

Virginia Retirement System 2017 Fiscal Impact Statement

1. Bill Number: HB 1967

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

2. Patron: Massie

3. Committee: Appropriations, Compensation and Retirement Subcommittee

4. Title: Virginia Retirement System; hybrid retirement program.

5. Summary: Modifies the hybrid retirement program by (i) adjusting the percentage of employee mandatory contribution allocated to the defined benefit component from 4% to 3%, (ii) adjusting the percentage of the employee mandatory contribution allocated to the defined contribution component from 1% to 2%, (iii) setting a new employee's voluntary contribution rate to the defined contribution component at 0.5% while allowing employees to opt out, and (iv) decreasing the amount of time between auto-escalation of voluntary contributions from every three years to every two years. The proposed changes would increase the minimum employer match to the defined contribution component of the hybrid from 1% to 2%, but would keep the maximum allowable employer match to the defined contribution component at 3.5%. The maximum employee contribution, including the mandatory 5% member contribution, would be reduced from 9% to 8%. The change would also require the employer to cover the additional 1% cost on the defined benefit normal cost due to the change in the allocation of member contributions to the plan.

6. Budget Amendment Necessary: Yes. Item 489. First-year implementation costs resulting from this legislation are estimated to be \$133,375 for additional staff to monitor auto-enrollment and auto-escalation, amendments to plan documents, programming, handbook revisions and employer outreach. This figure includes \$25,000, which will be an ongoing cost in future years, for half of an additional full-time position devoted to monitoring auto-enrollment and auto-escalation. This amount is higher than the projected estimate for the legislation in 2016, due to an increase in the hourly rate for systems programming and increased estimated printing costs. The estimated costs also take into account that VRS handbooks and other benefit materials were reprinted in January 2017 and, in order to comply with Chapter 10 of Title 51.1, would need to be reprinted upon the effective date of this legislation to accurately reflect benefits. The cost of reprinting VRS handbooks and other benefit materials will be allocated across any bills that require materials to be reprinted out of cycle.

Additionally, the appropriation for state employers and for the state portion of teacher contributions would need to be increased to reflect the higher blended contribution rate.

7. **Fiscal Impact Estimates:** The estimated aggregate cost impacts of HB 1967, assuming 50% of Hybrid Plan members would not opt-out of auto enrollment and auto-escalation increases in the voluntary contributions to the defined contribution component of the hybrid, are provided below.

a. Fiscal Impact Estimates/Expenditure Impact:

Exhibit 1

<i>Fiscal Year</i>	<i>Dollars</i>	<i>Positions</i>	<i>General Fund</i>	<i>Non-General Fund & Local Funds</i>
2018	\$48,243,900		\$16,588,300	\$31,655,600
2019	\$63,173,800		\$21,505,600	\$41,688,200
2020	\$63,173,800		\$21,505,600	\$41,688,200
2021	\$97,956,900		\$33,544,100	\$64,412,800
2022	\$97,956,900		\$33,544,100	\$64,412,800
2023	\$110,016,500		\$37,770,200	\$72,246,300

A more detailed breakdown of estimated costs are shown in Item 8 below.

b. Fiscal Impact Estimates/Revenue Impact: N/A

8. **Fiscal Implications:** The impact of HB 1967 on plan funding will vary by plan based on the number of Hybrid Plan members, as well as the number of members who choose to retain the auto-enrollment and auto-escalation of the voluntary contributions. Exhibit 2 below provides a range of the initial impacts of HB 1967 based on the results of the June 30, 2016 actuarial valuations.

Exhibit 2

**Hybrid Plan Proposed Modifications
Estimated First Year Cost Impacts**

Plan	Impact 25% Retention	Impact 50% Retention	Impact 75% Retention	Impact 100% Retention
State	0.27%	0.33%	0.39%	0.45%
Teachers	0.30%	0.34%	0.39%	0.43%
JRS	0.64%	0.71%	0.78%	0.85%
Political Subdivisions in Aggregate	0.20%	0.24%	0.29%	0.33%

As members are added to the Hybrid Plan, VRS expects the cost as a percentage of payroll to increase over time. Exhibit 3 below is the estimated cost impacts to the State plan under four retention scenarios. These cost impacts include both the defined benefit cost impacts as well as the employer costs associated with employer match associated with the defined contribution component of the hybrid. VRS estimates the long-term impact of the proposed changes, after more than 20 years and all applicable members being in the hybrid, to approach 2.40% of covered payroll assuming 50% of the members do not opt-out of auto-escalation once the Hybrid Plan is fully implemented and contains a majority of VRS members. The ultimate impact will depend heavily on the employee's participation in the voluntary contributions contained within the defined contribution component of the hybrid plan.

Exhibit 3

Hybrid Plan Proposed Modifications Cost Impact for all Proposed Changes as a Percent of Payroll State Plan

Hybrid Scenario	1st Year	After 5 Years	After 10 Years	After 20 Years
3% DB/2% DC - 25% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.26%	0.61%	0.78%	0.81%
3% DB/2% DC - 50% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.33%	0.77%	1.08%	1.23%
3% DB/2% DC - 75% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.39%	0.89%	1.25%	1.45%
3% DB/2% DC - 100% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.45%	1.02%	1.42%	1.67%

Exhibit 4 below shows similar estimated cost impacts for the Teacher plan under four retention scenarios. These cost impacts include both the defined benefit cost impacts as well as the employer costs associated with employer match associated with the defined contribution component of the hybrid. VRS estimates the long-term impact of the proposed changes, after more than 20 years and all applicable members are in the plan, will also approach a similar level of 2.40% of covered payroll assuming 50% of the members do not opt-out of auto-escalation once the Hybrid Plan is fully implemented and contains a majority of VRS members. Due to lower turnover in the Teacher plan, the impacts of HB 1967 are slightly less for the Teacher plan due to having fewer hybrid members than the State plan shown in Exhibit 3.

Exhibit 4

Hybrid Plan Proposed Modifications Cost Impact for all Proposed Changes as a Percent of Payroll Teacher Plan

Hybrid Scenario	1st Year	After 5 Years	After 10 Years	After 20 Years
3% DB/2% DC - 25% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.29%	0.66%	0.79%	0.73%
3% DB/2% DC - 50% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.34%	0.78%	1.01%	1.00%
3% DB/2% DC - 75% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.39%	0.87%	1.16%	1.28%
3% DB/2% DC - 100% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.43%	0.96%	1.31%	1.56%

Exhibit 5 below shows the potential impact on prospective funding assuming 50% of Hybrid Plan members would not opt-out of the auto enrollment or auto escalation increases in voluntary contributions to the defined contribution component of the Hybrid. As mentioned above, the ultimate impact will depend heavily on the employee's participation in the voluntary contributions contained within the defined contribution component of the hybrid plan.

Exhibit 5

	<u>FY 2018</u>	<u>FY 2019</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>	<u>FY2023</u>
State - General Fund	\$ 5,631,100	\$ 7,687,700	\$ 7,687,700	\$ 11,749,600	\$ 11,749,600	\$ 13,045,100
SPORS - General Fund	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
VaLORS - General Fund	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
JRS - General Fund	\$ 464,900	\$ 559,800	\$ 559,800	\$ 812,900	\$ 812,900	\$ 890,100
Teacher - General Fund	\$ 10,492,300	\$ 13,258,100	\$ 13,258,100	\$ 20,981,600	\$ 20,981,600	\$ 23,835,000
TOTAL General Fund	\$ 16,588,300	\$ 21,505,600	\$ 21,505,600	\$ 33,544,100	\$ 33,544,100	\$ 37,770,200
State - Non-General Funds	\$ 7,547,100	\$ 10,303,400	\$ 10,303,400	\$ 15,747,400	\$ 15,747,400	\$ 17,483,800
SPORS - Non-General Funds	-	-	-	-	-	-
VaLORS - Non-General Funds	-	-	-	-	-	-
TOTAL - Non-General Funds	\$ 7,547,100	\$ 10,303,400	\$ 10,303,400	\$ 15,747,400	\$ 15,747,400	\$ 17,483,800
Teacher - Local Funds	\$ 15,738,500	\$ 19,887,200	\$ 19,887,200	\$ 31,472,400	\$ 31,472,400	\$ 35,752,400
Political Subdivisions - Local Funds	\$ 8,370,000	\$ 11,477,600	\$ 11,477,600	\$ 17,193,000	\$ 17,193,000	\$ 19,010,100
TOTAL Local Funds	\$ 24,108,500	\$ 31,364,800	\$ 31,364,800	\$ 48,665,400	\$ 48,665,400	\$ 54,762,500
Grand Totals	\$ 48,243,900	\$ 63,173,800	\$ 63,173,800	\$ 97,956,900	\$ 97,956,900	\$ 110,016,500

Estimated projections based on employee data and valuation results as of June 30, 2016 and assume a level population throughout projection period.

Payroll projections are assumed to remain level throughout projection period.

I. Changing the Allocation of the 5% Member Contribution between the Defined Benefit and Defined Contribution Components from 4% DB /1% DC to 3% DB /2% DC.

Changing the allocation of the 5% member contribution between the defined benefit and defined contribution components from the current 4/1 to 3/2 would affect the degree to which a Hybrid member bears the load of paying the normal cost of his or her defined benefit component under the Hybrid Plan. Compared to a member in one of VRS' traditional defined benefit plans, Plan 1 and Plan 2, a Hybrid member pays a higher percentage of the normal cost for the defined benefit component of the Hybrid Plan. Exhibit 6 shows the current (i.e., under the 4% DB/1% DC allocation) percentage of normal cost borne by a member in Plan 1, Plan 2, and the Hybrid Plan based on the June 30, 2015 actuarial valuation results.

Exhibit 6

Normal Cost Distribution under the Current 4% DB/1% Hybrid Plan DC Member Contribution Allocation

State	Plan 1	Plan 2	Hybrid Plan
Total Normal Cost	9.64%	8.95%	5.17%
Member Contribution	5.00%	5.00%	4.00%
Percentage of Normal Cost Funded by Member	51.87%	55.87%	77.37%

Teachers	Plan 1	Plan 2	Hybrid Plan
Total Normal Cost	11.23%	9.70%	5.68%
Member Contribution	5.00%	5.00%	4.00%
Percentage of Normal Cost Funded by Member	44.52%	51.55%	70.42%

Exhibit 7 below shows the estimated percentage of normal cost borne by a member if the Hybrid Plan member contribution allocation were changed to 3% DB/2% DC as proposed in HB 1967. Under this scenario, the percentage of the normal cost borne by a Hybrid Plan member more closely aligns with that of Plan 1 and Plan 2 members.

Exhibit 7

Normal Cost Distribution under the Proposed 3% DB/2% DC Hybrid Plan Allocation of Member Contribution

State	Plan 1	Plan 2	Hybrid Plan
Total Normal Cost	9.64%	8.95%	5.17%
Member Contribution	5.00%	5.00%	3.00%
Percentage of Normal Cost Funded by Member	51.87%	55.87%	58.03%

Teachers	Plan 1	Plan 2	Hybrid Plan
Total Normal Cost	11.23%	9.70%	5.68%
Member Contribution	5.00%	5.00%	3.00%
Percentage of Normal Cost Funded by Member	44.52%	51.55%	52.82%

The proposed shift from a defined benefit to defined contribution allocation of 3% DB/2% DC results in a higher income replacement ratio for Hybrid members upon retirement. The income replacement increase for a member who retires with 30 years of service, as demonstrated in Exhibit 8 below, is estimated to be approximately 5.7% (assuming that a member makes the minimum contributions). While the maximum benefit provides the same replacement ratio under the current hybrid provisions and the proposed provisions of HB 1967, the employee would pay 1.0% less of payroll to attain this benefit.

Exhibit 8

Income Replacement Ratios of VRS Plan 1, Plan 2, and Current Hybrid Compared to Proposed Changes in the Hybrid Plan

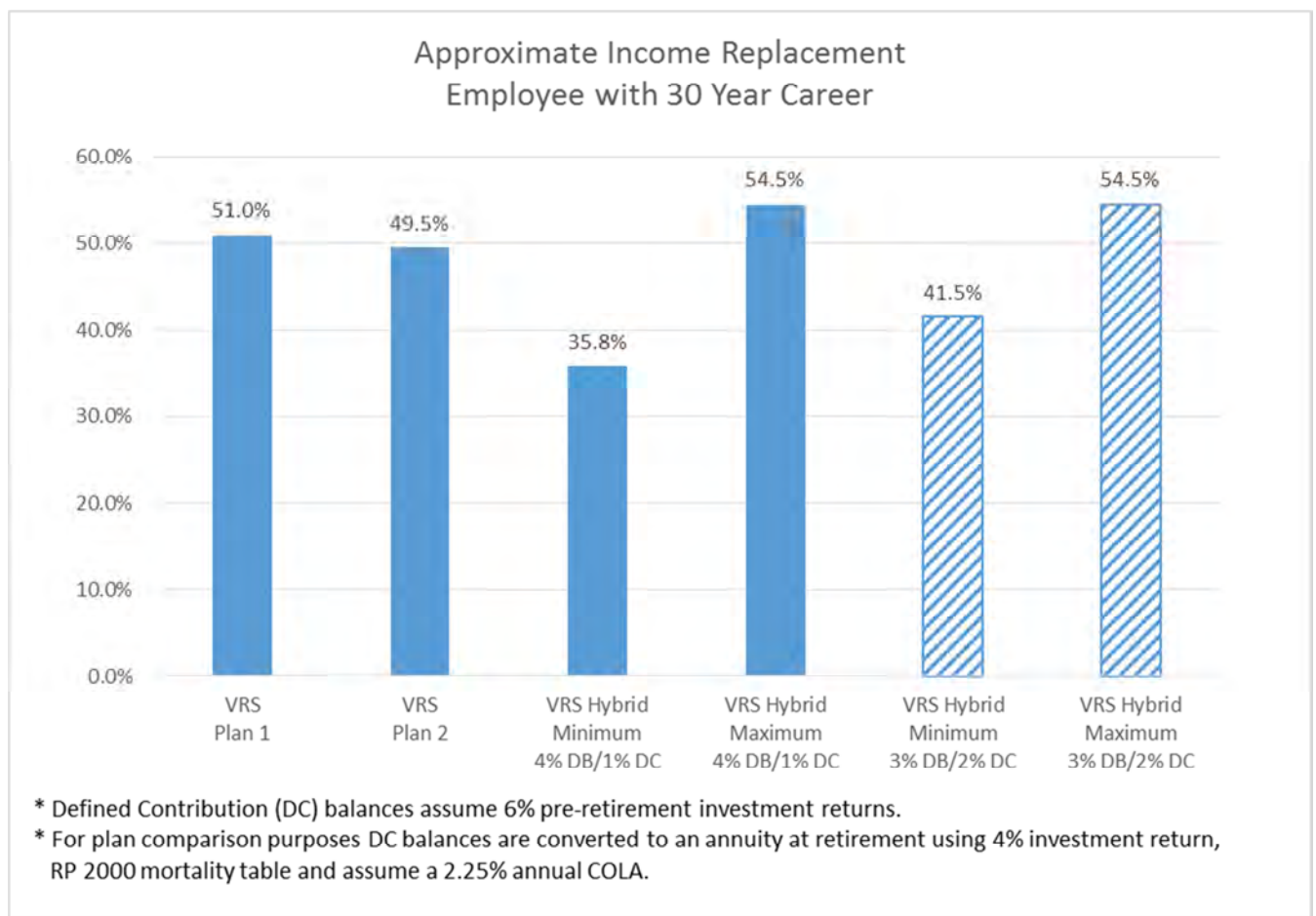
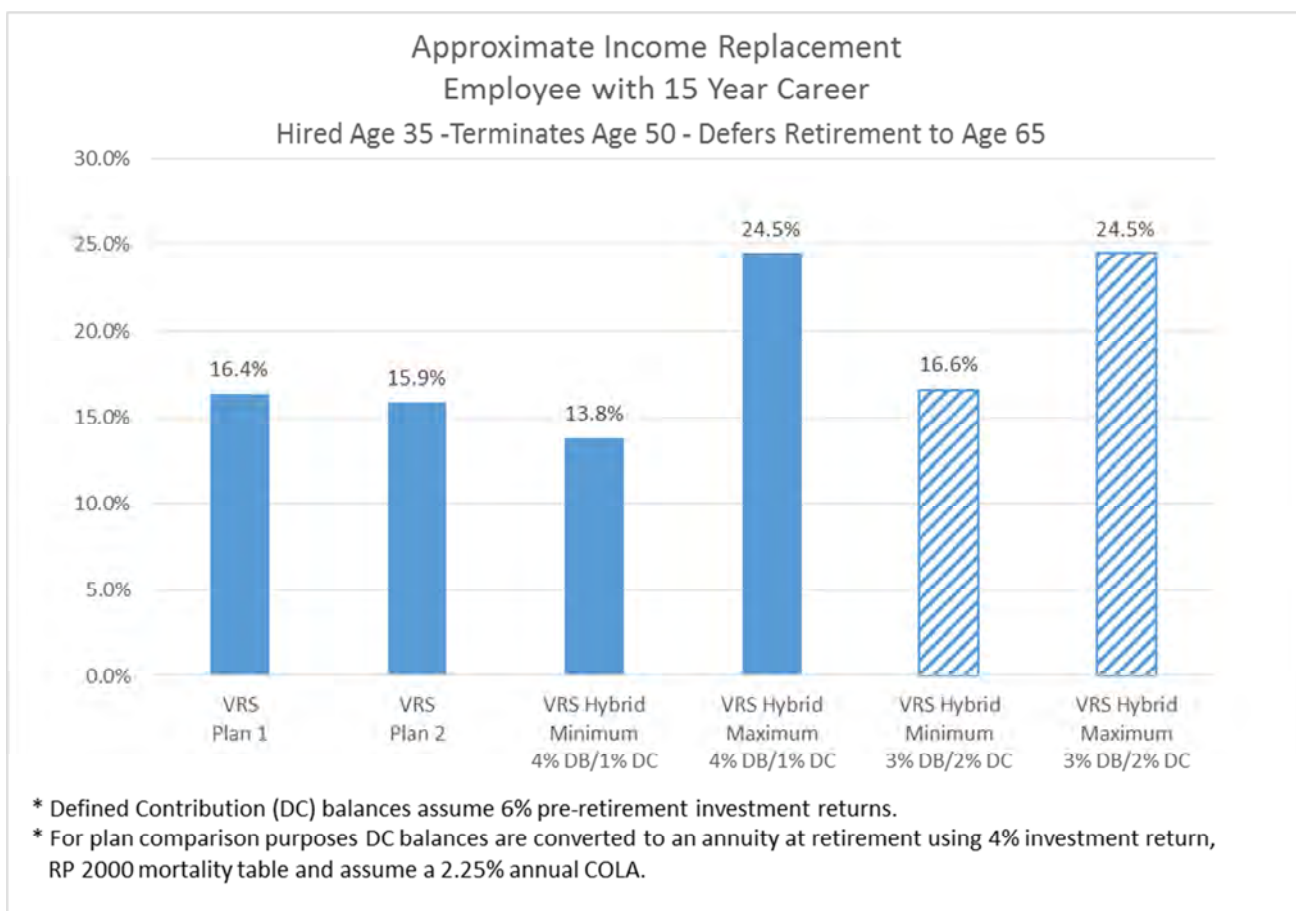


Exhibit 8 and Exhibit 9 do not reflect the effects of auto-enrollment or auto-escalation as the scenarios shown assume either that a member makes the minimum required contribution throughout his or her career, or the maximum allowable throughout his or her career. Auto-escalation and auto-enrollment examples can be found in Exhibits 12 and 13 below.

Similarly, a shorter term employee who is a Hybrid Plan member who terminates at age 50 with 15 years of service and defers retirement to age 65 could experience an estimated 2.8% increase in his or her replacement ratio under the proposed bill (assuming that a member makes the minimum contributions). Exhibit 9 below demonstrates the estimated replacement ratios under various voluntary contribution levels. As mentioned above, compared to the current plan design (4% DB/1% DC), the employee is able to have a better benefit outcome at the minimum level because they are increasing their mandatory contribution by 1.0% of pay without the total contribution being impacted. Similarly, the employee can achieve the max benefit at a lower total employee cost than the current plan design.

Exhibit 9



Risk Sharing

Although the legislation would require an employer to pick up a greater portion of Hybrid Plan costs to bring the normal cost distribution more in line with Plan 1 and Plan 2, about 30% of the member's benefit would remain risk-free to the employer in the future due to being part of the defined contribution component of the plan. This is different from Plan 1 and Plan 2, in which the employer bears all of the investment and longevity risk due to the entire benefit being a traditional defined benefit plan.

II. Auto-enrollment and auto-escalation.

Adjusting the auto-escalation period from three years to two years would increase the speed with which a Hybrid member begins making voluntary contributions at the maximum voluntary rate, which HB 1967 proposes to shift from 4% to 3%. Under the existing framework, as Exhibit 10 shows below, it would take a Hybrid member up to 24 years to be auto-escalated from 0% to 4% in voluntary contributions, assuming the member does not opt out of any of the increases and does not elect any additional voluntary contributions.

Exhibit 10

Current Auto-Escalation Provision

Date	Auto-Escalation Amount	Voluntary Rate
1/1/2017	0.0%	0.0%
1/1/2020	0.5%	0.5%
1/1/2023	0.5%	1.0%
1/1/2026	0.5%	1.5%
1/1/2029	0.5%	2.0%
1/1/2032	0.5%	2.5%
1/1/2035	0.5%	3.0%
1/1/2038	0.5%	3.5%
1/1/2041	0.5%	4.0%

Under HB 1967, shifting an additional 1% of the employee contribution to the defined contribution plan in combination with auto-enrolling new members at 0.5% of payroll at hire and creating shorter periods between auto-escalations would result in a Hybrid member contributing the maximum 3% in voluntary contributions in 10 years, assuming the member does not opt out of any of the auto-escalations. This change, demonstrated in Exhibit 11 below, encourages a Hybrid member to contribute money to retirement earlier in his or her career, thereby allowing more time for the member to take advantage of compounding interest.

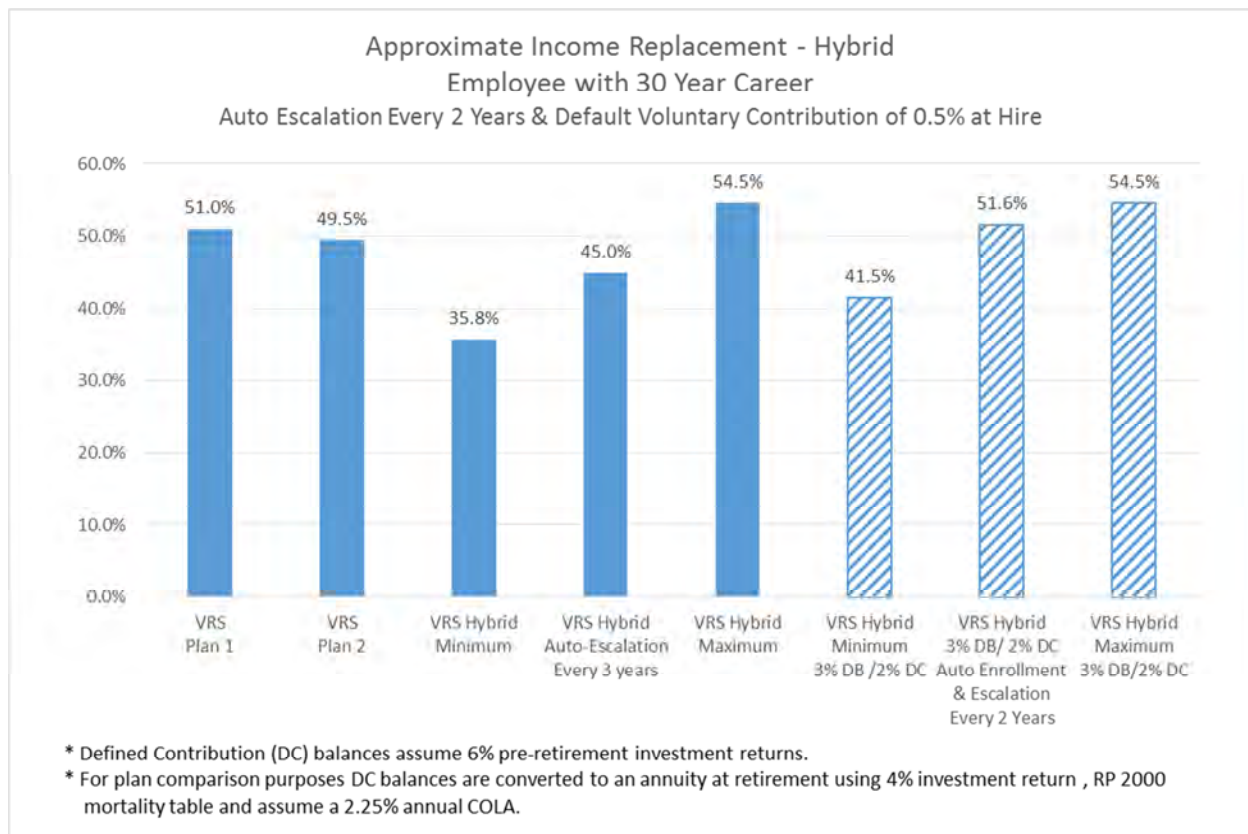
Exhibit 11

**Auto-Escalation Every Two Years
with modified allocation 2% Mandatory - 3% Voluntary
and Auto-Enrollment Rate of 0.5% at Date of Hire**

Date	Auto-Escalation Amount	Voluntary Rate
1/1/2017	0.0%	0.5%
1/1/2019	0.5%	1.0%
1/1/2021	0.5%	1.5%
1/1/2023	0.5%	2.0%
1/1/2025	0.5%	2.5%
1/1/2027	0.5%	3.0%

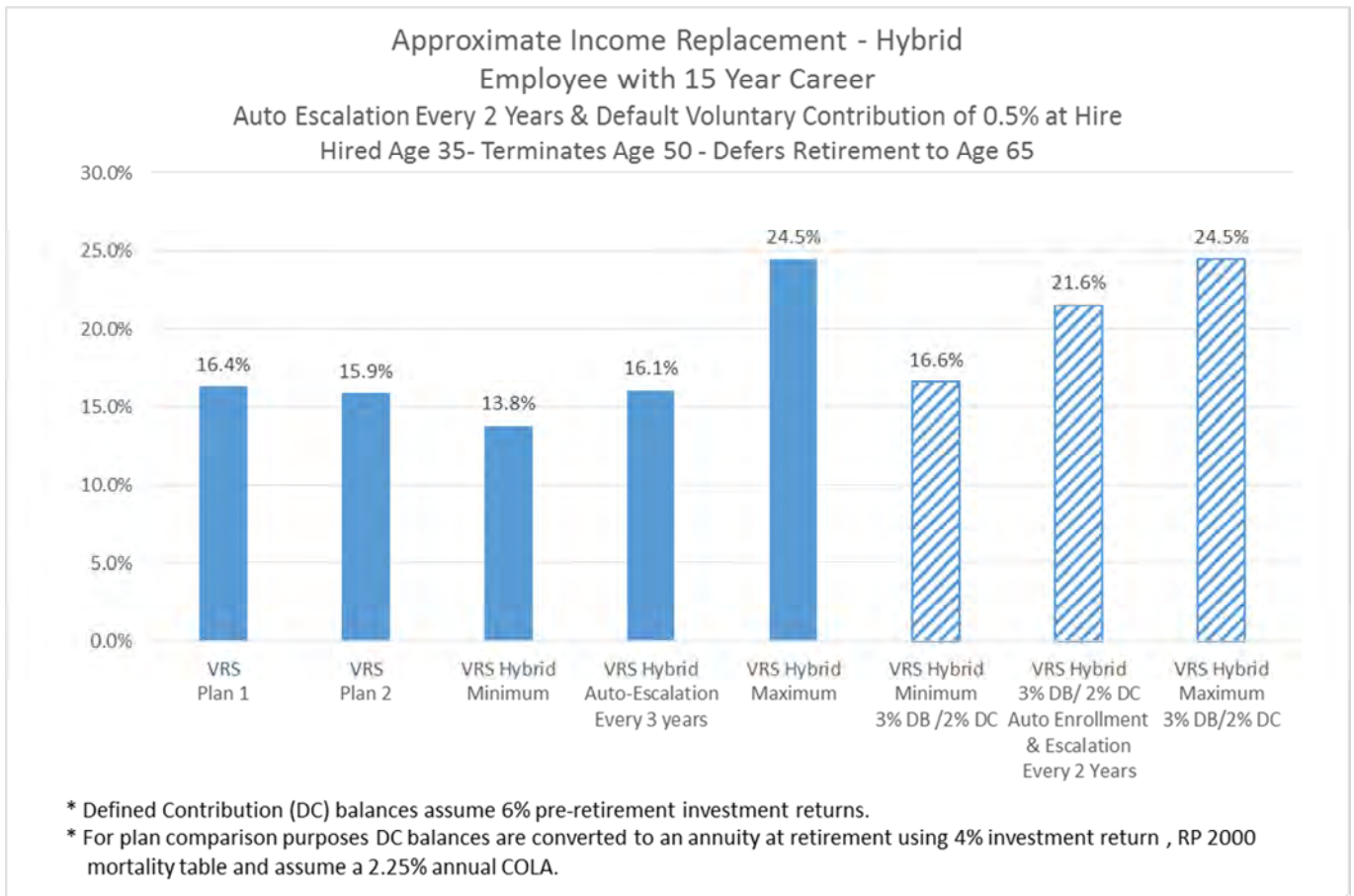
Exhibit 12 shows the potential impact of HB 1967 on a member's benefit levels. For a member retiring with 30 years of service, the proposed plan modifications could increase a member's replacement ratio by approximately 6% of average final compensation for a member either participating at the minimum level or following the auto-escalation schedule. Members opting to take full advantage of the employer matching contributions would be able to maximize their benefits with an 8% member contribution rather than the current 9% required under the Hybrid design. In Exhibit 12 below, VRS Hybrid Minimum represents a member who contributes only the minimum amount to the defined contribution component and opts out of auto-enrollment and auto-escalation. Hybrid Auto-Escalation & Enrollment represents a member who only contributes the minimum, plus the amounts based on auto-escalation (and auto-enrollment based on the proposed legislation). VRS Hybrid Maximum represents a member who contributes the maximum amount to the defined contribution program from commencement of employment until retirement.

Exhibit 12



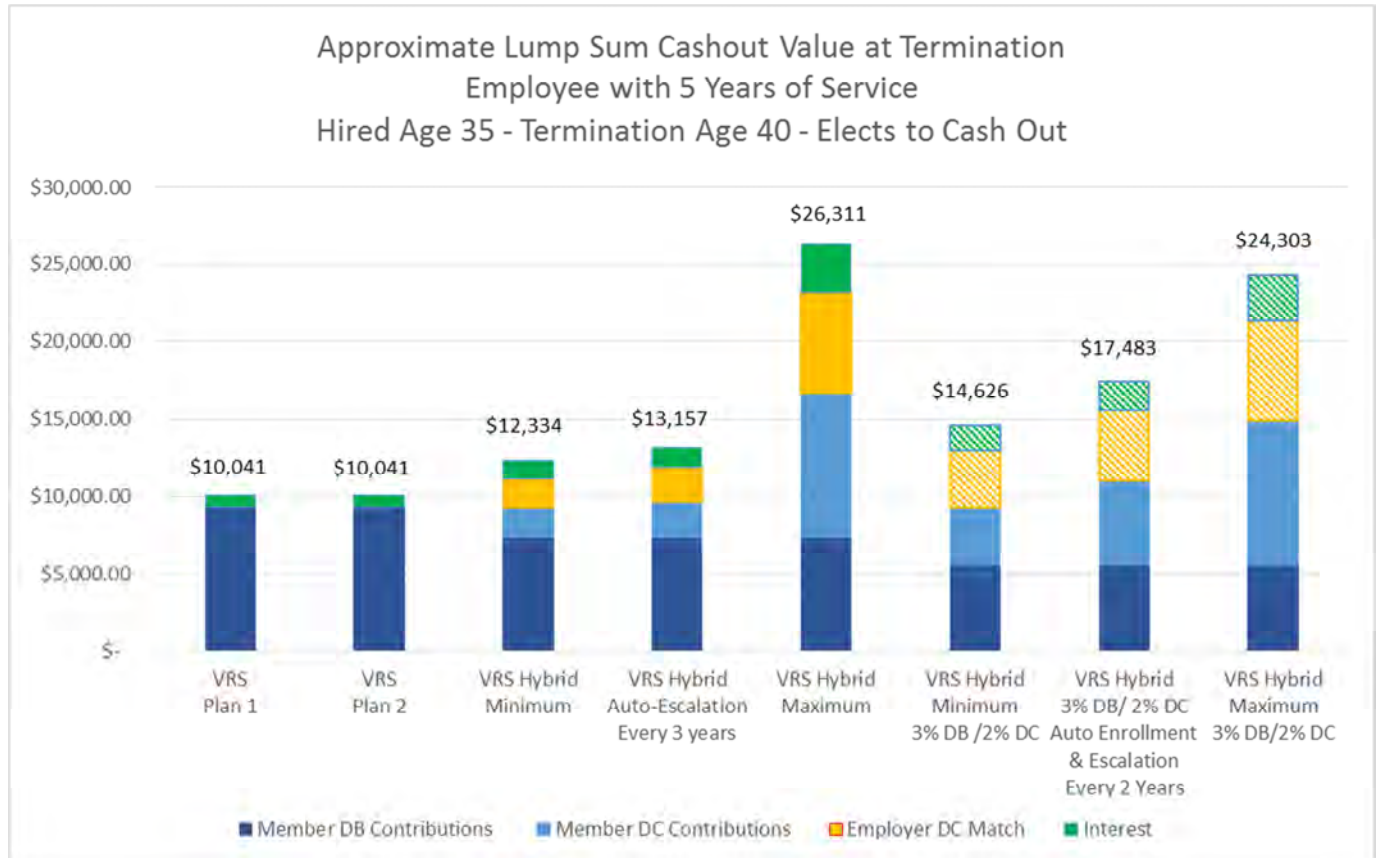
Similarly, a shorter term employee who is a Hybrid member who terminates at age 50 with 15 years of service and defers retirement to age 65 could increase the replacement ratio by approximately 5.5% under the proposed plan modifications if he or she followed the auto-escalation schedule. Exhibit 13 below demonstrates the estimated replacement ratios under various voluntary contribution levels.

Exhibit 13



For short term employees who would elect to cash out their benefits, Exhibit 14 below shows that members who maximize their voluntary contributions and vest in the employer match will have larger cash outs than the traditional defined benefit designs, Plan 1 and Plan 2, as well as Hybrid members who only participate at the minimum level.

Exhibit 14



9. Specific Agency or Political Subdivisions Affected: VRS, Hybrid members, and all employers of Hybrid members.

10. Technical Amendment Necessary: VRS is requesting a delayed effective date of the change in the allocation of employee mandatory contributions from the current 4% to the defined benefit component and 1% to the defined contribution component to 3/2. Under HB 1967, this change would need to be made as of July 1, 2017. This does not give VRS' over 580 local employers much time to implement the necessary payroll and related system changes to implement the new allocation. VRS is requesting a delay of six months, until January 1, 2018, to implement the change in employee contributions.

11. Other Comments: The General Assembly enacted the Hybrid Retirement Plan in 2012 and it became effective on January 1, 2014. All new VRS members participate in the Hybrid Plan, except for employees covered by the State Police Officers' Retirement System

(SPORS), the Virginia Law Officers' Retirement System (VaLORS), and those employees of a political subdivision who are covered by enhanced hazardous duty benefits.

The Hybrid Plan is different from VRS' other two primary plans, VRS Plan 1 and Plan 2, which are pure defined benefit plans. In addition to a defined benefit component, the Hybrid Plan also features a defined contribution component. The Hybrid's defined benefit and defined contribution components work together to form a VRS member's retirement benefit.

The defined benefit component of the Hybrid is structured similarly to VRS Plan 1 and Plan 2. At the end of an employee's career, he or she will receive a monthly retirement allowance that is calculated based on years of service, average final compensation, and the retirement multiplier. Because the defined benefit component of the Hybrid is not the entire benefit, the 1% retirement multiplier is smaller than the Plan 1 (1.7%) and Plan 2 (1.65%) multipliers. Under the current framework, a Hybrid member contributes 4% of creditable compensation towards the defined benefit component. The employer contributes a variable amount that is calculated on an actuarial basis. HB 1967 would decrease the member's defined benefit contribution to 3%. This would increase the employer contribution to the defined benefit component over time, and would ultimately approach 1.0% of payroll when fully implemented. The plan design would also allow the member to put those funds, which would otherwise be contributed toward the defined benefit component of the plan, into the defined contribution component of the Hybrid plan, and receive a corresponding employer match.

The defined contribution component, which HB 1967 also proposes to change, makes up the remainder of a Hybrid member's retirement benefit. It is similar to a 401(k)-style benefit. At the end of an employee's career, he or she has a lump-sum balance that is available for withdrawal. The defined contribution component is made up of both employer and employee contributions. An employer makes a mandatory contribution of 1% under the current framework, and the employee does the same. Furthermore, a member may make additional voluntary contributions up to 4%, which the employer must match according to the following schedule:

Exhibit 15 – Current Hybrid Defined Contribution Schedule

Current Hybrid Defined Contribution Schedule								
	Defined Benefit Plan	Defined Contribution					Maximum DC Contribution	Maximum Total Contribution
		Mandatory	Voluntary					
Employee	4.00%	1.00%	1.00%	1.00%	1.00%	1.00%	5.00%	9.00%
Employer	Actuarially Determined	1.00%	1.00%	0.50%	0.50%	0.50%	3.50%	Actuarially Determined for Defined Benefit plus up to 3.5% for Defined Contribution

HB 1967 would amend the foregoing schedule of contributions to the defined contribution component. Instead of a 1% mandatory contribution for both the employer and member, both would be required to make a 2% contribution. On the voluntary contribution side, a member would be permitted to make additional contributions of up to 3%. The employer would have to match 50% of any member voluntary contributions, up to an additional 1.5% of creditable compensation. Under HB 1967, the total contributions made by a Hybrid member and employer would be as follows:

Exhibit 16 – Proposed Hybrid Defined Contribution Schedule

Proposed Hybrid Defined Contribution Schedule

	Defined Benefit Plan	Defined Contribution				Maximum DC Contribution	Maximum Total Contribution
		Mandatory	Voluntary				
Employee	4.00%	2.00%	1.00%	1.00%	1.00%	5.00%	9.00%
Employer	Actuarially Determined	2.00%	0.50%	0.50%	0.50%	3.50%	Actuarially Determined for Defined Benefit plus up to 3.5% for Defined Contribution

HB 1967 would also change several other aspects of the current Hybrid Retirement Plan structure. The current structure does not provide for an immediate auto-enrollment in voluntary defined contributions for new employees. Depending on the date of hire, it could be three years before a new employee is auto-escalated into a 0.5% voluntary contribution (with the opportunity to opt out). HB 1967 would implement auto-enrollment for new Hybrid employees in voluntary contributions at 0.5%, still with the opportunity to opt out.

HB 1967 would also change the auto-escalation schedule from the current every three years to every two years. This would shorten the time period it would take for an employee to reach the full amount of voluntary contributions as compared to the current auto-escalation schedule, assuming that the employee did not opt out of the automatic increases.

Request: Delayed Effective Date of January 1, 2018

HB 1967 features three different effective dates as drafted. VRS requests an enactment clause that delays the first of these to January 1, 2018.

As HB 1967 is currently drafted, adjusting the allocation of a member's 5% contribution from 4/1 to 3/2 would take place on July 1, 2017. The auto-enrollment feature (i.e., a new employee being automatically enrolled to contribute 0.5% in voluntary contributions, with the opportunity to opt out), would begin effective January 1, 2018. Finally, although the

provisions related to the auto-escalation feature would become law on July 1, 2017, the first instance of auto-escalation under HB 1967's provisions would not occur until January 1, 2019.

VRS requests an enactment clause to delay the effective date of HB 1967 so that the adjustment to the allocation of a member's 5% contribution take place beginning January 1, 2018. VRS requests a delayed effective date of January 1, 2018 to provide an extra 6 months for the more than 580 local VRS employers to make necessary payroll and related system changes, as well as to allow VRS time to continue to move off of its mainframe system and more fully migrate to a client server system. VRS is in the midst of a comprehensive Modernization effort, which not only includes migrating to a client server environment, but also improving and enhancing online capabilities and functionality. Furthermore, the delay would give state agencies and VRS' more than 580 political subdivisions additional time to modify systems and processes to comply with the provisions of this bill.

Points of Consideration

1. HB 1967 puts the employee/employer sharing of the Hybrid Plan normal cost more in line with Plan 1 and Plan 2, while still keeping the expected employer cost below the current Plan 1 and Plan 2 normal cost rate.
2. Accelerating the auto-escalation feature and adding auto-enrollment for voluntary contributions will provide earlier opportunities for plan members to focus on retirement savings and potentially encourage members to save for retirement earlier in their careers. Both auto-escalation and auto-enrollment are considered industry best practices for encouraging employees to participate in defined contribution plans.
3. The bill increases the savings rate without reducing an employee's net salary. Although HB 1967 requires a Hybrid member to double his or her mandatory contribution to the DC portion of the plan from 1% to 2%, a member's take-home pay is not reduced since the legislation also decreases the member's defined benefit contribution from 4% to 3%.
4. Although the employer will pick up additional costs due to the provisions of this bill, approximately half of the contribution will bear no future investment risk to the employer because it will be part of the defined contribution component of the Hybrid Plan.

Date: 01-20-2017

Document: HB1967.DOC/VRS