PENSION BENEFITS, DESIGN, AND FUNDING TASK FORCE

Interim Report

October 15, 2021

Contents

Overview

Creation of the Task Force

The Pension Benefits, Design, and Funding Task Force was created by Act 75 (2021), "An act relating to the membership and duties of the Vermont Pension Investment Commission and the creation of the Pension Benefits, Design, and Funding Task Force."

The purpose of the Task Force is to review and report on the benefits, design, and funding of retirement and retiree health benefit plans for the Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS).

Specifically, the Task Force shall make recommendations about benefit provisions and appropriate funding sources along with other recommendations it deems appropriate for consideration, consistent with actuarial and governmental accounting standards, as well as demographic and workforce trends and the long-term sustainability of the benefit programs, including the following:

(A) developing and evaluating a range of strategies to lower the actuarially determined employer contributions and unfunded actuarially accrued liability based on actuarial value of assets in the State Employees' Retirement System and the Teachers' Retirement System by between 25 and 100 percent of the size of the increases from fiscal year 2021 to fiscal year 2022, as reported in the respective Actuarial Valuation and Review for each retirement system, dated June 30, 2020, while maintaining the 2038 amortization date;

(B) a five-year review of benefit expenditure levels as well as employer and employee contribution levels and growth rates and a three-, five-, and 10-year projection of these levels and rates;

(C) identifying potential options for limiting the growth in the actuarially determined employer contributions to not more than inflation;

(D) assessing the impacts associated with any modifications to the current amortization schedule;

(E) based on benefit and funding benchmarks:

(i) proposed benefit structures with the objective of adequate benefits, including an evaluation of a shared-risk model for employer and employee contributions and cost-of-living adjustments, with a focus on reducing any future increases to the unfunded actuarially accrued liability;

(ii) an estimate of the cost of current and any proposed benefit structures on a budgetary and full actuarial accrual basis;

(iii) the State's pension contributions as a percentage of direct general spending and a comparison of other states' pension contributions; and

(iv) how proposed benefit changes for new members may reduce the impact of future actuarial assumption losses;

(F) evaluating any cross-subsidization between all groups within the Vermont State Employees' Retirement System and adjusting contribution amounts to eliminate any cross-subsidization;

(G) examining permanent and temporary revenue streams to fund the Vermont State Employees' Retirement System and the State Teachers' Retirement System;

(H) a plan for prefunding other postemployment benefits, with an evaluation of using federal funds to the extent permissible, including identifying long-term impacts of pay-as-you-go funding;

(I) evaluating the intermediate and long-term impacts to the State and local economies because of any proposed changes to current benefit structures and contribution characteristics and their potential effects on retiree spending power, including retirees who identify as female and retirees who are persons with disabilities; and

(J) an examination of the effects of current benefit structures and contribution characteristics on the recruitment and retention of public school educators and State employees and an evaluation of any proposed changes to current benefit structures and contribution characteristics on the recruitment and retention of public school educators and State employees in the future.

The Task Force shall not make recommendations on adjusting the assumed rates of return.

During the course of its deliberations, and prior to any final recommendations being made, the Task Force shall:

(1) solicit input, including through public hearings, from affected stakeholders, including those impacted by issues of inequities; and

(2) consult with representatives designated by the Supreme Court acting in its constitutional role as the administrator of the Judicial Branch, Group D members of the State Employees' Retirement System, and members of the

State Employees' Retirement System who are employees of the Department of Corrections.

The Task Force is required by Act 75 to submit two reports to the Governor and House and Senate Committees on Government Operations:

- An interim written report with an update on the work of the Task Force shall be submitted by October 15, 2021.

- A final report with its findings and any recommendations for legislative action shall be submitted by December 2, 2021. The final report shall also be submitted to the VSERS and VSTRS Boards of Trustees for their consideration and comment to the General Assembly.

Consistent with its legislative mandate, the Task Force hereby submits this interim progress report to provide updates on its work to date.

Task Force Membership

Act 75 structured the Task Force to have 13 members (12 have a vote) consisting of 5 legislators, one administration official, and 6 representatives from labor organizations. The Office of the State Treasurer's designee serves as a non-voting member.

Legislative Members:
Rep. Sarah Copeland-Hanzas (co-chair)
Sen. Jeanette White (co-chair)
Rep. Peter Fagan
Rep. John Gannon
Sen. Corey Parent

Administration Official:
Michael Pieciak, Commissioner of Financial Regulation

Labor Representatives:
Eric Davis, Vermont State Employees' Association
Andrew Emrich, Vermont-NEA
Kate McCann, Vermont-NEA
Molly Stoner, Vermont-NEA
Dan Trottier, Vermont Troopers' Association
Leona Watt, Vermont State Employees' Association

Office of the State Treasurer (non-voting member):
Michael Clasen, Deputy Treasurer

The Task Force has fiscal assistance from the Legislative Joint Fiscal Office and the Office of State Treasurer.

The Office of Legislative Operations provides committee support services for the Task Force.

The Office of Legislative Counsel and Joint Fiscal Office are authorized by Act 75 to contract for advisory services for the Task Force from an actuary, benefits expert, and legal expert, as necessary.

Through agreement with the Office of the State Treasurer, the Task Force is utilizing the pension systems' existing actuary, Segal, to perform analysis as needed.

Following a competitive request for proposals process, the Task Force contracted with Ice Miller LLP to provide legal services. Costs for professional services are paid from the Task Force's $200,000 FY22 appropriation – not from the assets of the pension systems.

Hearings and Testimony

The Task Force held hearings and received testimony on July 2, July 7, July 22, July 29, August 4, August 18, August 25, September 9, September 15, September 22, October 6, and October 13. All hearings were open to the public and made available online.

July 2

- Testimony from Jennifer Carbee, Esq., Deputy Chief Counsel, Office of Legislative Council – providing an overview of Act 75 and the Task Force's charge.
- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office -"Pension 101" covering a basic overview of pensions; how pensions work; the challenges and numbers; why the numbers changed; and a summary and next steps

July 7

- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office
  - Providing an Overview of Other Post-Employment Benefits (OPEB)
  - Discussing the impact of one-time funds on the VSERS and VSTRS Systems
- Review of the recommendations made in the 2009 Pension Report submitted to the Governor and General Assembly by the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers
- Testimony from Thomas Golonka, Chair, Vermont Pension Investment Committee discussing VPIC and its duties and activities
  - Presenting historical data on the investment rate of return vs. the assumed rate of return in VSTRS
  - Presenting a monthly investment performance analysis for the period ended May 31, 2021

- Written testimony from Eric Henry, Chief Investment Officer, State of Vermont, addressing capital market assumptions; expected returns; actuarial rates of return; and pension liabilities and contributions

July 22

- Testimony from Beth Pearce, Treasurer, State of Vermont – presentation discussing pension funding status, method, and trends; gains, losses, and drivers of the unfunded liability; experience study data; overview of investments; prefunding OPEB; and conclusions
- Testimony from Beth Fastiggi, Commissioner; Harold Schwartz, Director of Operations; and Doug Pine, Director; Department of Human Resources – presentation providing an overview of State workforce demographics
- Testimony of Mark Hage, Director of Member Benefits, Vermont Education Health Initiative (VEHI) addressing enrollment in VEHI benefit plans

July 29

- Testimony from Stephen Klein, Chief Fiscal Officer, Joint Fiscal Office – presentation on the overall budget context, including Vermont's underlying revenue and fiscal outlook; potential impacts from demographic change, COVID-19 pandemic, and global warming; demands for State services; and other areas of fiscal pressure
- Testimony from Graham Campbell, Senior Fiscal Analyst, Joint Fiscal Office – presentation on the tax and revenue landscape; basic structure of taxes; current and potential sources of tax revenue; and tax expenditures
- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office concerning further discussion on the impact of one-time funds on the VSERS and VSTRS pension systems
- Testimony from David Hall, Esq., Legislative Counsel, Office of Legislative Council concerning development of a Task Force document articulating guiding principles and statement of the pension and OPEB problems

August 4

- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office
  - Further discussion concerning Task Force document articulating guiding principles and statement of the pension and OPEB problems
  - Presentation addressing strategies to reduce ADEC pressures and improve funding ratio
  - Presentation addressing the impact of various possible changes to plan design
- Testimony from Stephen Klein, Chief Fiscal Officer, Joint Fiscal Office – providing a preliminary education fund outlook for FY 2022 and addressing the July 2021 consensus economic review and revenue forecast update

August 18

- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office –

   - Further discussion concerning Task Force document articulating guiding principles and statement of the pension and OPEB problems, including Treasurer comments and updated revisions with comments
   - Presentation addressing pension unfunded liability drivers
   - Updated presentation addressing the impact of various possible changes to plan design
- Written testimony from the National Conference on Public Employee Retirement Systems (NCPERS) – "Unintended Consequence – How Scaling Back Public Pensions Puts Government Revenues at Risk – 2020 Update"

August 25

- Testimony from Keith Brainard, Research Director, and Alex Brown, Research Manager, National Association of State Retirement Administrators (NASRA) providing an overview of public pension issues in Vermont; comparison of Vermont pensions to other state pension systems and other state reform efforts; and COLA arrangements.
   - Overview of Public Pension Issues and Trends
   - Benefit Levels for General State Employees and School Teachers
   - Overview of variations to cost-of-living adjustments among public retirement systems
- Testimony from Doug Hoffer, State Auditor, concerning State expenditures and potential options for realizing cost savings; presentation concerning public safety expenditures
- Testimony from Annie Noonan, Former Commissioner, Vermont Department of Labor concerning State employee demographics, recruitment, and retention

September 9

- Testimony from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office –
   - Further discussion concerning past underfunding of retirement liabilities, including VSERS unfunded liability growth by actuarial year
   - Presentation concerning cross-subsidization among groups within the VSERS and VSERS member data
   - Overview of revenue analysis
   - Presentation and analysis concerning actuary reports:
      - Allocation of Liabilities and Costs Between Groups
      - Impact of Additional Funds for VSERS and VSTRS
- Testimony from Dan Noon, Director, National Institute on Retirement Security – presentation concerning economic impacts of pensions in Vermont
- Testimony from Paul Cillo, President and Executive Director, Public Assets Institute concerning Vermont-specific policy and revenue strategies, including raising additional revenues.
- Written testimony from Alex Brown, NASRA, in response to Task Force questions relating to retirement plans that offer participants an option to elect different contribution rates and benefit levels; plan designs that potentially incentivize participants to work longer and other issues.

September 15

- Task Force discussion concerning potential options for system design changes and concerning modeling scenarios to present for actuarial analysis
- Testimony from Beth Pearce, Treasurer, State of Vermont – memorandum and presentation concerning the impact of treatment of additional revenues on pension funds' unfunded liabilities and ADECs

September 22

- Breakout groups and Task Force discussion concerning modeling scenarios to present for actuarial analysis
- Updated presentation from Chris Rupe, Senior Fiscal Analyst, Joint Fiscal Office, concerning impact of various possible changes to plan design
- Testimony from Beth Pearce, Treasurer, State of Vermont – memorandum and concerning teacher pension underfunding and memorandum concerning OPEB background information, initiatives, and funding requests

October 6

October 13

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 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.

Glossary

	Financial Terms
Actuary	A person (or firm) who compiles and analyzes statistics to calculate financial risks and uncertainties.
Amortization	The process of reducing or paying off a debt, with interest, through regular payments over a period of time.
Amortization Schedule	The time period and method by which payments are calculated in order to pay off a debt and interest.
Asset	Cash and investments bought with the contributions to a pension system for the purpose of financing benefit payments.
Fiduciary	A person or organization that acts on behalf of another person or persons and is bound to put their clients' best interests ahead of their own.
Liability	The cost of future payouts that a pension system is obligated to make.
Rate of return	The gain or loss of an investment over a period of time compared to the initial cost of the investment.

	Pension-Related Terms
Actuarial Rate of Return	The annual rate of return that pension assets are assumed will earn through investment gains in the future.
Actuarial Value of Assets (AVA)	A measure of the value of the pension assets that recognizes investment gains and losses over a period of time to smooth out volatility from year to year. The AVA is typically used for funding calculation purposes. By smoothing market gains and losses over a five-year period, risk of sudden increases or decreases in funding requirements in response to year-to-year market fluctuations is minimized.
Actuarial Valuation	An annual analysis performed by the actuary to measure the assets and liabilities of a pension plan at a given point in time. The actuarial valuation is used to calculate the normal cost, unfunded liability, amortization payments, and ADEC.
ADEC	Actuarially Determined Employer Contribution. The ADEC represents the annual employer payment into the pension fund needed to fully fund the normal cost plus the amortization payment toward the unfunded liability.
Annuitant	A person who is entitled to receive benefits from the pension system.
Benefits	Pension benefits are cash payments from the pension fund to an annuitant, which typically occur monthly for life upon retirement. Examples of Other Post-Employment Benefits include subsidized health care and insurance coverage.
Defined Benefits (DB) Plan	A retirement system that calculates an annuitant's future benefit level by an established formula. Typically the formula is based on a member's years of service and average final compensation.
Defined Contribution (DC) Plan	A retirement system that uses an established formula to calculate an employer's contribution level to a member's retirement account. Unlike in a DB plan, the amount an annuitant has available for benefits is determined by their account balance, investment history, and retirement date/expected longevity rather than their years of service and average final compensation.
Demographic Factors	Characteristics of the plan membership that influence the expected and actual cost of benefits. Demographic factors include mortality rates, retirement rates, member termination or turnover rates for reasons other than retirement, and disability rates.

Experience Study	A periodic analysis (often every 3-5 years) that looks back at the actual experience of the pension system compared to demographic and economic assumptions. The experience study monitors recent trends and informs the development of forward-looking assumptions.
Market Value of Assets (MVA)	The fair value that the pension assets would be expected to fetch in the marketplace at a given point in time.
Normal Cost	The present value of the cost of future benefits accrued by the workforce each year. The normal cost represents the amount that must be paid into the pension system on an annual basis to ensure that enough assets will be available to pay for the benefits earned by the workforce that year.
Risk Sharing	An arrangement between members and retirement systems to share the impact of financial or actuarial gain or loss with members.
Unfunded Liability	The shortfall between a pension plan's accrued liabilities and assets. The unfunded liability represents the "gap" between the cost of all accrued future benefits and the assets available to pay for them.

	Acronyms
ADEC	Actuarially Determined Employer Contribution. The ADEC represents the annual employer payment into the pension fund needed to fully fund the normal cost plus the amortization payment toward the unfunded liability.
COLA	Cost of Living Adjustment. COLAs are post-retirement adjustments to pension benefits that are tied to the Consumer Price Index (a measure of inflationary impacts on spending power). COLAs increase pension benefits over time to keep pace with growth in prices and maintain purchasing power.
CPI	Consumer Price Index. The CPI is a statistical measure reported by the federal government that tracks the price of a basket of consumer goods and is used to evaluate inflationary impacts on consumer purchasing power over time.
FY	Fiscal Year. An annual time period used by governments for accounting and budgeting purposes. Vermont's fiscal years run from July 1 through June 30 and are named for the calendar year in which they end.
OPEB	Other Post-Employment Benefits. The term OPEB includes retirement benefits other than pension benefits. Subsidized health care for retirees is the primary OPEB benefit.
VPIC	Vermont Pension Investment Commission. VPIC is a 9-member body responsible for investing the collective assets of Vermont's statewide pension systems and setting the rate of return and other actuarial assumptions for the pension systems.
VSERS	Vermont State Employees Retirement System. VSERS is the pension system that covers most state employees.
VSTRS	Vermont State Teachers Retirement System. VSTRS is the pension system that covers most Vermont teachers.

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 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. The annual cost for Vermont taxpayers to fund the systems is projected to grow throughout the remainder of the amortization period ending in 2038. Absent any changes, the liabilities will most likely exceed the State's financial capacity to both support the systems in their current form and continue to provide critical public services.

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.
- Steep annual 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 ADEC increased by approximately 100% from FY2003 to FY2006, prior to re-amortization.
- An aging workforce, a baby boomer retirement bubble, longer life expectancies, and workforce changes impacting retirement were 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

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

members to annuitants declines, pension costs are often at risk of increasing – particularly in a poorly funded plan.

- 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.
- 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 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]

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.

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

Updates Since the 2009 Commission

[Insert post-2009 history here]

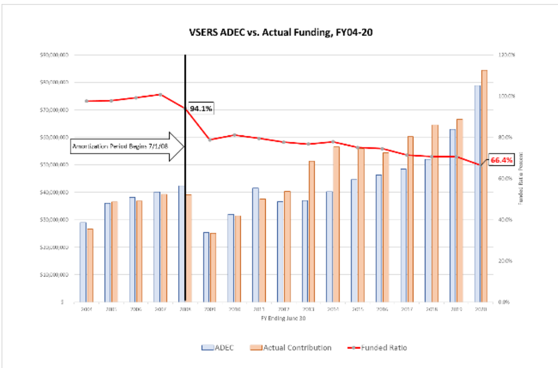
	Recent Changes to Pension Systems[4]
2005	Teacher Study made changes to Vermont's actuarial methods and put full funding of the ARC on track. The Legislature has consistently adopted a budget with full funding of the ARC since 2007.
2008	Committee restructured VSERS Group F benefits, lengthening the age of retirement, effective in FY2009, in concert with tiered 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.
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.

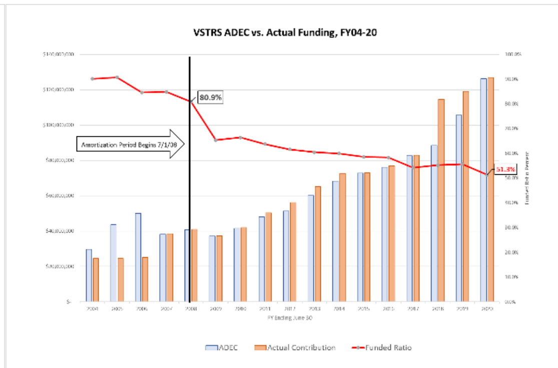
[4] Data from Treasurer's Office 2020 Annual Report. https://www.vermonttreasurer.gov/sites/treasurer/files/Reports/2020/Treasurer%27s%20Office%20Annual%20Report%202020.pdf

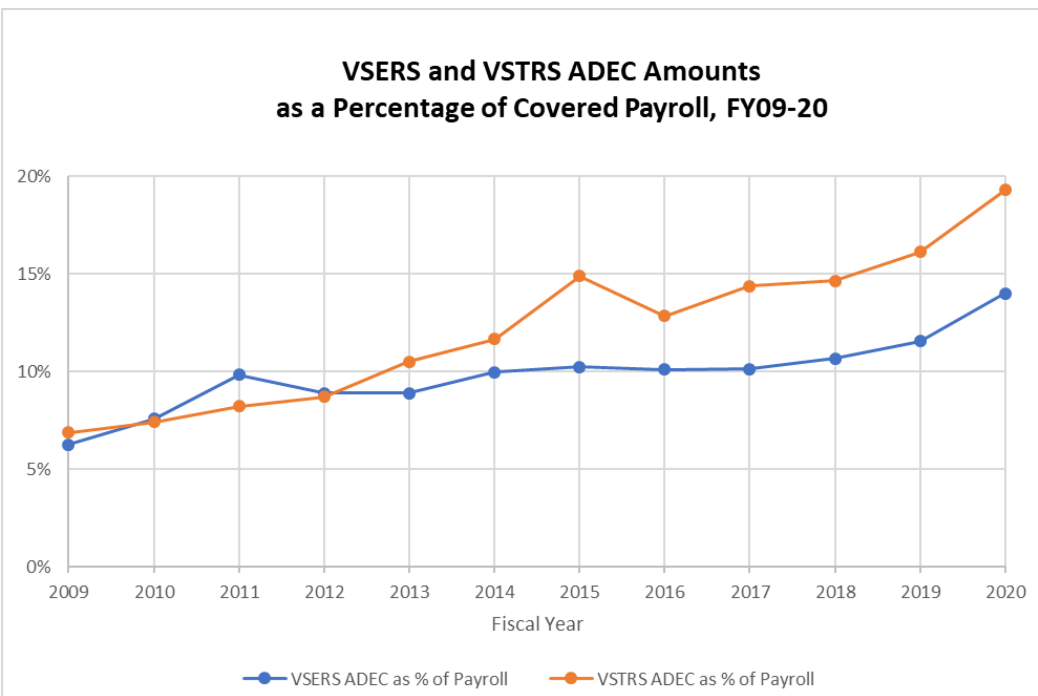
2016	Changes made to the amortization financing schedule for VSERS and VSTRS, saving approximately $165 million in interest through FY2038.
2016	Increased employee contributions will result in $1.2 million in annual savings, with savings growing larger in future years.
2018	Legislature appropriated an additional $26.2 million above ADEC for VSTRS and $12.5 million for VSERS.
2018	Risk assessment performed per ASOP 51
2019-2020	Amortization Plan enacted in 2016 takes effect.
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 – even though the actuarially recommended payments have been fully funded (and often excessively funded) by the State during that time. As a result, the cost of paying for pension benefits has increased significantly for both systems. From FY2009 to FY2020, the recommended employer pension cost has more than doubled as a percentage of payroll for each retirement system. .





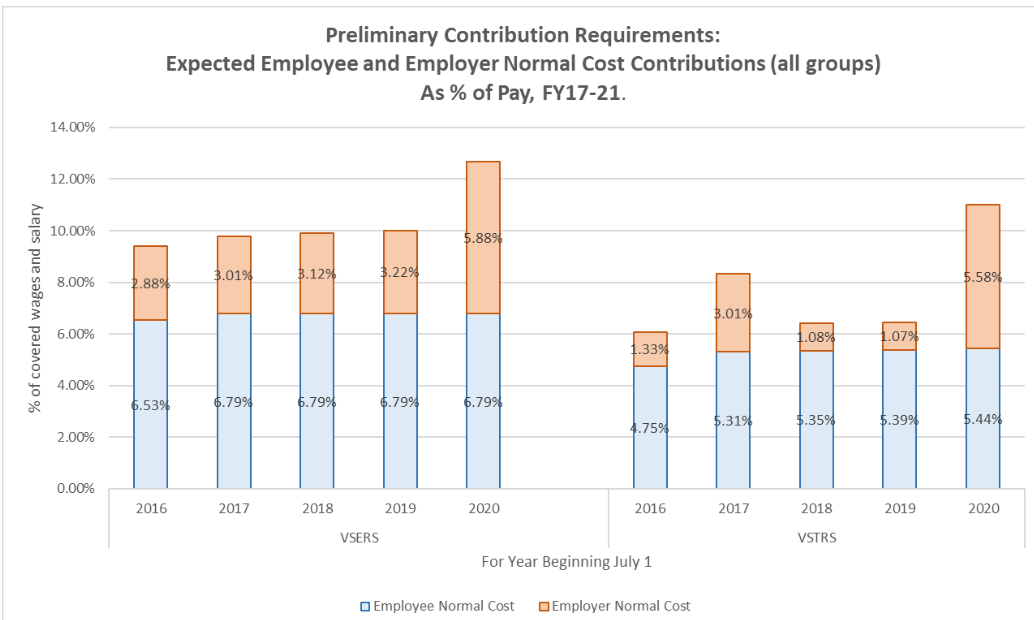


While certain federal and local sources contribute funding to the retirement plans, state government bears most of the responsibility for paying the employer share of pension costs.

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 Actuarially Determined Employer contribution **(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 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. The normal cost is calculated based on the pension system's economic and demographic assumptions in place at the time. 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.
The normal cost has grown over time as plan assumptions have changed. 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. The remaining portion of the normal cost that employee contributions are insufficient to fund is paid by the employer through the ADEC.



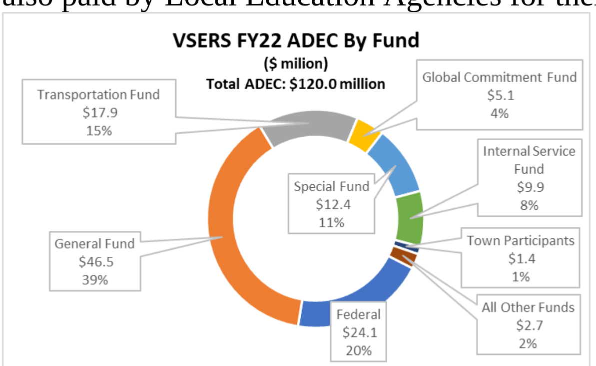
In addition to the normal costs, each retirement system has an "**unfunded liability**"—a gap between the costs of future benefits and the assets available to pay for them. The unfunded liability arises from prior years of underperformance relative to assumptions, legacy underfunding of the employer contribution in prior years, and increased costs from

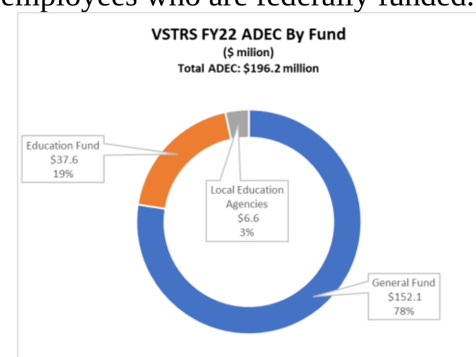
[5] Due to timing reasons, there is a lag between the actuarial valuation and the budgeting of the ADEC. Annual actuarial valuations, which measure the status of the pension fund each fiscal year to calculate the ADEC, are not completed until approximately midway through the subsequent fiscal year. The 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.

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 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.

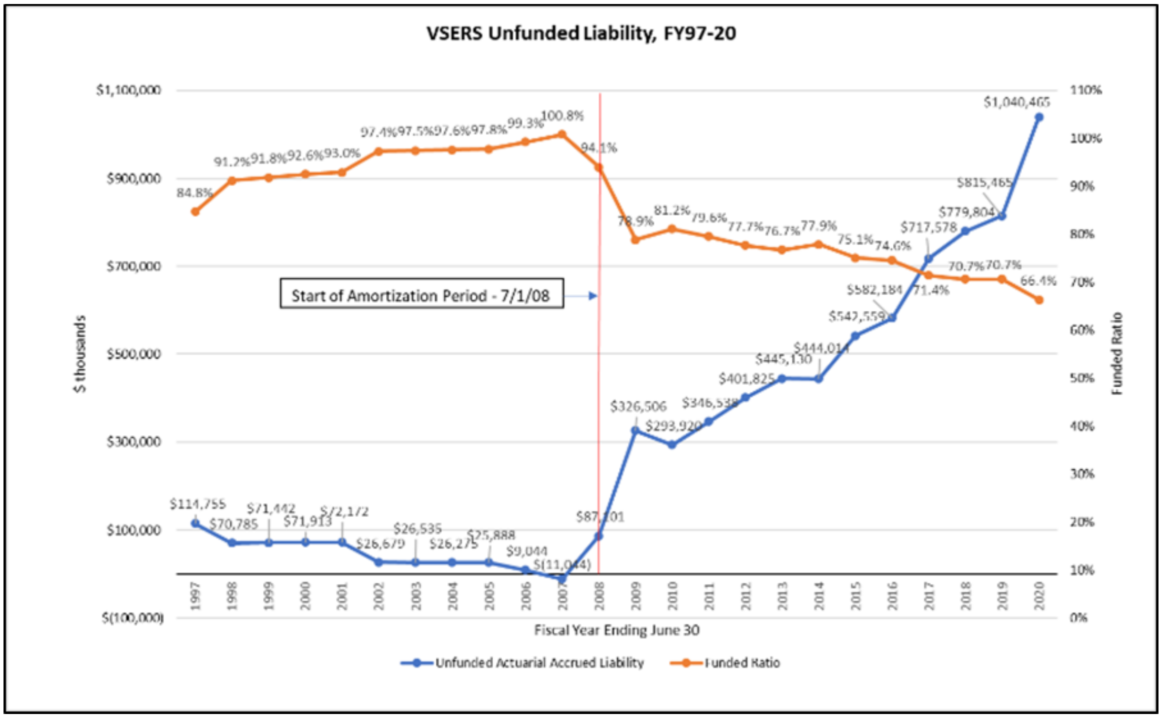
The VSTRS employer pension costs are treated differently than VSERS. The VSTRS employer normal cost is charged to the Education Fund and the unfunded liability amortization payment is paid from the General Fund. A smaller portion of these costs are also paid by Local Education Agencies for their employees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

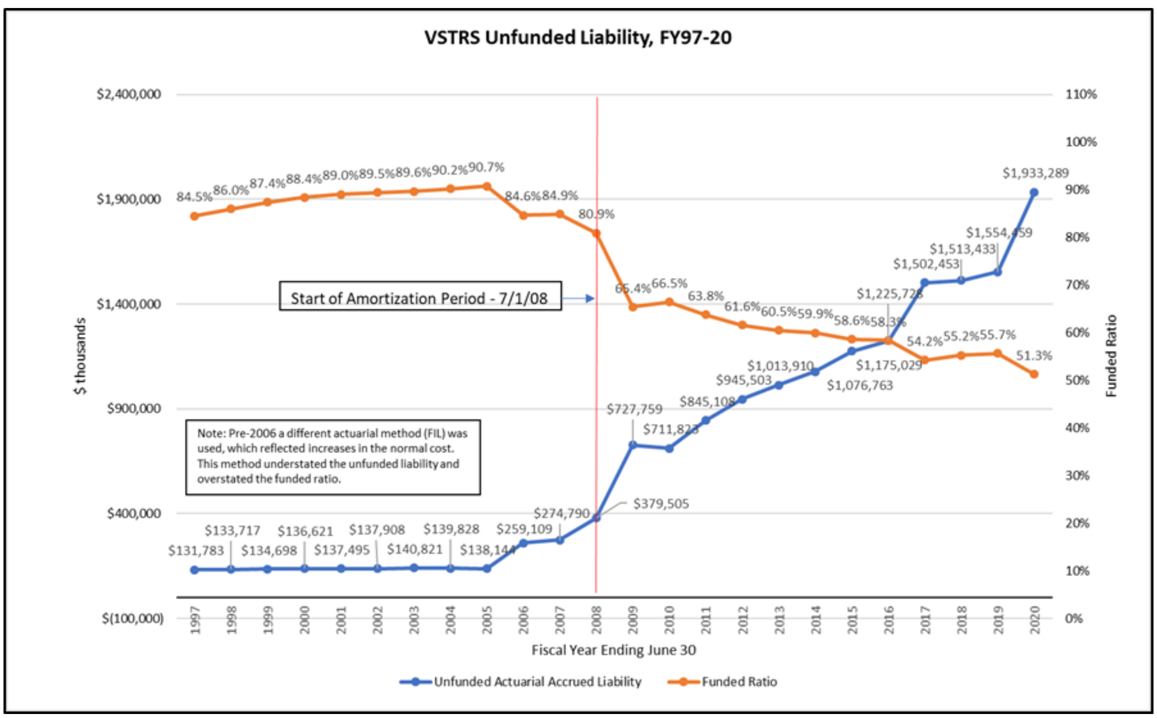




Despite the employer fully funding—and in some years more than fully funding—the actuarially required amounts since 2007, the unfunded liabilities for each system have grown significantly since the 2009 Commission report:

- 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.

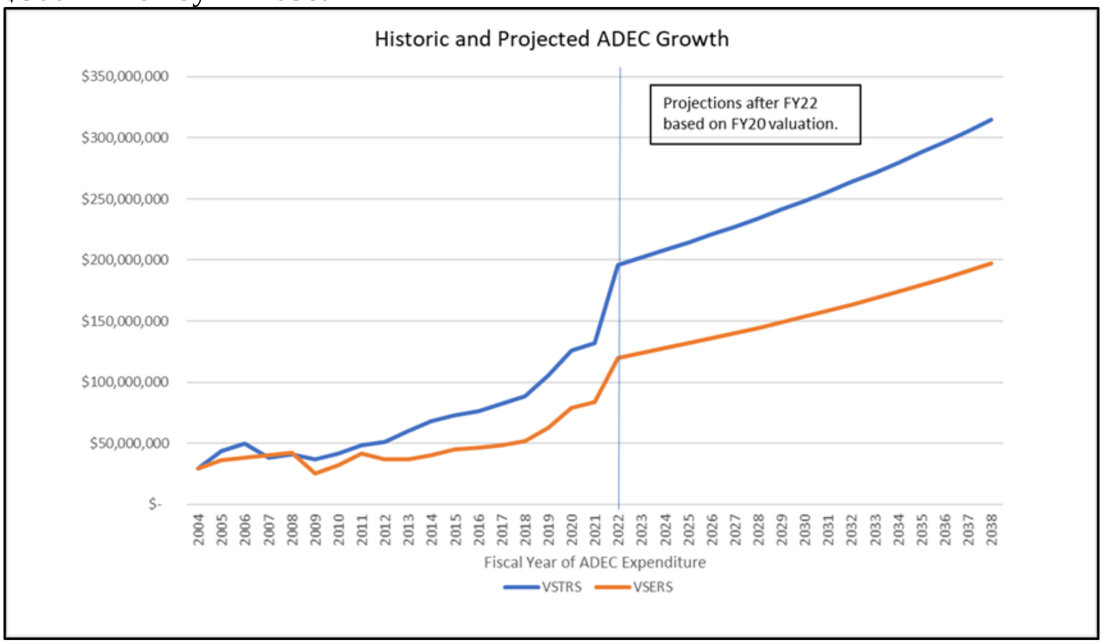




The amount that the employer must annually contribute to fully fund the normal costs of the plans and to pay down the unfunded liability—which together comprise the "ADEC," or actuarial determined employer contribution—has also grown significantly and may ultimately exceed the State's fiscal capacity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

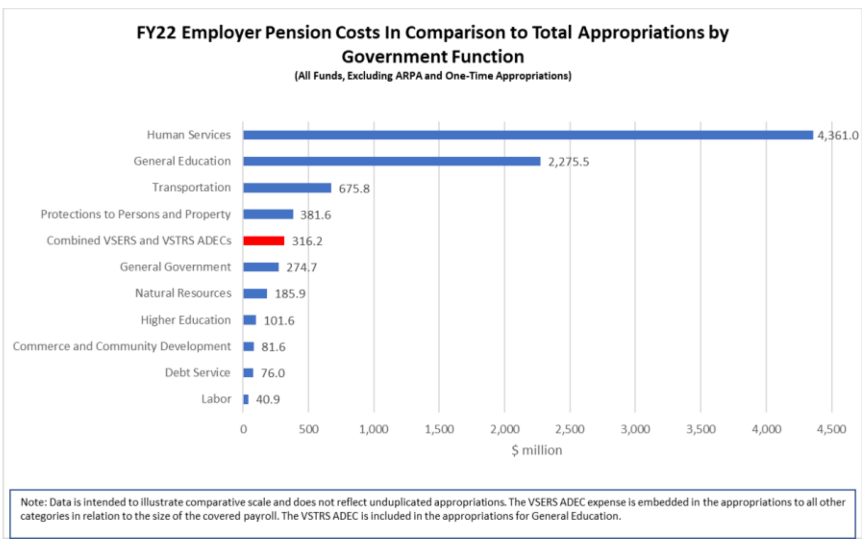
- The VSERS unfunded liability grew by $225.0 million and the ADEC by $36.1 million.

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

Across all funds, the FY22 pension ADEC expenditure is now larger than total appropriations for entire categories of state government functions. For a sense of scale, the $316.2 million of combined VSERS and VSTRS ADEC is more than state government spends on Labor, Debt Service, Commerce and Community Development, and Higher Education combined.



[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.

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:

- **Legacy underfunding.** The State underfunded the VSTRS employer contribution in all but four years from 1979 to 2006. Although this historic underfunding occurred prior to the current 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. Analysis from the State Treasurer estimates that legacy ADEC underfunding, combined with the former practice of paying VSTRS OPEB expenses from pension plan assets (see below), contributed approximately $353 million to the VSTRS unfunded liability (approximately 18.3% of the $1,933.3 million unfunded liability) and $28 million to the ADEC (approximately 14.3% of the $196 million ADEC) by FY2020. The State Treasurer estimates that had these practices not occurred, the VSTRS system would have been approximately 60.2% funded at the end of FY2020 instead of 51.3% funded. Although there were also occasions in the past when the VSERS ADEC was not fully funded, the VSERS system did not experience the degree of chronic underfunding or OPEB-related contribution shortfalls that VSTRS did, and any legacy under-funding of VSERS was made up for by other actuarial gains as evidenced by the fact that the VSERS system was 100.8% funded by the end of FY2007.[7]

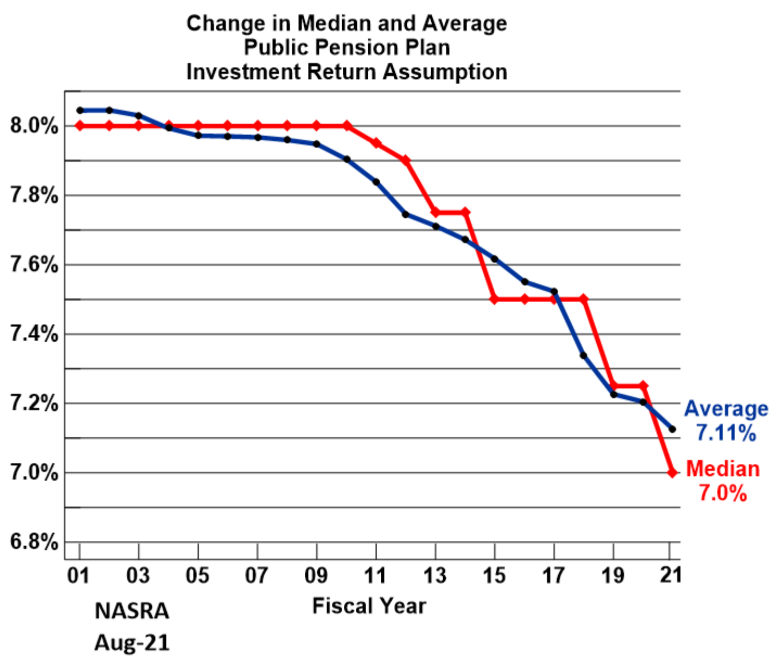
- **Great Recession**. The dramatic economic downturn in 2008-2009 created a hole in each pension fund that remains unfilled as of the end of FY2020. Actuaries in 2009 estimated that it would take more than 20 years at the then- actuarial investment rate of return of 8.25% to get back to the FY 2008 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.

[7] The ADEC is typically calculated with the objective of the pension system reaching 100% funded by the amortization date. In cases where the pension system is funded at levels higher than 100%, less money is required to be contributed into the fund because the impact of the over-funding is amortized to reduce the normal cost that would otherwise need to be paid. Therefore, it is not realistic to assume that the pension systems would have funded ratios higher than 100% today had there been no underfunding in decades past.

- **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. [8]



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.

- **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 FY2008, 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

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

of the state's General Fund. The impact of this practice is included in the estimates of legacy underfunding noted above.

- **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.

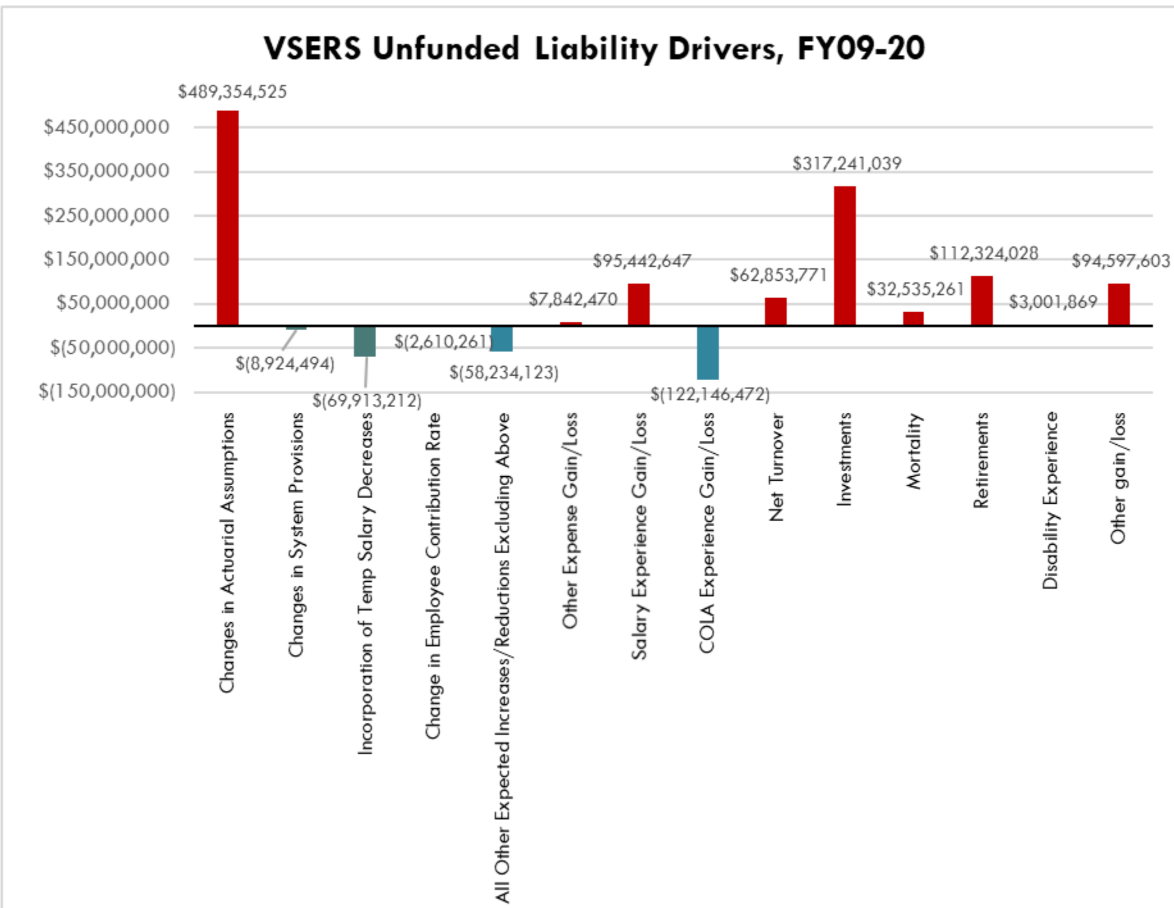
From the beginning of the amortization period in FY09 through the end of FY20:

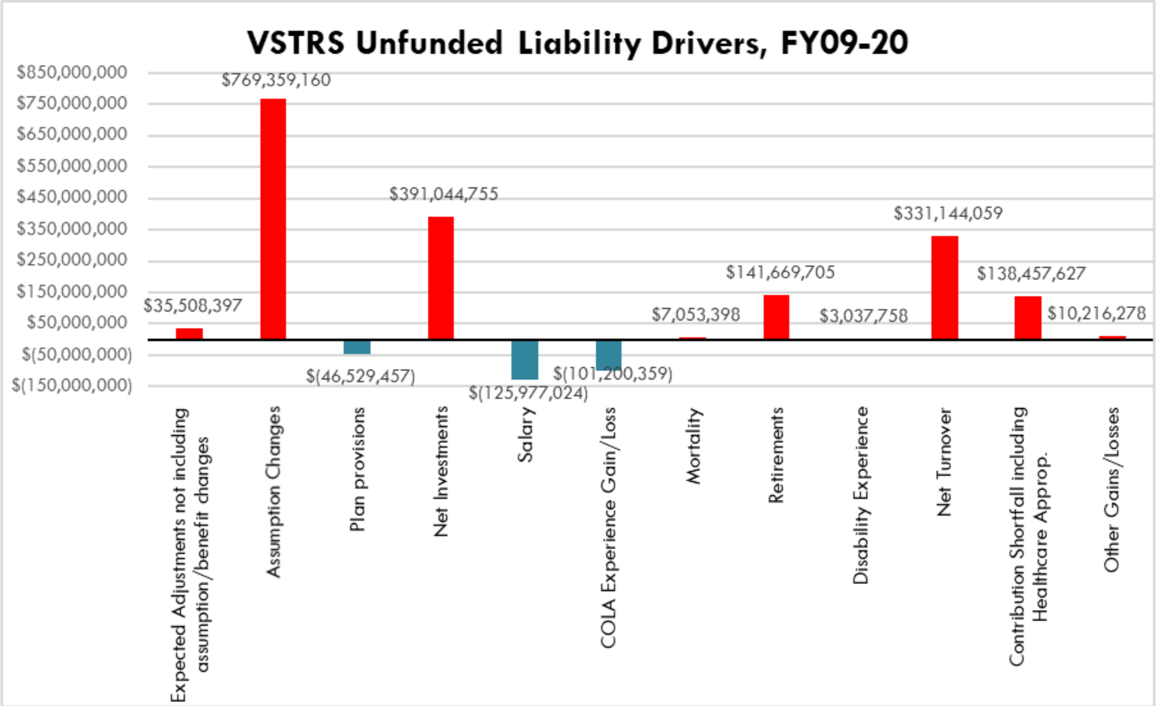
- Demographic experience deviating from assumptions increased the VSERS unfunded liability by $210.7 million and the VSTRS unfunded liability by $482.9 million.
- Investment performance deviating from assumptions increased the VSERS unfunded liability by $317.2 million and the VSTRS unfunded liability 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.

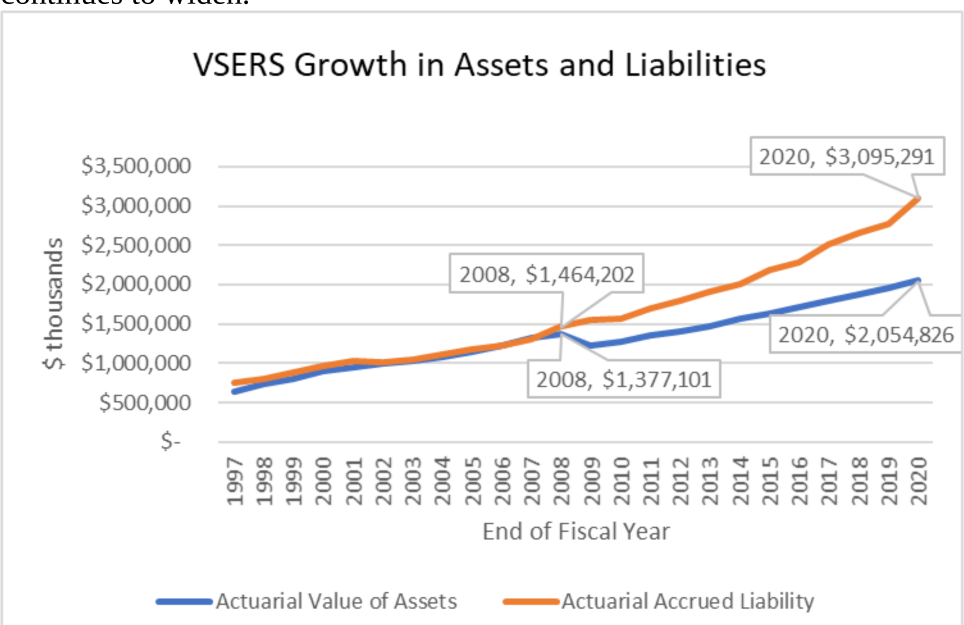
- **Changes to Assumptions** Actuarial assumptions, including the rate of return, have also been revised over time to more realistically mirror anticipated demographic and investment experience. These assumption changes, however, have also added to the unfunded liabilities. From the beginning of FY2009 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.

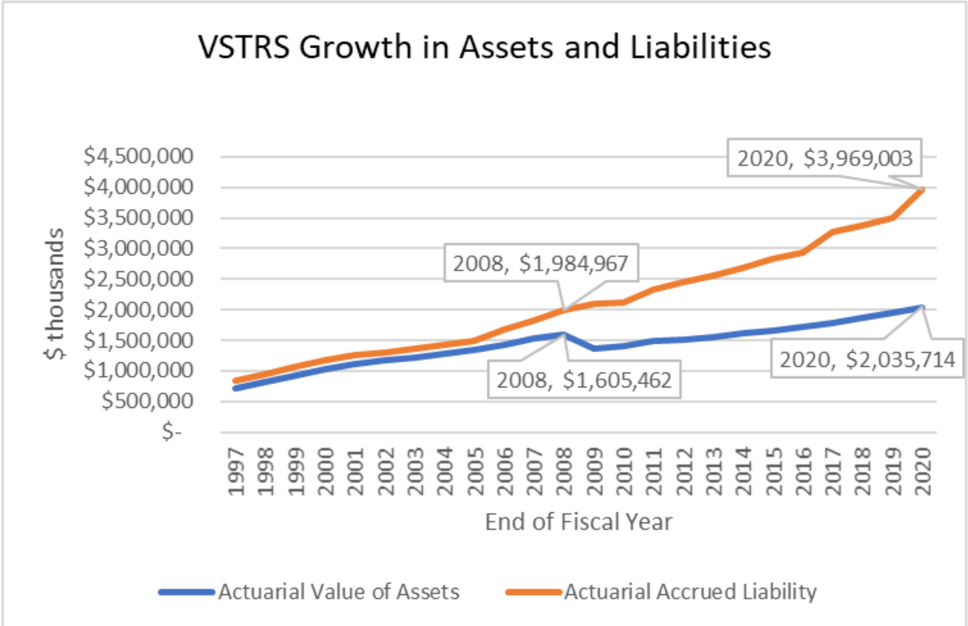
- Other miscellaneous factors, including system provision changes, expected adjustments, and other gains and losses accounted for the remaining pressures on the unfunded liability.





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.




VSTRS Growth in Assets and Liabilities
$ thousands
$4,500,000
$4,000,000
$3,500,000
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$-
2020, $3,969,003
2008, $1,984,967
2008, $1,605,462
2020, $2,035,714
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
End of Fiscal Year
Actuarial Value of Assets
Actuarial Accrued Liability

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 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. At the end of FY2020, this rate was 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 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.

Prefunding OPEB would require approximately $20 million in additional funds above the paygo amounts each year for each of the two systems.[9] 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.

[9] 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.

Actuarial Issues and Analysis

The Task Force is grateful for the assistance of the Office of the State Treasurer for facilitating actuarial analysis with Segal. To date, the Task Force has received or requested actuarial analysis on the following issues:

1) Cross-subsidization of pension costs between VSERS employee groups.
2) Projected impacts of one-time revenue on the ADEC and funded ratios for each of the two pension systems.
3) Projected impacts of recurring revenue on the ADEC and funded ratios for each of the two pension systems. No specific recurring revenue source has been identified by the Task Force. Rather, modeling was performed using generic timing and annual growth assumptions on different sums of base-year revenue.
4) Projected impacts of various changes to contribution rates, contribution rate structures, the COLA formula, and incentives to encourage employees to work longer.
5) Possible funding schedules to prefund OPEB benefits.

Legal Issues and Analysis

Options and Proposals for System Change