Funding Teacher Retirement and Healthcare

October 2013

Office of the State Treasurer

***Revised Title January 2014**

Teacher Retirement Overview

- **Teachers' retirement system (VSTRS) established July 1, 1947**
- **Over 7,700 retirees and beneficiaries as of June 30, 2013 (increased from 5,600 in 2008 and 4,000 in 2003)**

PENSIONS

- **FY15 pension annual required contribution (ARC) is $73.9 million, and State has 100% funded ARC since 2007. EXCELLENT, but . . .**
- **Pension fund is only 60.6% funded, with $1.55 billion of assets and $2.57 billion of liabilities. Why is this, even though we're funding the ARC?**

OTHER POST-EMPLOYMENT BENEFITS (OPEB – mainly health care)

- **FY15 OPEB ARC is $40.5 million, but State has never funded it, so …**
- **OPEB liability of $712.7 million is 0% funded, and worst of all …**
- **State draws current-year Teacher Health Care costs (estimated $26.5 million) from pension fund sub-trust. *This is the biggest problem!***

FAILURE TO FUND TEACHER HEALTH CARE ON A CURRENT-YEAR BASIS IS THE SINGLE GREATEST THREAT TO THE PENSION FUND.

We Have a Record of Incremental and Successful Steps – We need to complete the process

- **2005/2006:**
  - **Teacher funding study**
  - **Converted to Entry Age Normal (EAN) Actuarial Method, a better measure of funding status**
  - **Began funding pension actuarial recommendation, effective with 2007 budget (although OPEB/health care issue remained)**
- **2007/2008: Changes to state employees' system benefits**
- **2009: Pension and Health Care Benefit Study**
- **2010: Initiated pension and benefit savings with over $15 million in savings to the teachers' pension and significant reduction in health care liabilities**
- **2011: Increased contributions by employees in state system, $5+ million annual savings**
- **2011: Implemented more conservative interest return assumptions as part of experience study**
- **2011, 2012: Maximized dollars ($4.5 million) from federal ERRP program for teachers' system**
- **2011, 2012, 2013: Modest increases in health care funding in teacher system**
- **2013: Implemented EGWP, reduced liabilities by $203 million, effective 1/1/2014**

Health Care Expenses Are Creating Severe Strains on the Teachers' System

- ***<u>State Employees</u>***
  - **Administrative expenses, including health care, are appropriated through a "charge" to each department budget as a percentage of payroll and are collected with each payroll.**
  - **An OPEB prefunding account has been established by State Statute; to date only Medicare D funds have been designated to prefunding. Only $15.7 million through 6/30/13.**
  - **State OPEB is just 1.7% funded. Separate OPEB fund established.**
- ***<u>Teachers</u>***
  - **No explicit funding of administrative (including health care) expenses.**
  - **Health care expenses are treated as an actuarial loss, added to the unfunded liability and then amortized over the remaining payment period.**
  - **Funding would require over $20 million, increasing with inflation on an annual basis.**

Teacher Funding Issue

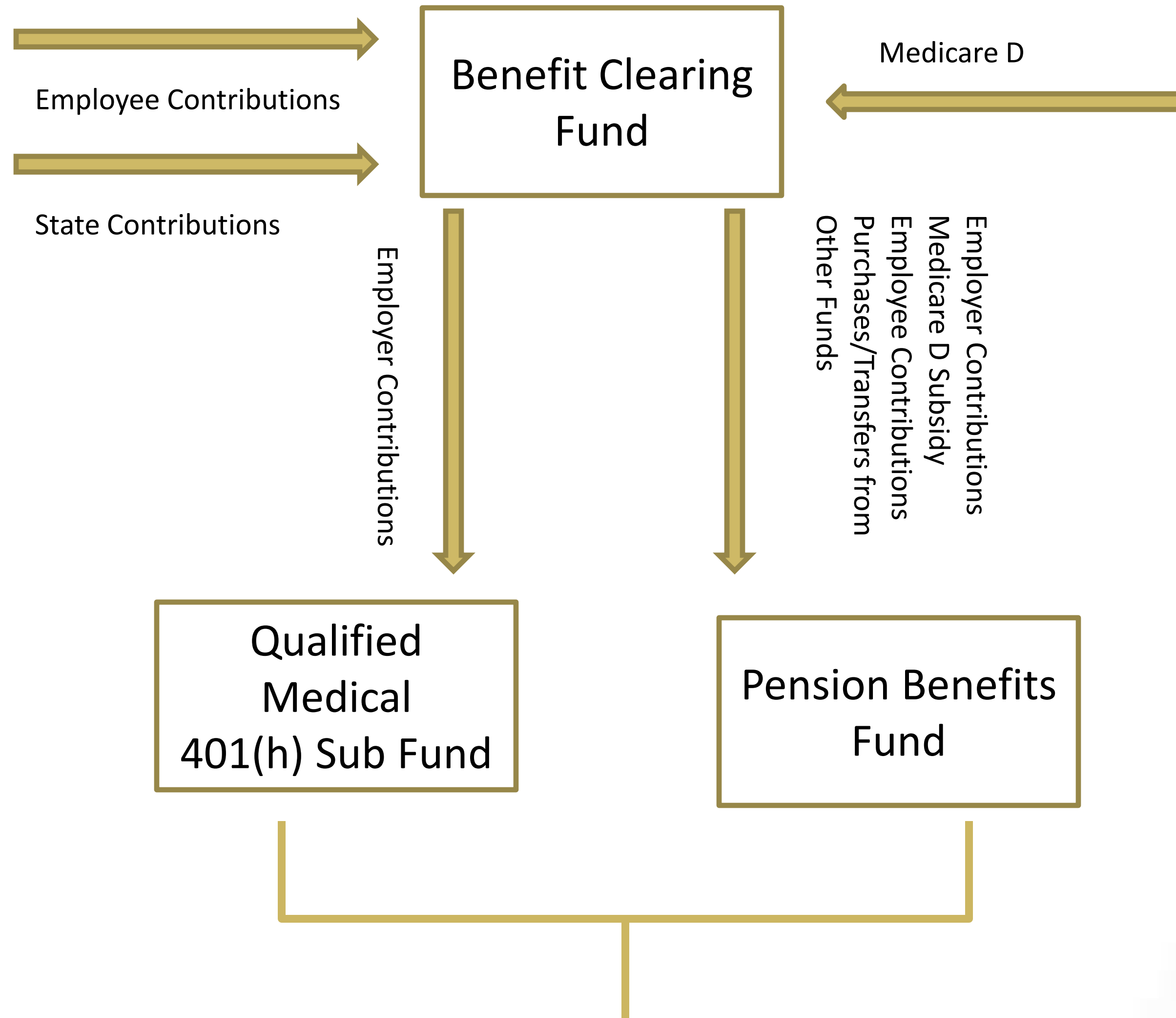
"Unlike the state system where the "pay-as-you-go" portion is budgeted and funded in a separate OPEB Trust fund, the health care expenses for VSTRS are paid out of the pension fund and are treated as an actuarial loss to the system, creating additional financial stresses on the pension system…Health care costs over the last decade or more have risen at a much higher rate than the rate of inflation, and while some stabilization of that trend is expected, costs are projected by our actuaries to continue to exceed CPI. The situation for the teachers' health care payments is reaching a critical phase…."

The Retirement Commission unanimously voted to include a recommendation to the Legislature to develop, without delay, a structural plan and process to fund the OPEB obligations and set money aside in a material way in a separate, independent funding mechanism."

- Source: "Report of the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers", December 2009, p.37.

As reported by the Treasurer on many different occasions, the lack of funding for teachers' health care liabilities is the **single greatest threat** to the stability of the teacher pension fund.

Pension Fund Structure



Fundamental Issue

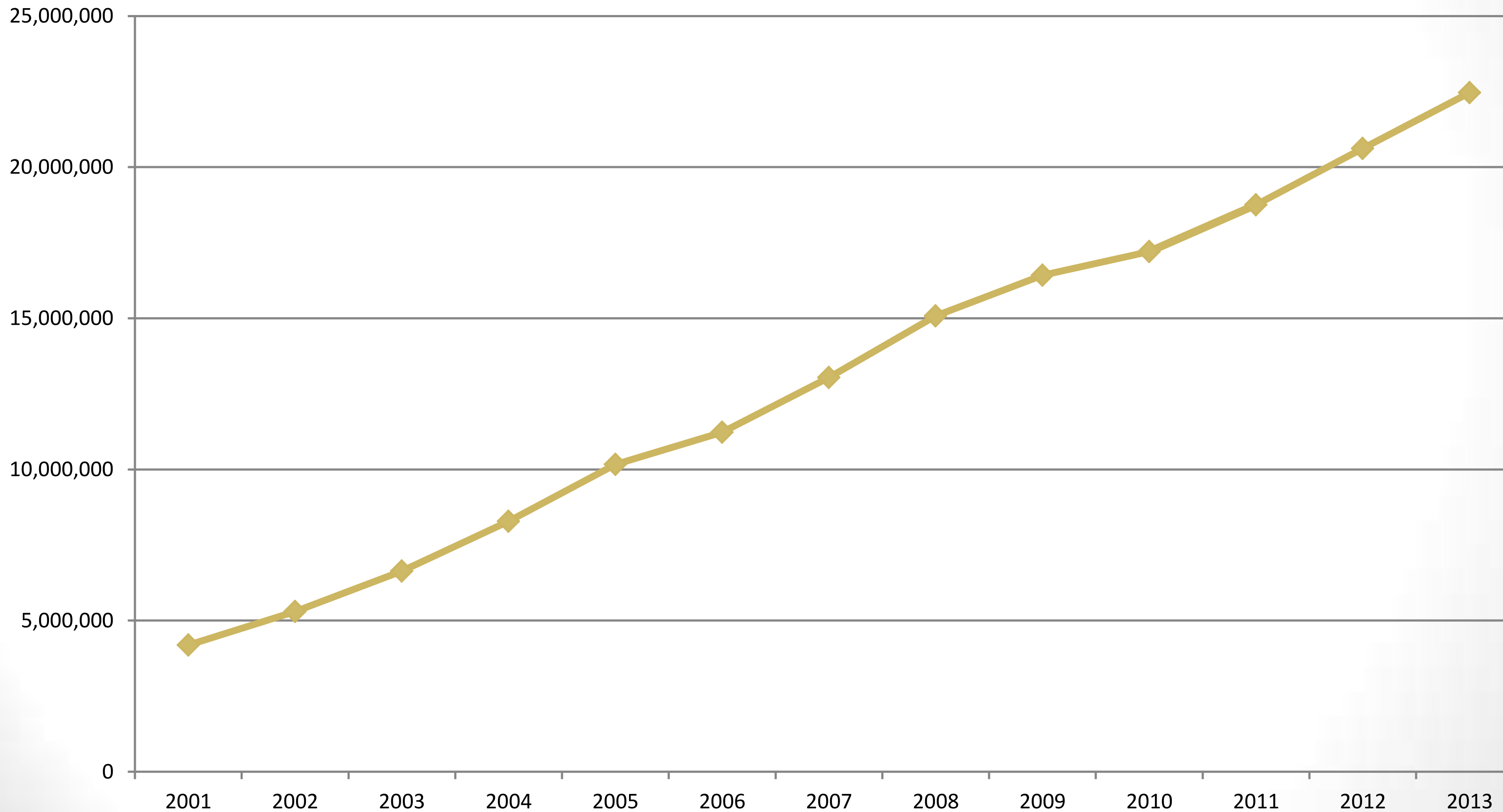
- **The State should establish and fund a separate trust to account for the assets and liabilities of the retiree medical benefit plan.**

- **Annual contributions to the Retiree Medical Plan should be separately identified in the State budget and not commingled with Retirement Plan contributions.**

- **A funding source needs to be in place, the current "retroactive" funding by default is not working and has reached a tipping point.**

- **Time for action is NOW.**

Health Care Expenses Are Rising



As retiree health care takes a bigger bite out of available funds, VSTRS' pension funded position is threatened and the annual actuarial required contributions (ARC) is rising at an accelerated rate.

Schedule of Funding Progress

(Dollar amounts in thousands)

Year Ending June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
2013	$1,552,924	$2,566,834	$1,013,910	60.5%	$563,623	179.9%
2012	1,517,410	2,462,913	945,502	61.6%	561,179	168.5%
2011	1,486,698	2,331,806	845,108	63.8%	547,748	154.3%
2010	1,410,368	2,122,191	711,823	66.5%	562,150	126.6%
2009	1,374,079	2,101,838	727,759	65.4%	561,588	129.6%
2008	1,605,462	1,984,967	379,505	80.9%	535,807	70.8%
2007	1,541,860	1,816,650	274,790	84.9%	515,573	53.3%
2006	1,427,393	1,686,502	259,108	84.6%	499,044	51.9%
2005 *	1,354,006	1,492,150	138,144	90.7%	468,858	29.5%
2004	1,284,833	1,424,661	139,829	90.2%	453,517	30.8%
2003	1,218,001	1,358,822	140,821	89.6%	437,239	32.2%
2002	1,169,294	1,307,202	137,908	89.5%	418,904	32.9%
2001	1,116,846	1,254,341	137,496	89.0%	403,258	34.1%
2000	1,037,466	1,174,087	136,621	88.4%	387,999	35.2%
1999	931,056	1,065,754	134,698	87.4%	372,299	36.2%
1998	821,977	955,694	133,717	86.0%	357,899	37.4%
1997	717,396	849,179	131,783	84.5%	364,695	36.1%

***The System's funding method was changed from Entry Age Normal with Frozen Initial Liability (FIL) to Entry Age Normal (EAN) effective with the 2006 actuarial valuation. Results, including the funded ratio, vary considerably under the two methods. For example, the FIL method resulted in overstatement of the unfunded ratio in 2005. Under the more predominant method, the unfunded liability would have been reduced from 90.7% to 81.1%. The unfunded liability under the EAN method for 2005 was $315 million, as opposed to $138 million using the FIL method.**

FY15 ARC Recommendation

Fiscal Year	Projected Payroll	Normal Rate	CONTRIBUTIONS		
			Normal	Accrued Liability	Total
2015	$588,986,475	1.89%	$11,131,844	$ 62,727,326	$ 73,859,170
2016	615,490,866	1.89%	11,632,777	65,863,692	77,496,469

ARC has two components:

- **Normal Cost**
- **Amortization of the Unfunded Actuarial Accrued Liability**

Normal cost represents the present value of benefits attributed by the funding method to service rendered during the valuation year. Under the Entry Age Normal method, the attribution is made by taking the cost of the full projected benefit for each participant and spreading it as a level percentage of payroll from year of hire to the assumed retirement date. The benefit changes/ employee contribution increases developed in 2010 had significant positive impact on the development of this cost on an annual basis.

Benefit Changes Have Lowered Normal Cost which has remained in expected parameters

FY 2011 normal cost as of 6/30/09 Valuation:	**$22.8 Million**
Revised as a result of enacted changes	**$10.3 Million**
Normal Cost for FY 2015 as projected in 2010	**$12.3 Million**
Normal Cost for FY 2015 in most recent valuation	**$11.1 Million**

Normal cost has been cut in half!

but Amortization cost for Unfunded Liability is Being Fueled, to a significant degree, by Health Care expense losses …

FY 2011 amortiz. cost as of 6/30/09 Valuation:	**$40.7 Million**
Revised as a result of enacted changes	**$37.9 Million**
Amortiz. Cost for FY 2015 as projected in 2010	**$46.1 Million**
Amortiz. Cost for FY 2015 in most recent valuation	**$62.7 Million**

Deferring the decision about how to pay for these liabilities is costing the taxpayer millions of dollars per year.

Example Amortization of $20 million of Retiree Health Care Costs

Fiscal Year-End Date	Unfunded Liability Balance	"Select and Ultimate" Discount Rate	Interest on Unfunded Liability	Amortization Increasing at 5.00%
6/30/2012	20,000,000	6.25%	1,250,000	1,150,174
6/30/2013	20,099,826	6.75%	1,356,738	1,207,682
6/30/2014	20,248,882	7.00%	1,417,422	1,268,067
6/30/2015	20,398,237	7.50%	1,529,868	1,331,470
6/30/2016	20,596,635	7.75%	1,596,239	1,398,043
6/30/2017	20,794,831	8.25%	1,715,574	1,467,945
6/30/2018	21,042,459	8.25%	1,736,003	1,541,343
6/30/2019	21,237,120	8.25%	1,752,062	1,618,410
6/30/2020	21,370,772	8.50%	1,816,516	1,699,330
6/30/2021	21,487,957	8.50%	1,826,476	1,784,297
6/30/2022	21,530,137	8.50%	1,830,062	1,873,512
6/30/2023	21,486,686	8.50%	1,826,368	1,967,187
6/30/2024	21,345,867	8.50%	1,814,399	2,065,547
6/30/2025	21,094,719	8.50%	1,793,051	2,168,824
6/30/2026	20,718,947	8.50%	1,761,110	2,277,265
6/30/2027	20,202,792	8.75%	1,767,744	2,391,129
6/30/2028	19,579,408	9.00%	1,762,147	2,510,685
6/30/2029	18,830,869	9.00%	1,694,778	2,636,219
6/30/2030	17,889,428	9.00%	1,610,049	2,768,030
6/30/2031	16,731,447	9.00%	1,505,830	2,906,432
6/30/2032	15,330,845	9.00%	1,379,776	3,051,753
6/30/2033	13,658,868	9.00%	1,229,298	3,204,341
6/30/2034	11,683,825	9.00%	1,051,544	3,364,558
6/30/2035	9,370,812	9.00%	843,373	3,532,786
6/30/2036	6,681,399	9.00%	601,326	3,709,425
6/30/2037	3,573,299	9.00%	321,597	3,894,896
6/30/2038	0	9.00%	0	0

Total Amortization Payments: **58,789,350**

Teacher Health Care Initiatives Already Taken Have Reduced the Liability but Cannot Replace Funding

- Benefit changes to a tiered structure effective July 1, 2010

- Take advantage of revenue opportunities
  - Retiree Drug Subsidy
  - Employer Group Waiver Plan (EGWP)
  - Early Retirement Reinsurance Program (ERRP)

- Some incremental increases in funding (more needed)

Teacher Health Care Benefit Changes Effective 2010

- For new hires and those with less than 10 years of service…
  - 1 to 14 years: No subsidized coverage
  - 15 years: 60% Single
  - 20 years: 70% Single
  - 25 years: 80% Single or spousal

- Current actives with more than 10 years of service…
  - 80% single coverage - same as now
  - 25 years: 80% single or spousal coverage
  - However:
    - Those with more than 30 years of service will have to work another 5 years to be eligible for spousal coverage.
    - Those with 25 to 30 years of service will have to work a total of 35 years.
    - Those with 15 to 24 years of service will have to work 10 more years.
    - Those with 10 to 15 year of service will be eligible upon 25 years of service.

Impact of Enacted Benefit Changes to 2010 OPEB Valuation

- **Actual impact on unfunded liability exceeded original estimates, in part in combination with other lower health care inflation rates.**
- **Per the consulting actuary, the decrease in liability is attributable to the following factors:**
  - **an increase in plan premiums smaller than expected;**
  - **removal of assumed age-morbidity factors;**
  - **changes to eligibility and cost-sharing plan provisions effective July 1, 2010, including associated changes in assumptions and attribution method.**
- **Unfunded liability reduced in 2010 from $872 million to $704 million.**

Teacher Unfunded OPEB Liability

Unfunded Teacher OPEB Liability

6/30/2013 $713 Million
6/30/2012 $827 Million
6/30/2011 $780 million
6/30/2010 $704 million
6/30/2009 $872 million

Implementation of Employer Group Waiver Plan (EGWP)

Implemented Savings Initiatives including Tiered Eligibility Structure

- Liability Side has been addressed with significant imitative

Factors Impacting Unfunded Liability:

- Expected increases due to the passage of time (and lack of funding) although offset in 2013 by EGWP initiative
- 2012: The inclusion of the retirements that occur on the day after the valuation date for the first time (improvement in processes to account for summer retirements)
- Updates to demographic assumptions as recommended by the Experience Study of the State Teacher's Retirement System of Vermont, presented to the Board on March 23, 2011
- 2009-2010- Negotiated benefit changes

Other Initiatives to Date

Initiatives to Maximize Revenues

- Early Retirement Reinsurance Program (ERRP)
  - $4.5 million
- Retiree Drug Subsidy (RDS)
  - currently approx. $1.5 million per year

Some Incremental Increases in Health Care Funding

- FY 2012: $1,750,000
- FY 2013: $4,750,000
- Governor's Recommended FY14 Budget includes $4,750,000,
  - No increase despite increase cost for health care
  - More is needed

2013 Liability Reduced Significantly Through Conversion from Existing Retiree Drug Subsidy (RDS) Program to Employer Group Waiver (EGWP) Plan

RDS: The 2003 Medicare Prescription Drug Improvement & Modernization Act

- Congress created the Retiree Drug Subsidy (RDS) for employers that provide post-retirement drug benefits.
- The RDS was created to encourage employers to continue funding benefits rather than terminate funding and force retirees to seek Medicare benefits.
- In 2006, employers were permitted to apply for the RDS subsidy. Vermont applied on behalf of state and teacher retirement systems.
- Annual subsidy generally in $1.5 million range
- FY12: $1,672,423

EGWP

- Employer Group Waiver Plans (EGWP) allow employers to realize cost savings on Medicare eligible retiree drug costs.
- The EGWP generates savings relative to the current RDS strategy through the net impact of the government subsidies and pharmacy discounts.
- Administration "heavy lifting" done by a pharmacy benefit manager
- May result in subsidies for low-income retirees.
- **Cash savings <u>over and above</u> the RDS dollars by approximately <u>$2.3 million</u> per year.**
- **Reduce OPEB liabilities by <u>$203.6 million</u> in 2003 although offset by lack of expense funding and increases in retiree costs and counts.**

Development of OPEB Liability by Buck Consultants

6/30/2012 Unfunded Actuarial Accrued Liability		$ 827.2
End of year normal cost	$ 22.4	
Interest cost	32.6	
Expected Benefit Payments	(24.0)	
6/30/2013 Expected Unfunded Actuarial Accrued Liability		$ 858.2
Impact of recent year Demographic Experience	$ 19.1	
New per capita costs	38.4	
Other refinements	0.6	
Implementation of EGWP	(203.6)	
6/30/2013 Unfunded Actuarial Accrued Liability		$ 712.7

EGWP Overview

- **Convert the current prescription plan into a group EGWP for the Standard Part D plan design using a pharmacy benefits manager (PBM).**
- **Provide a “wrap” plan around the Standard EGWP through the PBM to preserve the current prescription drug plan design and formulary strategy, from the retiree's perspective.**
- **The Standard EGWP and wrap will coordinate at the pharmacy**
  - **no benefit disruption for retiree**
- **From the retirees’ perspectives they see the combined wrap plan design and formulary strategy, not the underlying program and “wrap”.**
- **Health Care Reform and PPACA made changes to Medicare Part D that make Part D financially more attractive than RDS for nearly all customers.**
- **CMS guidance for January 1, 2013 streamlined process.**
- **Plan will be implemented for teachers effective 1/1/2014.**

- **Significant benefit changes have *already* been made (2010) as well as changes to the service delivery (2013 EGWP) that have lowered the liability.**
- **Even *if* we were to consider additional benefit changes, they may impact the liability but will not result in the needed cash impact until some years down the road– *it will not address the immediate problem.***

Projected OPEB ARC and Cash Payouts for VSTRS

Fiscal year	Current ARC Per Valuation Report*	ARC Per Proposed Change		ARC Savings (vs. Low Utilization Estimate)	Current Cash pay-Out Per Valuation Report	Estimated Cash Payout Per Proposed Change		Cash Savings (vs. Low Utilization Estimate)
		Low**	High**			Low**	High**	
2011	$62,147,390	$46,942,500	$47,289,605	$15,204,890	$19,909,578	$19,864,521	$19,864,521	$45,057
2012	65,465,928	49,115,181		16,350,747	21,911,328	21,784,174	21,784,174	127,154
2013	68,929,161	51,362,195		17,566,966	23,734,393	23,467,565	23,467,566	266,828
2014	72,551,696	53,695,685		18,856,011	25,618,354	25,153,079	25,153,088	465,275
2015	76,341,837	56,121,360		20,220,477	27,470,533	26,750,893	26,750,929	719,640
2020	98,138,390	69,856,617		28,281,773	38,339,180	35,553,023	35,558,737	2,786,157
2025	125,653,260	86,828,322		38,824,938	50,717,835	46,070,997	46,116,278	4,646,838
2030	160,769,765	108,013,155		52,756,610	63,119,143	56,785,422	57,100,802	6,333,721
2035	206,235,042	135,040,474		71,194,568	73,392,103	65,347,465	66,344,688	8,044,638
2040	$266,156,263	$170,526,670		$95,629,593	$77,409,329	$68,633,228	$70,356,949	$8,776,101

*The ARC is the annual actuarially required contribution. ARC represents normal cost plus portion (amortized) of unfunded liability . The ARC above is calculated without pre-funding. If prefunding were implemented, the value of investment income would significantly reduce the ARC.

- **Note above is as of 3/10/10; no update at this time by actuary.**
- **Any change to benefits for "new hires" would not appreciably change the cash payout which is the most significant issue impacting the funding drain on the pension fund.**

Preliminary Recommendations & Areas for Review

Consider Chargeback of Pension Costs to Employers where Teachers are Paid through Federal Grants

- **A state's employer contributions to pension plans for employees who work on federally funded programs are allowable costs as employee benefits.**
- **Federal guidelines require that costs charged to federal grants be consistent with policies, regulations and procedures that apply uniformly to both federally assisted and other activities, and be accorded consistent treatment through application of generally accepted accounting principles.**
- **In state system, all state cost centers are assessed pension and health care costs, thereby receiving federal reimbursement for these costs.**
- **In the teachers' system, all employer costs picked are up by the general fund.**
- **Transparency issue: If implemented, full cost of program now identified and charged.**
- **Pension System Savings Impact- unknown at this time pending data from Dept. of Education.**
- **Other considerations before final determination: administrative requirements, reporting structure, impact on available grant dollars and programs.**

Example:

State of Maine

- **Retirement benefits are set by the Maine legislature. Maine state employees contribute a percentage of their salaries, at a rate fixed by statute. The state of Maine contributes to the MSRS pension fund at a rate, expressed as a percentage of payroll, that is set, based on actuarial recommendations, by a board of trustees, subject to limits imposed by the state legislature.**

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MainePERS Teacher Plan
Employer Contribution Rates*

	Employer Contribution Rate in Effect for:		
	FY 2013	FY 2014	FY 2015
Non Federally Funded School Teachers	13.85%	15.68%	15.68%
Federally Funded School Teachers	14.32%	16.15%	16.15%

* Employer Contribution Rates include normal cost plus unfunded actuarial liability (UAL); the federally funded school teacher rate includes the non federally funded rate plus an administrative rate (.47%).

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- **To the extent that its employees work on <u>federally-funded programs, Maine may receive federal reimbursement for a portion of its contributions to the MSRS made on behalf of those employees.</u>**

Sample Language

- **State of Maine Statute: "Notwithstanding this section, the employer retirement costs and administrative operating expenses related to the retirement plans applicable to those teachers whose funding is provided from federal grants or through federal reimbursement must be paid by local school systems from those federal funds."**

- **Note: Implementation would likely require phase-in language or date for grant approvals already completed.**

Consider Changes to Pension Funding Amortization Schedules for both State and Teachers' Systems

- **State System: "Until the unfunded accrued liability is liquidated, the basic accrued liability contribution shall be the annual payment required to liquidate the unfunded accrued liability over a period of 30 years from July 1, 2008, provided that the amount of each annual basic accrued liability contribution after June 30, 2009, shall be five percent greater than the preceding annual basic accrued liability contribution. Any variation in the contribution of normal, basic, unfunded accrued liability or additional unfunded accrued liability contributions from those recommended by the actuary and any actuarial gains and losses shall be added or subtracted to the unfunded accrued liability and amortized over the remainder of the 30-year period."**

- **Teachers' System: "It is the policy of the State of Vermont to liquidate fully the unfunded accrued liability to the system. Until the unfunded accrued liability is liquidated, the accrued liability contribution shall be the annual payment required to liquidate the unfunded accrued liability over a period of 30 years from July 1, 2008, provided that the amount of each annual accrued liability contribution after June 30, 2009, shall be five percent greater than the preceding annual accrued liability contribution. Any variation in the contribution of normal or unfunded accrued liability contributions from those recommended by the actuary and any actuarial gains and losses shall be added or subtracted to the unfunded accrued liability and amortized over the remainder of the 30-year period."**

Amortization Schedule

- **While the State has a date set in statute, 2038, to pay down the unfunded liability, the payment schedule increases in 5% increments each year.**
- **This has the effect of increasing interest associated with the payment of these liabilities.**
- **Leveling out the payment schedule would increase ARC payments in the short-term but have the effect of saving the taxpayers millions of dollars over the long-term.**
- **This would also have the effect of a more rapid reduction of the unfunded liability.**
- **Changes to amortization schedule can be phased in to cushion budgetary impact.**
- **The Treasurer’s Office will present sample amortization schedules to the Committee in a separate document.**
- **Treasurer’s Office staff will model alternatives schedules at the Committee’s request to obtain an optimum solution.**

While review of federal funding and revisions to amortization schedules will assist in remediating the problem, the <u>single most important step</u> is an immediate and significant increase in <u>funding</u>!

Additional Appropriations Are Needed NOW!

- **FY 2012: $1,750,000 increase**
- **FY 2013: increased to $4,750,000**
- **FY 2014: No increase; remained at $4,750,000**

- **FY 2015: The Governor and the General Assembly need to make a significant appropriation to address this issue in each of the next two years.**