

Virginia Retirement System 2011 Fiscal Impact Statement

1. Bill Number: SB 1115

House of Origin	X	Introduced	<input type="checkbox"/>	Substitute	<input type="checkbox"/>	Engrossed
Second House	<input type="checkbox"/>	In Committee	<input type="checkbox"/>	Substitute	<input type="checkbox"/>	Enrolled

2. Patron: Watkins and Stosch

3. Committee: Finance

4. Title: Virginia Retirement System; optional defined contribution retirement program for state and local employees.

5. Summary: Virginia Retirement System (VRS); 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 the System 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. This will be compounded by Governmental Accounting Standards Board (GASB) requirements under Statements 25 and 27 to reduce the 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.

Currently, VRS assumes 3% per year payroll growth and calculates an unfunded contribution that increases 3% per year to remain the same percent of the increasing payroll. GASB requirements would allow VRS to assume decreasing payroll and calculate a decreasing amortization payment so it is a level percent of that decreasing payroll. In

doing so, this approach would be in line with the current VRS funding policy for level contributions as a percent of pay.

With respect to the amortization period, the VRS actuary recommends considering a change from an open to a closed period to reflect a DB plan which will slowly shrink in size. Currently, VRS uses an open amortization period which begins at 20 years each actuarial valuation date. The open amortization period is acceptable for an ongoing, perpetual pension plan. With the creation of an optional DC plan, even with low participation in the DC plan, over time the number of members in the DB plan will decline. It will take many years but eventually the DB plan will diminish in size and transition from an open, ongoing plan to looking more like a closed plan. Therefore, the actuary suggests that consideration be given to changing to a closed (i.e., decreasing by one each year until the unfunded liability is paid) amortization period. This change in amortization method will increase the contribution required to the DB plan, at least in the near term.

VRS estimates the first year impact of changing the unfunded liability amortization method to level dollar would increase the contribution rate to the State and Teachers plan by approximately 3.10% and 3.50% of pay, respectively, for fiscal year 2013. The estimated impact is based upon the Board approved assumptions of 7% interest and 2.5% COLA rates, and a 20-year amortization.

The decision to change amortization methods will ultimately rest with the General Assembly. Current GASB accounting rules do not dictate at what point an optional DC plan should trigger the change from an open to a closed amortization period. At minimum, the actuary recommends monitoring the rate of decay of the active defined benefit payroll to judge when a closed amortization period should be put in place.

In addition, when a member terminates prior to retirement under a defined benefit plan with no right to a vested benefit, the employer contributions remain in the system. These employer contributions are no longer needed for the terminated member and are released to be used to fund other member's benefits. If a defined contribution is established for new hires, there will be less of these 'forfeited' employer contributions that currently help control the cost of the defined benefit plan.

Very few current members are expected to transfer to the DC plan. Accordingly, current unfunded liabilities for the DB pension and retiree healthcare benefits will remain substantially unchanged. Consequently, after adopting the defined contribution plan, the state and local employers will remain responsible for funding the current unfunded liabilities for the pension and retiree health and life benefits.

Some key elements to consider when offering a DC plan along with the existing DB plan: (1) as some participants elect the DC program, the DB plan will generally have a shrinking payroll; (2) as payroll decays, DB rates are generally going to rise; (3) in accordance with GASB principles, a change in the amortization period for the DB plan should be considered; and (4) depending on the level of participation in the DC program, the return

assumption in the DB plan might need to be adjusted at some point in order to account for a shorter time horizon and liquidity needs.

On an ongoing basis, there are additional costs that must be paid for either by the employer or the employee. For example, administrative expenses are greater if the employer has to maintain both a defined benefit and a defined contribution plan. In addition, there will be greater communication needs, not only for educational purposes, but also for participant access to the DC program's account information.

9. **Specific Agency or Political Subdivisions Affected:** VRS, state agencies, political subdivisions, colleges and universities
10. **Technical Amendment Necessary:** A technical amendment will be required to this bill. Language will need to be added to Section 51.1-1405 to insure eligibility for participants in this program for the state retiree health insurance program.

11. Other Comments:

The proposed bill would allow the establishment of an optional defined contribution program for employees hired on or after January 1, 2012, including state employees, local employees, local officers, teachers, college faculty, public safety officers, and members of the General Assembly.

Plan Election:

Employees shall make an irrevocable election to participate in either the optional DC program or the Virginia Retirement System defined benefit plan. 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. The default option is the existing defined benefit plan, which has been the practice of most states. In addition, institutions of higher education that have opted out to offer their own defined contribution plans may continue channeling new faculty into the institution's separate defined contribution plan as long as its plan operates in a manner identical to this program.

Eligibility for Other Related Benefits:

Participants in the optional defined contribution retirement program who are state employees will not have disability coverage under the Virginia Sickness and Disability Program. Similarly, local employees and teachers who elect the DC plan will not have coverage under the VRS traditional disability program. Hazardous duty personnel who elect the optional defined contribution retirement program will not be entitled to the hazardous duty supplement or other benefits such as the earlier retirement age relating to SPORS, VaLORS or LEOS. However, participants in the optional defined contribution retirement program will be eligible for the retiree health insurance credit. In addition, participants in the optional defined contribution retirement program will be eligible for coverage under the group life and optional life insurance programs.

Employer and Employee Contributions:

Employees may make voluntary contributions of up to 8% of pay to the optional DC plan. Employers shall make a minimum contribution of 2% of pay. In addition, employers shall make a matching contribution of 100% of the first 5% of the employee contribution plus 50% of the next 3% of pay contributed by the member, up to a maximum matching contribution of 6.5% of pay. The total maximum employer contribution would be 8.5% of pay if the member contributes the maximum voluntary contribution of 8% of pay.

Illustration of Tiered Employer Contributions

	Employer Contribution	Employee Contribution	
Tier 1	2 percent	0 percent	This is the mandatory employer contribution.
Tier 2	0 to 5 percent	0 to 5 percent	This is the one to one match by the employer of elective employee contributions.
Tier 3	0 to 1.5 percent	0 to 3 percent	This is the one-half to one match by the employer of elective employee contributions in excess of 5 percent.
Total	2 to 8.5 percent	0 to 8 percent	The employer contribution above 2 percent is entirely dependent on the level of employee contribution.

The employee contributions, which are capped at 8% 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 \$200,000. There are no loans or hardship distributions available from these funds. The reason for these restrictions is that optional defined contribution retirement program is now the primary source of retirement funds for the electing member.

All of the employee contributions to the optional defined contribution retirement program are elective deferrals, and as a result must go into an IRC 457(b) plan. This design will limit a participant’s ability 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 defined contribution retirement program and the deferred compensation plan. However, employee contributions to the optional defined contribution 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. The only exception allows opt out institutions of higher

education to use existing defined contribution plans as long as they are modified to operate identically to this optional defined contribution retirement program.

Vesting:

The bill provides a vesting schedule with respect to the employer contributions to the DC plan. Members with less than two years of service would be 0% vested, those with two to three years of service would be 50% vested, those with three to four years of service would be 75% vested and ,members with four or more years of service would be 100% vested in the employer contributions.

Illustration of Employer Contribution Vesting

2 or more years of service	50 percent
3 or more years of service	75 percent
4 or more years of service	100 percent

Below is a discussion of some of the issues to consider in establishing an optional defined contribution 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. 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.

Since the optional defined contribution program does not provide disability and pre-retirement death benefits, the General Assembly may wish to consider establishing a separate insured or self-insured program to provide these benefits. Although, VRS provides long-term disability benefits through the Virginia Sickness and Disability Program (VSDP) for state employees, members in the optional defined contribution program will not have disability coverage under VSDP. In addition, employees of political subdivisions and teachers who opt for the optional defined contribution program will not have disability coverage under VRS.

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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