Review of Pension Funding Status
Vermont State Teachers' Retirement System

Jeb Spaulding

State Treasurer

January 25, 2005

As the legal custodian of the pension funds for Vermont's public school educators, I am increasingly concerned about the persistent underfunding of the Vermont State Teachers' Retirement System.

Unfortunately, the problem has been getting worse in recent years. Whereas five years ago the State appropriated 93% of the recommended actuarial contribution for this pension fund, this year it is paying only 43%. The underfunding in this year alone is $27 million dollars. The indicator normally used to justify continued underfunding, the GASB 25 funding ratio, does not accurately portray the financial health of this pension fund since annual underfunding is not added into the calculation of the ratio. The net pension obligation, which reflects the cumulative impact of underfunding, grew from $87.5 million in Fiscal Year 2002 to $110.9 million in FY 2004. The problem will continue to grow unless responsible steps are taken soon. Each year we do not address this situation, the problem will be more difficult to fix.

Ironically, the level of underfunding has been worsening at a time when State revenues have been increasing. The General Fund revenue forecast has been upgraded twice since last July, adding over $55 million in previously unanticipated revenues in FY 2005 and 2006. The Governor has proposed spending those additional revenues on lots of worthy causes, but none on this particular existing obligation this year. He has now recommended funding for FY 2006 at last year's level of $24 million, instead of the actuarially derived figure of $50 million. While every bit helps, that would still be less than half of the needed contribution.

In past economic and revenue downturns, the State has occasionally resorted to funding substantially less than the actuarial recommendation for a year or two, but when revenues rebounded more adequate funding was forthcoming. If we can't come up with the necessary funding when times are good, I fear the results when the next revenue downturn comes along.

I appreciate the difficult task the Governor and Legislature have in balancing a number of budgetary pressure points, but choosing not to adequately address this obligation of the State would be imprudent. Continued underfunding of the teachers' pension fund not only increases the future cost to taxpayers for obligations already incurred, at the current scale it may well undermine benefits and lead to increased contributions for future teachers as well. Vermont taxpayers are already bearing the burden of past underfunding. Over $14 million of the 2004 recommended State contribution was on account of past shortfalls. Vermont parents and students will be losers, too, if we cannot continue to offer competitive retirement benefits to recruit and retain quality teachers.

I believe this problem can be solved, but only with commitment from three parties: the State, the local districts, and the teachers. There are a variety of steps that could be taken if we have the collective will to do so. I stand ready to work with interested parties to develop a realistic and sustainable funding plan for the Vermont State Teachers' Retirement System pension fund. The sooner we begin, the better.

I hope this presentation is helpful in providing information to assist policymakers in addressing this issue.

Jeb Spaulding

Jeb Spaulding, State Treasurer

Pension Benefits are essentially IOUs to employees that accumulate while they are working and that are cashed in at the time of retirement. These benefits are also a partnership, since employees make ongoing contributions to the plan with the expectation that the employer will meet its obligations.

Public funds must ultimately turn to individual sponsors, in this case the State of Vermont, to make good on retirement IOUs.

The Bottom Line

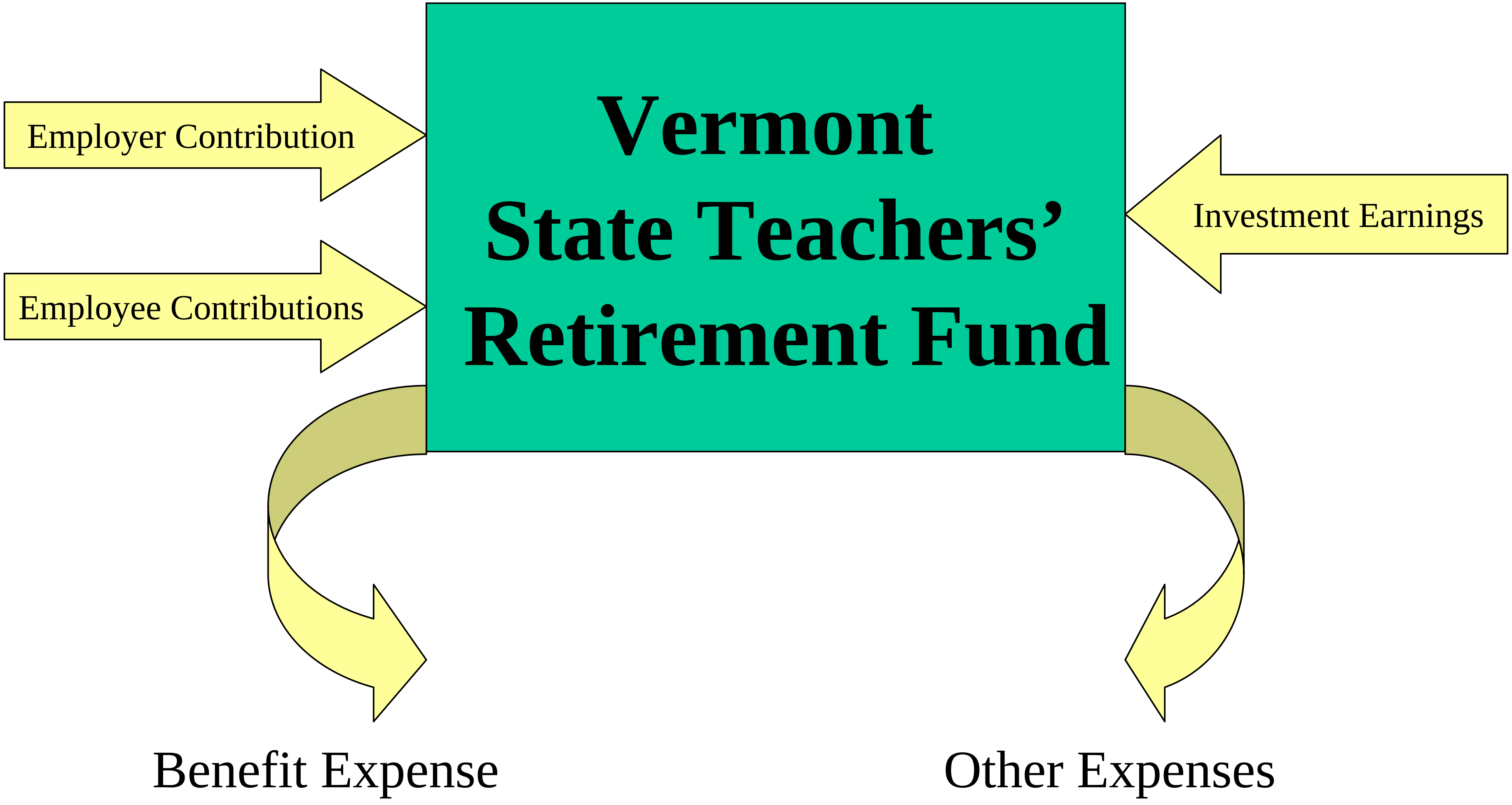
Fiscal Year	Actuary's Recommend	Actual Approp.
FY 2001	$20,970,278	$19,143,827
FY 2002	$22,146,880	$20,446,282
FY 2003	$28,279,810	$20,446,282
FY 2004*	$41,658,946	$20,446,282
		$ 4,000,000**
FY 2006	$49,923,599	$24,446,282***
FY 2005	$47,714,318	$20,446,282

*** The significant increase in the actuarial recommendation in FY 04 resulted in large part from the required five-year actuarial experience study, chronic underfunding by the State, and investment returns.**

**** In addition to the base appropriation of $20,446,282, a "waterfall" allocation of $4,000,000 from excess revenues was appropriated in FY2004.**

***** Based on Governor's recommendation.**

Pension Funding Model



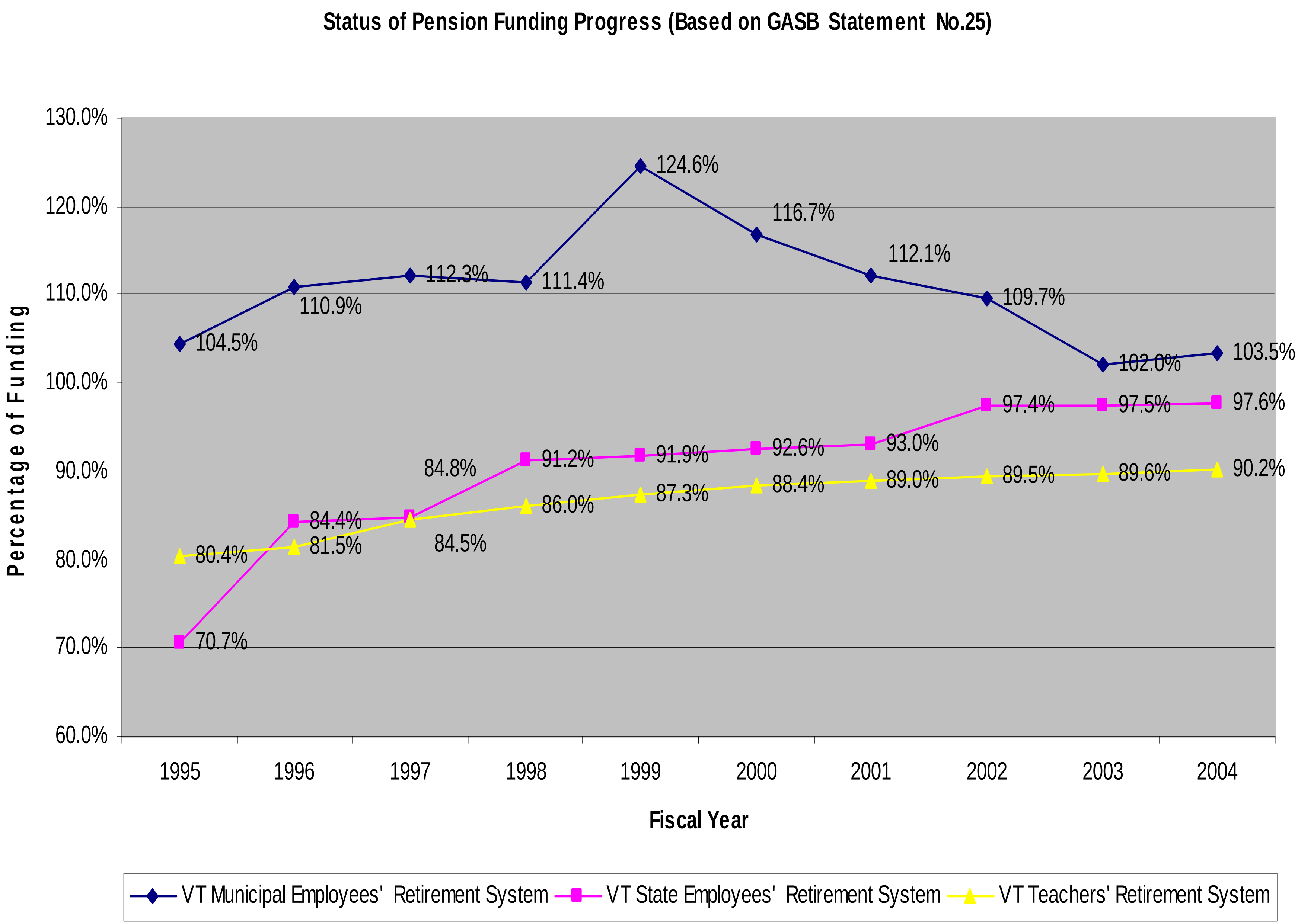
Pension Operations Summary

Vermont State Teachers' Retirement System				
Category	Fiscal Year 2004	Fiscal Year 2003	Fiscal Year 2002	Fiscal Year 2001
SOURCES OF FUNDS				
Employee Contributions	$21,088,345	$18,820,703	$18,075,514	$16,350,020
Employer Contributions	$24,446,282	$20,446,282	$20,446,282	$19,143,827
Other Income	$267,330	$438,166	$121,238	$296,005
Investment Income	$166,325,045	$52,506,838	-$56,937,537	-$38,810,722
APPLICATION OF FUNDS				
Retirement Benefits	$55,246,342	$50,409,313	$46,624,879	$42,526,838
Refunds	$711,806	$1,109,174	$867,715	$1,089,403
Health/Life Insurance Expenses	$8,279,332	$6,634,738	$5,299,600	$4,194,215
Administrative Expenses	$805,495	$763,527	$663,545	$677,493
Other Expenses	$543,746	$702,568	$280,609	$441,354
Addition to Net Assets Held in Trust for Pension Benefits	$146,540,281	$32,592,669	-$72,030,851	-$51,950,173

Long-term Investment Performance Of Vermont's Three State-Supported Retirement Systems

As of June 30, 2004

Retirement System:	Last 1 Year	Last 3 Years	Last 5 Years	Last 7 Years	Last 10 Years
Teachers Composite (Gross)	15.7%	5.2%	4.5%	7.1%	10.6%
Employees Composite (Gross)	15.7%	4.7%	3.7%	6.4%	9.9%
Municipal Composite (Gross)	14.8%	4.8%	4.2%	7.8%	10.8%
Median Public Fund	14.6%	4.4%	4.1%	6.7%	9.7%


Status of Pension Funding Progress (Based on GASB Statement No.25)
Percentage of Funding
Fiscal Year
130.0%
120.0%
110.0%
100.0%
90.0%
80.0%
70.0%
60.0%
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
104.5%
110.9%
112.3%
111.4%
124.6%
116.7%
112.1%
109.7%
102.0%
103.5%
70.7%
84.4%
84.8%
91.2%
91.9%
92.6%
93.0%
97.4%
97.5%
97.6%
80.4%
81.5%
84.5%
86.0%
87.3%
88.4%
89.0%
89.5%
89.6%
90.2%
VT Municipal Employees' Retirement System
VT State Employees' Retirement System
VT Teachers' Retirement System

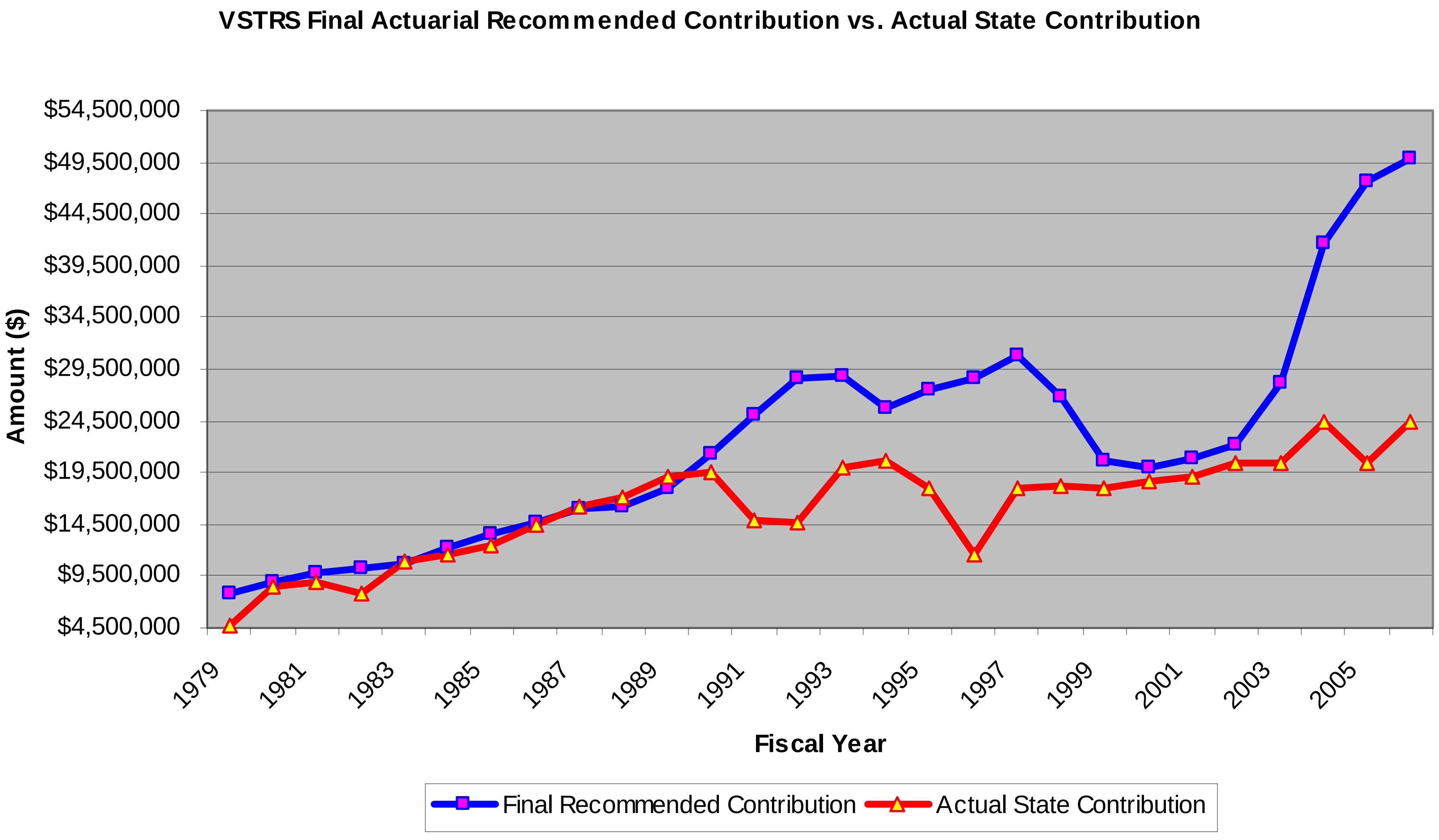
GASB 25 and the actuarial method used by our systems do not accurately reflect the effect of annual underfunding.

- Although the GASB 25 ratio for VSTRS has improved, relying on these ratios as an indicator of the financial health of these pension funds may lead to a false sense of security.

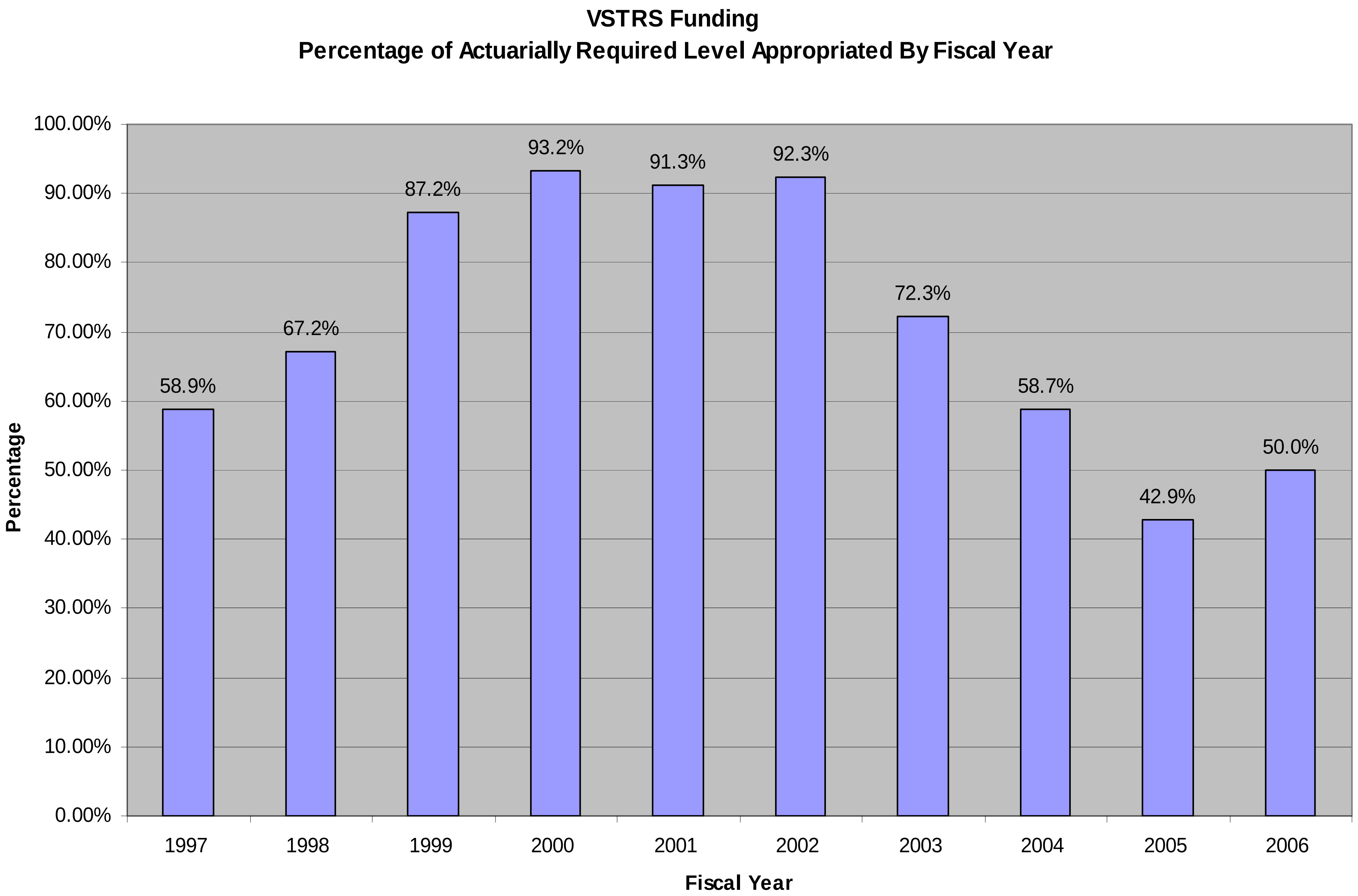
- Statute requires that the pension liability be determined on the basis of the actuarial cost method known as "entry age normal cost with frozen initial liability."

- Instead of the annual underfunding being added to the accrued liability measured by GASB 25, it simply gets added to the calculation of “normal costs” for the next year.

- While the GASB 25 ratio improves and the portion of total required annual contribution for the accrued liability is fairly stable, the total required contribution (accrued liability and normal) is escalating rapidly. Other factors include demographics, actuarial experience, benefit enhancements, and market fluctuations.



Note: Final recommended contribution is developed in October of the same fiscal year. FY 05 and 06 are projected based on actuarial valuation. FY06 contribution is based on Governor's recommendation.



Note: FY06 based on Governor’s recommendation

VSTRS Liability Looking Forward

Fiscal Year	Projected Payroll	Normal Rate	CONTRIBUTIONS		
			Normal	Accrued Liability	Total
2005	$ 453,517,153	7.79 %	$35,328,986	$12,385,332	$47,714,318
2006	473,925,000	7.79%	36,919,000	13,004,599	49,923,599
2007	495,252,000	7.79%	38,580,000	13,564,829	52,234,829

How VSTRS Compares to Other Public Funds: 2004 Wilshire Report

•Assets of large state pension funds fell 4% in 2003, while liabilities grew 6%, according to a 2004 survey by Wilshire Associates Inc.

•State pension plans have a combined shortfall of $366 billion dollars in 2003 as compared to $180 billion in 2002.

• Of the 123 state funds in the survey, 93% are underfunded, according to Wilshire, up from 79% in 2002, 51% in 2001, and 31% in 2000.

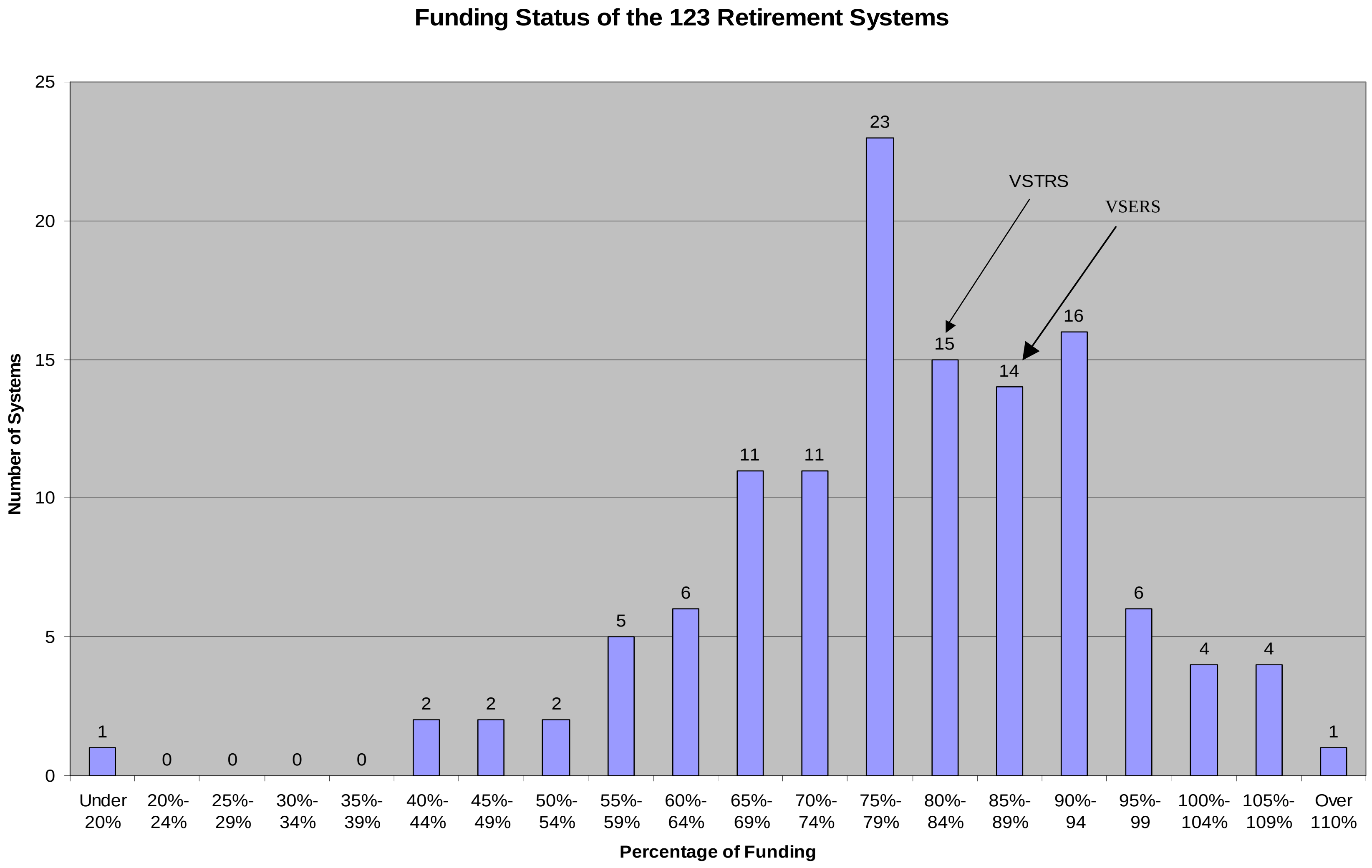
•Wilshire forecasts a long-term return on state pension assets of about 7.2% per annum, slightly below the VSTRS average **actuarial** interest rate assumption of 8%.

•Vermont's actuarial assumption was reduced from 8.5% to 8%, but still is higher than the Wilshire estimate.

Source: Wilshire Associates, 2003, 2004

Keep in mind that the reporting of data on public retirement systems lacks uniform timeliness, disclosure and methodology.

Vermont Retirement Systems: Where do We Stand in Comparison to Other States?



Source: Wilshire Report, 2004. Note: these are stated at market value, not actuarial value.

Impacts of Underfunding

- Continued underfunding will further increase the tax burden for future generations of taxpayers.

- Taxpayers in Vermont are already bearing the burden of past underfunding. For example, if additional funding had not been required to make up for prior shortfalls, the recommended contribution for FY 2004 would have been $14 million less than it was.

- Lost investment earnings will also need to be repaid. The approximate cumulative effect of lost earnings since 1979 is $120 million.

- Based on an underfunding study completed last year, if there had been no shortfall in contributions, the funded ratio would have been 99.2% instead of 89.6% as of June 30, 2003.

- Could increase pressure, in the absence of a budgetary solution, to reduce employee benefits and/or lead to a disproportionate increase in employee contributions.

Potential Impacts of Underfunding on Vermont's Credit Rating

"Pension funding is an important element of credit analysis because pension expense has a direct effect on current budgets and a long-term impact on overall financial flexibility. Contractually obligated pension expenditures, along with debt service commitments, are amongst a governmental entity's fixed-cost burden, pulling resources from other essential programs.... Fitch Ratings expects few, if any, downgrades to occur solely as a result of rising pension costs. However, increasing pension expenses can contribute to or exacerbate declines in liquidity and financial flexibility that may lead to downgrades in the absence of corrective action."

-Fitch Rating Service: September 18, 2003

Funding Options:

- Rely on investment returns to buoy system
  - *Not really an option; investment returns will simply not be sufficient to cover liabilities.*
- Revise funding schedule to increase amortization timeline
  - *Analogous to extending your mortgage.*
  - *Short-term budget solution, but increases costs significantly in long run.*
  - *May raise eyebrows at rating agencies.*

Funding Options:

- Pension Obligation Bonds -- Borrow to raise funds to close funding gap at interest rates lower than anticipated investment returns
  - *Competes with other bonding needs; adds to State debt.*
  - *While returns may be higher than debt payments, the reverse can happen as well. Some retirement funds employing this strategy did not make enough to pay debt service over last few years.*
  - *Would definitely raise eyebrows at rating agencies.*
- Increase Employee Contribution
  - *By itself, not a fair solution, as teacher contributions have not faltered over the years.*
  - *Shifts burden and alters the promised IOU.*

Funding Options:

- **Increase Employer Contribution**

  - *Requires legislative commitment to increase funding over time to match actuarially required contributions.*

- **Use a significant portion of surplus or "waterfall" funds to address unfunded liability**
  - *Temporary solution, but does not address the underlying problems*

Funding Options:

- **Combination of above**:
  - *No one solution likely to be large enough to make up the gap*
  - *Various combinations of increased employer contributions at the state and local levels, “waterfall”appropriations, and/or employee contribution increases might be necessary to obtain a solution within the context of budget constraints and fairness to employees.*
  - *Share the burden over long term.*