State Treasurer's Annual Report

Vermont State Treasurer's Office

James H. Douglas, Treasurer

February 22, 1999

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February 22, 1999

To Members of the General Assembly:

This Debt and Financial Report is presented to assist committee members with a general overview of the state's financial condition in the particular areas of debt, investments and cash management, as well as other areas that affect the State of Vermont's financial condition. A general understanding of these areas will also assist the committees to examine the appropriations of the Treasurer's office operating budgets as well as the appropriations for debt management.

The two appropriation committees, in conjunction with the administration and this office, have been active partners in returning Vermont to fiscal stability and on a course to begin to reduce the high debt burdens that the State had accumulated.

In recent years we set a course to trend down new authorizations of long-term debt to overcome rating agency concerns. Consequently, the State has reduced its new authorizations in this decade from $83.4 million in FY'91 to $39 million in FY'99. As a result of this trending down policy the State's total debt decreased from $536.2 million as of June 30, 1997 to $528.6 million as of June 30, 1998, a decline of 1.4%. Also more expensive financing mechanisms employed in the past, such as long-term capital lease obligations and certificates of participation, were refinanced with lower cost general obligation bonds. Total debt service — the amount appropriated to pay principal and interest on bonds — declines in fiscal year 1999, to $72.4 million compared to the prior year's debt service of $74.5 million in fiscal year 1998. Future debt service payments should level off instead of increasing as they have done for much of this decade.

Similarly, the State has made great strides in the area of short-term debt. For example, in fiscal year 1999, for the first time in a decade and only the third time in 30 years, the State of Vermont will not need to issue short-term debt. In the early 1990's, Vermont was issuing between $155-$192 million annually, not including $65 million in deficit notes. On numerous occasions the rating agencies cited concern about the State's cash flow position which necessitated such high levels of short-term borrowing.

In October 1998 Standard & Poor's upgraded Vermont's rating from a AA- to a AA (The State is also rated Aa2 by Moody's and AA by Fitch Investor Services). Standard & Poor's noticed that Vermont's financial operations and debt conditions over the last several years stood in stark contrast to conditions that existed in June, 1991 when Standard & Poor's reduced the State's rating from AA to AA-.

As we prepare for fiscal year 2000 the Capital Debt Affordability Advisory Committee recommends that the State authorize new long-term debt at the same level as fiscal year 1999: $39 million. However, the actual issuance of any new long-term debt may be below the authorization level given the desire by the Legislature and the Governor to use surplus cash to avoid long-term debt. In addition, it is expected that short-term borrowing will again be either avoided or minimal in fiscal year 2000.

Vermont faced some very difficult financial challenges in the beginning of this decade but as the decade ends the State finds itself fiscally strong, with a stronger economy, and poised not to repeat its fiscal mistakes of the past.

Sincerely,

James H. Douglas

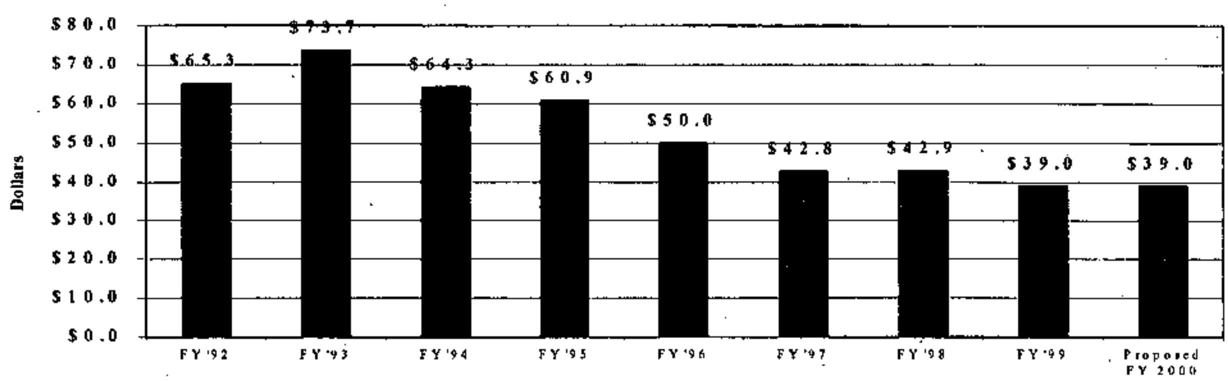
TABLE OF CONTENTS

I. Debt Management

A. The Policy of "Trending Downward" Long and Short-term Debt And The Result

Since fiscal year 1995, the State Treasurer's office, in conjunction with the Administration, set a course to trend down new authorizations of long-term debt to overcome rating agency concerns. Consequently, the State has reduced its new authorizations in this decade from $83.4 million in FY '91 to $39 million in FY '99 (See Chart 1 below).

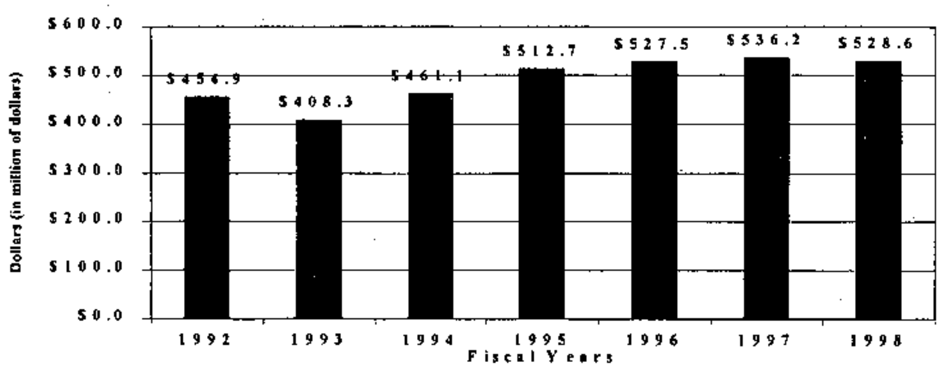
Chart 1
New Long-term Debt Authorizations from FY '92 to FY 2000 (in Millions)



By lowering new authorizations the State of Vermont is starting to show improvement in its total level of outstanding long-term debt. The State's total debt decreased from $536.2 million as of June 30, 1997 to $528.6 million as of June 30, 1998, a decline of 1.4%. Also more expensive financing mechanisms employed in the past, such as long-term capital lease obligations, and certificates of participation, were refinanced with lower cost general obligation bonds.

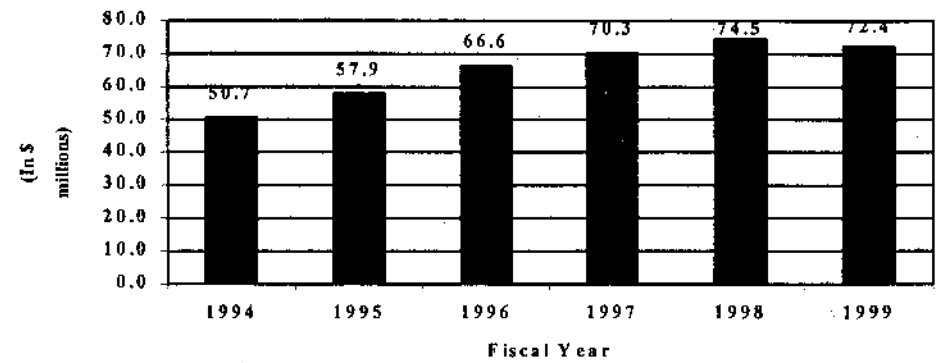
Chart 2

Net Tax Supported Debt Outstanding



In addition, total debt service — the amount appropriated to pay principal and interest on bonds — has exhibited a similar trend. For fiscal year 1999, the State will owe $72.4 million in debt service, compared to $74.5 million in fiscal year 1998. Future debt service payments should level off instead of increasing as they have done for much of this decade.

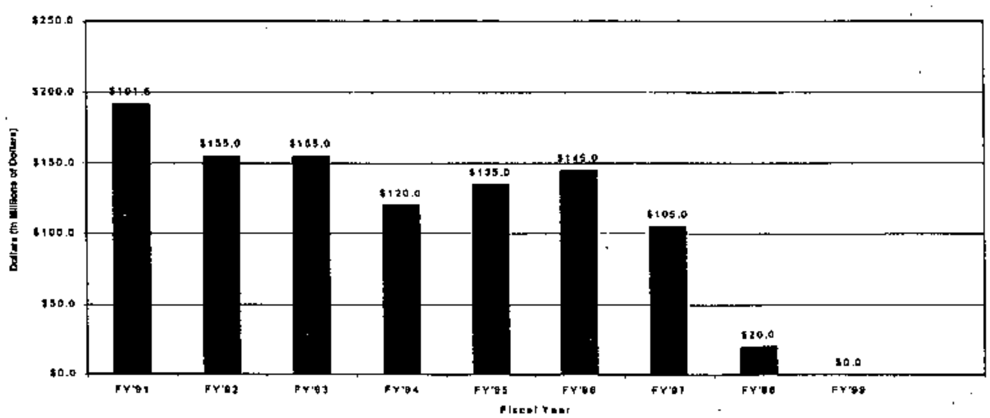
Chart 3
Net Tax-Supported Debt Service by Fiscal Year



The State continues to struggle in reducing key indicators monitored by the rating agencies, but one key ratio is showing improvement. On an absolute basis, the State's ratio of debt as a percentage of personal income improved dramatically from 1997 to 1998. The drop from 4.7% to 4.2% represents the largest improvement and lowest level for this ratio since 1991. The State's ranking also improved in this category, from 8th to 9th highest, despite a decline in debt to income ratios in all fifty states.

Similarly, the State has made great strides in the area of short-term debt. In fiscal year

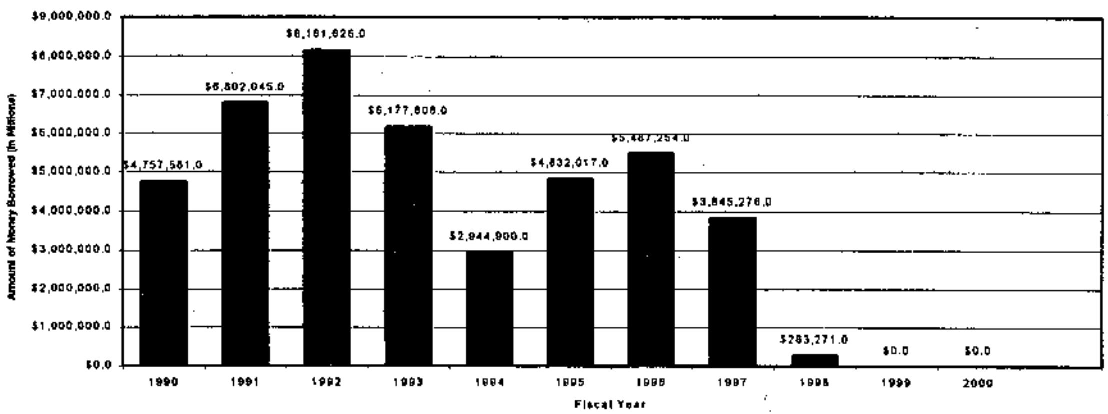
Chart 4
Short Term Borrowing For Fiscal Years 1991 To 1999



1999, for the first time in a decade and only the third time in 30 years, the State of Vermont will not need to issue short-term debt. In the early 1990's, Vermont was issuing between $155 and $192 million annually, not including $65 million in deficit notes. On numerous occasions the rating agencies expressed concern about the State's cash flow position which necessitated such high levels of short-term borrowing.

Beside the many other benefits of reducing short-term borrowing (see comments below relating to Standard and Poor's), the State of Vermont saves significant amounts of monies by avoiding interest charges on borrowed amounts. (See Chart 5 below.)

Chart 5
Interest Paid on Short-term Borrowing



In October 1998 Standard and Poor's upgraded Vermont's rating from a AA- to a AA. The rating agency noticed that Vermont's financial operations and debt conditions over the last several years stood in stark contrast to the conditions that existed in June, 1991 when Standard and Poor's lowered the State's rating from AA to AA -.

Several factors were cited by Standard and Poor's when comparing the finances of the State today with the situation in 1991:

1. In 1991 there were no funds in the State's budget stabilization reserve; Vermont was on the verge of issuing $65 million of deficit notes; and the economy suggested further financial weakness. By contrast, over the last three years, the

State has experienced consistently strong financial operations with full funding of all its stabilization reserves.

2. Vermont's cash flow position has so improved that the State has not issued any short-term public debt during the last two fiscal years (a small amount, $20 million, was sold on a private placement basis for seasonal purposes last year). In the early 1990's, Vermont was issuing $155-$192 million annually, not including $65 million in deficit notes.

3. Vermont's debt picture has improved considerably in recent years. For the last several years debt authorizations have been in the $39-$43 million range, having fallen from the $70-$83 million range in the early 1990's. As a result of refundings and other actions, the State no longer carries any certificates of participation, capital leases, or bond anticipation notes. The State is now repaying in principal a lower amount than the amount of new debt it is issuing annually. As a result of these factors, the State's debt picture is very favorable for the future.

4. Vermont's stable economic base, with modest employment growth, establishes a secure environment in which the State's financial and debt management operations can continue to perform predictably and positively.

Given the fact that the State of Vermont is well on its way to achieving another sizable operating surplus for fiscal 1999, there is no comparison between the State's current credit position and the one that existed in 1991. Standard and Poor's concluded what Vermonters already knew: we deserved an upgrade.

Whenever the State of Vermont enjoys a higher rating it enhances the marketing of the State's long-term debt. That should result in lower interest rates the State pays its bondholders. In addition the Vermont Municipal Bond Bank has been automatically increased from A- to A as a result of the State's improved bond rating.

The State is also rated Aa2 by Moody's and AA by Fitch Investor Services.

B. Long-term Debt

This year, the State issued $34.3 million of general obligation bonds in the late fall of 1998, which exhausted all remaining authorizations. This amount represents $39 million of debt authorization specifically for fiscal year 1999, plus $5.3 million authorized but unissued debt carried over from previous years, less $10 million of surplus allocated to the reduction of authorized debt. This debt sale affords the State the ability to achieve a steady state of annual debt issuance of about $39 million. Establishing a pattern in which the State consistently issues all or nearly all of the authorized amount of debt at or close to $39 million a year will enhance the State's debt position from the rating agencies' perspective. For fiscal year 2000 the Capital Debt Affordability Advisory Committee adopted a recommendation of maintaining a yearly issuance of $39 million of new debt each year into the foreseeable future. That level of issuance will have positive effects on key debt ratios monitored by the Committee.

For example, the general debt per capita guideline set by the State is approximately $700 in 1995 dollars. Currently, the State's debt per capita ratio of $893 exceeds the inflation-adjusted target of $761. By continuing this level of authorization in future years and employing the population forecast developed by Economic Policy Resources, the State would achieve the targeted debt per capita goal in 2002.

The State's guideline for debt as a percentage of personal income reads: "Aggregate projected State debt should not exceed five percent of projected State personal income in the next ten years." After nearing the five-percent threshold in 1996, the State has steadily improved in this category. Under the adopted recommendation, improvement would continue at approximately two-tenths of a percent each year, and the State would equal the five-year Moody's median (2.1%) in 2008.

Another debt management guideline states: "Projected annual State debt service on bonds should not be in excess of eight percent of projected revenues in the aggregate General and Transportation Funds during the next ten years." Under the adopted recommendation, this ratio would decline to 7.0% in 2001 and ultimately to 5.2% in 2008.

As can be clearly demonstrated the State has reaped enormous benefit from following its policy of trending down debt. The legislature is urged to continue this course.

C. Short-Term Debt

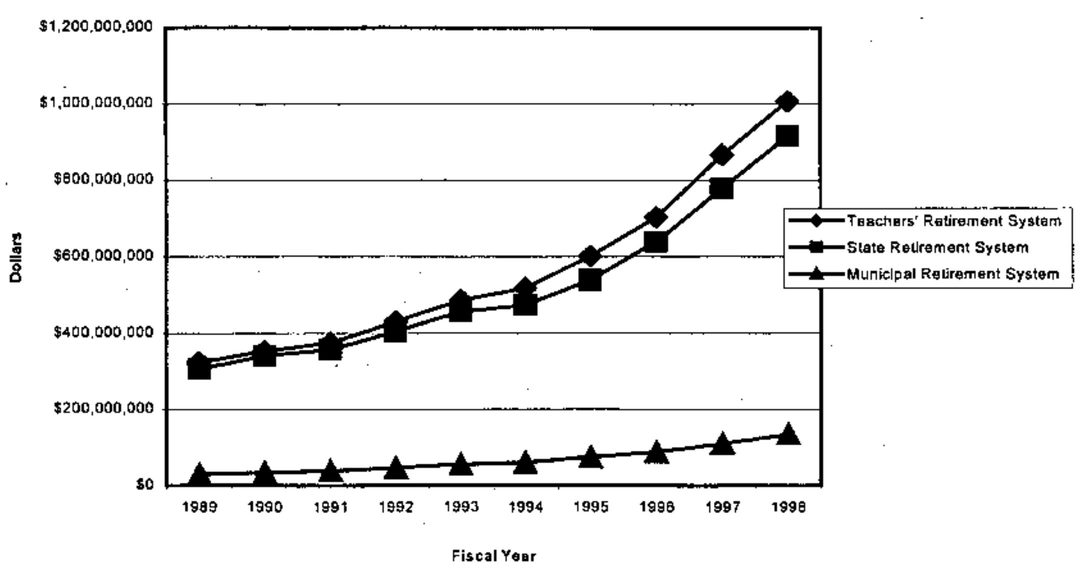
The amount and duration of short-term borrowing is usually dependent upon two critical factors: a recurring revenue stream matching recurring expenditures (in other words, an ongoing balanced budget); and a healthy stabilization reserve so that seasonal or economic dips in revenue as well as heavy expenditures that do not match up precisely with times of heavy revenue collection are offset by this reserve. Vermont has achieved these two standards to ensure little or no short-term borrowing and hopefully the General Assembly will continue to maintain balanced budgets and fully funded stabilization reserves.

II. Investing

A. Long-Term Investments

The Vermont State Retirement System, the Vermont State Teachers' Retirement System, and the Vermont Municipal Employees' Retirement System have combined assets in excess of $2 billion. The funds have almost doubled in size since March 1995.

Chart 6
Total Assets at Market For Three Retirement Systems FY 1989 to FY 1998



A diversified investment strategy is credited with achieving these results. A diversified investment strategy positions the portfolio to weather ups and downs in various investment sectors by placing assets in numerous categories instead of betting on just one. As a result, if one category is faltering another may be doing exceeding well. This strategy is quite different from market timing, where an investor tries to time precisely the ups and downs of various markets. In this strategy substantial losses can occur if the timing decision is wrong. In fiscal year 1998 assets grew 16.86% for the Vermont State Teachers' Retirement System, 18.44% for the Vermont State Retirement System, and 21.03% for the Vermont Municipal Employees' Retirement System. The Table below displays the asset distribution of the three retirement funds.

Table 1
Asset Allocation of Three Retirement Funds
Quarter Ending June 30, 1998

Investment Category	Municipal	Teachers'	State
Domestic Equity	52%	48%	51%
Domestic Bonds	27%	19%	16%
Cash	5%	0%	3%
Intl Equity	4%	21%	18%
Intl Bonds	7%	5%	2%
Real Estate	5%	7%	9%
Special Investments	0%	1%	1%

B. SHORT-TERM INVESTMENTS

Over the past four years the State Treasurer's office has instituted a competitive bidding system in its short-term investment program and become more aggressive in investing the State's resources. ***Overall, these changes have resulted in very favorable returns at reduced costs.*** For example, in fiscal year 1998, our average return was 5.35% as compared to the average three-month treasury bill rate of 5.05%.

III. Housing and Economic Development

A. Vermont Economic Development Authority's Refinancing Project

Over the years the State Treasurer's office has been called upon to fund the expansion of various Vermont Economic Development Authority programs through the State's cash flow. The State of Vermont has approximately $19 million in notes outstanding to VEDA for the programs that make loans available to local development corporations and private companies. However, the previous funding mechanism of using the State's cash flow had two fundamental problems: one, it put enormous pressures on the State's cash flow, which contributes to additional borrowing; and two, it was not a lasting and sustainable funding mechanism for VEDA, which needs approximately $10 million in new monies each year in order to meet the loan demand generated through these two programs. The State Treasurer's office, working closely with VEDA, has developed a sustainable funding mechanism that uses the existing assets of VEDA to borrow monies from the capital markets each year and repay investors using the cash flow of the existing loan portfolio. This program will allow VEDA to approve $10 million in new loans each year to local development corporations and private companies without a State appropriation or loans from the State's cash flow. In addition, the State's existing loans to VEDA will be repaid in accordance with an amortization schedule that complies with the law.

B. VHFA and VHMGB

Given the emergence of a very competitive private mortgage insurance industry interconnected by sophisticated technology to major government sponsored enterprises (i.e., Fannie Mae and Freddie Mac) as well as local lending institutions, the Vermont Home Mortgage Guarantee Board (VHMGB) has lost, and continues to lose, significant market share. Coupled with this loss of premium income is the continued prospect of significant claims (mostly Vermont Housing Finance Agency [VHFA] loans) against the fund that, if left unchecked, will ultimately draw upon the State's full faith and credit pledge. Such a draw would have significant credit implications for the State. The entire guarantee amount of approximately $120 million would be posted to the State's debt statement.

To suddenly increase the State's debt position by $120 million would be counterproductive to the enormous strides that the State has made in recent years to lower its outstanding debt, debt service, and debt ratios, and might lead to an adverse rating event.

The housing finance market has changed dramatically over the past several years and the increased competition from private mortgage insurance providers is only one indication of the changing market. Private mortgage insurance providers have learned to process a loan faster and in some cases more cheaply than VHMGB without much of the paperwork and sometimes at a financial advantage to the originating institution. But VHMGB will not be the only housing agency facing significant challenges. VHFA will have problems as well in this changing environment. In many instances Fannie Mae and Freddie Mac have as attractive a product as VHFA with almost instant approval. Lenders can tap into this instant loan approval process by computer, which is less cumbersome for them and their customers. In addition, many of the private mortgage insurance providers are electronically linked to this loan approval process. VHFA does not have this instant loan approval process, nor is it electronically linked to the originating lender. Already VHFA has seen a dramatic decrease in its business, and consequently this has had a spillover effect on VHMGB, since a significant portion of VHMGB guarantees are provided to VHFA.

The futures of VHFA and VHMGB are closely linked. Solving one agency's problem without regard to the other may adversely affect one or both agencies. It is therefore necessary to solve the immediate VHMGB situation in tandem with VHFA to ensure VHFA's future market and financial viability.

1. BACKGROUND

While most of the lenders in the State of Vermont are doing at least twice their 1997 volume, the use of VHMGB for loan guarantees has dropped 47 percent over the same period. In addition, FY 1998 claims were higher than forecasted by $380,000 and the continuation of significant claims into the future seems highly probable. In fact, if claims continue at the current pace, the cash reserves of the program will likely be exhausted within two years. In light of this significant drop in premium income, coupled with the prospect of significant claims and a risk of tapping the full faith and credit pledge of the State of Vermont, the Board hired Mortgage Dynamics, Inc. (MDI) to advise us on whether the guarantee program is still needed in a market now aggressively served by private mortgage insurance companies, or if the program should be restructured to compete in this ever changing market.

2. WHY LENDERS ARE NOT USING VHMGB

Based on interviews, the consulting firm suggests various reasons why lenders are not using VHMGB that are above and beyond other reasons mentioned previously in this report.

a. Insurance exchanges or "pools" are being used more and more by originating lenders. At least five VHMGB users, including the three largest users, have joined the New England Mortgage Insurance Exchange. They will be able to share in the premium income and risk of loans they insure with the operator of the Exchange. Of the 14 lenders interviewed all are heavy users of the Mortgage Guarantee Insurance Corporation (MGIC), the operator of the Exchange, and only one has ruled out joining the Exchange.

b. Although Freddie Mac and Fannie Mae accept VHMGB guarantees, many private investors and servicers, including wholesalers, who buy loans from lenders and then resell them to the agencies and other investors do not accept the VHMGB guarantee.

c. All of the lenders interviewed indicated that the private MI companies have become more predictable and flexible in their credit underwriting and rarely turn down loans for specific property groups.

d. Lenders don't have the same confidence in approval from VHMGB as they do from private mortgage insurers.

e. Lenders that sell bulk packages of servicing rights on Fannie Mae and Freddie Mac loans indicate most buyers only want to handle loans carrying insurance issued by the standard private MI companies.

f. VHMGB is more bureaucratic than private mortgage insurers.

3. CONSULTANT'S CONCLUSIONS

The consultant's report offered two options: closing down the program, or operating on a more limited scale if found financially feasible. However, operating the program on a more limited basis is problematic. Given the loss of market share and the very real likelihood of never regaining that market share because of insurance exchanges or "pools" being used more and more by originating lenders -- because they get a dividend -- and continued competition from other private mortgage insurers which are technologically connected, it is likely any new, smaller version of a program would experience adverse selection. Adverse selection means that those loans where mortgage insurance was unavailable elsewhere — the riskiest — would be brought to the VHMGB program. As a result, claims would be higher. Then premiums would have to be raised to offset the losses and the program would become less and less attractive. In a relatively short time period the program would again be faced with financial difficulty.

Closing down the program can be accomplished two ways: transferring the existing book of business to an MI company through a competitive bidding process or managing the run-off through VHMGB. However, only by selling the book of business will the State cap its risk and reduce its exposure to the entire $120 million guarantee being placed on its debt statement.

4. IMPLEMENTING THE TERMINATION OPTION

The Board is actively pursuing the termination option and has instructed the consulting firm to begin the process of requesting proposals from private mortgage insurers for purchasing the existing book of business of VHMGB and then shutting down the program. However, several other factors must be taken into account as well.

First, in order to satisfy existing bond stipulations the purchaser must be rated the same as, or higher than, the State of Vermont by the credit rating agencies.

Second, the purchaser will require some additional payment to cover losses, administration expense, and a profit. This means that VHMGB, through the amount in the debt service reserve fund and other equity, would pay the winning bidder to take on the existing book of business. Since the assets of VHMGB -- that could be used for this purpose -- are only approximately $3.8 million, any additional monies required by a successful bidder would have to be picked up by the State of Vermont. However, the State of Vermont would be rid of its $120 million liability. It is only a matter of time, perhaps as little as a few years, given the erosion of market share and continued claims against the fund, that the State of Vermont would have to initiate a bailout plan. Once the State initiates a bailout, we own the portfolio in the eyes of the rating agencies.

Third, all potential options which need to be explored must be pursued in tandem with VHFA so as not to adversely impact either VHFA or VHMGB. Frankly, the future viability of VHFA revolves around the ability of VHFA to offer a substantial interest rate discount as opposed to other lenders. Currently this interest rate differential is minimal and as a result VHFA has suffered market share reduction.

5. Conclusion

With strong economic conditions preventing a more rapid deterioration in VHMGB's financial condition, and a strong real estate market ensuring limited depreciation, coupled with cash reserves from both VHMGB's claims reserve fund and the State of Vermont's general fund to handle a limited deficiency, it will be in the best interest of VHMGB and the State of Vermont to sell this portfolio. Delaying a sale may expose VHMGB and the State of Vermont to less favorable conditions and may cause further deterioration in the viability of VHFA as well.

IV. ELECTRIC RESTRUCTURING

Some advocate proposals would allow Vermont municipalities to file for bankruptcy. The theory is if private utilities (such as Green Mountain Power and Central Vermont Public Service) file for bankruptcy protection, then allowing municipalities to also file for bankruptcy protection would shield them from the so-called "step-up" provision. The "step-up" provision in utility contracts is interpreted by some (there is dispute on this point) as allowing Hydro-Quebec, which sells power to the utilities, to collect its entire contractual obligation from those remaining, solvent utilities. The theory continues that if municipal utilities are protected from making a substantially larger payment to Hydro-Quebec because of the "step-up" provision, then they can continue making payments on their debt obligations to the Vermont Municipal Bond Bank and not have to trigger the moral obligation pledge of the State of Vermont on Bond Bank debt.

But this process may in fact have the opposite effect on those communities from what is intended and may have far-reaching adverse credit consequences for other Vermont towns and cities as well as the State of Vermont.

First, it is unclear and unpredictable what will happen in a municipal bankruptcy. As a general rule, other states do not allow municipalities to file for bankruptcy because of this uncertainty and the future effect it has on obtaining credit. While there is some body of research on the subject of municipal bankruptcy, virtually all of these cases and studies involve either home rule or modified home rule jurisdictions. Vermont is not one of these.

In the case of municipal bankruptcy, the liability for the bonds that have been floated by these various entities will continue, but what happens to the payments of these bonds once a court becomes the receiver? When will bond payments occur and how much will they be? And suppose bond payments are delayed, which causes the Vermont Municipal Bond Bank reserve fund to be drawn to pay bondholders and thereby triggers a call on the State's moral obligation pledge. Once even a one dollar payment is made to the reserve fund, the entire $370 million of the Municipal Bond Bank debt becomes the liability of the State of Vermont. Allowing municipal bankruptcy may trigger the moral obligation rather than prevent it.

Secondly, from a debt management perspective, allowing municipalities to file for bankruptcy would have detrimental consequences for the credit standing of the State and other entities in Vermont for the following reasons:

- Standard & Poor's recently upgraded the State's general obligation credit. One of the factors frequently cited by the rating agencies for Vermont's credit rating is Vermont's conservative debt management practice. To make it easier for a locality to take bankruptcy relief and to abrogate its debt would undermine this positive credit feature enjoyed by the State of Vermont.

- While it would not be easier for the State itself to take advantage of bankruptcy as a result of this proposal, the active encouragement of the State for local units to take bankruptcy would affect the analysis of the State's rating in the future. There are two primary considerations when the State's credit position is evaluated: ability to pay and willingness to pay. Ability to pay is a very objective standard consisting of various economic, financial and debt policies, perceived administrative capacities, etc. Proposing bankruptcy for localities, which could lead to abrogation of debt and other obligations, would harm the State's position with the rating agencies regarding its "willingness to pay" factor, which has been so positive for the State in the past.

- The Municipal Bond Bank recently had its rating increased. Relaxation of bankruptcy restrictions would also directly and adversely impact the Bond Bank's credit standing for all local jurisdictions throughout the State.

The State of Vermont and its municipalities cannot be perceived by the purchasers of debt as continually seeking ways to avoid legal contracts. A bond agreement between the bondholder and the State or a municipality is a legal contract. Unsettling the nerves of investors in State and municipal debt drives the cost of borrowing upwards, or worse yet, makes capital harder to obtain, while at the same time drives down the value of outstanding bonds for current investors, many of whom are Vermonters. For example, if local utilities are currently in the market seeking capital, how receptive are investors going to be if the State is going to allow bankruptcy for these local utilities?

Allowing communities to file for bankruptcy may have serious implications for the State of Vermont. A far better solution is to find avenues to mitigate costs through negotiations.

V. PRIVATE SCHOOL FINANCING

A. INTRODUCTION

During the waning days of the 1998 legislative session a proposal was floated in the capital bill allowing independent secondary schools to finance future capital construction projects through the Vermont Municipal Bond Bank. Currently, these independent schools may use the Vermont Educational and Health Buildings Financing Agency to obtain tax-exempt financing for capital projects, but are excluded from using the Vermont Municipal Bond Bank, which can only be utilized by governmental units (i.e., towns and cities, union and incorporated school districts). The major difference between the Vermont Educational and Health Buildings Financing Agency and the Vermont Municipal Bond Bank is that the latter agency carries the moral obligation of the State of Vermont. Given the State's relatively high credit rating, theoretically, any agency that has the State of Vermont's moral obligation pledge backing its debt financing should be rewarded with lower interest rates when it goes to market to finance debt as opposed to agencies that do not carry the MO pledge. Consequently, any school financing through the Vermont Municipal Bond Bank should receive lower interest rates. Of course if an entity with a higher credit rating than the State of Vermont finances through the Bond Bank, then the moral obligation would not enhance its credit rating and consequently its rates. In this instance, the entity with the higher credit rating than the State would be better served, in most cases, financing its capital needs through the Vermont Educational and Health Buildings Financing Agency.

A moral obligation technically means that the General Assembly is legally authorized, but not legally obligated, to appropriate money to maintain the reserve funds at required levels. But in practical terms, if the Bond Bank borrower falters financially, the State of Vermont, in most circumstances, will assume the financial obligations of the Bond Bank and may have to show it on the State's debt statement -- all $370 million of it -- as tax-supported debt. The State's moral obligation has been extended to the Bond Bank because a municipality, which includes a public school district, backs its bonds with the full taxing capacity of the municipality. For example, if a municipality ever defaulted on a bond payment to the Bond Bank, the municipality is required to raise property taxes to make the payment. Therefore the risk to the State of Vermont is minimized. However, a private school has no such taxing ability to back up its payment which could leave the Vermont Municipal Bond Bank and the State of Vermont financially exposed in cases of default. A significant default, or a series of defaults, could require the Legislature to fill the reserves of the Vermont Municipal Bond Bank, which in turn would trigger the rating agencies' requirement of redefining the $370 million of Bond Bank debt as State of Vermont tax-supported debt.

As a result of this office's concerns over extending the mandate of the Vermont Municipal Bond Bank, the 1998 Capital Construction Act was amended to include the following section:

> The state treasurer is directed to study the feasibility of authorizing nonsectarian and nondiscriminatory independent schools accepting publicly tuitioned students and located in Vermont, including the Austine School for the Deaf and Hard of Hearing in Brattleboro, to issue bonds for purchase by the Vermont Municipal Bond Bank. The study shall consider the impact of such an authorization on the credit ratings of the state and examine possible alternative methods of accessing tax exempt financing. The treasurer shall consult with potentially affected schools, the Bond Bank, relevant state agencies, the state's bond counsel and any other appropriate party. The state treasurer shall submit a report on the study by January 15, 1999 to the house and senate committees on institutions and to the house committee on ways and means and the senate committee on finance.

B. Background

This office met with representatives of nonsectarian and nondiscriminatory independent schools accepting publicly tuitioned students and located in Vermont, including the Austine School, and also spoke with them on numerous occasions on several conference calls. In addition, this office held meetings with the representatives of the Vermont Municipal Bond Bank, the State's financial advisor and bond counsel, and reviewed input from the Education Department. Because of the overriding concern of this office that allowing these entities to finance capital projects through the Vermont Municipal Bond Bank could have an adverse impact upon the State's credit rating with the potential inclusion of over $370 million of new debt being assigned to the State, three other options were discussed at length: 1) continue the current debt financing arrangement where these agencies finance through the Vermont Educational and Health Buildings Financing Agency; 2) restructure the independent school to more resemble a public school and thus be in a position to use a full faith taxing pledge of participating towns and consequently use the Vermont Municipal Bond Bank; or, 3) set up a new financing mechanism, outside the legal parameters of the Municipal Bond Bank, but where a few of these independent schools — defined as schools that have been long established and serve as the main high school for the host and surrounding communities — could obtain tax-exempt financing backed by a moral obligation pledge of the State of Vermont but with the level of moral obligation capped at an acceptable risk. Each of these options, any one of which is acceptable to the Treasurer's office if within certain parameters, is discussed in more detail below.

C. Options

Option One -- Continued Financing Through the Vermont Educational and Health Buildings Financing Agency

The independent schools have sought an alternative to their existing mechanism for financing long-term capital projects because they believe that issuing through the Vermont

Educational and Health Buildings Financing Agency is more expensive in terms of issuing costs and in terms of interest rate. After analyzing a case study presented by the independent schools, issuance costs were more affected by external factors (i.e., whether insurance coverage is obtained or not) than by the specific agency used.

But a compelling argument could be mounted that if the Vermont Municipal Bond Bank and the Vermont Educational and Health Buildings Financing Agency are in the market at the same time, with a similarly structured bond deal, the agency that holds the State's moral obligation pledge — the Bond Bank — should be more competitive with regard to interest rates. However, the likelihood of such a coinciding event with exactly the same set of underlying circumstances is remote. Given the fact that markets go up and down, at any one time an agency's financing package could be higher or lower than the other, irrespective of the State's moral obligation pledge.

Nevertheless, if the Legislature is seeking a general rule, the agency with the moral obligation pledge — the Vermont Municipal Bond Bank — should result in lower interest rates in the same economic and market conditions.

Option Two -- Restructure Independent Schools To Resemble a Union School District For Capital Debt Financing Purposes

Under this option in order for private schools to obtain financing through the Vermont Municipal Bond Bank they would have to reorganize themselves to establish a debt adoption process similar to the union school districts. Simply put, debt decisions would have to be voted upon by participating communities, a major departure from existing practices where boards of trustees make the sole determination on authorizing debt financing. In any vote dealing with debt service the cities or towns themselves, instead of the individual independent school, would be liable for debt service. Since the full taxing authority of the local communities backs these bonds, this arrangement would make these entities no different from a union school and thereby eligible to obtain debt financing, like any other municipality, through the Municipal Bond Bank.

It is expected that this option would be adamantly opposed by independent schools since it would restrict the autonomy that some have enjoyed for over 100 years.

Option Three -- Create a New Entity Only for Use by a Specified Group of Independent Schools That Would Allow Them to Obtain Tax-Exempt Financing at Virtually the Same Rates as the Municipal Bond Bank

This option would create a new entity, legally separate from the Vermont Municipal Bond Bank but administered by the Bond Bank, called the Independent School Financing Authority. Eligibility to use this new entity would be restricted to: Lyndon Academy, St. Johnsbury Academy, Thetford Academy, Burr and Burton Seminary, and the Austine School for the Deaf and Hard of Hearing. These schools are nonsectarian and nondiscriminatory independent schools located in Vermont and accept and enroll principally, students from the Vermont community in which the institution resides or students of surrounding Vermont communities. As such, they serve in lieu of a public school in a specific region of the State of Vermont and have the prime responsibility of providing secondary education to the children of the region. Their educators are members of the Vermont State Teachers' Retirement System and as members are appropriated monies each year by the State of Vermont to fund their retirement. There would be extended to this new entity a State of Vermont moral obligation pledge capped at $25 million. The institutions would have to meet certain eligibility requirements to participate. First, they would have to be rated at an investment grade or higher level by a major Wall Street rating agency to finance through this new entity. Second, the institution would pledge revenues equal to the maximum annual debt service. Third, the institution would maintain unrestricted assets the market value of which would be at least equal, on each semi-annual report date, to one hundred percent (100%) of the aggregate principal amount of debt outstanding. Fourth, the institution would agree to maintain revenues of at least 105% of annual operating expenses and annual debt service.

This new entity would provide equivalent interest rates to those few independent schools of its companion entity, the Vermont Municipal Bond Bank, but would limit any liability to the

State of Vermont to $25 million instead of a potential $370 million liability exposure if these schools defaulted as part of the Municipal Bond Bank. If these schools need additional debt in excess of the $25 million moral obligation pledge cap, then any overflow financing could be obtained through the Vermont Educational and Health Buildings Financing Agency. Security on the bonds, however, is not equivalent to the full taxing pledge of a public school.

VI. RETIREMENT

A. OVERVIEW

The State maintains three statutory pension plans: the Vermont State Teachers' Retirement System with 9,808 active and 3,289 retired members as of June 30, 1998; the Vermont State Retirement System with 7,257 active and 3,349 retired members; and the Vermont Municipal Employees' Retirement System, with 4,082 active and 710 retired members. Both the Vermont State Teachers' Retirement System and the Vermont State Retirement System are funded by employee contributions as well as those made by the State of Vermont. The Vermont Municipal Employees' Retirement System involves no State money.

B. FUNDING OF THE RETIREMENT SYSTEM

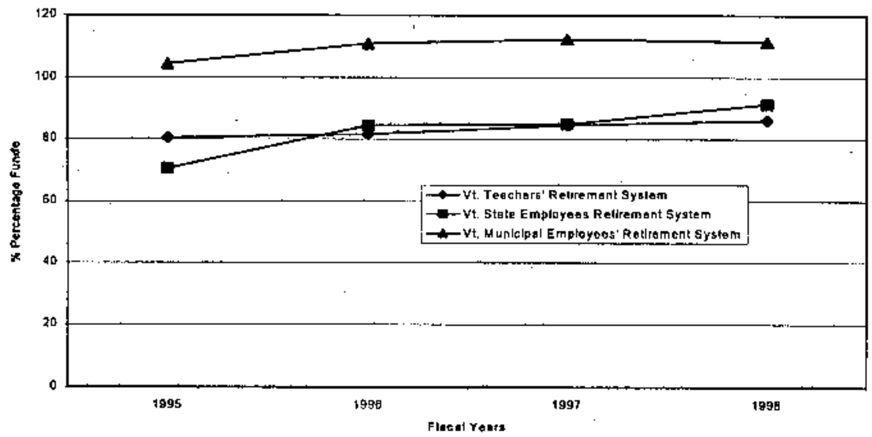
Pursuant to Governmental Accounting Standards Board Opinion No. 25 the funding status of the State and the Teachers' retirement systems has improved. (See Table 2.)

Table 2
Percent Funded Using GASB Opinion No.25

	State Teachers' Retirement System	Vermont State Retirement System	Vermont Municipal Employees' Retirement System
Actuarial Value of Assets	$821,977,000	$733,716,000	$113,678,000
Actuarial Accrual Liability (AAL)	955,694,000	804,501,000	102,005,000
Unfunded AAL (UAAL)	133,717,000	70,785,000	(11,673,000)
Funded Ratio	86%	91.2%	111.4%

Below is the funded status in recent years.

CHART 8
ANALYSIS OF FUNDING PROGRESS USING GASB STATEMENT NO. 25
FY '95 TO FY '98



Based upon the actuarial recommendation, I will request $20,723,874 in FY 2000 for the State's contribution to the Teachers' Retirement System.

C. STATUS OF THE NEW DEFINED CONTRIBUTION RETIREMENT PROGRAM

349 out of an eligible pool of 806 State employees or 43% have elected to leave their present State retirement plan and transfer to a new State defined contribution program. Any new

exempt employee hired after January 1, 1999 will be given the same option of choosing between the two retirement plans.

Each exempt employee has been given the option of staying with the current defined benefit plan, which factors retirement benefits by a formula mainly based upon age, years of service, and the average salary in the final years of employment. Both the employer and employee may make contributions to the defined benefit plan, but only the employer assumes the liability of the future pension benefits.

Under the new defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute a specific amount (a percentage of their annual salary) to their individual accounts. The State makes a fixed contribution to each employee's account. Employees are responsible for making all investment decisions regarding contributions among investment options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their account, plus investment earnings. The defined contribution plan provides portability for a mobile workforce. It also reduces the unfunded liability for the State of Vermont because the State does not assume the liability of a future pension benefit.

The retirement division, in conjunction with Fidelity Investments Public Sector Services Company (the firm selected to provide record keeping, education, and investment services) did an excellent job of ensuring that eligible employees were briefed on the advantages and disadvantages of each plan and the various investment options available. They went to great lengths to ensure that the information presented was done in such a way as to eliminate the potential for any bias toward one plan or the other.

Vermont is in the forefront of pension system reform. Few states offer this type of a plan. In those few similar circumstances where an option between a defined benefit and a defined contribution is offered Vermont is a leader in the percentage of employees who elected to convert to the new plan. According to published reports, and data that Fidelity provided, the 43% conversion rate is one of the highest in the country when comparing similar types of defined benefit to defined contribution conversions in the public sector. The numbers speak to the success of the information program, given the almost even split between employees choosing to remain with the current program and those switching to the new plan.

The defined contribution option was made available to exempt employees by the legislature during the last session. If the legislature wishes to expand the program to include classified employees, the Treasurer's office encourages legislators to keep the plans optional, as is the current arrangement with exempt employees, rather than impose any mandatory defined contribution plan.

VII. Abandoned Property

A. Overview

The primary function of the abandoned property division is to locate and return to a rightful owner monies or property (i.e., stocks, bonds, bank accounts, contents of safe deposit boxes) that has been turned over to the State by companies and financial institutions that claim they are unable to locate these owners.

Currently, more than $7 million of unclaimed property is held by the State Treasurer's office. In fiscal year 1998, the State Treasurer's office returned 67 percent of assets that had been turned over to the State that year. According to the National Association of Unclaimed Property Administrators the average rate is between 35 percent and 50 percent. Vermont led the nation last year in the percentage of abandoned property returned to owners. The average claim amounts to $180 but a single claim has been as much as $66,000.

There are several reasons for this success. For one thing, the legislature has granted increases over the last four years to increase staffing and to upgrade our computers and software. Also, we have enlisted the help of town clerks in an effort to locate individuals. With increased staff we've been able to devote some time to tracking people down through telephone books and other means, which has proven beneficial. In addition, we've put the names of owners of abandoned property on the Internet where it is easier to search for a name; shortened the time after which property is deemed abandoned (from seven years to five years) so owners can more easily be found; and reciprocated with other States in order to return abandoned property to the state in which the owner most recently lived.

However, there are still many Vermont companies that are unaware of the requirements of the abandoned property program and probably have not reported as required by law. We are undertaking an education program that will focus on in-state companies and institutions so they are informed of their obligations under the abandoned property law.

VIII. Y2K

The Treasurer's office has undertaken a major effort to ensure its information technology is Y2K compliant. In fact, this office is scheduled to be fully Y2K compliant by April 1999. Already a major effort has been undertaken to ensure that hardware and software components are reprogrammed and tested. The larger, and in most cases, older program conversions are taking place between January and April 1999.

We have also contacted various contractors that the State Treasurer's office utilizes in the course of its financial management, investment, and debt management functions and asked for Y2K updates and compliance reports. As of yet, no conditions have been reported that have caused concern.

We have reported concerns in a recent bond issue Official Statement about the overall effort of the State's Y2K effort being headed by the Office of Chief Information Officer. These concerns are based upon reports from the Auditor of Accounts' office. In the most recent Official Statement the Chief Information Officer has updated this information. Succinctly, the CIO reports, "The State does not anticipate any major problems or disruption of services related to the Year 2000 Issue. The State's critical systems are expected to achieve Year 2000 Issue compliance by June 30, 1999." However, we also reported that the Office of the Auditor of Accounts periodically issues reports outlining the progress of the State's Year 2000 issue compliance efforts. From reading the previous Official Statement both the rating agencies and investors realize there is a difference of opinion as to the level of preparedness for Year 2000. In addition, we have informed both the Chief Information Officer and the Secretary of Administration that overall State efforts and compliance with Y2K issues are of concern to the rating agencies as well as investors in the State's debt.

IX. FINANCIAL MANAGEMENT

A. ELECTRONIC BANKING/PAYMENTS/TRANSFERS

The State Treasurer's Office is continuing to encourage electronic payments of such items as vendor payments, payroll, and hopefully, welfare and other benefits. Already most State aid payments to municipalities are handled electronically. Also, in conjunction with the Department of Taxes, a pilot program has begun to receive tax payments electronically. The ultimate goal is to have most financial transactions occur electronically.

B. INTERACTION WITH THE AUDITOR OF ACCOUNTS' OFFICE AND COMPLIANCE WITH AUDIT FINDINGS

Interaction with the Auditor of Accounts' office has proven essential in our desire to improve financial reporting systems. We have used the Auditor's office as a resource and they have been kind enough to offer financial reporting recommendations which have proven helpful. In addition, we have taken each audit finding seriously and, since the Treasurer's office handles more than $2 billion of retirement and state funds, we will use our audit compliance division to ensure proper financial controls.

X. Legislative Reporting Requirements

A. Brandon Training School

Section 23 of Act 62 (Capital Bill) of the Public Acts of 1995 specifies that the State Treasurer notify the chairs of the senate and house institutions committees upon receipt of monies from the sale of the Brandon Training School property as well as certain federal receipts associated with the Vermont Veterans Home. The State has received amounts due from the federal government for reimbursement of expenses associated with the Vermont Veterans Home, but has not recorded any receipts for the sale of the Brandon Training School.

B. Various Receipts

Section 22 of Act 185 (Capital Bill) of the Public Acts of 1996 specifies that the State Treasurer notify the chairs of the house and senate institutions committees, the members of the joint fiscal committee, the secretaries of human services, natural resources and transportation, and the commissioner of buildings and general services of acceptance of certain anticipated receipts. The amounts cited under this section have been received.

C. McBride Principles

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the retirement boards compile a list of corporations that conduct business in Northern Ireland in which the State Treasurer and retirement boards have invested monies. This list is available to anyone who desires to examine it at the retirement division of the State Treasurer's Office.

Appendix A

State of Vermont
Pension Trust Funds
Combining Statement of Plan Net Assets
June 30, 1998
(with comparative total for June 30, 1997)

	Vermont State Retirement Fund	State Teachers' Retirement Fund	Vermont Municipal Employees' Retirement Fund	Totals June 30, 1998	Totals June 30, 1997
ASSETS					
Cash and Short-term Investments	$ 32,967,080.48	$ 6,397,996.54	$ 4,192,649.41	$ 43,557,726.43	$ 39,364,548.42
Receivables					
Contributions	$ 2,172,701.37	$ 1,983,885.80	$ 1,587,862.95	$ 5,744,450.12	$ 4,973,554.23
Investments	40,441,194.44	14,826,609.66	1,019,174.48	56,286,978.58	100,289,303.50
Other Receivables	127,755.81	144,338.78	28.34	272,122.93	348,173.35
Total Receivables	**$ 42,741,651.62**	**$ 16,954,834.24**	**$ 2,607,065.77**	**$ 62,303,551.63**	**$ 105,611,031.08**
Investments					
Fixed Income	$ 164,383,344.39	$ 227,587,349.76	$ 29,136,365.30	$ 421,107,059.45	$ 395,916,076.02
Common and Preferred Stock	623,024,384.16	690,582,440.32	91,435,117.80	1,405,041,942.28	1,148,665,312.78
Mortgages	130,375.87	255,505.34	0.00	385,881.21	360,671.16
Real Estate/Venture Capital	95,536,842.43	79,931,742.80	7,842,195.30	183,310,780.53	163,544,237.34
Total Investments	**$ 883,074,946.85**	**$ 998,357,038.22**	**$ 128,413,678.40**	**$ 2,009,845,663.47**	**$ 1,708,486,297.30**
Total Assets	**$ 958,783,678.95**	**$ 1,021,709,869.00**	**$ 135,213,393.58**	**$ 2,115,706,941.53**	**$ 1,853,461,876.80**
LIABILITIES					
Accounts Payable					
Investments	$ 42,597,483.92	$ 11,306,897.64	$ 199,484.31	$ 54,103,865.87	$ 92,771,662.39
Other	649,488.32	1,012,748.86	144,090.91	1,806,328.09	1,298,779.58
Total Liabilities	**$ 43,246,972.24**	**$ 12,319,646.50**	**$ 343,575.22**	**$ 55,910,193.96**	**$ 94,070,441.97**
Net Assets Held in Trust for Pension Benefits	**$ 915,536,706.71**	**$ 1,009,390,222.50**	**$ 134,869,818.36**	**$ 2,059,796,747.57**	**$ 1,759,391,434.83**

A schedule of funding progress for each plan is presented on page ______.

State of Vermont
Pension Trust Funds
Combining Statement of Changes in Plan Net Assets
For the Year Ended June 30, 1998
(with comparative total for June 30, 1997)

	Vermont State Retirement Fund	State Teachers' Retirement Fund	Vermont Municipal Employees' Retirement Fund	Totals June 30, 1998	Totals June 30, 1997
ADDITIONS					
Contributions					
Employer	$ 23,560,464.21	$ 18,080,000.00	$ 3,665,833.35	$ 45,306,297.56	$ 45,520,175.93
Plan Members	7,242,653.15	14,424,951.82	3,285,697.25	24,953,302.22	24,278,325.06
Pension Accumulation Fund	192,523.71	133,730.97	48,307.08	374,561.76	358,783.73
Other Contributions	184,802.61	38,928.53	25,321.97	249,053.11	187,654.63
Total Contributions	**$ 31,180,443.68**	**$ 32,677,611.32**	**$ 7,025,159.65**	**$ 70,883,214.65**	**$ 70,344,939.35**
Investments					
Net Appreciation (Depreciation) in Fair Value of Investments	$ 119,753,414.91	$ 120,280,615.07	$ 20,656,921.78	$ 260,690,951.76	$ 280,589,834.20
Dividends	11,552,032.88	12,462,575.12	936,104.47	24,950,712.47	24,030,270.95
Interest	12,404,645.54	15,214,823.65	1,714,570.24	29,334,039.43	25,659,706.14
Security Lendings Income	1,179,205.69	2,552,346.97	63,192.01	3,794,744.67	4,421,343.47
Other Income	94,096.91	230,759.90	0.00	324,856.81	85,031.90
Total Income from Investments	**$ 144,983,395.93**	**$ 150,741,120.71**	**$ 23,370,788.50**	**$ 319,095,305.14**	**$ 334,786,186.66**
Less Investment Expenses					
Investment Managers and Consultants	$ 3,310,215.97	$ 3,506,116.92	$ 449,679.92	$ 7,266,012.81	$ 6,616,426.69
Security Lending Expenses	1,098,908.28	2,449,090.57	57,835.51	3,605,834.36	4,195,608.90
Total Investment Expenses	**$ 4,409,124.25**	**$ 5,955,207.49**	**$ 507,515.43**	**$ 10,871,847.17**	**$ 10,812,035.59**
Net Investment Income	**$ 140,574,271.68**	**$ 144,785,913.22**	**$ 22,863,273.07**	**$ 308,223,457.97**	**$ 323,974,151.07**
Total Additions	**$ 171,754,715.36**	**$ 177,463,524.54**	**$ 29,888,432.72**	**$ 379,106,672.62**	**$ 394,319,090.42**
DEDUCTIONS					
Retirement Benefits	$ 31,294,000.86	$ 31,763,599.80	$ 2,559,892.07	$ 65,617,492.73	$ 61,005,060.27
Refunds of Contributions	571,058.64	799,515.26	1,775,842.82	3,146,416.72	1,935,572.80
Death Claims	69,234.32	133,043.72	44,417.09	246,695.13	225,850.83
Transfers to Other Fund	64,166.58	58,710.16	291,403.39	414,280.13	305,637.49
Operating Expenses	5,624,307.65	3,404,033.88	248,133.64	9,276,475.17	8,812,152.86
Total Deductions	**$ 37,622,768.05**	**$ 36,158,902.82**	**$ 4,919,689.01**	**$ 78,701,359.88**	**$ 72,284,274.25**
Net Increase	**$ 134,131,947.31**	**$ 141,304,621.72**	**$ 24,968,743.71**	**$ 300,405,312.74**	**$ 322,034,816.17**
Net Assets Held in Trust for Pension Benefits:					
Beginning of Year, restated	**781,404,759.40**	**868,085,600.78**	**109,901,074.65**	**1,759,391,434.83**	**1,437,356,618.66**
End of Year	**$ 915,536,706.71**	**$ 1,009,390,222.50**	**$ 134,869,818.36**	**$ 2,059,796,747.57**	**$ 1,759,391,434.83**

Appendix B

1 STATE OF VERMONT DEFINED CONTRIBUTION PLAN FOR EXEMPT EMPLOYEES

2 Overview Of The Defined Contribution Plan

- Goal of the Program
- Eligibility and Participation
- Election Results
- Employee and Employer Contributions
- Investment of Funds
- Vesting of Benefits

3 Goal of the Program

- The goal of the program is to attract a talented workforce in a very mobile society by offering a retirement package as flexible and mobile as the career path of the employee.

4 Eligibility and Participation

- On January 1, 1999 each of the existing 806 exempt State of Vermont employees had the opportunity to transfer from the current defined benefit plan to a new defined contribution pension plan. Exempt employees consist of all elected and appointed officials, judges, senior State employees and staff in sensitive positions.

5 Eligibility and Participation (Continued)

- For those existing exempt employees who opted for the new defined contribution plan the amount that was transferred to the new plan was based on the full actuarial value of the accrued benefit or the accumulated member's contributions with interest, whichever was greater.

6 Eligibility and Participation (Continued)

- Any new exempt employee will also have the option of electing either the defined benefit or defined contribution plan.
- Once a choice of retirement plans is made, it is irrevocable as long as the employee retains exempt status. If the employee changes to a classified position, the opportunity to "buy back" into the defined benefit plan will be available.

7 Election Results

- 349 out of an eligible pool of 806 State employees or 43% have elected to leave their present State retirement plan and instead opt for a new State defined contribution program.

8 Employee and Employer Contributions

- Both the employee and employer contributions will be deposited each pay period into an account that is maintained for each plan member by the State Treasurer. In addition, eligible "rollover" accounts will be allowed. The employee is furnished with a statement of account balances on a quarterly basis.

9 ☐ Employee Contribution

- All exempt employees will be required to make a pre-tax contribution that is equal to the rate contributed under the existing defined benefit plan, currently at 2.85%.

10 ☐ Employer Contribution

- The State of Vermont will contribute to each individual account an amount equal to 7% of the employee's bi-weekly salary at each pay period. This rate has been determined to approximate current parity of payments to the defined benefit plan. As with the defined benefit plan, the State will assume the administrative costs of the defined contribution plan.

11 ☐ Guidelines for Investments

- While not required for governmental plans the State Treasurer followed the ERISA defined contribution requirements under the Internal Revenue Code, which requires that plan members have a minimum of three investment choices, each of which has differing risk and return characteristics.

12 ☐ Investment of Funds

- All defined contribution plan members have the responsibility for the investment of all employee and employer contributions among a group of Fidelity family of funds chosen by the State Treasurer.

13 ☐ Vesting of Benefits

- Under the current defined benefit plan, members are fully vested after completing five years of service with the State. Under the *NEW* plan a participant is fully vested after one year and eleven months service.