, particularly as they would alleviate significant fiscal risks to the state over roughly the next 12 years tied to scheduled, escalating contributions to the Teachers Retirement Fund (TRF). However, the funding changes to be made for TRF would increase costs to the state over the long run, in the same manner as funding changes made two years ago for the State Employees Retirement System (SERS). The fate of the proposals is not expected to affect Fitch's rating on the state, as Connecticut's pension burden is unlikely to diminish any time soon absent more extensive changes to funding practices or retirement benefits.

Connecticut's unfunded pension burden, among the highest of the states, contributes to its high burden of long-term liabilities and fixed costs and weighs on its credit quality; Fitch rates Connecticut 'A+'/Outlook Stable, a relatively low level for a U.S. state. As of fiscal 2017, data used in Fitch's 2018 state pension update, the state reported a net pension liability of $37 billion, or $48 billion when adjusted by Fitch to reflect a 6% discount rate, instead of the 8% rate used for TRF and 6.9% rate used for SERS. Debt and adjusted pensions together measured 28% of personal income, second highest among the states and well above the 6% states median as of fiscal 2017. Contributions for debt service, pensions and retiree health care together consumed nearly 21% of governmental spending.

The pension proposals outlined in the governor's executive budget would primarily affect TRF, with some modest additional changes to SERS. The key TRF change would align its amortization profile with that of SERS, which was agreed to in negotiations with organized labor in 2017. The unfunded liability for TRF would be re-amortized over a new, 30-year closed period through fiscal 2049, replacing the current closed amortization schedule through fiscal 2032, which has been in place since 1992.

Given TRF's 58% funded ratio as of its 2018 funding valuation, extending the amortization would avert the risk that the state general fund would have to absorb a contribution spike during the progressively shorter amortization window through fiscal 2032. Such a spike could occur if market returns fail to match the plan's current unrealistic 8% discount rate, or if other actuarial assumptions are not met. Simultaneously, the proposal would lower the TRF discount rate to 6.9%, with amortization payments recalculated on a level dollar basis, a less back-loaded payoff profile relative to the level percentage of payroll basis currently used by TRF. As with the 2017 changes to SERS, the trade-off for reduced near-term contribution risk would be much slower funding progress and higher contributions beyond fiscal 2032.

As part of the proposal, the state would establish a backup funding mechanism to satisfy a restrictive covenant contained in the state's $2.2 billion general obligation (GO) bond transaction from 2008, the proceeds of which were deposited to the TRF. The covenant requires the state to make full actuarial contributions to TRF, unless adequate provision for bondholders is made; the state has interpreted the covenant as limiting its ability to modify TRF's existing amortization schedule. The new pension proposal would establish a TRF special capital reserve fund (SCRF) at $381 million, equal to maximum annual debt service (MADS) for the 2008 bonds, with the initial SCRF deposit derived from the sizable income tax revenue windfall currently expected to be deposited in the state's Budget Reserve Fund. If drawn in the future, the SCRF would be replenished from net state lottery receipts, but given the GO pledge to bondholders, Fitch views the likelihood of a SCRF draw to be remote. The state's attorney general has opined that the proposal satisfies the covenant.

Beyond these provisions, the governor proposes shifting small portions of TRF normal costs from the state onto local governments, a proposal that appears modest relative to pension cost shifts undertaken by other states in recent years. Connecticut's towns make no employer contributions to TRF at present, and teachers themselves contributed a fixed 6% of payroll to TRF from long before the Great Recession until Jan. 1, 2018, when it rose to 7%. By contrast, since fiscal 2016, county school boards in Maryland have borne all normal costs for teachers, replacing the state as the funder of newly-earned benefits; the state retains responsibility for unfunded liabilities. Since the Great Recession, pension systems in other states including California, Florida and Virginia have shifted larger shares of their rising contribution burdens to employees to shore up pension system funding and reduce fiscal pressure.

In contrast to New Jersey and Illinois – other states with high pension burdens – Connecticut has paid virtually full actuarial contributions for SERS and TRF for more than a decade, and the use of a closed amortization period has been a notable strength relative to the rolling amortization used to date for major New Jersey plans and the inadequate 90% statutory funding target for major Illinois pension plans. However, TRF's discount rate assumption, at 8%, has long been an unrealistic target for future investment returns, in Fitch's view, resulting in actuarial contributions that are inadequate to support long-term funding improvement, thus exposing the state to severe fiscal risk. The state's forecast assessment for TRF concedes this point, as it calculates that lowering the future targeted returns by only 110 bps, to the 6.9% level in the state's restructuring proposal, while maintaining the fiscal 2032 closed amortization target would spike TRF's contribution to about $3.4 billion, from the current $1.3 billion level. Fitch recalculates pension liabilities based on a 6% discount rate, if plans use a higher rate, to reflect Fitch's expectation that future pension asset performance is unlikely to match historical experience.

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