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STATE OF VERMONT
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TO: Jill Krowinski, Speaker of the House of Representatives
Becca Balint, Senate President Pro Tempore
Rep. Mary Hooper, Chair, House Committee on Appropriations
Sen. Jane Kitchel, Chair, Senate Committee on Appropriations
Rep. Sarah Copeland-Hanzas, Chair, House Committee on Government Operations
Sen. Jeanette White, Chair, Senate Committee on Government Operations
Stephen Klein, Chief Fiscal Officer, Joint Fiscal Office
Susanne Young, Secretary of Administration
Adam Greshin, Commissioner of Finance

FROM: Beth Pearce, Vermont State Treasurer

DATE: March 3, 2021

RE: Pension and OPEB Initiatives

This memo is intended to provide an update on the requests made by the State Treasurer's Office relative to retirement/pensions and other post-employment benefits (OPEB or health care), and to reiterate this Office's position on funding these benefits. Recommendations for all four "buckets" have been submitted to the General Assembly. Simply put, we urge the General Assembly and the Governor to fully fund, and make the necessary benefit changes, to the two retirement/pension systems and begin prefunding the two health care benefit systems (this requires both funding and a statutory prefunding policy). While the Treasurer's Office has submitted a comprehensive plan, each "bucket" also stands on its own, significantly reduces State Liabilities, and should be acted on immediately. Failure to act on the individual plan components as opportunities arise puts the State at considerable risk as noted below.

As you are aware, each Board of Trustees passed a motion directing the Treasurer to work with stakeholder groups to identify and review recommendations to lower the pension unfunded liability and the Actuarially Determined Employer Contribution (ADEC) to at least the previous FY2021 projections and to present those recommendations to the Governor and the General Assembly by January 15, 2021. That report was completed as scheduled and submitted to all parties. The report included recommendations to reduce liabilities and the ADEC. The State system recommendations fully achieve the objectives. In the case of the Teachers' system recommendations, while significant, they did not fully reduce liabilities to prior levels. The recommendations nonetheless are significant and merit passage.

These recommendations, if enacted, will result in significant reductions in liabilities and put the plans on a path to success. They are also painful, and while reluctantly submitted given the required benefit changes, they are necessary to preserve the defined benefit system, now and for generations to come. The pension recommendations are summarized below.

Target Reductions vs. Recommended Reductions (In Millions $)				
System/Category:	Target	Recommended Changes	Variance:	Percentage of Target Reached*
State (VSERS)*				
Unfunded Liability	$225.0	$219.9	$5.1	97.7%
ADEC	$36.0	$33.2	$2.8	92.2%
Teacher				
Unfunded Liability	$379.0	$254.1	$124.9	67.0%
ADEC	$60.6	$52.2	$8.4	86.1%
Total				
Unfunded Liability	$604.0	$474.0	$130.0	78.5%
ADEC	$96.6	$85.4	$11.2	88.4%

*Note: The VSERS recommendations included four (4) scenario options. The UAAL savings ranges from $218.2 to $256.3 million while the ADEC savings ranges from $33.2 to $39.7 million, resulting in options to fully meet the targets. The preferred recommendations are included in the chart above.

The General Assembly will, of course, review these recommendations and make revisions. The Treasurer's Office believes, however, that any changes to these recommendations must at least remain in the recommended dollar ranges relative to the targets. Failure to make the requisite changes at the necessary levels will continue to leave the systems at risk.

The Trustee Boards and the Treasurer's Office have consistently advocated for prefunding of the OPEB benefits, which includes health care. FY22 provides the opportunity to do this and we urge immediate appropriation of the requisite dollars and the inclusion of necessary statute changes to establish prefunding.

By way of background, there are two ways to pay for post-retirement benefits (pension and OPEB):

- Pay-As-You Go: No assets are set aside. Instead benefits/premiums are paid as they come due for payment. These are paid out of current revenues.
- Prefunding: Setting aside funds to pay for future benefits to employees. These assets are invested and the proceeds are used to pay benefits in the future.

No prefunding structure exists for the OPEB funds. The longer the State waits to pre-fund OPEB that the State provides to teachers and State employees, the larger the future liabilities, annual OPEB costs and long-term financial risk to the State. This, in combination with the current pension underfunding gap, results in detrimental impacts for the State:

- Significant increases in unfunded liabilities
- Long-term cost to the taxpayer
- Stresses to the State's bond rating; and
- Erosion of investor confidence in the State's commitment in addressing its liabilities.

These pressures, in combination with the State's demographics and workforce issues, could have a significant impact on the State's long-term bond rating. The "Negative Outlook" on our rating by S&P

Global is a wakeup call. Failure to answer that call would not only affect the State's bonds but have a negative impact on other Vermont authorities that utilize the State's credit rating to lower the cost of their bonds. If a downgrade were to occur it would negatively impact economic development (the Vermont Economic Development Authority), affordable housing (the Vermont Housing Finance agency), the ability of Vermont students to finance post-secondary education (Vermont Student Assistance Corporation) and the bonding of the capital projects, the bricks and mortar, for the municipalities you represent (via the Vermont Bond Bank). While we can't speak for the rating agencies, it would be ill advised to add these additional stresses to the rating process.

The State of Vermont needs to address pension and OPEB liabilities and move to a prefunding mode for OPEB. The time to do this is **NOW**.

Pension benefits are established by State statute. While the Boards recommend funding, based on actuarial valuations, the General Assembly and the Governor appropriate the needed dollars. As you know, historical funding, particularly for the VSTRS system, was less than the actuarially recommended contributions. I commend the General Assembly and the Governor for consistently funding the ADEC since 2007, even in tough times. But recent economic and demographic pressures have exacerbated the situation.

With the exception of some small contributions to the OPEB systems, there is no consistent funding policy for either OPEB fund. They operate as pay-as-you go structures, funding just the premium payments.

The funding of both OPEB systems rests with the General Assembly and the Governor. The State cannot afford to kick the can down the road anymore. We need to be responsible to our investors, citizens, taxpayers, and town governments. The Treasurer's Office has, over several years, consistently made recommendations to move to a prefunding model. Again, I urge the General Assembly to take action to provide the start-up funds and ongoing funds to support prefunding and to make the required statutory changes to adopt a prefunding policy. This would result in immediate reductions in liabilities. In the case of VSTRS this is estimated to lower the FY22 liabilities by $821.9 million. The VSERS system is estimated to result in a reduction of $861.9 million in liabilities. The combined reductions for OPEB liabilities are $1,683.8 million. The structure of the funding proposals, has been developed to reduce volatility, provide budget predictability, lower liabilities, and ultimately reduce the costs to the taxpayer. The table below summarizes the results.

OPEB Pre-funding Requirements and Impact on Liabilities
(In Millions $)

System/Category:	FY 22 Estimated Net (unfunded) OPEB Liability	Current Funding in Governor's Budget	Treasurer's Office Recommended Funding	Increased Funding	Estimated Resulting Net OPEB Liability	Change to Net OPEB Liability
State (VSERS)	$1,617	$37.2	$58.8	$21.6	$754.9	$861.9
Teacher (VSTRS)	$1,480.7	$35.1	$55.1	$20.0	$658.8	$821.9
Total Unfunded Liability	$3,097.5	$72.3	$113.9	$41.6	$1,413.7	$1,683.8

* Approximately 40% of the VSERS increase is expected to be allocated to the general fund. Approximately 23% of total expenditures are reimbursed through federal funds.

The Governor's budget fully funded the increased ADEC for the pensions of $96.6 million. To the extent the recommended changes in the January 15th report are adopted, it will free up dollars to fund the OPEBs and still provide a net savings to the FY22 budget.

Adoption of the pension recommendations, or a similar proposal, in scope and funding by the General Assembly, will generate $85.4 million in savings. Funding needed to begin OPEB funding will require $41.6 million. If the recommendations are enacted, this will result in total budget savings of $43.8 million. This is not a one-time occurrence; the reductions in the pension ADECs going forward will continue to free up dollars for OPEB and create additional budgetary savings.

Pension liability reductions are an estimated $474 million while the OPEB liability reductions are estimated at $1,683.8 million. All in, the recommendations or equivalent options are estimated to take $2.2 billion of liabilities off of the State books. The recommendations will reduce the costs to the taxpayer. In addition, each component of the four-bucket plan also stands on its own, as each adds value to the State by reducing liabilities while generating long-term savings to the taxpayer.

While the General Assembly continues to review the pension proposals, the Treasurer's Office proposed and testified on the VSTRS OPEB issue with the expectation that it would be included in H.315, the COVID relief bill. The $20 million budget request was, in fact, included in the bill and is appreciated. While the bill includes language "to develop a long-term funding initiative to address pension and OPEB liabilities" by May 30, 2021, the Treasurer's position is that a plan already exists, was presented including the requisite statutory language, and should be included in H.315.

As noted in the attached memo, the OPEB prefunding concept was presented to House and Senate committees in February and March of 2020, further articulated in the September 1, 2020 memorandum, and included in the January 15th report. While the VSERS details were only recently finalized, the VSTRS plan has undergone extensive documentation and testimony. On its own, it is a significant step forward. Inclusion of the statutory language previously submitted to the House, in combination with the proposed dollars, would permit the State to recognize $822 million in reduced liabilities on its balance sheet. This would send a clear message to the taxpayers, the investor community that buys our bonds, and/or firms looking to move to Vermont.

I hope that the General Assembly will take immediate action on the VSTRS OPEB proposal and expedite the review of the remaining recommendations for the VSERS OPEB and the pension systems. We are available to answer questions, give testimony, and provide any needed assistance.

Enclosures:

VSTRS OPEB Language for H.315

September 1, 2020 Memo to Legislature

Attachment A

Draft Language on Proposal to Prefund OPEB

Sec. 1. 16 V.S.A § 1944b is amended to read:

§ 1944b. Retired Teachers' Health and Medical Benefits Fund

(a) There is established the Retired Teachers' Health and Medical Benefits Fund (Benefits Fund) to pay retired teacher health and medical benefits, including prescription drug benefits, when due in accordance with the terms established by the Board of Trustees of the State Teachers' Retirement System of Vermont pursuant to subsection 1942(p) and section 1944e of this title. The Benefits Fund is intended to comply with and be a tax exempt governmental trust under Section 115 of the Internal Revenue Code of 1986, as amended. The Benefits Fund shall be administered by the Treasurer.

(b) The Benefits Fund shall consist of:

(1) all monies remitted to the State on behalf of the members of the State Teachers' Retirement System of Vermont for prescription drug plans pursuant to the Employer Group Waiver Plan with Wrap pursuant to the Medicare Prescription Drug Improvement and Modernization Act of 2003;

(2) any monies appropriated by the General Assembly for the purpose of paying the health and medical benefits for retired members and their dependents provided by subsection 1942(p) and section 1944e of this title;

(3) any monies pursuant to subsection ~~(e)~~ (g) of this section; and

(4) [Repealed.]

(5) any monies pursuant to section 1944d of this title.

(c) No employee contributions shall be deposited in the Benefits Fund.

* * *

(h) Beginning on July 1, 2021, and annually thereafter, the annual contributions to be made to the Benefits Fund by the State shall be determined on the basis of the funding schedule set forth in subdivision (2) of this subsection.

(1) Purpose. It is the purpose of the funding schedule and the policy of the State of Vermont to liquidate fully the net other post-employment benefit liability to the Benefits Fund.

(2) Funding schedule.

(A) The State contribution for the year beginning on July 1, 2021 shall be $41,818,509.00.

(B) Beginning on July 1, 2022, and until the net other post-employment benefit liability to the Benefits Fund is liquidated, the annual State contribution shall be equal to the prior year's annual State contribution adjusted by the percentage increase set forth below:

(i) From July 1, 2022 to June 30, 2025, the percentage increase over the prior year's annual State contribution shall be 10.0 percent.

(ii) From July 1, 2025 and annually thereafter until such time as the net other post-employment benefit liability is fully liquidated, the percentage increase over the prior year's annual State contribution shall be 3.0 percent.

Sec. 2. 16 V.S.A § 1944d is amended to read:

§ 1944d. Employer annual charge for teacher health care

* * *

(c) On or before January 15, 2033, the State Treasurer shall report on options for extension or repeal of this section, as well as other alternatives to ensure the financial stability of the Benefits Fund. The provisions of 2 V.S.A. § 20(d) regarding expiration of required reports shall not apply to the report required by this subsection.

(d) This section shall remain in effect until June 30, 2033.

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TO: Kitty Toll, Chair, House Committee on Appropriations
Jane Kitchel, Chair, Senate Committee on Appropriations
Sarah Copeland-Hanzas, Chair, House Committee on Government Operations
Jeanette White, Chair, Senate Committee on Government Operations
Mitzi Johnson, Speaker of the House
Tim Ashe, Senate President Pro Tempore

FROM: Beth Pearce, State Treasurer

DATE: September 1, 2020

RE: Formal Update Regarding the Retired Teachers Health and Medical Benefit Fund ("RTHMB") and Vermont State Employees Other Post-Employment Benefits Fund (collectively "OPEB")

This letter is a formal update regarding key developments and initiatives for the Retired Teachers Health and Medical Benefit Fund ("RTHMB") and Vermont State Employees Other Post-Employment Benefits Fund (collectively "OPEB"):

- Recent market conditions reduced the discount rate used to value the OPEB liabilities from 3.50% at 6/30/19 to 2.21% at 6/30/20. This will increase the RTHMB liability by over $227M and the VSERS OPEB liability by over $266M.
- We have undertaken a study on RTHMB to review and compare the actual healthcare costs incurred versus national trends used to value the liability.
- We have engaged an actuarial firm to evaluate alternative models for the RTHMB healthcare plan, moving to a fully insured versus the current self-insured plan, without a reduction in benefits for our current and future retirees.
- We have begun working on the agreement for investing OPEB assets through VPIC, as authorized in Act 120 of 2019 (Sec. A.13. 3 V.S.A. § 523) to maximize return.

While the challenges facing the plan due to discount rate exposure are unfortunate, we can still work toward pre-funding and reducing the OPEB liabilities for the future. We continue to work to find creative solutions, but adequate funding is still missing. The investment authorization granted in Act 120 will help grow OPEB assets, but a commitment in statute to fund an amount above the Pay-Go is needed to achieve a pre-funded plan.

Background

On February 25, 2020, we communicated to you in memorandum our formal request to fulfill the requested $37,771,784 in funding from the General Fund, which was reduced by $5,973,050 in the

Governor’s recommended budget. In addition, we requested that a funding policy be created in statute to provide for on-going funds for the RTHMB in lieu of an ADEC.

On March 10, we reiterated our request and pointed out the potential to save almost $500M on the State’s financial statements. We noted that the lost interest on the reduced appropriations would total $40.8M by 2048, and by not adopting a funding policy in statute, the state would be exposed to the benchmark interest rate used in lieu of an investment return rate.

While we have not received the requested funding or a commitment in statute to a funding policy for the RTHMB, we do appreciate the insertion of language in Act 120 of 2019 granting the Treasurer the ability to contract with the Vermont Pension Investment Committee (“VPIC”) to maximize the return on investment of OPEB assets.

Since our Last Communication

The Federal Reserve Bank reduced the target benchmark interest rate several times during the past fiscal year and once since our last communication to 0-.25%. Furthermore, economic uncertainty associated with the COVID-19 pandemic has adversely affected yields. As noted in our previous letter, the discount rate used to value the OPEB investments is the benchmark 20 year AA General Obligation Bond rate. That rate has declined over the past fiscal year from 3.50% at 6/30/2019 to 2.21% at 6/30/20, a decrease of 1.29% While we will not have the results of the actuarial valuation dated 6/30/20 until closer to the end of the calendar year, previously we estimated that the impact of a 1.00% decrease in rates for each of the OPEB funds was a $375M increase in liability. Our estimates of a 1.29% decrease are almost $500M across both OPEB funds. When compared to the $500M savings that could have been achieved by reaching pre-funding with a funding policy in statute and the restoration of the requested RTHMB appropriation, there is a swing of $1B.

Earlier this summer we engaged our actuarial firm to review the specific experience of the RTHMB as compared to national trend rates used to estimate the RTHMB liability. We decided to undertake this Healthcare Costs Trend Study due to gains related to experience in the plan over the past few years. While we do not have the results of this study yet, we expect to have something to report soon and will provide copies when available. We are hopeful that by using a healthcare cost trend line more indicative of our population versus national trends that there will be a corresponding reduction in the liability.

Currently we self-insure the RTHMB through Vermont Education Health Initiative (“VEHI”) which requires us to absorb any volatility in costs in the plan. In turn, we can save money in years when healthcare costs are below projections, and we are able to collect Employer Group Waiver Plan (“EGWP”) rebates and subsidies based on performance. The downside of EGWP is that it takes several years to collect all the rebates/subsidies related to a given year. We are currently evaluating the use of a fully insured plan that would limit our liability and reduce the overall costs, which are estimated by our consultants to be $3-7M over each of the first two years, without a reduction in services. This evaluation is currently at its early stages, and we are working with VEHI to better understand the implications, costs and benefits of such a change. Any decision on this subject will require action from the VSTRS Board to proceed if deemed worthwhile. We expect to have further updates regarding this potential reduction in healthcare costs later this calendar year.

Lastly, with the passage of Act 120 of 2019, we have been working with VPIC to invest OPEB assets. While the RTHMB does not currently have significant funds for investment, the State OPEB has over $51M which are available for investment by VPIC. Previously these assets were invested in the Trust

Investment Account (“TIA”) which had an overall rate of return of 6.2% in FY2020. We expect to begin investing these funds by the end of the calendar year.

Conclusion

Despite the efforts outlined previously, the decline in the benchmark discount rate will most likely result in a large increase of the OPEB liabilities. We believe that now is the time for continued attention, ensuring that we advance on the path of pre-funding and eventually toward fully funding the OPEB liabilities. Without proactive efforts toward developing a funding policy and continued support for these plans, the liabilities will be exposed to this volatility. We look forward to updating you later in the year on our efforts surrounding the Healthcare Cost Trend Study, evaluation of a fully insured versus self-insured RTHMB, and on our investment contracting with VPIC. While the expected increase in liabilities due to discount rate exposure is disappointing, we hope to work with you in the 2021 legislative session to work toward achieving pre-funding.

I would especially like to thank Will Kriewald, our Chief Financial Officer, for his critical work on this matter. Please do not hesitate to contact either myself or Will with any questions.