PENSION BENEFITS, DESIGN, AND FUNDING TASK FORCE

Principles

Any changes to the retirement systems that the Task Force might consider must balance multiple interests:

- **Recruitment, retention, and public benefit**. State employees, teachers, and other public sector employees provide a wide variety of critical services to Vermonters throughout the State. Retirement benefits are among the most important components of total compensation of public sector employees and an important tool for workforce recruitment and retention, particularly in a time when demographic and economic challenges are acute.

- **Commitment**. As an employer, the State should honor ~~the commitments it has made~~ its commitment to past, current, and future public sector employees to provide a solid foundation for a secure retirement and to ensure the long-term dignity and economic well-being of its workforce.

- **Sustainability**. The State has a fiduciary responsibility to public sector employees and to other taxpayers to ensure that the retirement plans remain solvent and responsibly managed.

- **Affordability**. The State has a fiduciary responsibility to all taxpayers to balance the cost of services provided with the burden of taxes and fees. The State also has a responsibility to continue providing critical services within the fiscal constraints posed by long-term needs.

- **Net economic and demographic impacts**. Making changes to the pension system—and a failure to make any changes to the system—will impact the State and local economies; the spending power of current employees and of retirees; the financial position of the State, local governments, and local school systems; and the demographic profile of the State.

- **Equity.** Any changes to the public pension system may affect different employees in different ways. To the extent possible, changes should have limited or no adverse impact on lower wage employees, employees who have historically experienced economic or social disadvantage, or employees who are at or near retirement eligibility.

Statement of the Issue

The State of Vermont values the work and services provided by its public teachers and State employees and is committed to providing secure and equitable retirement benefits. The Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS) are vital components of recruiting and retaining an excellent public sector workforce, but the systems are on an unsustainable financial path. Neither system has enough assets today to cover the projected cost of retirement benefits they must pay out in the future, and the size of the shortfall has grown significantly in recent years. Absent any changes, the cost to Vermont taxpayers of funding the systems will continue to grow until the liabilities exceed the State's financial capacity to support the systems in their current form and also continue to provide critical public services.

Statement of the Issue

Adequate retirement benefits are vital to recruit a qualified workforce for the effective delivery of public services and to adequately compensate public employees for their service. The Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS) face challenges. These include the level of employer contributions relative to the fiscal capacity of the State, as well as the predictability of expected contribution amounts. Additionally, the unfunded liability, which has grown significantly in recent years, impacts the fiscal position of the State. Absent any changes, the cost to Vermont taxpayers of funding the systems are projected to grow each year through the end of amortization period in 2038.

Commented [DE1]: Reflects Principle 1 and outlines why our work is important

Commented [DE2]: Reflects the conversation around the room. The intent is to be specific in terms of the issue, so that it can guide our work.

Commented [DE3]: As drafted, this reflects a concern about the unfunded liability, but also implies that anything less than 100% funded indicates an issue. The vast majority of plans are not fully funded and generally greater than 80% funded on a path to full funding. That being said, the amount of liabilities to pose challenges.

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Background

Vermont's pension systems, like those of other states, experienced significant investment losses from the Great Recession. In just one year from FY2008 to FY2009, the unfunded liabilities grew by $239.4 million (275%) for VSERS and $348.3 million (92%) for VSTRS. The funded ratios for each system also declined by approximately 15% during that one-year period.

Change in Pension Funded Status, FY08-09		
	VSERS	**VSTRS**
Unfunded Actuarial Accrued Liability		
As of FY08 Valuation	$87.1 million	$379.5 million
As of FY09 Valuation	$326.5 million	$727.8 million
Funded Ratio		
As of FY08 Valuation	94.1%	80.9%
As of FY09 Valuation	78.9%	65.4%

In 2009, in the aftermath of the Great Recession, the State of Vermont established a Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers ~~-~~to address the affordability and long-term sustainability of the pension and retirement health care plans serving state employees and teachers.~~-~~[1]

While the implosion of financial markets in 2008 and the first quarter of 2009 severely impacted the value of plan assets and contributed to a large increase in required employer contributions, the Commission also identified the economic and demographic trends pre-dating the Great Recession that had already set the retirement systems on an unsustainable financial trajectory, including:

- Financial commitments for retirement benefits, including health care, growing much faster than the rate of revenue growth at a time when the state was projecting significant deficits due to the impacts of the Great Recession.
    - ~~Annual increases in the required actuarial pension contribution as a percentage of total General Fund revenues (increases from 5% to 9.5%, from FY 2008 to FY 2011)~~ Formatted
- Steep a~~A~~nnual increases in the actuarially determined employer contribution (ADEC) for both pension systems:
    - VSERS ADEC increased 117% from FY2003 to FY2008, with a projected increase from FY2003 to FY2011 of 328%.
    - ~~(~~VSTRS~~ERS~~ ADEC increased by approximately 100% from FY2003 to FY2006, prior to re-amortization. ~~117% from FY 2003 to FY 2008, with a projected increase from FY 2003 to FY 2011 of 328%; VSTRS increase of just over 100% from 2003 to 2006 prior to re-amortization)~~ Formatted
    -
- ~~Annual increases in the amount of the unfunded liability for both systems (increasing in FY 2008-2009 from \$87.1m to \$326.5m (VSERS) and from \$379.5m to \$727.8m (VSTRS))~~ **Formatted:** Normal, No bullets or numbering
- An aging workforce, a baby boomer retirement bubble, ~~and~~ longer life expectancies, and workforce changes impacting retirement were resulting ~~resulting~~ in a rate of growth in retirees outpacing the rate of growth in active members. There were 2,800 more retired teachers and state employees in 2009 than in 2003. As the ratio of active members to annuitants declines, pension costs are often at risk of increasing – particularly in a poorly funded plan. ~~(2800 more retired teachers and State employees in 2009 vs. 2003)~~
- The amount of pension benefit payouts were steadily increasing by approximately \$15-16 million per year in total across both systems, and projected to increase by approximately 50% over 2009 levels by 2014.

[1] https://www.vermonttreasurer.gov/content/retirement-commission

- An assumed rate of return of 8.25% that exceeded the actual rate of return and

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- An assumed rate of return of 8.25% that exceeded the actual rate of return and that was higher than the rate used by a majority of other plans. ~~(~~In 2009, close to 75% of other plans ~~using~~ used a return assumption less than 8.25%.[2]~~)~~
- Failure of the State to fully fund the actuarially determined employer contribution (ADEC) preceding the Great Recession, particularly for the VSTRS system. The actual VSTRS contribution was less than 100% of the recommended amount in all but four years from 1979 to 2006. This caused the VSTRS system to have a lower funded ratio than VSERS and added costs to future VSTRS ADEC payments.
- Multi-million dollar annual increases in the employer cost for providing subsidized retiree health benefits.
- Funding of VSTRS retiree health benefits from pension assets rather than a dedicated funding source, resulting in an actuarial loss to the pension system.[3]~~plan~~

The 2009 Commission made several recommendations to place the retirement systems on a sustainable path, some of which were ultimately adopted. The consulting actuary estimated that adoption of all the recommendations made in the 2009 report would reduce the FY2011 ADEC by $29 million. Actual savings from implementation of the plan totaled roughly $20 million. However, the demographic and economic factors that the Commission identified in its report have only been exacerbated since that time, and the financial struggles of the retirement systems have only accelerated.

Updates Since the 2009 Commission

[Insert post-2009 history here]

Commented [CR5]: This section will be further developed to describe events from 2009-present.

	Recent Changes to Pension Systems[4]
2005	Teacher Study made changes to Vermont's actuarial methods and put full funding of the ARC on track. The Legislature has consistently adopted a budget with full funding of the ARC since 2007.
2008	Committee restructured VSERS Group F benefits, lengthening the age of retirement, effective in FY2009, in concert with health care changes.
2009	Pension and Health Care Study completed, providing basis for negotiated savings of the next few years for both VSERS and VSTRS systems.
2010	VSTRS: Lengthened normal retirement age, increased contributions, and other changes effective in FY11. Changes resulted in $15 million in annual pension savings. Additional health care savings also accrued from these changes.

[2] The assumed rate of return was 8.25% from 2006 to 2010 and was revised downward in 2011. The current rate of return (effective FY21) is 7.0%, which is lower than the average (7.11%) and in line with the median (7.00%) among major pension plans surveyed by NASRA as of August 2021.

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[3] The practice of paying for VSTRS OPEB out of the VSTRS pension fund ended in 2015.

[4] Data from Treasurer's Office 2020 Annual Report. https://www.vermonttreasurer.gov/sites/treasurer/files/Reports/2020/Treasurer%27s%20Office%20Annual%20Report%202020.pdf

2011	VSERS: Employee contribution rates increased beginning in FY2012, initially generating $5 million in savings per year and increasing each year.
2011-12	Secured one-time revenues in excess of $5 million for VSERS and VSTRS under the Federal Early Retirement Reinsurance Program
2013	Pension forfeiture statute enacted.
2014	VSTRS: Additional contribution increases for new and non-vested members, effective for FY2015, which generated $1 million in initial annual savings that increased each year.
2014	VSTRS: Statute change permitting teacher pension costs to be charged to federal grants (effective for FY2016), creasing an estimated $3-4 million in savings per year.
2015	VSTRS OPEB Reformed: • Created Retired Teachers' Health and Medical Benefits Fund starting FY2015. • Ended practice dating to 1980s of paying for health care premiums from a sub-trust of the VSTRS pension fund, which was costing over $20 million per year in interest costs and adding to the unfunded liability. • A new health care assessment for LEAs was implemented, linking local employment decisions to the benefit costs. • Changes were projected to save taxpayers $480 million in unfunded liability interest costs through FY2038.
2015	VSERS Disability retirement reform enacted to permit wage verification of disability pensioners.
2016	Changes made to the amortization financing schedule for VSERS and VSTRS, saving $165 million in interest through FY2038.
2016	Increased employee contributions will result in $1.2 million in annual savings, with savings growing larger in future years.
2018	Legislature appropriated an additional $26.2 million above ADEC for VSTRS and $12.5 million for VSERS.
2018	Risk assessment performed per ASOP 51
2020	Assumed rate of return lowered to 7.0% based on independent analysis. Demographic and mortality assumptions revised.

Scope of the Problem

Since the current 30-year closed amortization period began in FY2009, the funded ratios of both pension systems have steadily declined as accrued liabilities have grown faster than plan assets. As a result, the cost of paying for pension benefits has increased significantly. [insert chart showing funded ratios and ADECs over time]

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While certain federal and local sources contribute funding to the retirement plans, ~~the~~state government ~~State~~ bears most of the responsibility for paying the employer share of pension costs.

The employer pension costs are comprised of two components – a contribution to fully funding the normal cost and an amortization payment toward the unfunded liability. The ADEC, which is calculated annually, reflects the total recommended amount the employer should pay to fully fund both of these costs in the upcoming fiscal year.[5]

The normal cost represents the present value of future retirement benefits accrued during
The normal cost represents the present value of future retirement benefits accrued during the current year and, in practice, is the amount that should be paid into the pension fund every year to pay for the year's worth of future retirement benefits earned by the active workforce. Active participants pay pension contributions at a fixed rate set in statute, and these contributions fund a portion of the normal cost. The rate each active member pays varies based on which pension plan group they are enrolled in.
Employee contributions, however, have not grown at the rate the normal costs have
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grown, and as a result, employee contributions now pay approximately half of the total aggregate normal costs across all employee groups. The remaining portion of the normal cost that employee contributions are insufficient to fund is paid by the employer through the ADEC.

[Fagan question on history of employee contribution – we will add a chart showing trends over time]

In addition to the normal costs, each retirement system has an "unfunded liability"—a gap between the costs of future benefits and the assets available to pay for them. The unfunded liability arises from prior years of underperformance relative to assumptions, legacy underfunding of the employer contribution in prior years, and increased costs from changes to assumptions, such as adopting lower assumed rates of investment return or changes to demographic projections.
The unfunded liability is amortized, with interest, over a closed 30-year amortization period that ends in 2038. Although the payoff schedule is fixed in statute, the amount of the unfunded liability changes annually based on the performance of the pension funds. When the size of the unfunded liability changes from year to year, so does the amount of future amortization payments.

The VSERS employer pension costs (both the normal cost and unfunded liability amortization payment) are paid out of the various funds of state government in proportion to those funds' share of the active payroll. The state annually calculates a payroll charge

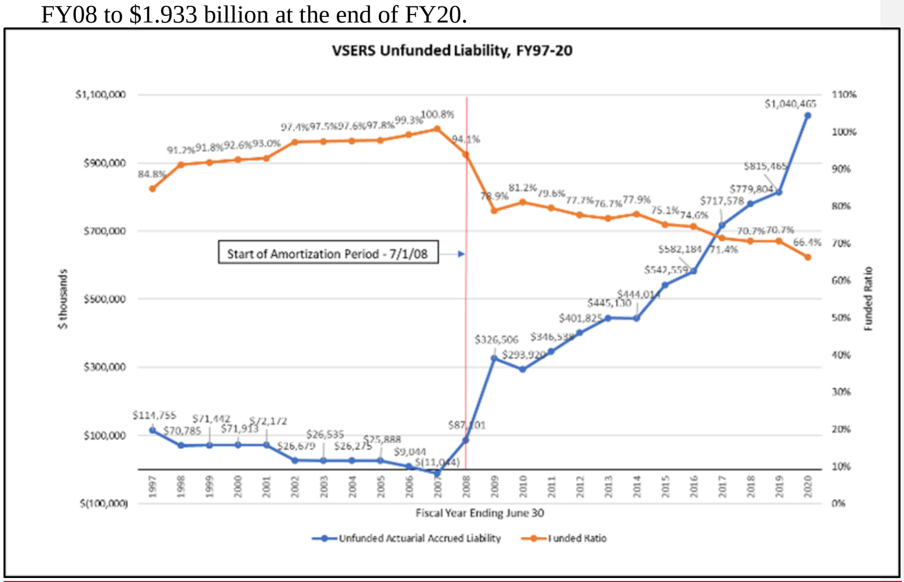
[5] Due to timing reasons, there is a lag between the actuarial valuation and the budgeting of the ADEC. Annual actuarial valuations, which measure the status of the pension fund each fiscal year to calculate the ADEC, are not completed until approximately midway through the subsequent fiscal year. The status of the pension fund at the beginning of a fiscal year determines the ADEC for the following fiscal year. For example, the unfunded liability and normal costs at the beginning of FY21 (which are reflected in the FY20 actuarial valuation) determine the ADEC to be paid from the FY22 budget.

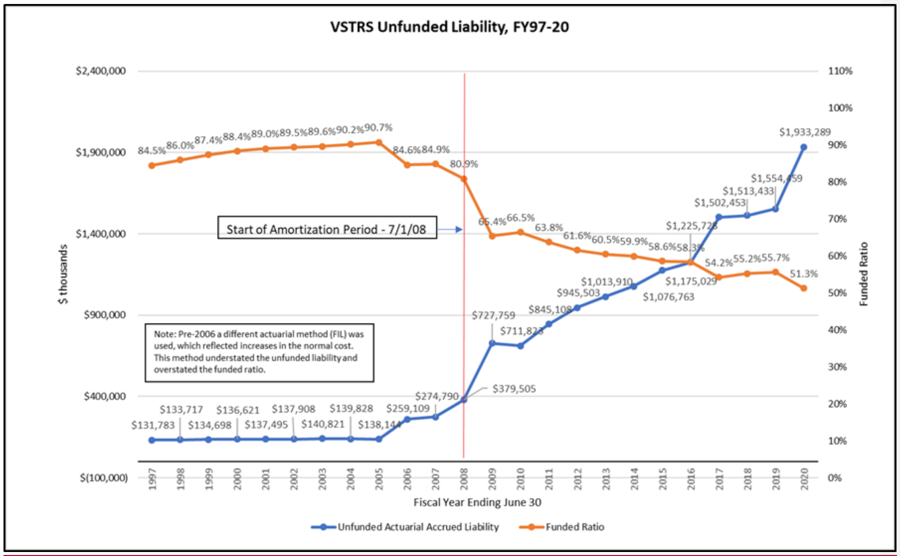
Formatted: Indent: Left: 0.25", First line: 0" as a percentage of wages and salaries that is sufficient to meet the projected obligations, and remits those funds to the respective benefit trust funds. For FY22, the VSERS employer retirement charge totals 25.5% of wages and salary, with 19.5% dedicated to pension costs and 6% dedicated to OPEB. Approximately 35-40% of these costs are paid out of the General Fund, with the remainder charged to federal and special funds that pay the salaries of the active workforce.

The VSTRS employer pension costs are treated differently than VSERS. The VSTRS employer normal cost is charged to the Education Fund and the unfunded liability amortization payment is paid from the General Fund. A smaller portion of these costs are also paid by Local Education Agencies for their employees who are federally funded. [will insert chart showing breakouts by fund for each ADEC]

Despite the employer fully funding—and in some years more than fully funding—the actuarially required amounts since 2007, the unfunded liabilities for each system have grown significantly since the 2009 Commission report:

- The VSERS unfunded liability has increased from $87.1 million at the end of FY08 to $1.040 billion at the end of FY20.
- The VSTRS unfunded liability has increased from $379.5 million at the end of FY08 to $1.933 billion at the end of FY20.



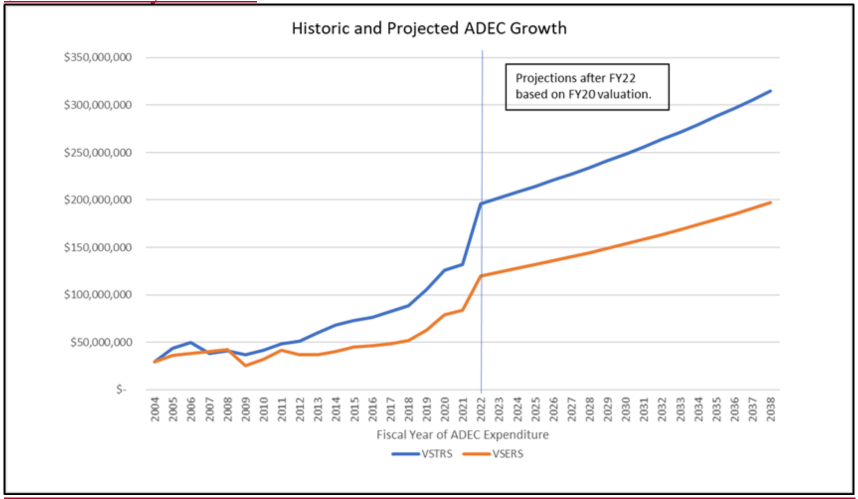


The amount that the employer must annually contribute to fully fund the normal costs of the plans and to pay down the unfunded liability—which together comprise the "ADEC," or actuarial determined employer contribution—has also grown significantly and may ultimately exceed the State's fiscal capacity to pay:

- In FY 2008, the ADECs totaled approximately $82 million.
- By FY 2022, the ADECs grew to approximately $316 million.

Under current assumptions, the normal costs are expected to grow in future years at a rate of approximately 3.5% (VSERS) and 3% (VSTRS) annually, in line with projected payroll growth. Additionally, the unfunded liability amortization payments are calculated, per statute, to increase in 3% annual increments for both systems until FY2038. In a status quo situation with all actuarial assumptions met, therefore, the total ADECs are projected to grow by approximately 3% annually. At that growth rate, they will exceed

$500 million by FY2038.



Informed by the most recent experience studies and economic forecasts, economic and demographic assumptions for both systems were revised in 2020. These assumption changes included lowering the assumed rate of return from 7.5% to 7.0%, revising inflation assumptions, and adopting new mortality and other demographic projections. These changes were intended to ensure that assumptions are met more consistently in future years; however, the assumption changes themselves led to significant increases in the unfunded liabilities, normal costs, and ADEC payments for both systems from FY21 to FY22. As reflected in the FY20 actuarial valuations, from FY21 to FY22:

- The VSERS unfunded liability grew by $225.0 million and the ADEC by $36.1 million.
- The VSTRS unfunded liability grew by $378.8 million and the ADEC by $64.1 million.[6]

[6] Act 75 charged this Task Force with recommending options to lower the unfunded liabilities and ADECs based on the numbers expressed in the June 30, 2020 actuarial valuations of each system. These numbers are from those valuations. Note that on October 31, 2018, the VSTRS Board of trustees adopted Alternative Amortization Schedule 3 of the Addendum to the June 30, 2018 actuarial valuation. This action increased the VSTRS ADEC for FY21 in the 2019 valuation by $3.5 million as part of a plan to maximize a $26.2 million additional employer contribution by holding it harmless and adding it to the statutory amortization schedule. As a result, the ADEC was higher in FY21, lowering the delta to $60.6 million instead of the $64.1 million reflected in the FY20 valuations. Ultimately the Governor and General Assembly reverted to the previous amortization schedule without the add-on.

- If nothing changes, and if all actuarial assumptions are met moving forward, the ADEC payments will continue to grow and will exceed $500 million by FY2038.

Although some elements of VSERS pension costs are charged to different funds of state government, the increasing cost for retirement liabilities continues to consume an ever-larger share of the General Fund.

- In FY2019, the total General Fund employer contribution to retiree pensions and OPEB (other post-employment benefits) for both VSERS and VSTRS was $167.8 million, or 10.51% of the General Fund.
- For FY2022, the total General Fund employer contribution has increased to $249.5 million, accounting for approximately 13.8% of the General Fund.

Put in broader context across all funds, the FY2022 retirement costs for both systems consumes more dollars than entire categories of state government programs, including:

- is a far greater amount than what the State appropriates annually from the General Fund for entire categories of government services, including: general government ($95m); protection to persons and property ($152m); labor ($4.9m); natural resources ($32m); and commerce and community development ($16m). [Add graph or other way of demonstrating scope of the problem, rather than specific budget items?]

Commented [CR6]: We should reframe this into broader "all funds" context and not just the General Fund.

Causes of Unsustainable Growth in Liabilities

Vermont's pension and OPEB liabilities have both grown significantly since 2009 and at a faster rate than state revenues.

Pension Liabilities

Unsustainable annual increases in the amount of the total unfunded liability, the ADEC, and the State's total cost for retirement contributions, including retiree health care benefits, are rooted in a variety of experience, economic, and demographic factors, including:

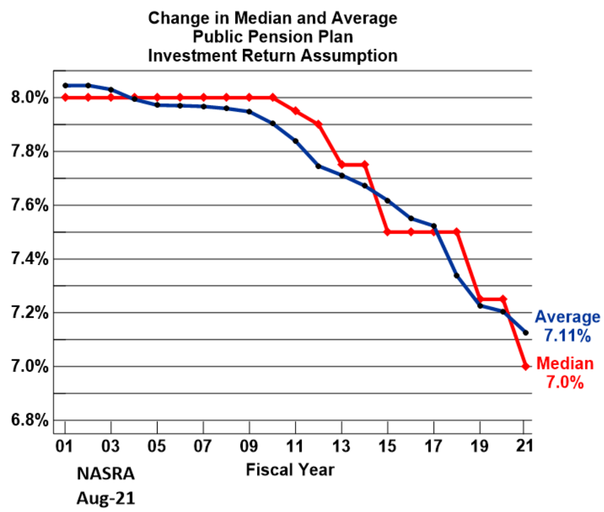
- **Underfunding pre-2008**. The State underfunded the VSTRS employer contribution in all but four years from 1979 to 2006. Although this historic underfunding occurred prior to the closed 30-year amortization period and is not responsible for the significant increases in liabilities subsequent to 2008, it added cost to the ADEC to make up for lost investment opportunities in the past and contributed to why VSTRS has a lower funded ratio than VSERS. [potentially ask actuaries to estimate how much cost it added to ADEC]

- **Great Recession**. The dramatic economic downturn in 2008-2009 created a hole in each pension fund that remains unfilled as of the end of FY20. Actuaries in 2009 estimated that it would take more than 20 years at the then- actuarial investment rate of return of 8.25% to get back to the FY 2008 funding level. From the beginning of FY08 to the end of FY20, investment performance falling short of assumptions increased the VSERS unfunded liability by $340.9 million and the VSTRS unfunded liability by $417.1 million.

- **Actuarial rate of return**. The systems previously adopted actuarial rates of return that proved over time to be overly optimistic. When a higher rate of return is assumed, the actuarial math expects that assets will grow over time at a higher rate, leading to lower recommended employer contributions into the pension funds. It is important to note that the rate of return does not affect the performance or outcomes of the fund or dictate asset allocation or investment policy; however, the assumed rate of return (and the extent to which experience meets that assumption over time) influences the size of the projected future liabilities and assets, which inform shorter-term funding recommendations and decisions.

In 2008, the two pension systems used an 8.25% rate of return. However, in the years since, actual investment experience has fallen short of this assumption due to the Great Recession and a changing global financial landscape.

Most states, including Vermont, have lowered their assumed rates of return since then due to changing global investment expectations. Vermont lowered its rate of return from 7.5% to 7.0% in 2020, which is the rate used by the median of major pension systems surveyed by NASRA as of August 2021. [7]



While a lower assumed ate of return is more likely to be consistently achieved through investment experience over time, it also leads to larger projected liabilities and higher employer ADEC costs to make up for the fact that less of the money required to pay benefits is expected to come from investment gains in the future.

[7] https://www.nasra.org/latestreturnassumptions

- **Retired teacher health benefits paid from pension fund**. The State paid VSTRS retiree health benefits (OPEB) from pension assets at an actuarial loss until 2015. This practice added approximately $155.3 million to the VSTRS unfunded liability since the beginning of FY08, which must ultimately be paid back with interest through future ADECs or actuarial gains. Subsequent to 2015, the employer share of these expenses have been paid on a pay-as-you-go basis out of the state's General Fund.

- **Demographic and Experience Factors.** Differences between the actual experience of plan participants compared to assumptions have significantly contributed to the increase in the unfunded liability and ADEC. Every pension plan has actuarial gains or losses each year as actual events during the year do not exactly match the long-term assumptions previously made. The State's actuary, Segal, categorizes them as follows:

    - Economic:
        - Inflation (which is an underlying component in all other economic assumptions)
        - Investment return
        - Salary increases
        - Payroll growth
        - Cost of Living Adjustments (COLA)
    - Demographic:
        - Mortality rates in active service and/or retirement
        - Retirement rates
        - Member termination/turnover rates for reasons other than retirement
        - Disability

Investment performance falling short of assumptions was a significant cause of prior actuarial losses, particularly when including the Great Recession years – although this factor has had less of an impact after 2010. Member turnover and retirement experience were major causes of actuarial loss (particularly for VSTRS) that have continued to grow over the course of the amortization period.

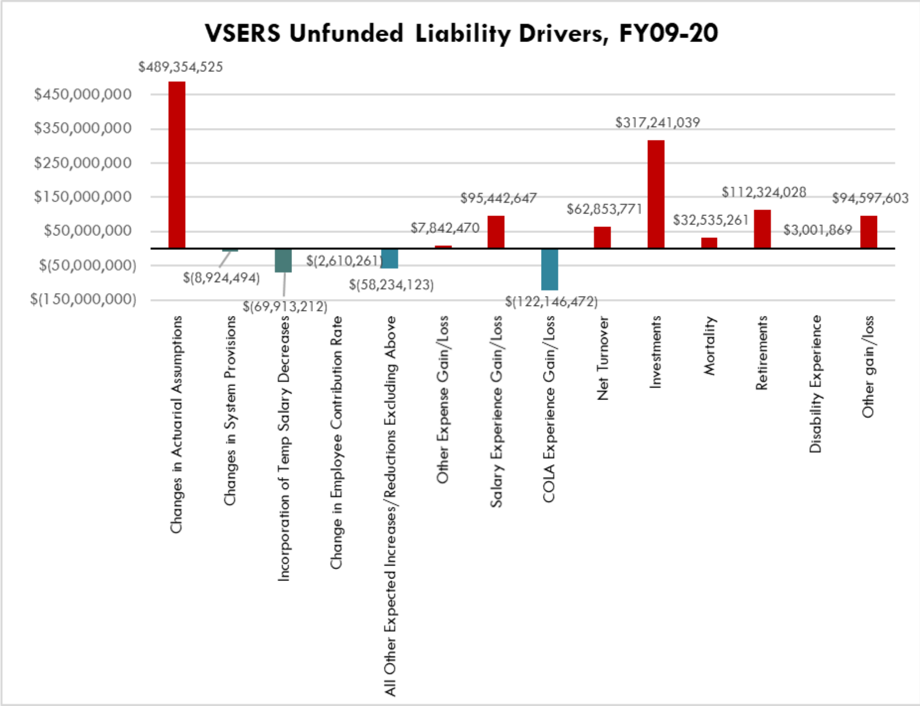
Other experience factors, however, have led to actuarial gains. Cost of Living Adjustments, for example, have been less than assumed in both systems. However, these assumptions can be significant risk factors going forward depending on inflation trends, as higher rates of inflation will likely lead to higher than expected salary increases and COLAs. While reviewing past experience is critical for understanding the change in liabilities to date, a review of all assumptions through periodic experience studies and risk assessments is important for ensuring that assumptions and funding policies are reasonable and realistic moving forward.

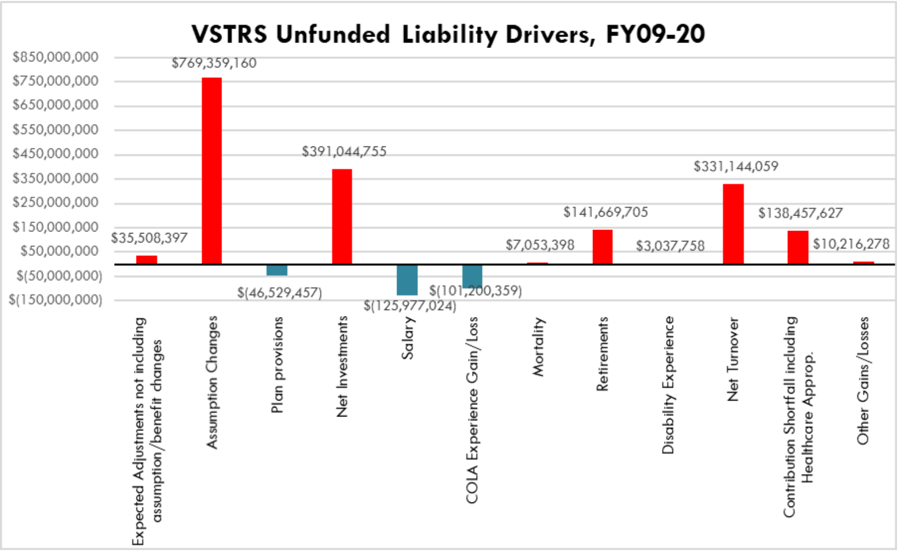
From the beginning of the amortization period in FY09 through the end of FY20:

- Demographic experience deviating from assumptions increased the VSERS unfunded liability by $210.7million and the VSTRS unfunded liability by $482.9million.
- Investment performance deviating from assumptions increased the VSERS unfunded liability by $317.2 million and the VSTRS unfunded liability by $391.0 million when including the peak of the Great Recession. When looking at the period of time from FY2011-2020 and excluding the Great Recession peak, this factor had a much smaller impact – it increased the VSERS unfunded liability by $56.2 million and VSTRS unfunded liability by $52.0 million.

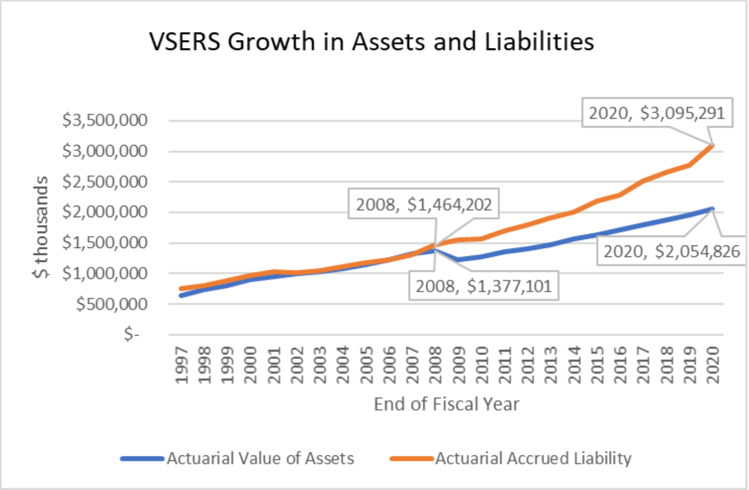
- **Changes to Assumptions** Actuarial assumptions, including the rate of return, have also been revised over time to more realistically mirror anticipated demographic and investment experience. These assumption changes, however, have also added to the unfunded liabilities. From the beginning of FY2009 through the end of FY2020, changes in actuarial assumptions increased the VSERS unfunded liability by $489.4 million and the VSTRS unfunded liability by $769.4 million.

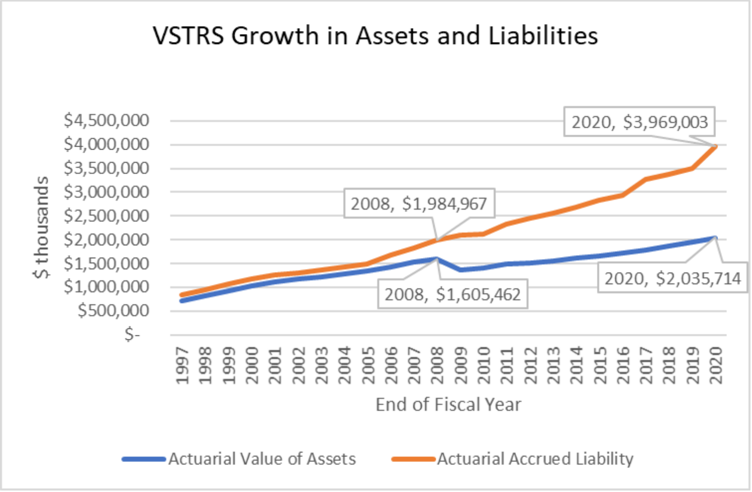
- Other miscellaneous factors, including system provision changes, expected adjustments, and other gains and losses accounted for the remaining pressures on the unfunded liability.


VSERS Unfunded Liability Drivers, FY09-20
$489,354,525
$450,000,000
$350,000,000
$250,000,000
$150,000,000
$50,000,000
$(50,000,000)
$(150,000,000)
$317,241,039
$95,442,647
$112,324,028
$94,597,603
$62,853,771
$7,842,470
$32,535,261
$3,001,869
$(2,610,261)
$(8,924,494)
$(58,234,123)
$(69,913,212)
$(122,146,472)
Changes in Actuarial Assumptions
Changes in System Provisions
Incorporation of Temp Salary Decreases
Change in Employee Contribution Rate
All Other Expected Increases/Reductions Excluding Above
Other Expense Gain/Loss
Salary Experience Gain/Loss
COLA Experience Gain/Loss
Net Turnover
Investments
Mortality
Retirements
Disability Experience
Other gain/loss


VSTRS Unfunded Liability Drivers, FY09-20
$850,000,000
$750,000,000
$650,000,000
$550,000,000
$450,000,000
$350,000,000
$250,000,000
$150,000,000
$50,000,000
$(50,000,000)
$(150,000,000)
$769,359,160
$391,044,755
$331,144,059
$141,669,705
$138,457,627
$35,508,397
$7,053,398
$3,037,758
$10,216,278
$(46,529,457)
$(125,977,024)
$(101,200,359)
Expected Adjustments not including assumption/benefit changes
Assumption Changes
Plan provisions
Net Investments
Salary
COLA Experience Gain/Loss
Mortality
Retirements
Disability Experience
Net Turnover
Contribution Shortfall including Healthcare Approp.
Other Gains/Losses

As a result of these factors, pension costs have grown significantly faster than pension assets, and consequently the gap between assets and liabilities (the unfunded liability) continues to widen.





Other Post-Employment Benefits (OPEB)

OPEB refers to “other post-employment benefits,” primarily health care offered through the VSERS and VSTRS health plans, which also contribute to the rising cost of Vermont’s long-term retirement liabilities.

Unlike pre-funded pension benefits, which are funded in part from investment gains, OPEB payments are almost entirely funded on a pay-as-you-go (or “paygo”) basis—the State appropriates funds annually from current revenues to pay for benefits and premiums for today’s retirees as they become due for payment. The annual General Fund expense has remained relatively consistent since FY 2019 for state employees at approximately $14.9 million, but has increased for teachers from $31.6 million in FY2019 to $35.1 million in FY 2022. While contributions and subsidy rates are codified in statute, potential recipients are not vested in the same way as pension benefits and these benefits are not as secure for future retirees.

There is general recognition that prefunding OPEB benefits would yield long-term savings for the State and more stability and predictability for retirees in the future. The lack of a formal and codified system of prefunding OPEB liabilities is responsible for $1.68 billion of Vermont’s unfunded OPEB liabilities. With prefunding, Vermont can calculate its unfunded liabilities by applying the assumed rate of return based on anticipated investment performance of the plan assets over time. The pension systems currently use a 7.0% rate of return. Without prefunding, accounting rules require Vermont ~~must~~ to use a standardized discount rate tied to the 20-year AA municipal rate, which is heavily influenced by federal monetary policy and interest rates. Currently, this rate is approximately 2.2%. However, prefunding OPEB benefits would require a long-term commitment of additional appropriations above the pay-as-you-go amount to build up a pool of assets that can be invested long-term. Further, OPEB costs can be heavily

~~influcenced~~influenced by both federal health care policy and pensions policies that influence the age at which employees retire, as the per-member premium cost of providing benefits is higher in the years prior to the member being eligible for Medicare. ~~it is significantly more expensive to provide health benefits to retirees who are not yet eligible for Medicare.~~

Prefunding OPEB would require approximately $20 million in additional funds above the paygo amounts each year for each of the two systems.[8] The VSERS OPEB trust received approximately $52 million in additional one-time funds in FY21 based on statutory provisions regarding year-end General Fund surpluses. This is a significant influx of dollars that almost doubled the net assets of the fund and may lower the funding requirements to initiate prefunding. However, even with this one-time infusion of funds, a prefunding plan will still require an incremental increase of funding above the paygo amount to be invested over time. ~~in FY22 would require an additional $41.6 million and this amount would increase every fiscal year.~~

Commented [CR7]: This entire OPEB section should be revisited in a few weeks.

[8] A more precise estimate requires actuarial modeling and depends on factors like the amortization method employed, funding policy. payroll growth and demographic assumptions, and health care cost growth assumptions. Changes to federal Medicare policy may also significantly impact future cost projections.