Virginia Retirement System
2014 Fiscal Impact Statement

1. **Bill Number:** HB 178

House of Origin	☒	Introduced	☐	Substitute	☐	Engrossed
Second House	☐	In Committee	☐	Substitute	☐	Enrolled

2. **Patron:** Farrell

3. **Committee:** Appropriations

4. **Title:** Virginia Retirement System; assumed rate of return on investments.

5. **Summary:** Provides that if the General Assembly adopts an assumed rate of return on investments that is different from the rate used by the Board of the Virginia Retirement System (VRS) in determining employer contribution rates for contributions to VRS, the Board shall recalculate the employer contribution rate for each employer to incorporate the assumed rate of return adopted by the General Assembly. The Board is required to provide each employer with its adjusted employer contribution rate as soon as possible.

6. **Budget Amendment Necessary**: Yes. VRS will need an appropriation of approximately $40,000 to cover the additional cost of actuarial services to implement the requirements of this bill.

7. **Fiscal Impact Estimates:** The fiscal impact would depend on the assumed rate of return the General Assembly adopts, and how different it is from the Board of Trustee's assumed rate of return used in the plan valuations. The Board's current assumed rate of return is 7.00%, which has been the assumed rate of return since 2010. The investment return assumption is established through a process that considers factors such as economic and financial criteria; the plan's liabilities; and the plan's asset allocation, which reflects the plan's capital market assumptions, risk tolerance, and projected cash flows. The VRS Board reviews these assumptions regularly, pursuant to § 51.1-124.22. The process for establishing and reviewing the investment return assumption involves consideration of various financial, economic, and market factors, and is based on a very long-term view, typically 30 to 50 years. A primary objective for using a long-term approach in setting the return assumption is to promote stability and predictability of costs.

   An investment return assumption that is set too low will overstate liabilities and costs, causing current taxpayers to be overcharged and future taxpayers to be undercharged. A rate set too high will understate liabilities, undercharging current taxpayers, at the expense of future taxpayers. An assumption that is significantly wrong in either direction will cause a misallocation of resources and unfairly distribute costs among generations of taxpayers.

It is important to note that the VRS Board certified rate is the rate that is used to value the liabilities of the retirement plans, and to set employer contribution rates. If the General Assembly chooses to base funding of contributions on an alternative rate, this does not change the underlying liability of the retirement system, it only creates a deficit or surplus in funding depending upon the rate selected by the General Assembly. If the General Assembly were to assume a rate of return less than 7.00% for funding, it would increase the employer contribution rates because the adjusted plan liability would be greater than the Board certified liabilities. Conversely, if the General Assembly were to assume a rate of return above the 7.00% Board certified rate, this would reduce the employer contribution rates by assuming that plan liabilities were going to be lower than the Board assumes.

In addition to potentially causing issues with underfunding, the Governmental Accounting Standards Board (GASB) and Bond rating agencies have adopted new standards with regard to the accounting for public pension plans and set parameters for the required rate of return. Funding the plan using a rate of return other than that adopted by the VRS Board could potentially lead to issues with both plan accounting and bond ratings.

For plan accounting, GASB is allowing the use of the Plan's rate of return only to the extent that a pension plan's net position and projected contributions associated with active and inactive employees, including retirees, is expected to fully cover projected benefit payments for those individuals. If there comes a point in the projections when plan net position and contributions related to active and inactive employees is no longer projected to be greater than or equal to projected benefit payments related to those employees and administrative expenses, then from that point forward a government would be required to discount the projected benefit payments using a municipal borrowing rate - a tax- exempt, high-quality (an average rating of AA/Aa or higher, including equivalent ratings) 20-year general obligation bond index rate. This would most certainly occur if the General Assembly chose to base funding on a rate of return in excess of the assumed 7.00% rate certified by the Board. This in turn would cause an increase in the pension liability that employers would be required to put on their balance sheets, and also cause a net pension obligation due to funding at less than the required rate set by the VRS Board.

The bond rating agencies (Moody's, Standard and Poors and Fitch) have adopted their own policies with regard to assumed rates of return. The exhibit below shows the basis for rate of return that each agency will use to value VRS pension liabilities for the purpose of providing credit analysis.

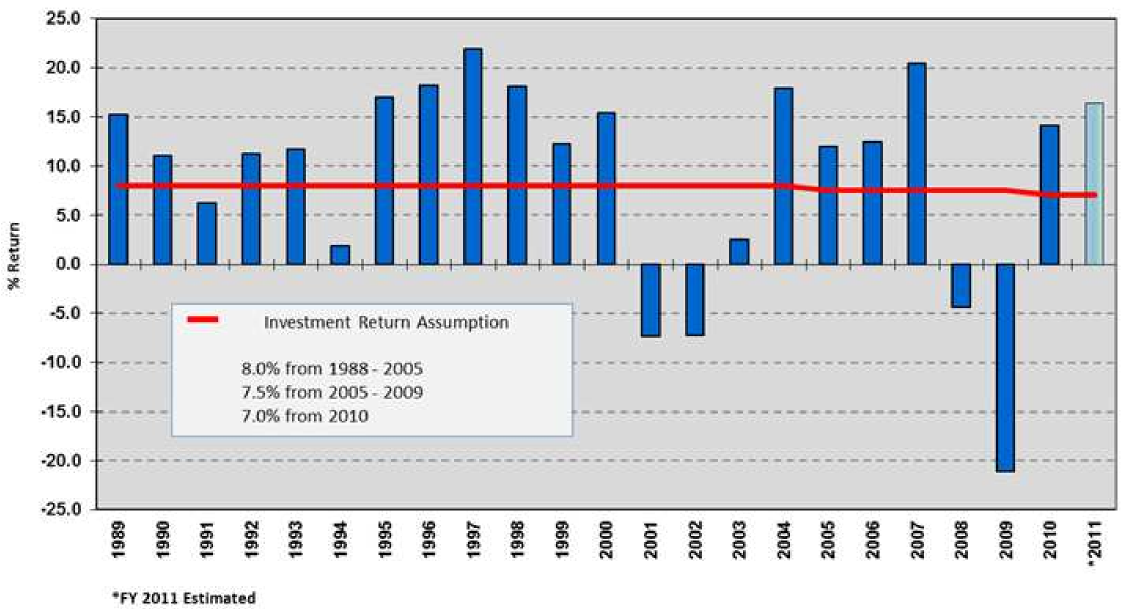
Rating Agency	Basis of Assumed Rate of Return
Moody's	High-grade long term taxable bond index discount rate as of date of valuation. (4.81% for 2013)
S&P	Same as GASB
Fitch	7.00%

Under their policies, a pension plan's funded position will be negatively impacted as the rating agencies strive to show results on a more mark-to-market basis. Again, any current unfunded liability will only be exacerbated by these policies.

As part of the pension reform effort the General Assembly undertook in 2012, §51.1-145, which governs employer contributions, was amended to add a section, §51.1-145 (K) (1), that specifically requires the General Assembly to set contribution rates that are at least equal to a schedule of gradually increasing percentages of the contribution rates certified by the VRS Board of Trustees, culminating in funding of 100% of the Board's certified contribution rates by FY 2019. The proposed amendment in HB 178 would be contradictory to the existing section 51.1-145(K) (1) and could potentially send mixed messages to the rating agencies - on the one hand committing to reaching 100% funding of the certified contribution rates and, on the other hand, under the proposed legislation, allowing the General Assembly to substitute its own assumed rate of return for purposes of calculating contribution rates.

The importance of maintaining adherence to the provisions of § 51.1-145(K) (1) cannot be overstated. Without consistent movement toward 100% funding of the Board's certified contribution rates the funding gap that currently exists will continue to increase, only offset by investment gains in years when the market return exceeds the VRS Board's long term rate of return assumption of 7.00%. The impact of new GASB policies will be felt by all employers by guaranteeing that balance sheets will reflect larger pension liabilities and net pension obligations associated with pension underfunding. Bond rating agencies will be forced to reassess Virginia's previous commitment to fully fund retirement obligations, which could negatively impact bonding ratings and the cost of future borrowing for the State and its localities.

Investment Return Assumptions



8. **Fiscal Implications:** See Fiscal Impact Estimates above.

9. **Specific Agency or Political Subdivisions Affected:** VRS and participating VRS employers.

10. **Technical Amendment Necessary:** It is unclear which rate the employers would pay in the event the General Assembly were to adopt a different assumed rate of return. The legislation requires VRS to have its Plan Actuary calculate contribution rates under a different assumed rate of return if the General Assembly adopts one, and to provide the adjusted employer contribution rates as soon as possible, but it does not specify which rate must be paid. Previous legislation or budget language of this nature has left the election to pay the full rate or a lesser rate to the employer. In the absence of additional statutory language prohibiting this, an employer could still pay the Board certified rates even after passage of this legislation.

11. **Other Comments:** The General Assembly took a very important step toward pension reform during its 2012 session, including developing a new pension plan (the Hybrid Retirement Program), making cost saving changes to the existing plans and, most importantly, codifying its commitment to fund 100% of the Board certified contribution rates. This proposed

legislation is contradictory to the current language in § 51.1-145(K) (1) and its enactment will likely signal to the rating agencies that there is not a firm commitment to full pension funding. As a result, the rating agencies would likely apply a "guaranteed funds" assumed rate of return to the VRS plans, which would lead to a much larger projected unfunded liability than is the case under current assumptions.

Date: 01.13.2014
Document: HB178.DOC