

## PENSION BENEFITS, DESIGN, AND FUNDING TASK FORCE

### **Statement of the Issue**

The Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS) 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 each year.

### **Background**

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.

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 the required employer contribution, 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
- 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)
- Annual increases in the actuarially determined employer contribution (VSERS increased 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)
- 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))
- An aging workforce, a baby boomer retirement bubble, and longer life expectancies, resulting in a rate of growth in retirees outpacing the rate of growth in active members (2800 more retired teachers than State employees in 2009 vs. 2003)
- Annual increases in the amount of pension benefit payouts (increases of \$15-\$16m per year)

- Annual increases in the cost for retiree health benefits (annual increases of several million dollars per year for the 80% employer’s share for retiree health insurance premiums)
- 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 (close to 75% of other plans using a return assumption less than 8.25%)
- Failure of the State to fully fund the actuarially determined employer contribution preceding the Great Recession (VSTRS actual contribution was less than 100% of recommended contribution in all but four years from 1979 to 2007)
- Funding of VSTRS retiree health benefits from pension assets rather than a dedicated funding source, resulting in an actuarial loss to the plan

The 2009 Commission made several recommendations to place the retirement systems on a sustainable path, some of which were ultimately adopted. 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.

While certain federal and local sources contribute funding to the retirement plans, the State bears most of the employer responsibility to pay the “normal costs” of annually funding the operation of the retirement plans. Active participants, distributed among various groups within each plan, also pay employee contributions at a fixed rate set in statute and these contributions fund a portion of the normal cost. Employee contributions, however, have not grown at the rate the normal costs have grown, and as a result, employee contributions now pay approximately half of the total aggregate normal costs across all employee groups.

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, and also reflects increased costs from changes to assumptions. 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 and continues to escalate with increases in future projected costs relative to assets.

Despite the employer fully funding the actuarially required amounts, the unfunded liability for each system has grown significantly since the 2009 Commission report:

- The VSERS unfunded liability has increased from \$87 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 will ultimately exceed the State’s capacity to pay for it:

- In FY 2008, the ADECs totaled approximately \$82 million.
- By FY 2021, the ADECs grew to approximately \$205 million.

Informed by the most recent experience studies and economic forecasts, economic and demographic assumptions for both systems were revised in 2020. These changes were intended to ensure that assumptions are met more consistently in future years; however, the changes led to significant increases in the unfunded liabilities, normal costs, and ADEC payments for both systems from FY21 to FY22.

- The VSERS Unfunded Liability grew by \$225.0 million and ADEC by \$36.1 million.
- The VSTRS Unfunded Liability grew by \$378.8 million and ADEC by \$64.1 million.
- 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 FY38.

The increasing cost for retirement liabilities continues to consume an ever-larger share of the General Fund.

- In FY 2019, the total employer contribution to retiree pensions and OPEB (other post-employment benefits) was \$167.8 million, or 10.51% of the General Fund.
- For FY 2022, the total contribution has increased to \$249.5 million, accounting for approximately 13.8% of the General Fund.
- Put in context, the FY 2022 ADEC 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).

## Causes of Unsustainable Liabilities

### *Pension Liabilities*

Unsustainable annual increases since 2008 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 2008. 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 and contributed to why VSTRS has a lower funded ratio than VSERS.
- **Great Recession.** The dramatic economic downturn in 2008-2009 created a hole in each fund that remains unfilled as of the end of FY20. Actuaries in 2009 estimated that it would take more than 20 years at the 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 adopted, the systems assume that assets will grow over time at a higher rate, leading to lower required employer contributions into the pension funds.
  - In 2008, the then-actuarial investment rate of return of 8.25%, approved by the pension boards of trustees and the Vermont Pension Investment Committee, was higher than the rate of return experienced.
  - As of the 2009 report, the approved rate of return was equal or lower than the rate used in all but one of the New England States, and was higher than the rate used by 75% of plans in the U.S.
  - As in most States, Vermont's approved rate of return has been on a downward trajectory in recent years, most recently lowered from 7.5% to 7.0%. While a lower assumed rate of return is more likely to be consistently achieved, it leads to 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.
- **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 million to the VSTRS unfunded liability since the beginning of FY08.

- **Demographic and Experience Factors.** Differences between the State's actual experience compared to assumptions has significantly contributed to the increase in the unfunded liability and ADEC, including:
  - Changes in actuarial assumptions
  - Changes in system provisions
  - Salary experience
  - Net turnover
  - Actuarial investment loss
  - Mortality experience
  - Retirement experience
  - Disability experience

From the beginning of FY08 through the end of FY20:

- Demographic experience deviating from assumptions increased the VSERS unfunded liability by \$290.4 million and the VSTRS unfunded liability by \$268.3 million.
- Investment performance deviating from assumptions increased the VSERS unfunded liability by \$340.9 million and the VSTRS unfunded liability by \$417.1 million

Actuarial assumptions 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 FY08 through the end of FY0, changes in actuarial assumptions increased the VSERS unfunded liability by \$496.6 million and the VSTRS unfunded liability by \$828.5 million.

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 “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 liability has remained relatively consistent since FY 19 for state employees at approximately \$14.9m, but has increased for teachers from \$31.6m in FY 19 to \$35.1m in FY 22. 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, Vermont must use a standardized discount rate – the 20-year AA municipal rate. Currently, this rate is approximately 2.2%. However, prefunding OPEB benefits would require a long-term commitment of additional appropriations above the paygo amount to build up a pool of assets that can be invested long-term. Further, OPEB costs can be heavily influenced by both federal health care policy and pensions policies that influence the age at which employees retire, as it is significantly more expensive to provide health benefits to retirees who are not yet eligible for Medicare.

Prefunding OPEB in FY22 would require an additional \$41.6 million and this amount would increase every fiscal year.

## Principles

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

- **Recruitment and retention.** 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 to past, current, and future public sector employees to provide a solid foundation for a secure retirement.
- **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.