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TO: Kitty Toll, Chair, House Committee on Appropriations
Jane Kitchel, Chair, Senate Committee on Appropriations
Sarah Copeland-Hanzas, Chair, House Committee on Government Operations
Jeanette White, Chair, Senate Committee on Government Operations
Mitzi Johnson, Speaker of the House
Tim Ashe, Senate President Pro Tempore

FROM: Beth Pearce, State Treasurer

DATE: September 1, 2020

RE: Formal Update Regarding the Retired Teachers Health and Medical Benefit Fund ("RTHMB") and Vermont State Employees Other Post-Employment Benefits Fund (collectively "OPEB")

This letter is a formal update regarding key developments and initiatives for the Retired Teachers Health and Medical Benefit Fund ("RTHMB") and Vermont State Employees Other Post-Employment Benefits Fund (collectively "OPEB"):

- Recent market conditions reduced the discount rate used to value the OPEB liabilities from 3.50% at 6/30/19 to 2.21% at 6/30/20. This will increase the RTHMB liability by over $227M and the VSERS OPEB liability by over $266M.
- We have undertaken a study on RTHMB to review and compare the actual healthcare costs incurred versus national trends used to value the liability.
- We have engaged an actuarial firm to evaluate alternative models for the RTHMB healthcare plan, moving to a fully insured versus the current self-insured plan, without a reduction in benefits for our current and future retirees.
- We have begun working on the agreement for investing OPEB assets through VPIC, as authorized in Act 120 of 2019 (Sec. A.13. 3 V.S.A. § 523) to maximize return.

While the challenges facing the plan due to discount rate exposure are unfortunate, we can still work toward pre-funding and reducing the OPEB liabilities for the future. We continue to work to find creative solutions, but adequate funding is still missing. The investment authorization granted in Act 120 will help grow OPEB assets, but a commitment in statute to fund an amount above the Pay-Go is needed to achieve a pre-funded plan.

Background

On February 25, 2020, we communicated to you in memorandum our formal request to fulfill the requested $37,771,784 in funding from the General Fund, which was reduced by $5,973,050 in the

Governor's recommended budget. In addition, we requested that a funding policy be created in statute to provide for on-going funds for the RTHMB in lieu of an ADEC.

On March 10, we reiterated our request and pointed out the potential to save almost $500M on the State's financial statements. We noted that the lost interest on the reduced appropriations would total $40.8M by 2048, and by not adopting a funding policy in statute, the state would be exposed to the benchmark interest rate used in lieu of an investment return rate.

While we have not received the requested funding or a commitment in statute to a funding policy for the RTHMB, we do appreciate the insertion of language in Act 120 of 2019 granting the Treasurer the ability to contract with the Vermont Pension Investment Committee ("VPIC") to maximize the return on investment of OPEB assets.

Since our Last Communication

The Federal Reserve Bank reduced the target benchmark interest rate several times during the past fiscal year and once since our last communication to 0-.25%. Furthermore, economic uncertainty associated with the COVID-19 pandemic has adversely affected yields. As noted in our previous letter, the discount rate used to value the OPEB investments is the benchmark 20 year AA General Obligation Bond rate. That rate has declined over the past fiscal year from 3.50% at 6/30/2019 to 2.21% at 6/30/20, a decrease of 1.29% While we will not have the results of the actuarial valuation dated 6/30/20 until closer to the end of the calendar year, previously we estimated that the impact of a 1.00% decrease in rates for each of the OPEB funds was a $375M increase in liability. Our estimates of a 1.29% decrease are almost $500M across both OPEB funds. When compared to the $500M savings that could have been achieved by reaching pre-funding with a funding policy in statute and the restoration of the requested RTHMB appropriation, there is a swing of $1B.

Earlier this summer we engaged our actuarial firm to review the specific experience of the RTHMB as compared to national trend rates used to estimate the RTHMB liability. We decided to undertake this Healthcare Costs Trend Study due to gains related to experience in the plan over the past few years. While we do not have the results of this study yet, we expect to have something to report soon and will provide copies when available. We are hopeful that by using a healthcare cost trend line more indicative of our population versus national trends that there will be a corresponding reduction in the liability.

Currently we self-insure the RTHMB through Vermont Education Health Initiative ("VEHI") which requires us to absorb any volatility in costs in the plan. In turn, we can save money in years when healthcare costs are below projections, and we are able to collect Employer Group Waiver Plan ("EGWP") rebates and subsidies based on performance. The downside of EGWP is that it takes several years to collect all the rebates/subsidies related to a given year. We are currently evaluating the use of a fully insured plan that would limit our liability and reduce the overall costs, which are estimated by our consultants to be $3-7M over each of the first two years, without a reduction in services. This evaluation is currently at its early stages, and we are working with VEHI to better understand the implications, costs and benefits of such a change. Any decision on this subject will require action from the VSTRS Board to proceed if deemed worthwhile. We expect to have further updates regarding this potential reduction in healthcare costs later this calendar year.

Lastly, with the passage of Act 120 of 2019, we have been working with VPIC to invest OPEB assets. While the RTHMB does not currently have significant funds for investment, the State OPEB has over $51M which are available for investment by VPIC. Previously these assets were invested in the Trust

Investment Account ("TIA") which had an overall rate of return of 6.2% in FY2020. We expect to begin investing these funds by the end of the calendar year.

Conclusion

Despite the efforts outlined previously, the decline in the benchmark discount rate will most likely result in a large increase of the OPEB liabilities. We believe that now is the time for continued attention, ensuring that we advance on the path of pre-funding and eventually toward fully funding the OPEB liabilities. Without proactive efforts toward developing a funding policy and continued support for these plans, the liabilities will be exposed to this volatility. We look forward to updating you later in the year on our efforts surrounding the Healthcare Cost Trend Study, evaluation of a fully insured versus self-insured RTHMB, and on our investment contracting with VPIC. While the expected increase in liabilities due to discount rate exposure is disappointing, we hope to work with you in the 2021 legislative session to work toward achieving pre-funding.

I would especially like to thank Will Kriewald, our Chief Financial Officer, for his critical work on this matter. Please do not hesitate to contact either myself or Will with any questions.