Report of the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers

Recommendations to the Governor and the General Assembly

December 2009

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Guiding Principles for a Retirement Plan

Fairness and Sustainability Are Both Essential to Benefit Plans

What Do We Want From Our Retirement Benefit Plan?

- ► **Recruitment – The benefit plan should act as an incentive for recruiting high quality employees. The plan must be competitive with those in other states and within Vermont.**
- ► **Retention – The benefit plan should act as an incentive for retaining high-quality employees and maintaining a stable workforce. The plan should also be compatible with changing workforce and demographic trends.**
- ► **Reward – The benefit plan should provide a solid foundation for retirement security following a career in public service.**
- ► **Sustainability – The cost of the benefit plan should be sustainable and predictable over the long term.**
- ► **Affordability – The cost of the benefit plan should be affordable for current and future public employees and other taxpayers.**
- ► **Fairness – The benefit plan should be fair to workers and other taxpayers.**
- ► **Equity – The benefit plan should be equitable for all parties.**

"A broad deterioration in funding levels for public sector pensions is adding to fiscal pressure on some state and local governments and could contribute to negative rating actions for select issuers in the next several years."

- ***Moody's investors Service, November 2009***

"Even if financial markets improve, and help retirement trust funds recover, the state fiscal crisis, political, and demographic issues will continue their stress on retirement systems."

- ***NCSL Fiscal Leaders Seminar, December 2009***

"The driving force behind the growing cost of retirement is the fact that the baby boomers will spend more time in retirement than any previous generation. According to the Center for Disease Control, a 65-year-old can now expect to live another 18 years, on average. American seniors are living 50 percent longer than they were in the 1930s, when Social Security set 65 as the benchmark retirement age"

- ***PBS Frontline Report, May 2006***

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Commission Membership

- Jeb Spaulding, State Treasurer and Chair of the Commission
- Terry Macaig, member of the House of Representatives
- Jeanette White, member of the Senate
- Neale Lunderville, Secretary of Administration
- Douglas Wacek, member of the public appointed by the Governor
- David Coates, member of the public appointed by the Speaker of the House and President Pro Tempore of the Senate
- William Talbott, designee of the Commissioner of Education

Executive Summary

The 2009 General Assembly created the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State employees and Teachers to review and report on the design and funding of retirement and retiree health benefit plans for the State employees' and teachers' retirement systems. The Joint Fiscal Committee provided the Commission with a target for the expenditure growth rate of 3.5 percent. Similar efforts are occurring across the country because the costs of maintaining retirement programs have been increasing faster than states' ability to pay for them.

The Legislature, Governor, employees, and taxpayers are all concerned about the affordability and long-term sustainability of the pension and retiree health care plans. Certainly, the serious implosion of the financial markets in 2008 and the first quarter of 2009 is the largest factor in the very large increase in this year's actuarially required contribution, but demographics, workplace trends, and current benefit provisions also play an important role and are adding significant stress on the State's ability to maintain adequate pension plan funding. There are 2,800 more retired teachers and State employees this year than there were in 2003. Pension benefit payouts for State employees and teachers have been increasing by roughly $10-11 million each year in recent years and are now increasing by $15-16 million each and every year. It is not uncommon to have employees begin drawing their pension and retiree health benefits in their early to mid-fifties. With increasing life expectancies, these people may well receive retirement benefits for more years than they had spent in employment with the State or the school districts.

The State's combined actuarially required contribution this year is $73.5 million and, without changes being implemented, will be $103.5 million next year. That is a $32-million one-year increase in a year when the State is facing a budget deficit recently estimated in the $150 million range. Simply put, financial commitments for pension and health benefit programs are growing much faster than the rate of revenue growth or the ability of taxpayers to pay for them.

The Commission looked at ways to address this within the context of a set of guiding principles for our retirement plans, including recruitment and retention of high quality employees, provision of a solid foundation for retirement security, fairness, affordability, and sustainability. The recommendations adopted by the Commission and included in this report are intended to address those considerations. We also recognize that these pension benefits are a significant contributor to Vermont's economic health. When retirees spend their pension benefits to buy products, they create demand for goods and services, resulting in jobs. A recent report by the National Institute on Retirement Security estimated that retiree expenditures stemming from state and local pension benefits supported close to 1,400 jobs in Vermont. The report stated that retirement benefits also have a large multiplier effect, creating additional economic activity. As retirees pay income tax on their benefits, this is an important revenue source for the operation of government. However, these positive economic contributions cannot be maintained if pension benefit cost increases exceed the ability of taxpayers to afford them.

The recommendations made in this report, if adopted, would cut the FY 2011 actuarially required contributions for the State pension system from the actuary's recommendation of $41.6 million to $33.1 million and for the teachers' pension system from $63.5 million to $43.0 million, a combined reduction of $29 million or 28 percent, and would produce significant savings for many years. This also meets the Joint Fiscal Committee's 3.5 percent benchmark. Of the $29 million reduction in the State's FY 2011 contribution, $12 million results from benefit revisions and $17 million comes from increased employee contributions. We have also proposed recommendations to adjust the premium assistance for health coverage for future retirees, recognizing at the same time the need for the State to begin a plan for funding these important future liabilities.

Later in this report we will address what groups of active State and teacher employees would be affected by the various recommendations. *Under no circumstances, however, do we consider any recommendations of this report to apply to current retirees of either system.* These individuals have ended their public service careers with an agreed-upon income benefit.

The recommendations of this Commission, therefore, attempt to strike a balance, recognizing the public policy and economic context in which the current benefit structures operate. We do not make these recommendations lightly and hope that the Legislature and the Governor recognize the urgent need to balance these concerns and create sustainable plans. Change will occur, either by careful long-term planning or by default. We are fast approaching the tipping point where the failure to address the issue now will lead to potentially larger problems later and the need for more draconian steps, failing both the employees and the taxpayers.

While we believe that these recommendations provide a solid course of action, we also recognize that there is a range of options inherent in each, with varying impacts on the overall cost of benefits. We see this report as the foundation of a meaningful dialogue within which varying features can be reviewed and adjusted. The Commission looks forward to working with all interested parties through the coming legislative cycle to meet our mutual goal of a fair, equitable, and sustainable retirement system that provides benefits to the labor force and the state economy.

Key Findings

General

- Funding for retirement benefits, including health care, is among the largest fiscal challenges facing many state governments, including Vermont. Financial commitments for these programs, especially retiree health insurance, are growing much faster than the rate of revenue growth.

- While some of the State's pension costs are paid for through other than the General Fund, a comparison of the required annual contributions to the total General Fund revenues indicates an alarming trend. The State's combined actuarial pension contribution in fiscal year 2008 ($66.3 million) represented about 5 percent of General

Fund revenues ($1.2 billion). The State's combined actuarial pension contribution this year ($71.5 million) represents about 7 percent of the General Fund revenues ($1.0 billion). The State's projected actuarial contribution for fiscal year 2011, assuming no changes, represents about 9.5 percent of the expected General Fund revenues ($1.1 billion). When health care liabilities are added to the total, it is clear that these programs put excessive budgetary pressure on available revenues and are crowding out other important State expenditure items.

- The Joint Fiscal Committee considered the recent performance of a number of indicators that reflect State revenue and spending trends and broader economic trends, including the general fund growth rate and the state and local price index. After considering this information, the Joint Fiscal Committee recommended to the Commission a target of 3.5 percent for the rate of expenditure growth for retirement and health benefits. The current pension fund growth, not including any unfunded liabilities or investment loss, assumes a growth rate of approximately 4.5 percent. Amortization schedules increase at 5 percent. For health, actuarial assumptions vary by year, but all exceed the benchmark. Since no significant prefunding has occurred for VSERS and none at all for VSTRS, significant funding in the order of $47.8 million would be needed just to bring current the annual actuarially required contribution (ARC) for each system, on a prefunded basis. Costs escalate even further without prefunding.

- Investment upturn will not get the state out of this problem. Our actuaries estimate that it will take more than 20 years at our current actuarial investment rate of return of 8.25 percent to get back to fiscal year 2008 funding level. It should be noted that the current assumed rate of return is on the high side when compared to other plans, with close to 75 percent of other plans using a return assumption less than 8.25 percent. Also, keep in mind that the FY 2008 levels were not fully funded (94.1 percent for VSERS and 80.9 percent for VSTRS). It would not be prudent to rely on future market returns above the assumed rate of return to solve the problem.

Pension Benefits

- As noted, the State's combined actuarially required contribution this year is $73.5 million and, absent changes being implemented, will be $105.1 million next year, almost a $32 million one-year increase:

Pension Funding Requirements:	STATE EMPLOYEES	TEACHERS
FY 2010 Annual Actuarial Required Contributions (ARC):	$32 million	$41.5 million
FY 2011Annual Actuarial Required Contributions (ARC):	$41.6 million	$63.5 million
Additional Resources Needed to Fund FY11 Estimated ARC over FY10 Levels:	$9.6 million	$22 million
TOTAL ADDITIONAL RESOURCES NEEDED FOR *BOTH* SYSTEMS:	**$31.6 million**	

- The ARC has been increasing at an unsustainable pace, even before consideration of current economic events. Prior to the market meltdown, the annual actuarially recommended contribution (ARC) (pension only, excluding expenses) for the State system increased 117 percent over a five-year period from FY 2003 to FY 2008. The current ARC recommendation by the actuary, absent any recommendations included in this report, is $41,581,656 for FY 2011 and represents a 328 percent increase compared to FY 2003, even after re-amortization implemented in FY 2010.

- For the teachers' system, the ARC increase from 2003 to 2008 was 46 percent, reduced by re-amortization of the unfunded liability in FY 2007. The ARC increased just over 100 percent from FY 2003 to FY 2006, prior to re-amortization. The current ARC recommendation, absent any recommendations included in this report, will rise to $63,501,209, a 53 percent increase in one year.

- As of the FY 2008 valuation, the State pension system (VSERS) had an unfunded liability of $87.1 million while the Teachers' system had an unfunded liability of $379.5 million. The FY 2009 unfunded liabilities have increased to $326.5 and $727.8 million, respectively, significantly reducing the funding ratio.

Pension Liabilities

UAAL (pension only)	**STATE EMPLOYEES**	**TEACHERS**
As of 6/30/08 Valuation:	$87.1 million	$379.5 million
As of 6/30/09 Valuation:	$326.5 million	$727.8 million
Funding Ratio		
As of 6/30/08 Valuation:	94.1 percent	80.9 percent
As of 6/30/09 Valuation:	78.9 percent	65.4 percent

- There are 2,800 more retired teachers and State employees this year than there were in 2003.

- Due to the aging of the workforce and current retirement age provisions, the rate of growth in retirees has been outpacing the rate of growth in active members. This creates additional stresses, especially given current levels of underfunding, and could impact pension asset allocation in the future as more liquid assets are needed to pay benefits.

- Pension benefit payouts for State employees and teachers have been increasing by roughly $10-11 million each year in recent years and are now increasing by $15-16 million each and every year.

- Five years ago the annual benefit payouts for State employees and teachers totaled $111.6 million; this year the annual payout is projected to be $172 million, and in five

years an independent actuary projects the annual benefit payout will be $255.8 million. That will be close to a 50 percent increase from what the annual benefit payout is now.

Health Care Benefits

- Beginning in FY 2008 the Government Accounting Standards Board required the disclosure of other post employment benefits (OPEB) in the State's financial reports. OPEB refers to any post employment benefit other than pensions, although medical is the most significant component.

- Currently the State does not prefund its OPEB benefits, with the exception of a small portion of Medicare D reimbursements from the State Employees' system. The State system is 0.7 percent funded; while the teachers' system is 0 percent. In other words, little or no assets have been set aside for this liability.

- OPEB liabilities are as follows:

Vermont OPEB Liabilities

STATE EMPLOYEES	**8.25% (Pre-funding Assumed)**	**4.25% (Partial Funding Basis)**
Unfunded Liability:	$448.5 million	$775 million
ARC for FY 2010:	$37.6 million	$58 million
Pay-As-You-Go Applied to ARC:	$22 million	$22 million
TEACHERS		
Unfunded Liability:	$431.8 million	$872.2 million
ARC for FY 2010:	$32.2 million	$59 million

- Payments for the 80 percent employer share for retiree health insurance premiums are projected to escalate by several million dollars a year.

	VSTRS Retiree Health Payment	**VSERS Retiree Health Payment**
FY 2008	$15.08 million	$16.37 million
FY 2009	$16.42 million	$17.89 million
FY 2010	$18 million estimated	$22 million estimated

- By 2020 the actuary estimates health care pay-as-you-go payments for teachers will more than double, at $38.3 million, and will reach $77.4 million by 2040. For the State system, the pay-as-you-go payments will reach $46.5 million in 2020 and $73.8 million by 2040.

- The State currently funds a year’s premiums in the State Employees’ system; expenses are not explicitly funded in the teachers' system, creating further actuarial losses in the pension system from which benefits are paid. Since health care for teachers is paid by the pension fund, IRS limitations will soon force curtailment of benefits if mitigating steps are not taken.

Key Recommendations

The Commission, by a majority vote, recommends the following: (For details, see Commission Votes section of this report.)

CATEGORY: General Framework

RECOMMENDATION ONE

Make **no change** to the following:

- Pension or retiree health benefits for those already retired.
- Pension or retiree health benefits for anyone close to retirement, which the Commission defined as within five years of eligibility for a particular benefit.
- Basic provisions (maximum benefit, multiplier, COLA, etc.) that would make the plans less competitive than the mainstream of other state public systems.

RECOMMENDATION TWO

Do not replace the current defined benefit plan and transition to a defined contribution plan.

RECOMMENDATION THREE

That the Legislature and the Governor continue to fully fund the annual actuarially required contribution (ARC) for the state and teachers’ pensions, as calculated after any or all recommendations made below are enacted. Continued discipline in fully funding the ARC is critical to the long-term sustainability of the pension funds.

RECOMMENDATION FOUR

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

In addition, the Commission voted not to take a position on shifting the State’s payment for the teacher’s retirement plan from the General Fund to the Education Fund or local districts.

CATEGORY: Pension Plan Recommendations

RECOMMENDATION FIVE

Revisions to normal and early retirement ages:

State Group F and Teachers' Group C:

- Raise normal retirement age from 62 or 30 years at any age to 65 or rule of 90 (combination of age and years of service) for those more than five years from normal retirement eligibility.

  It should be noted that "five years from normal retirement eligibility" for purposes of these recommendations means the member must be either 5 years or less from normal retirement age for their group plan, or have a minimum of 25 years of service as of the date the retirement legislation is enacted. If a member has begun making a purchase of service that is documented in the system prior to December 31, 2009, the total years of service being purchased may count toward the total years of service as of the effective date of the legislation. No service that is initiated after January 1, 2010 will count toward total creditable service as of the effective date.

  Raise the early retirement age from 55 to 58 for those more than five years from early retirement eligibility. Change the early retirement penalty to full actuarial reduction.

State Group D:

- Raise normal retirement age from age 62 to age 65 for those more than five years from normal retirement eligibility.

State group C:

- Raise the early retirement age to 52 from 50 for those more than five years from early retirement eligibility.

RECOMMENDATION SIX

Lengthening the salary compensation period:

State Group F and Teachers' Group C:

- Use a five-year compensation period instead of a three-year period to calculate benefits for those more than five years from retirement eligibility.

State Group C:

- Use a three-year compensation period instead of a two-year period to calculate benefits for those more than five years from retirement eligibility.

State Group D:

- Use a two-year compensation period instead of final salary to calculate benefits for those more than five years from retirement eligibility.

RECOMMENDATION SEVEN

Increase the maximum benefit from 50 percent to 60 percent of final compensation for State Group F and Teachers' Group C for those more than five years from retirement eligibility.

- This would provide an opportunity for increased benefits to employees who choose to work more than 30 years. Right now most teachers and State employees are capped at their maximum retirement benefit of 50 percent of average final compensation after 30 years of service. With this change, one would receive 60 percent of AFC after 36 years of service.

RECOMMENDATION EIGHT

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

Recommended Rate/Risk Sharing Impact

	Employer ARC	Employee Contribution %	State Contribution %
VSERS			
FY 2011 actuarial recommendation, no changes	$41.6 Million	5.10% (Group F)	9.80%
FY 2011 recommendation, changes, 3.5% state increase	$33.1 Million	5.83%	7.84%
VSTRS			
FY 2011 actuarial recommendation, no changes	$63.5 Million	3.40% (Group C)	9.67%
FY 2011 recommendation, changes, 3.5% state increase	$43.0 Million	5.47%	7.32%

Employee contributions in both systems are pre-tax contributions under Section 414(h) employer pick-up provisions and will therefore reduce the member's tax liability while he or she is employed. In contrast, Social Security and Medicare taxes are not considered pre-tax deductions, and therefore are included in the total taxable income when calculating federal and state taxes each pay period. Later in this report, there is a full chart with a number of other rate-sharing models reviewed by the Commission. It is important to remember that rate/risk sharing creates a partnership; employer and employee contributions will rise and fall in tandem. Both parties will have a stake in keeping benefit, administrative, and other costs in check. If investment returns perform very well for an extended period, both parties will enjoy a decrease in contribution levels. The new contribution rates would apply to all State employees and teachers.

CATEGORY: Health Care Recommendations

RECOMMENDATION NINE

The Commission recommends a tiered medical premium co-payment structure based on length of service. Instead of the current straight 80/20 split of retiree health insurance premiums utilized for most retired teachers and State employees (new hires in the State system after July 1, 2008, have a tiered system), a new tiered system would apply to all of those not within five years of eligibility to draw this benefit. In recognition of the fact that the Group C plan of the State employees retirement system is essentially a 20 year plan, the Commission recommends a pro-rated tiered medical premium co-payment for Group C plan members.

The new employer share for the tiered system would be:

40 percent - 10 yrs 60 percent - 20 yrs 80 percent - 30 yrs

Note: Retirees with less than 10 years would have access to group health insurance, but would have to pay the full premium.

RECOMMENDATION TEN

The Commission recommends providing the ability to "recapture" the retiree health benefit to those vested, terminated members with 20 or more years of service when they begin drawing benefits. This opportunity is not currently allowed for general State employees and is allowed for teachers with 10 or more years of service.

Commission Approach & Scope

The Commission, established pursuant to Act 1 of the Special legislative Session of 2009, was given the following charge by the legislature:

> …to review and report on the design and funding of retirement and retiree health benefit plans for the State employees' and teachers' retirement systems. The commission is charged with making recommendations about plan design, 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. The joint fiscal committee may provide benchmark targets reducing the rate of expenditure growth for retirement and retiree health benefits to the commission to guide the development of recommendations.

The Commission was further charged to prepare a report including, but not limited to, the following:

> (1) an evaluation of current benefits structures and contribution characteristics in comparison to other comparable public and private systems;
>
> (2) an estimate of the cost of current and proposed benefits structures on a budgetary, pay-as-you-go basis and full actuarial accrual basis;
>
> (3) a five-year review of benefit expenditure levels as well as employer and employee contribution levels and growth rates and a three-, five- and ten-year projection of these levels and rates;
>
> (4) based on benefit and funding benchmarks, options for providing new benefit structures with the objective of adequate benefits within the established cost containment benchmarks;
>
> (5) funding methods, including contributions from State, municipalities, and employees, to achieve these objectives; and
>
> (6) an evaluation of whether current governance, oversight, and lines of authority are appropriate and consistent with funding objectives.

In completing its work the Commission held nine meetings, including a public hearing conducted through Vermont Interactive Television, attended by approximately 280 individuals, primarily state employees and teachers. Time for public comment was made available at all of its meetings and the Commission heard testimony or comments from staff and/or members of

the Vermont National Education Association, the Vermont State Employees' Association, the Vermont League of Cities and Towns, and past and current members of the Vermont State Employees' Retirement System (VSERS) and the Vermont State Teachers' Retirement System (VSTRS).

Early in the process, the Commission agreed to concisely define what Vermont should expect from a retirement plan for both State employees and teachers. A previous study on funding the teachers' system provided a base. After several presentations and considerable discussion, the Commission agreed on a set of guiding principles, as follows:

Guiding Principles for a Retirement Plan

Fairness and Sustainability Are Both Essential to Benefit Plans

What Do We Want From Our Retirement Benefit Plan?

- **Recruitment – The benefit plan should act as an incentive for recruiting high quality employees. The plan must be competitive with those in other states and within Vermont.**
- **Retention – The benefit plan should act as an incentive for retaining high-quality employees and maintaining a stable workforce. The plan should also be compatible with changing workforce and demographic trends**.
- **Reward – The benefit plan should provide a solid foundation for retirement security following a career in public service.**
- **Sustainability – The cost of the benefit plan should be sustainable and predictable over the long term**.
- **Affordability – The cost of the benefit plan should be affordable for current and future public employees and other taxpayers**.
- **Fairness – The benefit plan should be fair to workers and other taxpayers.**
- **Equity – The benefit plan should be equitable for all parties.**

An important theme across these principles is that our retirement systems are a shared responsibility or a partnership among retirees, employees, and the taxpayers.

Treasury staff, working with the State's consulting actuaries, presented data on the current funding status of the plan, preliminary cost projections, budgetary impacts and long-term sustainability issues. Many of the issues are not unique to Vermont, and other State systems are reviewing their alternatives. Staff provided data from a number of sources and trends in other States; the Commission also received testimony and presentations on those initiatives from representatives of some of these States.

In the course of its work, the Commission explored a number of topics, including:

- actuarial valuation studies of the Vermont State and teachers' pension and health care systems;
- a review of the actuarial assumptions used to develop the valuations;
- current funding status of the pension and health care systems;
- anticipated revenue trends for the state and benchmarks funding targets provided by the Joint Fiscal Committee;
- historical overview and pension systems, benefits, and contributions structure;
- comparison of Vermont pension plans to other state retirement plans;
- review of pension models used in other states including defined benefit, defined contribution, and hybrid/combination plan studies;
- review of strategies and actions taken in other states to deal with pension and health care sustainability issues;
- legal questions relating to changes in pension statutes and benefits
- review of the Federal Employees' Retirement System (FERS);
- analysis of eligibility, length of service, benefit formulas, and age of retirement, and employee and employer contributions;
- final average salary (FAS) provisions;
- review of pension obligation bonds as a financing mechanism;
- health care funding issues for the teachers' system and future regulatory concerns;
- governance issues related to any changes in education funding;
- potential use of the education fund as sources for teacher pension and health care; and
- potential cost savings of specific proposals.

Based on the guiding principles and the topics above, a list of preliminary areas of review was developed based on individual Commission member suggestions. These were reviewed by staff and potential fiscal impacts were estimated by the actuary using a "low," "medium," or "high" impact designation. Commission members then reviewed the list to further define areas for consideration.

In its early deliberations the Commission, while recognizing the major funding hurdles undermining the future financial solvency of the plans, sought to define the parameters of action in a manner that preserved fairness to all partners. Early in the process it was determined that recommendations would include <u>no pension and health benefit changes for current retirees</u>. The Commission further defined the population for which their recommendations would apply. The consensus was that new-hires and non-vested members would be included. Opinions concerning the inclusion of active, vested members varied and the majority of the Commission determined that anyone "close to retirement" should not be included as an affected group in any recommendations.

Recognizing that there are legal constraints on making changes to employee retirement benefits, the Commission, pursuant to a public bid process, contracted with Ice Miller, LLC a well respected national law firm with extensive expertise in public employee pension and

retiree health care issues to provide advice as to what options for change may and may not be legally defensible. Ice Miller has worked with dozens of states on a range of retirement issues. Their legal advisory report is attached.

In summary, Ice Miller advised there are some changes that would clearly be off limits from a legal/contractual perspective, some that are clearly within limits, and some for which there is uncertainty.

The Ice Miller advisory report stated:
"Courts in states which recognize a constitutional protection of pension and/or retirement benefits have also recognized that benefits may be subject to modifications in limited circumstances. These circumstances include:

(i) Where a disadvantage is offset by an advantage.

(ii) Where a change is reasonable and necessary to preserve the pension system

(iii) Where a change is reasonable and necessary to maintain the integrity of the pension system.

(iv) Where the creator of the plan has reserved the right to amend the plan."

Again, the Ice Miller report clearly states that contractually protected benefits could be modified ("impaired") in the following situations:

a. Where a disadvantage is offset by an advantage.

b. Where the stability or the integrity of the pension system requires the change and the change is reasonable.

c. Where a compelling situation requires unilateral change.

The majority of the Commission believes this report makes a strong case that the stability of the pension system requires change and that the recommended changes will substantially improve the sustainability of the retirement benefit plans. The Commission believes its recommendations are reasonable and necessary to preserve the pension system. We have recommended no changes to those already retired or that are close to retirement. The recommended changes are modest, consistent with existing or contemplated features in other states, and will continue to provide significant retirement security for State employees and teachers.

All new and active employees not within five years of normal retirement, as defined by their group classification (currently age 62 or 30 years of service for Group F in VSERS and Group C in VSTRS) or five years of early retirement (currently age 55 for VSERS Group F and VSTTRS Group C), would be included in the recommended benefit changes. Employee contribution rate changes would apply to all active employees.

While some members expressed an interest in reviewing a defined contribution (DC) or a hybrid cash balance plan option as a recommendation, the Commission voted early on to also exclude that from the scope of possible recommendations.

The Commission, upon refining the scope of possible pension and changes, engaged independent actuaries (Buck Consultants) to develop cost projections and estimate savings on the FY 2011 ARC and subsequent years. These were analyzed over a series of meetings, with the intent of further narrowing in on a set of possible recommendations. The final group of proposals and/or decision points was then voted on by Commission members on 12/15/09.

Overview of the Benefit Systems

Retirement Defined Benefit Plan Descriptions

The Vermont State Retirement System (VSRS) (3 V.S.A., Chapter 16) is a single-employer public employee defined benefit retirement system which covers substantially all general State employees and State Police, except employees hired in a temporary capacity. Membership in the system is a condition of employment. The membership consists of:

- general employees who were hired prior to 1984 and did not join the non-contributory system (Group A), with a contribution rate of 5.1 percent of payroll (contributions cease upon attainment of 25 years of creditable service);

- State police, law enforcement positions, and airport firefighters (Group C), with a contribution rate of 6.98 percent of payroll;

- judges (Group D), with a contribution rate of 5.1 percent of payroll;

- terminated vested members of the non-contributory system (Group E); and

- all other general employees (Group F), with a contribution rate of 5.10 percent of payroll.

Effective July 1, 2008, the contribution rate for Group F employees was raised, through legislation enacted in fiscal year 2008, from 3.35 percent to 5.1 percent through June 30, 2019, and 4.85 percent thereafter, due to increases in the cost of living benefit for all Group F employees and other benefit changes described below.

The Vermont State Teachers' Retirement System (VSTRS) (16 V.S.A., Chapter 55) is a cost-sharing public employee defined benefit retirement system. It covers nearly all public day school and nonsectarian private high school teachers and administrators, as well as teachers in schools and teacher training institutions within and supported by the State that are controlled

by the State board of education. Membership in the system for those covered classes is a condition of employment. The membership is made up of:

- general teachers who were hired prior to 1984 and did not join the non-contributory system (Group A), with a contribution rate of 5.5 percent of payroll (contributions cease upon attainment of 25 years of creditable service);

- terminated vested members of the non-contributory system (Group B); and

- all other general teachers (Group C), with a contribution rate of 3.40 percent.

The State appropriates funding for pension costs associated with the above two plans. In fiscal years prior to 1982, both systems were solely contributory. Under legislation effective July 1, 1981, Vermont State employees and State teachers could elect to transfer their current memberships from a contributory to a non-contributory membership class (see Note 5 E. Single Deposit Investment Account). However, in 1990, the Legislature again made both systems contributory effective July 1, 1990, for the VSTRS and January 1, 1991, for the VSERS. The State's contribution to each system is based on percentage rates of each member's annual earnable compensation. These rates include a "normal contribution" rate and an "accrued liability contribution" rate and are calculated based upon the liabilities of each system as determined by actuarial valuations.

At June 30, 2009, VSERS and VSTRS membership consisted of:

	VSERS	VSTRS
Active employees:		
Vested	5,752	8,076
Non-vested	2,343	2,723
Total active employees	8,095	10,799
Retirees & beneficiaries of deceased retirees currently receiving benefits:	4,797	5,910
Terminated employees entitled to benefits but not yet receiving them (vested):	798	721
Inactive members:	939	2,655
TOTAL PARTICIPANTS:	14,629	20,085

The largest concentration of members by system are Group F in the VSERS system and Group C in the VSTRS system, accounting for 93.9 percent and 99.8 percent , respectively, of the total active members of each system. While health care benefits vary, these groups do have a similar benefit structure for pensions, although COLA provisions were adjusted, as noted below for Group F members, with a corresponding contribution rate increase:

Benefit Comparison VSERS Group F and VSTRS Group C		
Selected Benefit Categories:	**VSERS Group F**	**VSTRS Group C**
Maximum Retirement Allowance	50% of Average Final Compensation (AFC)	50% of Average Final Compensation (AFC)
Benefit Formula	1.25% x service prior to 12/31/90 + 1.67% on 1/1/91	1.25% x service prior to 6/30/90 + 1.67% on 7/1/90
Average Final Compensation (AFC)	Highest 3 consecutive years, excluding unused annual leave payoff	Highest 3 consecutive years, excluding payments for anything other than service actually performed
Early Retirement Reduction	Normal allowance reduced by 6% for each year commencement precedes age 62	Normal allowance reduced by 6% for each year commencement precedes age 62.
Early Retirement Date	Age 55 with 5 years of service	Age 55 with 5 years of service
Normal Retirement Date	62 or 30 years of service	62 or 30 years of service
Member Contributions	5.1% of earnings	3.4% of earnings adjusted each year for changes in the cost of retiree medical insurance; currently 3.54%

Note: see below for changes for Group F members hired after 7/1/2008.

Under legislation enacted in fiscal year 2008, VSERS benefits were modified in three respects for members hired on or after July 1, 2008. First, the maximum benefit payable was increased from 50 percent to 60 percent of the average final compensation (AFC). Second, the eligibility condition for an unreduced benefit changed from the attainment of age 62 or 30 years of service to age 65 or a "rule of 87," attainment of that number through a combination of years of service and age. Third, for members not eligible for an unreduced benefit, the reduction for early retirement changed from a uniform 6 percent per year to one determined on a service-based schedule.

The remaining significant provision of the same legislation makes changes to retiree cost of living (COLA) adjustments. The annual-cost-of living adjustment (COLA) applicable to the benefits of Group F members retiring after July 1, 2008, rose from 50 percent of the annual increase of the Consumer Price Index (CPI) to 100 percent of the annual increase in the CPI index, up to a ceiling of 5 percent, effective January 1, 2014. Only current Group F members who were actively contributing into the system on June 30, 2008, and retire on or after July 1, 2008, will be eligible for the enhanced COLA in 2014. Group F members who terminated service or transferred to another group plan prior to June 30, 2008, are not eligible for the new

COLA unless they return to active Group F service after July 1, 2008, and it is prior to retirement.

Vermont's benefits for these groups are modest when compared to other state public retirement plans. In reviewing the value associated with each year of service, Vermont service year benefits (1.67 percent) are low compared to the median of 1.85 percent. Also, the limitation of the retirement benefit (50 percent for all but VSERS Group F hired after 7/1/08) is extremely low. The cost-of-living adjustments seem to be slightly on the positive side of a continuum of benefits, as are early retirement eligibility provisions. These factors were considered when identifying possible recommendations with the objective of maintaining basic provisions that would not make the plans less competitive than the mainstream of other state public systems. As a result, the emphasis of the Commission was to explore the raising of the age for eligibility for normal and early retirement (with a corresponding increase in the maximum benefit) which is also consistent with the increases in life expectancy and work productivity.

VSERS Group C members account for 5.4 percent of the system's active members while Group D accounts for just 0.6 percent of the total. Their benefit structures include:

Benefits - VSERS Group C

Selected Benefit Categories:	**VSERS Group C**	**VSERS Group D**
Maximum Retirement Allowance	50% of Average Final Compensation (AFC)	100% of Final Salary
Benefit Formula	2.5% x service	3.33% x service (after 12 years in group D)
Average Final Compensation (AFC)	Based on highest 2 consecutive years of pay	Final salary at retirement
Early Retirement Reduction	No reduction	Normal allowance reduced by 3% for each year commencement precedes age 62.
Early Retirement Date	Unreduced at age 50 with 20 years of service	Age 55 with 5 years of service
Normal Retirement Date	Age 55 (mandatory)	Age 62
Member Contributions	6.98% of earnings	5.1% of earnings

Again, the Commission directed its efforts at reviewing impacts of raising retirement eligibility ages as opposed to making major changes to the basic benefit structures.

A more detailed listing of benefits by system and group is attached as Exhibits #1 (for VSERS) and #2 (VSTRS). In addition, a number of key benefit provisions are compared to state public plans in New England (Exhibits #3 and #4). Exhibits are located on pages 22-25 of this report.

Medical Insurance Plan Descriptions

Vermont State Employees' Retirement System

Employees retiring directly from active State service for any reason (disability, early, or normal), may carry whatever coverage is in effect at that time into retirement for themselves and their dependents. During the lifetime of the retiree, currently only 20 percent of the cost of the premium will be paid by the retiree. If the retiree chooses the joint and survivor pension option, and predeceases his or her spouse, the medical benefits may also continue for the spouse, along with the pension. However, generally the surviving spouse must pay 100 percent of the cost of the premium. In addition, once retirees become eligible for Medicare coverage (at age 65) it is mandatory that they enroll in both Medicare Part A and Part B as soon as possible. Medicare thus becomes the primary insurer, with the State plan becoming secondary. The retiree's State insurance premium costs will then decrease in recognition of this change.

If an employee, other than a Group C member, does not retire directly from State service, he or she is not eligible to participate in the State's medical insurance plan. Group C members who terminate with 20 or more years of service, but are not yet 50, may pick up the medical coverage at the time they begin retirement benefits. If the insurance is terminated at any time after retirement, coverage will not be able to be obtained again at a later date.

Based on legislation enacted during fiscal year 2008, Group F employees hired after July 1, 2008, will receive a tiered retiree health care reimbursement based on completed years of service. As part of the enacted legislation, Group F employees hired after July 1, 2008, also have the ability to recapture (access) subsidized health insurance at 80 percent upon initiation of retirement benefits in a manner comparable to regular retirements. This applies even if the employee terminated prior to his or her early retirement date, providing the member has 20 years of service upon termination of employment. At the time, this initiative was projected to realize a savings of approximately $265 million over 30 years on a pay-as-you-go basis.

As of June 30, 2009, 3,571 retirees were enrolled in the medical plan in the single, spouse, and family plan options. The retirees contributed $5.1 million in premiums and incurred $26.7 million in claims expenses for the fiscal year ending June 30, 2009. The State's fiscal year 2009 contributions to the VSERS included, on a pay-as-you-go basis, $18.1 million for the State's share of the cost of the premiums. The VSERS paid S17.9 million in premiums, on a pay-as-you-go basis, to the Medical Insurance Fund for this benefit in fiscal year 2009.

State Teachers' Retirement System

Retirees in the VSTRS plan participate in multi-employer health coverage plans operated by the Vermont Education Health Initiative (VEHI) which is managed jointly by the Vermont School

Boards Insurance Trust and the Vermont-National Education Association. VEHI partners with Blue Cross Blue Shield to provide health insurance to retired and active teachers.

Members of the VSTRS have access to three medical benefit plans in retirement. The plans are identical to those offered to active teachers in public school systems in Vermont. Members may pick up medical coverage under one of the plans offered for themselves and all eligible dependents at the time of retirement, or anytime thereafter during one of the semi-annual open enrollment periods. If the member has a minimum of 10 years of creditable service at the time of retirement, the system picks up 80 percent of the retiree's premium only, based on the cost of the "standard plan" as defined by statute; the retiree must pick up the full cost of the premium for all covered dependents. As of June 30, 2009, 3,932 retirees are enrolled in the single, spouse, and family medical plan options. The retirees contributed $10.96 million in premiums and the system contributed $16.7 million in premiums and paid $16.4 million, on a pay-as-you-go basis, in fiscal year 2009.

Once a retiree becomes eligible for Medicare coverage (at age 65), it is mandatory that he or she enroll in both Medicare Part A and Part B. Medicare becomes the primary insurer and the Teachers' medical plans become the secondary carrier. Two of the plans offered become "carve-out" plans to coordinate with Medicare, and one of the plans is replaced with a true Medicare supplemental plan. The premiums for all plans are reduced in accordance with the decrease in liability once Medicare becomes primary.

Exhibit #1

VSERS Group Comparison

Group Comparison	Group A	Group C	Group D	Group F
Employee Contributions	5.10% of gross salary	6.98% of gross salary	5.10% of gross salary	5.1% of gross salary
Average Final Compensation (AFC)	Highest 3 consecutive years, including unused annual leave payoff	Highest 2 consecutive years, including unused annual leave payoff	Final salary at retirement	Highest 3 consecutive years, excluding unused annual leave payoff
Benefit Formula	1.67% x creditable service	2.5% x creditable service	3.33% x creditable service (after 12 years in Group D)	1.25% x service prior to 12/31/90 + 1.67% x service after 1/1/91
Maximum Benefit Payable	100% of AFC	50% of AFC	100% of Final Salary	50% of AFC **#1(see footnote at bottom of chart)**
Normal Retirement (no reduction)	Age 65 or 62 with 20 years of service	Age 55 (mandatory)	Age 62	Age 62 or with 30 years of service **#2(see footnote at bottom of chart)**
Post-Retirement COLA	Full CPI, from a minimum of 1% up to a maximum of 5%, after 12 months of retirement	Full CPI, from a minimum of 1% up to a maximum of 5%, after 12 months of retirement	Full CPI, from a minimum of 1% up to a maximum of 5%, after 12 months of retirement	50% CPI until 1/1/2014; 100% of CPI thereafter, from a minimum of 1% up to a maximum of 5%, after reaching age 62, or (if retired after June 30, 1997) 30 years service
Early Retirement Eligibility	Age 55 with 5 years of service or 30 years of service (any age)	Age 50 with 20 years of service	Age 55 with 5 years of service	Age 55 with 5 years of service
Early Retirement Reduction	Actuarially reduced benefit if under 30 years of service	No reduction	3% per year from age 62	6% per year from age 62 **#3(see footnote at bottom of chart)**
Post-Retirement Survivorship Options	100% and 50% (with or without pop-ups), all actuarially reduced based on age of beneficiary	70% spousal survivorship with no reduction in retiree's benefit	100% and 50% (with or without pop-ups), all actuarially reduced based on age of beneficiary	100% and 50% (with or without pop-ups), all actuarially reduced based on age of beneficiary
Benefit Eligibility - Other (Vested Rights, Disability, Death-in-Service)	5 years of service (vested and disability) 10 years of service, or age 55 with 5 years (death-in-service)	5 years of service (vested and disability) 10 years of service (death-in-service)	5 years of service (vested and disability) 12 years of service, or age 55 with 5 years (death-in-service)	5 years of service (vested and disability) 10 years of service, or age 55 with 5 years (death-in-service)
Disability Benefit	Unreduced, accrued benefit with minimum of 25% of AFC	Unreduced, accrued benefit with minimum of 25% of AFC, with children's benefit of 10% of AFC to maximum of 3 concurrently	Unreduced, accrued benefit with minimum of 25% of AFC	Unreduced, accrued benefit with minimum of 25% of AFC
Death-in-Service Benefit	Disability benefit or early retirement benefit, whichever is greater, with 100% survivorship factor applied plus children's benefits up to maximum of three concurrently	70% of accrued benefit with no actuarial reduction applied, plus children's benefit	Disability benefit or early retirement benefit, whichever is greater, with 100% survivorship factor applied plus children's benefits up to maximum of three concurrently	Disability benefit or early retirement benefit, whichever is greater, with 100% survivorship factor applied plus children's benefits up to maximum of three concurrently
Medical Benefits	80% of total premium	80% of total premium	80% of total premium	80% of total premium **#4(see the footnote at bottom of chart)**

If new to the membership of the Vermont State Retirement System on or after July 1, 2008, the following provisions are applicable to the Group F plan:
#1 60% of AFC
#2 Age 65 or a combination of years and service equal to 87
#3 Sliding scale for early retirement penalty based on years of service at retirement
#4 Pro-rated percentage of total premium based on years of service at retirement

Exhibit #2

VSTRS Group Comparison

Group Comparison	Group A	Group C
Employee Contributions	5.5% of gross salary	3.40% of gross salary
Benefit Formula	1.67% x creditable service	1.25% x service prior to 6/30/90 + 1.67% x service after 7/1/90
Maximum Benefit Payable	100% of AFC	50% of AFC
Average Final Compensation (AFC)	Highest 3 consecutive years, including unused annual leave, sick leave, and bonus/incentives	Highest 3 consecutive years, excluding all payments for anything other than service actually performed
Normal Retirement (no reduction)	Age 60 or with 30 years of service	Age 62 or with 30 years of service
Post-Retirement COLA	Full CPI, up to a maximum of 5% after 12 months of retirement	50% CPI, up to a maximum of 5% after 12 months of retirement or with 30 years
Early Retirement Eligibility	Age 55 with 5 years of service	Age 55 with 5 years of service
Early Retirement Reduction	Actuarial reduction	6% per year from age 62
Post-Retirement Survivorship Options	100%, 75%, and 50% (with or without pop-ups), all actuarially reduced based on age of beneficiary	100%, 75%, and 50% (with or without pop-ups), all actuarially reduced based on age of beneficiary
Benefit Eligibility - Other (Vested Rights, Disability, Death-in-Service)	5 years of service (vested and disability) 10 years of service, or age 55 with 5 years (death-in-service)	5 years of service (vested and disability) 10 years of service, or age 55 with 5 years (death-in-service)
Disability Benefit	Unreduced, accrued benefit with minimum of 25% of AFC	Unreduced, accrued benefit with minimum of 25% of AFC
Death-in-Service Benefit	Disability benefit or early retirement benefit, whichever is greater, with 100% survivorship factor applied, plus children's benefit up to maximum of 3 concurrently	Disability benefit or early retirement benefit, whichever is greater, with 100% survivorship factor applied, plus children's benefit up to maximum of 3 concurrently
Medical Benefits	80% of retiree's premium with 10 years of service	80% of retiree's premium with 10 years of service

Exhibit #3 – Characteristics of State Public Pension Plans in New England

Characteristics of State Public Pension Plans in New England

Category	Vermont	Maine*	New Hampshire	Connecticut	Massachusetts*	Rhode Island
Employee Contribution	5.10%	7.65%	5.00%	None	9% + 2% of pay above $30,000	8.75%
Employer Contribution	7.61%	17.01%	8.74%	4.9% (as of 6/30/05)	6.64%	18.40%
Benefit Formula	1.67% x years x Final Average Salary (FAS)	2% x years x Final Average Salary (FAS)	Age 60-64: 1.67% x year x Final Average Salary; age 65 and above: 1.5% x years x Final Average Salary (FAS)	1.33% + .5% for salary above Social Security breakpoint	2.5% x years x Average Final Salary (FAS)	[(1.6% x 1st 10 years) + (1.8% x 2nd 10 years) + (2% x years 21-25) + (2.25% x years 26-30) + (2.5% x years 31-37) + (2.25% x year 38)] x Final Average Salary (FAS)
Maximum Benefit Payable	60% of FAS	No Limit	100% of FAS	75% of FAS	80% of FAS	75% of FAS
Eligibility for Retirement	Age 65 OR any Rule of 87	Age 60 with 10 years of service; or age 62 with 5 years of service	Age 60 with any number of years of service	Age 62 with 5 years of service OR age 60 with 25 years of service	Age 65 with 10 years of service OR any age with 20 years of service	Age 59 with 29 years of service; or age 65 with 10 years of service
Post Retirement COLA	50% of CPI up to a maximum of 5%, compounded until 1/1/2013; full CPI with maximum of 5% thereafter	Full CPI up to 4%, compounded	Ad Hoc	60% of CPI, with minimum of 2.5% and maximum of 6%, compounded	Ad Hoc with 3% maximum for 1st $12,000 of benefits, compounded	CPI up to 3% after 3rd anniversary of retirement, compounded
Early Retirement Eligibility	55 with 5 years of service	Any age with 25 years of service	Age 50 with 10 years or service OR when age plus service = 70	Age 55 with 10 years of service OR at any age with 25 years of service	Age 55 with 10 years of service	Age 55 with 20 years of service
Early Retirement Penalty	Actuarial sliding scale	6% per year from normal retirement age	1.5% - 6.67%, depending on years of service	6% OR 4%, depending on years of service	0.1% in the formula multiplier for each year under age 65	Actuarially Reduced
Vesting Requirement	5 years of service	5 years of service	10 years of service	10 years of service	10 years of service	10 years of service
Actuarial Method	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal
Funding Ratio at 6/30/08	100.80%	73.90%	67.80%	53.30%	85.10%	53.40%
Assumed Interest Rate	8.25%	7.75%	8.50%	8.50%	8.25%	8.25%
Assumed Inflation Rate	3.25%	4.50%	3.50%	4.00%	3.50%	3.00%

Note: Maine and Massachusetts are not covered by Social security.

7/142009

Exhibit #4 – Characteristics of Teacher Public Pension Plans in New England

Characteristics of Teacher Public Pension Plans in New England

Category	Vermont	Maine*	New Hampshire	Connecticut*	Massachusetts*	Rhode Island
Employee Contribution	3.54%	7.65%	5.00%	6.00%	5.00% - 11.00%, depending on date of entry	9.50%
Employer Contribution	7.38%	16.72%	8.93%	15.28%	16.00%	19.64%
Benefit Formula	1.67% x years x Final Average Salary (FAS)	2% x years x Final Average Salary (FAS)	Age 60-64: 1.67% x year x Final Average Salary; age 65 and above: 1.5% x years x Final Average Salary (FAS)	2% x years x Average Final Salary (FAS)	2.5% x years x Average Final Salary (FAS); teachers who eleted into RetirementPlus and have 30 or more years receive an add'l 2% for years above 24	[(1.6% x 1st 10 years) + (1.8% x 2nd 10 years) + (2% x years 21-25) + (2.25% x years 26-30) + (2.5% x years 31-37) + (2.25% x year 38)] x Final Average Salary (FAS)
Maximum Benefit Payable	50% of FAS	No Limit	100% of FAS	75% of FAS	80% of FAS	75% of FAS
Eligibility for Retirement	Age 62 OR any age with 30 years of service	Age 60 with 10 years of service; or age 62 with 5 years of service	Age 60 with any number of years of service	Age 60 with 20 years of service OR any age with 35 years of service	Age 65 with 10 years of service OR any age with 20 years of service	Age 59 with 29 years of service; or age 65 with 10 years of service
Post Retirement COLA	50% of CPI up to a maximum of 5%, compounded	Full CPI up to 4%, compounded	Ad Hoc	Between 3% and 5%, depending on date of retirement, compounded	Ad Hoc with 3% maximum for 1st $12,000 of benefits, compounded	CPI up to 3% after 3rd anniversary of retirement, compounded
Early Retirement Eligibility	55 with 5 years of service	Any age with 25 years of service	Age 50 with 10 years or service OR when age plus service = 70	Age 60 with 10 years of service OR at any age with 25 years of service	Age 55 with 10 years of service	Age 55 with 20 years of service
Early Retirement Penalty	6% per year reduction from age 62	6% per year from normal retirement age	1.5% - 6.67%, depending on years of service	6% OR 4%, depending on years of service	0.1% in the formula multiplier for each year under age 65	Actuarially Reduced
Vesting Requirement	5 years of service	5 years of service	10 years of service	10 years of service	10 years of service	10 years of service
Actuarial Method	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal	Entry Age Normal
Funding Ratio at 6/30/08	84.90%	73.90%	67.80%	63.00%	69.60%	53.40%
Assumed Interest Rate	8.25%	7.75%	8.50%	8.50%	8.25%	8.25%
Assumed Inflation Rate	3.25%	4.50%	3.50%	3.00%	3.00%	3.00%

Note: Maine, Massachusetts and Connecticut are not covered by Social Security.

7/14/2009

The Sustainability Gap

Benefits are earned throughout a career rather than simply when are funds paid out to retirees. In order to meet these obligations, each system has developed a funding plan to accumulate monies, which, properly invested over time, will fund member retirements. The plans, when fully funded and operating under appropriate actuarial assumptions that correspond to demographic, economic, and workforce experience, and with manageable benefit design, have the effect of reducing volatility and providing the assurance that funds will be available to pay for benefits at member retirement.

As of the FY 2008 valuation, VSERS had an unfunded liability of $87.1 million while VSTRS had an unfunded liability of $379.5 million. The FY 2009 unfunded liabilities have increased to $326.5 and $727.8 million, respectively, significantly reducing the funding ratio to 80.9% for VSERS and 65% for VSTRS, down from 94.1% and 78.9% respectively.

The severe decline in the financial markets and subsequent economic recession has resulted in investment declines in Vermont as well as all other States. This has adversely impacted the funded status. While investments have triggered severe deterioration of funding levels, the problem has been brewing for some time in the form of an aging workforce, a baby boomer retirement bubble, longer life expectancies and a retirement benefit design that is not consistent with these trends.

As noted in a PBS Frontline report (Pernot, "Why Does Retirement Cost So Much?" May 16, 2006):

> "The driving force behind the growing cost of retirement is the fact that the baby boomers will spend more time in retirement than any previous generation. According to the Center for Disease Control, a 65-year-old can now expect to live another 18 years, on average. American seniors are living 50 percent longer than they were in the 1930s, when Social Security set 65 as the benchmark retirement age"

Investment losses and demographic pressures put additional budgetary pressures on the State at a time when Vermont faces fiscal stress from declining revenues, increasing unemployment and housing market declines. As noted by the Joint Fiscal Office, the recent history has been marked by significant revenue decline (JFO, "Vermont revenue Picture: Facing Vermont's Fiscal Challenges", November 17, 2009):

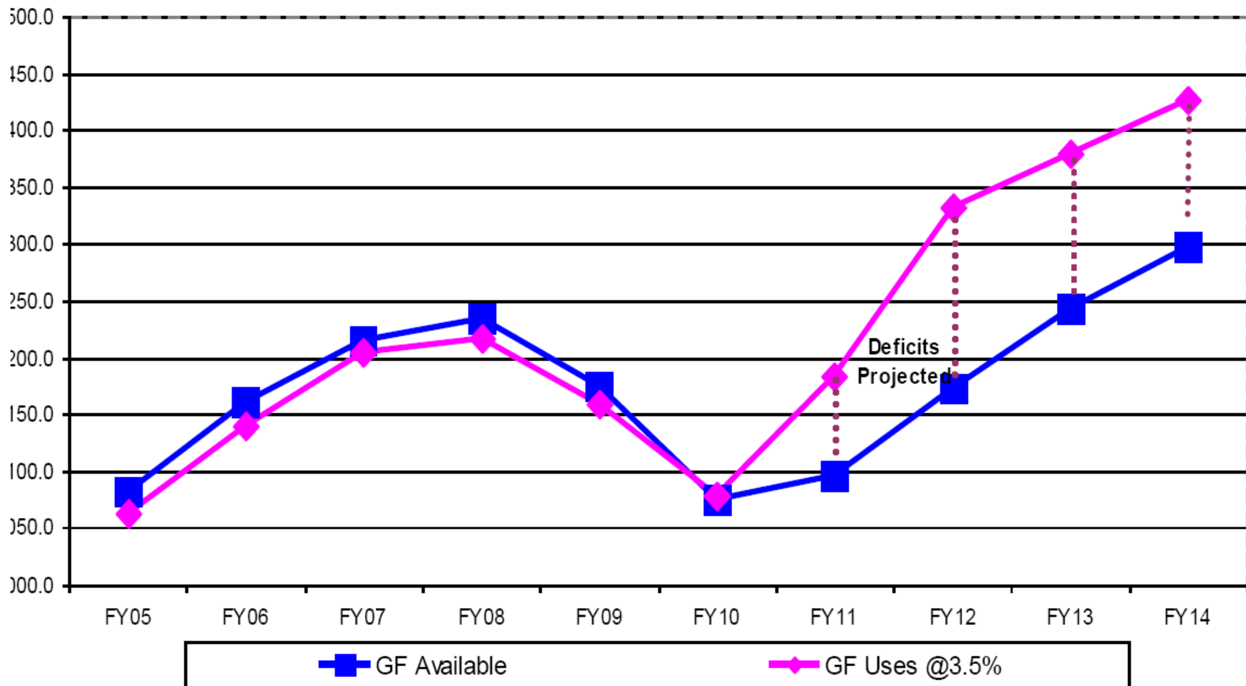
- In July 2007, FY 2010 income tax revenues were projected at $650 million. As of November 2009, Vermont economists revised the projection downward to $489 million, with risk on the downside - a 25 percent decline.

- In July 2007, FY 2010 total sales tax revenues were projected at $373 million. As of November 2009, Vermont revised the projection downward to $310.4 million, with risk on the downside -a 17 percent decline.

- Overall, since July 2007, total projected available General Fund revenue for FY 2010 decreased from $1,249 million to $1,026 million, an 18 percent decline.

- This was despite a $20 million increase in tax revenues for FY 2010 (during the last legislative session).

As noted by JFO, Vermont's FY 2010 total revenues are below those of FY 2005. While stimulus funds have provided some relief, Vermont has a long-term structural imbalance and will experience significant budget shortfalls that must be addressed by the Legislature and the Governor:



At the time this chart was developed by JFO the FY 2011 deficit was projected to be $88 million. That number is now closer to $150 million.

While an economic recovery and investment rebound would obviously be welcomed, this would not solve the problem. The States consulting actuaries were asked to complete an analysis bringing the assets of the VSERS and VSTRS forward at the assumed rates of return indicated at the top of each column, applying the so-called smoothing method used to determine the actuarial value of assets, and combining the results with the projected normal

cost and accrued liability of each system to show what the required state contribution for FY 2012 would be. The results show that even if the overall rate of return on assets in fiscal year 2010 substantially exceeds the assumed 8.25 percent rate of return, the FY 2012 required state contribution to both systems can be expected to exceed those developed in the most recent actuarial valuations. This is because additional portions of investment losses that have been not yet been recognized in the actuarial value of assets will have to be recognized in the 2010 valuation, and even a rate of return as high as 15 percent on the market value of each system's assets will not be high enough to offset them. At a positive 15 percent rate of return, well above the assumes actuarial rate of return of 8.25 percent, the unfunded liability for the VSERS system will again increase to $369,229,953 lowering the funding ratio even further to 77.41 percent. For VSTRS, the unfunded liability would increase to 813,954,713 and the funding ratio would drop to 63.28 percent. Also note that the unfunded liability is 133 percent of the projected payroll for the entire year for the VSTRS system. In the projections stated above, costs and liabilities are made using the actuarial assumptions employed in the valuation, so no positive or negative impacts of other actuarial assumptions (mortality, workforce separations, etc) are included.

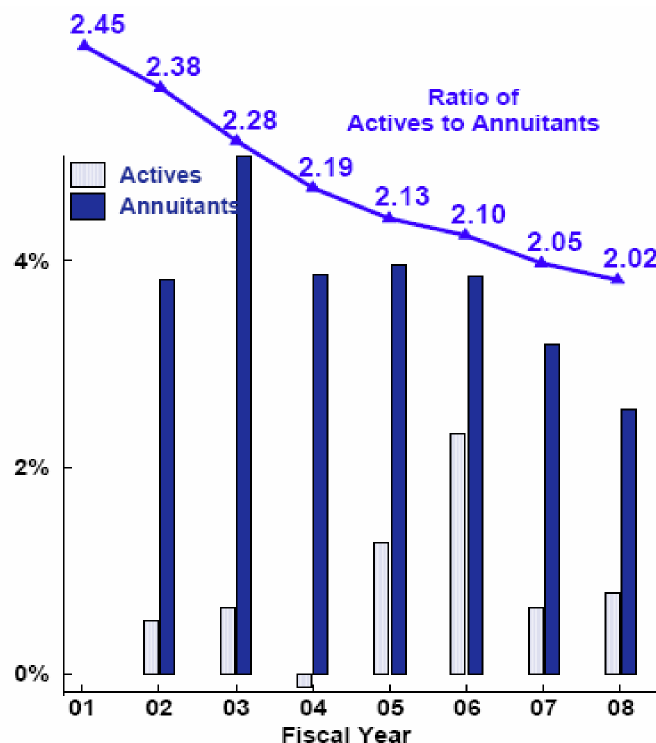
While investment markets have rebounded somewhat, assets of the retirement funds as of 12/31/09 are still 15 percent lower than the high water mark of 2007. Further there is no guarantee that the rebound will continue. In fact, as far as economic recovery is concerned, the Legislature's consulting economists (see Kavet, Rockler & Associates, "November 2009 Economic Review and Revenue Forecast Update", November 17, 2009) state that "real estate and housing markets will be slow to heal and remain credit-sensitive " and that risks to the forecast "are mostly on the downside."

Our actuaries estimate that it will take more than twenty years at our current actuarial investment rate of return of 8.25 percent to get back to fiscal year 2008 funding level. This rate may be a difficult benchmark, especially if the aging workforce and increased benefit payments, as noted in the next section, create a need to move to a higher percentage of liquid assets. It would not be prudent to rely on future market returns above the assumed rate of return to solve the problem.

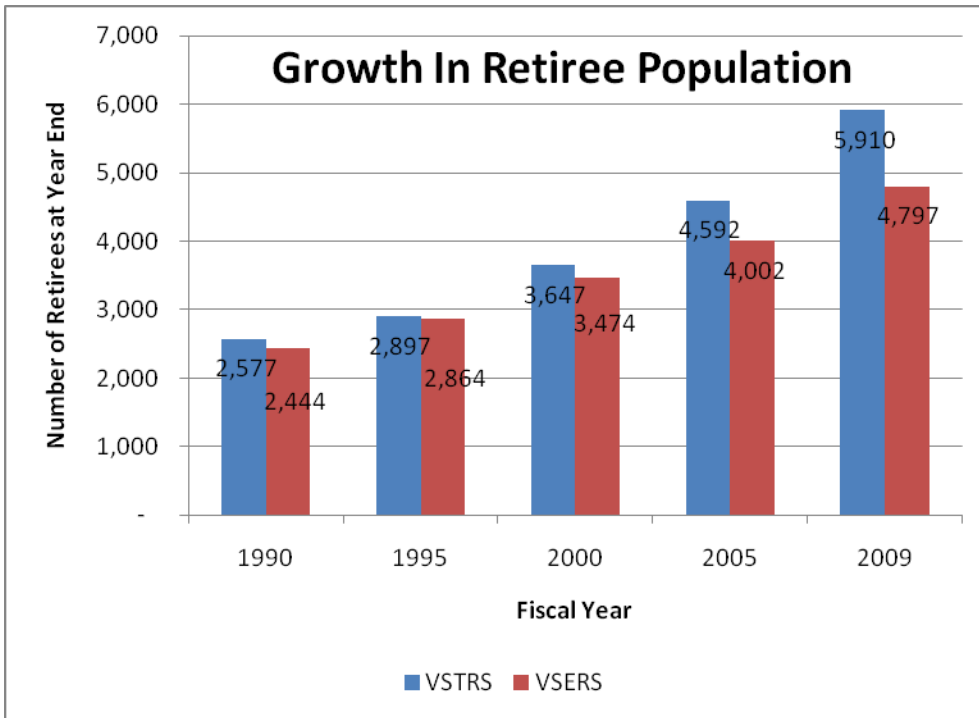
Vermont significant budgetary pressures and must respond to them in a deliberate and measured way to maintain the integrity of its retirement systems. Without immediate intervention, the costs to support the existing plans may go well beyond state government's ability to find additional tax resources or expenditure cuts.

Demographics of Aging

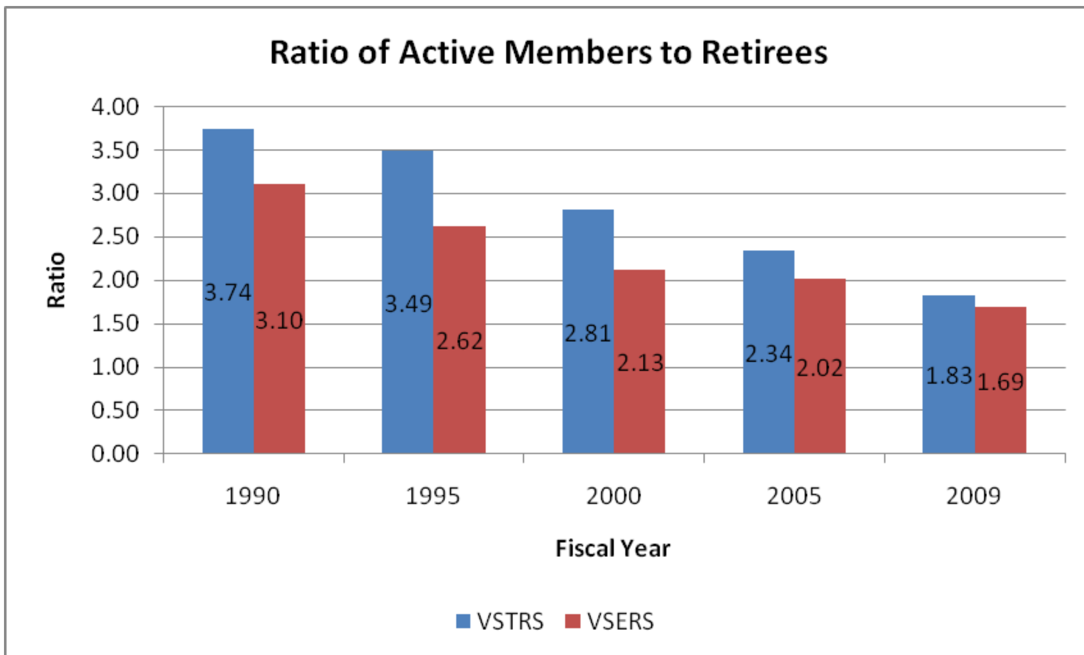
One important demographic trend placing additional stresses on the pension systems is the aging of the workforce and increased life spans of retirees. In the 2008 Public Fund Survey, the National Association of Retirement Administrators noted that "the rate of growth in annuitants has been outpacing the rate of growth in active (working) members (NASRA, Public Fund Survey of Findings FY 08, October 2009). As noted in the graph provided by NASRA, the ratio of actives to annuitants has declined from 2.45 in FY 2001 to 2.02 in FY 2008:



The Wisconsin Legislative Council's 2008 Comparative Study of Major Public Employee Retirement Systems issued in December 2009 showed declining ratios of active to retired participants. According to published reports, 47 of the 87 systems surveyed had an active employees-to-retired-employees ratio of less than two, as compared to 17 of the systems in the 2000 report (Plan Sponsor, "Public Plans' Number of Retirees Growing Faster than Active Participants", December 24, 2009). Vermont has a similar trend. Both the VSERS and VSTRS retiree populations are growing, due to increasing numbers of retirees and the fact that people are living longer.



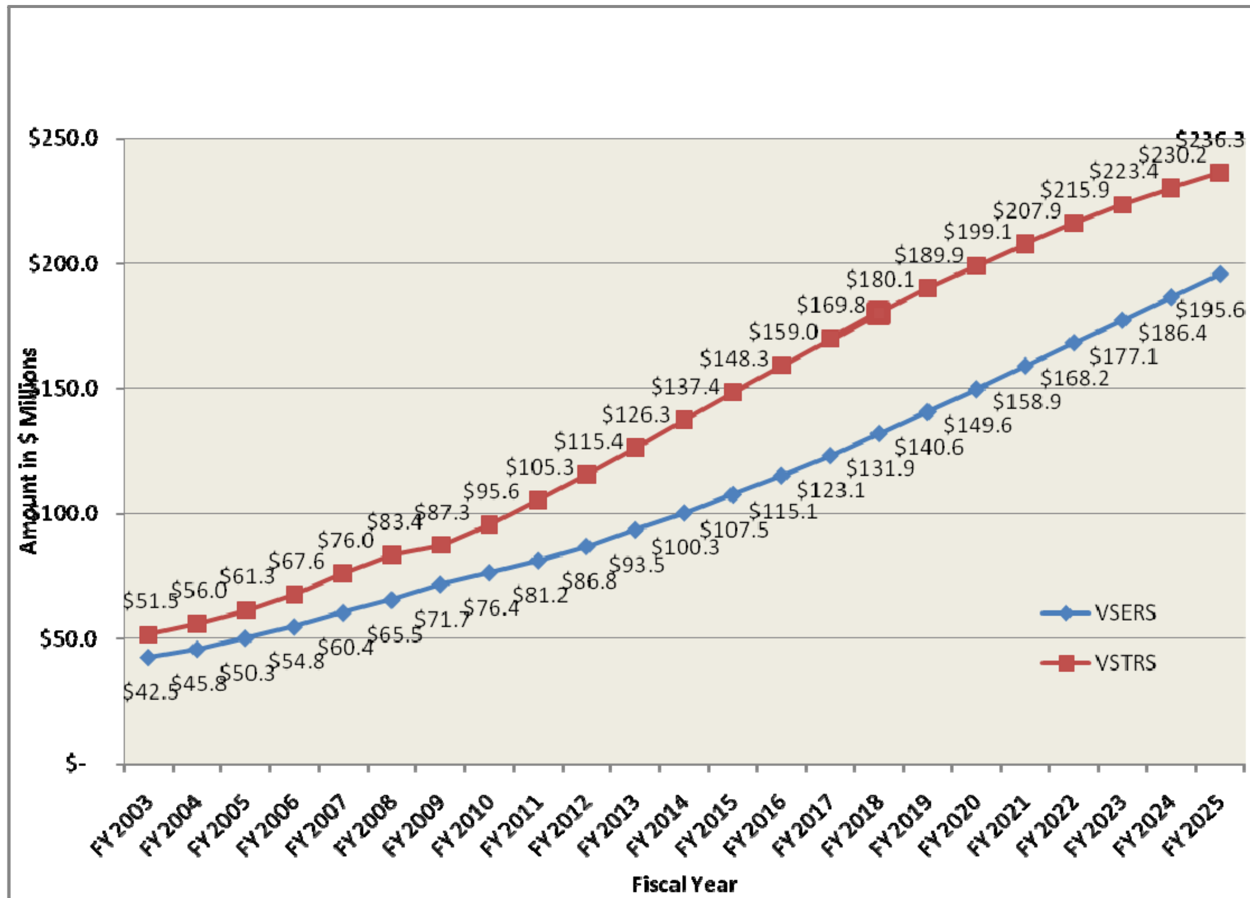
In addition, the ratio of active members to retirees is decreasing:



Unlike a "pay-as-you-go" plan such as Social Security, the actuary takes this in account when developing models to prefund benefits. However, the increasing trend may get ahead of actuarial mortality assumptions, creating actuarial losses. In addition, these trends are indicative of a maturing plan and can make it more difficult to achieve the objectives of full

funding, not just for the pension plan but especially for the severely underfunded OPEB plans. It also creates more volatility in employer contribution rates. Further, as more funds are needed for benefit payments, a trend readily apparent in Vermont, the systems have a greater negative cash flow (benefit payments exceed contributions), requiring more liquid assets to fund these payments. This creates a greater likelihood of adjustments to asset allocation plans which could adversely impact assumed and actual investment rates of return.

Pension Benefit Payouts: Actual and Projected



Review of Recommendations

The National Context

In reviewing these recommendations, it should be noted that this crisis is not unique to Vermont and that many other States are taking action, some quite similar to Vermont. A December 2009 publication by the NCSL notes that, "over the years from 2005 through 2009, 18 states have enacted such changes to reduce long-term costs of retirement plans." More changes are on the way. As noted by the National Conference Public Employment retirement Systems (NCPERS) and the NSCL:

> "The principal theme in pension legislation in 2009 was the need to make future pension costs manageable in the light of states' straitened fiscal circumstances and the losses most retirement trust funds have experienced. Few benefit increases were enacted, and reductions in various forms appeared in a number of states." (NCPERS, Pension and Retirement Plan Enactments in 2009 State Legislatures, 2009)

Consistent with Vermont's analysis of the funding, economic, and demographic issues, the NCSL notes that:

> "Even if financial markets improve, and help retirement trust funds recover, the state fiscal crisis, political and demographic issues will continue their stress on retirement systems…. I'd expect additional states to make the kinds of changes I have reported for 2009--broad programs of increases in employee and employer contributions; higher age and service requirements for retirement; smaller post-retirement benefit increases." (NCSL, Presentation, Fiscal Leaders Seminar, December 10, 2009).

The National Association of Retirement Administrators recently compiled a list of "Responses to 2008 Market Decline and Rising Pension Costs." (copy is included in the appendices to this report.) Based on that report and the NSCL studies, some efforts consistent with those of Vermont are evident as well as some that go further than recommended by the Commission. The list below is illustrative rather than comprehensive.

- Study Commissions:
    - Several states (Illinois, Kansas, Maine, Montana, Nebraska, New Mexico, North Carolina), along with Vermont, have formal commissions studying the entire structure of all their state retirement plans this fall.

- Other states, including Rhode Island and New Hampshire, have completed studies recently and have implemented some changes as a result.

- Employee Contributions:
  - New Mexico, Nebraska, Kentucky, Idaho, and Texas increased required employee contributions for current employees.
  - Connecticut, Nevada, and New Hampshire raised contribution rates for future employees.
  - In Nebraska, beginning September 1, 2009, the school employees' contribution rate increased from 7.28 percent to 8.28 percent.
  - The Colorado PERA Board, an Iowa Legislative Committee, and the Minnesota Teachers' Retirement Association, have recommended increases to employee and employer rates.
  - The legislature is expected to consider higher employee and employer contributions in Wyoming.

- Benefit or Age of Retirement Date Changes:
  - A number of states reduced benefits in conjunction with new-hires after a prescribed date. Changes included adjustments to COLAs, raising the age of normal and early retirement, changes to vesting, increasing years for FAS calculations, and others.
  - Louisiana and Rhode Island reduced post retirement benefits for existing state employees.
  - The Rhode Island changes are estimated to save in the neighborhood of $50 million in general fund expenditures in FY 2010.

As noted previously, our consulting actuaries maintain that recovery is a long-term proposition. Our actuaries estimate that it will take more than 20 years at our current actuarial investment rate of return 8.25% to get back to Fiscal Year 2008 funding levels. Some have suggested that we wait out the current downturn and re-assess the landscape in a year or two. The longer we wait, the worse the problem and the more severe the ultimate fix.

Specific Recommendations of the Commission

CATEGORY: General Framework

RECOMMENDATION ONE: Make no change to the following.

- Pension or retiree health benefits for those already retired.

- Pension or retiree health benefits for anyone close to retirement, which the Commission defined as within five years of eligibility for a particular benefit.

It should be noted that "five years from normal retirement eligibility" for purposes of these recommendations means the member must be either 5 years or less from normal retirement age for their group plan, or have a minimum of 25 years of service as of the date the retirement legislation is enacted. If a member has begun making a purchase of service that is documented in the system prior to December 31, 2009, the total years of service being purchased may count toward the total years of service as of the effective date of the legislation. No service that is initiated after January 1, 2010, will count toward total creditable service as of the effective date.

- Basic provisions (maximum benefit, multiplier, COLA, etc.) that would make the plans less competitive than the mainstream of other state public systems.

RECOMMENDATION TWO: Do not replace the current defined benefit plan and transition to a defined contribution plan.

The Commission did discuss and consider the possibility of a transition from the current defined benefit plans for all teachers and most state employees to a defined contribution or cash balance type plan. Telephone dialogues took place with retirement officials in other states with experience in this area. These states included Florida which currently offers both a defined benefit and defined contribution plan to employees, Nebraska which moved after many years from a defined contribution plan to a cash balance plan, and West Virginia which has moved back and forth between defined contribution and defined benefit plans on more than one occasion.

Proponents of a defined contribution/cash balance approach point out that the employer and employee contribution rates are more stable and predictable, that these plans provide greater portability for employees, that few employees in the private sector have access to defined benefit plans, and that in the long run defined contribution/cash balance plans can be expected to be less expensive for the employer (State).

Opponents of defined contribution/cash balance plans believe that they provide less retirement security for employees, shift financial risk from the employer to employees, cost more in the near and intermediate term as employers maintain two systems for many years, are less attractive to employees, and are less efficient or effective from an investment perspective.

The majority of the Commission chose not to recommend adoption of a defined contribution/cash balance plan for teachers or state employees at this time. The majority did recommend further consideration of this issue in the future.

RECOMMENDATION THREE: Full funding of Pension ARC.

The Commission recommends that the Legislature and the Governor continue to fully fund the annual actuarially required contribution (ARC) for the state and teachers' pensions as calculated after any or all recommendations made below are enacted. While budget constraints may

create pressures to reduce or limit full funding, continued discipline in fully funding the ARC is critical to the long-term sustainability of the pension funds. "Rate holidays" or other forms of underfunding do not address the real problem and only exacerbate the fiscal stresses because lost investment opportunity will increase future funding needs, hitting strapped budgets even harder. Beyond the harm to the pension fund, it could potentially impact the State's credit rating. As noted by Moody's Investors service (Special Comment: Employee Pension Costs Pressure State and Local Governments, November, 2009):

" A broad deterioration in funding levels for public sectors adding to fiscal pressure on some state and local governments could contribute to negative rating actions for select issuers in the next several years … The problem for some issuers will be exacerbated by decisions by select governments to defer pension contributions during periods of budgetary stress… A reduction in plan contributions would not appear consistent with the challenging environment in which most pensions presently exist (underline added)."

While the Commission believes that the significant recommendations included in this report are necessary to preserve the stability and the integrity of the pension systems, these actions are fair to taxpayers and members of the system only if the State meets its obligations. If the plan is to be sustained, all parties must share the pain and meet their obligations.

RECOMMENDATION FOUR: Fund OPEB Obligations.

To date, the VSERS OPEB plan has set aside just over $5.7 million against an OPEB liability of $775 million. The teachers' system has no assets but has an unfunded actuarial liability of $872.2 million. Unlike the state system where the "pay-as-you-go" portion is budgeted and funded in a separate OPEB Trust fund, the health care expenses for VSTRS are paid out of the pension fund and are treated as an actuarial loss to the system, creating additional financial stresses on the pension system. While there was no consensus on a solution to this issue, the treatment of teacher health care is reviewed below, in the "Review of Outstanding Issues" section of the report.

Health care costs over the last decade or more have risen at a much higher rate than the rate of inflation, and while some stabilization of that trend is expected, costs are projected by our actuaries to continue to exceed CPI. The situation for the teachers' health care payments is reaching a critical phase.

The Retirement Commission unanimously voted to include a recommendation to the Legislature to develop, without delay, a structural plan and process to fund the OPEB obligations and set money aside in a material way in a separate, independent funding mechanism.

CATEGORY: Pension Plan Recommendations

RECOMMENDATION FIVE: Revisions to Normal and Early Retirement Ages.

Background Discussion: Normal retirement is defined as the age, number of years of service, or both, that a member must attain in order to qualify for full retirement benefits without an actuarial reduction to the pension. In addition to stand alone age or service requirements, some plans have adopted "Rule of X" requirements under which a person can retire with normal retirement benefits through attainment of that number through a combination of years of service and age. For the majority of State employees (Group F) and teachers (Group C), normal retirement is currently age 62 years or retirement at any age with 30 years of service. Under legislation enacted in fiscal year 2008, VSERS Group F benefits were modified so that the eligibility condition for an unreduced benefit changed from the attainment of age 62 or 30 years of service to a "Rule of 87."

As noted in the previous sections of this report, demographics are changing; people are living longer and they are able to contribute to the workforce later in life. They are a valuable resource to governments and educational institutions as these employees provide valued institutional knowledge and experience in the workplace. From a pure pension economics standpoint, the maturing of a pension system, as evidenced by the declining ratio of active members to retirees, creates additional volatility and strains on pension systems, especially during periods of financial stress. The extension of the years at which an individual may retire with unreduced benefits has a significant impact on the fiscal health of the system, as funds may be invested for longer periods of time and the total disbursements over the span of the retirement will be less.

In the case of early retirement, where an individual commences receipt of retirement benefits prior to the attainment of normal retirement eligibility, the pension is reduced from the amount that would have been received if the person had reached the normal retirement requirements. This is done to maintain system health as, at least in theory, the retiree would receive a benefit that is cost neutral, i.e., is not subsidized by contributions of other members. It also is an equity issue in that the adjustment should create an "equivalent benefit." Since the Commission is extending normal retirement, the recommendation is also made to create a similar pattern for early retirement. In addition, the Commission recommends using full actuarial reductions rather than percentages or factors that may not fully address the need to achieve a cost neutral impact. This does not create savings for the pension plan, in that the member is accruing additional benefits for that same time, but it does create additional OPEB savings (health care).

Recommendation

State Group F and Teachers' Group C:

- Raise normal retirement age from 62 or 30 years at any age to 65 or rule of 90 (combination of age and years of service) for those more than five years from normal retirement eligibility.

- Raise the early retirement age from 55 to 58 for those more than five from early retirement eligibility.

State Group D:

- Raise normal retirement age from age 62 to age 65 for those more than five years from normal retirement eligibility.

State group C:

- Raise the early retirement age to 52 from 50 for those more than five years from early retirement eligibility.

RECOMMENDATION SIX: Lengthening the salary compensation period (average final compensation).

Background Discussion: For defined benefit systems, the final average salary used in conjunction with a "multiplier" to calculate the pension benefit, is generally the member's highest earnings over a specified number of years. Sometimes there is a requirement that the years be consecutive; in some systems the highest years are used. In most, but not all, the member's highest salary will be the amount of salary he or she earned immediately prior to retirement. The VSERS Group F and VSTRS Group C members currently have a three highest consecutive years requirement. The Wisconsin Legislative Council released its biannual "2008 Comparative Study of Major Public Employee Retirement Systems" in December 2009. It notes that 55 of the 87 plans it surveyed used some form of a three-year model, the next most utilized average being five years (by 18 of the 87 plans). A review of recent legislative initiatives summarized by NCSL and NCPERS indicate recent efforts by several states to move to a longer compensation period. These reduce the impact of significant increase in the compensation of members in the last year or two of service, which may or may not be intended to increase pension benefits and more accurately reflect the wage earnings over an extended period.

<u>Recommendation</u>

State Group F and Teachers' Group C:

- Use a five-year compensation period instead of a three-year period to calculate benefits for those more than five years from retirement eligibility.

State Group C:

- Use a three-year compensation period instead of a two-year period to calculate benefits for those more than five years from retirement eligibility.

State Group D:

- Use a two-year compensation period instead of final salary to calculate benefits for those more than five years from retirement eligibility.

The following are sample calculations for various groups to demonstrate the difference in an average monthly benefit that would result from the changes in the AFC calculation changes as recommended. These examples do not reflect any of the other changes that are being contemplated.

Vermont State Teachers' Retirement System

Group C Plan

Example #1: 16.821917 years of service

3 year average = $58,827; annual maximum benefit = $16,524
5 year average = $56,366; annual maximum benefit = $15,840
Difference = **$684** annually

Example #2: 33.00 years of service

3 year average = $72,889; annual maximum benefit = $36,192
5 year average = $70,214; annual maximum benefit = $34,860
Difference = **$ 1,332** annually

Vermont State Retirement System

Group F Plan

Example #1: 16.346153 years of service

3 year average = $77,432; annual maximum benefit = $21,137
5 year average = $74,129; annual maximum benefit = $20,236
Difference = **$901** annually

Example #2: 40.24359 years of service

3 year average = $43,255; annual maximum benefit = $21,628
5 year average = $41,183; annual maximum benefit = $20,592
Difference = **$1,036** annually

Group C Plan

Example: 26.339726 years of service

2 year average = $124,928; annual maximum benefit = $62,464
3 year average = $117,306; annual maximum benefit = $58,653
Difference = **$3,811** annually

Group D Plan

Example: 31.281119 years of service

Final salary = $128,827; annual maximum benefit = $128,827
2 year average = $127,786; annual maximum benefit = $127,786
Difference = **$1,041** annually

RECOMMENDATION SEVEN: Increasing the Maximum Benefit.

Background Discussion: The maximum benefit establishes limit on the amount of pension benefits that may be received by a retiree. Increasing this cap would provide an opportunity for increased benefits to employees who choose to work more than thirty years. Right now most teachers and state employees are capped at their maximum retirement benefit of 50 percent of average final compensation (AFC) after 30 years of service (exception is VSERS Group F members hired after 7/1/08). With this change members would receive 60 percent of AFC after

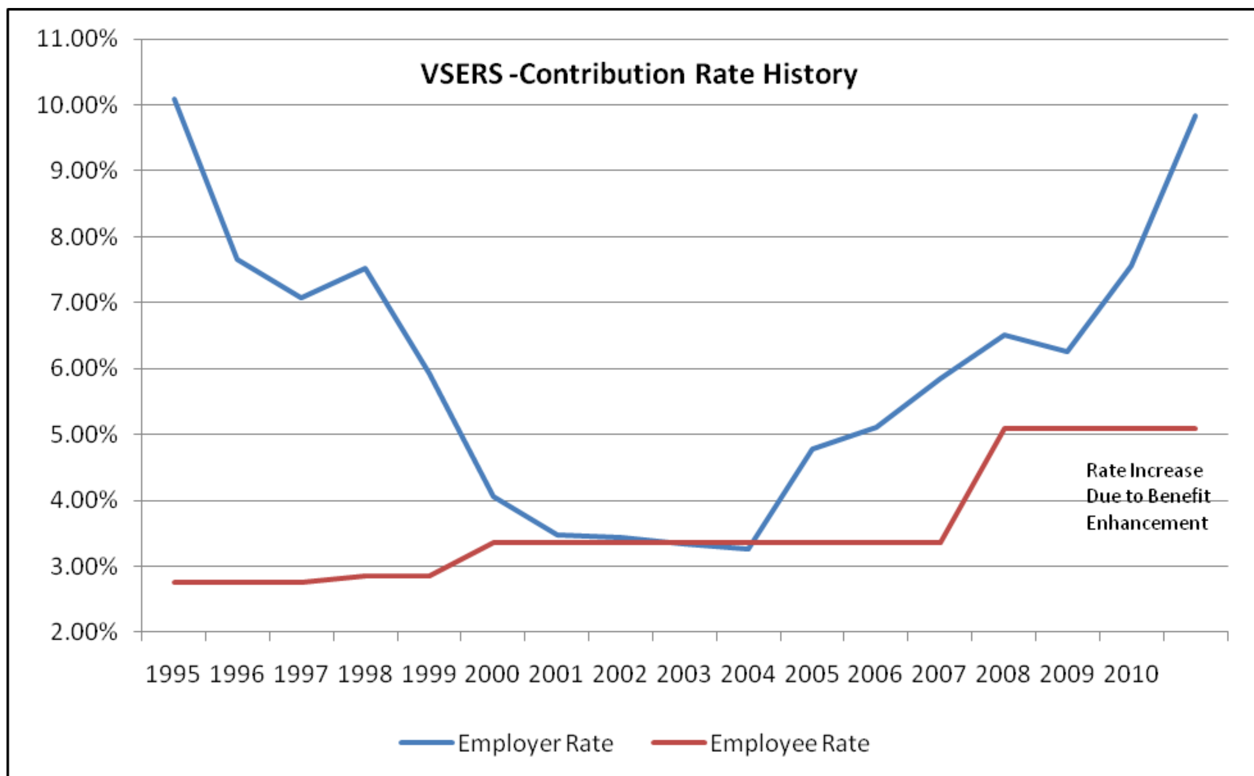
36 years of service. The overwhelming majority of public plans have higher caps than 50%; many with no cap at all. This would have the result of rewarding longer service and provide some mitigation to both the AFC change and the adoption of the "Rule of 90" for normal retirement. Group F members hired after 7/1/08 currently have the 60 percent cap.

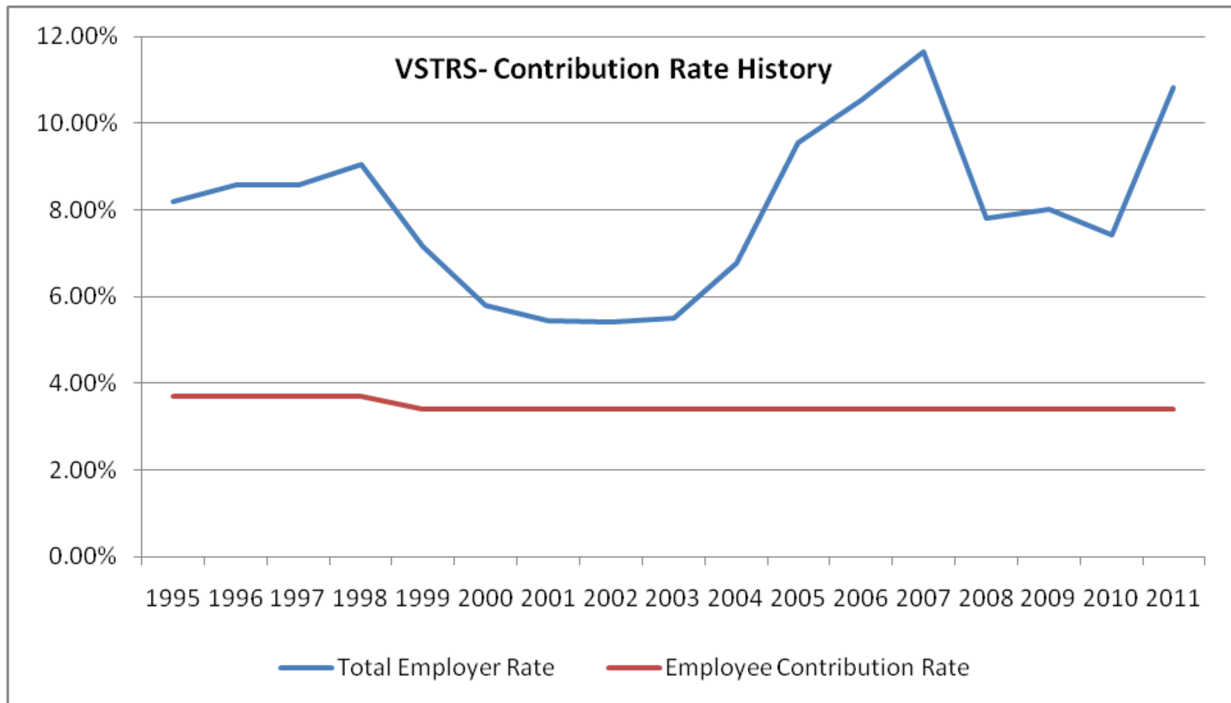
Recommendation

Increase the maximum benefit from 50% to 60% of final compensation for State Group F and Teachers' Group C for those more than five years from retirement eligibility.

RECOMMENDATION EIGHT: Revising the contribution rate ratio and rates for employer and employees.

Background Discussion: While contribution levels for state employees and teachers have remained constant in recent years, the State's share, represented as a percentage of payroll, is much more volatile and generally represents a more significant share of the contribution to the pension benefit.





The Commission is recommending employment of a "risk sharing" approach to the payment of necessary contributions to fund the system in FY 2011 and subsequent years. Essentially, the total contributions required to meet the funding needs of the system would be calculated by the actuary on an annual basis. This would include the employer and employee contributions. The additional need over the previous year's base, or in optimum economic climates, reductions to contributions, would be spread across both employer and employees' estimated contributions. Instead of having a fixed employee contribution rate set in statute, with the State/employer contribution rate floating on an annual basis, the Commission recommends a proportional contribution system between the State and employees/teachers. This would require both employers and employees to pay the established percentage of the increased costs of pension benefits that result in market downturns or when other variables that result in performance that do not meet assumed actuarial experience. When actuarial experience is exceeded, the contribution rate for both employers and employees would go down. It is important to remember that rate/risk sharing creates a partnership; employer and employee contributions will rise and fall in tandem. Both parties will have a stake in keeping benefit, administrative, and other costs in check.

As part of its review the Commission studied a number of rate sharing options and their impacts on the employer ARC and employer and employee rates, incorporating all other pension recommendations above. These are summarized on the next page.

Preliminary Projected Fiscal Impact Summary: Commission Recommendations to Pension Plans

VSTRS –	Employer ARC	Employee Contribution %	State Contribution
FY 2010 actuarial recommendation & appropriation:	$41.5 million	3.4%	7.4%
FY 2011 actuarial recommendation, no changes:	$63.5 million	3.4%	10.8%
FY 2011 recommendation, changes, no cost sharing	$56.7 million	3.4%	9.67%
FY 2011 recommendation, changes, 3.5% state increase	$43.0 million	5.47%	7.32%
FY 2011 recommendation, changes, 50/50 sharing*:	$50.1 million	4.25%	8.53%
FY 2011 recommendation, changes, 50/50 sharing**:	$37.5 million	6.39%	6.39%
FY 2011 recommendation, changes, 60/40 sharing***:	$45.0 million	5.11%	7.67%

Changes = Normal retirement at 65/rule of 90, early retirement at 58 with actuarial equivalent reduction for early commencement, lengthening salary averaging period from three years to five years, increase in maximum benefit from 50% to 60% of FAS; changes not applicable to those presently within five years of normal retirement (for early retirement change, exclusion applies to those now within five years of early retirement eligibility).

Sharing:
* 50/50 using FY 2010 as baseline (based on changes above)
** 50/50 of total required contribution (based on changes above)
*** 60/40 of total required contribution (based on changes above)

VSERS –	Employer ARC	Employee Contribution %	State Contribution %
FY 2010 actuarial recommendation & appropriation:	$32.0 million	5.1%	7.6%
FY 2011 actuarial recommendation, no changes:	$41.6 million	5.1%	9.8%
FY 2011 recommendation, changes, no cost sharing	$36.4 million	5.1%	8.62%
FY 2011 recommendation, changes, 3.5% state increase	$33.1 million	5.83%	7.84%
FY 2011 recommendation, changes, 50/50 sharing*:	$34.3 million	5.56%	8.11%
FY 2011 recommendation, changes, 50/50 sharing**:	$28.9 million	6.84%	6.84%
FY 2011 recommendation, changes, 60/40 sharing***:	$34.7 million	5.47%	8.20%

Changes = Normal retirement at 65/rule of 90, early retirement at 58 with actuarial equivalent reduction for early commencement, lengthening salary averaging period from three years to five years for Group F, from two to three for Group C, and from final salary to two years for state Group D, increase in maximum benefit from 50% to 60% of FAS; changes not applicable to those presently within five years of normal retirement (for early retirement change, exclusion applies to those now within five years of early retirement eligibility).

Sharing:
* 50/50 using FY 2010 as baseline (based on changes above)
** 50/50 of total required contribution (based on changes above)
*** 60/40 of total required contribution (based on changes above)

The results of application of these rates to an employee's pay will vary depending on the rate of pay and the rate configuration adopted. Ranges of impact by various rate sharing strategies are as follows:

VSERS Employee Contribution					
	Baseline	Tied to 3.5% State Increase	50/50 using 2010 as baseline	50/50 sharing of total	60/40 sharing of total
	5.10%	5.83%	5.56%	6.84%	5.47%
Salary					
$30,000	$1,530	$1,749	$1,668	$2,052	$1,641
$35,000	$1,785	$2,041	$1,946	$2,394	$1,915
$40,000	$2,040	$2,332	$2,224	$2,736	$2,188
$45,000	$2,295	$2,624	$2,502	$3,078	$2,462
$50,000	$2,550	$2,915	$2,780	$3,420	$2,735
$55,000	$2,805	$3,207	$3,058	$3,762	$3,009
$60,000	$3,060	$3,498	$3,336	$4,104	$3,282
$65,000	$3,315	$3,790	$3,614	$4,446	$3,556
$70,000	$3,570	$4,081	$3,892	$4,788	$3,829

VSTRS Employee Contribution					
	Baseline	Tied to 3.5% State Increase	50/50 using 2010 as baseline	50/50 sharing of total	60/40 sharing of total
	3.40%	5.47%	4.25%	6.39%	5.11%
Salary					
$30,000	$1,020	$1,641	$1,275	$1,917	$1,533
$35,000	$1,190	$1,915	$1,488	$2,237	$1,789
$40,000	$1,360	$2,188	$1,700	$2,556	$2,044
$45,000	$1,530	$2,462	$1,913	$2,876	$2,300
$50,000	$1,700	$2,735	$2,125	$3,195	$2,555
$55,000	$1,870	$3,009	$2,338	$3,515	$2,811
$60,000	$2,040	$3,282	$2,550	$3,834	$3,066
$65,000	$2,210	$3,556	$2,763	$4,154	$3,322
$70,000	$2,380	$3,829	$2,975	$4,473	$3,577

Employee contributions in both systems are pre-tax contributions under Section 414(h) employer pick-up provisions and will therefore reduce the member's tax liability while he or she is employed.

Recommendation

The Commission chose to recommend a sharing of the total annual contribution, with the State share capped at the 3.5 percent growth target to accommodate the expenditure growth rate target of the Joint Fiscal Committee.

Cost Impacts of Pension Recommendations

Buck Consultants analyzed the Commission's recommendations to determine their financial and actuarial impacts of the above recommendations. The pension recommendations above, if adopted, would cut the FY 2011 actuarially required contributions for the State pension system from the actuary's recommendation of $41.6 million to $33.1 million and for the Teachers' pension system from $63.5 million to $43.0 million, a combined reduction of $29 million or 28%, and would produce significant savings for many years. Of the $29 million reduction in the State's FY 2011 contribution, $12 million results from benefit revisions and $17 million comes from increased employee contributions. The impact of the various recommendations, excluding the rate sharing, is outlined for each system below.

Summary of Fiscal Impacts: VSERS Recommendations

	Individual Components of Recommendation					
	Baseline Before Recommendations	Age 65 or Rule of 90	Early Retirement & Rule of 90	Recommended Changes to AFC	60% Salary Cap	Combined Recommendation Package Without Rate Sharing
NORMAL COST EMPLOYER	$23,334,122	$19,236,962	$20,205,997	$21,075,233	$23,392,634	$19,110,506
ACCRUED LIABILITY	1,544,144,066	1,506,950,166	1,505,921,599	1,529,292,721	1,563,452,860	1,512,825,881
UNFUNDED LIABILITY	326,506,488	289,312,588	288,284,021	311,655,143	345,815,282	295,188,303
FY 2011 ARC	$41,581,656	$36,290,324	$36,407,795	$39,441,225	$43,759,841	$36,449,613

Summary of Fiscal Impacts: VSTRS Recommendations

Individual Components of Recommendation

	Baseline Before Recommendations	Age 65 or Rule of 90	Early Retirement & Rule of 90	Recommended Changes to AFC	60% Salary Cap	Combined Recommendation Package Without Rate Sharing
NORMAL COST EMPLOYER	$22,828,834	$18,896,875	$19,777,164	$21,655,115	$23,357,007	$18,838,189
ACCRUED LIABILITY	2,101,837,843	2,040,655,962	2,059,100,549	2,083,298,780	2,120,003,744	2,051,972,216
UNFUNDED LIABILITY	727,758,506	666,576,625	685,021,211	709,219,443	745,924,407	677,892,878
FY 2011 ARC	$63,501,219	$56,175,450	$58,061,082	$61,291,404	$65,044,634	$56,723,725

The current column is the baseline for comparative purposes, based on the FY 2009 actuarial valuation and represents the FY 2011 actuarially required contribution absent any recommended changes. Each component of the recommendations was analyzed to approximate its individual impacts. Independently, each of these recommendations has an impact, but they are interdependent and change as each component impacts others. The actuary then ran a hypothetical model with all of the above pension recommendations to ascertain a combined savings, prior to rate sharing.

In FY 2011, the savings for the pension recommendations above (excluding rate sharing) are $5,132,043 for VSERS and $6,777,494 for VSTRS. The largest single impact for each system is the adoption of the age 65 or “Rule of 90” for normal retirement. Early retirement changes as recommended do not add savings on the pension side, and in fact add costs, but create offsetting savings in the tiered health care OPEB scenario described below. In the case of VSERS, the proposed extension of the average final compensation and the 60 percent maximum cap basically offset each other, while there is a net gain to the system of approximately $666,000 in the VSTRS system.

The combined recommendation would also reduce the liability in future years. While this is an extrapolation based on the current actuarial valuations, adoption of these recommendations would result in savings over the baseline of approximately $6.2 million in 2015 and $7.7 million in 2020 for VSERS and, for the same years, $8.1 million and $10.3 million for VSTRS.

If rate sharing is applied as recommended by the Commission, with a 3.5 percent employer cap, approximately $17 million is reduced from the employer ARC. In addition, other possibilities reviewed by the Commission are also noted:

	VSERS Employer ARC	VSTRS Employer ARC	Total Combined ARC
FY 2010 actuarial recommendation & appropriation	$32.0 million	$41.5 million	$73.5 million
FY 2011 actuarial recommendation, no changes:	**$41.6 million**	**$63.5 million**	**$105.1 million**
FY 2011 recommendation, changes, no cost sharing	$36.4 million	$56.7 million	$93.1 million
FY 2011 recommendation, changes, 3.5% state increase*	**$33.1 million**	**$43.0 million**	**$76.1 million**
FY 2011 recommendation, changes, 50/50 sharing**:	$34.3 million	$50.1 million	$84.4 million
FY 2011 recommendation, changes, 50/50 sharing***:	$28.9 million	$37.5 million	$66.4 million
FY 2011 recommendation, changes, 60/40 sharing****:	$34.7 million	$45.0 million	$79.7 million

Notes:
*3.5% State ceiling increase configuration is recommended by the Commission
** 50/50 using FY 2010 as baseline (based on changes above)
*** 50/50 of total required contribution (based on changes above)
**** 60/40 of total required contribution (based on changes above

CATEGORY: Health Care Recommendations

RECOMMENDATION NINE: A Tiered Medical Premium Copayment Structure.

Background Discussion: Under the State System, members may continue their medical coverage for themselves and all eligible dependents in retirement for the remainder of their lifetime, and only pay 20 percent of the premiums for all covered lives. The only stipulation is that the member must be eligible to draw their pension immediately upon separation of service, meaning that they must be at least age 55 and have at least 5 years of service. The only deviation to this configuration is for Group F members whose membership began in the system on or after 7/1/2008. For those members, a “tiered health” plan is in place, based on years of service at retirement. The State pays 80 percent at 20 years, 60 percent at 15 years, and 40 percent at 10 years.

In the Teachers’ System, a member must have a minimum of 10 years of service at retirement, and they will receive 80 percent of their premium paid by the system, based on the standard medical plan. The retired teacher must pick up the full premium for all covered dependents.

Under the scenarios above, a retiree receives 80 percent of their medical premium paid by the system for the remainder of their life, with as little as 5 years of service. This is very generous and very expensive to the respective systems. It is not only more affordable but fairer for the percentage of the system’s subsidy to be tied to the number of years of service accrued by the member. This method not only rewards longevity, but mirrors the way that pension benefits

are calculated by providing long-term members with a higher benefit than short-term members.

The Commission explored a number of health care options centering on the concept of applying a tiered health care system for all members of both systems new tiered system would apply to all of those not within five years of eligibility to draw this benefit. Possible tiers included:

30 percent - 10yrs	50 percent - 15 yrs	70 percent - 20 yrs
40 percent - 10yrs	60 percent - 15 yrs	80 percent - 20 yrs
40 percent - 10yrs	60 percent - 20 yrs	80 percent - 30 yrs

The Commission also considered not allowing access to the health benefit until age 60 or age 65.

Recommendation

The Commission recommends a tiered medical premium copayment structure based on length of service. Instead of the current straight 80/20 split of retiree health insurance premiums utilized for most retired teachers and state, a new tiered system would apply to all of those not within five years of eligibility to draw this benefit.

The new employer share for the tiered system would be:

40 percent - 10yrs 60 percent - 20 yrs 80 percent - 30 yrs

RECOMMENDATION TEN: Provide the Ability to "Recapture" the Retiree Health Benefit.

Background Discussion: For most VSERS employees (with the exception of Group F employees hired after 7/1/08) and group C members there is no access or "recapture" if you do not carry state insurance at the time you retire. Therefore if you leave state service but do not retire until a later date, you cannot recapture this benefit in the VSERS system. In the VSTRS system, members currently have the recapture option available with ten years of service but do not have spousal coverage. Providing a recapture option was seen as consistent with rewarding longevity and was viewed as a more equitable treatment for members.

Recommendation

The Commission recommends providing the ability to "recapture" the retiree health benefit to those with 20 or more years of service when they begin drawing benefits. This opportunity is not currently allowed for state employees and is allowed for teachers with 10 or more years of service.

Cost Impacts of Health Care Recommendations

The charts below are based on analyses prepared by Buck consultants to identify the impacts of these changes on both the cash expenditure (pay-as-you-go costs) for health and the development of the OPEB ARC, incorporating full accrual. The following analyses also incorporate, as assumptions, the recommended changes to normal and early retirement described above.

For both systems, the pay-as-you-go does not change appreciably, if at all, in the early years, although there are some savings as you get further out in years. The addition of spousal coverage adds additional financial stresses to the current pay-as-you-go expenditures and is not affordable, given the current lack of appropriations to support teacher health care expenses, without an offsetting increase to employee contributions.

The impact on the ARC is, however, much more significant. Assuming limited prefunding for VSERS and no prefunding for VSTRS, there are sizeable savings on a full actuarial accrual basis in FY 2011, $15.4 million for VSTRS and $6.6 million for VSERS with greater savings in the out years.

VSERS Tiered health Care at 40%, 60% and 80% at 10, 20 and 30 years of service

	Baseline		For employees > 5 yrs from retirement	
	w/o recapture	w/ recapture	w/o recapture	w/ recapture
Total Active Member Liability	468,333,367	491,204,926	433,396,102	**449,515,273**
Retiree Liability	312,414,941	312,414,941	312,414,941	**312,414,941**
Total Liability	780,748,308	803,619,867	745,811,043	**761,930,214**
Normal Cost	34,759,864	36,590,423	29,809,106	**31,069,652**
Assets	5,748,582	5,748,582	5,748,582	**5,748,582**
Unfunded Accrued Liability	774,999,726	797,871,285	740,062,461	**756,181,632**
Amortization of Unfunded Liability	23,238,214	23,924,013	22,190,627	**22,673,957**
ARC	57,998,078	60,514,436	51,999,733	**53,743,609**
Projected Cash Payments				
2011	30,450,971	30,664,880	30,296,434	**30,450,909**
Projected ARC				
2011	63,578,771	66,333,881	57,017,455	**58,926,874**

VSTRS Tiered Health Care at 40%, 60% and 80% at 10, 20 and 30 years of service				
	Baseline		For employees > 5 yrs from retirement	
	w/o spouse	w/ spouse	w/o spouse	w/ spouse
Total Active Liability	480,458,988	632,567,208	**409,919,649**	537,910,713
Retiree Liability	391,777,332	391,777,332	**391,777,332**	391,777,332
Total Liability	872,236,320	1,024,344,540	**801,696,981**	929,688,045
Normal Cost	33,745,199	44,306,494	**21,661,787**	28,198,018
Assets	-	-	**-**	-
Unfunded Accrued Liability	872,236,320	1,024,344,540	**801,696,981**	929,688,045
Amortization of UAL	25,221,028	29,619,293	**23,181,358**	26,882,266
ARC	58,966,227	73,925,787	**44,843,145**	55,080,284
Projected Cash Payments				
2011	21,911,328	23,367,423	**21,911,328**	23,367,423
Projected ARC				
2011	64,656,785	81,039,069	**49,212,660**	60,430,639

Comments on Other Proposals Reviewed by the Commission

Actuarial Assumptions

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Actuarially determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. State statute provides that at least once in each five-year period, the State's actuary is to make an investigation into the mortality, service, and comprehensive experience of the members and beneficiaries of the system and make recommendations for certain modifications of the actuarial assumptions, as needed.

As a matter of practice, it is recommended that changes in methods or assumptions be considered only in conjunction with a full experience study, unless a significant event impacts their use. In the current economic climate a number of actuarial assumptions might vary from experience including investment rate of return and wage inflation and CPI changes. For instance, a decrease in the assumed rate of investment return would increase the calculated unfunded liability and increase the ARC. On the other hand, a decrease to the wage inflation would decrease accrued liabilities, reduce the unfunded liability, and decrease the ARC.

Assumptions are interdependent and should be consistent with one another. In addition, short-term anomalies may not hold into the future. For instance, wage inflation assumptions may be out of sync with recent collective bargaining, but the future is still uncertain. Inflation

assumptions could be lowered for now but the potential for inflation with the economic stimulus initiatives at the national level could quickly result in another change. Finally, credit agencies may see some of these changes as pragmatic approaches rather than disciplined funding practices.

The Commission has elected to recommend against any changes to the actuarial assumptions.

<u>Lengthening the Amortization Period</u>

In 2008, the General Assembly the amortization period for VSERS was reset for thirty years beginning 7/1/2008. The previous thirty year amortization period set by statute was set to expire in 2018. Even without the recent investment experience, resetting the amortization period made sense. As reported by the consulting actuaries, unusually short periods create greater volatility in the ARC. If there were no amortization at all, gains and losses would be absorbed in one year. Resetting the VSERS amortization period therefore did have a significant impact on the FY10 and now the FY11 ARC. Longer amortization periods reduce the payment toward the unfunded liability by stretching them over longer periods.

In the case of VSTRS the thirty year amortization period for amortization of the unfunded liability was restarted effective 7/1/2006 as a result of a previous recommendation made by the 2005 Commission on Funding the State Teachers' Retirement System. This was done in concert with a change in the actuarial funding method from "Frozen Initial Liability" or FIL to "Entry Age Normal or EAN", for both VSTRS and VSERS. Under the previous method, the unfunded liability was frozen at 1988 levels. Any impact of underfunding subsequent to the "freezing" of the liability in 1988 fell to normal cost instead of being added to the unfunded liability as in more conventional funding methods.

At the time the legislature made the change to restart the VSERS liability effective 7/1/2008, VSTRS was also set to the same date as was the municipal system (VMERS). This was done as an administrative convenience so that all three systems were on the same schedule. It had little impact on the VSTRS ARC as the system was only two years into the previous thirty year schedule.

As a result of these actions, the current amortization periods are not far from the limit set by the Government Accounting Standards Board (GASB) and any re-amortization to thirty years would have little impact. Some States have however, given, the significant investment loses, have opted to temporarily extend the amortization period even further, to forty years. Again this will lessen the annual ARC in the short run but will have the effect of increasing overall interest costs, similar to the effect of extending your mortgage payment. In addition, states and coal governments extending the amortization period will be required under GASB to recalculate the ARC using the thirty year amortization for financial statement purposes and show a liability (net pension obligation) for any underfunding of the ARC on the balance sheet.

The Commission did not recommend an increase in the amortization period.

Pension Obligation Bonds

Some states have sold pension obligation bonds (POBs) to provide cash in order to lower unfunded liabilities and to invest to meet future benefit payments. The Commission benefited from a presentation by Thomas Howard, Executive Director of the Kentucky Office of Financial Management, on this subject. The ultimate goal of the use of POBs is to lower costs for the system. This will happen if the investment return on the proceeds of the borrowed money is greater than the interest costs. If that turns out not to be the case, the State and the retirement systems would be in worse shape than if the bonds had not issued in the first place. The sale of pension obligation bonds converts the pension funding obligation from a soft liability for the State, which can be adjusted to meet changing economic conditions, into a firm legal commitment codified in a bonded liability. On the one hand this will add discipline to the funding obligation and on the other hand it will significantly curtail the State's budgetary flexibility in meeting the myriad obligations it may have. This financing technique is not commonly utilized by highly rated states and has enjoyed mixed results. The Commission felt that the risks of issuing POBS outweighed the potential benefits and recommended against utilization by the State of Vermont.

Education Fund

Part of the legislative charge to the Commission was to consider funding methods, including contributions from the State, municipalities, and employees. This charge was interpreted as applying to the VSTRS system, as, while teachers are employees of local districts, there is currently no local contribution to cover either teacher pension or retiree health costs. The "employer" share of the pension contribution is made entirely by the State. The 80 percent "employer" share of retiree health insurance is paid from the assets of the pension fund.

The Commission did consider transferring all or a portion of the employer contributions for teacher pensions to the Education Fund. Reasons stated for why this might be appropriate included improvement of transparency for total educational expenditures, increased accountability between incurrence of liabilities and responsibility to pay, and improved likelihood of full funding on a consistent, dependable basis.

One scenario the Commission reviewed would have:

- Continued to pay for unfunded pension liabilities (about 2/3 of the total contribution) from the General Fund and transferred normal costs to the Education Fund or directly to local districts with a multi-year phase-in. This would have avoided shifting the burden of any past underfunding by the State to local districts via the Education Fund.
- Continued paying the employer share of VSTRS retiree health insurance for those already on the job as is. For new hires, districts would be assessed on a prefunding actuarial basis with the proceeds deposited in a dedicated trust fund to pay for future health care.
- Revised VSTRS Board Governance by increasing membership from six to seven, adding a school board member and a superintendent and removing the BISHCA Commissioner or designee.

In the end, the majority of the Commission voted not to include any recommendation to transfer any part of the obligation for funding teacher pension or retiree health benefits to the Education Fund or local districts. The reasons for this position varied among Commission members, but included recognition that such a transfer would increase property taxes unless concurrent cost reductions were implemented at the local level, and a desire not to have the debate on this hot-button topic overshadow consideration of the remaining Commission recommendations to improve the affordability and sustainability of the retirement plans.

The Commission does emphasize that the current process for funding retiree health care of teachers cannot continue as is and immediate corrective measures need to be taken as discussed in the next section.

<u>VSTRS Health Care</u>

Regulatory Context: Pension plans are expected to provide primarily pension benefits. Where health care benefits are provided through the same plan (not the predominant model), they must, according to IRS code, be subordinate to the pension benefits and must also be managed through a separate "sub trust." IRS code establishes a 25 percent limitation on contributions to a 401(h) sub trust. One of the many conditions that a pension program must meet is that the "aggregate actual contributions" for medical benefits do not exceed 25 percent of the "total actual contributions" to the plan after the date it first offers medical benefits. Our historical analysis indicates that we have not exceeded the 25 percent limitation in aggregate. However, health care increases exceed the estimated increase for benefits (based on increasing populations and wages and other demographics). It is clear that at some time in the future we will reach this ceiling, which if not addressed, could have adverse consequences to the entire pension fund or the ability to provide adequate health care benefits.

Funding Context: In the case of the State system, "pay-as-you-go" health care premiums are explicitly budgeted, along with other administrative expenditures, and are budgeted as an "add-on" to the actuarial required contribution for pension benefits. That provides an ongoing funding mechanism. A "true-up" is conducted each year, impacting future appropriations, accounting for any surpluses or deficits in the planned expenditures. In the Teachers' system, health care is treated as a loss to the system and therefore impacts the contribution level calculated by the actuary. It is in essence "retrospective financing," always incorporating a lag. As such, there are no explicit current appropriations to pay for the health care expenses. Without an explicit appropriation, funds cannot be transferred to an OPEB trust or similar fund to pay for these.

Funding Need: FY 2009 health care "pay-as-you-go" health care premiums totaled $16,421,176. In order to create a separate fund to pay these costs, we would need to appropriate similar amounts of funds, in the order of $16 to $17 million plus, going up each year. Over time, funding this will reduce the pension ARC, which incorporates a heath care portion, but not at a 1:1 ratio; and new resources are needed to "jump-start" funding for a separate health care fund.

A number of concepts were discussed:

1. Directly assess local education agencies (LEAs) for a portion of retiree pay-as-you-go health care (cost of premium payments) funding for existing active members as of 7/1/2010 or future new hires, or both of these categories of participants. If phased in, this proposal has the advantage of a gradual phase-in and will take some of the pressure off the 25 percent health care threshold issue.

2. A variation to the above would be to assess LEA for new hires on a "prefunded basis" instead of a pay-as-you-go basis. Funds would then be deposited in an OPEB Trust fund, earning interest, and providing a phase in of prefunding.

Spousal Coverage

The teachers' system currently pays 80 percent of the retirees' premium only, based on the standard plan. The retiree must pick up the full premium for all covered dependents. This would primarily be a spouse, although it is not unusual for a retiree to also have one or more children still in school as well. A retiree who must have two person coverage will pay $616.44 per month, which jumps up to $970.44 per month for family coverage. This is cost-prohibitive for many teachers, and is actually a very real deterrent for a teacher who wishes to retire. Although the majority of the Commission members voted not to add a spousal subsidy for Vermont State Teachers' Retirement System members because of the cost, it is an issue that should be discussed in more depth to determine if there are alternative ways of paying for some level of subsidy that would enable retirees to better afford medical coverage for their dependents.

Conclusion

Failure to address the issue of the sustainability of our public retirement plans now will surely lead to larger problems later and the need for more draconian steps, failing both the employees and the taxpayers. As stated early in this report, the recommendations of this Commission attempt to strike a balance, recognizing both the public policy and economic context in which the current benefit structures operate. We do not make our recommendations lightly and hope that the Legislature, the Governor, and all interested parties recognize the urgent need to balance these concerns and create sustainable plans. Change will occur, either by careful long-term planning, by default, or in crisis. Clearly, there are no easy solutions, but there are fiscally and socially responsible steps we can take.

While we believe that these recommendations provide a solid course of action, we also recognize that there is a range of options inherent in each, with varying impacts on the overall cost of benefits. We see this report as the foundation of a meaningful dialogue within which varying proposals can be reviewed. We look forward to working with you and all interested parties through the coming legislative cycle to meet our mutual goal of a fair, equitable, and sustainable retirement system that provides benefits to the labor force and the state economy.

Acknowledgments /Bibliography

Acknowledgments

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- David Driscoll and Daniel Sherman, Consulting Actuaries, Buck Consultants
- Ice Miller, LLC
- Staff from the Vermont State Treasurer's Office, including the Retirement Division
- Legislative Joint Fiscal office

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Act No. 1 of the 2009 Special Session
Sec. E.135.1 COMMISSION ON THE DESIGN AND FUNDING OF RETIREMENT AND RETIREE HEALTH BENEFITS PLANS FOR STATE EMPLOYEES AND TEACHERS

(a) A commission is created to review and report on the design and funding of retirement and retiree health benefit plans for the state employees' and teachers' retirement systems. The commission is charged with making recommendations about plan design, 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. The joint fiscal committee may provide benchmark targets reducing the rate of expenditure growth for retirement and retiree health benefits to the commission to guide the development of recommendations.

(b) The commission shall comprise the following members:
(1) one member of the house of representatives, appointed by the speaker of the house;
(2) one member of the senate, appointed by the president pro tempore of the senate;
(3) the state treasurer, who shall chair the commission;
(4) the secretary of administration or designee;
(5) the commissioner of education or designee;
(6) one member of the public with pension and benefit experience appointed by the governor;
(7) one member of the public with pension and benefit experience appointed jointly by the speaker of the house and the president pro tempore of the senate.

(c) The report shall include, but not be limited to, the following:
(1) an evaluation of current benefits structures and contribution characteristics in comparison to other comparable public and private systems;
(2) an estimate of the cost of current and proposed benefits structures on a budgetary, pay-as-you-go basis and full actuarial accrual basis;
(3) a five-year review of benefit expenditure levels as well as employer and employee contribution levels and growth rates and a three-, five- and ten-year projection of these levels and rates;
(4) based on benefit and funding benchmarks, options for providing new benefit structures with the objective of adequate benefits within the established cost containment benchmarks;
(5) funding methods, including contributions from state, municipalities, and employees, to achieve these objectives; and

(6) an evaluation of whether current governance, oversight, and lines of authority are appropriate and consistent with funding objectives.

(d) During the course of its deliberations and prior to any final recommendations being made, the commission should solicit input from the affected parties, such as employees, taxpayers, and organizations representing those parties, including the Vermont state employees association, Vermont– NEA, and the Vermont league of cities and towns.

(e) The commission may select and oversee outside expert benefit and legal expert advisory services as it deems appropriate. An amount of $150,000 is appropriated for this purpose in Sec. B.1101(a) of this act.

(f) On or before December 18, 2009 the commission shall file a report and recommendations with the governor and the general assembly.

(g) The commission shall also provide the report to the board of trustees of the state employees' and teachers' retirement systems for their consideration, deliberation, and comment to the general assembly.

(h) Administrative support shall be provided by the office of the state treasurer.

(i) Legislative and public members shall be entitled to per diem compensation and expenses as provided for in § 406 of Title 2 and § 1010 of Title 32 respectively.

Commission Votes

Retirement Commission Votes

December 15, 2009

1. Should we recommend benefit changes for employees already vested?

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

2. If we are going to recommend benefit level changes for employees not close to retirement, what do we mean by 'close'? More than five years from retirement eligibility?

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

3. Would contribution level increases apply to everyone, all groups, all employees in the system?

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

State Group F and Teachers' Group C

4. Raise normal retirement age from 62 or 30 years at any age to 65 or rule of 90 (combination of age and years of service) for those more than five years from normal retirement eligibility?

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

5. Raise the early retirement age from 55 to 58 for those more than five years from early retirement eligibility?

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

State Group D

6. Raise normal retirement age from 62 to age 65 for those more than five years from normal retirement eligibility?

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

State Group C

7. Raise the early retirement age to 52 from 50 for those more than five years from early retirement eligibility?

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

State Group F and Teachers' Group C

8. Use a five year compensation period instead of a three year period to calculate benefits for those more than five years from retirement eligibility?

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

State Group C

9. Use a three year compensation period instead of a two year period to calculate benefits for those more than five years from retirement eligibility?

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

State Group D

10. Use a two year compensation period instead of final salary to calculate benefits for those more than five years from retirement eligibility?

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

11. Increase the maximum benefit from 50% to 60% of final compensation for State Group F and Teachers' Group C?

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

12. Sharing cost of total actuarial contribution changes (50/50, 60/40) to be determined by actuary to get to 3.5% recommendation?

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

13. Implement a tiered system so that degree of premium assistance is linked to length of service for those more than five years from retirement eligibility:

40% - 10 years 60% - 20 years 80% - 30 years

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

14. Provide ability to 'recapture' health benefit with 20 years of service upon drawing of retirement benefit?

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

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

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

16. Include a comment discussion was held concerning the Education Fund/local districts contribution to pension and/or retiree health costs.

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

17. Include a comment the Commission encourages legislature to examine the issue of the payment of the employers' share of VSTRS retiree health insurance.

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

18. Include a comment which includes the Commission's recommendation of further consideration for a defined contribution/cash balance plan alternative to the current defined benefit plan.

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

19. Include a comment that discussion was held concerning use of pension obligation bonds to pay off a portion of the unfunded liability, but there is no recommendation to use pension obligation bonds.

20. Include a comment discussion was held and there is not a recommendation to lengthen the amortization period for unfunded liabilities from 30 years.

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

20. Include a comment discussion was held and there is not a recommendation to revise the assumptions.

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

21. Finally, the Retirement Commission unanimously voted to include a recommendation to the Legislature to begin a structural process to fund the OPEB obligations and set money aside in a material way in a separate, independent funding mechanism.

Appendices

Legislative Joint Fiscal Committee Benchmark Target Recommendation

ONE BALDWIN STREET
MONTPELIER, VT 05633-5701

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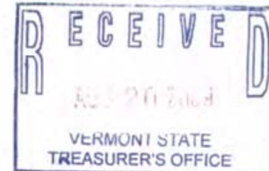
STATE OF VERMONT
LEGISLATIVE JOINT FISCAL COMMITTEE



August 12, 2009

Jeb Spaulding
Office of the State Treasurer
109 State Street
Montpelier, VT 05609-6200

RE: Legislative Joint Fiscal Committee Benchmark Target Recommendation

Dear Treasurer Spaulding,

Pursuant to Sec. 135.1 of Act 1 of the 2009 Special Session, the Legislative Joint Fiscal Committee (JFC) has met and discussed providing the Commission on the Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers with benchmark targets for the rate of expenditure growth for retirement and retiree health benefits to guide its development of recommended reforms to the retirement systems.

The JFC considered the recent performance of a number of indicators that reflect state revenue and spending trends and broader economic trends; examples include the general fund growth rate and the state and local price index.

After considering this information, the Joint Fiscal Committee recommends a benchmark target of 3.5% for the rate of expenditure growth for retirement and retiree health benefits.

The JFC recognizes the fact that controlling the rate of expenditure growth will require difficult decisions on the part of the Commission, the legislature, and system participants. The JFC also recognizes that this recommendation serves as a guide and does not bind the Commission; however, in the event that a higher growth rate is targeted, the Commission should be specific as to how it is to be financed.

Sincerely,

Michael J. Obuchowski

Rep. Michael Obuchowski
Legislative Joint Fiscal Committee, Chair

VT LEG 248954.1

History of State Responses to 2008 Market Decline and Rising Pension Costs

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
AK					
AL					Legislature is expected to consider the following changes when it convenes in January: a 1% increase in employee contributions, effective immediately; benefit based on highest 5 of 10 years of service, rather than highest 3; for new hires, minimum retirement age of 60 rather than any age with 25 years of service; for new hires, eligibility for DROP at age 60 with 25 years of service; extend amortization period from 20 to 30 years.
AR					
AZ	Employee and employer contribution rates will rise from 9.0% to 9.6% as of 7/1/10. These rates include the health insurance benefit supplement.				The ASRS has suggested the legislature consider the following for new hires a) increasing normal retirement eligibility from Rule of 80 to 85; b) raising FAS from 3 years to 5; c) limiting refunds for terminating members to 25% of employer contributions (current law permits up to 100% after 10 years of service). These changes have been suggested previously to the legislature but have not been approved.
CA	CalPERS adjusted state, local and school employer contribution rates via modifications described in Actuarial Methods/Processes.		CalPERS added an employer rate smoothing methodology for local governments and school employer rates. The technical changes include: 1) Expanding the current rate smoothing corridor from 80% to 120% of market value of assets (MVA) to 60% to 140% of MVA in the first year, to 70% to 130% in the second year, then back to 80% to 120% of MVA in the third year. 2) Isolating and amortizing investment gains and losses in the next three years using a fixed and declining 30-year period as opposed to the current rolling 30-year amortization period.		A taxpayer rights group has filed ballot initiatives that would establish a new tier of pension benefits for all public employees in the state. Among other provisions, the changes would 1) impose maximum multipliers on new hires, such as 2.3 for police and fire, 1.25 for general employees, and 1.65 for general employees outside Social Security; 2) impose minimum retirement ages of 58 on police and fire, and the Social Security retirement age for general employees; 3) place a cap on pensions of 75% of workers' pay; 4) exclude from the pension benefit overtime, bonuses, unused sick and vacation leave; 5) require that future benefit changes be subject to public vote; and 6) require that full costs of retiree health care benefits be paid by employees and employers, to end the accumulation of unfunded liabilities. The initiative must receive the requisite number of valid signatures to appear on the November 2010 ballot.
CO	The CO Legislature eliminated for fiscal years 08-09, 09-10, and 10-11 the state's annual contribution to the fire and police pension association (FPPA), to assist in amortizing the unfunded accrued liability of old hire pension plans; resumes the state's annual contribution to the FPPA beginning in FY11-12, and extends the contribution through FY 14-15.				CO PERA Board recommended to legislature revisions that include: increases to employee and employer contribution rates; reduced (from 3.5% to max of 2.0%) auto-COLAs for current and future retirees; delay onset of COLA to 12 months after retirement; revising return-to-work rules to, among others, require retirees returning to work to make contributions that do not accrue a benefit nor are available to the member; increase the final average salary period from 3 years to 5; adopt Rule of 90 with minimum age 60 for all employees unvested on 1/1/11; adjust early retirement reduction for those ineligible to retire by 1/1/11 to reflect true actuarial cost; and other changes as described at www.copera.org. Also, the CO Fire & Police Pension Assn. Board recommended legislation to allow its members and employers to vote to increase employee contributions to the main DB plan from the current 8% (employer contributions would remain unchanged at 8%).
CT					
DC					
DE	The state's contribution rate will increase in FY11 from 6.01% to 7.4%				Legislature is likely to consider reducing retirement multiplier for new hires, from 1.85% to 1.67%.
FL		The legislature terminated eligibility of retired members to receive a second benefit by returning to work and increased the required break-in-service from 1 month to 6.			

Sources: Retirement systems, NCSL, media reports   Compiled by NASRA   12/22/2009

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
GA	TRS increased employee rates effective 7/1/09 from 5.0% to 5.25%, and employer rates from 9.28% to 9.74%. Effective 7/1/10, TRS employee rates will increase again, to 5.53%, to 10.28% for employers.	Legislature approved prohibition of COLAs to members of ERS and the judges retirement system hired after 6/30/09. Also, passed legislation designed to limit spiking: for new hires, limited the increase in retirants' final year's salary to 5%; for existing members, the employer must pay ERS of GA for the present value of the impact of any increase above 5% to the system.			
HI					
IA					A legislative committee has proposed the following: raising contribution rates from 11.95% to 13.45%, which are paid 60% by employers and 40% by employees; raising the vesting period for new hires from 4 years to 7; raising FAS period to 5 years from 3; and a higher reduction for early retirement, intended to reflect the true actuarial cost.
ID	The Idaho PERS Board elected to phase in contribution rate increases, shared 1/3 by employees and 2/3 by employers, as follows: 1.5% each on 7/1/11 and 7/1/12, and 2.31% effective 7/1/13. By 7/1/13, employer rates for general employees and teachers will be 13.65% and 8.19% oremployees; employer rates for public safety will be 13.99% and 10.04%.	Idaho law requires that the Board implement a negative COLA if the August to August CPI-U is negative. The CPI-U was negative 1.48%. Thus the Board initially established a COLA of that amount. The Board had to consider rate increases before they could consider any retro COLA (i.e. the UAL amortization period must be at or below 25 years after the COLA.) After approving statutorily-required contribution rate increases (see Contribution Rates), the board approved a COLA of 2.48%, effectively increasing benefits for most retired members by 1%.			
IL	Legislature authorized issuance of $4.3 B in pension bonds to fund contributions to the state retirement systems in FY10, which may be issued in 1/10. Contributions will rise for employers in the IL Municipal Retirement Fund.		IMRF Board increased funding corridor from 10% to 20%; revised amortization period from a closed 22-year period (which would have declined to 10) to a rolling 30-year; and employers were given an option to pay the ARC or to phase in contribution rate increases. Also, legislature approved conversion from market value of assets to five-year smoothing for SURS, SERS, and TRS, effective with the valuations dated 6/30/09. No funding corridor was specified. Remaining 80 percent of 2009 losses will be recognized in subsequent actuarial valuations.	Pension Modernization Task Force met over summer and fall; components of report were adopted by task force sub-committees, but report in its entirety was not adopted. The report provides background on covered topics and appendices with individual opinions. The report is accessible at the task force's website: http://www.illinois.gov/gov/pensionreform/	For the SERS, TRS, and SERS, the legislature is expected to consider various proposals when it convenes in 2010, including: lower defined benefit formulas (different formulas for SS coordinated and noncoordinated); higher retirement ages; longer vesting periods; lower maximums; caps on salaries that could be used for retirement purposes; elimination of the survivor benefit program; and elimination of early retirement programs.
IN	Upon recommendation of the actuary, the IN PERF Board approved an employer contribution rate increase for the state from 6.5% for FY10 to 7.0% for FY11. As an agency plan, the average contribution rate for local units also increased, from 7.143% to 7.552% for the same years.				
KS				The Kansas Legislature's Joint Committee on Pensions, Investments and Benefits is studying a wide range of options, including: increasing employer and employee contribution rates, lowering the multiplier for future service, issuing bonds in lieu of an employer contribution increase, and a mandatory defined contribution plan for new employees. The Committee expects to make recommendations for statutory changes in the 2010 legislative session.	
KY	Based on recommendations from its actuary, the KRS board requested employer contribution rates that are sharply higher for several plans above current levels; the General Assembly will approve the actual rates during its 2010 session. The GA in 2008 established a schedule for reaching the ARC by 2024; the GA may or may not comply with that schedule in FY 11.	The General Assembly approved, and the governor signed in 2008 a number of changes affecting KRS participants, including reduced pension benefits for new hires, higher employee contributions for all participants, and modifications to the auto-COLA by limiting it and authorizing the General Assembly to suspend it.		A working group appointed by the governor met and produced a report in 2008; no other study commissions are in place.	KRS expects during the 2010 General Assembly attempts to define "full funding" as 80% funded (based on a January 2008 Government Accountability Office report entitled, "State and Local Government Retiree Benefits"): http://www.gao.gov/new.items/d08223.pdf

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
LA	The employer rate is scheduled to rise to 22% in FY 11 from 18.6% in FY 10.	Legislature modified COLA provisions for statewide systems to retain more assets in the trust funds to amortize the unfunded liability, limiting future COLAs and changing the terminology from "cost-of-living" to "permanent benefit increase." COLAs also are limited to those retired at least one year and who have reached age 60. Also, approved bill allowing a member of any statewide retirement system who retires after 7/1/09 to self-fund a guaranteed 2.5% annual COLA through an actuarial reduction of benefits. Any COLAs provided supplement the self-funded annual 2.5%.	Legislature authorized the refinancing of unfunded liabilities for LASERS and TRS of LA over a 30-year period beginning in FY10.	The Commission on Streamlining Government was created to reduce the cost of state government, through all means available, including efficiencies, economies, and greater effectiveness. The commission inquired about LASERS' retirement incentive programs and cost saving measures.	The Commission on Streamlining Government recommended a defined contribution plan for new employees. The Commission also recommended allowing the purchase of air time for eligibility and closing the DROP program effective 1/1/2015. Legislation is required to implement any of these recommendations.
MA					A commission has been studying pension benefits during 2009 and is expected to submit recommendations for consideration by the 2010 general assembly. Also, a gubernatorial candidate has proposed pension reforms that include an annual pension cap of $90k and pension benefit based on lifetime earnings.
MD					
ME		Legislature approved a bill amending existing statutes to provide that if the inflation rate in a given year is less than zero, benefit levels for current retirees will not be reduced.		Legislature established a task force to study creation of a new unified plan that would require all new hires to be enrolled in Social Security and Medicare, would coordinate retiree health benefits with the new plan, and provide a defined benefit plan. The combined actuarial costs of the new plans are to be divided equally between employers and employees. The task force is to report no later than 3/1/10.	
MI	Some MERS employers increased rates in 2008 and MERS has advised others that higher rates may be forthcoming.	MERS adopted a bridged or tiered benefit system, allowing a municipality to lower the benefit multiplier on a prospective basis.	MERS temporarily suspended a declining amortization schedule. For 08 and 09 valuations, the amortization period will remain at 28 years for unfunded accrued liabilities, then to resume declining in 10 at 1-year increments until reaching 20 years in 17. Also, revised actuarial assumptions to reflect increases to employer contributions for assumptions for turnover, retirement and FAS.	MERS is working with the state on fiscal responsibility for plan design changes.	MERS Board is evaluating raising the retirement age, lowering the discount rate for service credit purchases, and prohibiting use of overtime in FAS.
MN					The TRA Board is recommending a shared sacrifice approach, via the following legislative package: 1) A phased increase in employer and employee contributions, from 5.5% each to proposed 7.5%, phased in over 4 years, rising by 0.5% each year. After the phase-in, TRA is requesting authority for an auto contribution stabilizer that provides the board with authority to set future contribution rates (within boundaries) should the system have a contribution deficiency. 2) A 2-year suspension on annual benefit increases followed by a more permanent reduction in the COLA from 2.5% to 2% until the funding ratio reaches 90%. 3) Reduction in the interest rate paid on refunds of contributions from 6% to 4%. 4) Reduction in the annual increase for deferred benefits to 2%. Deferred benefits are paid to members who terminate, leave their money on deposit with TRA, and later collect a benefit. The deferral interest rate is applied to the member's benefit beginning from the member's termination date to collection of the benefit. Also, the PERA Board adopted a legislative position supporting: 1) a reduction in annual benefit increases from 2.5% to 1.0% until the funding ratio reaches 90%; 2) an increase of 0.25% in both employee and employer contribution rates; 3) a reduction in the interest rate paid on refunds of contributions from 6% to 4%; 4) reduction in the annual increase for deferred benefits to 1%; and 5) increase in vesting period for new hires, from 3 years to 5.

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
MO	The MOSERS employer contribution rate will rise 7/1/10 from 12.75% to 13.81%; MOSERS is non-contributory for employees. The PSRS/PEERS Board voted to increase the contribution rates for 09/10 and 10/11. PSRS was increased by 1% each year (the maximum annual increase allowed by law). The rate for PEERS increased by 0.5% in 09/10 and 0.26% in 10/11 (the maximum annual increase allowed by law). Contributions are paid equally by employers and employees of both systems.		MOSERS temporarily widened the funding corridor, from 120% to 130%, to moderate required increase in contribution rates.		
MS	MS PERS board approved increased employer contribution rates, from 12.0% to 13.56%, effective 7/1/10.			The MS PERS Board voted to establish a commission to study legal issues associated with increasing the employee contribution rate; this commission will remain in place to review the plan's benefit structure, with possible recommendations to legislature in 2011.	Governor has proposed higher employee contributions, lower employer contributions, and rolling back recent benefit enhancements, including an auto-COLA.
MT				Legislature established an interim committee to examine and recommend funding and benefit changes in the statewide public employees' and teachers' retirement systems.	
NC	In line with the historical funding policy of always contributing the ARC, the employer contribution for the state system is due to increase from 3.57% in FY10 to 6.71% in FY11. The employer contribution for the local system is due to increase from a base rate of 4.80% to 6.35% as of 7/10.			NC Retirement System Board established the Future of Retirement Study Commission to recommend the retirement benefits that should be provided to future hires of state and local government. The commission is scheduled to begin meeting 1/10.	
ND				Legislature directed the HR Management Services to study how to retain state workers who are nearing retirement; relates to workforce recruitment and retention.	
NE	Legislature increased school employees' contribution rate by one percent, from 7.28% to 8.28%, effective through 2014. Employer rates will rise also, from 7.35% to 8.36%. The state also committed to paying $20 million annually to the school pension fund for 5 years. Also, increased employee rate to the state patrol fund, from 13% to 15%, to match the employer rate.				
NH	Legislature increased employee contribution rate from 5% to 7% for those hired after 6/30/09. Increased employer contribution rate for non-state government employers from 65% of the annual required contribution in FY09 to 70% in FY10 and to 75% in FY11 (state government contributes the remainder).				Actuary has recommended sharply higher employer contribution rates that would take effect 7/1/11.
NJ	Legislature reduced required contributions of municipal employers by one-half; remainder may be paid over a 15-year period.				
NM	For the two-year period beginning 7/1/09, legislature increased employee contribution rates for all public employees, including teachers, by 1.5%, and reduced the contribution rate for all employers by the same amount.	Legislature in 2009 created new retirement plans for state and municipal general members of the PERA other than peace officers. Retirement eligibility under the new plans is any age and 30 of service, age 67 and five years of service, or the "Rule of 80". The bill also contains a new retirement plan for members of the Education Retirement Board (ERB), in which eligibilty for retirement is the same as under the new PERA plans, except benefits are reduced for a member retiring under the rule of 80 if the member is under 60 years old. The new retirement plans are effective 7/1/11 and will apply to employees hired on or after 7/1/10.		Legislature created the retirement systems solvency task force, to study the actuarial soundness and solvency of the state retirement plans and the health care plan of the retiree health care authority, and to prepare a solvency plan for each entity. The solvency plans are to include analyses and recommendations that address: 1) employer and employee contributions; 2) retirement eligibility; 3) the number of retirement plans; 4) retirement benefits; 5) investment policy and asset allocation; 6) disability retirement and benefits; 7) actuarial assumptions; 8) health insurance plan benefits and eligibility; 9) the costs of health insurance plans; and 10) member services.	The legislature is planning to increase the size of the PERA board from 12 to 16 by adding 3 outside investment professionals (to be appointed by our board) and the State Auditor. This stems from the poor returns last year and the legislature's view that the PERA board lacks investment expertise that may have lessened the losses. The legislature also is proposing creation of an Alternative Investment Advisory Committee should PERA investments in Alternative assets reach $500 million. This group would oversee and advise the board on the investments in that asset class. These committees will be made up of both board members and outside investment professionals with experience in that particular asset class. Each committee will be made up of 5 members.

Sources: Retirement systems, NCSL, media reports   Compiled by NASRA   12/22/2009

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
NV		Legislature approved changes for those hired after 1/1/10. For non-public safety members, eligibility for current members is 65/5, 60/10 or 30 years of service. This bill changes 60/10 to 62/10. For public safety officers, eligibility of current members is 65/5, 55/10, 50/20 or 25 years of service. This bill removes the 25-and-out option. For current members, the actuarial reduction for early retirement is 4% per year, prorated for months short of a year; for those joining on or after 1/1/10, it will be 6% per year, prorated. For current members, the benefits formula is 2.5% of FAC times years of service before 7/1/01, plus 2.67% for years of service earned thereafter. This bill removes the higher benefit factor for service after 7/1/01 for new hires. For new hires, FAS will exclude increases in compensation to 10% per year for the 60-month period that begins 24 months before the 36 months used in the calculation of FAC. Employees so limited are entitled to a prorated refund of their contributions for the appropriate period. Also, the legislature reduced the COLA for new hires, from the current method that provides a gradually-increasing COLA up to 5% annually for those retired 14 years. New hires will receive a COLA that rises to 4% annually after 12 years of retirement.			
NY	As of 1/1/10, employee rate for new hires rises from 3.0% for the first 10 years and 0% thereafter to 3.0% lifetime for State employees and 3.5% lifetime for teachers.	The legislature approved a new tier for those hired on or after 1/1/10, featuring a) 10-year vesting (up from 5); b) a cap on the portion of the retirement benefit that can come from overtime pay; and 3) larger reductions for early retirement (pre-62). For state employees, no unreduced retirement permitted prior to age 62. For teachers, unreduced retirement is permitted prior to age 62 if at least age 57 and 30 years of service. For teachers, benefit multiplier of 2.0% starts at 25 years of service instead of 20.			
OH					The Ohio Retirement Study Council directed statewide plans to submit proposals for restoring sustainability, which the legislature is expected to consider in 2010. Proposals vary by system. For example, the STRS, P&F, and Highway Patrol Systems proposed higher contribution rates for employees and employers. All but the Highway Patrol system proposed more stringent eligibility criteria for both normal and early retirement, thru either higher age or more years of service, or both. All but STRS proposed reducing payments to retiree health care funds. For detail on each systems' proposal, see the comparative grid at the Ohio Retirement Study Council website: http://www.orsc.org/uploadpdf/Updated_Comparative_Summary.pdf
OK					
OR	Under current actuarial methods (including fair market value of assets), employer contribution rates generally would increase from 12% to 18% on 7/1/11. This increase is capped by a rate collar policy adopted by the PERS board, which limits biennial employer contribution rate increases to 6% of covered payroll if the employer's individual or pooled funded status falls below 80% (excluding pension obligation bond side accounts). Most PERS employers would be below this level, although some employers may still have an individual funded status above 80%, so their rate increase would be limited to 3% of covered payroll. Member contributions are fixed in statute at 6% of covered salary.				The PERS board is considering revising its rate collaring policy. For example, they may choose to revise the upper limit on employer rate increases so they would slope from a 3% maximum increase at 80% funded to a 6% maximum at 70% funded, instead of rising from 3% to 6% in one step if funded status falls below 80%. Alternatively, they may impose an ad hoc limit on employer rate increases for the 11-13 biennium at 3% or 4.5% of covered payroll, instead of having them rise the full 6% (assuming the employer's funded status falls below 80%).
PA	Legislature approved bill permitting City of Philadelphia to raise sales tax to fund cost of pension benefits.		Legislature approved bill permitting City of Philadelphia to extend funding amortization period to reduce near-term costs.		

Sources: Retirement systems, NCSL, media reports

Compiled by NASRA

12/22/2009

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
RI		Reduced benefits for state employees, teachers and judges not eligible to retire on or before 9/30/2009, by increasing retirement age to 62 with a methodology that proportionally changes age requirement based on years of service, so the closer one is to retirement, the less the impact. Also, increased FAS calculation period from 3 years to 5, and reduced COLA to lesser of CPI or 3.0%. Also, allows purchased credit to count toward total service time but not toward vesting (as in current law), and provides that credit must be purchased at full actuarial cost after 6/16/09.			
SC					
SD			Reduced assumption for expenses and increased funding period from 20 to 30.		In November 2009, the SDRS board proposed a reduction in the auto-COLA, from 3.1% to 2.1%, linking COLA to plan funding level, and a reduction in the benefit for terminating plan participants. Also, the legislature is expected to stiffen return-to-work provisions, including reducing retirement benefit and eliminating benefit accruals for employees who have returned to work.
TN	Effective 7/1/10, employer contribution rate for teachers will increase from 6.43% to 9.05%, and for state employees from 13.02% to 14.91%.		Adjusted funding period to 20 years, from 18.		
TX	Legislature increased state employee contribution rate from 6.0% to 6.45%. The State may increase its contribution to 6.95% based on interpretation of the appropriations bill and an AG opinion. If the state contribution increases, the employee contribution will rise to 6.5%. Also, the state contribution (employer) rate to TRS was increased from 6.58% to 6.644% after the Attorney General ruled a $500 13th check was not structured properly by the Legislature.	For state employees hired after 9/1/09, normal retirement eligibility increases to 65/10 or the Rule of 80 at age 60, with a reduction for each year of age under 60. Current provisions are 60/5 or the Rule of 80 with no minimum age. Also, new hires may no longer apply unused annual leave or sick leave toward retirement eligibility, but may continue to use in determining the annuity amount. FAS period increases from highest 36 to highest 48 months. Annuity will be reduced 5% for each year short of age 60, with a maximum reduction of 25%. Similar provisions apply to newly-hired law enforcement and custodial officers, who have a normal retirement age of 55. Also, return-to-work changes require employers who hire an employee who retires after 9/1/09 to pay the ERS trust fund a surcharge equal to the retirement contribution that the employer would make for an active employee, and to wait at least 90 days before hiring an employee who retires after 5/1/09.	Actuarial cost method for funding purposes was changed such that the total liability is based on the benefit provisions for each member and the normal cost rate is based on the benefit in effect for members hired after August 31, 2009		
UT			Board approved broadening funding corridors from 80/120 to 75/125. Also, the amortization period was moved from 20-year open to 25- year fixed, but moving each year over the next 5 years to a 20-year open period again.		Legislature is expected to consider freezing the existing DB plan and providing a different plan for new hires. The new plan will be either a pure DC plan or a hybrid plan which will include a DB plan with a 1% multiplier combined with a DC contribution. Retirement eligibility will be based upon Social Security eligibility. The new plan would be for all public employees, including public safety, firefighters, judges, teachers, and others. Existing employees may have their 30-year at any age retirement moved incrementally to 35-year eligibility, and public safety and firefighters may move from 20- to 25-year retirement eligibility. Since the existing plans are noncontributory, members cannot be asked to pay into the system. The new plan will have a contributory element.
VA			Temporarily suspended 120/80 funding corridor; "substantial asset losses have been recovered since the valuation date, and a 5-year projection of contribution rates shows little difference with or without the corridor."	The legislative watchdog agency, JLARC, issued a study on state employee compensation in December 2008, which devotes a chapter to retirement benefits and presents a number of changes in plan design that would produce either short or long-term savings.	The VRS Board is requesting an increase in contribution rates for state employees and school teachers, currently funded at 11.26% and 13.81% respectively, to 13.46% and 17.91%. Requested rates are unlikely to be funded, however, due to major budget reductions. When the General Assembly convenes in January, numerous proposals are expected. Among those that will gain most attention are 1) phase in a mandatory employee contribution that was eliminated in the 1980's; 2) revise the COLA formula to change the manner in which it matches the CPI; and 3) increase the age at which new members can qualify for an early unreduced retirement benefit.

Sources: Retirement systems, NCSL, media reports

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
VT			Legislature extended funding period of the VRS from 2018 to 2039.	Legislature created a commission to review and report on the design and funding of retirement and retiree health benefit plans for state employees and teachers. The commission is charged with making recommendations about plan design, 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. The joint fiscal committee may provide benchmark targets reducing the rate of expenditure growth for retirement and retiree health benefits to the commission to guide the development of recommendations.	
WA			Legislature directed reduction in salary growth assumption, from 4.25% to 4.0%; postponed adoption of revised mortality tables and minimum required contribution rates; and directed that new funding method be phased in, saving an estimated $450 million over the biennium.		
WI	The WRS governing board increased the 2010 contribution rates by 0.6% for general category employees, of which 0.3% is on the employer portion and the other 0.3% is on an employee-related portion (which the employer can agree to pay). The rates for general category employees were 10.4% of salary in 2009 and will be 11.0% of salary in 2010.	Generally, monthly annuities on the Core Fund component of plan benefits decreased 2.1% effective May 1, 2009 as a result of the 2008 market decline. In addition, monthly annuities on the Variable Fund (a voluntary all-stock option) portion of plan benefits decreased 42% effective May 1, 2009 as a result of the 2008 market decline.			
WV		Legislature established new, consolidated statewide plan for new public safety hires, featuring lower benefits and 40-year funding basis.			
WY					Legislature is expected to consider higher employer and employee contributions. Also, a closed plan for firefighters is considering increasing its amortization period from 10 years to 20.

Legal Advisory Report, Ice Miller, LLP

Report begins next page.

VERMONT COMMISSION ON DESIGN AND FUNDING OF RETIREMENT AND RETIREE HEALTH BENEFITS

LEGAL ADVISORY REPORT

Preliminary Draft

Attorney-Client Communications

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REVIEW OF VERMONT LAW AND ANALYSIS:

Beth Pearce
VERMONT STATE TREASURER'S OFFICE

October 5, 2009

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I. INTRODUCTION

Pursuant to a Request for Proposals ("RFP"), Ice Miller LLP ("Ice Miller") was retained by the Vermont Commission on Design and Funding of Retirement and Retiree Health Benefits Plans for State Employees and Teachers ("Commission") to perform the following services: (a) Review constitutional, legal, and contractual issues relative to the provision of, and revision thereto, of governmental pension and retiree health benefits; (b) Advise the Commission on the legality, under state and federal law, of options to modify existing Vermont State benefit design, structure, and contribution levels consistent with the charge of the Commission; (c) Review proposed pension benefit, design, or contribution level revisions to assure compliance with IRS and other regulatory compliance for governmental plans; and (d) Provide other legal consultation services as requested by the Commission.

This report addresses (a) and (b) described in that RFP.

Ice Miller works with retirement systems in 32 states and has had the opportunity to review the constitutional and state law protections in most of those states. The purpose of this report is to provide you with an overview of those constitutional and state law protections, and then to identify how Vermont fits into that overview. A detailed summary of state constitutional provisions and cases is attached as Appendix A to this report.

Vermont state employees participate in the Vermont State Retirement System ("VSRS"). Vermont public school teachers participate in the Vermont State Teachers' Retirement System ("VSTRS"). The Vermont municipal employers and their employees may participate in the Vermont Municipal Employees' Retirement System ("VMERS"). We will address solely the VSRS and VSTRS in this report.

The purpose of this report is not to recommend or suggest any particular changes to the benefit structure, but rather to provide background on the legal issues associated with changes. Of course, any decisions on benefit changes would also require consideration of many other ramifications, to identify but a few:

- sufficiency of benefits,
- competitiveness of total benefit package for public employees,
- effects of changes on retirement decisions, retention, recruitment, and workforce demographics,
- effects on funded status, and
- employee and employer contribution needs.

This report cannot predict the outcome of any particular litigation. The outcome of litigation depends on the specific facts and issues that are presented, how the litigants argue their respective cases, and how a court applies the law. The Vermont Attorney General's office is responsible for advising state agencies directly on these matters.

II. FRAMEWORK FOR ANALYSIS

A. Federal Constitutional and Common Law

1. The Contract Clause

Article I, section 10, clause 1 of the United States Constitution states: "No State shall … pass any … Law impairing the Obligation of Contracts." ("Contract Clause"). This clause applies only to the States (the Due Process Clause applies to the federal government and provides similar protection). There is no specific definition of what constitutes a contract or whether pension obligations are covered.

The Contract Clause was drafted to prevent states from enacting debtor relief laws, but under Chief Justice Marshall the Contract Clause was given an expansive reading to prohibit states from impairing agreements to which the state was a party. Ronald D. Rotunda and John E. Nowak, Treatise on Constitutional Law § 15.8 (4th ed. 2007) ("Rotunda and Nowak").

2. The U.S. Trust Case

In 1977 the United States Supreme Court issued United States Trust Co. v. New Jersey, 431 U.S. 1 (1977). In this case the New Jersey legislature sought to repeal legislation implementing a limitation agreement which was designed to reassure Port Authority bondholders regarding the financial security of the bonds. The Court found that because the legislation was seeking to relieve the state of its own obligations, deference to legislative judgment was not appropriate. Therefore, the Court assessed whether the state's action was "necessary and reasonable." The Court found the law to be neither, because alternative means were available to promote the goals of the legislation.

Any analysis of state action needs to consider the possible applicability of the Contract Clause. If federal courts were to treat governmental pensions as constituting contracts (to whatever degree), the courts could follow basic three-step analysis for determining whether legislation which impairs the contractual obligations of a governmental unit violates the Contract Clause:

a. Step One: Contractual Relationship: Does a contractual relationship exist? The Supreme Court has stated that "[i]n general, a statute is itself treated as a contract when the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State." United States Trust Co., 431 U.S. at 17, n.14. Additionally, "the obligations of a contract long have been regarded as including not only the express terms but also the contemporaneous state law pertaining to interpretation and enforcement." Id. at 19, n.17.

b. Step Two: Substantial Impairment: Does the legislation constitute a substantial impairment of a contractual relationship?

(i) Rights v. Remedies. There is no clear distinction between rights and remedies, but laws regulating only the form of remedies to enforce state obligations may be considered an insubstantial impairment of the contract.

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(ii) Reservation of Right to Modify. From the beginning, the Supreme Court has held that, if a state reserved the right to modify the terms of the contract, either by a provision in the contract or a general statutory scheme, the state could subsequently modify the contract without violating the Contract Clause. See, e.g., Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518, 666 (1819) (Story, J. concurring opinion). However, later cases have required a very explicit reservation to allow modification if a third party has accrued rights under the contract—a general reservation is insufficient. If a state explicitly reserves the right to modify benefit levels, any subsequent modification may be considered an insubstantial impairment. See Rotunda and Nowak.

c. Step Three: Narrowly Tailored to Serve a Public Purpose: Is the law that impairs the obligation justified by a significant and legitimate public purpose? Is the method used to advance the public purpose reasonable and necessary?

(i) Police Powers v. Economic Obligations. A state cannot bargain away its police powers, which are necessary for the protection of the health and safety of its citizens. However, states will be held to their economic obligations if unrelated to a police power. See Rotunda and Nowak.

(ii) Reasonable. Whether a method is reasonable should be judged in light of whether the effects which the legislation is seeking to remedy "were unforeseen and unintended by the legislature" when the statute creating those obligations and rights was adopted. United States Trust Co., 431 U.S. at 27.

(iii) Necessary. To be considered necessary, two conditions must be satisfied. First, no less drastic modification could have been implemented. Second, the state could not have achieved its stated goals without the modification. Id. at 29-30.

B. Overview of Other State Laws

We have attached to this report a multi-state survey of constitutional provisions and case law, concerning pension and retiree health benefit protections. See Appendix A.

1. Constitutional Provisions

As is indicated in Appendix A, states fall into three categories with respect to state constitutional protections for pension and retirement benefits:

a. No constitutional provision. This would the category in which Vermont would fall.

b. General constitutional protection of contracts.

c. Specific constitutional protection of pension and retirement benefits.

2. Court Interpretation of Constitutional Provisions

a. For states with no constitutional provision, a limited number of state courts have found that pensions are a gratuity to which no protection applies. Other states in this category have applied the federal Contract Clause.

b. For states where a general constitutional contract clause protection is applied to pension and retirement benefits, there is a wide variation among state courts as to when that contract clause protection vests:

(i) Upon commencement of employment

(ii) Upon commencement of participation in the plan.

(iii) After fulfilling service requirements

(iv) Upon eligibility for a pension

(v) Upon retirement.

c. For states with specific constitutional protection of pension and retirement benefits, the cases are more apt to find an earlier vesting of the contract than in those states with only a general contract clause.

d. Courts in states which recognize a constitutional protection of pension and/or retirement benefits have also recognized that benefits may be subject to modifications in limited circumstances. These limited circumstances include:

(i) Where a disadvantage is offset by an advantage.

(ii) Where a change is reasonable and necessary to preserve the pension system.

(iii) Where a change is reasonable and necessary to maintain the integrity of the pension system.

(iv) Where the creator of the plan has reserved the right to amend the plan.

We believe that preservation of the pension system may be a different concept from maintaining the integrity of the pension system. Although this difference is not fully developed in the cases, we believe that the sustainability of the pension system (funding, contribution levels, benefit levels, cash flows) is clearly the key concept in maintaining a pension system. On the other hand, integrity may encompass benefit design and benefit administration issues, such as avoiding benefit spiking, compliance with federal laws, and achieving the goals of the pension system.

3. <u>What Generalizations are Found from Other States?</u>

From Appendix A, there seems to be little variation among the state law decisions on the following points:

a. Those individuals who are hired after a change occurs cannot claim that their rights have been impaired.

b. On the other hand, in most states employees who are actually retired and receiving benefits are protected as to the benefit being paid (barring erroneous benefit payments, and perhaps not as to any prospective changes (<u>e.g</u>., COLAs) to the benefit).

c. In most states, employees who are currently eligible for an immediate benefit have protected rights to that benefit.

d. In contrast, in most states, when constitutional or statutory language specifies vesting requirements, individuals who have not satisfied those requirements probably have lesser or no protection.

As to the remaining population, there are numerous cases across the country that explore all these issues, and they reach different conclusions. We realize this is not a "bright line" situation, but rather, a complex and nuanced one.

4. <u>Questions Left Unanswered by Court Cases</u>

What is often left unanswered by the general holdings of existing court cases is what is the exact nature of the protection afforded by the Constitution:

a. If an employee started employment when benefits were X and benefits over time have been increased to 2X, is the employee who is still working vested in X or 2X?

b. Does the protection cover solely the "core" retirement benefit, e.g., X% times years of service times final average salary?

c. Does the protection cover any other benefits, e.g., post-retirement benefit increases, employee/employer contribution levels?

d. Does the protection extend only to benefits accrued to the date of the impairment, or to the completion of the person's career?

III. <u>VERMONT AUTHORITY</u>

A. <u>Vermont Constitution</u>

We understand from the Treasurer's office that there is nothing in the Vermont Constitution concerning contract or pension rights. This would place Vermont in the "company" of Connecticut, Delaware, Kansas, and Maryland. However, in each of these states, state courts

have established certain protections for contractual rights. Therefore, in the next section of this report, we summarize existing Vermont cases and indicate how they compare to other state law cases and the U.S. Trust case.

B. Vermont Case Law

1. Burlington Case

The first Vermont case to consider contractual rights with respect to public pensions appears to be the Burlington Fire Fighters' Association v. the City of Burlington, 543 A.2d 686 (Vt. Sup. Ct. 1988). This case involved a City retirement ordinance amendment enacted on October 29, 1984, made retroactively effective to July 1, 1983. The plaintiffs (the Burlington Fire Fighters' Association and the Burlington Fire Fighters' Officers Association) challenged the validity of the retroactive application of the ordinance. The ordinance itself contained a number of benefit improvements, but did increase both the amount (4½% to 6%) and the period (25 to 35 years) of employee contributions. The challenge was not to the City's authority to change pension benefits, but rather to apply changes retroactively. The Vermont Supreme Court found that the City had the power to enact retroactive provisions since "absent express statutory constitutional language to the contrary, the ability to enact retroactive provisions to the pension ordinance may be necessarily fairly implied from the powers which have been expressly granted . . .", citing 24 V.S.A. 1121, 1122 and Senter, 72 Vt. at 113, as well as 6 McQullin Mun. Corp. § 20.70 (3rd ed. 1988) since "(in the absence of constitutional prohibition, retroactive municipal legislation is permissible unless it interferes with contract obligations or vested rights)." The Burlington case did not consider benefit changes to VSRS or VSTRS. However, we believe that analyzing the case gives some indication of the Court's thinking on the question of what legal approach would be applied if the Vermont legislature modifies benefits for VSRS and VSTRS.

In considering contract impairment, the court found

> . . . where an employee makes mandatory contributions to a pension plan, that pension plan becomes part of the employment contract as a form of deferred compensation, the right to which is vested upon the employee's making a contribution to the pension plan. See *Snow v. Abernathy,* 331 S.2d 626, 631 (Ala.1976) (pension is vested contract right upon acceptance of plan); *Olson v. Cory,* 27 Cal.3d 532, 540, 636 P.2d 532, 537, 178 Cal.Rptr. 568, 573 (1980) (pension plans create vested contract rights accruing upon acceptance of employment); *In re State Employees' Pension Plan*, 364 A.2d 1228, 1235 (Del.1976) (pension is vested contract right for employees who fulfill pension's eligibility requirements); *Halpin v. Nebraska State Patrolmen's Retirement System*, 211 Neb. 892, 898, 320 N.W.2d 910, 914 (1982) (public employee pensions are deferred compensation and create "'reasonable expectations which are protected by the law of contracts'") (quoting *Pineman v. Oechslin*, 494 F.Supp. 525, 538 (D.Conn.1980)).

Having found a contract right, the Vermont Supreme Court then considered the Contract Clause of the United States Constitution. U.S. Const., Art. I, § 10, Cl. 1:

> To trigger the constitutional protection of the Contract Clause, there must first be an impairment of a contract. *Id.* [*United States Trust Co. v New Jersey*, 431 U.S. 1, 17, 97 S.Ct. 1505, 1515, 52 L.Ed.2d 92 (1977)]. Assuming plaintiffs establish the existence of an impairment, such impairment only violates the clause if it is not reasonable and necessary to achieve an important public purpose. *Id.* at 25, 97 S.Ct. at 1519. The United States Supreme Court has suggested that an overall determination of reasonableness be used to evaluate challenged legislation under the Contract Clause. *Id.* at 22 n. 19, 97 S.Ct. at 1517 n. 19 (citing *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398, 445-47, 54 S.Ct. 231, 242-43, 78 L.Ed. 413 (1934)). An employee's vested pension rights may, therefore, be modified prior to retirement if such modifications are reasonable, since it allows the pension system to adapt to changing conditions. See *Olson*, 27 Cal.3d at 541, 636 P.2d at 537, 178 Cal.Rptr. at 573; *Singer v. City of Topeka*, 227 Kan. 356, 366, 607 P.2d 467, 475 (1980); *Bakenhus*, 48 Wash.2d at 701-02, 296 P.2d at 540.
>
> [7] To be sustained as reasonable, "'alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation . . ..'" *Bakenhus*, 48 Wash.2d at 702, 296 P.2d at 540 (quoting *Allen v. City of Long Beach*, 45 Cal.2d 128, 131, 287 P.2d 765, 767 (1955)); see *Singer*, 227 Kan. at 366, 607 P.2d at 475. Furthermore, any changes in the plan which result in disadvantage to the employees must be accompanied by comparable new advantages. *Bakenhus*, 48 Wash.2d at 702, 296 P.2d at 540 (citing *Allen*, 45 Cal.2d at 131, 287 P.2d at 767).

The court found that:

> In the instant case, the amendments to the pension plan bear close relationship to the continued success of the pension system to meet the changing needs of municipal employees. Plaintiffs agree that the City had the power to amend the pension ordinance and that the changes made by the new ordinance are beneficial. Although the amendments have a retroactive effect, the fact that legislation is retroactive is not by itself sufficient to establish a violation of the contract clause. *United States Trust Co.*, 431 U.S. at 17, 97 S.Ct. at 1515. In this case the retroactive effect of the increased benefits is simply being offset by the requirement of retroactive contributions. In effect, we find that plaintiffs have not shown that the ordinance amendments created a constitutional impairment of their contract.

The court also rejected an equitable estoppel argument.

2. Cases Cited by Burlington Case

The Vermont Supreme Court cited a number of cases in the Burlington case from other states.

First, for the proposition that a right becomes vested "upon the employee's making a contribution to the pension plan" four cases were cited. This section gives additional details on those cases:

- Snow v. Abernathy, 331 So.2d 626 (Alabama Sup. Ct. 1976): Largely based on voluntary participation and employee election, case concluded that there had been a vesting of contract rights, citing Smith v. City of Dothan, 279 Ala. 571 (Alabama Sup. Ct. _____).

- Olson v. Cory, 636 P.2d 532 (Calif. Sup. Ct., 1980: Case concluded that limits on cost-of-living salary increases cannot be applied to judges who are mid-term if the judge served prior to January 1, 1977. It also discussed the rights of those in pension payment status. The court relied on "a long line" of California cases holding that a "public employee's pension rights are an integral element of compensation and a vested contractual right accruing upon acceptance of employment" citing Betto v. Board of Administration, 582 P.2d 614 (Calif. Sup. Ct.) and Kern v. City of Long Beach, 179 P.2d 799 (Calif. Sup. Ct.). The court summarized the position that while an employee does not obtain any absolute right to fixed or specific benefits, there are strict limitations on the conditions which may modify the pension system in effect during employment. Modifications must be reasonable and disadvantageous changes should be accompanied by comparable new advantages. The case did not seem to rely on voluntary contributions as a crucial factor.

- In re State Employees' Pension Plan, 364 A.2d 1228 (Del Sup. Ct. 1976): Delaware has a mandatory contribution structure. The court found that vested pension rights exist at least as to individuals who have statutory vested rights or who have otherwise fulfilled eligibility requirements for a pension.

- Halpin v. Nebraska State Patrolmen's Retirement System, 320 N.W.2d 910 (Nebraska Sup. Ct., 1982): This case involved a change to the calculation of the benefit for state police. The court found that the Nebraska statutes at issue contained no provisions preventing vesting until a certain time, thus legitimate expectations were raised that the amounts in issue would be included in the calculation.

Second, in order for the Contract Clause to apply, the Vermont Supreme Court found there must be an impairment of the contract which is not reasonable and necessary to achieve an important public purpose, such as allowing the pension system to adapt to changing conditions. The court cited three cases:

- Olson (see above).

- Bakenhus v. City of Seattle, 296 P.2d 536 (Supreme Court of Washington, 1956): Washington Supreme Court found a pension is deferred

compensation for services rendered, as a gratuity would be prohibited under the Washington Constitution as a gift of public funds, and further found that the contractual promise arises at employment. The court found this contract was for a "substantial pension" at the time of fulfillment of the prescribed conditions. The court recognized that the pension rights could be modified prior to retirement, "but only for the purpose of keeping the pension system flexible and maintaining its integrity."

- See also Allen v. City of Long Beach, 287 P.2d 765 (California Supreme Court, 1955)
- Singer v. City of Topeka, 607 P.2d 467 (__________, 1980) See Brazleton v. Kansas Public Employees Retirement System, 607 P.2d 510 (Kansas Supreme Court) court rejected a "hard and fast rule" of no change, since there "may be times when changes are necessary to protect the financial integrity of the system or for some other compelling reason which would mandate and justify some unilateral changes."

3. Summary of Burlington Approach

The Vermont Supreme Court in the Burlington case upheld a retroactive contribution increase for a municipal plan under the theory that the ability to retroactively amend is implied from the ability to enact. However, the court placed limits on retroactive legislation in an instance where the legislation interfered with contract obligations or vested rights.

Because there is no Vermont constitutional provision on contract obligations or vested rights, the Vermont Supreme Court looked at the contract clause of the U.S. Constitution and the U.S. Trust case. Under the U.S. Trust case, there are three questions to be analyzed:

- Does a contract exist?
- Has the contract been impaired?
- Is the impairment reasonable and necessary to achieve an important public purpose?

Applying the U.S. Trust case to the facts in Burlington, the Vermont Supreme Court found that the amendments bore a close relationship to the continued success of the pension option and that the impact of the retroactive contributions was offset by enhanced benefits. In this situation, no constitutional impairment was found.

4. How Does the Burlington Approach Compare to the U.S. Trust Case and Other State Cases?

a. If/When a Contract Arises.

The cases that were cited by the Vermont Supreme Court with regard to if/when a contract arises for pension benefits do not necessarily present a consistent picture, demonstrating the challenge in reconciling cases with different facts and different underlying statutes. If the

Burlington decision indicates that all four cases should be applied, then one way to achieve that would be to use the following interpretations from the cases:

(i) A voluntary participation system creates vested contract rights when the election to participate or contribute is made by the employee.

(ii) In a mandatory system, an employee who has met statutory requirements for vesting or for a pension has contractual rights to that vested amount or that pension.

(iii) In a mandatory contribution system, an employee has the right to participate in the pension system upon employment, but has no absolute or fixed right to a benefit until the employee meets the statutory requirement for vesting or for a pension.

(iv) An impairment does not exist if there is a balance between disadvantageous and advantageous changes.

The above interpretation would be consistent with what we have previously characterized as the generally accepted position in many states and with the U.S. Trust case.

b. Whether an Impairment is Reasonable and Necessary.

The cases that were cited by the court with regard to whether an impairment was reasonable and necessary to achieve an important public purpose present a consistent picture. The cases cited would permit an impairment in the following circumstances:

(i) When the impairment is reasonable and necessary to achieve an important public pursuit such as to protect the financial integrity of the system or to keep the pension system flexible, or

(ii) When there is a compelling reason that justified unilateral actions.

This interpretation would also be consistent with the position in many states and with the U.S. Trust case.

5. Jacobs Case

The next case to consider is Jacobs v. State Teachers' Retirement System, 816 A.2d 517 (Vermont Supreme Court 2000). In this case Ms. Jacobs brought a class action suit against VSTRS to recover the amount of a service purchase plus interest, claiming the system had breached statutory and fiduciary duties to her. The question presented to the Court was whether VSTRS was protected by sovereign immunity so that Jacobs and other class members could not recover. The Court concluded that (1) the State of Vermont would ultimately be responsible for the payment of any money judgment paid to the plaintiffs and (2) the system was an arm of the state. As a result, the Court held that sovereign immunity prevents a suit for money damages absent a waiver. Ms. Jacobs took the position that under a contract theory the state had waived its immunity. Her specific claim was that VSTRS had not provided her with accurate

information and that constituted a contract breach. The Court considered this argument but did not decide whether Ms. Jacobs had established that a contract existed. Instead the Court issued a very narrow decision on the issue that a failure to provide accurate information was not a breach of contract. In its discussion of this decision, the Court stated the following:

> State-created contract rights may be entitled to constitutional protection. See Halpin, 320 N.W.2d at 914. As a result "before governmental action will be held to grant a constitutionally protected contract right, the intent to do this must be expressed in clear and unmistakable language." Robert T. Foley Co. v. Wash. Suburban Sanitary Comm'n, 289 A.2d 350, 358 (Md. 1978). Thus there is a "recognized presumption that statutory enactments do not create contractual obligations in the absence of an 'unmistakable' intent on the legislature's part to do so." McGrath, 88 F.3d at 19.

6. Summary of Jacobs Reasoning

The Jacobs case is a narrowly drawn decision. However, it is very important in the following respects:

1. At least with respect to VSTRS, it makes available the argument of sovereign immunity as a defense to legal action, although there could possibly be a waiver of that immunity for a contract breach.

2. It seems to stand for the proposition that a contract is only created through government action if the intent to create a contract is clearly and unmistakably expressed.

7. How Does the Jacobs Case Compare to Other States Case Law?

The Jacobs case addresses an issue that is an important part of the U.S. Trust analysis – has the state created a contract. The Jacobs case is very helpful in providing direction to look specifically at state legislative action to determine if a contract has been created.

8. Kaplan Case

In July, 2009, the Vermont Superior Court issued a decision in Kaplan v. Morgan Stanley & Co., 47 EBC 1891 (Vermont Sup. Ct., 2009). This case involved the Town of Stowe and its police pension programs. It was decided on a statute of limitations basis, but the court discussed equitable estoppel ("which requires a showing that a defendant's conduct in some way induced the plaintiff to delay bringing suit") and equitable tolling (which applies "either where the defendant is shown to have actively misled or prevented the plaintiff in some extraordinary way from discovering the facts essential to the filing of a timely lawsuit, or where the plaintiff has timely raised the same claim in the wrong forum").

C. Vermont Attorney General

We were supplied by the Treasurer's Office with a number of Attorney General letters and memoranda. These were not official opinions of the Attorney General. This section contains a discussion of the ones we thought would be most relevant to the Commission 's work.

1. 2002 McShane Memorandum

On January 10, 2002, a memorandum was issued by Mike McShane, as Assistant Attorney General, regarding the potential for legal challenge if legislation was passed to establish a year of service requirement for the retiree medical state subsidy and to establish a minimum number of years of service to be eligible for a retirement benefit. The memorandum stated that:

> The Contract Clause of the United States Constitution limits the ability of states to pass laws that impair contractual obligations. The Contract Clause does not absolutely prohibit laws, which impair contractual obligations. Rather the United States Supreme Court has held that laws, which result in substantial impairment of contractual relationships, are prohibited unless the impairment is reasonable and necessary to serve an important public purposes. General Motors v. Romein, 503 U.S. 181 (1992).

This memorandum also addressed the status of Vermont state law as follows:

> I am aware of no decision from the Vermont Supreme Court that holds that the Vermont State Employees Retirement System creates contractual rights. [Footnoting that "There is a case suggesting that the municipal retirement system is contractual in nature. Burlington Fire Fighters v. City of Burlington, 149 Vt. 293."] However, most courts that have addressed this question in other states have held that public pension plans do create contractual rights.

This memorandum went on to emphasize that "[I]f it is assumed that the Retirement System creates contractual rights, the more difficult question is to whom do those rights apply." Mr. McShane then reviewed a Maine case finding that contractual rights of members not yet receiving pension benefits were not violated by changes in the system. He also commented that some state cases (not Vermont cases) suggest "there is a substantial risk in applying benefit reductions to existing employees, particularly employees who have vested."

The memorandum identified the following legal analysis, which follows the U.S. Trust approach:

> In order to successfully challenge the proposed legislative changes any plaintiff would have to establish the following:
>
> 1. That the Retirement System creates contractual rights and benefits.
>
> 2. That the plaintiff has rights which are protected under the contract and that those rights are impaired by the amendments.
>
> 3. That the impairment of rights are not reasonable and necessary to serve an important public purpose.

2. 2003 and 2005 Asay Memoranda

On June 2, 2003 [also dated May 29, 2003], a memorandum was issued by Ms. Bridget Asay, an Assistant Attorney General concerning changes to teachers' retiree health benefits. This memorandum stated that:

> The Vermont Supreme Court has not directly considered whether state retirement benefits are constitutionally protected. But the Court has recognized, in the retirement context, that "[s]tate-created contract rights may be entitled to constitutional protection." Jacobs v. State Teachers' Retirement Sys., ____ Vt. ____, 816 A.2d 517, 526 (2002). To find a constitutionally protected contract right, the State's intent to create such a right 'must be expressed in clear and unmistakable terms.' Id. The Court in Jacobs stated further that 'statutory enactments do not create contractual obligations in the absence of an 'unmistakable' intent on the legislature's part to do so.' Id.

(Note: The same language as immediately above was also used in a November 14, 2005 memorandum from Ms. Asay, again on health benefit rights.) The ultimate conclusion in both the 2003 Asay memorandum and the 2005 Asay memorandum was:

> At most, members who retired after May 22, 1996, may have constitutionally protected rights to (1) access health and medical benefits through plans approved by the Board, with the Board retaining discretion to determine the terms of those plans; and (2) have the System pay some portion of the cost of health and medical benefits, with the Board retaining discretion to determine the System's share of the cost. It is not clear whether a court would find these rights enforceable. Because the amount and scope of the benefit is left to the Board's discretion, a court might find that the Legislature did not intend to create enforceable rights. On the other hand, a court might conclude that the right to access health and medical benefits in some form is clear, and that right is valuable enough, even if retirees must pay most of the cost, to be constitutionally protected.

3. 2005 McShane and Griffin Emails

Earlier in 2005 there was an exchange of emails between the Attorney General's Office and Cynthia Webster. The original question from Ms. Webster was whether anything in the state retirement statutes directly states that it is not possible to reduce retirement benefits. Mr. McShane's response (dated March 31, 2005) was:

> There is not a specific statutory provision that so states. However, U.S. Constitution contains what is referred to as the Contract Clause. The Contract clause has been interpreted to invalidate legislation which impairs vested contract rights. The Vermont Supreme Court has discussed the contracts clause in situations which are not exactly on point. The clause is found at Article I, Section 10 of the Constitution. It is an enumeration of the powers denied to the states and quit [sic] directly states that no state shall pass a law "impairing the obligation of

contracts." Of course it is possible to change benefits for new hires but vested contract rights cannot be retroactively altered.

Mr. Griffin responded that same date that:

> I agree with Mike that 'vested contract rights cannot be retroactively altered.' The more interesting question in the context of a public retirement system is what contract rights have 'vested' and what changes might be characterized as 'retroactive.' The answers to these questions would depend on the nature of the benefits (for example, cash or insurance), the specific statutory language that governs those benefits, any statutory and plan changes over time, the extent of those changes, the circumstances of particular retirees and other factors.

Mr. Griffin then cited the Asay 2003 Memorandum and concluded:

> It is difficult to predict how the courts will ultimately decide these issues, and the outcomes may be very fact specific. To my knowledge the AG's Office has not done the research and analysis that would be needed to provide legal advice on any proposals to alter any retirement benefits other than that reflected in the Asay memorandum.

4. **2006 Rice Memorandum**

We note that there is also a June 5, 2006 memorandum from William H. Rice, Office of State Treasurer, reviewing whether the State Employee Retirement Board has the same discretion to change state retiree medical benefits as the Asay memoranda reflects for teachers' retiree medical benefits. The memorandum reviewed the statutory provisions regarding modifications of retiree medical benefits for state employees and then reviews the Burlington standard:

> "where an employee makes mandatory contributions to a pension plan, that pension plan becomes part of the employment contract as a form of deferred compensation, the right to which is vested upon the employee's making a contribution to the pension plan." Burlington Fire Fighters Association v. City of Burlington.

The memorandum further observed that the Vermont Supreme Court had determined that vested pension rights may be modified prior to retirement if such modifications are reasonable "since it allows the pension system to adopt to changing conditions." Id. at A.2d at 690. The memorandum also observed that the Vermont Supreme Court had:

> established a two part test of reasonability: 1) "[t]o be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation" and 2) "any changes in the plan which result in disadvantage to the employees must be accompanied by comparable new advantages." Id. 149 Vt. at 298, 543 A.2d at 690.

5. Summary of Attorney General Analyses

The memoranda from the Assistant Attorneys General have reviewed the Burlington case and found that it would have limited application to the question of whether state pension benefits can be modified. The memoranda have generally followed the U.S. Trust case in that a three part analysis must be followed:

1. Is there a contract and what are the terms of that contract?

2. Has that contract been impaired?

3. Is there a legally acceptable reason for that impairment?

With respect to retiree health benefits, the memoranda have not concluded whether there is state law protection for retiree health benefits, although there may be some protected rights to access.

These memoranda are very consistent with general state law principles and the U.S. Trust case. We will consider these memoranda in more detail as we consider the Commission's specific questions.

IV. APPLICATION OF CONSTITUTIONAL AND STATE LAW PRINCIPLES

A. Pension Benefits

Following the rationale in the Vermont cases (primarily Burlington and Jacobs), we have reviewed the statutes governing VSRS and VSTRS to identify statutory provisions that could be construed as clearly established contract rights with respect to pension benefits. This is in keeping with the U.S. Trust case and the AG Memoranda which set forth the first step in the analysis as identifying if a contract has arisen.

a. In this regard, we believe that in VSRS the legislature has identified an individual with 5 years of creditable service as being "vested." Such a member may allow employee contributions to remain in VSRS and "receive a deferred vested retirement allowance," based on their compensation and service at termination. (Title 3, Chapter 16, § 465)

b. With regard to VSTRS, we believe this same status is established under Title 16, Chapter 55, § 1940(a).

c. With regard to benefit payment, we also believe that the Vermont statutes establish entitlements at certain combinations of age and service. See for example Title 16, Chapter 55, § 1937(a) for VSTRS and Title 3, Chapter 16, § 455(13) for VSRS.

d. In addition, both VSTRS and VSRS are established as qualified governmental pension plans under Internal Revenue Code Sections 401(a) and 414(d). Under these Sections, benefits must be vested upon attainment of normal retirement age

and upon plan termination, to the extent funded. (***Note*:** Both VSTRS and VSRS were submitted for IRS approval and those applications are still pending.)

Based upon the foregoing and applying the general principles of the state law cases and the Jacobs rationale, we believe the contractually protected members would be:

a. VSRS and VSTRS members who have reached normal retirement age are vested in their benefits because the legislature has clearly said that VSRS and VSTRS are qualified, governmental pension plans.

b. VSRS and VSTRS members who have reached eligibility for normal or early retirement benefits have a contract right in those benefits because the legislature has said that they are entitled to these benefits.

c. VSRS and VSTRS members who have at least five years of service are vested in their accrued benefit and thus have a contract right with respect to that benefit (leaving open the question of what is a member's "accrued benefit" at any point in time, and whether the protection extends to benefits not yet earned or accrued).

d. VSRS and VSTRS members who do not have five years of service are not vested in a benefit and thus have no contract right.

We realize that this analysis leaves a "middle group" (those who are vested but have not reached eligibility for a benefit) where the Commission must analyze whether a contract right exists with respect to a particular benefit feature. In this regard, we recommend that the Commission do additional fact finding with respect to any specific changes it is interested in. This would include identifying if there has been any modification to the plan with respect to that benefit feature at any time or times during the career of the middle group. This will be helpful to measure the length of time that the benefit feature has been applicable. The Commission may also wish to consider any other relevant facts concerning any new tiers or coverage changes affecting the middle group.

Under the U.S. Trust case and the state law principles, including cases cited in the Burlington case, these contractually protected benefits could be modified ("impaired") in the following situations:

a. Where a disadvantage is offset by an advantage.

b. Where the stability or the integrity of the pension system requires the change and the change is reasonable.

c. Where a compelling situation requires unilateral change.

B. Retiree Health Benefits

With regard to retiree health benefits, Title 3, Chapter 21, Section 631 provides that

> "the secretary of administration may contract on behalf of the state with any insurance company … to secure the benefits of franchise or group insurances. Beginning July 1, 1978, the terms of coverage under the policy shall be determined under section 904 of this title [collective bargaining], but may include … hospital, surgical, and medical benefits for any class or classes of state employees or for those employees and any class or classes of their dependents. *** For purposes of group hospital-surgical-medical expense insurance, the term "employees' shall include … former employees … who are retired and receiving a retirement allowance from the Vermont state retirement system or the state teachers' retirement system of Vermont.

As stated in the Asay Memoranda, it is not clear from the above whether the extension of medical coverage to retirees is intended to be a contractual right by the legislature. If the a court were to find that a contract exists, it appears that the contract would only be for access to coverage, not for a particular level of benefits or for a particular level of premiums.

V. VERMONT QUESTIONS

A number of questions have been identified as being helpful to understanding how to apply the legal framework described above.

A. Pension

1. Summary of Pension Groups

a. There are four defined benefit groups under VSRS for state employees. Each group must considered separately for certain purposes:

(i) Group F for state employees

(ii) Group D for judges

(iii) Group C for state law enforcement officers

(iv) Group A original retirement plan which some members elected to remain in, and predecessor to plan F.

b. For VSTRS, there are basically two groups remaining:

(i) Group C for public school teachers employed within the State of Vermont on or after to July 1, 1990. Group B members as of on July 1, 1990, are now in Group C.

(ii) Group A for public school teachers employed within the State of Vermont prior to July 1, 1981 and elected to remain in Group A.

2. **Raising Retirement Age**

Questions: Can the legislature raise normal retirement and/or early retirement age for all current state employees and teachers? Certain current state employees and teachers? Non-vested state employees and teachers? Could ages be changed to reflect the Social Security structure?

Analysis: Based upon Jacobs and Burlington and the general state law principles, it appears that a court could find that the Vermont statutes are intended to create certain contractual rights in a pension benefit.

a. Assuming that a court would find that contractual rights apply, raising normal and/or early retirement ages for any member who had already reached eligibility for a retirement benefit would not be permissible without an offsetting advantage or unless reasonable and necessary to preserve the pension system.

b. It is not clear whether the court would find that a vested member who had not reached retirement age would receive the same degree of protection, or only be protected in the amount of benefit earned to the point of the change. If the court found either, the court would then likely need to decide if the change in retirement age was an impairment. If yes, then the court would likely analyze whether the impairment was reasonable and necessary to protect the financial integrity or flexibility of the pension system.

c. Because the legislation has not expressed any intent to create a contract for a non-vested member, under general state law principles, a court could uphold a change in normal and/or early retirement age for a non-vested member.

3. **Revise Early Retirement Criteria**

Questions: Can the following elements be modified with respect to early retirement:

- Age eligibility restriction?
- Application of penalty based on actuarial cost?

Analysis:

a. We believe changing the early retirement age would follow the analysis outlined in 1 above.

b. As to changes in the actuarial reduction factors, a good argument can be made that this either is not a contractually protected provision, or even if it is a protected provisions, reasonable modifications should be considered as a reasonable and necessary actions to retain the integrity of the plan. Actuarial factors, such as life expectancy, change over time. Boards typically retain the ability to review their plan's actuarial experience and modify assumptions and factors based on the actuary's recommendations. We see this as presenting different arguments than changing the age. As to the first

question, whether it is a contractually protected benefit, we note Title 3, Chapter 16, § 459(d) provides early retirement reduction factors as follows:

(i) Group A (except DOC facility employees) – early retirement is "actuarial equivalent of normal retirement allowance." "Actuarial Equivalent" is defined in § 455(a)(2) as "a benefit of equal value under the actuarial assumptions last adopted by the retirement board under subsection 472(a)(h)." That subsection gives the board the express right to modify the assumption by resolution.

(ii) Group F (except for certain exceptions) – early retirement is reduced by .5%/month under age 62; although if a group member first participated on or after July 1, 2008 the reduction varied by years of service but was measured from 65.

(iii) Group D – early retirement reduced by .25%/month under age 62.

Therefore, it seems clear the legislature reserved the right to change the assumptions for Group A. Groups D and F are less clear as to whether there is a contract right in the early reduction factor. If the court found there was, it would then likely analyze whether the impairment was reasonable and necessary to protect the financial integrity or flexibility of the plan. One question to consider is whether the reductions for Groups F and D represent actuarial reductions as of the time that they were implemented (o/a 1990)

c. Group C is entitled to retire at age 50 with 20 years of service without penalty for early retirement. Without a showing of necessity, we do not believe that these eligibility conditions could be changed for a member who has reached either the normal retirement of 55 or the early retirement of 50 and 20.

If the Commission wishes to consider changes in this category, it may wish to identify all the requirements for each group and plan for early retirement and normal retirement and create a protected category in each group and plan of all members who meet those requirements. We also think the Commission would want to review what changes (if any) had been made in the different factors over time. Lastly, the Commission will want to have an actuary consider whether the factors would be different today if they were to be "actuarial equivalents" of the unreduced benefit.

4. Increase Employee Contribution Rates For All Groups and Consider Appropriate Contribution Rates for Different Groups or Plans

Questions: Would it be possible to raise contribution rates for all current state employees and teachers, in order to provide long-term sustainability for the current plan and benefit levels? Certain current state employees and teachers? Non-vested state employees and teachers? Would it be possible to tie employee contributions to salary or age?

Analysis:

a. Title 3, Chapter 16, § 473(b) establishes employee contribution rates as follows:

(i) Group A: The amounts so allocated as regular contributions shall be determined as if the rate of contribution of four percent has been continuously in effect in the predecessor system from which such amounts were transferred and the balance of any amount so transferred on account of any group A member shall be deemed additional contributions. In the case of group C members who were members as of the date of establishment and D members all contributions transferred from predecessor systems shall be deemed regular contributions. Those members who, prior to the date of establishment of this system, had been contributing at a rate less than four percent shall have any benefit otherwise payable on their behalf actuarially reduced to reflect such prior contribution rate of less than four percent.

(ii) Groups C and F: Contributions shall be made on and after the date of establishment at the rate of five percent of compensation except at a rate of 6.18 percent of compensation for each group C member unless the member was a group C member on June 30, 1998 in which case contributions shall be at the rate of six percent of compensation for each group C member who has elected not to have his or her compensation from the state be subject to Social Security withholding or at the rate of five percent of compensation if the member elected to have compensation from the state subject to Social Security withholding and at the rate of five percent of compensation of each group F member and, commencing July 1, 2019, at the rate of 4.75 percent of compensation for each group F member.

Consequently, it appears as though the legislature has already changed the employee contribution rates in the past, sometimes with some "grandfathering." We are unaware that there has been any contract impairment found. This would suggest that there was not a reasonable expectation of a contract right to a particular rate for the entire career. The Commission would likely want to have a complete history of the different contribution rates and the previous changes, as well as an actuarial study giving the effect on the rates.

b. As provided in state cases, if there is a contract right in a particular rate, any increase in contribution rates can be deemed appropriate if offset by benefit improvements. Additionally, if increased contributions were reasonable and necessary to maintain the retirement system, state cases would support the proposition that contributions could be increased without a benefit improvement. The U.S. Trust case would support the proposition that a change in a contract (if it existed) could be modified if reasonable and necessary.

c. We would have to research decisions and guidance under the Age Discrimination and Employment Act if the Commission wishes to consider age based contributions. There has been litigation on that issue.

5. Revise Multiplier Used to Calculate Benefits for All Groups and Plans

Questions: Can the legislature change the multiplier going forward for all current state employees and teachers? Certain current state employees and teachers? Non-vested state employees and teachers? ***Note:*** Assume that for the time already earned, the current multiplier would be used, but going forward a lower multiplier would be used.

Analysis:

> The general state law principles and the Vermont cases do not provide any guidance on whether there is a contract right that prevents prospective changes in the multiplier. In certain states that follow a strict contract law approach, a prospective change in a multiplier would be considered a contract impairment. If we looked to federal law, this approach would be permitted since only the benefit accrued (or earned) to the date of the change would be preserved.

We think there would likely be no contract right for the non-vested employees and teachers. We also believe that based upon the AG Memoranda and the state case law principles it would be defensible to take the position that prospective multiplier changes are permissible

6. Revise Vesting Period

Questions: Can the legislature change things like vesting period (5 to 10 years) for all current state employees and teachers? Certain current state employees and teachers? Non-vested state employees and teachers?

> Analysis: "Vesting" is established by Title 3, Chapter 16, § 465(a), as five years for a deferred vested retirement allowance. Under the general state law principles, we believe that a court would hold that increasing the number of years would not be permissible for a member who already had five years unless there was an offsetting advantage or unless the change was reasonable and necessary to preserve the pension system. For non-vested members, we believe the change would likely be permitted.

7. Define Types of Income Eligible for Calculation of Average Final Compensation (AFC)

Question: Can the elements of AFC be modified? Based upon our conversations with retirement system staff, we understand the definition of AFC to be described as follows:

a. VSRS Group A is a closed group with just a few members. AFC for this group is similar to Group C, that is, the highest 3 consecutive fiscal years, or the last 36 months including unused annual leave pay off.

b. VSRS Group B is a closed non-contributory group with just a few active members.

c. VSRS Group C (Public Safety): AFC is the average of gross pay for the last 24 months of employment or any 2 consecutive fiscal years. AFC consists of gross pay, but does not include the payment of unused sick leave, except that ½ of the time period of sick leave at the final annual salary can be substituted for the period of lowest pay. Contributions are not made on this amount. With regard to State Troopers, there is a cap on the amount of overtime that can be counted.

d. VSRS Group D (Judges): AFC consists of the statutory pay for the year in which the judge retires. For example, if the legislature sets the annual salary rate at $125,000 for FYE June 2010, then the AFC for a judge who retires in that Fiscal Year is $125,000 regardless of whether the judge has received $125,000 by the time he/she retires.

e. VSRS Group E is a closed plan.

f. VSRS Group F (most State employees): AFC is the average of gross pay for 3 consecutive fiscal year or the last 36 months of employment. AFC excludes unused annual leave pay off. AFC includes compensatory time and personal time. Contributions are also made on these amounts.

g. VSTRS Group A (Only 25 left): AFC is the highest 3 consecutive years, including unused annual leave, such leave, and bonus/incentives.

h. VSTRS Group C: AFC is the 3 consecutive year average. AFC is based upon what they earn as teacher plus compensation for extracurricular activities. This is the same base for benefits and contributions. AFC cannot include any retirement incentives. The Board has to approve any increase that exceeds 10% year to year.

i. VSTRS Group B is closed.

Analysis: The pension contract (to the extent it exists) likely includes the definition of AFC. "Average final compensation" is defined in Title 3, Chapter 16, § 455(a)(4). In every case except judges, the term refers to "average annual earnable compensation." Title 3, Chapter 16, § 455(a)(8) defines that as the full rate of compensation that would be payable to an employee if the employee worked the full normal working time for the employee's position. Therefore, in general, the definition of AFC would be considered part of the benefit that is vested and/or protected for employees – so that protected categories would include vested members and members eligible for a benefit. However, it may be that a change for a member of a protected group would be permissible if the change was needed for integrity of the retirement system – for example, to prevent benefit spiking. In addition, the Commission may want to review when any prior changes to the definition occurred in VSRS Groups C and F and VSTRS Group C.

8. Review Impact of Going From a Three Year to Five Year Salary Calculation for AFC

Question: Can the calculation of AFC be expanded to include 5 years instead of 3?

Analysis: As to the first point of whether there is a constitutionally protected benefit, the normal retirement benefit for groups in VSRS is based on "average final compensation"(except for judges, which is based on their salary). Title 3, Chapter 16, § 459. "Average final compensation" is defined in Title 3, Chapter 16, § 455(a)(4) as the "average annual earnable compensation" in the three (for Group A and F: two for Group C) consecutive fiscal years or last three (two) employment years. Therefore, as noted above, the definition of AFC would be considered part of the benefit that is vested and/or protected for employees – so that protected categories would include vested members and members eligible for a benefit.

If the Commission is interested in further considering this, the Commission may also want to consider whether a special protected group of those within 3 or 5 years of retirement eligibility should be created, so that any change here would allow some additional security for that population.

9. Revise COLA Changes and Revise Definition of CPI

Questions: Can COLAs be changed, including a revision to the definition of CPI?

Analysis: Title 3, Chapter 16, § 470 establishes the COLA provisions. Every group has a COLA based on CPI. For some group it is either a full or half-COLA. Group A, C and D's COLA is as follows:

> as of June 30 in each year, commencing June 30, 1972, a determination shall be made of the increase or decrease, to the nearest one-tenth of a percent, in the ratio of the average of the Consumer Price Index for the month ending on that date to the average of said index for the month ending on June 30, 1971 or the month ending on June 30 of the most recent year subsequent thereto as of which an increase or decrease in retirement allowance was made. If the increase or decrease, so determined, equals or exceeds one percent, the retirement allowance of each beneficiary in receipt of an allowance for at least one year on the next following December 31st shall be increase or decreased, as the case may be, by an equal percentage. Such increased or decrease shall commence on the January 1st immediately following such December 31st. Such percentage increase or decrease shall also be made in the retirement allowance payable to the beneficiary in receipt of an allowance under an optional election, provided the member on whose account the allowance is payable and such other person shall have received a total of at least 12 monthly payments

> by such December 31st. The maximum adjustment of any retirement allowance resulting from any such determination shall be five percent and the minimum shall be one percent, and no retirement allowance shall be reduced below the amount payable to the beneficiary without regard to the provisions of this section.

Group F members' COLA is as follows:

> as of June 30 in each year, commencing January 1, 1991, a determination shall be made of the increase and decrease, to the nearest one-tenth of a percent of the Consumer Price Index for the preceding fiscal year. The retirement allowance of each beneficiary is receipt of an allowance for at least one year on the next following December 31st shall be increased or decreased, as the case may be, by an amount equal to one-half of the percentage increase or decrease. Commencing January 1, 2014, the retirement allowance of each beneficiary who was an active contributing member of the group F plan as of June 30, 2008 and who retires on or after July 1, 2008 shall be increased or decreased, as the case may be, by an equal percentage of the Consumer Price Index for the preceding year. The increase or decrease shall commence on the January 1st immediately following such December 31st. The adjustment shall apply to group F members receiving an early retirement allowance only in the year following attainment of age 62, provided the member has received benefits for at least 12 months as of December 31 of the year preceding any January adjustment. The maximum adjustment of any retirement allowance resulting from any such determination shall be five percent and the minimum shall be one percent, and no retirement allowance shall be reduced below the amount payable to the beneficiary without regard to the provisions of this section.

The language of the statute provides that benefits "shall be increased or decreased" indicating that in specified circumstances the benefits shall be adjusted up or down as a result of CPI. This would seem to mean that a decrease resulting from CPI would be part of the contract and/or there has been a reservation of rights to amend the contract.

10. <u>Review Potential of Limiting Allowable Earnings After Retirement</u>

a. <u>VSTRS</u>: Teachers may "retire" and receive a pension so long as they occupy a non-qualified position – that is, a position that is not covered by VSTRS. If a retired teacher returns to a position covered by VSTRS, then the retiree is not allowed to earn more than 60% of a teacher's salary.

b. VSRS: A retired state employee may not return to active permanent employment. However, a retired state employee may return to a temporary or contractual position.

Analysis: As noted in Section VI, state law changes with regard to the reemployment of retirees have been made in other states. This is an area where, if a contractual right is found, changes may be made to preserve a pension system's integrity.

11. Member Options

Questions: Could the legislation offer an option to all current state employees and teachers for an increase in the employee contribution rate to retain existing benefit levels versus retaining the existing contribution rate but with reductions in some of the benefit levels and/or plan provisions? Certain current state employees and teachers? Non-vested state employees and teachers?

Analysis: There is no clear guidance on this point under the Vermont cases, but we believe the analysis would be similar to that above.

However, an additional concern would be that the Internal Revenue Service is very restrictive on elections with respect to employee levels of contributions if those contributions are pre-tax. Thus, additional tax analysis would be needed if the Commission is interested in pursuing any solutions involving member options.

B. Retiree Health Care

The Treasurer's Office has advised us that a couple of years ago, Vermont instituted, in legislation, a new tiered retiree health coverage plan for new state employees. Instead of being able to get 80% coverage retiring after 5 years of service and age 55, new state employees must work 10 years to get 40% coverage, 15 years for 60% coverage, and 20 years for 80%. Could the legislation apply that system to all current employees? Certain current employees? Same question for teachers.

Analysis: Based upon the Jacobs analysis, it is not clear that any contract has been established with respect to any term of retiree health coverage for retirees. Therefore, it may be permissible to make any of these changes.

- Could the legislature provide no retiree health benefits for new state employees and/or teachers?

Analysis: We believe the answer is yes.

- Can the legislature change retiree health coverage for already retired state employees and/or teachers?

Analysis: We do not believe that the legislature has established any right to health insurance other than coverage under the program. It appears that the terms of that coverage can be modified.

VI. RECENT STATE ACTIVITY

A. Pensions

Many other states are considering a range of pension and/or retiree medical changes, and in some cases have actually passed legislation containing changes. We thought the Commission would want to be aware of this activity. For this discussion we relied heavily on a National Council of State Legislatures ("NCSL") report ("State Revisions and Retirement Legislation 2009"), dated August 17, 2009, as well as information from the National Association of State Retirement Administrators ("NASRA"). See also "Trends in Public Sector Retirement Systems" presented in Commission's August 20, 2009 meeting.

The changes may be briefly summarized as follows.

a. **Changes for New Hires**. Six states created new benefit structures for new hires. In two of those states (Georgia and Louisiana) the primary effect was an elimination (Georgia) or limitation (Louisiana) on post-retirement benefit increases. In the other four (Nevada, New Mexico, Rhode Island and Texas), the changes were more extensive – affecting retirement ages, service requirements, the amount of the benefit or COLA, and/or the amount of the reduction for any early retirement. The other type of change for new hires was to change employee contribution. For example, New Hampshire increased the employee contribution from 5% to 7% for new members (effective July 1, 2009).

b. **Employee Contribution Changes for Existing Employees**. Nebraska and New Mexico and Texas increased employee contributions for existing employees (1% increase in Nebraska for school employees for five years, 2% increase for state patrol and a 1.5% increase in New Mexico for two years, and a .45% increase for Texas ERS members). Employee unions in New Mexico have brought action to overturn these changes as unconstitutional. Texas also added an employee contribution (.5%) in a previously non-contributing plan (law enforcement and custodial members).

c. **Benefit Changes for Current Employees**. Bills were passed in a few states that impacted current members. Those changes tended to be very targeted at particular features. Notable examples include the following:

- eliminated of ability of elected officials to be credited with a full year's credit for as little as one day of service and/or receive a "termination allowance" (Massachusetts),
- eliminated "out-of-grade" accidental disability pensions (Massachusetts),
- revised the compensation definition for benefit calculations (Massachusetts),

- imposed a period of separation before retiree could be retired
  - 90 days (Texas ERS)
  - 180 days (Arkansas)
  - 60 days (Kansas) (Note: Kansas also imposed special payments for employees and employers for rehired retirees),
- imposed restrictions on working in retirement for certain elected officials (West Virginia),
- imposed suspension of retirement benefit for rehired retiree less than NRA (Georgia),
- suspension of benefits in certain reemployment situations (Indiana).

d. **Benefit Reductions for Current Retirees**. None, except a few COLA changes.

B. Health

The accounting changes imposed by the Government Accounting Standards Board have caused many states to review their benefits and their funding for retiree health care. See "Trends in Public Sector Post Retirement Health Care Benefits" in Commission's August 20, 2009 materials for general summary.

There were changes to retiree health programs in the 2009 sessions. Examples include the following:

a. New Hampshire (added withholding to help fund retiree health coverage).

b. New Mexico (increased employer and employee contributions to fund).

c. Creation of new funding vehicles for retiree medical (Georgia, Delaware, Alaska).

d. Kentucky (established employer rate schedule for retiree medical).