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

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***

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 <u>that it will take more than 20 years</u> 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.

<u>Pension Benefits</u>

➢ 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

Revising the contribution rate ratio and rates for employer and employees:

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.