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STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO:	Representative Kitty Toll, Chair, House Committee on Appropriations Representative Sarah Copeland-Hanzas, Chair, House Committee on Government Operations Senator Jane Kitchel, Chair, Senate Committee on Appropriations Senator Jeanette White, Chair, Senate Committee on Government Operations Mitzi Johnson, Speaker of the House Tim Ashe, President Pro Tempore
FROM:	Beth Pearce, State Treasurer Beth
DATE:	March 10th, 2020
RE:	An Analysis of Proposed Reductions to Teacher Health Care Liabilities and the Cost of Inaction

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The Vermont Legislature has moved to the second half of the 2020 cycle and as the development of a budget for FY2021 approaches, the Treasurer's Office wants to reiterate its request to fully fund the Retired Teachers Health and Medical Benefit Fund ("RTHMB") line item which was underfunded by the Governor's recommended budget request by $5,973,050. This is a follow-up to my memorandum of February 25th (see attached) and my previous testimony on January 23rd and January 31st.

Adopting this proposal will reduce our liabilities by almost $500 million. On the other hand, inaction will mean these savings will not be realized; but also additional liabilities will be incurred by delay. The purpose of this memorandum is to detail the costs of delay. I believe, based on the analysis below, that you will agree that it is imperative that we simultaneously fund the RTHMB per our budgetary request and establish a funding policy in statute to achieve pre-funding.

While we will discuss these items in further detail, there are essentially three major detriments by remaining in the current primarily pay-go funding patterns and delaying/not achieving pre-funding:

- *Discount Rate Exposure* – The unfunded liability is directly impacted by the 20 Year AA General Obligation Bond Rate (a standard required by government accounting); it has declined over a full percent this year and would increase the liability by at least $175M if it remains at current levels.

- *Loss of Investment Earnings* – by not appropriating for investment purposes, we grow the unfunded liability. The current year shortfall of $5,793,050 would cause the liability to increase by $40.8M in 2048 at our current assumed investment rate.

- *Financial Statement Impact* – We currently carry the liabilities for the OPEB on our Government Wide Financial Statements in the State's Comprehensive Annual Financial Report ("CAFR"). Once we achieve pre-funding there is a one-year lag until we can recognize that savings, the delay in reaching pre-funded status pushes that date back further.

All of the above will add over $200 million to the RTHMB liability if the proposal requested by my office is not enacted. On the other hand, we can avoid the $200 million increase and additionally save almost $500 million if the General Assembly chooses to include the Treasurer's Office request in the FY2021 budget.

Over the years we have discussed or seen the need for action and the impacts of past inaction. Inaction on pensions in the 1990s and early 2000s contributed to our current unfunded liabilities, further compounded by the impacts of the Great Recession, economic changes, workforce changes enacted over the years, and the continued underfunding of health care liabilities. Most recently we saw the same pattern in our clean water assets; years of inadequate resources exacerbated our clean water problems requiring significant dollars and resources to address the issue. On the other hand the Appropriations Committees and the General Assembly have taken real steps to address our long term liabilities; you addressed the funding of clean water, you increased our rainy day and other reserves, you have put additional dollars into pensions (which despite the rhetoric have had a positive impact), and you have reduced our reliance on debt by enacting the CDAAC recommendations. At the same time, you have worked to find compassionate answers to the needs of citizens, and we recognize that more needs to be done, but ask you to take this additional step to fund our proposal.

You have heard a great deal about the "four buckets" and the need to review each bucket to determine the right course of action. We agree. But the need for further review should not be used as an excuse for not taking action on a proposal that clearly has an immediate and significant benefit. Our taxpayers will benefit by our taking action now.

Attached is a sheet that identifies the four buckets (State and Teacher Pensions, State and Teacher OPEB) and steps to be taken in <u>all four</u>. We are currently moving through a risk assessment review with a collaborative work group to develop proposals to reduce the two pension liability buckets. The group, including Administration officials, has tentatively pointed to an October date to conclude its work; although I still remain hopeful that we can have some dialogue on these for the FY2021 budget year. The OPEB buckets (other post-employment benefits, i.e. health care) have an even more promising ability to immediately lower liabilities. We have proposed action to the Teacher OPEB (RTHMB) as it is the most immediately attainable although we hope to present a similar solution for the State Retiree Health Care for the FY2022 budget cycle in the next legislative session. Acting on our proposal does not preclude additional discussions among the members of the General Assembly, Treasurer's Office and the Administration on proposals to lower health care liabilities- changes to formularies, contracts, even benefit changes for future retirees. But it does take a proactive step to lower our liabilities, create a disciplined financial policy that will benefit future taxpayers and send a clear message to the rating agencies that we are serious about lowering our liabilities.

I am reminded of what I stated when we addressed the enormous cost of addressing our clean water needs:

> "While I appreciate the value of additional research and refinement, we should not allow a continued search for the perfect solution to take the place of good, concrete action based on known data. The time to identify a more permanent and sustainable funding source is now. I urge the General Assembly to take action now… The time to act is now. Like an unpaid credit card bill—the longer we defer action, the more expensive the solution will become."

The Treasurer's Office would like the opportunity to present further background information on our request and the development of cost estimates on any delay. We will work to schedule a meeting with House Appropriations and look forward to a dialogue with the Senate as well.

We appreciate your time in reading both this memorandum as well as the formal request for funding the RTHMB. While there are many funding requests and pressures on the General Fund, we believe the benefits as well as the avoidance of the detriments in this instance represent a compelling reason to prioritize pre-funding that delivers significant savings to Vermonters while keeping our promises to State employees and teachers. We hope to bring a plan to achieve pre-funding for the VSERS OPEB next legislative session and believe the momentum from achieving pre-funding this year for the RTHMB will boost support for that proposal as well.

As stated above, there is a significant cost to the taxpayer if we delay. Now is the time for disciplined, forward thinking action. My office is available to meet with you at your convenience and to respond to any questions you may have. Thank you for your consideration.

Pension Summary Sheet

6/30/2019

(in Millions) AVA	VSTRS	VSERS	VSTRS OPEB (RTHMB)	VSERS OPEB
Assets	$ 1,950.90	$ 1,964.50	$ 0.31	$ 51.70
Liabilities	$ (3,505.30)	$ (2,780.00)	$ (1,041.06)	$ (1,279.30)
Net Liability	$ (1,554.46)	$ (815.46)	$ (1,040.75)	$ (1,227.60)
Funded Percentage	55.65%	70.67%	-0.03%	4.04%
Current Plan	- Amortization Schedule moves us to full funding by 2038. - Alterntiave Amortization scheduled to preserve $77M in interest on $26.2M contribution in 2018 - Performed Risk Assessment identifying opportunities for savings/reduced volatility. - Experience Study currently in progress (results post session)	- Amortization Schedule moves us to full funding by 2038. - Performed Risk Assessment identifying opportunities for savings/reduced volatility. - Experience Study currently in progress (results post session)	- RTHMB Plan adopted by legislature last year. - Funding Sources from Federal, State, Local and Teachers.	- Assets are invested in the Trust Investment Account (TIA). Resulted from 2019 Surplus and RDS Subsidies in prior years.
Potential Changes/Updates	- Risk Assessment identified possibility of increased member contributions, rolling amortization, and one time cash infusions - Results of experience study may yield additional opportunities - Discussion ongoing about revisions/changes	- Risk Assessment identified possibility of increased member contributions, rolling amortization, and one time cash infusions - Results of experience study may yield additional opportunities - Discussion ongoing about revisions/changes	- Funding Plan through end of GASB 74 Amortization Period (2048) - Negotiate NTHCA Sunset Date - Funding Policy commitment in Statute, pursue VPIC like Investment Opportunities - Review Formulary for opportunities	- Funding Plan through end of GASB 74 Amortization Period (2048), ~$8M GF need (assuming 35% GF Funding of Total), reduced exposure to volatility in front end due to balance - Funding Policy commitment in Statute, pursue VPIC like Investment Opportunities - Review Formulary for opportunities

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TO: Representative Kitty Toll, Chair, House Committee on Appropriations
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Mitzi Johnson, Speaker of the House
Tim Ashe, President Pro Tempore

FROM: Beth Pearce, State Treasurer Beth

DATE: February 25th, 2020

RE: Formal Request regarding the Retired Teachers Health and Medical Benefit Fund ("RTHMB")

On January 23rd, 2020 the Treasurer's Office presented its annual budget request and informed the House Appropriations Committee that the request was underfunded by the administration by roughly $9.5 million ($3.5 million in pensions and just under $6 million in retired teacher heath care. This memo addresses the issue of the teacher health care shortfall. On January 31st, 2020 the Treasurer's Office again presented its request to House Appropriations to restore $5,973,050 in FY 2021 General Fund appropriations funding for the Teachers Retired Teachers Medical Benefits Fund, an OPEB trust fund that pays for and accumulates resources to pay future retiree health care. This memo is intended to restate this request and to provide additional information relative to the request. To reiterate, our request is as follows:

- Full funding of our requested General Fund appropriations for the RTHMB totaling $37,771,784 for FY2021.
- Creation of a funding policy in Statute that provides for on-going appropriations to the RTHMB in lieu of an ADEC, allowing for prefunding, stability and budget predictability going forward.

The combination of these actions will result in the removal of approximately $474 million from our OPEB liability on the State's Balance Sheet and send a strong message to the Ratings Agencies that Vermont is proactively addressing its unfunded balances.

Background

In 2014, a collaborative effort by the Administration, Treasurer's Office, VSTRS Trustees, JFO, and both the Senate and the House created a funding plan for the RTHMB through 2038. This funding plan included sources of federal dollars, contributions by teachers, local contributions, and explicit General Fund appropriations. This plan has been followed until recently.

On January 23rd, 2019, the Treasurer and Deputy Secretary of Administration presented a plan to the House appropriations committee to pay off an interfund loan between the RTHMB and General Fund using one-time money, and subsequently reduce the requested General Fund appropriation in FY2020. This request included a provision to restore funding in FY2021 which would put the fund on a pathway to a projected balance of $75 million by 2025.

On November 27th, 2019, a memorandum was sent to the Secretary of Administration and Commissioner of Finance detailing the request for funding of the RTHMB totaling $37,771,784. Subsequently, the Governor's Budget only provided funding for $31,798,734, a shortfall of the request by $5,973,050. Those dollars were intended to increase the balance of the fund and continue the prefunding path.

You cannot reach the FY2025 $75 million target by shorting appropriations, unless you assume that future appropriations will cover the balance. Given the Administration's reluctance to fund the 2021 appropriation as requested, it is difficult to rely on future appropriations above and beyond the expected plan, which would be necessary to make up the difference.

The Cost of a Reduced Appropriation

In calculating the overall unfunded liability, the actuaries take into consideration the balance of assets in the fund, the expected investment return rate, and the funding policy of the plan. If these amounts exceed the expected benefit payments of the plan, then the plan qualifies for pre-funding. If these amounts do not exceed the expected benefit payments, then the plan is considered to be pay-go, or funding benefit payments as they are incurred. The liability associated with the plan is required to be calculated under Governmental Accounting Standards Board ("GASB") 74 using:

> *"the single rate that reflects (1) a long-term expected rate of return on OPEB plan investments to the extent that the OPEB plan's fiduciary net position is projected to be sufficient to make projected benefit payments and OPEB plan assets are expected to be invested using a strategy to achieve that return and (2) a tax-exempt, high-quality municipal bond rate to the extent that the conditions for use of the long-term expected rate of return are not met.*

The resulting effect is that we are required to use the second option, which is the index rate for 20-year, tax-exempt general obligation municipal bonds with an average rating of AA/Aa or higher, which at 6/30/2019 was 3.50%. Compared to an expected rate of return of 7.50%[1] currently used for our pension investments, this increases the liability significantly. As of the date of the most recent valuation for the RTHMB, the net liability was estimated at 6/30/2021 to be $1,068,897,395 using the 3.50% required rate. If the 7.50% rate was used, the net liability would have totaled $594,577,337, a total reduction of $474,320,058.[2] If we are able to meet the criteria detailed in our request, this savings can be realized on our next valuation as of 6/30/2020. This would then be included in the 2020 CAFR in the "Notes to the Financial Statements". Because GASB 75 permits, and the state uses, an annual lag for financial statement purposes, it would reduce the government wide financial statements for FY2021 by the same amount.

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[1] The current actuarial assumption is a return rate assumption of 7.5%. The Teachers' Board of Trustees has authorized an experience study, to be completed prior to the 2020 valuation, to review and potentially reset economic, demographic and experience assumptions. While the current assumed rate is used in this analysis, we have modeled the prefunding scenarios at 7.3% and 6.5%.

[2] Based on current projections. Given current decline in treasury rates and 20-year bond rates, the spread could be more, depending on any adjustment to the assumed rate of return.

Additionally, any dollars not appropriated into the fund lose the ability to earn interest through investment. If restored as an investment, based on the 7.5% expected investment return, the dollars would be worth $7.7M by 2025, or $40.8M in 2048. This shortfall represents a significant cost to taxpayers that can be avoided by meeting the Treasurer's Office's full request this year. The key to this is to use investment earnings as opposed to appropriations to pay benefits. We believe we have a plan to get us there.

Developing a Funding Policy
While restoration of the full funding request for the RTHMB is the primary ask in terms of appropriations, the creation of a funding policy is equally important to achieve pre-funding. The funding policy is a clear directive in statute to continue to fund the RTHMB in excess of the pay-go amount. This policy allows the actuaries to include future payments in addition to assets and expected investment earnings when calculating pre-funding eligibility.

We have created an example funding plan, which the actuaries reviewed, to determine the sufficiency for pre-funding status. The plan requires 10% funding increases for FY2022-2025, and then changes to a 3% annualized increase allowing for budget stability. Volatility in the early years risks that status which is why it is imperative to also restore this year's RTHMB appropriation to the requested amount.

The actuary has verified that the plan generates a surplus of funds by 6/30/2048, which is the target amortization date determined in accordance with GASB 74. Also as noted in their report, the calculation for determining pre-funding eligibility does not account for future members. The surplus noted is expected to cover that assumption, as well as provide a cushion for volatility in other actuarial assumptions.

Furthermore, we had the actuaries evaluate the sufficiency of the plan with a reduced discount rate to ensure there was room for investment volatility, which both plans still achieved surplus'. We believe that formalizing one of these plans (or something similar) in Statute would allow us to recognize pre-funded status on the upcoming June 30, 2020 valuation reports, which will be reported in the FY2021 Comprehensive Annual Financial Report.

The language that we are proposing (see attached) would include a base appropriation, which then could be increased by a fixed percentage each year. Our recommendation is to increase the appropriation by 10% from FY 2022 - 2025, and then increase the funding by 3% thereafter until the unfunded liability is liquidated. We are open to discussing alternative plans if suggested.

The plan has less volatility if one were to simply appropriate an annual ADEC which can change from year to year based on actuarial gains and losses. By utilizing a percentage increase per year, we limit that volatility and provide a more predictable number for budget purposes.

Change in Investments
At the end of FY 2019, the balance of the RTHMB was approximately $300K, and is currently invested in State's cash and earns a short-term rate of interest. The VSERS OPEB has a balance of $51.7M and is invested in the Trust Investment Account ("TIA"). The TIA account has a 60/40 mix of bonds and stocks respectively and has a target return below that of the VPIC Investments. Our final ask is that language be adopted in Statute, as part of the Miscellaneous Retirement Bill (H. 922)

to allow for the Treasurer as Fiduciary to invest these funds in agreement with VPIC in a manner similar to the three pension systems it currently invests on behalf of. This would allow for a greater return on investment and reduce the necessary appropriations to the RTHMB and VSERS OPEB that would be required if invested in their current manner.[3]

Conclusion

We are aware of the difficulties faced on an annual basis in determining the best use of taxpayer dollars. Restoring the VSTRS OPEB requested General Fund appropriation represents a compelling case because of the potential savings, and opportunity that we have when combined with the requested changes in Statute and establishment of a funding policy.

- Restore $5,973,050 in FY 2021 General Fund appropriations to cushion against volatility in the plan.
- Commit in Statute to a funding policy that is for an explicit amount as opposed to a changing ADEC.

We thank you for your consideration of the above and look forward to discussing with you in the near future.

[3] This is not a request of the Appropriations Committees. This language is contained in the Miscellaneous Retirement Bill, H.922, which has already passed the House and is currently in the Senate Committee on Government Operations.

Title 16 : Education

Chapter 055 : State Teachers' Retirement System Of Vermont

- **§ 1944b. Retired Teachers' Health and Medical Benefits Fund**

(a) There is established the Retired Teachers' Health and Medical Benefits Fund (Benefits Fund) to pay retired teacher health and medical benefits, including prescription drug benefits, when due in accordance with the terms established by the Board of Trustees of the State Teachers' Retirement System of Vermont pursuant to subsection 1942(p) and section 1944e of this title. The Benefits Fund is intended to comply with and be a tax exempt governmental trust under Section 115 of the Internal Revenue Code of 1986, as amended. The Benefits Fund shall be administered by the Treasurer.

(b) The Benefits Fund shall consist of:

(1) all monies remitted to the State on behalf of the members of the State Teachers' Retirement System of Vermont for prescription drug plans pursuant to the Employer Group Waiver Plan with Wrap pursuant to the Medicare Prescription Drug Improvement and Modernization Act of 2003;

(2) any monies appropriated by the General Assembly for the purpose of paying the health and medical benefits for retired members and their dependents provided by subsection 1942(p) and section 1944e of this title;

(3) any monies pursuant to subsection (e) of this section; and

(4) [Repealed.]

(5) any monies pursuant to section 1944d of this title.

(c) No employee contributions shall be deposited in the Benefits Fund.

(d) Interest earned shall remain in the Benefits Fund, and all balances remaining at the end of a fiscal year shall be carried over to the following year.

(e) [Repealed.]

(f) Contributions to the Benefits Fund shall be irrevocable and it shall be impossible at any time prior to the satisfaction of all liabilities, with respect to employees and their beneficiaries, for any part of the corpus or income of the Benefits Fund to be used for, or diverted to, purposes other than the payment of retiree postemployment benefits to members and their beneficiaries and reasonable expenses of administering the Benefits Fund and related benefit plans.

(g) Beginning with the fiscal year beginning July 1, 2021, the annual contributions to be made to the Benefits Fund by the State shall be determined on the basis of the funding schedule set forth in this subsection. It is the purpose of the funding schedule and the policy of the State of Vermont to liquidate fully the unfunded accrued liability to the Benefits Fund.

(1) Funding Schedule. Beginning on July 1, 2021, until the unfunded accrued liability to the Benefits Fund is liquidated, the annual State contribution shall be equal to the prior year's annual State contribution adjusted by the percentage increase set forth below:

(A) From July 1, 2021 to June 30, 2025, the percentage increase over the prior year's annual State contribution shall be 10.0 percent.

(B) From July 1, 2025 and annually thereafter until such time as the unfunded accrued liability is fully liquidated, the percentage increase over the prior year's annual State contribution shall be 3.0 percent.

[Repealed.] (Added 2013, No. 179 (Adj. Sess.), § E.514.1; amended 2015, No. 114 (Adj. Sess.), § 6; 2017, No. 85, § E.515.1; 2017, No. 165 (Adj. Sess.), § 19; 2019, No. 6, § 90, eff. April 22, 2019.)