

Virginia Retirement System 2012 Fiscal Impact Statement

1. Bill Number: SB 506

House of Origin	X	Introduced	<input type="checkbox"/>	Substitute	<input type="checkbox"/>	Engrossed
Second House	<input type="checkbox"/>	In Committee	<input type="checkbox"/>	Substitute	<input type="checkbox"/>	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 locally administered 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. For those local plans that are separately rated, any impact would be felt locally. However, for the multi-employer cost sharing plan for school teachers, the impact could be felt statewide.

8. Fiscal Implications: Senate Bill 506 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 locality's defined benefit (DB) plan being closed to new members. While closure of the an existing defined benefit plan would not add to the current unfunded liabilities, it would require a much earlier funding of the existing liabilities.

Without any new hires joining 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 plan's unfunded accrued liabilities (UAL), the financial burden as a percentage 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 percentage 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., decreasing 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.

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 members' benefits. If a defined contribution plan is established for new hires, there will be fewer 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 a locality may begin to realize any cost savings anticipated by creating a DC plan with lower employer contribution rates. In addition, localities or school boards 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 to new members 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 return assumption in the DB plan will likely need to be adjusted at some point in order to account for a shorter time horizon as well as cash flow 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.

Localities wishing to consider the establishment of their own locally administered DC plan would be well advised to consult the VRS actuary for an estimate on the future costs of maintaining two plans.

Special Considerations for Multi-Employer Cost Sharing Plans (Teachers)

One area of particular concern relates to the provision that allows local school boards to establish a defined contribution retirement plan for their teachers. Unlike other political subdivision employees who are covered by plans that are separately valued for actuarial valuation purposes (these political subdivision plans have their own assets, liabilities, and contribution rates); the teachers are covered by a single statewide cost sharing plan. All of the assets and liabilities for the teacher group are pooled, and the state's school divisions pay one contribution rate. A cost sharing plan is not designed to allow for periodic exits from the plan by participating employers. If some school divisions cease participation in the cost sharing plan, for example, the remaining employers will be subject to the adverse effects of a shrinking payroll base discussed above and the corresponding financial burden related to the increase in the percentage of payroll required to fund necessary contributions. The unintended consequence would be that school boards that opt to place their teachers in a local DC plan would be shifting the legacy cost of unfunded liabilities to school boards that don't.

9. Specific Agency or Political Subdivisions Affected: VRS, political subdivisions, school boards, and their employees.

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.

In order to mitigate the impact on those school divisions that remain in the defined benefit cost sharing plan, an actuarially determined surcharge could be applied to those employers who choose to exit the defined benefit plan to address that employer’s share of the unfunded liabilities left stranded in the cost sharing pool by their exit. Such a surcharge provision is not set forth in the bill as currently drafted.

The bill also 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. As these plans would be locally administered on a locality by locality basis, the plans might not be able to take advantage of economies of scale and the ease of administration offered by a single consolidated plan. Further, the ease of portability between and among the Commonwealth’s political subdivisions and state agencies participating in VRS inherent in the current plan design would likely be eroded by individually administered plans with various provisions. The lack of portability could have an impact on recruitment.

Senate Bill 506 also contains a “double dipping” provision which VRS would likely be unable to enforce. The bill requires that if a member of the DC plan were to be employed in a VRS covered position; his or her benefit in the DC plan must be suspended. As the local DC plans would no longer be administered by VRS, VRS would have no way of knowing if a member drawing retirement benefits from a local DC plan was also enrolled as an active employee in a VRS covered retirement plan, in direct violation of the proposed statutory provision.

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. 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. As a result, consideration should be given to establishing separate insured or self-insured programs to provide these benefits, which are currently provided by the Retirement System. Finally, if local employers cease participation with VRS for retirement purposes, employees in these plans would not be eligible for the ancillary benefits provided by VRS, such as the Health Insurance Credit and the Group Life Insurance Program.

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. If such a member begins employment in a VRS DB plan position with no VRS service or ORP account balance prior to July 1, 2010, the employee will be a Plan 2 member. 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 retirement benefits, the Health Insurance Credit Program (HIC), the Virginia Sickness and Disability Program (VSDP) and on the defined benefit plan if the eligible Plan 1 employees purchase prior service at 5% or at approximate normal cost for Plan 2 employees for non-refunded service.

This bill is identical to House Bill 257 with the exception of several minor drafting differences that do not result in material changes.

Date: 01/24/2012

Document: SB506.DOC