PENSIONS – POTENTIAL OPTIONS

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House Committee on Government Operations

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Agenda

1. Options that Reduce Liabilities
2. Options that Increase Assets
3. Current vs. Future Hires

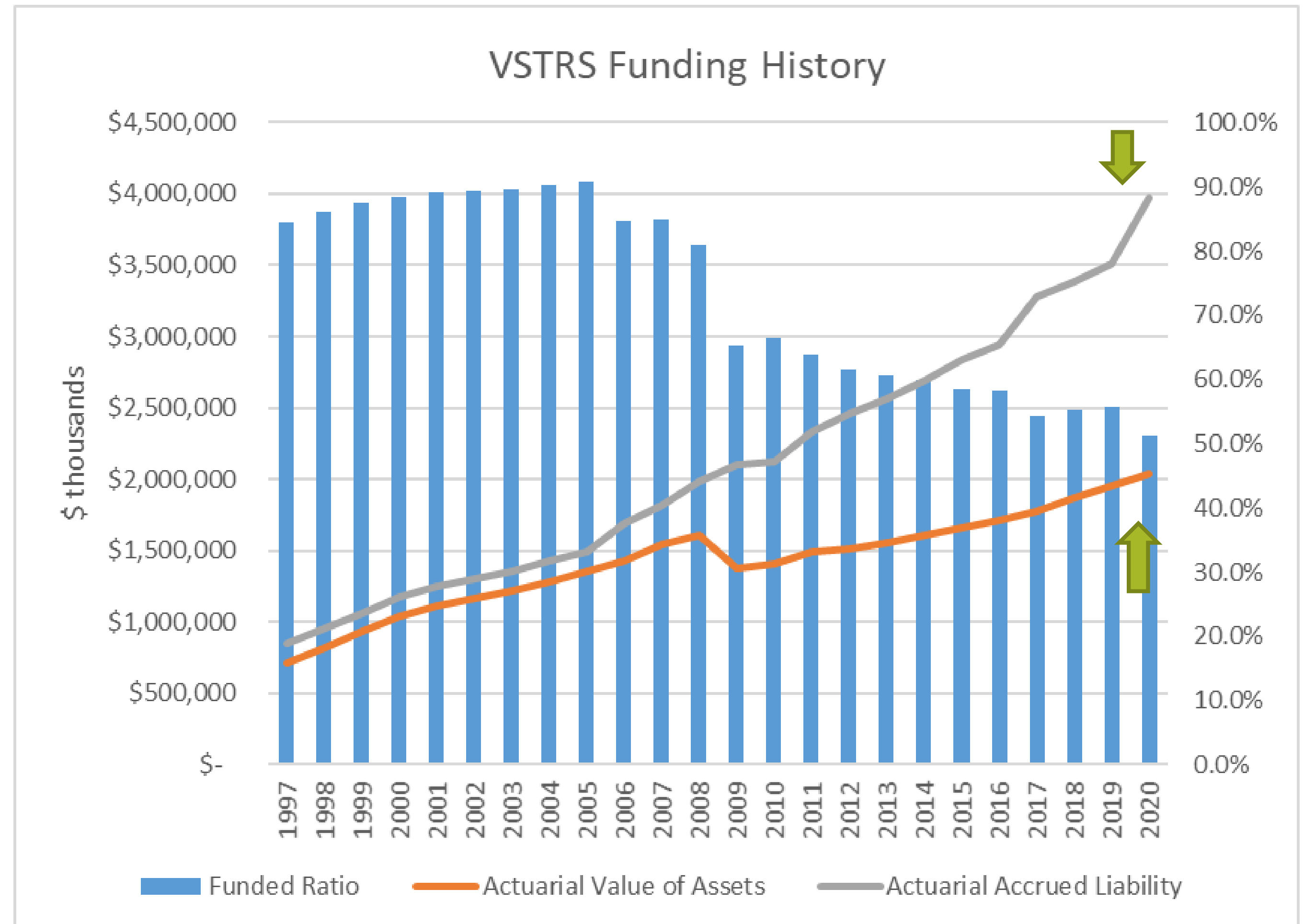
Strategies to Reduce ADEC Pressures and Improve Funding Ratio

Unfunded liabilities represent the "gap" between the accrued liabilities and the actuarial value of assets.

Theoretically, these lines converge by the end of the amortization period.

Unfunded liabilities must be paid off through higher ADEC payments when all else is held equal. In the conventional pension model, the employer bears the cost of these higher ADEC payments.

Reducing ADEC pressures requires you to take steps to make the asset and liability lines come closer together.

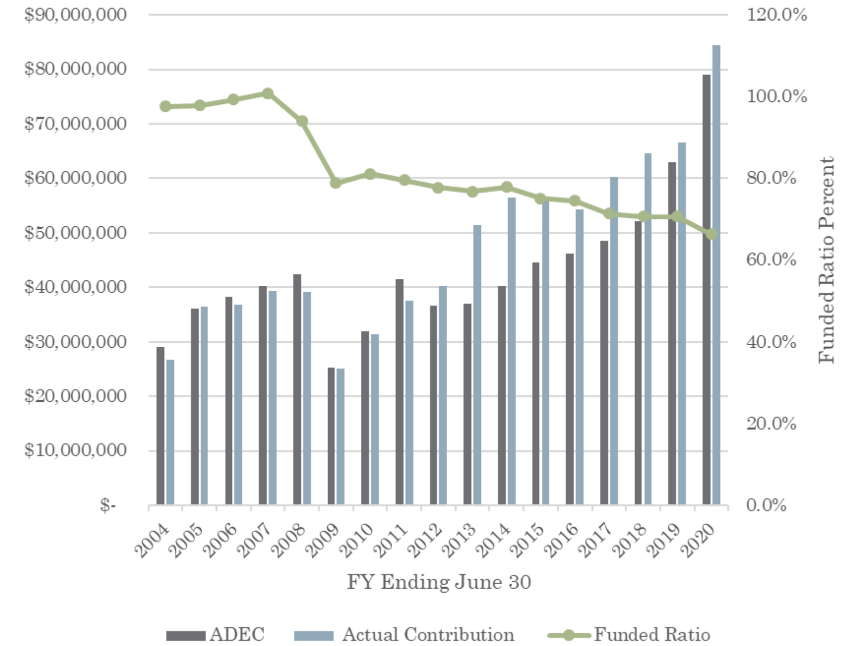


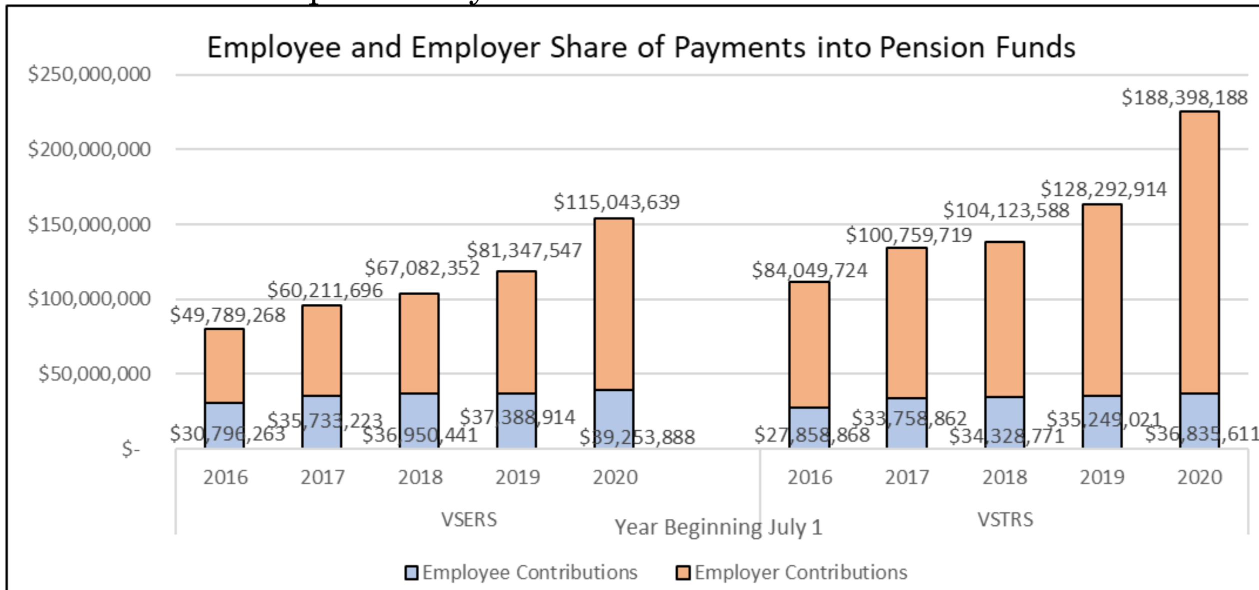
- In recent years, pension costs to the employer have grown significantly – and at a faster rate than employee contributions.

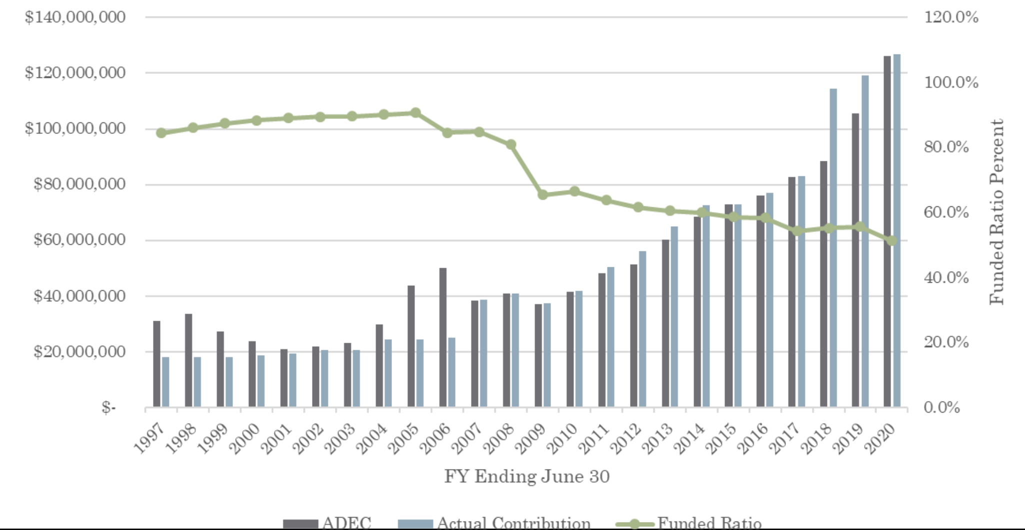
- Despite the employer fully funding its required ADEC payments every year since at least FY07, and despite sharp increases in these payments, the funded ratios of the plans has kept declining.

- Recent changes to demographic and economic assumptions have increased the normal cost, as well. This means that the cost of each year's pension benefits accrued by the active workforce is increasing, and also increasing the employer ADEC payment amount. Employee contributions now cover approximately half of the normal cost with the employer bearing the remainder of the cost through the ADEC.

- Employee contributions represent a declining percentage of the total payments made into the pension systems.





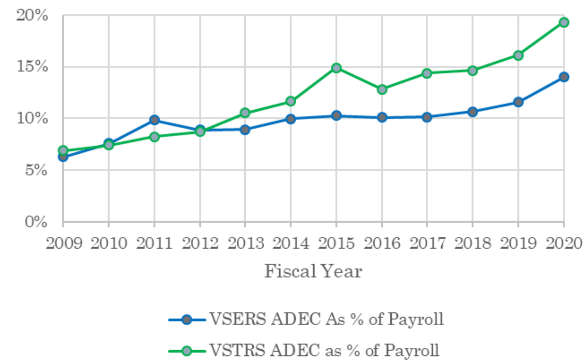


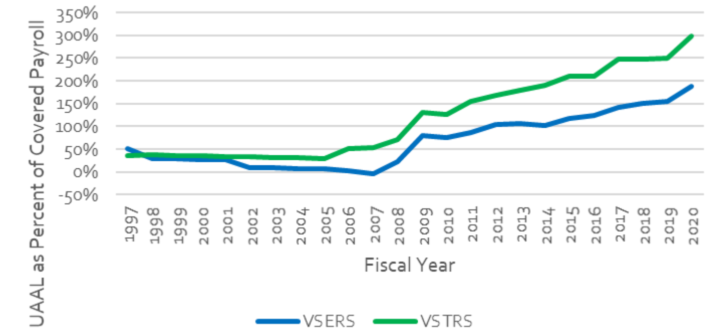
- The unfunded liabilities have increased more rapidly than the overall payroll. This means that payments toward the unfunded liability have, and will continue, to eat a larger slice of the budget pie.

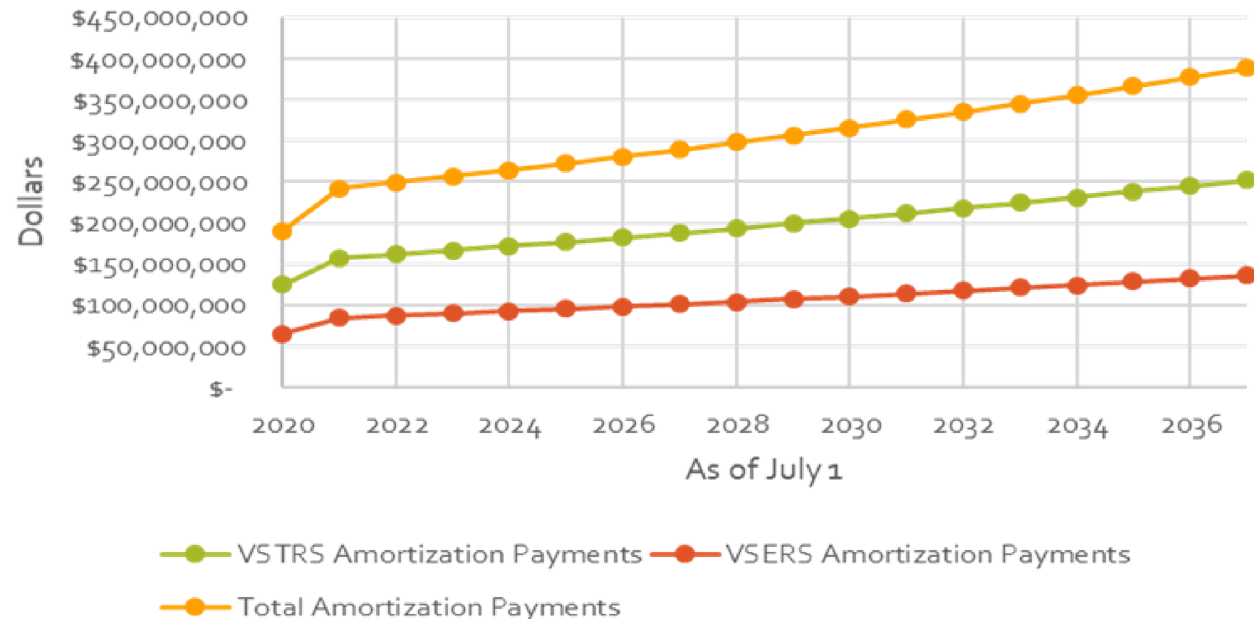
- In a status quo situation, employer payments toward the two unfunded liabilities are expected to increase from a total of $190.5 million in FY21 to $388.6 million in FY38 if all assumptions are met.

- In addition to these dollar figures, the employer would have to continue paying the remainder of the normal cost that isn't funded by employee contributions. Currently the employer pays approximately half of the normal cost in both systems, which translates to 5.58% (VSTRS) and 5.88% (VSERS) of payroll based on current data.

    - VSERS payroll is assumed to increase by 3.5% per year and VSTRS payroll is assumed to increase by 3% per year.







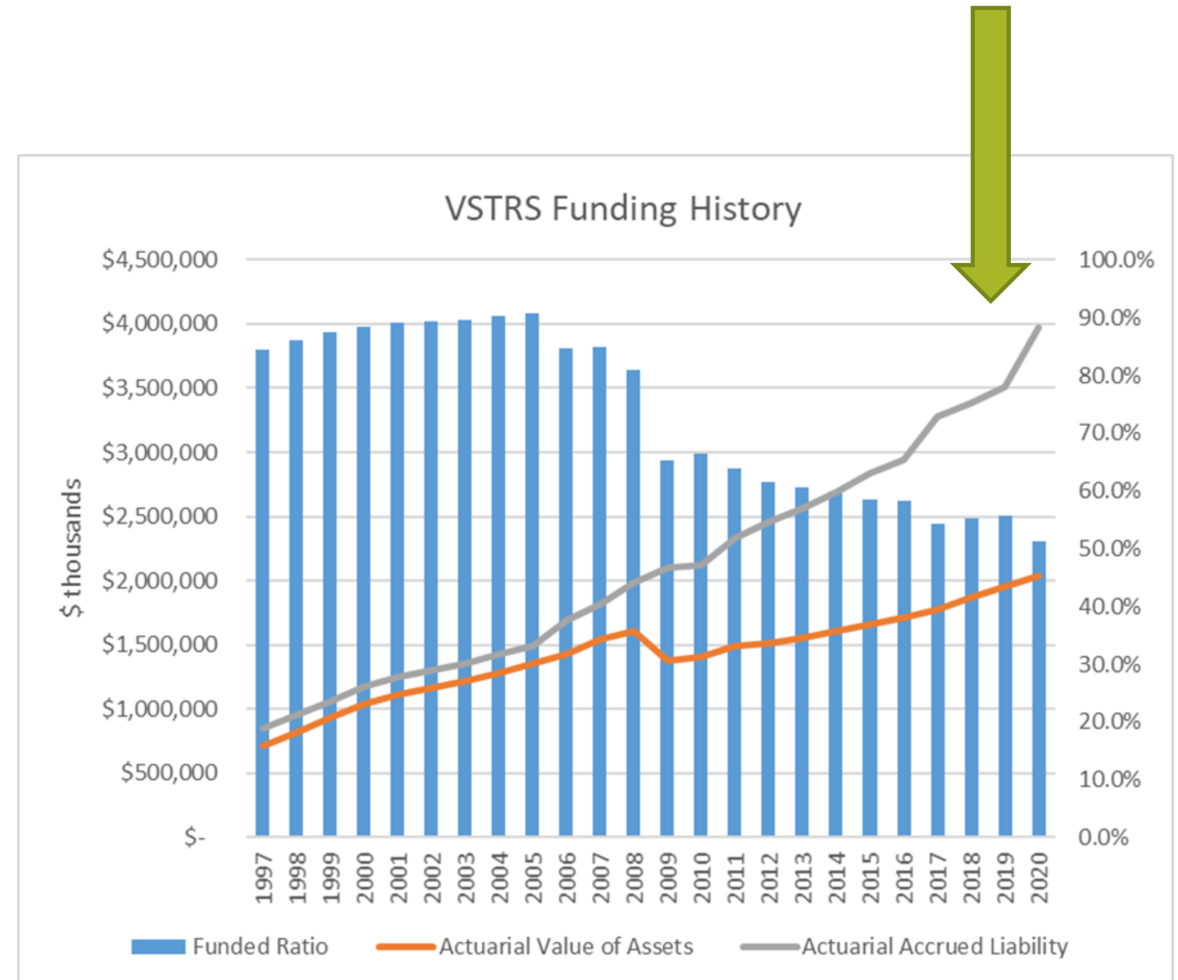
Strategies to Reduce Liabilities

Both the ADEC and Normal Cost can be lowered by making changes to plan design to lower the cost of future pension benefits.

Lowering the cost of future pension benefits has the effect of slightly "flattening" the steepness of the Actuarial Accrued Liability line:

- Gap between liabilities and assets (the unfunded liability) gets smaller.
- As unfunded liability gets smaller, so does the ADEC payment.
- Plan funding ratio improves when unfunded liability decreases.

As long as the pension system is open to new participants, the liability line will likely have an upward slope. The goal is to have the asset and liability lines get closer together over time.



Strategies to Reduce Liabilities

- On January 15th, the State Treasurer released a report that provided preliminary cost impacts for making a range of changes to plan design to reduce liabilities and the ADEC for both VSERS and VSTRS.

- Cost savings and revenue enhancements were both analyzed. Changes would not impact current retirees.

- The next few slides will present summaries of the options that were reviewed in the January report to provide you with context, as well as discussion around options often pursued in other states.

- This presentation does not aim to endorse or reject any option.

Scope of Challenge for Each Fund		
	VSERS	**VSTRS**
UAAL 2019 Valuation for FY21 Budget	$815.5 million	$1,554.0 million
UAAL 2020 Valuation for FY22 Budget	$1,040.5 million	$1,933.0 million
Change in UAAL	**$225.0 million**	**$379.0 million**
ADEC FY21	$83.9 million	$135.6 million
ADEC FY22	$119.9 million	$196.2 million
Change to ADEC	**$36.0 million**	**$60.6 million**

Strategies to Reduce Liabilities

Modify the COLA Formula

- Cost of Living Adjustments are pegged to the CPI and help retirement benefits keep pace with inflation. They also represent a significant cost over time to the pension systems.
- A range of options *could* be implemented to lower these costs:
  - Remove COLAs for some or all employees upon retirement.
  - Apply a COLA threshold (e.g. COLA applies to the first $xx of annual retirement benefit. Amounts above the threshold would not increase with the COLA).
  - **Risk sharing:**
    - COLAs apply when the fund achieves some metric of pension health (e.g. a defined funded ratio, exceeds a defined investment benchmark) and are paused when the fund does not reach those targets.
    - Shared risk/shared gain: Implement limits on COLAs when the fund is doing less well, and increase those limits when the fund is doing better.
  - Only apply COLAs once an employee has been retired for a minimum period of time.

Plan	Current Structure
VSERS Group C and D	100% CPI (1% min, 5% max) after 12 months of retirement.
VSERS Old Group F	100% CPI (1% min, 5% max) after reaching age 62 or 30 years of service.
VSERS New Group F	100% CPI (1% min, 5% max) after reaching age 65 or Rule of 87.
VSTRS Group C1	50% CPI (1% min, 5% max) after 12 months of retirement or with 30 years of service.
VSTRS Group C2	50% CPI up to max of 5%

Strategies to Reduce Liabilities

Modify the Vesting Schedule

- An employee must accrue a minimum number of service credit years in order to qualify for a retirement benefit. This time period is called the vesting period.
- Most VT members must accrue 5 years of service in order to vest.
- The most common vesting periods nationwide are either 5 or 10 years.

Modify the AFC Formula

- An employee's Average Final Compensation (AFC) is used to determine their pension benefit.
- Most VT members have their AFC calculated by averaging their 3 highest consecutive years of salary excluding unused annual leave payoffs.
  - Exceptions: VSERS Group C (2 Highest Consecutive, including unused annual leave) and VSERS Group D (Final Salary at retirement)
- Increasing the number of years considered when determining AFC has the potential to lower liabilities by reducing any impacts from unusual salary increases in final years of employment and providing an AFC that is more broadly reflective of the employee's overall salary history.

Strategies to Reduce Liabilities

Modify the Normal Retirement Eligibility

- To qualify for normal retirement, an employee must reach a minimum age or combination of age and years of service (*Rule of x*) – whichever comes first. For example, an employee covered by a Rule of 90 is eligible to retire if their age plus years of service total 90.

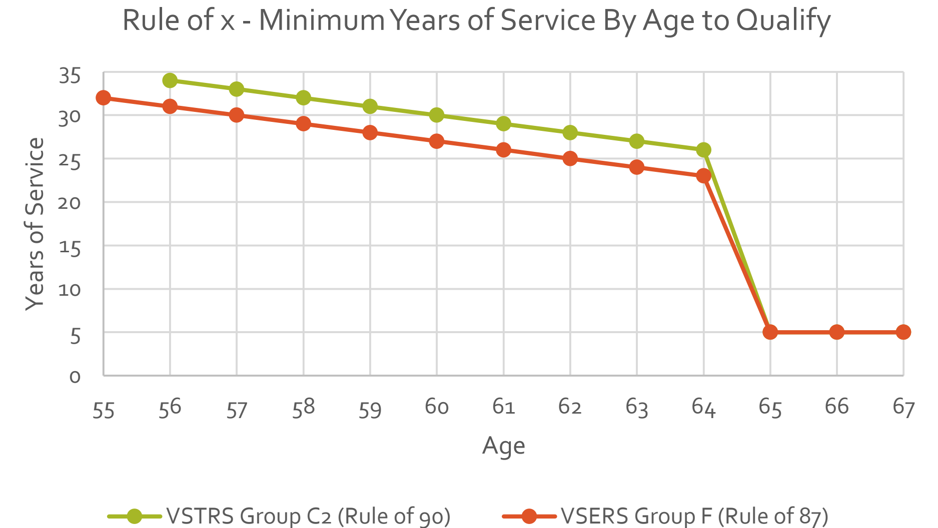
- Current normal retirement eligibility varies by plan:

  - VSERS Group F: Age 62 or with 30 years of service, or age 65 or a Rule of 87
  - VSERS Group C: Mandatory at age 55, or as early as age 50 with 20 years of service.
  - VSERS Group D: Age 62

  - VSTRS Group C1: Age 62 or with 30 years of service.
  - VSTRS Group C2: Age 65 or a Rule of 90.

- Some pension plans nationwide require all actives to reach a minimum age with no *Rule of x* option.

- A *Rule of x* can advantage employees who began their service earlier in their careers but can result in higher pension costs due to longer retirement periods.



For example:

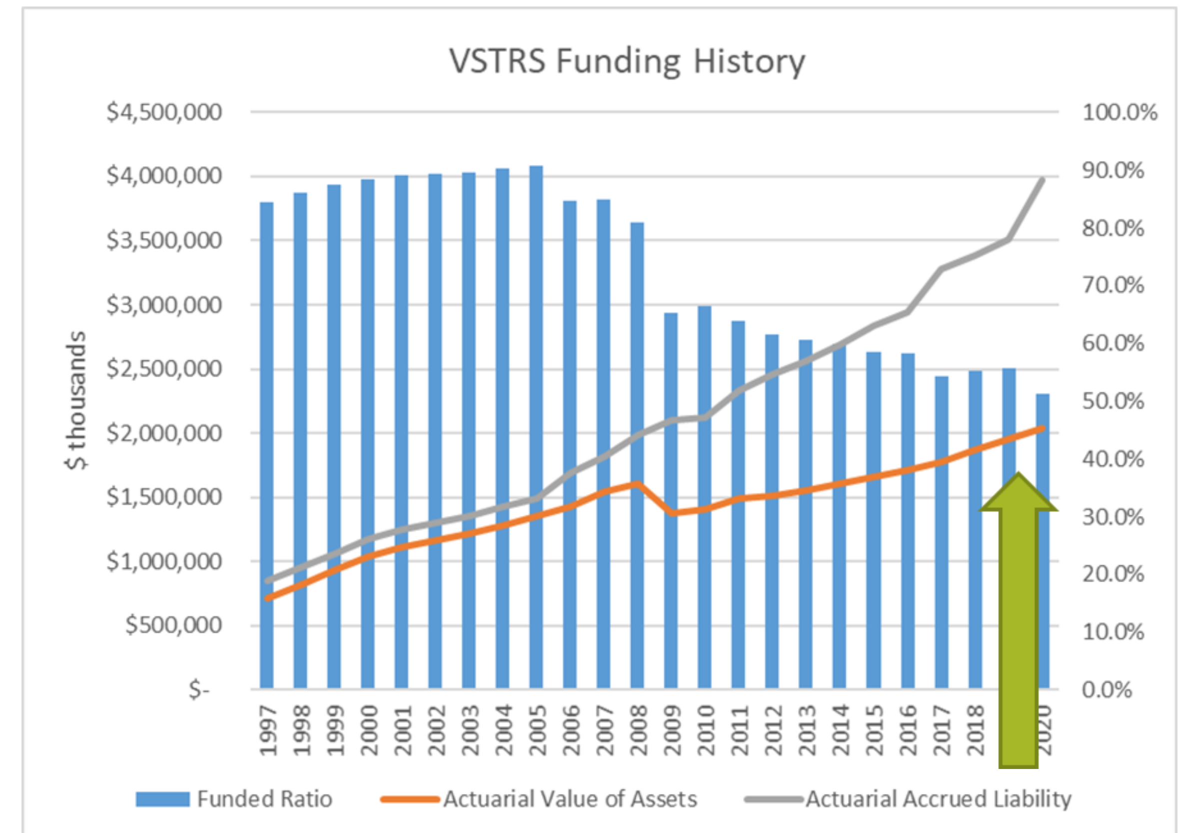
With a Rule of 87, a state employee can retire earlier than age 57 if they have more than 30 years of service.

With a Rule of 90, a teacher can retire earlier than age 60 if they have more than 30 years of service.

Strategies to Increase Assets

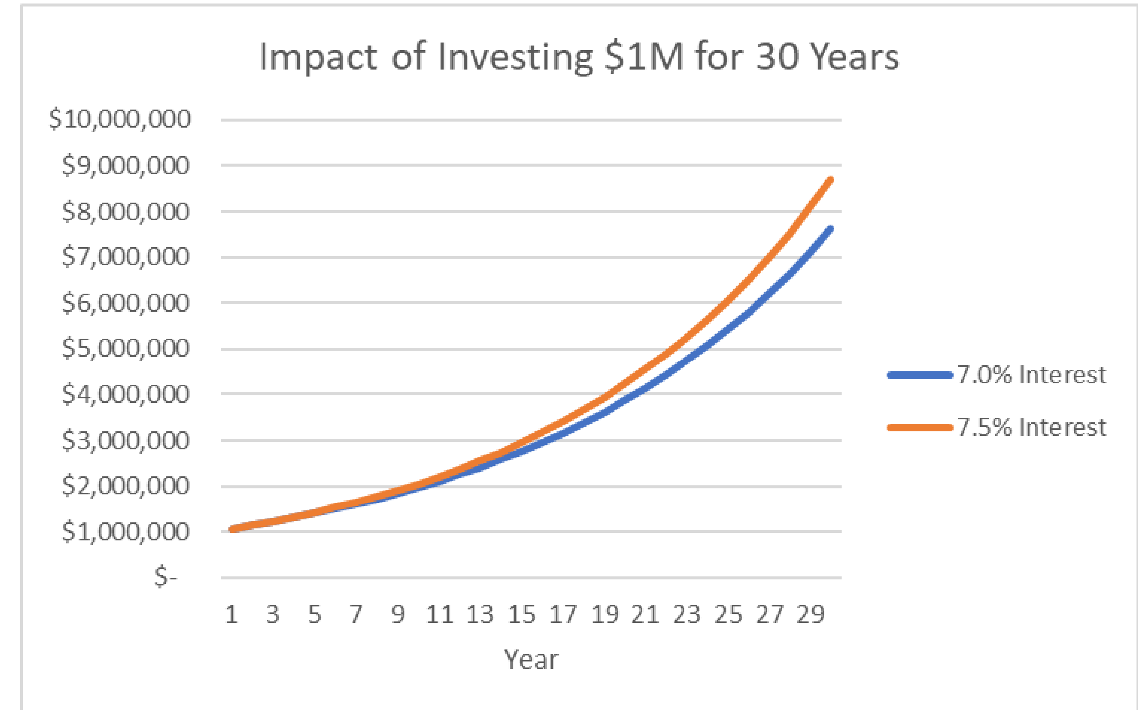
In addition to strategies aimed at lowering liabilities, strategies can be pursued to increase the plan's assets:

- Constant focus on investment managers and investment policies to ensure the fund is receiving strong performance at minimal expense is important. Hit the assumed rate of return over time!
    - *Remember – Pension plans invest differently than individuals! More focused on diversification, less tolerance for risk and volatility.*
- Find ways to put more money into the fund:
    - Invest one-time funds toward paying down long-term liabilities.
    - Additional dedicated revenue sources
    - Employee contribution rates



Strategies to Increase Assets

- Invest one-time revenues toward paying down the unfunded pension liabilities.
  - "The sooner the better" - The more you invest now, the greater the gain in the future. With the power of compound interest, time is your friend!
  - *For Context:*
    - $50M invested today could grow to approx. $153M by 2038 at 7%.
    - Each one-time $50M increase above the ADEC would, by itself, immediately increase the funded ratio by 1.6% for VSERS and 1.3% for VSTRS.
- Dedicating revenue sources to paying down pension liabilities can help relieve budgetary pressure from ADEC payments – particularly if they are new revenue sources.
- Use some unanticipated revenue to fund a reserve account to help offset year-to-year volatility in ADEC payments. Doing so can help ensure the ADEC payment is always fully made – particularly if the ADEC increases significantly due to market performance or experience, or the state is facing a budget shortfall. **BUT** – funds would likely earn a higher rate of return if they were invested directly in the pension portfolio instead.



Strategies to Increase Assets

Increase or Restructure Employee Contribution Rates

- Employees now pay a fixed percentage contribution rate regardless of how well the pension fund is doing.
  - VSERS Group C: 8.53% of gross salary
  - VSERS Group D and F: 6.65% of gross salary
  - VSTRS Group C: 5% or 6% of gross salary depending on hire date
- Over time, employee contributions have represented a smaller share of the total amount paid into the pension fund each year. Employee contributions pay a smaller share of the normal cost than they once did – they now only cover approximately half of the cost of the retirement benefits accrued by the workforce in a given year, and the rest of that cost (along with the payment on the unfunded liability) is paid by employer through the ADEC.
- Employee contribution rates can be structured different ways:
  - Flat across-the-board contribution rates (status quo)
  - Tiered/progressive rates – the more you earn, the more you pay.
  - Fixed vs. variable rates
    - Tie contribution rates to a percentage of normal cost.
    - Supplemental surcharges on top of regular contribution rates that are triggered by pension health metrics (achieving a certain funding ratio, ARR, etc).
- Additional employee contributions in isolation will not lower the total accrued pension liability, but they *can* help increase plan assets and lower the annual ADEC payments by covering a larger share of the normal cost.

For context:

An increase of 0.5% in employee contributions translates to approximately:

$2.8 million (VSERS)
$3.3 million (VSTRS)

Across all groups.

Current vs. Future Members

Another key variable involves the universe of impacted members.

- It is extremely difficult to change the pension benefits on members who are already retired.
- Changes that impact the current active workforce generate larger near-term financial impacts.
- Changes may have unintended consequences to employee behavior, which may adversely impact both the pension fund and the business side of delivering core services. These impacts should be understood and mitigated.
- It takes longer to mathematically recognize the impact of changes that only impact future hires.

Options for Future Hires

- Keep whatever existing plans are in place open to new hires (status quo).

- Or, create new plans with different benefit and contribution structures for new hires. Examples include:

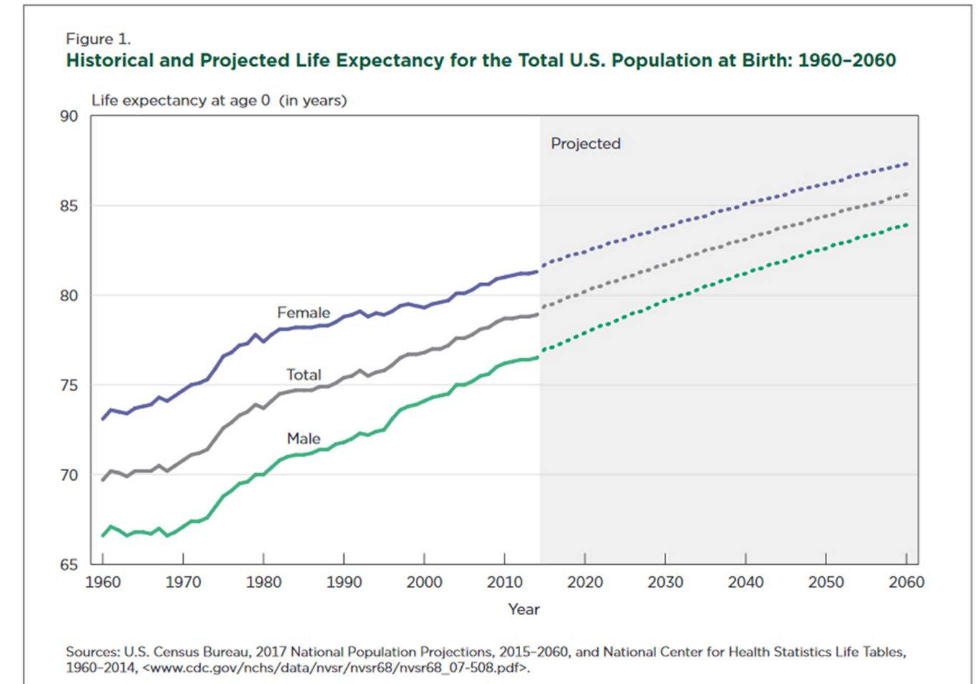
    - Maintain a Defined Benefit plan but with different terms than the “old” plans
    - Create Defined Contribution plans with employer matches
    - Hybrid plans with features of both DB and DC plans
    - To what extent should new hires have the option of choosing which plan? Incentives vs. Mandates.

- Typically, new plans are created for new hires with the goal of reducing the risk of growing retirement liabilities in the future.

- Having more plan options may appeal to different segments of the workforce. Not every public employee has a long-term career outlook. Employees with a higher expectation of career mobility/portability may desire a more portable retirement savings vehicle.

- Governments have increasingly adopted new plans for newer hires but few have abandoned the DB model entirely.

- Putting all new hires into a DC plan will not solve the existing structural issues in the legacy DB plans.



Questions?

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