ELIZABETH A. PEARCE
STATE TREASURER

RETIREMENT DIVISION
TEL: (802) 828-2305
FAX: (802) 828-5182

UNCLAIMED PROPERTY DIVISION
TEL: (802) 828-2407

ACCOUNTING DIVISION
TEL: (802) 828-2301
FAX: (802) 828-2884

STATE OF VERMONT
OFFICE OF THE STATE TREASURER

November 1, 2018

The Honorable Phil Scott
Pavilion Office Building
109 State Street
Montpelier, VT 05609

Dear Governor Scott:

As provided in Title 16, V.S.A., Chapter 55, Section 1942(r), the Vermont State Teachers' Retirement (VSTRS) Board of Trustees voted at a meeting held on October 25, 2018 to adopt the actuarial valuation prepared by Segal Consulting.

A copy of the Fiscal Year 2020 valuation is available for your review at: https://www.vermonttreasurer.gov/sites/treasurer/files/VSTRS/VSTRS-reports/Actuarial-Valuation/VSTRS_2018_Valuation_Report.pdf.

In a subsequent meeting held on October 30, 2018, the VSTRS Board voted to recommend the following State contribution to the Teachers' Retirement System:

Fiscal Year 2020: $129,491,206

The recommended State contribution to the VSTRS fund is made up of an employer normal cost of $7,116,765 and an unfunded liability amortization payment of $122,374,441.

Also please note that pursuant to section 1944(b)(2), the actuary has determined that the reduction to the recommended contribution for FY20 attributable to the increase from 5% to 6% for Group C members with less than five years service as of June 30, 2014 is $2,312,780.

This year, the recommended State contribution is slightly higher than the actuarially determined employer contribution (ADEC), which is what the Board typically recommends for the annual State contribution. The difference is attributable to the supplemental $26.2 million payment to the VSTRS fund appropriated in the 2018 Special Session, and how that payment is recognized in the calculation of the FY20 unfunded liability.

I think it may help to first provide some background on VSTRS' unfunded liability. Due to a long history of annual underfunding (from 1990 to 2007) and losses sustained during the Great Recession, VSTRS currently has an unfunded liability of approximately $1.5 billion. Ten years ago, the State committed to paying off this unfunded liability by amortizing it over a closed 30-year period ending in 2038. Initially, the State set a payment schedule that backloaded the annual payments, using an amortization rate of 5 percent. In other words, the State set a payment schedule in which the annual payment would be backloaded by 5 percent each year.

More recently, the State sought to save taxpayers' money by paying more upfront and reducing the amortization rate to 3 percent. *See* 16 V.S.A. § 1944(c)(4)(A) & (B). Just like with a home mortgage, by reducing the backloading of payments on the unfunded liability and paying more upfront, we save on interest costs over time. The expected savings associated with this change are significant. Considering both the VSTRS and the VSERS systems together, our expected savings are between $165 and $200 million through 2038.

Last year's supplemental $26.2 million payment provides a similar opportunity to save on long-term interest costs. But it depends on how we treat the $26.2 million payment both now and in the future. Our choices are (1) to recognize the $26.2 million gain this year and reduce our annual payments by a small amount each year, or (2) to defer recognizing the gain this year, continue to pay our expected annual contributions, and achieve a significant reduction in interest costs for the tax-payer over the long-term.

To illustrate the point, imagine making an extra payment on a credit card balance after receiving an unexpected source of funds. Once you make that payment, you essentially have the same two options. You can either slightly reduce the payments you make every month, or you can continue to make the same payment you made before you received the unexpected funds and reduce the overall interest you pay.

This is the choice we have this year, and I would like to commend both the General Assembly and the Administration for supporting the supplemental $26.2 million payment to the Teachers' System and providing us with this opportunity. Here is how it works:

As it does every year, our actuary calculated the ADEC in a way that values the unfunded liability based on all gains and losses to the System over the past year. In this scenario, the unfunded liability was reduced by the $26.2 million payment, which would have the effect of reducing the annual payment on the unfunded liability by a few million dollars. As presented in Segal Consulting's report, the ADEC for FY20 is $126,197,389, which is made up of an employer normal cost of $7,116,765 and an unfunded liability amortization payment of $119,080,624.

Based on discussions in the General Assembly last year, in which a desire was expressed to maximize the savings from the supplemental payment, we asked our actuary to run additional scenarios that would illustrate the effect of deferring recognition of the $26.2 million supplemental payment, thereby taking advantage of compound interest on those dollars, and continuing our expected annual payments through 2038. A copy of Segal's analysis of the supplemental $26.2 million payment is available for your review at: https://www.vermonttreasurer.gov/sites/treasurer/files/VSTRS/VSTRS-reports/Actuarial-Valuation/Addendum_2018_VSTRS_Valuation.pdf.

After reviewing these scenarios, the VSTRS Board is recommending a State contribution that is based on Schedule 3 of Segal's analysis. As can be seen on that Schedule, if we defer recognizing the $26.2 million, and continue to pay our expected State contributions both now and in the future, the State will have the opportunity to realize savings of $77.4 million in interest costs at the end of the amortization period in 2038.

Ultimately, the Board decided to recommend the $129,491,206 State contribution to the Administration and General Assembly because it would both recognize and help make up, in part, for the historical underfunding of the System. It would also be consistent with the State policy of expediting the amortization of the unfunded liability. However, perhaps most importantly, the Board sought to provide a recommendation that maximizes the value of the $26.2 million payment to both Plan members and taxpayers and provides the opportunity for taxpayers to save an additional $77.4 million through interest earnings over the long term.

I would like to emphasize that these savings will not appear overnight, and it will take a disciplined, long-term effort to maintain our expected annual contributions and realize the benefits of this approach. I applaud the State's efforts over the past 10 years and the discipline the State has shown in addressing the System's unfunded liability, and I am confident in our ability to continue down this path.

I look forward to working with the Administration and the General Assembly on funding the VSTRS system this year, and I am happy to work through any questions you may have.

Sincerely,

Elizabeth A. Pearce
Vermont State Treasurer

cc: Senator Jane Kitchel, Chair, Senate Committee on Appropriations
Senator Jeanette White, Chair, Senate Committee on Government Operations
Representative Catherine Toll, Chair, House Committee on Appropriations
Representative Maida Townsend, Chair, House Committee on Government Operations
Jon Harris, Chairperson, Vermont State Teachers' Retirement Board of Trustees
Laurie Lanphear, Director of Retirement Operations, Office of the Treasurer
Representative Mitzi Johnson, Speaker of the House
Senator Tim Ashe, Senate President Pro Tempore