PENSIONS – POTENTIAL OPTIONS

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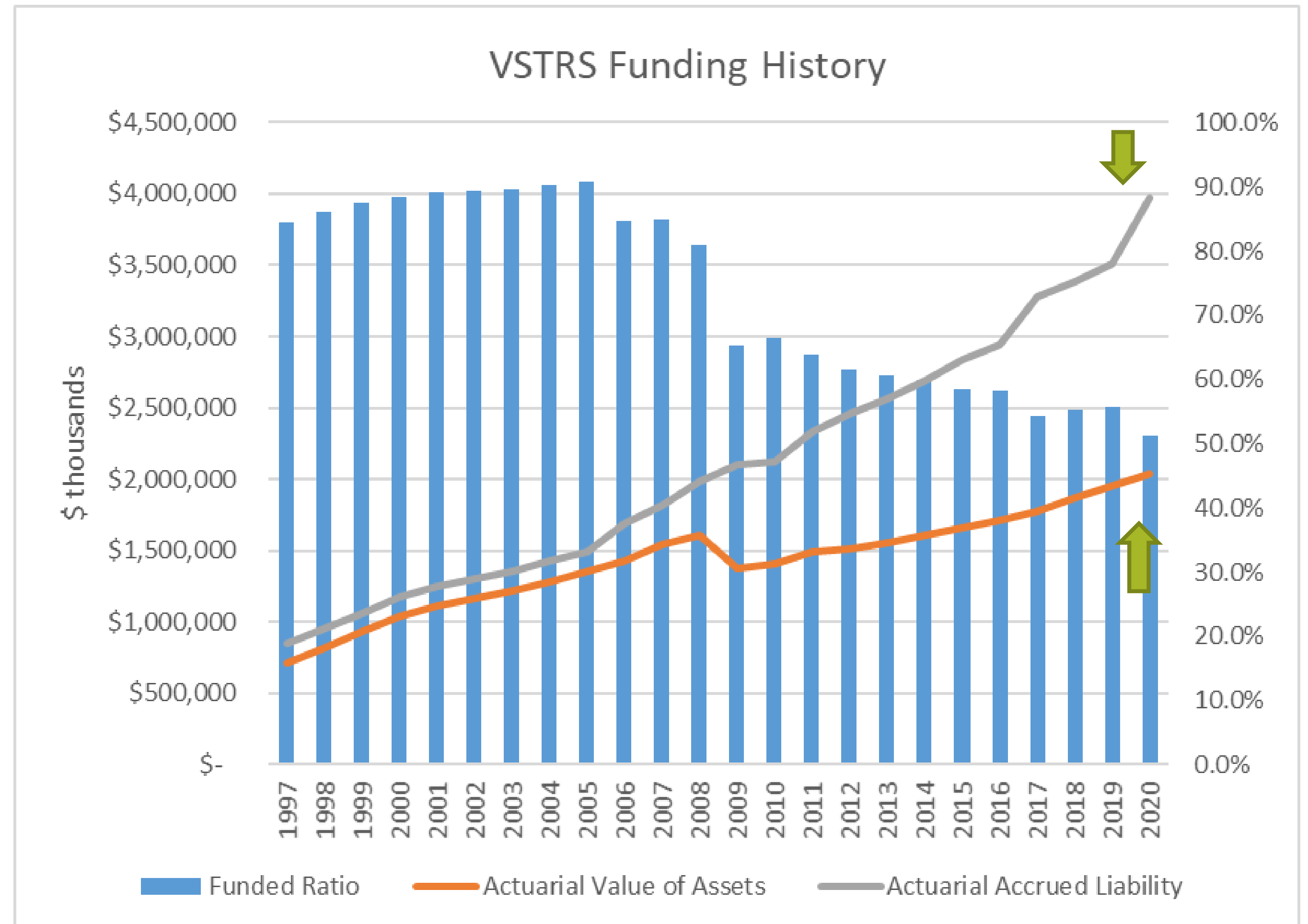
Strategies to Reduce ADEC Pressures and Improve Funding Ratio

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.



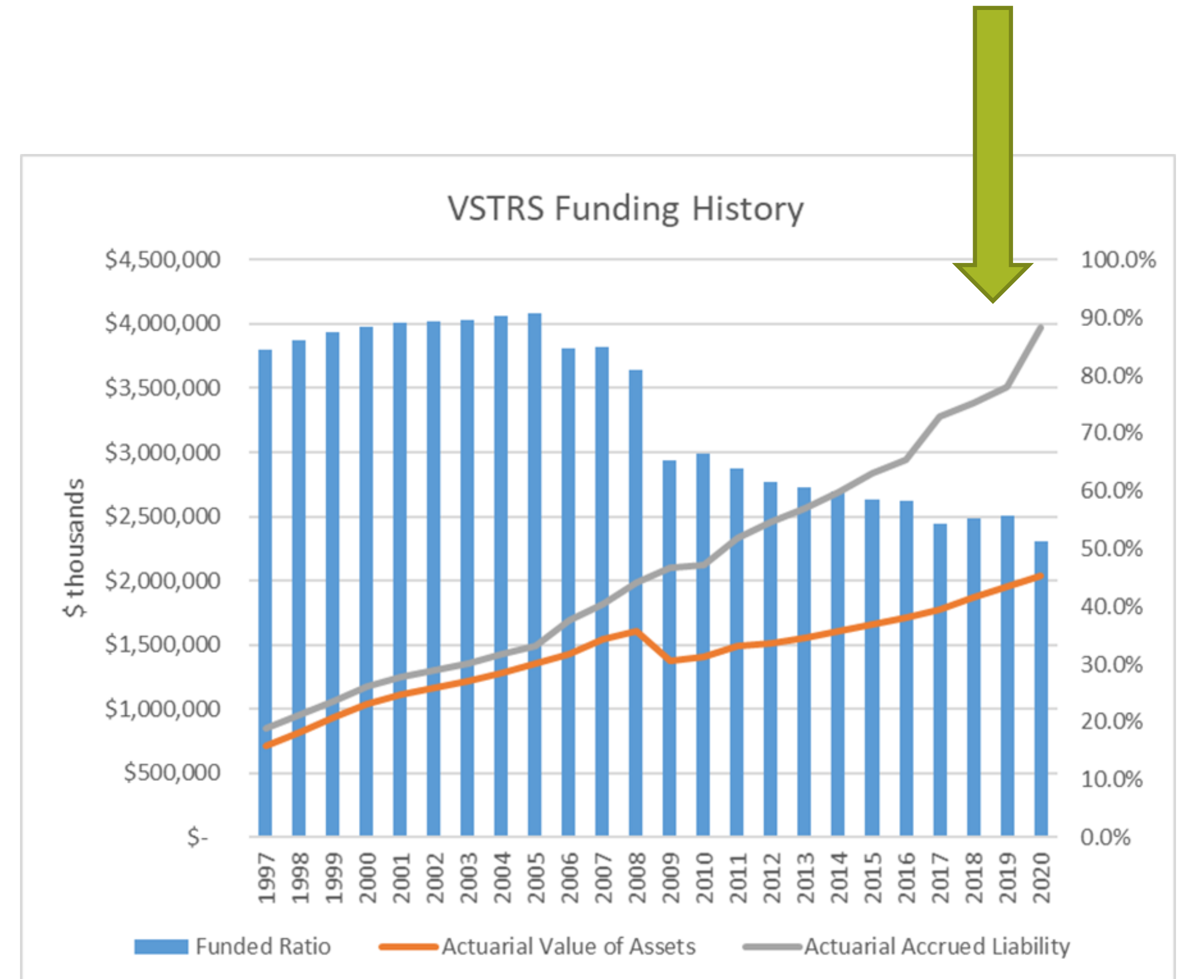
Strategies to Reduce Liabilities

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 and asset lines 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. In March, other potential changes were proposed in the House.
- Cost savings and revenue enhancements were both analyzed. Changes would not impact current retirees.
- Act 75 charges this Task Force with providing recommendations to reduce the unfunded liabilities and ADECs by 25-100% of the size of the year-over-year increases from FY21 to FY22.
- The next few slides will present summaries of the options that were presented and studied to provide you with context.

Scope of Changes for Each Fund

	VSERS	VSTRS
UAAL 2019 Valuation for FY21 Budget	$815,464,698	$1,554,459,287
UAAL 2020 Valuation for FY22 Budget	$1,040,465,119	$1,933,289,366
Change in UAAL	**+$225,000,421 (27.6%)**	**+$378,830,079 (24.4%)**
ADEC FY21	$83,876,570	$132,141,701
ADEC FY22	$119,967,769	$196,206,504
Change to ADEC	**+$36,091,199 (43.0%)**	**+$64,064,803 (48.5%)**

Fiscal Targets per Act 75

	25% of YOY FY21-FY22 Increase	100% of YOY FY21-FY22 Increase
VSERS - UAAL	$56.3 million	$225.0 million
VSERS - ADEC	$9.0 million	$36.1 million
VSTRS - UAAL	$94.7 million	$378.8 million
VSTRS - ADEC	$16.1 million	$64.1 million

Strategies to Reduce Liabilities

Modify the COLA Formula

- Cost of Living Adjustments are pegged to the Consumer Price Index (CPI) and help retirement benefits keep pace with inflation. They also represent a significant cost (and risk) 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.
  - COLAs could be offered as an elective option – members receive an actuarial reduction in their benefit to offset the cost of guaranteed COLAs in the future.

Plan	COLA 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%

VSERS Group C: Law enforcement and public safety
VSERS Group D: Judges
VSERS Old Group F: State employees hired before 7/1/08
VSERS New Group F: State employees hired on or after 7/1/08
VSTRS Group C1: Members who were at least 57 years old or had at least 25 years of service on June 30, 2010.
VSTRS Group C2: Members who were less than age 57 and had less than 25 years of service as of June 30, 2010

Strategies to Reduce Liabilities

Modify the AFC Formula

- A member'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. VSERS Groups C and D are exceptions.
- 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.

Plan	AFC Current Structure
VSERS Group C	2 Highest Consecutive, including unused annual leave payoff.
VSERS Group D	Final salary at retirement
VSERS Old and New Group F	3 Highest Consecutive, excluding unused annual leave payoff.
VSTRS Group C1 and C2	3 Highest Consecutive, excluding all payments for anything other than service actually performed.

Modify the Vesting Period

- 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.
- VT members must accrue 5 years of service in order to vest.
- The most common vesting periods nationwide are either 5 or 10 years.
- Relatively minimal savings from this change, since the highest rates of employee turnover occur before reaching 5 years of service.

VSERS Group C: Law enforcement and public safety
VSERS Group D: Judges
VSERS Old Group F: State employees hired before 7/1/08
VSERS New Group F: State employees hired on or after 7/1/08
VSTRS Group C1: Members who were at least 57 years old or had at least 25 years of service on June 30, 2010.
VSTRS Group C2: Members who were less than age 57 and had less than 25 years of service as of June 30, 2010

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.
  - Vermont's Rule of 87/90 allow employees with 30+ years of service to retire earlier than age 57 (VSERS) or age 60 (VSTRS), respectively.
  - 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 and OPEB costs.
- VSERS Group C members may retire early without penalty at age 50 with 20 years of service, with mandatory retirement at 55.
- Certain VSERS Group F Corrections staff may retire at age 55 with 20 years of service without reduction.
- VSERS and VSTRS members with 25 years of service may purchase 5 additional years of service credit.

Plan	Normal Retirement Current Structure
VSERS Group C	Age 55 (mandatory) No-penalty early retirement at age 50 with 20 years of service
VSERS Group D	Age 62
VSERS Old Group F	Age 62 or with 30 years of service
VSERS New Group F	Age 65 or Rule of 87
VSTRS Group C1	Age 62 or with 30 years of service
VSTRS Group C2	Age 65 or Rule of 90

Strategies to Reduce Liabilities

Modify the Benefit Calculation

- Retirement benefits are based on multiplying the member's years of service and average final compensation by a service credit multiplier.

- Vermont's pension systems also set forth a maximum benefit level as a percentage of AFC. COLAs are not subject to the maximum benefit level.

- Both the service credit multiplier and the AFC cap can be adjusted to encourage desired behavior. For example:

    - Increasing the max AFC cap may encourage employees to work longer than they otherwise would (which may lower pension and OPEB costs).
    - Adjusting the service credit multiplier upward/downward will adjust the relative generosity of the retirement benefit.

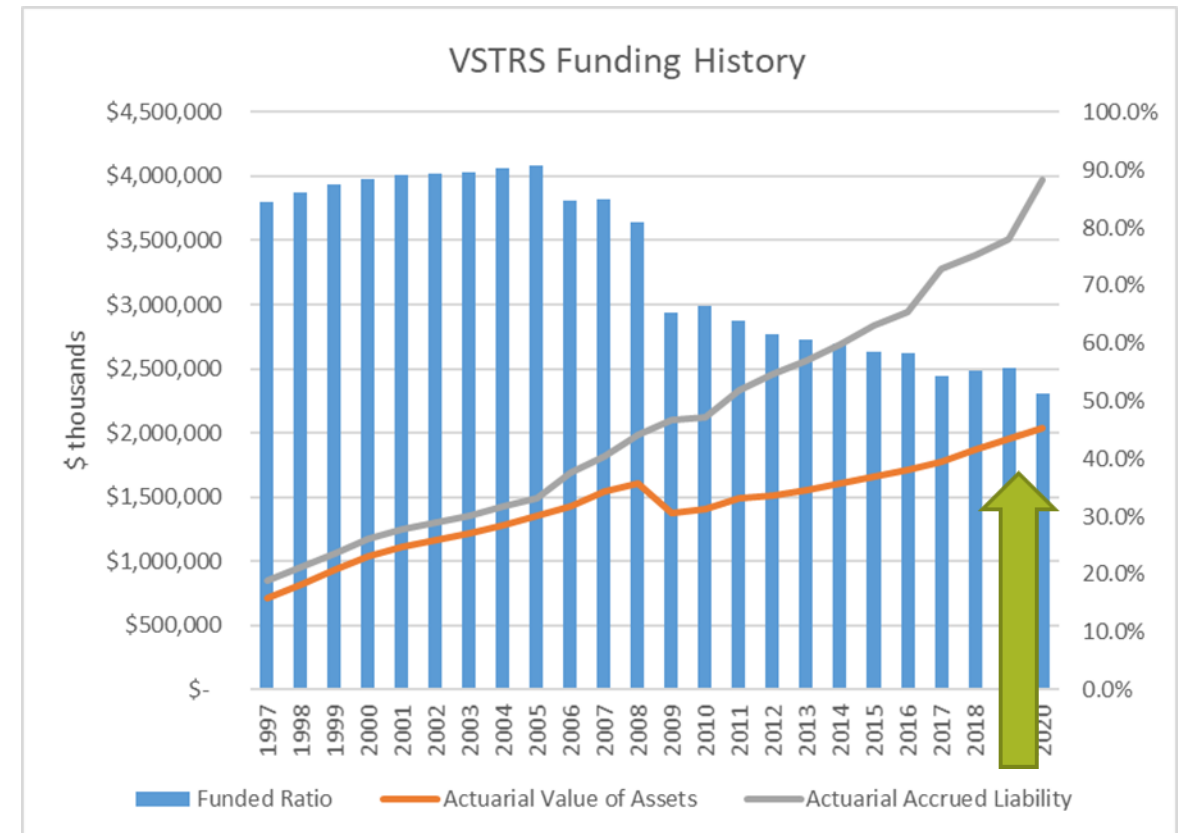
- Actuarial analysis is necessary to understand whether any adjustments would lead to actuarial gains or losses.

Plan	Current Structure
VSERS Group C	2.5% Benefit Multiplier with max of 50% of AFC cap. *A member reaches the 50% AFC cap after accruing 20 years of service.*
VSERS Group D	3.33% Benefit Multiplier after 12 years of service with max of 100% of Final Salary. *A member earns a benefit equal to 40% of final salary after 12 years and reaches the 100% AFC cap after accruing 30 years of service.*
VSERS Old Group F	1.25% Benefit Multiplier (prior to 12/31/90) plus 1.67% Benefit Multiplier (after 1/1/91) with a max of 50% of AFC. *A member reaches the 50% of AFC cap after accruing 30 years of service.*
VSERS New Group F	1.67% Benefit Multiplier with a max of 60% of AFC. *A member reaches the 60% of AFC cap after accruing 36 years of service.*
VSTRS Group C1	1.25% Benefit Multiplier (prior to 6/30/90) plus 1.67% Benefit Multiplier (after 7/1/90) with a max of 53.34% of AFC. *A member reaches the 53.34% of AFC cap after accruing approximately 32 years of service.*
VSTRS Group C2	1.25% Benefit Multiplier (prior to 6/30/90) plus 1.67% Benefit Multiplier (after 7/1/90) for first 20 years, then 2% after attaining 20 years with a max of 60% of AFC. *A member reaches the 60% of AFC cap after accruing approximately 33.3 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. Options may include:
  - Invest one-time funds toward paying down long-term liabilities.
  - Additional dedicated revenue sources
  - Employee contribution rates



Strategies to Increase Assets

- Fully fund (and plan to fully fund) the ADEC.
- Invest one-time revenues toward paying down the unfunded pension liabilities.
    - Every dollar earned through investment growth is a dollar that does not need to be paid in future ADECs.
- Dedicating revenue sources to paying down pension liabilities can help relieve budgetary pressure from ADEC payments – particularly if they are new revenue sources.
- If new recurring funding streams are available, develop a funding policy that specifies how those revenues are to be factored into the actuarial math. For example, should the new funds be used to pay a portion of the ADEC (which would maximize budget relief), or should new funds be dedicated above and beyond the ADEC (which would theoretically accelerate the improvement of the funded ratio and save interest costs over time, but provide less near-term budget relief)?
- Using borrowed funds is risky and not recommended by GFOA.

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, or how expensive the total normal cost becomes.
  - 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 overall 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 contribution rates set in statute (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.
    - Add 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 <u>not</u> lower the total accrued pension liability, but they *can* help increase plan assets and lower the annual ADEC payments.

For context:

According to the FY20 valuation studies, the FY22 projected covered payroll is expected to be:

VSERS: $598.4 million (with 3.5% annual increases)

VSTRS: $697.6 million (with 3% annual increases)

Across all groups.

Risk Sharing

- In the traditional DB model, the employer bears the risk of addressing under-performance of the pension fund. The employee bears no risk of higher than expected costs or lower than expected account balances.

- To help address costs and risks related to pension funds missing their actuarial assumptions (and the assumptions changing), many states have adopted risk sharing strategies (NASRA report linked here). Examples include:

  - Tying employee contribution rates to the performance of the pension system:

    - Rates can be tied to a percentage of the normal cost.
    - Rates increase when the fund misses some actuarial benchmark (e.g. investment performance falls below a target) and then decrease when the fund exceeds the benchmark.

  - Tying certain benefit provisions to the performance of the pension system:

    - Tie COLAs to the overall performance of the pension fund.
    - Freeze or modify COLAs until the fund reaches some benchmark.

  - Hybrid or cash balance plans

Hybrid Plans

- Increasingly adopted and incorporate features of DB and DC plans.

- Members typically participate in both a DB plan that may differ from the “legacy” plan with respect to the benefit formula and contribution rates, and also in a DC plan that the employer and employee both contribute into.

    - Example (PA SERS): Employee contributions are split between a DB (5%) and DC (3.25%) plan. The DB benefit is based on a 1.25% service credit multiplier with a 10-year vesting period, 5 year AFC calculation, and normal retirement at age 67 or Rule of 97. Employer contributes 2.25% toward the DC, in addition to the employee’s 3.25%. (PA SERS also offers a less generous benefit option with a lower contribution rate (4% DB, 3.5% DC) and 1% DB multiplier.)

- “Stacked” hybrid model maintains a DB plan up to a specified income cap and offers a DC plan to members who earn above the income cap. The DB member contributions and AFC calculations are limited by the income cap, which minimizes the risk of paying out extraordinarily high benefits to high earners. The DC component provides an additional savings tool with greater portability.

    - Example (Philadelphia): DB with a $65,000 income cap. Members earning less than $65,000 receive a similar DB benefit as under the legacy plan. Members earning above $65,000 contribute on their first $65,000 of income, and their compensation for AFC calculation purposes is capped at $65,000. These higher earning members, however, can also participate in a DC plan with employer contributions occurring on their income above $65,000.

Cash Balance Plans

- Not as widely adopted as hybrids.
- Cash Balance offers a defined benefit based on average career earnings, rather than on AFC.
- Members receive a defined employer credit as a percentage of pay, plus a defined interest credit, every year. These credits accrue in the member's hypothetical account, which is centrally managed. The employer funds the credits on an actuarial basis (like with DB pensions). Investment risk remains with the employer.
- The balance of credits that accrues in the member's hypothetical account, plus their retirement age, determines the retirement benefit.
- More portable than a DB. Terminated members can leave their balance in the plan and continue to receive interest credits, convert the balance of credits into an annuity, or convert the credits into a lump sum and roll into an IRA.
- Unlike hybrids, Cash Balance plans do not maintain member participation in the legacy DB systems.

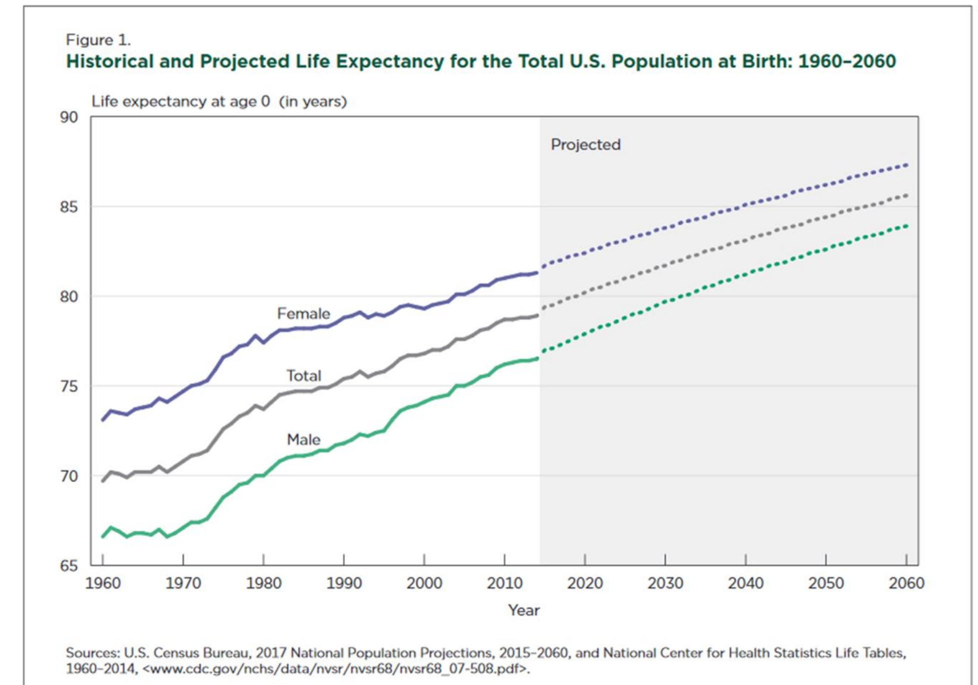
Current vs. Future

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 fiscal impacts. But they might be more difficult for parties to come to agreement on.
- On the other hand, agreement and acceptance of changes that only impact future hires **may** be less difficult to reach. But it takes longer to recognize the fiscal impact of those changes through attrition.
- One possible path forward – new plans for new hires, and incentives for current hires to switch to the new plans?
- 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.

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" groups.
    - 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?
    - Should steps be taken to encourage active employees to switch to other plans?
- 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.



Resources

COLAs: NASRA Issue Brief: Cost of Living Adjustments:
https://www.nasra.org/files/Issue%20Briefs/NASRACOLA%20Brief.pdf

Hybrid Pension Plans: NASRA Issue Brief: State Hybrid Retirement Plans:
https://www.nasra.org/files/Issue%20Briefs/NASRAHybridBrief.pdf

Risk Sharing: NASRA In-depth: Risk Sharing in Public Retirement Plans:
https://www.nasra.org/files/Spotlight/Risk%20Sharing%20in%20Public%20Retirement%20Plans.pdf

Other States: NASRA Spotlight On Significant Reforms to State Retirement Systems (December 2018):
https://www.nasra.org//Files/Spotlight/Significant%20Reforms.pdf

Questions?

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Thank you!

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