

## Virginia Retirement System 2015 Fiscal Impact Statement

**1. Bill Number:** SB1162

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

**2. Patron:** Watkins

**3. Committee:** Finance

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

**5. Summary:** Allows school divisions the option of establishing and administering their own deferred compensation and cash match plans for the hybrid retirement program. Employees of such school divisions would have the option of participating in such programs. The bill has a delayed effective date of January 1, 2016.

**6. Budget Amendment Necessary:** Yes. VRS and its third-party record keeper will incur implementation costs of approximately \$440,000 related to this change in the hybrid retirement plan.

**7. Fiscal Impact Estimates:** The VRS costs to implement the changes required by this bill are estimated at \$370,000, and 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 defined contribution areas to collect contribution information from employers and to recalculate employer contributions and credit amounts related to the employer match. This amount also includes VRS' costs for revisions to plan documents. Employers that elect to administer employee voluntary contributions and corresponding matching employer contributions locally will have similar expenses for revising their plan documents. VRS' third-party record keeper's implementation costs of approximately \$70,000 include programming to track employers that elect to allow 403(b) contributions and to prevent members who elect a 403(b) provider from using ICMA-RC for voluntary contributions, changes to member communications, and testing, documentation and administration of changes. Ongoing VRS costs are estimated at approximately \$110,000 per year for the new positions.

**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 school divisions who elect to use local 403(b) plans for voluntary hybrid contributions.

**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. In addition, VRS has included an amendment that would remove the ability for employees to take loans from funds invested in 403(b) plans that are part of their primary retirement plan.

Loans and hardship distributions – The amendments below deal with the ability to take loans and hardship distributions from primary retirement plan funds invested in 403(b) accounts.

Line 151, after “the administration of” delete :

Line 152, after “a. Vesting” insert: *vesting*

Line 155, after “matching contributions” delete “; and” and insert: .

Lines 156-158, delete “*b. Loans or hardship distributions for employee voluntary contributions under subdivision C 2 and employer matching contributions corresponding to employee voluntary contributions under subdivision B 2, notwithstanding the prohibitions on such loans or distributions in subdivisions B 5 and C 4.*”

Disclosures – The following amendments clarify to whom disclosure is provided and changes the disclosure schedule from upon enrollment to an annual basis.

On line 91 after “by the Board” insert: *on an annual basis*

On lines 91-92, strike “at enrollment, or at such later time upon request” and insert: *who does not make the election provided in G.1*

On line 187 after “Commonwealth” insert: *on an annual basis*

On line 187, strike “at enrollment, or at such later time upon request” and insert: *who makes the election provided in G.1*

Annual Employer-Election Period – If the election period and effective date coincide with the calendar year, it would align with the IRS annual contribution limits on both 403(b) and 457 accounts.

On line 164, strike “2106” and insert: *2016*

On lines 164 and 165, delete “a minimum period of”

On line 165, delete “18” and insert *12*

On line 167, strike “March 1” and insert: *November 30*

On line 168, strike “July” and insert: *January*

Annual Employee-Election Period – As written, the bill would permit an employee to elect back and forth from pay period to pay period. The following amendment limits the frequency of an employee-level election to once per year.

On line 169 after “3.” insert: *A person who participates in the hybrid retirement program maintained under this section may make an election to participate in the 403(b) plan established by his employer under subdivision G.1. Such election shall be exercised no later than November 30, 2015, and shall be effective January 1, 2016. If an election is not made by November 30, 2015, such employee shall be deemed to have elected not to participate in the 403(b) plan established by his employer under subdivision G.1. Thereafter, such employee may make or change his election on or before November 30 of each year by notifying his employer of a new or changed election, which shall become effective the following January 1. If an election is not made or changed by November 30, such employee shall be deemed to have elected not to change the prior year’s election. 4.*

On line 182 delete “4” and insert 5

On line 185 delete “5” and insert 6

On line 188 delete “6” and insert 7

VRS Policies and Procedures – The proposed amendment requires VRS to promulgate policies and procedures relating to members who elect to move in and out of VRS accounts.

After Line 191, insert a new paragraph: *8. The Board shall develop policies and procedures for administering the provisions of this subsection.*

## **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, 2014. Under the legislation, each local school division will determine on an annual basis whether their employees will be permitted to elect to contribute their voluntary Hybrid contributions (and the corresponding employer match) to a local 403(b) plan (or plans, as many school divisions have multiple 403(b) providers) or the VRS Hybrid 457 and VRS Hybrid 401(a) Cash Match plans. The initial decision by each school division must be made by November 1, 2015, with an effective date of January 1, 2016. Thereafter, school divisions will need to make a decision each March, beginning in 2016, as to whether their employees will be provided an election to participate in a local 403(b) plan or the VRS Hybrid 457 plan for voluntary hybrid contributions.

Amounts currently invested in the VRS Hybrid 457 plan may not be transferred to 403(b) plans. This could result in multiple low balance accounts that could be adversely affected by fees.

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.

This bill allows loans and hardship distributions from the voluntary employee contributions and matching employer contributions made to local 403(b) accounts administered by a school division, which is addressed in the Technical Amendments in section 10. While the IRS allows hardship distributions from 457 accounts such as the ones administered by VRS, these distributions, called unforeseen emergency withdrawals, are strictly limited by IRS rules and are allowed for only the most dire and unforeseen financial hardships, such as imminent foreclosure or eviction, natural disasters, and funeral expenses. A 403(b) plan, however, may permit in-service distributions in the case of a hardship. A hardship for this purpose is “an immediate and heavy financial need to be determined on the basis of facts and circumstances.” A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred. For example, a hardship may include costs directly related to the purchase of a principal residence or payment of tuition for up to the next 12 months of post-secondary education. The hardship distribution standard for 403(b) accounts differs from the “unforeseeable emergency” withdrawals under a 457 account, which include only those that are not reasonably foreseeable. Hardship distributions are different from loans. Hardship withdrawals may not be restored to the plan following receipt.

The bill also provides that school divisions and VRS, its officers, directors and employees, have no liability for contributions made to local 403(b) accounts. School divisions, as fiduciaries of the Hybrid funds contributed to 403(b) accounts, must select such funds under the standard of care set out in § 51.1-803.

As currently structured, the hybrid retirement plan requires that all participating localities use the VRS Hybrid 457 Deferred Compensation Plan and Hybrid 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 VRS Hybrid 401(a) Cash Match Plan. All political subdivisions, with the exception of school divisions, which will have an option under this legislation, will continue to use the VRS 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, including the employer match to voluntary contributions, are made to the VRS Hybrid 401(a) Cash Match Plan. Under the current structure, only the employee voluntary contributions go into the VRS Hybrid 457 plan, which frees up as much of the 457 annual Internal Revenue Service (IRS) limit (currently \$18,000 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 school division has the option to use its own 403(b) plan(s) and 401(a) cash match plan for the voluntary employee and employer matching contributions to the Hybrid plan. If a school division does not establish a 401(a) cash match plan, then both the employer and the employee contributions will be made to the 403(b) plan and will count toward the IRS maximum annual contribution limit. School division employees will likely be required to pay additional administrative costs as well as different investment fees for these separate accounts, and will not be able to view their complete retirement benefits in a holistic manner in one location.

#### 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 the 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 elect to allow employees to use 403(b) accounts for voluntary contributions will need to establish a forfeiture account for those employees 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 service with a single employer, will need to be tracked. School divisions that allow their employees to use 403(b) accounts will need to work with VRS and their 403(b) provider(s) to ensure that all non-vested employer sources are forfeited when a forfeiture event occurs. For example, if a terminated employee takes a distribution from non-vested employer match funds with a 403(b) provider, non-vested employer mandatory funds should also be forfeited at the same time. Employees can end up with multiple employer match buckets as they move between employers before being fully vested. Vesting is based on total creditable service at the time of distribution, not service with an individual employer.

#### 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 school divisions that allow their employees to use 403(b) plans to administer if the employer and employee contributions are segregated, as the auto-escalation provisions will require these school divisions to determine the percentage of voluntary contributions of each employee to administer the auto escalation schedule every three years.

#### Plan documents

School divisions that allow their employees to use 403(b) plans will need to ensure that the plan documents for their local plans (403(b) and 401(a)) are revised to include the additional provisions of the hybrid retirement plan, such as the schedule for employer matching contributions, the vesting schedule, forfeiture accounts, loans and hardship distributions, if allowed, as well as auto escalation of employee voluntary contributions every three years. Additionally, due to the relationship between the blended employer rate and the employer match, which may vary, employers will need to ensure that their plan documents consider VRS business rules related to when Hybrid participation and contributions should start and stop, as well as the definition of “creditable compensation,” which all Hybrid contributions are based on. This will be especially important for employees that choose to move into and out of the Commonwealth’s Hybrid 457 plan.

#### IRS Annual Account Limits

Opt-out school divisions 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 will also be required to monitor the IRC Section 401(a)(17) annual compensation limit and the IRC Section 415 annual contribution limit. 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.

#### Election Periods

This bill provides both the employer and the employee the option to elect to use a local 403(b) plan or plans in addition to the VRS Hybrid 457 plan for voluntary hybrid contributions and the associated employer match. However, an employee of a school division that has not elected to allow the use of local 403(b) plans cannot elect to use a 403(b) plan in lieu of the VRS Hybrid 457 and 401(a) plans. On an annual basis, each school division will have the opportunity to elect to give its employees the option to direct hybrid voluntary contributions to local 403(b) plans. The initial election period at the employer level will expire on November 1, 2015. Each year thereafter, the bill provides that a decision must be made by each school division by March 1, to become effective the subsequent July 1. The suggested technical amendment in Item 10 makes this election period begin with the calendar year to make it easier to track IRS annual contribution limits.

A school division’s election to permit its employees to use local 403(b) plans for voluntary hybrid contributions does not automatically require every employee to contribute to a local

403(b). If a school division makes the election to allow a 403(b) option, each employee will have the opportunity to decide whether to remain with VRS for their voluntary contributions and employer match or to use a local 403(b) plan. These plans would be established separately from the VRS Hybrid 401(a) Cash match Plan, which will still be used for all mandatory contributions. Because the bill is silent on how often an employee may exercise or revoke the option, VRS is requesting a technical amendment to limit the frequency of employee-level elections to once a year.

#### 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 school divisions that elect to allow employees to use local 403(b) plans for hybrid voluntary contributions with consolidated information about their retirement benefits. For state employees, judges and political subdivisions other than school divisions that elect to offer a 403(b) option, 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 school divisions that elect to allow a 403(b) option, the members who choose to use a local 403(b) account for voluntary hybrid contributions will not have access to a consolidated view of his or her primary 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. As school district employees that choose to utilize the 403(b) option move between employers, they will likely end up with multiple accounts over various providers, which may make this process more difficult.

VRS anticipates that school divisions that choose to offer 403(b) options to their employees in addition to the VRS Hybrid 457 plan will need to report to VRS annually and potentially more often 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 only 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 elect to offer a 403(b) option, 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 future VRS contributions. This will allow school divisions that elect to offer a 403(b) option to have the same contribution allocation result as employers who remain with the VRS administered plan, although not on a monthly basis.

#### Transferring Hybrid Funds

It will not be easy for a member who elects to make Hybrid voluntary contributions to a 403(b) plan pursuant to this bill to consolidate funds already deposited into his or her Hybrid 457 Deferred Compensation account, where Hybrid voluntary contributions are currently deposited. Additionally, plan to plan transfers between 457 plans and 403(b) plans are not

permissible, as the rules governing each respective type of account are slightly different. A member would have to meet break in service requirements prior to being eligible to take a distribution from the VRS Hybrid 457 Plan.

#### Loans

This legislation proposes to allow a Hybrid Plan member the ability to take loans from his or her 403(b) account. Under the existing Hybrid Plan, a member is prohibited from taking loans out against any mandatory or voluntary contributions to his primary retirement plan. (See proposed Technical Amendments in section 10.) VRS does not allow loans from any of its defined contribution plans.

#### 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, judges, or employees of political subdivisions in the hybrid retirement plan that do not elect to allow a 403(b) option. SPORS, VaLORS, and local hazardous duty employees with enhanced benefits are not eligible to participate in the hybrid.

#### Delayed Effective Date

This bill contains an enactment clause with a delayed effective date of January 1, 2016. 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 to allow employees to use local 403(b) plans. School divisions that make this election will need information on the rules of the Hybrid plan, including how to manage the forfeiture of unvested employer contributions, and how to monitor IRS annual limits, auto-escalation requirements, the separation of employee and employer contributions, and maintaining coordination with other aspects of the Hybrid plan.

This bill is identical to HB 2178.

**Date:** 01-23-2015

**Document:** SB1162.DOC