Virginia Retirement System
2011 Fiscal Impact Statement

1. **Bill Number:** SB861

   House of Origin X Introduced ☐ Substitute ☐ Engrossed

   Second House ☐ In Committee ☐ Substitute ☐ Enrolled

2. **Patron:** Wagner

3. **Committee:** Finance

4. **Title:** Local defined contribution retirement plan.

5. **Summary:** Local defined contribution retirement plan; Permits any locality or school board to establish a defined contribution (DC) retirement plan in lieu of any other retirement plan, for employees hired after such plan is established.

6. **Budget Amendment Necessary**: No

7. **Fiscal Impact Estimates:**

   7a. Expenditure Impact: Any such plans established pursuant to this legislation will be administered by localities and school boards, so there will not be any impact to the Commonwealth.

8. **Fiscal Implications:** Senate Bill 861 permits any locality or school board to establish a DC retirement plan in lieu of any other retirement plan, for employees hired after such plan is established. Accordingly, the DC plan will be mandatory for new hires and will result in the defined benefit (DB) plan being closed to new members.

   As less new hires join the current 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 (GASB) requirements under Statements 25 and 27 to reduce the payroll growth assumption in financing the UAL or move to a level dollar approach from the level percent of increasing payroll currently used. The amortization period would also have to be changed from open (i.e., remaining at 20 years into the future) to closed (i.e., reducing by one each year until the unfunded liability is paid). This change in amortization method will increase the contribution required, at least in the near term.

   Level dollar means the same dollar amount is paid each year in the future to amortize the unfunded liability. This is like the typical mortgage payment with equal payments for the term of the loan. If the DB plan is closed to new hires (which would be the case with a DC plan that is mandatory for new hires), the requirement would be that VRS could no longer assume future payroll increases to amortize the unfunded liability in the DB plan. Currently, VRS assumes 3% per year payroll growth and calculates an unfunded contribution that increases 3% per year to remain the same percent of the increasing payroll. VRS would have to change to either level dollar amortization, or decreasing payroll. GASB requirements would allow VRS to assume decreasing payroll and calculate a decreasing amortization payment so it is a level percent of that decreasing payroll. In doing so, this approach would be in line with the current VRS funding policy for level contributions as a percent of pay.

As previously stated, establishing a DC plan will likely require a change in the method used to finance the unfunded accrued liability (UAL). 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 the method will increase the contribution required to the DB plan, at least in the near term.

In addition, 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.

Since the DC plan will cover mostly new hires, the employee population covered by the DC plan will be slow in developing. As a result, it will take many years before the System may begin to realize any cost savings anticipated by creating a DC plan with lower employer contribution rates. In addition, locals adopting a defined contribution plan will have to continue funding the current unfunded liabilities for the pension plan, the retiree health insurance credit and the life insurance benefits of the current DB plan.

Some key elements to consider when closing a DB plan are: (1) the DB plan will have a shrinking payroll; (2) DB rates are going to rise; (3) under GASB requirements the amortization period for the DB plan will likely change if a mandatory plan is established; and (4) the a return assumption in the DB plan will likely need to be adjusted at some point in order to account for a shorter time horizon and liquidity needs. In addition, on an ongoing basis, there are additional costs that must be paid for either by the employer or the employee. Administrative expenses are greater if the employer has to maintain both a defined benefit and a defined contribution plan. Depending on plan design, however, as new hires are placed into the new DC plan over a longer period of time cost savings can be achieved.

9. **Specific Agency or Political Subdivisions Affected:** VRS. Employers and members of political subdivisions and school boards

10. **Technical Amendment Necessary:** Yes. A technical amendment will be required to this bill. Currently, Section 51.1-135 states that VRS membership is compulsory for all eligible employees entering service after the effective date of the coverage.

On line 49 insert the additional language provided in bold type: "*B. In lieu of the retirement plan required pursuant to subsection A of § 51.1-800,* ***and notwithstanding§ 51.1-135 if it is applicable,*** *any county or city, . . .*"

11. **Other Comments:** Any such plans will be administered by the locality or school board.

The bill does not provide for local plans to be administered by VRS as a consolidated state-wide DC plan. Accordingly, any locality choosing to offer a DC plan would become responsible for all legal and administrative responsibilities of maintaining their respective plans.

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. In addition, DC plans are good vehicles for creating 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. In addition, DC plans do not provide a guaranteed cost of living increase after retirement. Hazardous duty members frequently retire with fewer years of service and at younger ages than general employees. Therefore, under a DC plan, hazardous duty members have fewer years to accumulate assets and more years in retirement on which to rely on these assets. Similarly, another issue to consider in the design of a DC plan is that DC plans do not provide disability and pre-retirement death benefits. Therefore, consideration should be given to establishing separate insured or self-insured programs to provide these benefits which are currently provided by the Retirement System.

The bill allows a member of a locally established DC plan to terminate employment with that locality and, upon taking subsequent employment with a VRS covered employer, such individual would be eligible to purchase service credits in VRS (DB plan) with assets accumulated in his prior employer's DC plan. Since the employees have to pay full actuarial cost for all pension plan service credits they will receive, then the transfer will generally be cost neutral with respect to the VRS defined benefit plan since the plan will receive the present value of the actuarial accrued liability with respect to the service being purchased.

However, upon completing the purchase, nothing in the bill would prevent such a member from taking advantage of other purchase provisions for such service as prior military service or prior public service at less than full actuarial cost. Furthermore, such an employee could have a progressive and chronic illness and could, shortly after the transfer to VRS, apply for permanent disability from VRS. Either of these scenarios would be detrimental to VRS. Accordingly, VRS would suggest that purchase of prior service under §51.1-142.2 should be made at actuarial cost. In addition, a waiting period before someone would be eligible to retire for disability would help to mitigate any adverse selection.

The VRS actuary expects members who decide to transfer to the DB plan and pay full actuarial cost for service credits will do so in part because they see a greater pension benefit from the DB plan and are more committed to staying until retirement. VRS anticipates the turnover rate for these members would be lower than the current actuarial assumptions. This would eventually generate some actuarial losses. Further, while this bill provides for transfers to be made in an actuarial cost-neutral manner, the bill may still have an impact on the disability benefits, the Health Insurance Credit Program (HIC), the Virginia Disability and Sickness Program (VSDP) and on the defined benefit plan if the eligible employees purchase prior service at the 5% rate.

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