The Connecticut Pension Sustainability Commission and the Legacy Obligation Trust

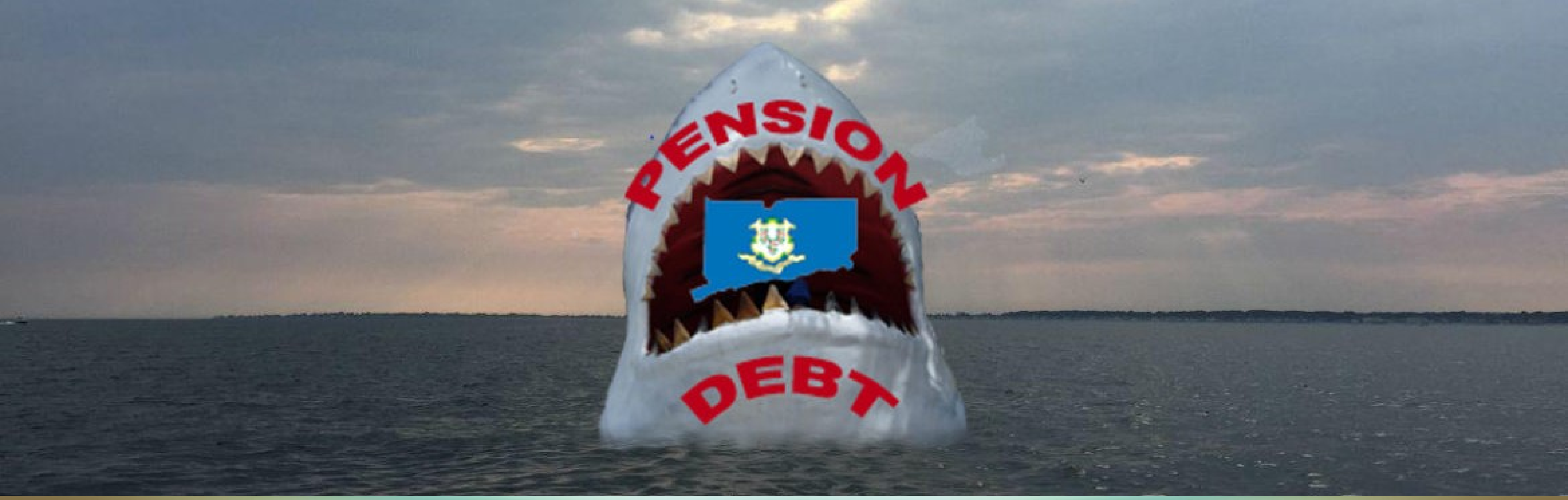
A new approach to funding pension & OPEB liabilities

Presented to the Government Fiscal Sustainability Work Group

October 23, 2018

Agenda

- **Connecticut's Pension Problem**
- **Connecticut Pension Sustainability Commission**
- **Legacy Obligation Trust Overview**
- **Lessons Learned to Date**



Connecticut's Pension Problem

(with apologies to Steven Spielberg)

Actuarial Assumptions and Results

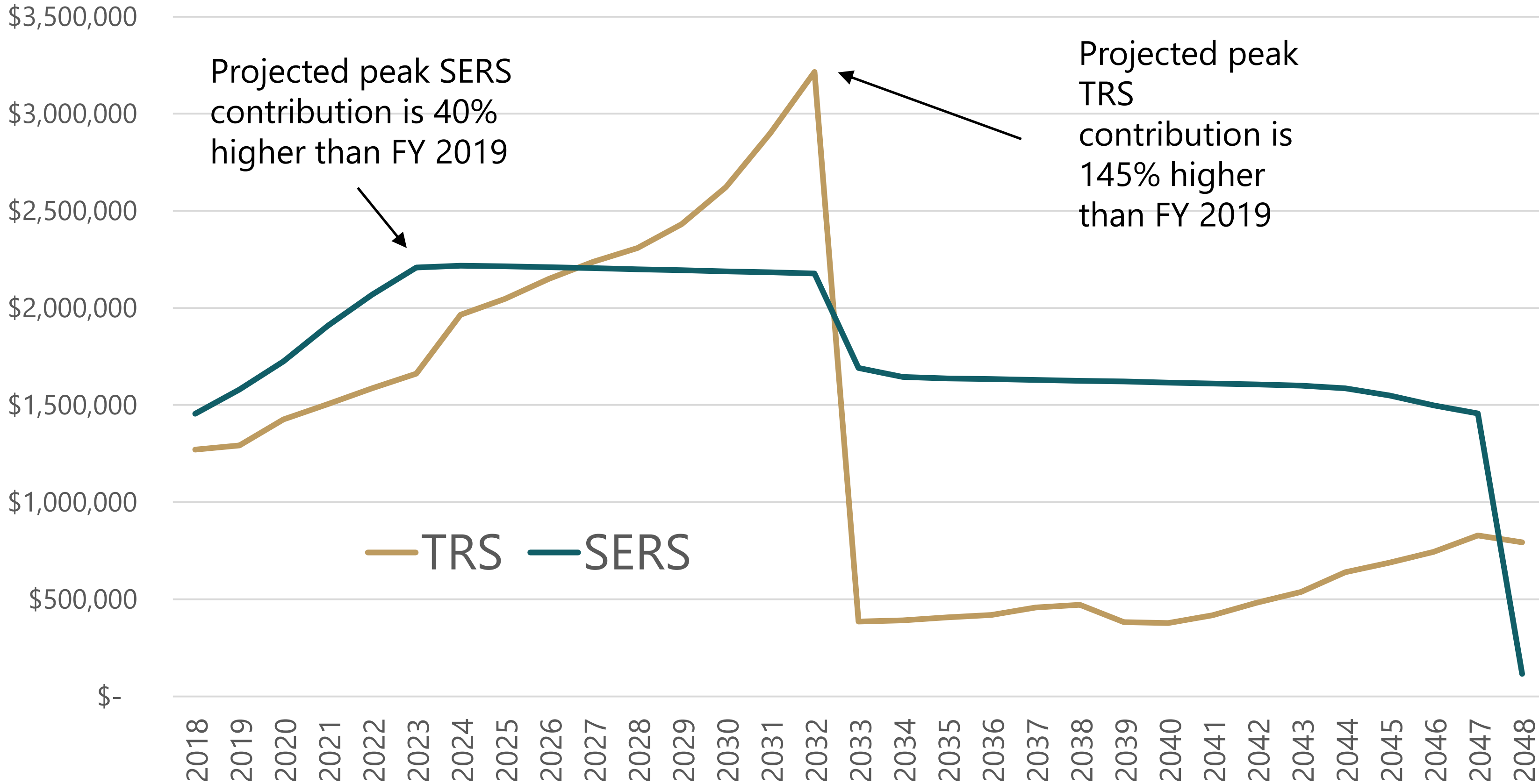
($ billions as of 6/30/2016)

	State Employees Retirement System	Teachers Retirement System
Investment Rate Of Return *(including inflation)*	**6.90%**	**8.00%**
Inflation Assumption	**2.50%**	**2.75%**
Remaining Amortization Period	**25.1 Years**	**17.6 Years**
Annual Contribution *(including POB amort)*	**$1.4**	**$1.4**
Accrued Actuarial Liability	**$32.3**	**$29.9**
Actuarial Value of Assets	**$11.9**	**$16.7**
FUNDED RATIO	**36.9%**	**56.0%**
UNDERFUNDED	**$20.4**	**$13.2**

Total Underfunded Pension $33.6 billion

Current Employer Contribution Projections

- **SERS projection** based on **achieving 6.9% return** assumption.
- **TRS projection** based on **8% discount rate with actual returns of 7.0%.**



Connecticut Pension Sustainability Commission

CT Pension Sustainability Commission

- **Introduced to CT in April 2016**
- **Authorizing legislation passed October 2017**
- **Commission appointed and activated July 2018**
- **13 member Commission**
  - 12 actually appointed
  - Appointment authority by Treasurer, Comptroller, legislative leadership, Governor
  - Includes two labor appointees:
    - Connecticut Education Alliance (teachers union)
    - AFSCME

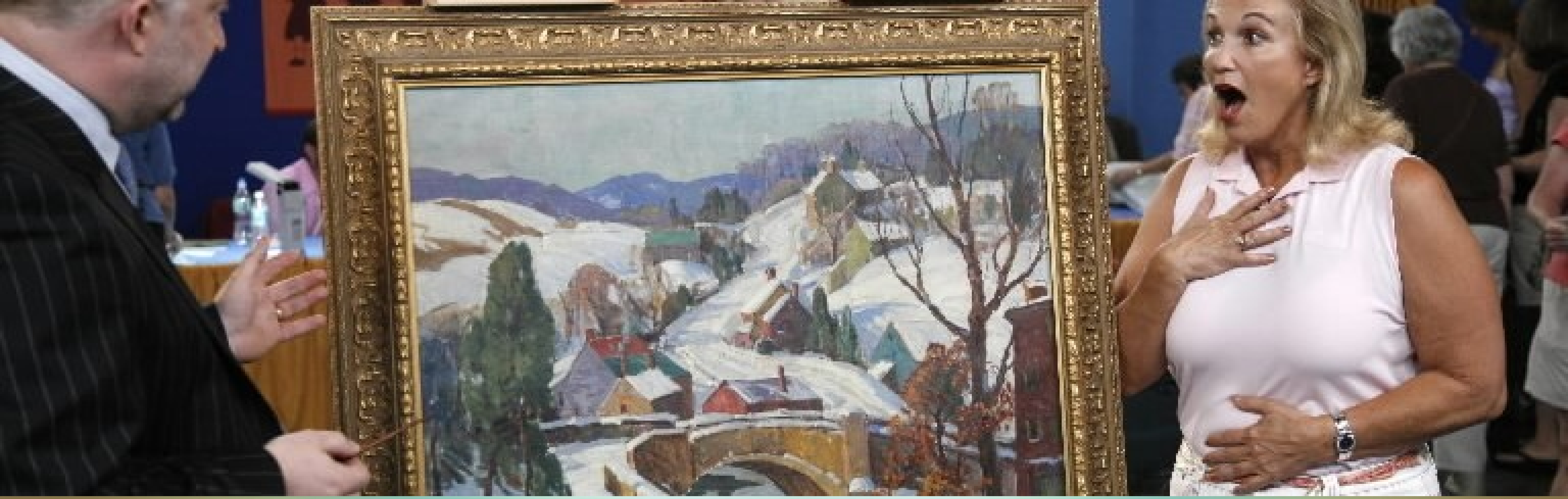
https://www.cga.ct.gov/fin/taskforce.asp?TF=20180710_Pension%20Sustainability%20Commission

Mandate

- **to study the feasibility of placing state capital assets in a trust and maximizing those assets for the sole benefit of the state pension system**

- Such commission shall
  - **preliminary inventory of state capital assets**
  - **potential impact on the unfunded liability of the state pension system**;
  - **appropriateness of placing state assets in a trust and maximizing those assets for the sole benefit of the state pension system;**
  - **examine the state facility plan**
  - **make recommendations for establishing a process to**
    - **(A) create and manage such a trust, and**
    - **(B) identify specific state capital assets for inclusion in such a trust**

- **Final report due, by statute, January 1, 2018**



Legacy Obligation Trust Concept

…or the Antiques Roadshow saves our pensions!

Executive Summary

- **The Legacy Obligation Trust ("LOT") concept is a new approach to solving the underfunded municipal pension and retiree healthcare problem in the United States.**
- A government unit makes an **in-kind contribution of real assets** – like land, buildings, infrastructure, enterprises - **to a professionally and independently managed trust** for the **benefit of one or more underfunded municipal pensions and retiree health plans**.
- The trust issues **Certificates of Trust ("COTs")** much like shares of stock, and divides them among the various pension & OPEB funds the government unit sponsors.
- The government unit's benefits include:
  - **an immediate credit against its unfunded liability based on the fair market valuation of the assets contributed to the trust**
  - the pension & OPEB funded ratios increase, which **may improve the credit rating agencies' assessment of the government unit**
  - **an immediate, positive cash flow impact on the unit's budget** as the "catch-up" payment for the underfunding goes down
  - the independent, **professional manager is incented to create additional value** to further increase the pension's funded ratio

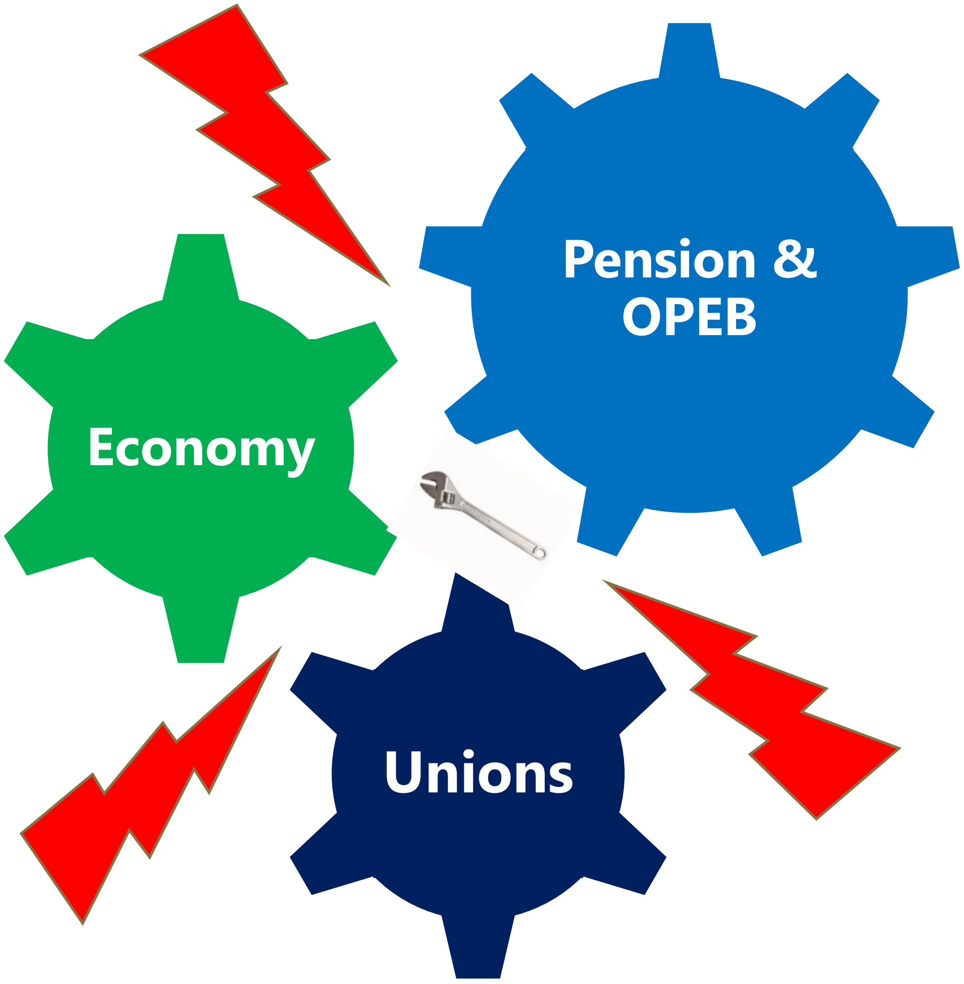
The LOT concept is a new idea that has not been previously implemented in the U.S. In-kind contributions to pensions have, however, been utilized in the U.S. and internationally.

Misaligned incentives are like grinding gears

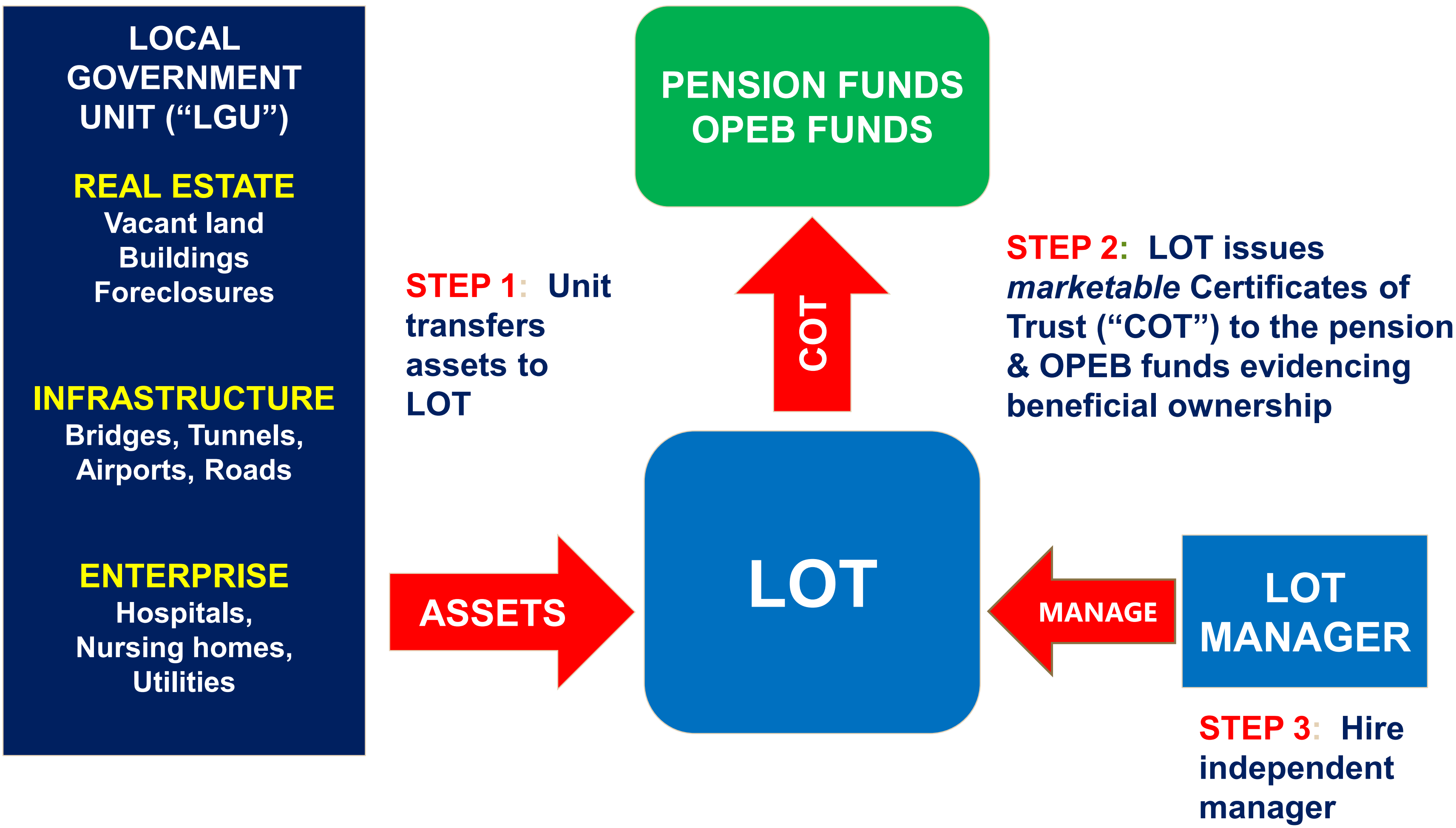
- **PENSIONS & OPEB:** "catch-up" payments for underfunded legacy obligations tend to **crowd out** current services and exacerbate government budget deficits

- **UNIONS:** union leadership is incented to maximize benefit for active employees regardless of government financial difficulties

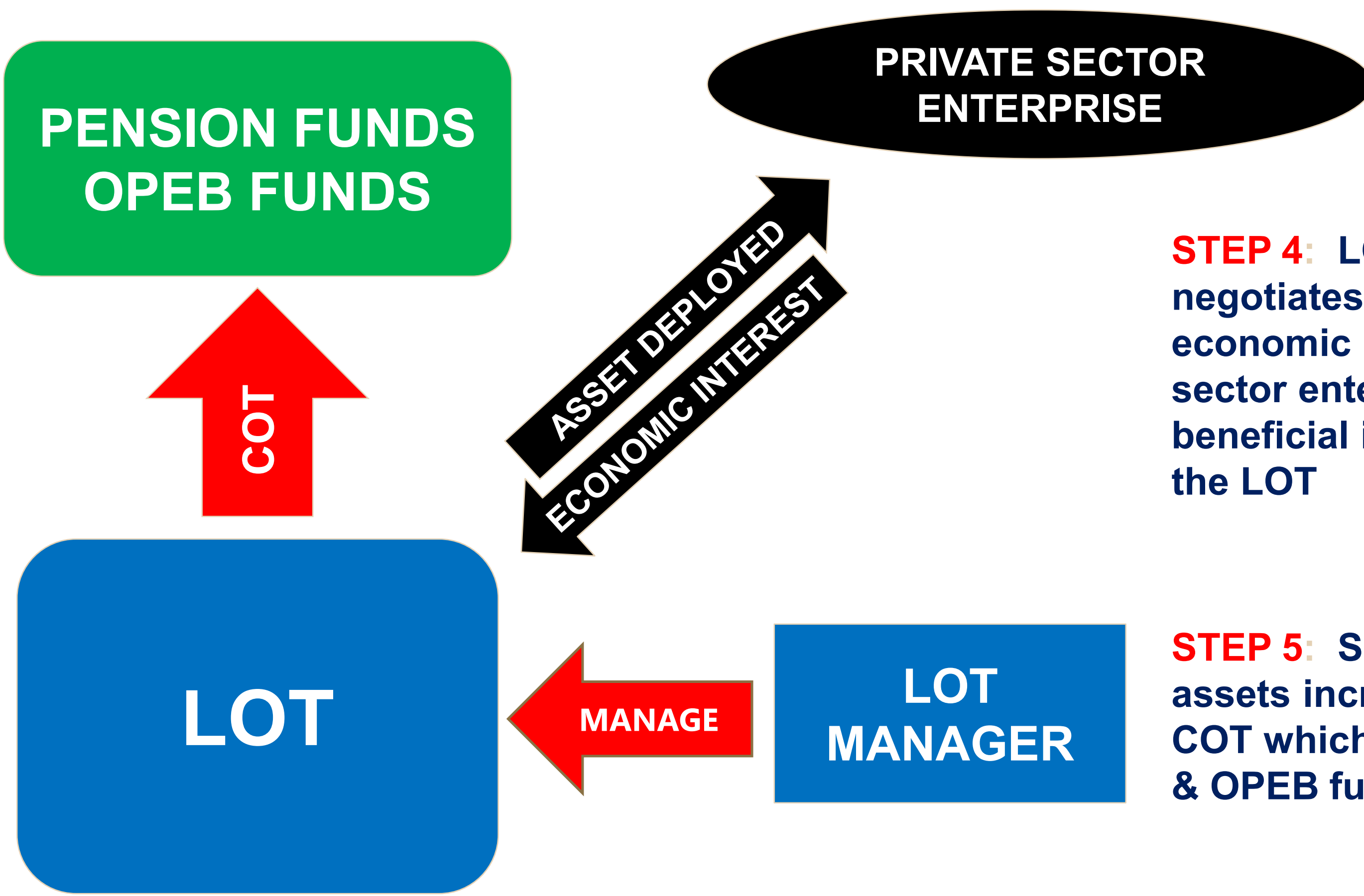
- **ECONOMY:** elected leaders are often conflicted between being good fiscal stewards of the economy and the practicalities and compromises required in politics. As such, governments often **sub-optimize economic utility of assets**



Legacy Obligation Trust Model



The LOT Manager maximizes economic value



STEP 4: LOT Manager negotiates sale, lease, or other economic interest with private sector enterprise where all beneficial interest accrues for the LOT

STEP 5: Success of deployed assets increase the value of the COT which benefits the pension & OPEB funds

Further thoughts on Capital Asset Universe

- **Undeveloped assets** can be converted to cash generating, unlocking new value
- **Developed assets** need to be assessed for highest and best use and potential for profitable turnaround

UNDEVELOPED	DEVELOPED ENTERPRISE ASSETS	
No $	**Making $**	**Losing $**
• Raw Land • Government occupied buildings	• Stadiums • Golf Courses • Utilities	• Hospitals • Skilled Nursing Facilities

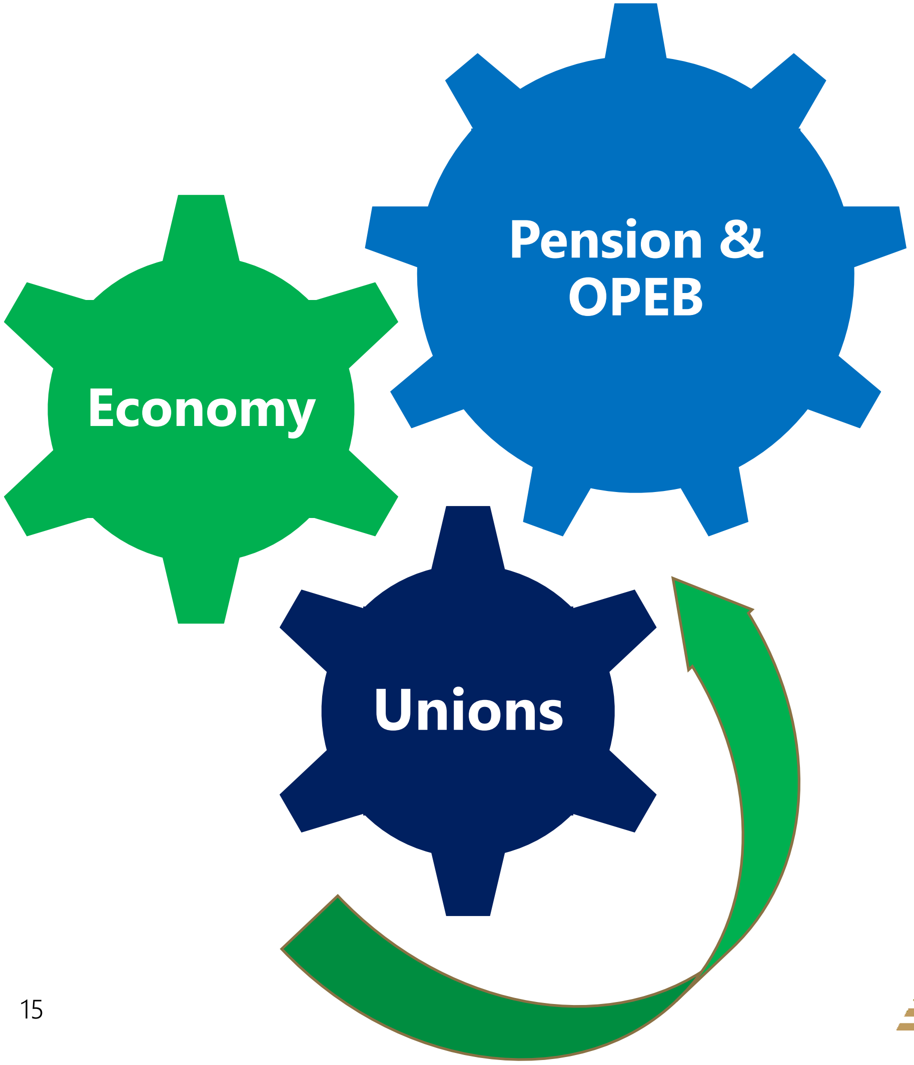
Aligned incentives make the “gears” turn

Labor and management become partners for economic growth

- **PENSIONS & OPEB:**
  - Funding ratios increased immediately
  - Retirees share in upside
  - Marketable COT enhances valuation

- **UNIONS:**
  - Current employee interests align with economy
  - LGU-owned assets become negotiating currency

- **ECONOMY:**
  - Stimulate new jobs and incents government to create growth environment
  - Enhance neighborhoods
  - Generate new tax revenue

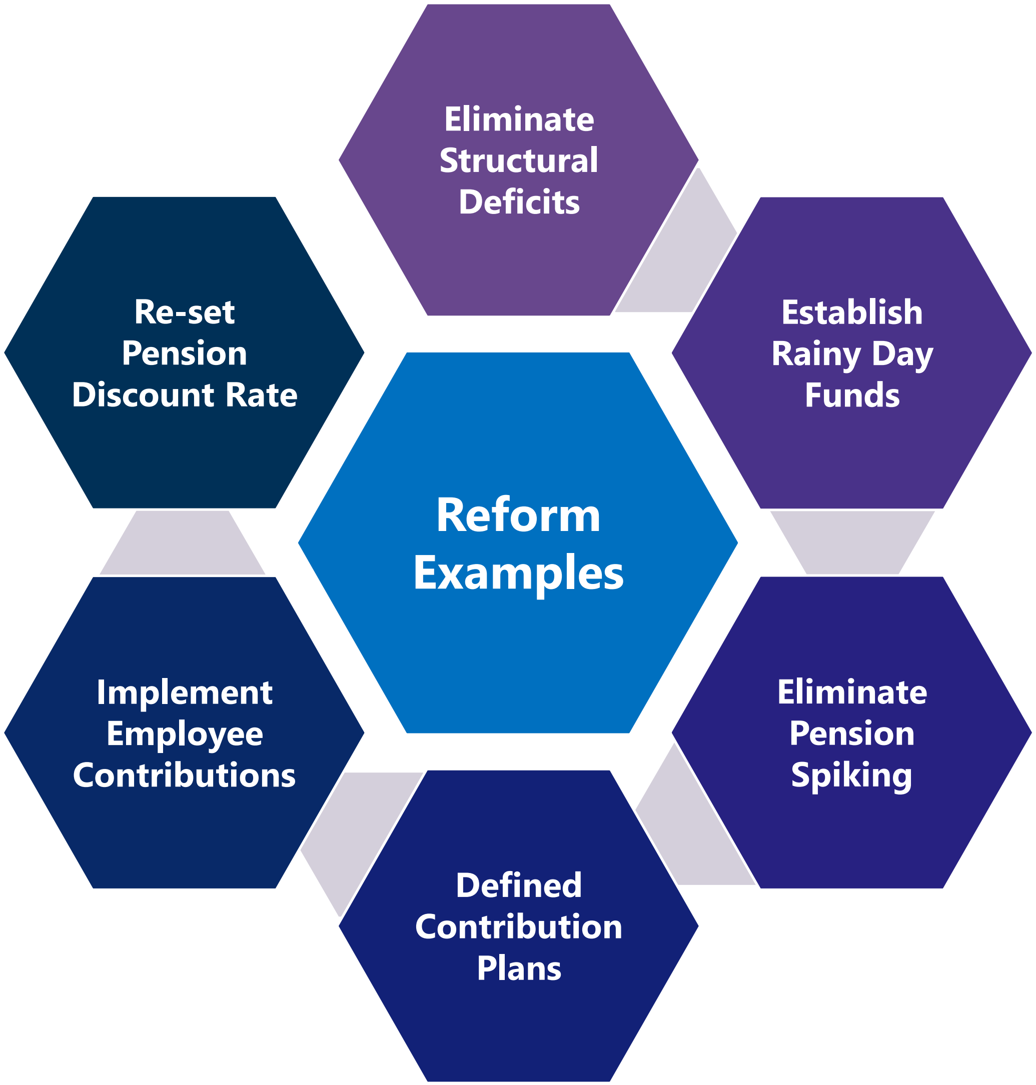


A sustainable solution requires other reforms…

- The LOT concept cannot be assumed to be the only reform necessary to effect sustainable change

- LOT implementation must be met with the fiscal discipline to adopt best practices in budget management

- Without other reforms, the bad habits of the past can create the legacy obligation funding problem again in the future

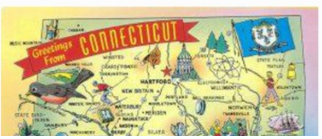


Media Coverage

Forbes

Has Connecticut Found A Solution To Underfunded Public Pensions?

Barnet Sherman Contributor
Intelligent Investing Contributor Group
Investing



Public pensions are underfunded.

Okay. I know, I know. We've all seen this headline before. Ad nauseum. To add to ... prove. Another ... ployee pensions

the ct mirror

BUDGET/ECONOMY/TAXES

Making a dent in our pension liabilities: A new solution

FEBRUARY 22, 2018

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THE BOND BUYER

Connecticut panel grasps pension crisis after years of underfunding

By
Paul Burton

Published
July 30 2018, 9:57am EDT

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Connecticut's pension funding crisis reflects several decades of underpayments by previous state leaders, said the chairman of a commission formed to tackle the problem.

How in-kind asset contributions could boost Connecticut's pension funding

By
Paul Burton

Published
September 11 2018, 11:07am EDT

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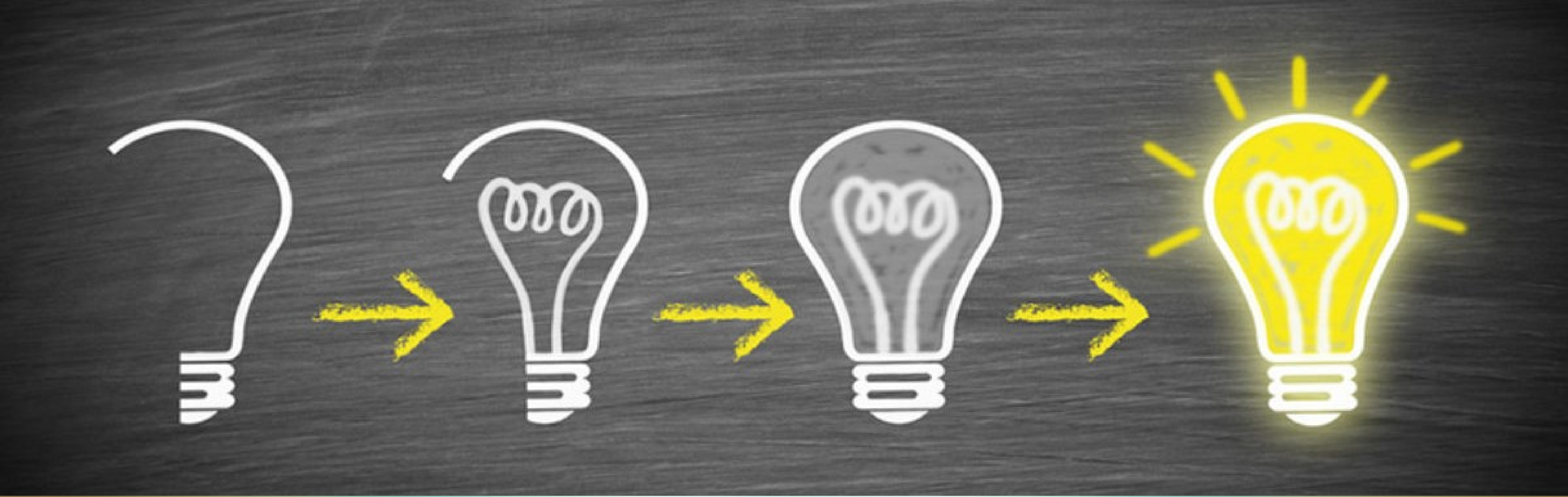
Print Reprint

HARTFORD, Conn. – Connecticut's special commission on pension funding is weighing how in-kind contributions of real-estate assets to an independently managed trust – novel among U.S. governments -- could help bolster the state's pension and retiree health plans.

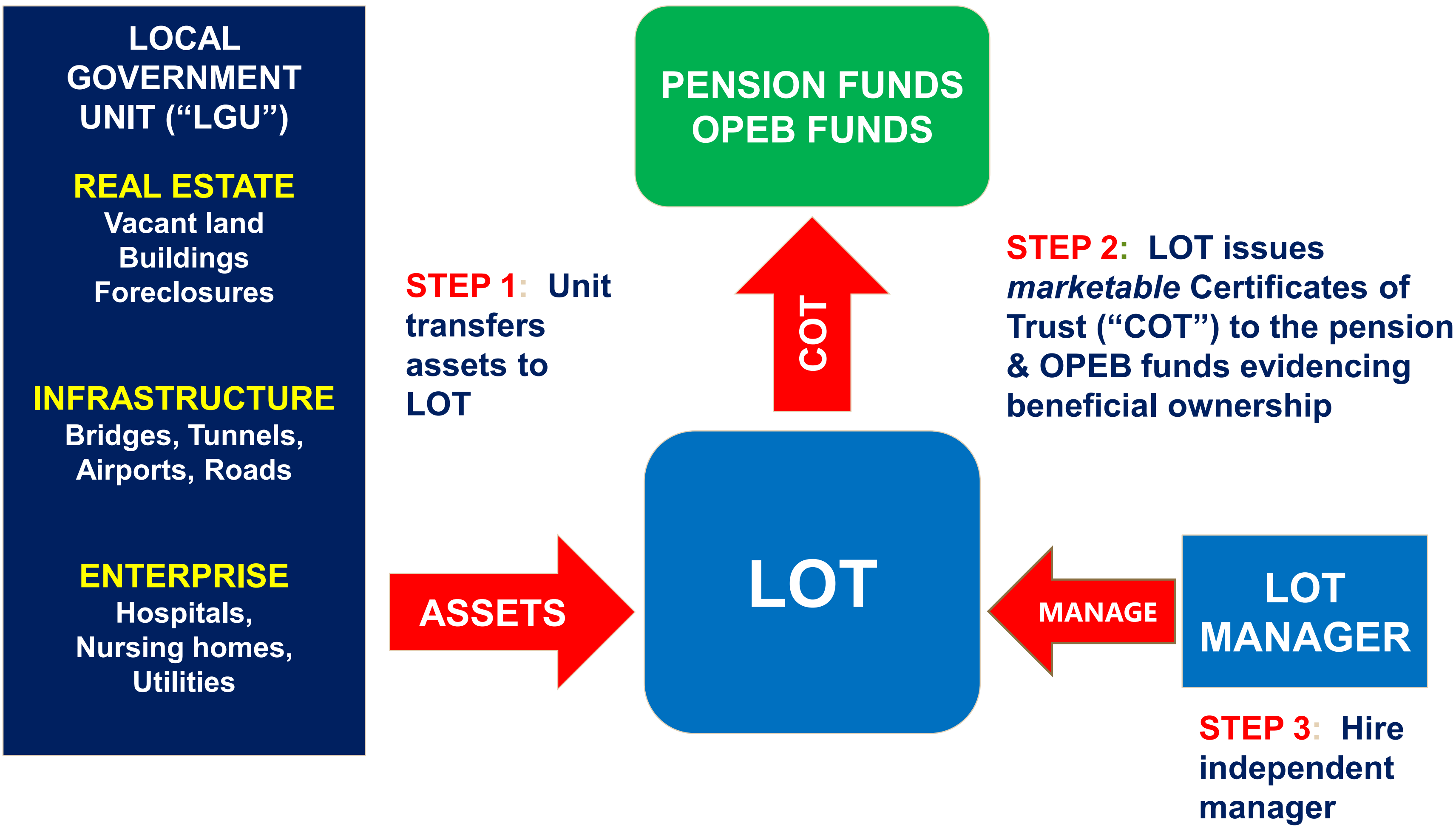


Lessons learned to date

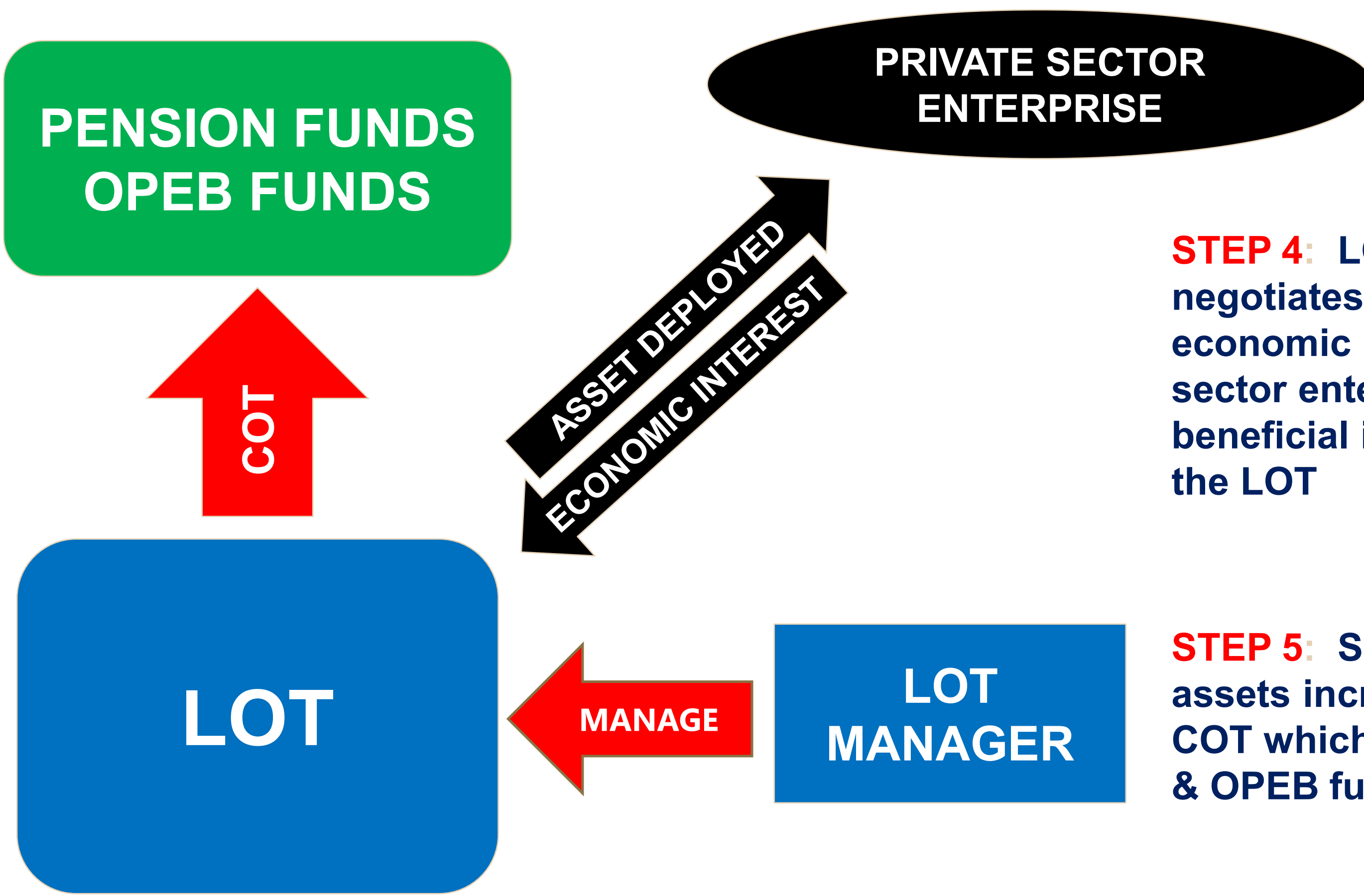
Appendix A

Step details of Legacy Obligation Trust concept

Legacy Obligation Trust Model



The LOT Manager maximizes economic value



STEP 4: LOT Manager negotiates sale, lease, or other economic interest with private sector enterprise where all beneficial interest accrues for the LOT

STEP 5: Success of deployed assets increase the value of the COT which benefits the pension & OPEB funds

STEP 1 – LGU Transfers Assets to the LOT

LGU identifies universe of potential assets for an in-kind contribution

- What are the assets that government does ***not*** need to own?
  - Real estate, infrastructure, enterprises
  - Governments often hold assets to maximize political, not economic, utility
  - Such assets hold unrealized equity value that, if professionally managed, could be unlocked to increase actual value and drive economic growth.
    - Examples might include:
      - Raw land to be developed into alternative commercial use
      - State offices are consolidated to empty entire buildings that could be leased or sold to the private sector

- The value of the in-kind contributed assets provide immediate credit to the pension and OPEB funds
  - Valuation methodology needs to be commercially reasonable
  - LOT assets must be re-valued each year

STEP 2 - LOT Issues Certificate of Trust

Pension & OPEB funds will own and hold Certificates of Trust ("COTs")

- The COTs serve as evidence of ownership of the LOT
- A large number of COTs may be issued to accommodate a division of ownership between multiple pension and OPEB funds
- **The COTs' value is based on the desk-top valuation of the assets at time of contribution and annually thereafter**
- The COTs could be structured as marketable securities
  - ➢ If the LOT assets generate steady cash dividends, the COTs may become an attractive investment opportunity for third-party money managers
    - ❑ Such a secondary market gives the pension & OPEB funds a liquidation option without forcing the sale of the assets from the LOT
  - ➢ A secondary market for COTs eliminates the need for an annual desk-top valuation
    - ❑ The COT market price becomes a proxy measure of the economic fortunes of the government that has contributed the assets

STEP 3 – Government hires LOT Manager

The LOT Manager is incentivized to maximize economic utility of trust assets

- The assets contributed to the LOT dictate the skill set of the manager to be hired

- The LOT Manager must be independent, authorized, and empowered

  - The LOT Manager is **not** subject to government control or influence

  - The LOT Manager is authorized and empowered to sell, lease, or contribute the assets to joint ventures

  - **The integrity and professionalism of the LOT Manager is critical to success**

STEPS 4 and 5 – LOT Manager

The LOT Manager is incentivized to maximize economic utility of trust assets

- The LOT Manager's authority and governance structure must be well defined in advance
  - Protocols for transparency must be established
  - Auction protocols must be defined

- A Board of Trustees provides oversight on the LOT Manager
  - Board members will include representatives of the beneficiary pension & OPEB funds, members of the business community, and labor

- New value creation is the LOT Manager's measure of success
  - Growing LOT asset value further offsets unfunded pension liability, minimizes "catch-up" payments, and stimulates the economy
  - Granting a share of the COTs to the LOT Manager aligns incentives

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Michael Imber is a Managing Director in the Financial Advisory Services Group and Co-Leader of the Public Sector Advisory Service Line. Michael has more than 25 years of experience counseling clients on bankruptcies, workouts and municipal consulting assignments. He has extensive municipal Chapter 9 bankruptcy experience and represented major unsecured creditors in the City of Detroit bankruptcy. In addition, Michael has generated 100% recoveries for the largest unsecured creditor claimants in the Jefferson County and the Mammoth Lakes Chapter 9 cases.

Michael is a member of the Connecticut Pension Sustainability Commission and is evaluating the feasibility of the use of in-kind asset contributions to satisfy state pension obligations. He has testified in front of the Connecticut General Assembly regarding the state's structural budget deficit and approaches for remediation. He led a team that identified $600 million of savings opportunities for the statewide K-12 education system as part of a broader efficiency study for the State of Kansas, and provided testimony for the Kansas General Assembly in support of his conclusions. Additionally, Michael led an engagement that identified more than $300 million of opportunities in the Nassau County budget for the Nassau County Interim Finance Authority and has represented the New York Metropolitan Transportation Authority, NJ Transit, and other major municipal transit authorities in a successful out-of-court workout of a major advertising vendor contract. This resulted in $125 million in senior lender and equity concessions and $80 million in concessions from the transit authorities.

Michael is a Board Member of the Municipal Analyst Group of York. He has served on the Executive Board of the Turnaround Management Association International and is is a past President of TMA's New York City Chapter. He has been quoted in *The Wall Street Journal, BusinessWeek, The Bond Buyer*, and *Bloomberg*. His most white paper, "Making a Dent in Our Pension Liabilities: A New Solution", was published in the *Connecticut Mirror*.

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