Virginia Retirement System
2011 Fiscal Impact Statement

1. **Bill Number:** HB2465

   House of Origin X Introduced ☐ Substitute ☐ Engrossed

   Second House ☐ In Committee ☐ Substitute ☐ Enrolled

2. **Patron:** Jones

3. **Committee:** Appropriations

4. **Title:** Virginia Retirement System; defined contribution retirement program for state and local employees.

5. **Summary:** Virginia Retirement System; defined contribution retirement program for state and local employees. The bill creates a mandatory defined contribution retirement program for state and local employees hired on or after January 1, 2012, in place of the current defined benefit plan. Employees hired prior to January 1, 2012, may elect to become members of the defined contribution program in lieu of the current defined benefit plan. The current defined benefit plans would be closed to new members.

6. **Budget Amendment Necessary**:

7. **Fiscal Impact Estimates:** See Fiscal Implications below

8. **Fiscal Implications:**

   As the bill creates a mandatory DC plan, the existing DB plan would be closed to new members. As no new hires would join the DB plan, the payroll base under this plan would begin to decline immediately. Since the payroll base is used to fund the DB system's unfunded accrued liabilities (UAL), the financial burden as a percent of payroll will increase. This will be compounded by Governmental Accounting Standards Board requirements to reduce the payroll growth assumption in financing the UAL and move to a closed amortization period for funding the remaining unfunded liabilities of the DB plan. The present use of an open amortization is not designed to ever fully extinguish future liabilities.

   Since the UAL does not change when the DC plan is implemented, and does not decrease significantly even if existing members are given the option of moving to the DC plan, changing to a closed amortization period will cause an immediate acceleration of unfunded liabilities not otherwise required by the open method.

   Since all new hires will go to the DC plan, the employee population covered by the DC plan will grow rapidly. At the same time, active membership in the DB plan will decline quickly. The actuary estimates that the active payroll in the DB plan will decline at an average rate of 7.5% annually for the state employee plan and at 5.0% annually for the teacher plan.

Estimated Annual Employer Costs for DB/DC Plan Combination for State Employees
DB Plan Closed to New Members in Year 1
All New Hires Join the DC Plan
(General Fund $ in millions)

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 28
Ongoing Cost of Continuing Current DB Plan	$176.7	$275.9	$318.8	$364.7	$411.9	$493.7
Cost of Closed DB Plan Combined with New DC Plan (at minimum DC rates)	$320.8	$430.8	$332.7	$271.4	$225.9	$223.0
Cost of Closed DB Plan Combined with New DC Plan (at maximum DC rates)	$325.1	$447.9	$364.2	$316.3	$283.7	$301.8
Difference – minimum DC	$144.1	$154.9	$13.9	($93.3)	($186.0)	($270.7)
Difference – maximum DC	$148.4	$172.0	$45.4	($48.4)	($128.2)	($191.9)

() denote budget savings

Estimated Annual Employer Costs for DB/DC Plan Combination for Teachers
DB Plan Closed to New Members in Year 1
All New Hires Join the DC Plan
(General Fund $ in millions)

	Year 1	Year 5	Year 10	Year 15	Year 20	Year 28
Cost of Continuing Current DB Plan	$333.2	$442.8	$487.8	$527.0	$584.0	$686.6
Cost of Closed DB Plan Combined with New DC Plan (at minimum DC rates)	$520.1	$643.9	$550.9	$464.7	$399.0	$371.5
Cost of Closed DB Plan Combined with New DC Plan (at maximum DC rates)	$524.9	$664.7	$589.9	$522.1	$477.3	$487.4
Difference – minimum DC	$186.9	$201.1	$63.1	($62.3)	($185.0)	($315.1)
Difference – maximum	$191.7	$221.9	$102.1	($4.9)	($106.7)	($199.2)

DC						

() denote budget savings

Assumptions:

- 8% interest, 3% COLA's, 30-year closed amortization period
- State employee DB payroll projected to decline at an average annual rate of 7.5%, with an increasingly accelerated decline in payroll in the last 6 years.
- Teacher DB payroll projected to decline at an average annual rate of 5.o%, with an increasingly accelerated decline in the last 6 years.
- Actuary used a "level percent of payroll" method to amortize the unfunded liability of the closed plan.
- General Fund is assumed to pay 43.27% of contributions for state employees and 33.63% for teachers.

Effect on Unfunded Accrued Liability (UAL) of Current DB Plans:

- The current unfunded liability for VRS will remain unchanged
- Current UAL does not decrease significantly even if existing members are given the option to move to the DC plan
- With new hires no longer entering the DB plan, the payroll base under the current DB plan will begin to decline immediately
- Since that base is used to fund the system's UAL, the financial burden as a percent of payroll will increase.
- While the closure of DB plan would not add to unfunded liabilities, it would require much earlier funding of existing liabilities.
- GASB accounting rules and actuarial practices would require full amortization of unfunded liabilities over a fifteen to 30 year period. A rolling 30-year amortization period, which is the General Assembly's current practice for the State and Teacher plans, would not be acceptable as it is not designed to ever extinguish the full liability of a DB plan by the time the last active member of the closed plan has left. Hence, full funding of the liability would need to be substantially accelerated.
- The VRS actuary recommends accelerated funding of the unfunded liability of a closed DB plan over the average active service period of the remaining employees in the plan, about 15 years. However, present GASB rules allow for extended amortization periods up to a maximum of 30 years.

Unfunded Accrued Liability – Amortization Period

Current Ongoing VRS DB Plan	Closed VRS DB Plan
Open – period remains the same (does not decrease) from year to year	Closed – remaining period decreases by one year every year
20 years open (VRS Board) 30 years open (Legislated rates)	30 years closed
	Actuary's Recommend alternative -

	closed amortization period to match the future remaining working lifetime of active members. Intent is to completely amortize the UAL over the expected future years of service of members in the closed plan. Expected to be 10 to 15 years.

Unfunded Accrued Liability – Amortization Payment

Current Ongoing VRS DB Plan	Closed VRS DB Plan
Level percent of increasing payroll	Level percent of decreasing payroll (actuary recommended) or level dollar amount.
3% payroll growth per year. Amortization payment increases 3% per year to remain the same percent of the increasing payroll.	Assumed annual payroll decrease: State – 7.5%; Teachers 5%. Amortization payments decrease annually by these percents to remain approximately the same percent of the decreasing payroll.
	Level dollar amount. Same dollar amount paid each year. Under closed plan with decreasing payroll, the payment as a percent of pay will increase annually.
	GASB requirement to change from increasing payroll approach to either decreasing payroll or level dollar.

Effect on Contribution Rates:

- In order to accelerate amortization of the unfunded liability on a shrinking payroll base, contribution rates would need to be increased substantially in the year the plan closes and increased dramatically over the next 20 to 30 years.
- The actuary estimates that DB plan rates in year one of the closure would increase by about 10.5% of payroll for the state plan and by about 9% for the teacher plan. Contribution rates would continue to rise over time until they reached 100% of payroll in year 28 for the state plan and 70% of payroll for the teacher plan.

- The increase in DB plan rates could be ameliorated somewhat by adding a surcharge on top of the required DC plan rates as a contribution toward the accelerated amortization of the unfunded DB liabilities.

<u>Effect on Cash Flow</u>

- VRS expects cash flow to become progressively more and more negative throughout future years
- The effect is due to a greater reduction in contributions in future years relative to the reduction in the amount of future benefit payments
- Most all mature, ongoing DB plans, like VRS, experience negative cash flow
- Prior to closing the DB plan to new hires, the degree of negative cash flow is limited due to new hires replacing those retiring and maintaining a stable flow of incoming contributions
- Negative cash flow could become a concern when it exceeds income attributable to interest and dividends, requiring the selling of invested assets to satisfy the cash need
- Assets sold for this purpose may reflect in a decrease to the expected return of the closed DB plans
- If this mandatory DC plan is adopted, the VRS actuary recommends close monitoring of cash flow in the closed DB plans

<u>Effect on Investment Portfolio and Investment Returns:</u>

- VRS would be required to gradually divest of illiquid assets and longer term investments and forfeit the expected higher returns they produce.
- As the payroll base of the DB plan shrinks and the number of retirees and beneficiaries rise, the trust fund will become increasingly cash constrained.
- Over time, the trust fund will go cash flow negative and require the liquidation of assets to meet continuing benefit payments.
- At this time, VRS has not performed long-term cash flow projections under a closed plan scenario, so VRS is unable to specifically estimate any adverse impacts on investment gains.

<u>Effect of Forfeited Contributions and Ancillary Benefits:</u>

- When a member terminates prior to retirement under a defined benefit plan with no right to a vested benefit, the employer contributions remain in the system. These employer contributions are no longer needed for the terminated member and are released to be used to fund other member's benefits. If a defined contribution is established for new hires, there will be less of these 'forfeited' employer contributions that currently help control the cost of the defined benefit plan.

- With the implementation of the DC program current unfunded liabilities for the DB pension and retiree healthcare benefits will remain substantially unchanged. Consequently, after adopting the defined contribution program, the state and local employers will remain responsible for funding the current unfunded liabilities for the pension and retiree health and life benefits.

Actuarial Analysis of DB and DC Plan Costs:

- The actuary estimated the combined effects of increased DB contribution rates, a declining DB plan payroll base, and the new DC plan contributions over a steadily expanding DC payroll. He used the DC plan contribution rate schedule included in HB 2465, under which employer's would make a minimum matching contribution of 2.5% and a maximum matching contribution of 5.0% of payroll.
- The actuary then combined the cost of increased contribution rates to the closed and declining DB plan together with the cost of contributions to the new and growing DC plan over the next 28 years.
- He then compared the annual employer cost of the combined DB/DC plans with the estimated ongoing cost of the current DB plan (assuming that state employees pay the full 5% member contribution as proposed in HB1500/SB800).
- While not the approach recommended by the actuary, the actuary amortized the liabilities of the closed DB plan over 30 years. This assumption was used, because the General Assembly may wish to fund the liability over an extended period presently allowed by GASB.
- Over the next 13 – 14 years after implementation of the new DC plan and closure of the DB plan, employer costs are likely to increase as compared to the ongoing costs of current DB plan.
- After 14 years, the diminishing unfunded liability of the closed DB plan together with the modest costs of the growing DC plan, are expected to produce annual savings.

9. Specific Agency or Political Subdivisions Affected: VRS, all VRS participating employers

10. Technical Amendment Necessary: Technical amendments will be required to this bill. Language will need to be added to (i) Section 51.1-601.1 to eliminate the requirement that the participants in this program be auto-enrolled in the deferred compensation program (unnecessary as it is the same platform as the optional DC plan), and (ii) Section 51.1-1405 to ensure eligibility for certain participants in this program for the state retiree health insurance program. Provided below is language to accomplish these changes.

1. Amendment to 51.1-601.1 to read as follows: § 51.1-601.1. Participation in plan by certain employees. All employees of the Commonwealth and its agencies commencing employment or who are reemployed on or after January 1, 2008, in a position covered by the Virginia Retirement System, and who have not elected to participate in a plan established pursuant to *(i)* § 403(b) of the Internal Revenue Code of 1986, as amended, *or*

(ii) § 51.1-126.5:1, shall participate in the plan described in § 51.1-602, unless such employee elects, in a manner prescribed by the Board, not to participate in such plan. The amount of the deferral for any such employee participating in the plan shall equal, on a semimonthly basis, $20 of otherwise payable compensation, unless the employee elects to defer a different amount.

2. Amendment to definition of "state retiree" in 51.1-1405 to read as follows: "State retiree" means a state employee retired under the Virginia Retirement System, State Police Officers' Retirement System, Judicial Retirement System, Virginia Law Officers' Retirement System, or any retirement system authorized pursuant to § 51.1-126*, § 51.1-126.5, or § 51.1-126.5:1*, who is eligible to receive a monthly retirement annuity from that retirement system.

11. Other Comments:

Mandatory DC Plan Overview:

- HB 2465 establishes a mandatory defined contribution (DC) program for all new hires on and after January 1, 2012.
- The current defined benefit (DB) plans would be closed to new members from January 1, 2012 forward
- Existing members may make an irrevocable election to participate in the DC program
- Current members may transfer their accumulated contributions (both those made by the member as well as those made by the employer on his behalf) to his defined contribution account. Funds in the employer account would not be eligible for transfer.
- The default option is the existing defined benefit plan, which has been the practice of most states.
- The existing ORPs for faculty, appointed officials, and school board personnel will no longer be available for employees hired on and after January 1, 2012. These individuals will have the option of participation in the ORP created by HB 2465 or the optional retirement plan administered by the institution of higher education provided the institution of higher education administers its optional plan in the same manner as HB 2465.
- Previously hired ORP employees would be able to continue participation in the existing ORPs, at the statutory contribution rates of 10.4 percent for employees hired prior to July 1, 2010, and 8.5 percent for employees hired between July 1, 2010 and December 31, 2011.

DC Plan Contributions:

- Mandatory (Tier 1): Members 5% of pay and employer 2.5% of pay
- Additional Optional (Tier 2): Members may contribute up to an additional 5% of pay and the employer match of 50% of additional member contribution
- Minimum employer contribution rate – 2.5% of pay
- Maximum employer contribution rate – 5% of pay

- Up to 5 percent of the employee contributions to the defined contribution retirement program are elective deferrals, and as a result must go into an IRC 457(b) plan. For state employees and other employers who participate in optional or supplementary 457 plans, the 457 limits will have to be coordinated in order to avoid exceeding IRS annual limits on such deferrals.
- For example, the current deferred compensation plan administered by VRS is a 457 plan, and the IRC elective deferral limits would have to be coordinated between the defined contribution retirement program and the deferred compensation plan. However, employee contributions to the defined contribution retirement program, whether elective or mandatory, will not affect the amount that can be contributed to an IRC § 403(b) plan by those who have one (teachers and other eligible employees of educational institutions).
- The deferred compensation plan administered (457) by the VRS Board and the cash match plan (401(a)) administered by the VRS Board are the plans to be used to carry out the provisions of the legislation. The only exception allows opt out institutions of higher education to use existing defined contribution plans as long as they are modified to operate identically to this optional defined contribution retirement program.

Illustration of Tiered Employer Contributions

	Employer Contribution	**Employee Contribution**	
Tier 1	2.5 percent	5 percent	This is the mandatory employer contribution with a mandatory employee contribution.
Tier 2	0 to 2.5 percent	0 to 5 percent	This is the one-half to one match by the employer of elective employee contributions in excess of 5 percent.
Total	2.5 to 5 percent	5 to 10 percent	The employer contribution above 2.5 percent is entirely dependent on the level of employee contribution.

Eligibility for Other Related Benefits:

Participants in the defined contribution retirement program who are state employees will not have disability coverage under the Virginia Sickness and Disability Program. Similarly, employees of political subdivisions in the newly created DC program will not have coverage under the VRS traditional disability program. Hazardous duty personnel who elect the optional defined contribution retirement program will not be entitled to the hazardous duty supplement or other benefits such as the earlier retirement age relating to SPORS, VaLORS or LEOS. However, participants in the defined contribution retirement program will be eligible for the retiree health insurance credit. In addition, participants in the defined contribution retirement program will be eligible for coverage under the group life and optional life insurance programs.

Vesting:

The bill provides a vesting schedule with respect to the employer contributions to the DC program. Members with less than two years of service would be 0% vested, those with two to three years of service would be 50% vested, those with three to four years of service would be 75% vested and ,members with four or more years of service would be 100% vested in the employer contributions.

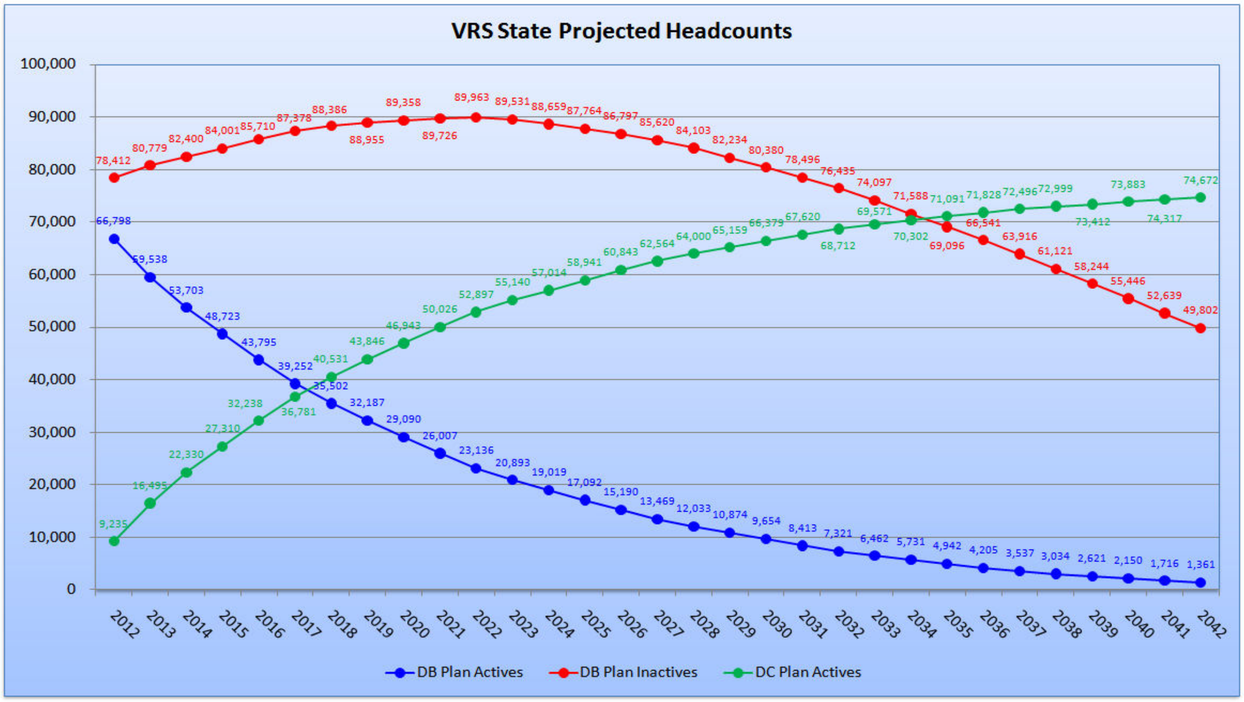
<u>Illustration of Employer Contribution Vesting</u>

2 or more years of service	50 percent
3 or more years of service	75 percent
4 or more years of service	100 percent

<u>Projection of DB and DC Plan Membership</u>:

Under a mandatory plan, the figure below displays the change in head counts over time for the current state DB plan active members, DB plan inactive members (retirees), and DC plan active members. This analysis was limited to state VRS membership, and does not include teachers, VaLORS, SPORS, JRS, or political subdivisions. As shown in the graphic, retirees will continue to grow at the same time DB plan active membership is decaying. As a result, contributions to the DB plan will be declining at the same time plan expenses are rising.

CLOSED STATE DB PLAN AND MANDATORY DC PLAN FOR NEW HIRES EFFECTIVE JULY 1, 2012



Other Considerations:

Below is a discussion of some of the other issues to consider in establishing a mandatory defined contribution plan.

From a benefits perspective, DC plans provide features not usually found in DB plans, such as portability, investment choice, personal responsibility, and lump sum payouts. DC plans are common vehicles for building retirement savings. However, whether the savings accumulated under the DC plan will provide adequate retirement income depends on several factors, including a member’s savings rate, asset allocation, investment income and life expectancy. Under a DC plan approach, it is possible for a retiree to outlive his or her retirement savings. DC plans do not provide guaranteed cost of living increases after retirement. Hazardous duty members who often retire with fewer years of service and at younger ages will have fewer years to accumulate assets and more years in retirement to draw on these assets.

Since the mandatory defined contribution program does not provide disability and pre-retirement death benefits, the General Assembly may wish to consider establishing a separate insured or self-insured program to provide these benefits. Although, VRS provides long-term disability benefits through the Virginia Sickness and Disability Program (VSDP) for state employees, members in the mandatory defined contribution program, proposed in HB 2465, will not have disability coverage under VSDP. In addition, employees of political subdivisions and teachers in the mandatory defined contribution program will not have disability coverage under VRS.

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