Written Testimony of John Pelletier
April 12, 2020
To the House Government Operations Committee

Madame Chair & Members of the House Government Operations Committee:

My name is John Pelletier, and I am the Director of the Center for Financial Literacy at Champlain College. My written testimony is in my capacity as a member of the Vermont Business Roundtable's Pension Reform Task Force and as one of the co-authors of this group's 2020 report on policy options available to the General Assembly that could help put Vermont's state employees' and teachers' pension and health care retirement systems on a sustainable path for the future.

I am submitting this written testimony today in support of this Committee's draft bill that: (1) amends membership and duties of the Vermont Pension Investment Committee (VPIC), and (2) creates a Pension Design and Funding Task Force (Task Force).

I. <u>How Did We Get Here?</u>

The causes of our underfunded pension plans have been well documented in your hearings on this topic with the many oral and written reports you have received. As the chart below indicates (based on the Treasurer's written testimony) we know that our current pension crisis is the result of:

a. *Poor pension plan investment performance* (more than $700 million since 2007);
b. *Unrealistic assumed rates of return since at least 2007* (this includes the use of the disastrous Select and Ultimate method for four fiscal years at a cost of $323 million and the $600 million recent increase unfunded liabilities from changing the assumed rate of return from unrealistic 7.5% to more a more realistic 7%; these costs are included in the Treasurer's office category in the chart below entitled "Total Assumptions Changes" which is in excess of $1.3 billion and is equal to 48% of the total increase in these liabilities since 2007);
c. *Chronic underfunding of the teachers' pension plan* by $172 million from 1991 to 2006;
d. *Using the teachers' pension plan as a funding mechanism for the costs of the teachers' retirement health care plan* ($175 million since 2007);
e. *Actuarial assumptions that, in hindsight, were wrong*, some financially positive but most being negative, on the following topics: Salary & Temporary Salary Reductions, COLA, Mortality, Retirement, Disability and Net Plan Turnover (a net cost increase to the unfunded liability of about $440 million);
f. *The pension and health care benefits promised to retirees cost the state much more than they were ever projected to cost when the benefits were gran*ted; and
g. *The General Assembly and the state failed to implement most of the 2010 recommendations from the Pension Commission it created in 2009*. This failure to act in 2010 has added to this unfunded liability burden.

The key question for this Committee and the General Assembly is whether the proposed VPIC changes and the creation of a Task Force will fix these structural problems. Will this result in sustainable pension and retirement healthcare plans that will protect and guarantee teachers' and state employees' pension and health care benefits when they retire?

Pension Data Provided by the Treasurer:

Cumulative Channge in Liability	VSERS 2007 - 2020	VSTRS 2007 - 2020	Total VSERS + VSTRS	Percent of Total Change in Liability
Beginning Unfunded Liability	$ 9,044,004.00	$ 259,108,435.00	$ 268,152,439.00	N.A.
Ending Unfunded Liability	$ 1,040,465,119.00	$ 1,933,289,366.00	$ 2,973,754,485.00	N.A.
Increase in Unfunded Liability	$ 1,031,421,115.00	$ 1,674,180,931.00	$ 2,705,602,046.00	100%
Total Assumption Changes*	$ 480,841,346.00	$ 828,540,973.00	$ 1,309,382,319.00	48%
Net Investment	$ 317,484,349.00	$ 384,996,680.00	$ 702,481,029.00	26%
Salary	$ 88,151,220.00	$ (129,391,882.00)	$ (41,240,662.00)	-2%
COLA	$ (123,583,917.00)	$ (102,730,234.00)	$ (226,314,151.00)	-8%
Mortality	$ 40,982,471.00	$ 18,350,215.00	$ 59,332,686.00	2%
Retirement	$ 128,594,128.00	$ 184,010,383.00	$ 312,604,511.00	12%
Disability	$ 2,590,399.00	$ 3,761,046.00	$ 6,351,445.00	0%
Net Turnover	$ 77,509,729.00	$ 320,448,149.00	$ 397,957,878.00	15%
Other Gains/Losses	$ 92,709,386.00	$ (502,768.00)	$ 92,206,618.00	3%
Other Expected Adjustments	$ -	$ 37,199,874.00	$ 37,199,874.00	1%
Plan Provisions	$ -	$ (46,409,122.00)	$ (46,409,122.00)	-2%
Health Care Approriation	$ -	$ 175,907,621.00	$ 175,907,621.00	7%
Change in System Provision	$ 47,465,002.00	$ -	$ 47,465,002.00	2%
Temporary Salary Decreases	$ (69,913,212.00)	$ -	$ (69,913,212.00)	-3%
Change in Employee Contribution Rate	$ (2,610,261.00)	$ -	$ (2,610,261.00)	0%
Other Expected Increases/Decreases	$ (57,597,843.00)	$ -	$ (57,597,843.00)	-2%
Other Expense Gain/Loss	$ 8,798,318.00	$ -	$ 8,798,318.00	0%

*Total Assumptions Changes includes $323 million for using the Select and Ultimate Method and the increases from the reduction in the assumed rate of return from 7.95% to 7.5% and finally to 7.0%. The last, most recent change resulted in an increase in the unfunded pension liabilities of $600 million.

II. ***Changes to VPIC***.

I support the proposed changes to the membership and the duties of the VPIC. These proposed changes will increase balance on this committee among key stakeholders, ensures that half of the committee is independent and increases the institutional and pension management expertise of this committee and improves oversight.

Changes to VPIC (and the required experience study every three years) will help address, and hopefully minimize, future increases to unfunded liabilities that have happened since 2007 due to: *(a) poor pension plan investment performance; (b) unrealistic assumed rates of return; and (c) actuarial assumptions that, in hindsight, were wrong. These three causes appear to have generated more than two-thirds of the increase in the unfunded liability since 2007.*

The Proposal Increases Balance

The recommendations establish balance between the plan members, employers and the public. Each stakeholder group is given three members of the VPIC.

The Proposal Promotes Independent Decision Making

The new structure requires that half of the 10 VPIC members be independent of the pension plans. All member of the VPIC, except the Treasurer and the Commissioner of Finance and

Management are subject to term limits. In addition, subject to transition rules, beginning in FY2024 General Assembly members will no longer be eligible to serve on the VPIC. Most importantly only the VPIC can approve key investment related actuarial assumptions.

The Proposal Increases VPIC Expertise and Enhances Oversight

The proposal requires that 30% of the VPIC members be financial experts. Studies show this type of expertise on pension fund board enhances investment returns. The proposal increases the expertise of the committee by requiring mandatory training by all members.

In addition to the enhanced oversight created by having three experts on the VPIC, the proposal greatly enhances oversight in the following ways: (1) increases the frequency of actuarial experience studies from every five years to every three years: (2) requires and asset allocation study each fiscal year; and (3) requires an asset/liability study looking at market and other risks every three years. Requiring the VPIC to submit an annual report to the General Assembly on the status of the plans is also a significant enhancement of governance oversight.

III. ***Creation of a Pension Design and Funding Task Force (Task Force***)

Task Force Membership

I would like to highlight a few concerns regarding the proposed membership of the Task Force:

- The House and Senate members on this Task Force should be independent of the pension plans and the independence definition used for General Assembly members on the Task Force should be similar to the definition proposed for VPIC members. As currently written, a General Assembly member of the Task force could have a child, grandchild, sibling (or the spouses of any of these family members) as beneficiaries of the plan and still be allowed to be on the Task Force. The current independence bill language only covers the General Assembly member and their spouse.
- School Boards negotiate the salary and benefits of current employees—they are not involved in negotiating the pension and retirement health care benefits. As you know this is negotiated at the state level not the local level.
- There is only one public member of the Task Force. The 2009 Pension Commission had two public members out of seven members of the commission. The taxpaying public has gone from $2/7^{th}$ to $1/15^{th}$ representation on this major issue. I suggest eliminating the school board member from the task force and replacing it with a second public member.

2009 Pension Commission—Recommendations Largely Ignored

I support the creation of the Task Force to look at these pension and retirement healthcare issues. *My fear of a Task Force is perfectly expressed in a saying I have heard in the past from* *members of this General Assembly: A Summer Study is where good ideas go to die.* I hope that this time will be different.

As you know a very similar Commission was created by the General Assembly in 2009. Most of the section of your bill describing the duties and powers of the Task Force is nearly identical to the 2009 bill that created this Commission. In fact, Section 10(c)(1)-(6) is word for word identical to the 2009 law, and only subsections (7) and (8) contain new language (see page 58 and 59 of the report issued by the Pension Commission in 2010: https://www.vermonttreasurer.gov/sites/treasurer/files/Retirement/retirement-commission-work-archive/Final%20Report%20of%20Retirement%20Commission%20Dec%202009.pdf)

Although likely apocryphal, some have attributed the following quote to Albert Einstein: ***"Insanity Is Doing the Same Thing Over and Over Again and Expecting Different Results."*** I truly hope that creating yet another summer study on retirement benefits will result in materially different outcomes when compared to the study completed a decade ago.

The 2009 Commission did not solve Vermont's pension and retirement healthcare problems. In fact, they have gotten much worse since they issued their report in 2010. Some recommendations were implemented, but many, and I would argue the most important recommendations, were ignored.

Attached as Exhibit A is a summary of the 10 recommendations from this Commission and an indication of whether that recommendation was ever implemented. Let's review a few of the Commission's recommendations that were ignored (all screen shots in this document are copied from the 2009 Commission's report issued in early 2010). Ignoring their recommendations has been very costly to the state.

The 2009 Commission was opposed to creating a new and very expensive retirement healthcare benefit for teacher's spouses. The commission, by a 5 to 2 vote rejected the creation of this brand-new benefit. Yet Vermont, in the aftermath of the Great Recession, was one of the few states in the nation that expanded benefits in such an expensive manner. The following is the vote description from the Commission report:

15. Include a comment discussion was held concerning adding spouses to coverage for Vermont State Teachers' Retirement System members. There was a vote held and 5-2 voted not to add spouses for Vermont State Teachers' Retirement System members.

YES	NO
Terry Macaig	Doug Wacek
Jeb Spaulding	Neale Lunderville
	Jeanette White
	David Coates
	Bill Talbott

How many millions of dollars has been spent so far on this new retirement healthcare benefit? How much of the state's projected ADEC and unfunded healthcare retirement liabilities are directly attributable to the creation of this new and expensive benefit? Why did the Vermont create a new benefit at a time when states across the nation were reducing benefits?

The 2009 Commission also had the following cost sharing recommendation in their report that was ignored (I have been shown an estimated that if this cost sharing mechanism had been implemented the pension plans would have $500 million more in assets today—the JFO can be asked to confirm the accuracy of this estimate—to be clear the estimate is not mine):

RECOMMENDATION EIGHT

<u>Revising the contribution rate ratio and rates for employer and employees:</u>
While contribution levels for State employees and teachers have remained constant in recent years, the State's employer share, as a percentage of payroll, is expected to continue escalating. Instead of having a fixed employee contribution rate set in statute, with the State/employer contribution rate floating on an annual basis, the Commission recommends a proportional contribution system between the State and employees/teachers. The Commission chose to recommend a sharing of the total annual contribution, with the State share capped at the 3.5 percent to accommodate the growth target set by the Joint Fiscal Committee. The result, assuming all other recommendations are enacted, is as stated below and compared to the baseline if no recommendations are enacted. A similar rate increase would occur in the other group plans.

The 2009 Commission also unanimously recommended the prefunding of OPEB benefits—something that we still have not done one decade later.

RECOMMENDATION FOUR

That the Legislature, without delay, develop and implement a structural plan to fund OPEB obligations and set money aside in a material way through a separate, independent funding mechanism.

So, I ask this Committee, how does this bill ensure that something is actually going to be done with the Task Force recommendations? If just these three 2010 recommendations were implemented instead of being ignored, Vermont's unfunded liabilities from these pension and retirement health care plans would likely be more than $2 billion lower than they are today.

Task Force Must Be Given a Clear and Very Specific Mandate

The current bill requires that the Task Force meet no later than July 15, 2021 and issue its report to the General Assembly by September 1, 2021. This gives the Task Force a minimum of

48 days to complete its work. This very tight timeline is possible, but only if you give the Task Force very clear directions on what problems they are trying to solve.

This can be done by giving the Task Force certain assumptions that they should be operating from and certain dollar specific ADEC and unfunded liabilities goals to be met.

The following charts are informational only and are not recommendations to the Committee, they are concrete examples of how the bill could be amended to give the Task Force very clear and specific instructions that would make completing its task in a short time frame possible.

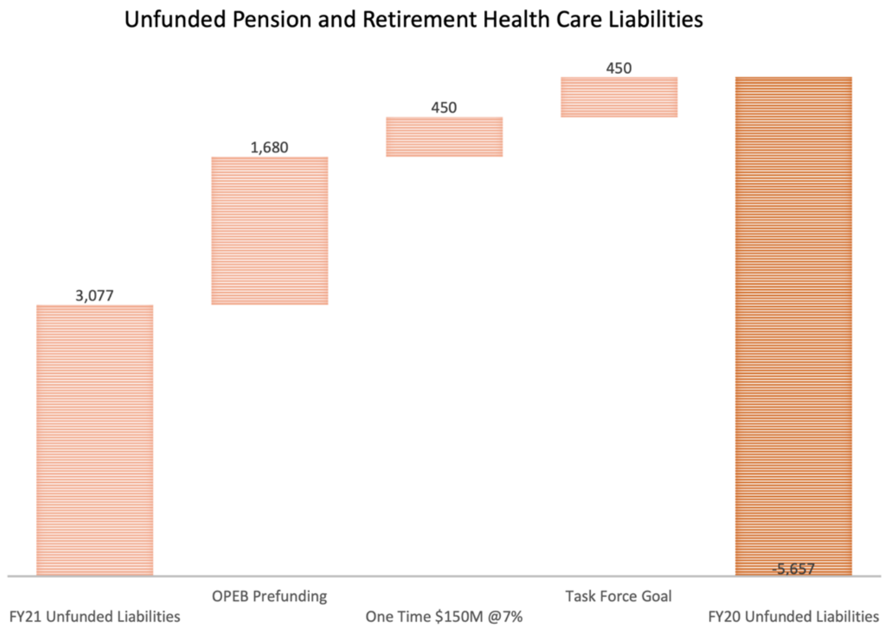
Examples of Task Force Goals and Assumptions:

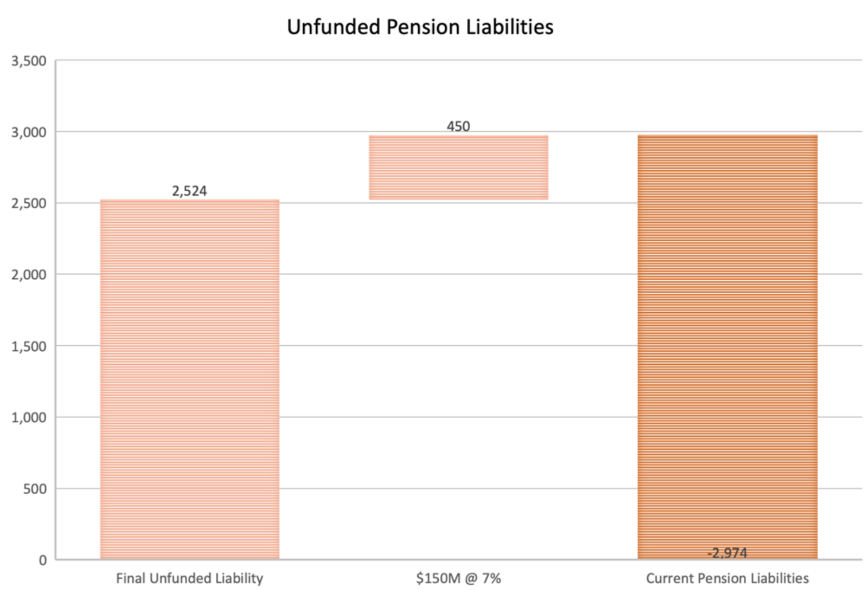
1. The Task Force should assume that OPEB will be prefunded as recommended by the Treasurer (invested in an account with an assumed rate of return of 7%, identical to the pension plans). The prefunding of OPEB will reduce the unfunded pension liabilities by $1.68 billion.
2. The Task Force should assume that Vermont will make a one-time investment into the state employees' and teachers' pension systems of $150 million. This investment with a one-time assumed rate of return of 7% will reduce the total unfunded liabilities by $450 million.
3. The Task Force shall make recommendations that will result in a reduction in pension and retirement healthcare unfunded liabilities by an additional $450 million to the assumed reductions in numbers 1 and 2 above (number chosen because it is identical to the total reduction in number 2).
4. The Task Force shall make recommendations that result in a reduction of the ADEC for the pension and retirement healthcare systems equal to $97 million (this was the target reduction in the Treasurer's January 15, 2021 report, rounded up to a whole number).
5. The Task Force shall make recommendations on the structure of retirement benefits for all new state and teacher employees hired on or after July 1, 2022.
6. The Task Force shall recommend pension and retirement health care system cost sharing mechanisms that could be triggered as a result of future severe and unexpected market and/or economic events and material actuarial assumption errors.

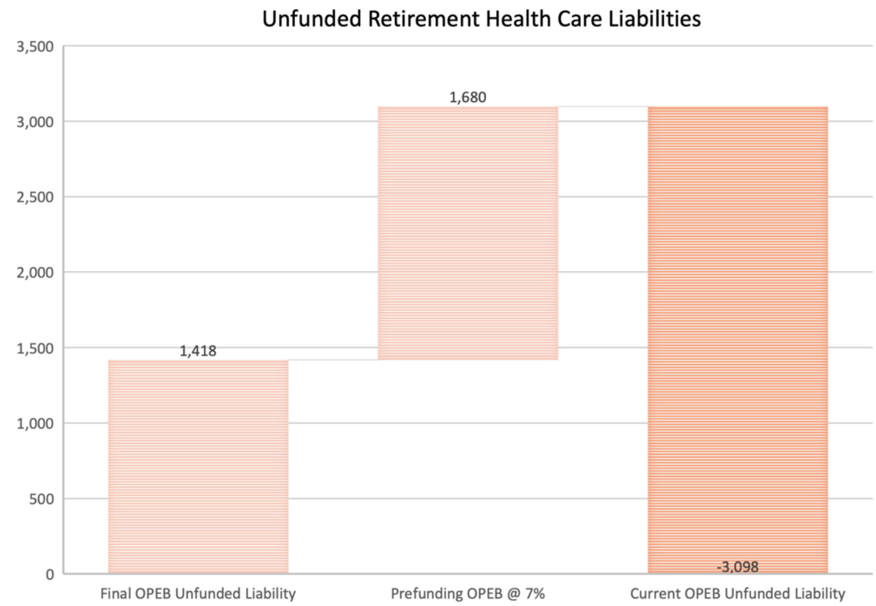
The following are charts that explain how the assumptions and goals would work if a structure of this nature were incorporated into the bill.

Given the sense of urgency surrounding this matter and the short time frame given to the Task Force to complete its work, clearly defined goals for the Task Force is likely a predicate for success.

Thank you for your service.

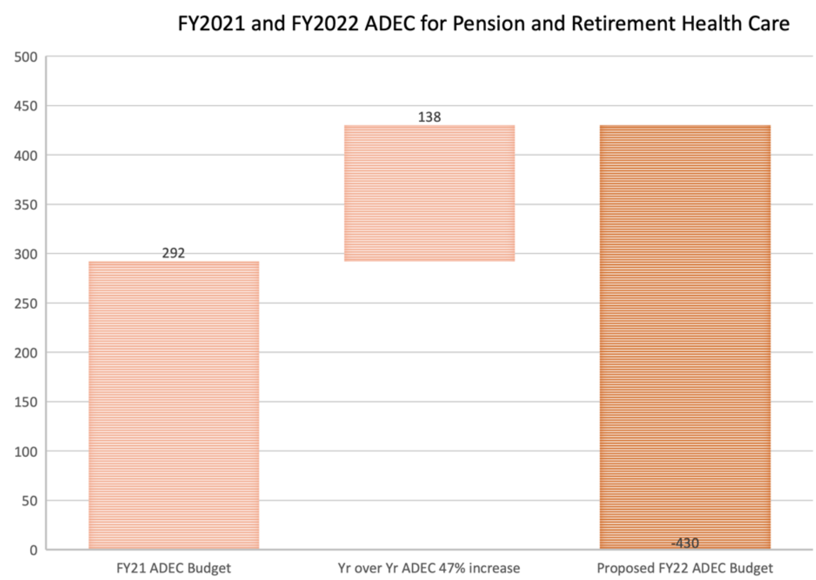

Unfunded Pension and Retirement Health Care Liabilities
3,077
1,680
450
450
-5,657
FY21 Unfunded Liabilities
OPEB Prefunding
One Time $150M @7%
Task Force Goal
FY20 Unfunded Liabilities


Unfunded Pension Liabilities
3,500
3,000
2,500
2,000
1,500
1,000
500
0
2,524
450
-2,974
Final Unfunded Liability
$150M @ 7%
Current Pension Liabilities



Retirement Plan	2019 Valuation 2021 Budget ADEC $ Millions*	2020 Valuation 2022 Budget ADEC $ Millions**	Change from 2021 to 2022 Budget $ Millions
VSERS Pension	$83.9	$119.9	$36.0
VSTRS Pension	$135.6	$196.2	$60.6
VSERS OPEB	$37.2	$58.8	$21.6
VSTRS OPEB	$35.1	$55.1	$20.0
Total	$291.8	$430.0	$138.2 (47% increase)

*OPEB Using Current Governor Budget Number Proposals
**OPEB Using Number from Treasurer for Pre-Funding


FY2021 and FY2022 ADEC for Pension and Retirement Health Care
500
450
400
350
300
250
200
150
100
50
0
138
292
-430
FY21 ADEC Budget
Yr over Yr ADEC 47% increase
Proposed FY22 ADEC Budget

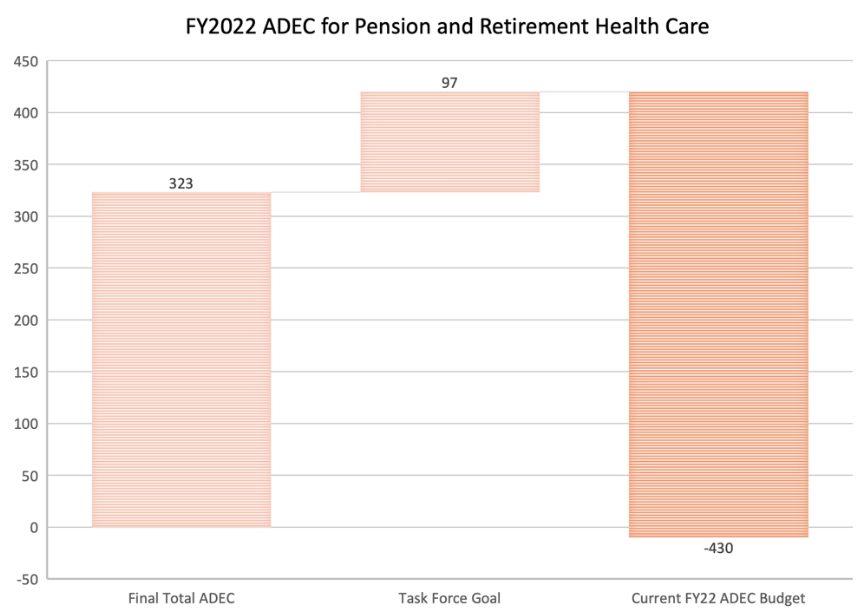

FY2022 ADEC for Pension and Retirement Health Care
450
400
350
300
250
200
150
100
50
0
-50
97
323
-430
Final Total ADEC
Task Force Goal
Current FY22 ADEC Budget

Exhibit A

2009 Task Force Recommendations and Action Taken by Vermont

Recommendation by 2009 Task Force	Action Taken by Vermont
1. Make <u>no change</u> to the following: **(a) Pension or retiree health benefits for those already retired.** **(b) Pension or retiree health benefits for anyone within 5 years of eligibility for a particular benefit.** **(c) Basic provisions (maximum benefit, multiplier, COLA, etc.) that would make the plans less competitive than other state public systems.**	Task Force Recommendation Implemented Beneficial to Employees
2. Do not replace the current defined benefit plan and transition to a defined contribution plan.	Task Force Recommendation Implemented Beneficial to Employees
3. That the Legislature and the Governor continue to fully fund the actuarially determined employer contribution (ADEC, formerly called ARC) for the state and teachers' pensions	Task Force Recommendation Implemented Long-term Beneficial to Employees Long-term Beneficial to State & Taxpayers, short-term can cause crowding out effect on General Fund
4. That the Legislature, without delay, develop and implement a structural plan to fund OPEB obligations and set money aside in a material way through a separate, independent funding mechanism.	Task Force Recommendation Never Implemented Long-term Beneficial to Employees Long-term Beneficial to State & Taxpayers, short-term can cause crowding out effect on General Fund
5. Revisions to normal and early retirement ages: ***<u>State Group F and Teachers' Group C:</u>*** **(i) Raise normal retirement age from 62 or 30 years at any age to 65 or rule of 90 for those more than five years from normal retirement eligibility; and (ii) Raise the early retirement age from 55 to 58 for those more than five years from early retirement eligibility. Change**	Task Force Recommendations not implemented Economically harmful for Employees Long-term beneficial to State & Taxpayers

the early retirement penalty to full actuarial reduction. ***<u>State Group D:</u>*** **Raise normal retirement age from age 62 to age 65 for those more than five years from normal retirement eligibility.** ***<u>State group C</u>*****: Raise the early retirement age to 52 from 50 for those more than five years from early retirement eligibility.**	
6. Lengthening the salary compensation period: ***<u>State Group F and Teachers' Group C:</u>*** **Use a five-year compensation period instead of a three-year period to calculate benefits for those more than five years from retirement eligibility.** ***<u>State Group C:</u>*** **Use a three-year compensation period instead of a two-year period to calculate benefits for those more than five years from retirement eligibility.** ***<u>State Group D:</u>*** **Use a two-year compensation period instead of final salary to calculate benefits for those more than five years from retirement eligibility.**	Task Force Recommendations were not implemented Economically harmful for Employees Long-term beneficial to State & Taxpayers
7. Increase the maximum benefit from 50 percent to 60 percent of final compensation for State Group F and Teachers' Group C for those more than five years from retirement eligibility. This would provide an opportunity for increased benefits to employees who choose to work more than 30 years.	Task Force Recommendation Implemented Beneficial to Employees Depending on life expectancy of employees, this can be either beneficial to the State & Taxpayers or harmful
8. Risk Sharing Mechanism Recommendation. Revising the contribution rate ratio and rates for employer and employees: Instead of having a fixed employee contribution rate set in statute, with the	Task Force Recommendations were not implemented. Economically harmful for Employees Long-term beneficial to State & Taxpayers

State/employer contribution rate floating on an annual basis, the Commission recommends a proportional contribution system between the State and employees/teachers. The Commission chose to recommend a sharing of the total annual contribution, with the State share capped at the 3.5 percent to accommodate the growth target set by the Joint Fiscal Committee.	
9. For most state employees and all teachers, the Commission recommends a tiered medical premium co-payment structure based on length of service as follows: (i) 40 percent - 10 years; (ii) 60 percent - 20 years; (iii) 80 percent - 30 years; and (iv) retirees with less than 10 years would have access to group health insurance, but would have to pay the full premium. In recognition of the fact that the Group C plan of the State employees' retirement system is essentially a 20 year plan, the Commission recommends a pro-rated tiered medical premium co-payment for Group C plan members.	Task Force Recommendations were mostly implemented. Years of service tied system was implemented for most state employees and teachers hired on or after July 1, 2008. Group C state employee recommended changes were not implemented. No changes were made to Group D state employees. Retirees with 5-9 years could buy-in to the medical plan—this was not the recommendation of the committee Economically harmful for only new Employees Long-term beneficial to State & Taxpayers
10. The Commission recommends providing the ability to "recapture" the retiree health benefit to those vested, terminated members with 20 or more years of service when they begin drawing benefits. This opportunity is not currently allowed for general State employees and is allowed for teachers with 10 or more years of service.	*UNKNOWN—Cannot determine from any document provided to Government Operations Committee, but oral testimony seemed to indicate this recommendation was implemented.* *Beneficial to Employees* *Appears to be a new benefit for state employees but not for the state teachers.*