December 23, 2009

Initial Summary of Recommendations--December 2009

Commission on the Design and Funding of Retirement and Retiree Health Benefit Plans

While the formatting and narrative will likely change in the final version of our report, this initial summary reflects the considerations and decisions of the Commission.

The challenge

The Commission was created by the Vermont Legislature to review and report on the design and funding of retirement and retiree health benefit plans for the state employees' (VSERS) and teachers' (VSTRS) retirement systems. The Legislature and Governor were concerned about the affordability and long-term sustainability of the retirement plans, pension, and retiree healthcare, and asked for recommendations from the Commission addressing the situation. The Joint Fiscal Committee provided the Commission with a target in the expenditure growth rate of 3.5% and stated that in the event a higher growth rate is targeted, the Commission should be specific as to how it is to be financed.

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. In Vermont, 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. The State's contribution to the Teachers' retirement plan has increased by 70% over the last five years, from about $24.4 million to $41.5 million, and, without change, will rise by more than 50% to $63.5 million in one year.

	VSTRS Employer ARC*	VSERS Employer ARC*
FY 2009	$37,077,050	$25,333,307
FY 2010	$41,503,002	$32,013,894
FY 2011	$63,501,220	$41,581,656

*refers to the actuarially required contribution recommended in October as part of the annual valuation

Why the dramatic increase? Certainly the serious implosion of the financial markets in 2008 and the first quarter of 2009 is the largest factor this year. But demographics and workplace trends also play an important role over time. 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, going

forward, are projected to increase 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 spent in employment for the State or school districts.

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% increase from what the annual benefit payout is now.

In fiscal year 2008, the State's contribution to the two systems represented about 5.5% of General Fund revenues. This year the combined contributions represent about 7.1% of General Fund revenues, and next year they will represent about 10.1% of General Fund revenues. While some of the funds for the State Employees' retirement system are federal, all of the appropriations for the Teachers' plan are General Funds, and the message is clear: Without change, the State's costs to maintain the current benefit plans will crowd out support for other important programs.

Even if investment returns experience a sustained recovery, the current level of growth in the required contributions to fund the pensions exceeds historical growth of the past 15+ years or any current long-term revenue growth projections. Assuming a 15% positive investment return this year and based on current benefits and assumptions, the independent actuary projects that the employer ARC for VSTRS will continue to escalate from $63.5 million in FY 2011 to $70.3 million in FY 2012; for VSERS it would escalate from $41.5 million in FY 2011 to $45.5 million in FY 2012. That would be an $11 million increased appropriation need in FY 2012, on top of the $32 million increase in FY 2011, assuming we can sustain 15% for the year ending June 30, 2010.

Payments for the 80% employer share for retiree health insurance premiums also are escalating 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

The Commission recognized that the benefit levels for both systems are modest when compared to public systems in other states; employee contribution rates are modest as well. It also recognizes that the relative competitiveness of public benefits should not only be compared against other state systems, but also to what is competitive within Vermont and for

the many thousands of workers in the private and other non-profit sectors. Most private and non-profit sector employers and members of the public do not have comparable benefits. Total compensation (salary and benefits) must be considered when making comparisons between the public and private sectors.

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. 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. Retirees pay income tax on their benefits--an important revenue source for the operation of government. But a healthy economic balance cannot be maintained if pension benefit increases exceed the ability of taxpayers to afford them.

What we are not recommending

- Changes to pension or retiree health benefits for those already retired.
- Changes to pension or retiree health benefits for anyone close to retirement, which we are defining as within five years of eligibility for a particular benefit.
- Ending the current defined benefit plan and moving to a defined contribution plan.
- Making the basic provisions (maximum benefit, multiplier, COLA, etc.) of our plan less competitive than the mainstream of other state public systems.
- Shifting the State's payment for the Teachers' retirement plan to the Education Fund or local districts.

What we are recommending for pension benefit changes

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.

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.

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.

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

- 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% of average final compensation after 30 years of service. With this change one would receive 60% of AFC after 36 years of service.

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 share, represented as a percentage of payroll, has been escalating.

Employer/employee contribution levels as a percentage of payroll:

	Teachers		State Employees	
	Employee	Employer	Employee	Employer
FY 2009	3.4%	6.88%	5.10%	6.27%
FY 2010	3.4%	7.41%	5.10%	7.57%
FY 2011	3.4%	10.82%	5.10%	9.84%

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 considered various methods and percentages for implementing such a system. For example, this could be accomplished by a sharing of the total annual contribution developed by the actuary or on a going-forward basis using FY 2010 as a baseline; the proportional shares could be 50/50, 60/40, or some other ratio. The Commission chose to recommend a sharing of the total annual contribution. In order to accommodate the Joint Fiscal Committee growth rate target for the State of 3.5%, the recommended State and employee shares will fall between 55% to 60% and 40% and 45%, respectively, based on final calculations to be completed by our consulting actuaries. This contribution system 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.

What we are recommending for retiree health insurance changes

The Commission recommends a tiered medical premium copayment structure based on length of service. Instead of the current straight 80/20 split of retiree health insurance premiums utilized for most retired teachers and State 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.

The new employer share for the tiered system would be:

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

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

Conclusion

The recommendations of this Commission attempt to strike a balance, recognizing the public policy and economic context in which the current benefit structures operate, the need for a dependable retirement for our workforce, and the need for fiscal sustainability. 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 though inaction. We are fast approaching the tipping point where the failure to address the issue now will lead to potentially larger problems later and 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 models can be reviewed. We look 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 economy.