

## 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 Prior to Substitute--**Jones, S. Chris

**3. Committee:** Appropriations

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

**5. Summary:** The substitute bill allows school divisions the option of establishing and administering their own 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 hybrid retirement program. This choice would be made on an annual basis. The bill also states that state or local entities are not liable for loss. The bill has a delayed effective date of January 1, 2015.

**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. School divisions 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 school divisions that choose to administer their own 403(b) plans for purposes of the voluntary employer and employee contributions to the hybrid retirement plan, and hybrid employees of these school divisions.

**10. Technical Amendment Necessary:** No.

## 11. Other Comments:

### Overview of Changes

The substitute bill 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 for school divisions that choose this option. Under the substitute each school division will determine on an annual basis whether their employees will contribute voluntary hybrid contributions (and the corresponding employer match) to a local 403(b) plan or the VRS 457. The initial decision by each school division must be made by November 1, 2014, with an effective date of January 1, 2015. Thereafter, school divisions will need to make a decision each March, beginning in 2016, as to whether their employees will participate in a local 403(b) plan or the VRS 457 plan for voluntary hybrid contributions.

This legislation also removes the requirement that local employees 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 for loans and hardship distributions to be made from the voluntary employee contributions and matching employer contributions made to a local 403(b) account administered by a school division, and provides that neither school divisions nor VRS has any liability for contributions made to a local 403(b) or 401(a) 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 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 401(a) cash match plan. Under the substitute, all political subdivisions, with the exception of school divisions, will continue to use the Commonwealth's hybrid 457 and the associated hybrid 401(a) cash match plan for both mandatory and voluntary hybrid defined contribution amounts.

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 on elective deferrals (currently \$17,500 per calendar year 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.

The substitute provides that school divisions have the option to use their own 403(b) plans and 401(a) cash match plans for the voluntary employee and employer matching contributions to the hybrid plan. School division employees may be required to pay additional administrative costs as well as different investment fees for these separate accounts.

#### Forfeiture accounts

School divisions 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 school division'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, school divisions 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 school divisions 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 school divisions 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 Limits on Elective Deferrals and Error Correction

School divisions that opt out of the VRS plan or their record keepers will also need to monitor IRS annual account contribution limits for 403(b) accounts to ensure that those limits are not exceeded, as VRS will not have access to the information necessary to do this. School divisions 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.

#### Opt-Out Periods

The substitute legislation provides that each school division will be able to decide whether its employees will participate in the VRS accounts or in a local 403(b) account. The initial decision must be made by November 1, 2014 and then annually each March, beginning in 2016, going forward. The default will be participation with VRS, so each school division'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 locally. This will provide additional flexibility to school divisions, 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 school divisions that decide to administer the voluntary contributions locally, it will not be possible for VRS to provide members in opt-out school divisions with consolidated information about their retirement benefits. For state employees, judges and political subdivisions (other than school divisions that opt out) 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 school divisions, the member will not have access to a consolidated view of retirement benefits. 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 school divisions that 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 that also 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 school divisions 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 school division a credit for that amount against a future VRS contribution. This will allow opt-out school divisions 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, judges, or political subdivision employees participating in the hybrid, other than school divisions that opt out. No loans or hardship

distributions will be available for state employees, judges, political subdivision employees or employees of school divisions that do not opt out. SPORS, VaLORS, and local hazardous duty employees with enhanced benefits are not eligible to participate in the hybrid.

Delayed Effective Date

HB877H1 has a delayed effective date of January 1, 2015. This additional time will allow for system modifications and testing. Further, it will give VRS time to provide educational materials to school divisions that wish opt out of the VRS provided plans. School divisions that opt out 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.

HB877H1 is identical to SB422S1. Budget amendment 4-14.00 #1h also contains similar language, but is not restricted to 403(b) plans and does not have a delayed effective date.

**Date:** 02.14.2014

**Document:** HB877H1.DOC