



STATE OF VERMONT
OFFICE OF THE STATE TREASURER

TO: General Assembly
FROM: Mike Pieciak, State Treasurer
RE: Other Post-Employment Benefits Funds – Governance Report
DATE: January 15, 2024

Background

The State of Vermont provides health insurance benefits to retired State employees and Teachers. These benefits are generally referred to as other post-employment benefits, or OPEB. In order to fund these OPEB benefits, the State has established two trust funds (one for State employees and one for teachers) pursuant to section 115 of the Internal Revenue Code. *See* 3 V.S.A. § 479a, 16 V.S.A. § 1944b. Both funds are administered by the State Treasurer.

Historically, the State of Vermont has funded OPEB benefits on a pay-as-you-go basis. This funding method (paying only the costs incurred each year) stands in contrast to the manner in which pension benefits have been historically funded. For pension benefits, the State prefunds the benefits by paying an actuarially determined amount necessary to fund present and future benefits.

While this pay-as-you-go funding method cost the State less each year, it foregoes significant benefits associated with prefunding, the two most important of which are (1) prefunding allows the State to earn a return on invested funds, and therefore defray the cost of these benefits to taxpayers, and (2) prefunding reduces the liability reflected on the State's financial statements and is therefore seen as a credit positive by ratings agencies.

As part of the Act 114 pension reforms in 2022, the State formally moved from a pay-as-you-go funding method for OPEB to a prefunding method. This move came after years of discussing the issue and after the State had already implemented smaller steps in the direction of prefunding, either by directing federal reimbursements from an employer group waiver plan (EGWP) into the OPEB funds, or by establishing the New Teacher Assessment under 16 V.S.A. § 1944d, whereby school districts make an annual payment into the OPEB fund for new teachers as of July 1, 2015.

As this evolution from a pay-as-you-go to a prefunding method for OPEB benefits demonstrates, the State has shown a commitment to prudent investment of resources to ensure that funds are available to pay for the OPEB benefits provided to State employees and teachers, and at the same time, ensure that these benefits are funded at the lowest long-run cost to the taxpayer.

Report

Building off this success, the Legislature directed the Treasurer to develop the report appended here, in consultation with the Vermont Pension Investment Commission (VPIC) and the Agency of Administration. This report provides the opportunity to step back and evaluate the governance structure of the OPEB funds now that the State is prefunding these benefits, and following the reorganization of VPIC.

We believe this report provides valuable insight into a potential to move the oversight and investment of the OPEB funds from the Treasurer’s Office to VPIC, and to do so in phases to ensure that any such move complies with applicable federal requirements and is done in a prudent manner.

We look forward to working with the Legislature, Administration, and VPIC to discuss this opportunity during the upcoming legislative session.

Appendix 1: Legislative Directive

Act 3 of 2023

**Sec. 101. OTHER POSTEMPLOYMENT BENEFITS; GOVERNANCE STRUCTURE;
REPORT**

(a) The Office of the State Treasurer, in consultation with the Vermont Pension Investment Commission and the Agency of Administration, shall produce a report that examines and makes recommendations on the governance structure of the two OPEB funds, other possible governance structures, and whether changes should be made to better align the governance structure with nature of the OPEB funds. In reviewing the governance structure, the report shall evaluate both the manner in which the funds are overseen as well as the underlying section 115 trusts in which they are held. Specifically, the report shall address the following:

- (1) the advantages and disadvantages of retaining the existing governance structure of the OPEB funds with the State Treasurer as sole trustee;
- (2) alternative governance structures for the OPEB funds, the advantages and disadvantages of each alternative examined, and the steps and timeline required to implement each alternative; and
- (3) to the extent possible, other issues relating to the OPEB funds identified as warranting study.

(b) Assistance. The Office of the State Treasurer shall have the administrative support of the Vermont Pension Investment Commission as well as the Agency of Administration in producing the report.

(c) Funding. \$100,000 is provided in 2022 Acts and Resolves No. 185, Sec. B.1100, as amended by Sec. 45 of this act for the purpose of subsection (a) of this section.

(d) Report. On or before January 15, 2024, the Treasurer shall submit a written report to the General Assembly with findings and recommendations.

Appendix 2: OPEB Governance and Investment Structure Report

State of Vermont, Office of the State Treasurer

OPEB Governance and Investment Structure

October 5, 2023

Executive Summary

The Vermont Legislature has requested the Office of the State Treasurer, in consultation with the Vermont Pension Investment Commission ("VPIC"), produce a report that addresses the following:

1. The advantages and disadvantages of retaining the existing governance structure of the Other Post-Employment Benefits ("OPEB") funds with the Treasurer as sole trustee responsible for investment and administration of the funds.
2. Any alternative governance structures for the OPEB funds, the advantages and disadvantages of each alternative, and the steps/timeline necessary to implement such alternative.
3. Any other issues relating to the OPEB funds that may warrant study.

We reviewed available legal guidance and publicly available information regarding other state structures when considering the above issues. Based on our analysis, the State has flexibility to restructure the governance of the OPEB funds to transition investment authority to VPIC. Such a restructure would streamline investment authority and leverage existing investment expertise for the OPEB funds. The State appears to also have the option to commingle the OPEB funds assets with the State's retirement plans assets for investment purposes, but for certainty, the State should consider requesting a private letter ruling from the Internal Revenue Service ("IRS"). Finally, the State could also consider whether to restructure the administration of the OPEB funds, which could further streamline responsibility for the OPEB funds.

Current Structure

Vermont maintains two OPEB funds: the State Employees' Postemployment Benefits Trust Fund (the "State Employees' OPEB") and the Retired Teachers' Health and Medical Benefits Fund (the "Teachers' OPEB")(collectively the "OPEB Funds"). The OPEB Funds are each an Internal Revenue Code ("Code") section 115 tax-exempt trust. The Treasurer administers and has investment authority for the OPEB Funds. The Treasurer has entered into an investment consulting agreement with a third-party investment consultant, RVK Inc. ("RVK"), to assist with investing the OPEB Funds. Pursuant to the RVK agreement, the Treasurer provides RVK with information on how the assets should be invested and works with RVK to investigate new investment vehicles and select investments of the assets. The Treasurer also has the option to enter into agreements with VPIC to provide additional investment expertise, which the Treasurer has elected to do since 2021. However, the Treasurer remains ultimately responsible for the investment of the OPEB Funds.

VPIC also invests the assets of the three State retirement plans, but the OPEB Funds are maintained and invested separately (*i.e.*, the plans are not commingled).

The current structure with a sole trustee responsible for investments is not uncommon and there are some advantages to maintaining this structure, such as clear delineation of authority between funds, no administrative changes or costs related to such changes, and ease of distinguishing investment priorities. However, several states that have employed this single trustee structure for purposes of pension benefits have abandoned the single trustee model in recent years. A primary reason is a desire to streamline administration and investment responsibility.

Alternative OPEB Governance Structure – Transfer Investment Authority to VPIC

As the primary alternative, the State could transfer investment authority for the OPEB Funds to VPIC. This option would streamline decision-making and investment authority. VPIC is already responsible for investing the retirement plan assets of the State retirement systems and is in the best position to invest the OPEB Funds as its members have the investment expertise and infrastructure necessary for this role. This change would also make VPIC the sole investment fiduciary of the OPEB Funds. While the Treasurer would lose some control over the OPEB Fund investments, the Treasurer or the Treasurer's designee is an ex-officio member of VPIC. Therefore, the Treasurer would continue to have input on the investment of the OPEB Funds.

Absent significant concerns from VPIC, the steps necessary to transfer investment authority of the OPEB Funds to VPIC are fairly minor and could be completed in 2024. The State legislature would need to amend the governing Statutes for each of the OPEB Funds to expressly grant VPIC investment authority and control. The State could use as a model the language from the State's retirement plan Statutes, each of which expressly delegates investment authority over the assets to VPIC.¹

In addition to amending the Statutes, the Treasurer should discuss this proposal with VPIC and determine any administrative changes or additional resources that would be required for VPIC to assume this new role. For example, the Treasurer's contract with RVK would likely need to be amended to have VPIC as the investment authority. Other contracts, such as with the OPEB Funds' custodian, may also need to be revised. Additional considerations include whether VPIC has the requisite accounting policies and processes to monitor and track the OPEB Funds' investments and whether VPIC will require additional staffing or administrative support.

These administration considerations should be included in the report for the Legislature. Provided that VPIC does not express significant concerns about its capability to manage investments on behalf of the OPEB Funds, it appears the State could implement the transfer as soon as the requisite administrative resources and legislation are in place.

Secondary Consideration - Commingling of OPEB and 401(a) Plan Assets

If the State elects to transfer investment authority to VPIC, the Treasurer and VPIC could consider at this time or in the future whether the OPEB assets, which are intended to be tax-exempt under Code section 115, can and should be commingled with the State's 401(a) retirement plan assets for investment purposes. We understand that currently, the State retirement systems' assets are

¹ See 3 V.S.A. § 472(a) (concerning the State Employees' Retirement System); 16 V.S.A. § 1943(a) (concerning the State Teachers' Retirement System; and 24 V.S.A. § 5063(a) (concerning the Municipal Employees Retirement System).

commingled for investment purposes but are accounted for separately. Unlike transferring investment authority to VPIC, the steps necessary to commingle the OPEB Funds and the 401(a) retirement plan assets are more involved and more expensive. An overview of this issue and the initial steps necessary to implement a commingled arrangement are discussed below.

Background

The IRS has informally indicated that commingling the assets of Code section 115 trusts with the assets of Code section 401(a) trusts would not jeopardize the entities' tax-qualified statuses, provided the combined entity clearly and unambiguously delineates how investment earnings are allocated to each fund, and ensures that the assets of one fund cannot be used to satisfy the liabilities of another.

Code section 115 states that income derived from the exercise of essential governmental functions and accruing to a state or any political subdivision thereof is not included in gross income. In Revenue Ruling 90-74, the IRS held that an organization formed, funded, and operated by several political subdivisions to pool risks, including for employees' health care, qualified for exemption under Code section 115 as performing an essential governmental function. In contrast, Code section 401(a) provides that a trust must be used to fund retirement plan benefits in order to qualify for tax-exempt status. Importantly, Code section 401(a)(2) provides that it must be impossible, at any time prior to the satisfaction of all liabilities under the plan and trust, for any part of the trust to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries.

Commingled 115 Trust

On the surface, the language of Code section 401(a)(2) would seem to pose a hurdle for employers wishing to commingle pension and OPEB assets for investment purposes, as the potential could exist for retirement plan assets to be diverted away from the retirement plan participants. However, the IRS has indicated through a private letter ruling ("PLR") that Code section 115 trusts that are used to fund both OPEB benefits and contributions to a pension plan qualified under Code section 401(a) remain qualified and tax-exempt under Code section 115.² As determined by the IRS in this informal guidance, a trust providing health, welfare and pension benefits to former and current employees constitutes the performance of an essential governmental function. It may also satisfy the requirements of Code section 115 and be tax-exempt by ensuring the following:

- The trust provides that the assets are held for the exclusive purpose of funding the employers' benefit obligations and defraying the reasonable expenses of the trust;
- The assets in each employer's account are held in trust for the exclusive purpose of funding OPEB or pension benefits and cannot be used for any other purpose, including the satisfaction of another employer's obligation;
- All participating employers are a state or political subdivision;

² See PLR 201607025.

- No private interests participate in or benefit from the operation of the trust other than as providers of goods and services; and
- In no event, including termination, will the trust's assets be distributed to or revert to an entity that is not a state or political subdivision.

While the PLR did not directly address the qualified status of the 401(a) trust, it follows that if commingling the trust did jeopardize the 401(a) trust's qualified status, the IRS would have included such a statement. Further supporting the position that commingling a 115 trust and 401(a) trust does not jeopardize either trust's tax-exempt status, a number of states appear to structure their trusts similarly to the structure described in the PLR.³ It is likely the IRS would be aware of these structures and would have issued guidance if it had determined that commingling the trusts disqualified the 401(a) trust.

IRS PLR Request Recommended

Importantly, while PLRs can provide an indication of how the IRS may view a similar situation, PLRs are informal guidance and cannot be relied upon by anyone other than the taxpayer requesting the PLR. The PLR discussed above suggests that OPEB and pension plan assets may be commingled in a trust meeting certain requirements, which may provide the State with the basis to elect to commingle the OPEB and retirement plan assets for investment purposes. However, because this is informal guidance without a clear indication regarding the qualification status of the 401(a) trusts, to provide assurance of the continued tax-exempt status of the trusts, the State should consider requesting a PLR to obtain IRS approval for the combined trust.

As part of this consideration, the State should note that the PLR request process is lengthy and expensive. PLR requests are generally responded to in the order they are received by the IRS. It takes on average 6 to 12 months to receive a response from the IRS on a PLR request and can take longer if the IRS is backed up. From a fiscal standpoint, it costs on average \$60,000 to \$70,000 to prepare a PLR request given current IRS filing fees and legal preparation costs. If there is a need for follow up with the IRS or a conference, legal costs can increase further.

Practical Considerations Related to Commingling of Trusts

As part of its review regarding whether to commingle the OPEB Funds with the retirement funds for investment purposes, the State should consider the following practical issues:

1. *Master Trust.* The State and VPIC should discuss with the OPEB Fund's custodian and auditor whether a master trust is beneficial in this situation. From a legal standpoint, the IRS did not specify in its PLR the governing documentation needed to establish a commingled trust, but several factors suggest that a master trust document could be beneficial for a commingled trust. A master trust document could clearly describe the ownership structure and administration of the commingled trust, detail the VPIC's authority to invest the trust's assets on behalf of the State's qualified plans, and prohibit each plan's assets from being diverted to beneficiaries of another State

³ For example, Massachusetts and West Virginia appear to commingle their OPEB and retirement plan trusts for investment purposes. See Mass PRIM Annual Comprehensive Financial Report and West Virginia Investment Management Board 2022 Annual Report.

plan. When the IRS reviews the qualified status of a plan, the agency often references and relies upon provisions of the sponsor's trust agreement(s). While the same could potentially be accomplished via Statute, one advantage of a master trust agreement is that it can be amended by the trustee in response to legal or administrative changes without involving the Legislature.

2. *Investment Consulting.* The Treasurer should discuss any proposal with both VPIC and RVK, as the investment consultant, to determine whether such a change makes practical sense. RVK should ensure the combined trust's asset allocation generates returns suitable to meet each participating plan's needs. It may be that the OPEB Funds' asset allocation should be different than the asset allocation for the pension plans, due to potential differences in risk tolerance and liquidity needs. This may mean designing separate allocations for each plan. RVK should also advise whether commingling the trusts would prohibit the combined fund from participating in certain investments (whether due to governmental regulation or otherwise). Our investment attorneys work with a number of funds that have commingled assets and have not had an issue with investing the commingled assets, but as RVK is most familiar with the investments of the OPEB Funds and VPIC, it would be useful to obtain their comments.

3. *Accounting and Reporting.* Trusts with commingled assets should have rigorous accounting policies and procedures to ensure plan assets are not diverted away from participants and beneficiaries, as any diversion could jeopardize the tax-qualified status of each participating plan. This will likely involve designing an ownership structure that allows for the tracking and reporting of interests for each participating plan. The Treasurer and VPIC would need to work with their auditors to confirm what policies and procedures should be in place to ensure adequate tracking will occur.

4. *Clear Lines of Authority.* Trusts with commingled assets should also have established governance structures that clearly delineate what entity has authority to process investments on behalf of the combined fund. Investment managers (and their administrators) have rigorous anti-money laundering and Know Your Customer processes in place to prevent fraud and other illegal practices. As part of these processes, managers often request documentation of signing authority for individuals authorizing a transaction. Accordingly, if the State decides to commingle the OPEB Funds and retirement plans for investment purposes, it will be important to ensure that there is clear documentation in place to allow VPIC the investment authority it needs.

Other Issues Potentially Warranting Study

In addition to the changes to investment authority, the State could in the future consider alternatives to the current administration of the OPEB Funds.

Currently, the State Teachers' Retirement System of Vermont ("VSTRS") Board has the authority to establish and amend benefits for the Teacher's OPEB, including entering into insurance arrangements to provide health and medical benefits for retirees, but per Statute, the Fund is administered by the Treasurer.

State employees are eligible to continue their health benefits after retirement. The State Employees' OPEB is administered by the Treasurer, and the Retired Employees' Committee on Insurance reviews and recommends changes to the Secretary of Administration. Additionally, the Vermont State Employees' Retirement System ("VSERS") Board reviews the contributions

recommended by the actuary and determines the amount of contributions necessary for the next year.

It appears that the administration of the OPEB Funds is not a significant concern. However, if there are questions regarding the administration in the future, the following are some alternative structures used by other State OPEBs.

Possible Alternatives

1. *Single Entity Administration.* The State could consider whether to have a single entity in charge of the administration of both OPEB Funds. The advantage of this structure is that it streamlines administration of retiree health benefits and allows an organization that is most familiar with these types of benefits to make decisions related to OPEB administration. However, depending on the specific benefits of each of the OPEB Funds, this structure may not work as well for Vermont. For example, it appears the Teachers' OPEB benefit structure may have different benefits and different funding than the State Employees' OPEB, and depending on these different structures, a single-entity approach may not be as desirable.

2. *Each System Administers its OPEB.* A second alternative would be for the State to change the administration for the State Employee's OPEB so that responsibility for the OPEB administration and changes are addressed by VSERS and its Board, similar to the VSTRS administration structure. Under this approach, the State would move administration of the OPEB Funds to each retirement system instead of having the Treasurer as the administrator. The advantage of this structure is that it streamlines administration within each of the retirement system boards, both of which are familiar with the retiree population and its needs. The potential disadvantage is that the VSERS Board may not be as familiar with health benefits or investments, so there may be more of a learning curve.