Virginia Retirement System
2014 Fiscal Impact Statement

1. **Bill Number:** HB 877

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

2. **Patron:** Jones, S. Chris

3. **Committee:** Appropriations

4. **Title: Hybrid retirement program; local deferred compensation and cash match plans.**

5. **Summary:** Allows political subdivisions the option of using their own 403(b) or 457 deferred compensation and cash match plans if they elect not to participate in those plans administered by the Board of Trustees of the Virginia Retirement System for the voluntary employer and employee contributions to the defined contribution component of the hybrid retirement program. The bill also states that state or local entities are not liable for losses.

6. **Budget Amendment Necessary**: Yes. VRS and its third-party record keeper will incur costs related to this change in the hybrid retirement plan of approximately $236,550.

7. **Fiscal Impact Estimates:** The costs to implement the changes required by this bill include internal VRS system changes and testing to accommodate annual reporting of decentralized (local) hybrid contributions, as well as additional positions in the finance, employer reporting and deferred compensation areas to collect annual information from employers and to recalculate employer contributions and credit amounts related to the employer match. VRS' plan documents will also need to be revised. Employers that elect to administer employee voluntary contributions and corresponding matching employer contributions locally will have similar expenses for revising their plan documents.

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

9. **Specific Agency or Political Subdivisions Affected:** VRS, participating political subdivisions that choose to administer their own deferred compensation plans for purposes of the voluntary employer and employee contributions to the hybrid retirement plan, and hybrid employees of these political subdivisions.

10. **Technical Amendment Necessary:** Yes. In order to administer a change of this magnitude to the structure of the hybrid retirement plan, VRS will need technical amendments to provide time limits and parameters concerning employer and employee voluntary contributions to the defined contribution component of the hybrid retirement plan.

    For administrative simplicity, VRS suggests that the choice of record-keeper for employees with elective contributions be left with the employer rather than the employee. The bill as

introduced would leave this choice with the employee and provides no limit as to the frequency of employee directed changes. However, monthly reconciliations of employee contributions will be much more difficult if potentially thousands of employees are permitted to log into multiple record-keepers and attempt to direct contribution changes. VRS proposes to give employers the authority to select either the VRS record-keeper or its preferred alternate record-keeper(s). This choice could be renewed or revised annually.

Again for administrative simplicity, VRS suggests that the number of employers with the option to elect alternative record-keepers and investment providers be narrowed to employers who have established 403(b) plans. These are plans set up under federal law for "educators". A limit of this nature would help focus efforts at coordination and employer education to about 150 units of local government as compared to about 600 otherwise.

VRS and its third-party administrator (ICMA-RC) have already built a system designed to handle, collect and reconcile all DC contributions from each of 1,000 state/local payroll departments. Under HB877 this system will need to be modified. Additional time will allow for system modifications and testing. Further, it will give VRS time to provide educational materials to employers that wish to choose an alternate record-keeper. Employers will need information on the rules of the hybrid plan, including how to manage the forfeiture of unvested employer contributions, IRS annual limits, auto-escalation requirements, the separation of employee and employer contributions, and maintaining coordination with other aspects of the hybrid plan. For these reasons, VRS is requesting a delayed effective date of January 1, 2015.

11. Other Comments:

Overview of Changes

This legislation authorizes the decentralization of voluntary employee and employer matching contributions under the defined contribution component of the hybrid retirement program that went into effect on January 1 of this year. This legislation also removes the requirement that a local employee must contribute the maximum amount of voluntary contributions to the hybrid retirement program before being eligible for a local cash match on supplementary contributions to a 403(b) or 457 account. It allows loans and hardship distributions from the voluntary employee contributions and matching employer contributions made to a local 403(b) or 457 account administered by a political subdivision, and provides that political subdivisions and VRS have no liability for contributions made to a local 403(b), 401(a) or 457 account.

As currently structured, the hybrid retirement plan requires that all participating localities use the VRS 457 deferred compensation plan and 401(a) cash match plan for all contributions—mandatory and voluntary—for the hybrid defined contribution component. The hybrid plan requires mandatory contributions from both employer and employee of 1%, and under this legislation these mandatory contributions will continue to be made to the Commonwealth's hybrid 457 plan and its hybrid 401(a) cash match plan. As is the case under the current legislation, no loans or hardship distributions will be allowed from the mandatory employee

and employer contributions made to the Commonwealth's hybrid 457 plan or the associated hybrid 401(a) cash match plan.

Under the hybrid retirement program, additional contributions may be made by the employee on a voluntary basis up to an additional 4%, with a matching component by the employer up to an additional 2.5%. As currently structured, all mandatory hybrid contributions are made to the VRS 401(a) cash match plan. Under the current structure only the employee voluntary contributions go into the Commonwealth's 457 plan, which frees up as much of the 457 annual Internal Revenue Service (IRS) limit (currently $17,500 for all employees, with additional amounts possible for those over 50 and those close to retirement) as possible for any supplemental contributions an employee may be eligible to make in addition to the hybrid contributions.

This legislation would provide that a locality has the option to use its own 457 or 403(b) accounts for the voluntary employee and employer matching contributions to the hybrid plan. Employees may be required to pay additional administrative costs as well as different investment fees for these separate accounts. Only school board employees are allowed to participate in 403(b) plans, so a locality that chooses to provide its own plans for the voluntary hybrid contributions will need to have a 457 option for those employees who are not eligible for a 403(b) plan. In addition, the employer may wish to consider establishing a 401(a) plan for the employer match on the voluntary contributions.

Forfeiture accounts

Employers that choose to administer their own plans for purposes of this legislation may want to consider adding a 401(a) account for the employer contributions if they do not already have one. This will facilitate the political subdivision's administration of the forfeiture provisions of the hybrid retirement plan, which they will be required to oversee if they opt out of the VRS accounts. Employees who terminate employment prior to vesting in the employer contributions to the hybrid retirement plan (full vesting in the defined contribution component takes four years) forfeit a portion of those employer contributions and any earnings thereon. If the employer and employee contributions are commingled, this will create administrative complexity for the employer. Under the legislation, employers that opt out will need to establish a forfeiture account and specify the uses of the account. Additionally, consideration needs to be given to the forfeiture guidelines as an employee moves between different employers during the initial four-year vesting period as the employee's total time in the hybrid plan, and not just with a single employer, will need to be tracked.

Auto-escalation

In order to encourage employees to contribute the maximum voluntary amount, the hybrid retirement program includes an auto-escalation feature that automatically increases the voluntary contributions by 0.50% every three years until the employee is contributing the maximum amount of voluntary contributions. The auto-escalation requirements of the hybrid retirement plan will be much easier for the opt-out employers to administer if the employer and employee contributions are segregated, as the auto-escalation provisions will require the

employer to determine the percentage of voluntary contributions of each employee to determine the auto escalation schedule every three years.

Plan document

Opt out employers will need to ensure that the plan documents for their local plans (457, 403(b) and 401(a)) are revised to include the additional provisions of the hybrid retirement program, such as the schedule for employer matching contributions, the vesting schedule, forfeiture accounts, loans and hardship distributions, as well as auto escalation of employee voluntary contributions every three years.

IRS Annual Account Limits

Local employers or their record keepers will also need to monitor IRS annual account contribution limits for 457 and 403(b) accounts to ensure that those limits are not exceeded, as VRS will not have access to the information necessary to do this. Local employers that opt out will need to be able to correct errors in the voluntary contributions and the related employer match to ensure compliance with IRS requirements related to errors in contributions. Employers may also be subject to liability for failure to comply with those requirements.

Proposed Opt-Out Period

The legislation as proposed is silent on whose decision it will be to participate in the VRS accounts or to opt out, and how often such a decision may be made or changed. VRS is requesting amendments that provide for an initial opt-out period for political subdivisions so that they can make a decision as to where their employees' voluntary contributions and corresponding employer match will be invested, and an annual enrollment period thereafter for political subdivisions that wish to opt out or opt back in to the VRS-provided accounts. The default will be participation with VRS, so each political subdivision's governing body will need to decide whether to remain with VRS or opt out and administer the voluntary hybrid contributions and the employer match in their local accounts. This will provide additional flexibility to political subdivisions, but will also allow VRS the ability to administer the accounts on a more structured basis (i.e., one transition period per year). However, some investment options in local 403(b) plans may have rules concerning lock-ups and forfeiture provisions. Employers need to be mindful of the provisions related to the investment options that they provide through the 403(b) plans that they establish for this purpose.

Reporting and Contributions

Because VRS will not have access to voluntary hybrid contribution information for political subdivisions that decide to administer these investments, it will not be possible for VRS to provide members in opt-out localities with consolidated information about their retirement benefits. For state employees, judges and any political subdivisions that opt to have VRS administer their employees' voluntary contributions, the employee will have access to a member benefit profile that consolidates all VRS-administered benefits to provide the member with a complete snapshot of his or her retirement benefit. For opt out employers, the member will not have access to a consolidated view of the retirement benefit. In addition, for

counseling purposes, VRS will not be in a position to provide information concerning the locally administered portion of the benefit.

VRS anticipates that employers who opt out of the VRS accounts will need to report to VRS annually on the amount of voluntary contributions and the employer match on those contributions. This is necessary because the employer contribution rate is a blended rate, based on the defined benefit actuarially determined rate and incorporates an estimate of the employer match for hybrid employees. For employers that use the VRS accounts, there is a monthly accounting for the employer match on the employee's voluntary contributions and the billing for the defined benefit component of the hybrid plan is reduced accordingly. For employers that opt out, VRS will use the annual employer report of the employer matching contributions on the employee's voluntary contributions (or a similar method) and provide the employer a credit for that amount against a future VRS contribution. This will allow opt-out employers to have the same contribution allocation result as employers who remain with the VRS administered plan

Provisions of the Hybrid that are Unchanged

The mandatory employee and employer contributions to the defined benefit component of the hybrid plan would not be affected by this legislation. This legislation would also not change any of the provisions related to state employees and judges participating in the hybrid. No loans or hardship distributions will be available for state employees and judges in the hybrid retirement plan. SPORS, VaLORS, and local hazardous duty employees with enhanced benefits are not eligible to participate in the hybrid.

HB877 is identical to SB422. Budget amendment 4-14.00 #1h also contains the same language.

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Document: HB877.DOC