Virginia Retirement System
2012 Fiscal Impact Statement

1. **Bill Number:** HB 949

House of Origin	X	Introduced	___	Substitute	___	Engrossed
Second House	___	In Committee	___	Substitute	___	Enrolled

2. **Patron:** Bell

3. **Committee:** Appropriations

4. **Title:** **Virginia Retirement System; defined contribution retirement plan.**

5. **Summary:** Establishes an optional defined contribution retirement plan that state employees may elect to join in lieu of the defined benefit retirement plan.

6. **Fiscal Impact Estimates:** Start-up and ongoing costs of this bill will be approximately $477,744, including the procurement and monitoring of third party administrators, legal expenses for developing and maintaining plan documents, educational materials for new members, training of employers, and other costs associated with the establishment and maintenance of a defined contribution (DC) plan. However, depending upon certain plan design features and whether the Board is given authority to assess fees to employer/employees, these costs could potentially be covered from various sources including reversions of nonvested contributions, fees charged to employers, and recordkeeping fees charged to employee accounts.

7. **Budget Amendment Necessary:** Yes. Initial establishment of a defined contribution plan requires significant administrative costs. Assuming that start-up and ongoing costs could be covered as described above, they could be funded by DC plan reversions and administrative fees. An increase in the VRS maximum employment level will also be necessary to manage the program and oversee the third party administrator.

8. **Fiscal Implications:** The contribution rates for the defined contribution (DC) plan should be established by the General Assembly. In other DC plans administered by VRS, the General Assembly has established the employer contribution rate at 10.4% of pay for Plan 1 members and 8.5% of pay for Plan 2 members. The ultimate impact on total costs to the Commonwealth will be a function of the employer contribution rate for the new plan as established by the General Assembly and the proportion of current VRS members who elect the new DC plan as well as the assignment of plan administration costs.

   According to the VRS actuary, establishing an optional DC plan for new hires would result in a decline in the payroll base of the VRS defined benefit plan. This decline would be more gradual with an optional DC plan than it would be with a plan that is mandatory for new hires. This payroll base is used to fund the defined benefit plans' unfunded accrued liabilities (UAL). As the growth in the payroll base declines over time, the impact of the UAL on the employer contribution rate will cause it to increase. The Governmental Accounting Standards Board (GASB) statements 25 and 27 requirement could lead to a reduction in the plans' payroll growth assumption for addressing the UAL or even require a move to a level dollar approach from the level percent of payroll currently used.

Providing existing VRS defined benefit plan members the option of joining the DC plan will lead to anti-selection transition costs. In other words, members would likely choose the plan that they perceive to be in their financial best interest. The actuary reports that younger VRS members would be more inclined to select the DC plan while older members would elect to remain in the VRS DB plans. Yet, the cost to fund the younger member's DB benefits is less than the cost of funding an older member's benefits.

9. **Specific Agency or Political Subdivisions Affected:** VRS, state agencies, and state employees who opt in to the DC plan.

10. **Technical Amendment Necessary:** Yes. In order for the Board of Trustees of the Virginia Retirement System to establish a Defined Contribution (DC) plan, the following areas should be addressed in the bill:

Vesting Schedule and Reversions of Forfeited Funds:

The proposed legislation does not provide for a vesting provision or the reversion of forfeited contributions upon termination prior to the vesting date. A vesting schedule, coupled with reversion of a portion of contributions, could be considered to reduce the cost of a new DC plan.

Administrative Fees:

VRS will need a revenue source to cover administrative costs of monitoring third party administrators, the legal expense of maintaining plan documents, educational materials for new members, training of employers, information systems programming, and other costs directly related to the development and maintenance of this new program. These costs cannot be paid using funds deemed to be Defined Benefit Trust Funds as federal regulations require that such defined benefit funds must be used exclusively for the benefit of the members and beneficiaries of the plan. Typically, DC plans allow charges to employers and to members for covering administrative costs. Reversions can also be used to defray administrative costs or to reduce future employer contributions, but may not be sufficient to fully cover the costs.

Disability Insurance/Disability Retirement

The provisions of HB 949 are silent on disability insurance or income protection for employees in the DC plan. Currently, state employees in a defined benefit plan are enrolled in either the Virginia Sickness and Disability Program (VSDP) or are eligible for the traditional VRS disability retirement. Should some type of disability coverage for DC plan members be desired, language could be added to require that some type of disability coverage be available, either at the cost of the employer, employee, or on a shared basis.

Employer Contributions:

Current language requires contributions to a DC plan to be made from the Commonwealth but does not specify the amount of the contributions, or the ratio of mandatory to matching contributions. The General Assembly would need to set these amounts.

Limitations on Election to Join a Retirement Plan and Switching Between Plans:

For current members of the defined benefit plan, the General Assembly may wish to consider additional language that would allow for a plan to plan transfer of a member's accumulated contributions and interest.

Enactment Clause:

The VRS is requesting an enactment clause that would delay implementation of this legislation for at least 18 months to allow sufficient time to develop the plan design, plan documents, education and training materials for employers and employees, procurement of a third party administrator and the selection of investment options if existing vehicles are not used.

11. **Other Comments:** 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 during which to rely on these assets.

    JLARC issued a report in December, 2011, entitled *Review of Retirement Benefits for State and Local Government Employees.*[1] In the report, JLARC notes that HB 2410 from the 2011 General Assembly Session would have implemented an optional defined contribution plan for state and local employees as an alternative to the current defined benefit plan. While HB 949 is only open to state employees, some elements of HB 2410 are instructive in an analysis of an optional DC plan. HB 2410 would have included a disability benefit, as well as life insurance benefits, a health insurance credit, and long-term care coverage. Existing employees who opted into the DC plan would have been able to transfer their accumulated member contributions and interest under their defined benefit plan or the balance in their optional retirement plan account to the DC plan, but not the full actuarial value of their defined benefit plan. 2011 JLARC Report, pp. 104-105.

    Importantly, the 2011 JLARC report notes on page 105 that HB 2410 included an employer surcharge to reduce the impact of the cost of the new optional DC plan on the existing DB

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[1] JLARC also issued a report in 2008, *State Employee Total Compensation,* which outlined three defined contribution options: a Combination Plan, a Cash Balance Plan, and a new Defined Contribution Plan. (Pages 101-104 of the 2008 report specifically address the establishment of a new defined contribution plan).

plan. As the report indicated, as more employees opt into a DC plan, fewer employees would be enrolling in the existing DB plan. As a result, there would be lower contributions to the trust fund and a lower payroll base to help cover the current actuarial unfunded liability of the DB plan. To counteract this effect, employers would have been charged an additional amount for each employee, regardless of the plan the employee chose, in order to reduce the risk of undermining the funding of the existing DB plan and its liabilities. The VRS actuary indicated that without such a surcharge, or without a high-enough surcharge, an optional DC plan could result in added costs over time. 2011 JLARC report, p. 105.

According to Mercer, JLARC's actuary, while the optional DC plan outlined in HB 2410 could have potentially provided adequate income replacement, this would have depended on the amount and consistency of employee contributions, as well as investment returns over the employee's career. 2011 JLARC report, pp. 105-106. Mercer also noted that while the plan set out in HB 2410 could be attractive to shorter-term or early-career employees, it would be less attractive to longer-term employees and could be expected to have a negative effect on retention compared to the existing defined benefit plan.   2011 JLARC report, p. 107. Lastly, Mercer indicated that cumulatively, the DC plan proposed in HB 2410 could potentially increase the contribution rate for the defined benefit plan for general state employees and teachers. 2011 JLARC report, p. 107.

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