Overview of Initial Pension Proposal

Proposal of Chair and Vice Chair

House Government Operations Committee

March 24, 2021

Committee Overview

- This proposal is designed to address the structural challenges facing Vermont's state employee and teacher retirement systems by reducing future liabilities, increasing the pension system assets, and relieving budgetary pressures to improve the state's long-term fiscal health.

- This is a draft proposal subject to feedback.

- Proposed changes would **not** apply to:
    - Existing retirees
    - Active employees who are within 5 years of current normal retirement eligibility, or
    - Inactive vested members.

- Proposal focuses on both VSERS and VSTRS because those systems have significant differences from VMERS.

- All VSERS and VSTRS employee groups open to new entrants are included in the proposal.

- Proposal includes components that share risk with employees, but also share gains with employees.

Background

- Both the VSERS and VSTRS pension systems are facing significant and growing unfunded liabilities. As of the end of FY2020:
    - VSERS had an unfunded liability of $1,040,465,119 (188.5% of covered payroll) and a funded ratio of 66.4%.
    - VSTRS had an unfunded liability of $1,933,289,366 (299.3% of covered payroll) and a funded ratio of 51.3%.
- Due to a combination of factors, including historic underfunding, lower than anticipated investment returns, changes to demographic assumptions based on plan experience, and revised economic assumptions (including reducing the assumed rate of return from 7.5% to 7.0%), the unfunded liability amount and Actuarial Determined Employer Contribution (ADEC) payments for both VSERS and VSTRS are projected to significantly increase in FY22 from FY21 levels.
    - For VSERS, the unfunded liability is projected to increase by $225 million (to $1,040.5 million) and the ADEC payment is projected to increase by $36 million (to $119.9 million).
    - For VSTRS, the unfunded liability is projected to increase by $379 million (to $1,933.0 million) and the ADEC will increase by $60.6 million (to $196.2 million).

Background

There is no single option that will make these liabilities go away or drop back to FY21 levels. Charting a path forward will require multiple options and painful tradeoffs for both employees and the state. Any path forward on pension reform should be guided by a set of principles or goals that the reform effort should be designed to achieve and balance.

This particular proposal was guided by the following principals and goals:

- In order to attract and retain a talented and effective workforce that serves all Vermonters, retirement security should be maintained for Vermont's public sector workers and their families.
- Any changes to the pension system should exempt existing retirees and those close to retirement.
- Pre-funding retirement and OPEB benefits is a prudent long-term strategy for funding long-term obligations and should be pursued to the greatest extent possible.
- Consistently fully funding amounts according to the pre-determined funding schedule is key to making progress toward paying off the state's long-term liabilities and shoring up the fiscal health of the state.
- Any changes to the pension and retiree health care systems should consider what impacts those changes may have on the behavior of the existing workforce – particularly for employees nearing retirement age.
- The long-term preservation and strengthening of the retirement system will require participation from all participants.
- The costs for dealing with pension liabilities are likely to escalate further in future years and create increasing pressure on budgets. The time to make the necessary changes to put the state on a stronger path toward resolving these issues in future years is *now.*

This proposal addresses the following:

- Reduces long-term pension liabilities by:
  - Modifying the Cost of Living Adjustment structure
  - Increasing the number of years considered when calculating Average Final Compensation
  - Increasing the vesting period to be eligible for a retirement benefit
  - Changing the eligibility for normal retirement and making related adjustments to the maximum benefit to account for additional service credits.
- Increases assets to the pension system by:
  - Increasing base employee contribution rates
  - Implementing a supplemental, progressive risk sharing employee contribution rate
  - Allowing for a shared risk/shared gain provision for the COLA structure based on pension health
  - Dedicating significant one-time state revenue to paying down long-term retirement liabilities

COLA Threshold

- <u>Current:</u>
  - Retired members receive an annual Cost-of-Living Adjustment tied to the CPI on the full amount of their pension benefit.
  - For most members, the COLA has a 1% minimum and 5% maximum and applies once a retiree reaches normal retirement eligibility.
    - VSTRS Group C2 accrues COLA at 50% of CPI up to 5% max.
- <u>Proposal (VSERS and VSTRS, all groups)</u>:
  - COLA is preserved but applies to the first $24,000 of retirement benefit.
    - Per the FY20 Valuation Studies, the average retirement benefits across all groups is $21,060 (VSERS) and $21,960 (VSTRS)
  - COLA tied to actual 100% CPI with no 1% minimum; 5% maximum maintained.
  - COLA does not apply until a retiree reaches 67 years old (60 years old for VSERS Group C)

Plan	Current Structure	Proposed
VSERS Group C and D	100% CPI (1% min, 5% max) after 12 months of retirement.	100% CPI COLA on first $24,000 of benefit; no min, 5% max. Group C: COLA applies at age 60. Group D: COLA applies at age 67.
VSERS Old Group F	100% CPI (1% min, 5% max) after reaching age 62 or 30 years of service.	100% CPI COLA on first $24,000 of benefit; no min, 5% max. COLA applies at age 67.
VSERS New Group F	100% CPI (1% min, 5% max) after reaching age 65 or Rule of 87.	100% CPI COLA on first $24,000 of benefit; no min, 5% max. COLA applies at age 67.
VSTRS Group C1	50% CPI (1% min, 5% max) after 12 months of retirement or with 30 years of service.	100% CPI COLA on first $24,000 of benefit; no min, 5% max. COLA applies at age 67.
VSTRS Group C2	50% CPI up to max of 5%	100% CPI COLA on first $24,000 of benefit; no min, 5% max. COLA applies at age 67.

VSERS Group C: Law enforcement and public safety
VSERS Group D: Judges
VSERS Old Group F: State employees hired before 7/1/08
VSERS New Group F: State employees hired on or after 7/1/08
VSTRS Group C1: Members who were at least 57 years old or had at least 25 years of service on June 30, 2010.
VSTRS Group C2: Members who were less than age 57 and had less than 25 years of service as of June 30, 2010

Average Final Compensation (AFC)

- Current:

  - AFC is calculated by averaging the **3 Highest Consecutive** years of salary, with the following exceptions:
    - VSERS Group C: 2 Highest Consecutive
    - VSERS Group D: Final salary upon retirement

- Proposal (VSERS and VSTRS, all groups):

  - AFC is calculated by averaging the **7 Highest Consecutive** years of salary for all groups.
  - For VSERS Group C, exclude annual leave payoff from the AFC calculation.

Vesting Period

- Current:
  - Employees must accrue **5 years of service** in order to vest and qualify for normal retirement.
- Proposal (VSERS and VSTRS, all groups):
  - Employees must accrue **10 years of service** in order to vest and qualify for normal retirement.

Normal Retirement Eligibility

- <u>Current:</u>
  - Most employees must reach an age or a combination of age plus years of service (Rule of 87 or 90) in order to qualify for normal retirement.
  - VSERS Group C members may retire early without penalty at age 50 with 20 years of service with mandatory retirement at 55.
- <u>Proposal (VSERS and VSTRS, all groups)</u>:
  - Age-based retirement, where the employee must reach the full Social Security retirement age to qualify for normal retirement.
    - Currently the full Social Security age is 66 or 67.
  - For VSERS Group C, no-penalty early retirement at age 50 with 20 years of service is eliminated. Existing mandatory retirement at age 55 is maintained.
  - Eliminate the Rule of 87/90, which currently allow employees with more than 30 years of service to retire with full benefits earlier than age 57 (VSERS) or age 60 (VSTRS), respectively.

Plan	Current Structure	Proposed
VSERS Group C	Age 55 (mandatory) No-penalty early retirement at age 50 with 20 years of service	Age 55 (mandatory) Eliminate no-penalty early retirement at age 50 with 20 years of service.
VSERS Group D	Age 62	Social Security full retirement age
VSERS Old Group F	Age 62 or with 30 years of service	Social Security full retirement age.
VSERS New Group F	Age 65 or Rule of 87	Social Security full retirement age.
VSTRS Group C1	Age 62 or with 30 years of service	Social Security full retirement age.
VSTRS Group C2	Age 65 or Rule of 90	Social Security full retirement age.

Maximum Benefit Payable

- <u>Current:</u>
    - Benefits are capped at a percentage of AFC that varies by plan.
- <u>Proposal (VSERS and VSTRS, all groups)</u>:
    - Maximum benefit caps are increased by 1% for each year of service worked beyond the point at which their benefit multiplier and years of service hit the existing maximum benefit caps.
    - No changes to multipliers for any group.
    - VSERS Group D maximum benefit reduced from 100% of final salary to 60% of AFC, plus 1% escalator beyond 18 years of service.

Plan	Current Structure	Proposed
VSERS Group C	2.5% Benefit Multiplier with max of 50% of AFC cap. *A member reaches the 50% AFC cap after accruing 20 years of service.*	2.5% Benefit Multiplier with max of 50% of AFC, plus 1% increase in max for each year worked beyond 20 years.
VSERS Group D	3.33% Benefit Multiplier after 12 years of service with max of 100% of Final Salary. *A member reaches the 100% AFC cap after accruing 30 years of service.*	3.33% Benefit Multiplier after 12 years of service. Max of 60% of AFC, plus 1% increase for each year worked beyond 18 years.
VSERS Old Group F	1.67% Benefit Multiplier with a max of 50% of AFC. *A member reaches the 50% of AFC cap after accruing 30 years of service.*	1.67% Benefit Multiplier with a max of 50% of AFC, plus 1% for each year worked beyond 30 years.
VSERS New Group F	1.67% Benefit Multiplier with a max of 60% of AFC. *A member reaches the 60% of AFC cap after accruing approximately 35.9 years of service.*	1.67% Benefit Multiplier with a max of 50% of AFC, plus 1% for each year worked beyond 35 years.
VSTRS Group C1	1.67% for first 20 years, then 2% after attaining 20 years with a max of 53.34% of AFC. *A member reaches the 53.34% of AFC cap after accruing approximately 30 years of service.*	1.67% for first 20 years, then 2% after attaining 20 years with a max of 53.34% of AFC plus 1% for each year worked beyond 30.
VSTRS Group C2	1.67% for first 20 years, then 2% after attaining 20 years with a max of 60% of AFC. *A member reaches the 60% of AFC cap after accruing approximately 33 years of service.*	1.67% for first 20 years, then 2% after attaining 20 years with a max of 60% of AFC plus 1% for each year worked beyond 33.

Base Employee Contributions

- <u>Current:</u>
  - Employees pay a fixed percentage of gross salary that varies by plan
- <u>Proposal (VSERS and VSTRS, all groups)</u>:
  - Base employee contributions increase across all groups.
  - Like with other elements of the proposal, active employees within 5 years of current normal retirement eligibility would not be impacted by changes to contribution rates.

Plan	Current Structure	Proposed
VSERS Group C	8.53% of gross salary	8.75% of gross salary
VSERS Group D	6.65% of gross salary	7.75% of gross salary
VSERS Old Group F	6.65% of gross salary	7.75% of gross salary
VSERS New Group F	6.65% of gross salary	7.75% of gross salary
VSTRS Group C1	5.0% of gross salary	7.25% of gross salary
VSTRS Group C2	5.0% of gross salary for employees who had more than 5 years of service as of 6/30/14 6% of gross salary for others.	7.25% of gross salary for all members.

Employee Risk Sharing Contribution

- Current:
  - None
- Proposal (VSERS and VSTRS, all groups):
  - An additional tiered risk sharing contribution would be assessed on top of employee base contributions.
  - The risk sharing contribution would be assessed depending on whether the pension's investment performance meets a target defined as the assumed rate of return currently in place plus 0.5% (currently 7.5%).
  - The risk sharing contribution would be implemented for the fiscal year if the average investment performance of the two most recently concluded fiscal years falls short of the target based on the actuarial value of assets.
    - *For example, if the average investment performance based on the actuarial value of assets during FY19 and FY20 is lower than 7.5%, the risk sharing contribution would apply to FY22. If the average investment performance exceeds 7.5%, no risk sharing contribution would be assessed during FY22. Calculation process repeats annually.*
  - Structured similarly to income taxes – salary that falls within certain brackets would be assessed different marginal rates.
  - Like with other elements of the proposal, active employees within 5 years of current normal retirement eligibility would not be impacted by changes to contribution rates.

Salary Bracket	Contribution Rate Assessed on Salary
Up to $40,000	0.25%
$40,001- $60,000	0.50%
$60,001 - $80,000	0.75%
$80,001 - $100,000	1.0%
$100,001 +	1.25%

An Employee earning….	Would pay….
$40,000	$100
$60,000	$200
$80,000	$350
$100,000	$550

Shared Risk/Shared Gain – COLA Threshold

- Current:
  - None
- Proposal (VSERS and VSTRS, all groups):
  - The proposed $24,000 COLA threshold will increase by the CPI once the respective pension fund reaches 85% funded.
  - If the funded ratio subsequently declines below 85%, the COLA threshold would be frozen in the level in place at the time until the funded ratio once again exceeds 85%.
  - Funded ratio and CPI data would be based on the most recently completed fiscal year and any updates to COLA thresholds would apply for the upcoming calendar year. For example, the CPI and funded ratio during FY20 would determine the COLA threshold for calendar 2021.

Additional Funding from State

- Additionally, in recognition of the importance of addressing long-term liabilities, the proposal calls for the state to dedicate a total of **$150 million** above the ADEC amounts for paying down the state's 4 major retirement liabilities.

- These funds can be invested to grow with interest over the amortization period, thereby helping to reduce ADEC pressures and the size of the unfunded liability in the future and improve the funding ratio of the pension systems.

Preliminary Fiscal Estimates from Revenue Increases

- $150 million in additional state funds for retirement obligations.

  - $50M invested today could grow to $153M by the 2038 amortization date if it consistently grows at 7%.
  - Each one-time $50M increase above the ADEC would, by itself, immediately increase the VSERS funded ratio by 1.6% and 1.3% for VSTRS. The impact of this investment will grow over time with investment gains.
  - Funds can also support prefunding of OPEB.

- The proposal increases base contribution rates by 1.1% for most VSERS employees and by 1.25-2.25% for VSTRS members. With this increase, the VSTRS contribution rate would remain slightly lower than the VSERS rate but closer in parity than they currently are.

  - Every 0.5% increase in employee contributions generates approximately $2.8 million for VSERS and approximately $3.3 million for VSTRS. These numbers will increase over time with overall salary growth.

  - Based on these estimates, a 1.1% increase for most VSERS employees would generate approximately $5.8 million in additional revenue for that system and increasing contribution rates to 7.25% for all VSTRS members would generate approximately $12 million. *Note: These are preliminary estimates based on the size of the overall payroll that have not been adjusted for exclusion of active members within 5 years of retirement eligibility.*

- Difficult to model with precision the future revenue from the employee risk sharing fee structure due to changes in salaries and uncertainty over future investment performance, but the proposed structure would result in an effective additional contribution rate below 0.5% for the vast majority of the workforce.

Preliminary Fiscal Estimates from Plan Changes

VSERS Estimated Financial Impact of Changes (all groups excluding Group D) - $ millions

	COLA <$24K	No COLA until 67	Remove Rule of 87 and Require Age-Based Normal Retirement	Age-Based Normal Retirement at 67 for non-law enforcement and remove 50/20 Early Retirement for Group C	AFC 7 Highest Consecutive for All Groups	Vesting – 5 to 10 years	Cumulative Impact of All Changes
ADEC	-$12.0	-$3.4	-$2.2	-$12.1	-$4.9	-$0.1	**-$34.7**
Liability	-$71.6	-$18.3	-$14.5	-$79.5	-$26.9	$0.3	**-$210.5**

VSTRS Estimated Financial Impact of Changes (all groups) - $ millions

	COLA <$24K	No COLA until 67	Remove Rule of 90 and Require Age-Based Normal Retirement	Age-Based Normal Retirement at 67 for Group C	AFC 7 Highest Consecutive for All Groups	Vesting – 5 to 10 years	Cumulative Impact of All Changes
ADEC	-$9.4	-$1.6	-$15.4	-$13.1	-$6.3	$0.1	**-$45.7**
Liability	-$63.3	-$10.7	-$111.0	-$84.1	-$40.2	$0.7	**-$308.6**

NOTE: Preliminary estimates do not factor in the impact of additional employee contributions or proposed changes to VSERS Group D (both of which would generate additional savings beyond what is reflected here) or increases to the maximum benefit cap of 1% for each year of service worked beyond the current maximums (which would generate slightly lower savings for both systems than what is reflected here).

Summary of Impact

- The cumulative impact of all other proposed benefit changes would:

  - VSERS: Lower the ADEC by $34.7 million and unfunded liability by $210.5 million (preliminary estimates).
  - VSTRS: Lower the ADEC by $45.7 million and unfunded liability by $308.6 million (preliminary estimates).

- When factoring in the impact from both plan changes and enhanced revenues, **the increases to the ADEC from FY21 to FY22 for both systems due to assumption changes** ($36M increase for VSERS, $60.6M increase for VSTRS) **would be largely eliminated and the increases to the unfunded liabilities would be significantly reduced by more than $500 million from the proposed changes.**

Questions?