Virginia Retirement System
2011 Fiscal Impact Statement

1. **Bill Number:** HB2410

   House of Origin ☐ Introduced X Substitute ☐ Engrossed

   Second House ☐ In Committee ☐ Substitute ☐ Enrolled

2. **Patron:** Putney

3. **Committee:** Appropriations

4. **Title:** Virginia Retirement System; optional defined contribution retirement program.

5. **Summary:** Virginia Retirement System (VRS); optional defined contribution retirement program for state and local employees. This bill creates an optional defined contribution retirement program for state and local employees beginning January 1, 2012.

6. **Budget Amendment Necessary**:

7. **Fiscal Impact Estimates:** See Other Comments below.

8. **Fiscal Implications:** Since the Optional Defined Contribution Program will cover mostly new hires, the employee population covered by the defined contribution (DC) plan will be very slow in developing. As a result, it will take many years before employers may begin to realize any benefits anticipated by creating a DC plan.

   There are two separate issues to consider in amortizing the unfunded liability of the defined benefit (DB) plan after implementation of the optional defined contribution retirement program: (1) the future payroll for the DB plan which will be the basis on which contribution rates will be paid; and (2) the amortization period.

   As fewer new hires join the current DB plan, the payroll base under this plan would begin to decline immediately. Since the payroll base is used to fund the DB system's unfunded accrued liabilities (UAL), the financial burden as a percent of payroll will increase. To comply with Governmental Accounting Standards Board (GASB) Statements 25 and 27, the DB plan could be required to change to a decreasing payroll growth assumption in financing the UAL or move to a level dollar approach from the level percent of increasing payroll currently used. (Level dollar means the same dollar amount is paid each year in the future to amortize the unfunded liability. This is like the typical mortgage payment with equal payments for the term of the loan.) However, the bill provides that the employer may make a contribution (an employer surcharge) to the defined benefit plans toward the amortization of the unfunded liability with respect to employees enrolled in the optional defined contribution plan. Since unfunded contributions are expected to be made on the entire payroll including employees enrolled in the defined contribution plan, a significant decrease in the growth of the payroll base used to amortize the UAL is not expected. As a result, the actuary does not recommend a change to the current payroll growth assumption of 3% per year. If the defined contribution plan is adopted, VRS will monitor future experience, including the success in implementing the employer surcharge, to evaluate what impact, if any, the DC on plan is having on the DB plan's payroll growth and any necessary recommend changes.

Below is an illustration of VRS' understanding of how the additional contribution on the payroll of employees enrolled in the DC plan would work. Under this approach, the total employer contribution – DC plan plus additional DB – with respect to employees enrolled in the DC plan would be equal to the contribution payable with respect to members in the DB plan. VRS has estimated the impact for fiscal year 2013 using the Board approved assumptions of 7% interest and 2.5% COLA rates, and 20-year amortization. VRS has also assumed the DB plan employer contribution rate does not include the 5% Plan 1 member contribution.

	State DB Plan		Teachers DB Plan	
Employer DC plan contribution level	Minimum	Maximum	Minimum	Maximum
Estimated employer contribution rate DB plan FY 2013	15.95%	15.95%	19.60%	19.60%
Minus employer contribution rate DC plan	5.00%	8.50%	5.00%	8.50%
Additional contribution toward DB plan UAL rate (surcharge)	10.95%	7.45%	14.60%	11.10%
Minus estimated UAL rate DB plan FY 2013	11.99%	11.99%	13.47%	13.47%
UAL rate excess (shortfall) with respect to employees enrolled in DC plan	(1.04%)	(4.54%)	1.13%	(2.37%)

Depending on the level of employer contribution to the DC plan, under the approach above the contribution to the State DB plan will be less than the required UAL contribution rate by approximately 1.04% to 4.54% of the payroll of members enrolled in the DC plan. With respect to the Teachers DB plan, VRS estimates a contribution excess of 1.13% with the minimum 5% DC plan employer contribution rate and a contribution shortfall of 2.37% with an 8.50% employer contribution to the DC plan.

In the short-term, the total contribution payable by employers with respect to employees enrolling in the DC plan - reflecting the surcharge contribution - will equal the required contribution to the DB plan for members of that plan. Therefore, VRS would not anticipate a reduction in the employer cost after the adoption of the optional DC plan. However, the ultimate cost of the DB plan, after the unfunded accrued liability has been paid off, is the employer normal cost plus expenses.

Under HB 2410, employees enrolled in the DC plan would not participate in the Virginia Sickness and Disability Program (VSDP). However, the proposed bill provides a disability program for employees enrolled in the DC plan. The long-term disability (LTD) benefit under the DC plan disability program will be similar to the current VSDP benefit, except:

- There will be no cost-of-living adjustment (COLA) on the LTD benefit for members in the DC plan.
- A contribution will be made by the new LTD plan to the defined contribution plan (10% of credible compensation multiplied by the income replacement percentage).
  - Note: The results assume this is an amount in addition to the income replacement benefit and is exclusive of any benefit offsets.
- Disability benefits will cease to be paid to a participating employee based upon the conditions specified by 51.1-1161.
  - The date that the participating employee attains age 65; or
  - The date that the participating employee takes an initial distribution from the defined contribution retirement plan established pursuant to § 51.1-126.5:1.
  - Notwithstanding the above conditions, an employee who is approved for disability benefits (i) at age 60 through 64 shall be eligible for five years of disability benefits, (ii) at age 65 through 68 shall be eligible for disability benefits to age 70, and (iii) at age 69 or older shall be eligible for disability benefits for one year. The eligibility periods include short-term disability and long term disability.

VRS estimates that the changes proposed by HB 2410 will result in a long-term cost for the DC plan disability program of approximately 0.58% of pay under Plan 1 and 0.61% of pay under Plan 2. These costs are approximately 0.05% of pay higher for Plan 1 and 0.03% of pay higher for Plan 2 than the LTD VSDP normal cost rate as of June 30, 2010. Please note the following, which may have an impact on the estimated cost.

- The calculations are based on the data and actuarial assumptions and methods used in the June 30, 2010 actuarial valuation of the VSDP LTD benefit, including benefit offsets (where applicable), rates of termination, rates of disability, rates of mortality, and rates of retirement (dates of initial distribution).
- For purposes of this analysis, the results are estimated by applying the DC plan LTD disability benefit provisions to the June 30, 2010 active employee population consisting of only those employees participating in VSDP.
- Plan 2 results are based upon the June 30, 2010 active employee population.
- The normal cost rates reported above do not include the portion of normal cost attributable to UNUM administrative fees.
- The employee population covered under the DC plan LTD program may be different than the current VSDP population, since the DC plan will be subject to different payout conditions and be open to teachers, judges and local employees who are not currently covered under VSDP.
- The results do not provide the impact to the STD or LTC benefits currently offered under VSDP.

Additionally, it may be worth noting the difference in the termination provisions from those used by VSDP. Currently, VSDP coverage terminates at recovery, death, retirement, or Normal Retirement Age (NRA), with a minimum of 5 years of benefit payments (NRA differs by VaLORS/SPORS, State Plan 1, and State Plan 2).

Life Insurance

The eligibility for life and accident insurance coverage for participants in the optional defined contribution retirement program receiving disability benefits is designed to be identical to the existing VSDP program. If the participant is participating in a group life and accident insurance program established under Chapter 5 of Title 51.1, he or she is eligible for continued coverage during periods of absence covered by short-term and long-term disability benefits.

Health Insurance Credit

Eligibility to Participate in the State Plan
At retirement, members in the new DC program would become eligible for the state retiree health benefit if they begin receiving a periodic payment from the DC program immediately upon leaving employment and qualifying for a distribution. This can also be accomplished by the purchase of an immediate annuity from a plan provider.

Eligibility to Receive the Health Insurance Credit
A member is eligible with 15 years of VRS and/or ORP service. To qualify, the member must receive a periodic distribution from the ORP immediately upon qualifying and incur a cost for his or her own health insurance.

As with the current ORP plan, costs results are assumed to be unaffected by assumptions related to eligibility, rates of termination, rates of disability, rates of mortality, and rates of retirement from the defined contribution plan which follow the same timings and patterns as the current defined benefit plan.

Long-term Care Costs

HB 2410 also provides employer-paid Long-term Care (LTC) coverage at the same level as provided by VSDP. VRS' initial assessment is that HB 2410 would not impact LTC cost (as a percent of pay – although the increase in the covered population will increase the dollar cost). VRS' preliminary view is based upon the following:

- HB 2410 does not change the level of LTC benefits.
- Continuance of the LTC benefit after employment requires the member to pay the premium and there is no retiree LTC liability to VRS (i.e., the premium paid by retirees is not subsidized explicitly or implicitly).
- The active employee survival model (termination, disability, mortality, retirement, and LTC incidence rates) are not different for the group electing the DC plan.
- The LTC premium is not paid by VSDP for those receiving LTD benefits.

HB 2410 provides LTC benefits to members who elect to participate in the Optional DC Retirement Program, including teachers, political subdivision employees, hazardous duty personnel and judges. By virtue of participation in the DC Program, these members would have access to the disability program that includes the LTC benefits. As a result, the required LTC contribution amount will increase depending on the number of current and future hires that elect to participate in the optional DC plan. Since VRS expects few current members will choose to move to the DC plan, and growth in the new DC plan will be gradual, the LTC contribution will also increase gradually over many years as new hires join the optional DC plan.

9. **Specific Agency or Political Subdivisions Affected:** VRS, state agencies, political subdivisions, colleges and universities

10. **Technical Amendment Necessary:** Yes. The following technical amendments are needed:

Line 338, "(i)" should be italicized.
Line 339, "or (ii) § 51.1-126.5:1," should be italicized.
Line 484, Insert "of" after "subsection B".
Line 623, insert "§" after "subsection D and".

11. Other Comments:

Plan Election:

Employees shall make an irrevocable election to participate in either the optional DC program or the Virginia Retirement System DB plan. New hires will have 60 days to make the election. The default option of the person fails to make an election is the existing defined benefit plan, which has been the practice in most states with optional DC plans.

Current VRS members may make an irrevocable election to participate in the optional DC program and may be allowed by the VRS Board to transfer their accumulated contributions and interest under the VRS DB plan or the balance in an optional retirement plan.

Current members must make their election by March 31, 2012. If an election is not made by March 31, 2012, the employee will remain in his current defined benefit plan.

Employees who are eligible for or participate in the Optional Retirement Plan for Higher Education as defined in §51.1-126, the DC plan set forth in §51.1-126.1 for employees of certain teaching hospitals, the University of Virginia Medical Center plan as provided in §51.1126.3, the Virginia Port Authority plan as set forth in §51.126.4, the Optional Retirement Plan for Political Appointees as set forth in §51.1-126.5, the plan for superintendents of public school divisions set forth in §51.1-126.6, and the Virginia Outdoors Foundation plan set forth in §51.1126.7 are not eligible for this Optional Defined Contribution Retirement Program. The higher education faculty will continue to participate in the ORPHE. Plan 1 ORPHE participating employees (generally those hired prior to July 1, 2010), receive an employer contribution of 10.4% to their DC plan. Plan 2 ORPHE participating employees (generally those hired on or after July 1, 2010). receive a minimum employer contribution of 8.5%, but not in excess of 8.9%. In addition, Plan 2 ORPHE participants must make member contributions in the amount of 5% on a pre-tax basis. As established by the VRS Board of Trustees, the same contribution provisions apply to the school superintendent (§51.1126.6) and the political appointee (§51.1-126.5) plans.

Employer and Employee Contributions:

Employers and employees each shall make a minimum contribution of 5% of pay. In addition, employees may make voluntary contributions of up to 3.5% of pay or the limit on elective deferrals unde the Internal Revenue Code Section 457(b) to the optional DC plan. The employer shall make a matching contribution of 100% of the employee's voluntary contribution. The total maximum employer contribution to the DC program would be 8.5% of pay. Similarly, the minimum employer plus employee contribution to the program will be 10% of pay.

Illustration of Tiered Employer Contributions

	Employer Contribution	Employee Contribution	
Tier 1	5 percent	5 percent	This is the mandatory employer contribution.
Tier 2	0 to 3.5 percent	0 to 3.5 percent	This is the one to one match by the employer of elective employee contributions.

The employee contributions are capped at 8.5% of creditable compensation or the elective deferral limit under IRC § 457 (b), whichever is less. The deferral limit only comes into play for a person less than 50 years of age earning in excess of $471,000. There are no loans or hardship distributions available from these funds. The reason for these restrictions is that optional DC retirement program is now the primary source of retirement funds for the electing member.

All of the mandatory employee contributions go into an IRC 401(a) account. All of the voluntary employee contributions to the optional DC retirement program are <u>elective</u> deferrals, and as a result must go into an IRC 457(b) plan. This two-tier design with mandatory employee contributions provides more flexibility and allows a participant to make additional deferrals into the 457 plan since there is an annual limit on such deferrals. For example, the current deferred compensation plan administered by VRS is a 457 plan, and the IRC elective deferral limits would have to be coordinated between the optional DC retirement program and the deferred compensation plan. Employee contributions to the optional DC retirement program, whether elective or mandatory, will not affect the amount that can be contributed to an IRC § 403(b) plan by those who have one (teachers and other eligible employees of educational institutions).

The deferred compensation plan administered (457) by the VRS Board and the cash match plan (401(a)) administered by the VRS Board are the plans to be used to carry out the provisions of the legislation.

Vesting:

The bill provides a vesting schedule with respect to the employer contributions to the DC program. Members with less than one year of continuous service would be 0% vested, those with at least one but less than to two years of service would be 20% vested, those with at least two but less than three years of service would be 40% vested, those with at least three but less than four years of service would be 60% vested and members with at least four years but less than five years of service would be 80% vested and those with five or more years of service would be 100% vested to the employer contributions.

Illustration of Employer Contribution Vesting

Less than 1 year of service	0 percent
1 or more years of service	20 percent
2 or more years of service	40 percent
3 or more years of service	60 percent
4 or more years of service	80 percent
5 or more years of service	100 percent

Below is a discussion of some of the issues to consider in establishing an optional DC plan.

From a benefits perspective, DC plans provide features not usually found in DB plans, such as portability, investment choice, personal responsibility, and lump sum payouts. DC plans are common vehicles for building retirement savings. However, whether the savings accumulated under the DC plan will provide adequate retirement income depends on several factors, including a member's savings rate, asset allocation, investment income and life expectancy. Under a DC plan approach, it is possible for a retiree to outlive his or her retirement savings. DC plans do not provide guaranteed cost of living increases after retirement. In addition, hazardous duty members who often retire with fewer years of service and at younger ages will have fewer years to accumulate assets and more years in retirement to draw on these assets.

Eligibility for Other Related Benefits:

Participants in the optional DC retirement program are eligible for a disability program. Please see the more detailed discussionof the disability program below. In addition, participants in the optional DC retirement program will be eligible for the retiree health insurance credit. Further, participants in the optional DC retirement program will be eligible for coverage under the group life and optional life insurance programs.

Disability for DC Program Participants

Short Term Disability (Non Work Related)

A member would be eligible for this coverage if the member was participating in the Optional DC Program. The employee will not be eligible for non Work Related benefits until completing one year of continuous employment with their respective employer. The Short Term Disability (STD) program provides up to 125 work days for the STD benefit. The program also offers 60% of the pre-disability salary for those members with less than 5 years of service with their current employer and 100%, 80% and 60% for those members who have 5 or more years of service under this program. The levels of income replacement are based on the months of continuous service with the employer. The employer pays the STD income replacement and a third party administrator provides case management.

Short Term Disability (Work Related)

A member, who participates in the Optional DC Program, is immediately eligible for work related short term disability. This benefit would be supplemental to payments made under the Workers' Compensation Act. The income replacement would be 60% of the member's pre-disability income with an offset for the Workers' Compensation award if the member had less than 5 years of service with their current employer. For members who have 5 or more years of service with their current employer, income replacement is 100%, 80% and 60% of pre-disability salary. The levels of income replacement are based on the number of months of service that the member has with the employer. The benefit is offset by any payments under Workers' Compensation.

The work related STD benefit program includes special provisions for the State Police. Members of the State Police receive 100% pre-disability replacement income for the full STD period. In certain cases, the STD period can be extended to one full year.

As in the non work related STD program, the employer pays the benefit and a third party administrator provides case management.

Long Term Disability (Non Work Related and Work Related)

The Long Term Disability (LTD) program provides extended disability coverage with income replacement at 60% pre-disability income. For work related injuries, the LTD benefit would be offset by any benefit paid under Workers' Compensation or any other government benefit programs.

Payment of the LTD benefit ends when the member reaches the age of 65 or when the person begins a distribution from the Optional DC Program.

General Terms and Administration of Program

The program offers a benefit for catastrophic illnesses with income replacement at 80% of the member's pre-disability income.

Contributions to the member's DC plan will be made by both the employer and employee based on the member's STD benefit income replacement amount. During periods of LTD, a 10% contribution will be made by the Disability Trust Fund based on the amount of the benefit the member is receiving.

Disability benefits are offset by outside income, SSDI and other governmental benefit programs.

In addition, the members covered by this program are eligible for Long Term Care insurance at a rate of $96 a day up to maximum of two years. They also have Group Life Insurance coverage.

Anti-selection:

It is important to note the costs regarding anti-selection. Under the proposed bill, since existing and new members are given a choice between the DB and DC plan, many will be able to choose the plan that is in their financial best interest. Younger employees will tend to opt for the DC plan, and these are the people who are cheaper to fund in the DB plan. By contrast older employees, who are more costly to fund in a DB plan, will tend to opt for that plan.

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