Virginia Retirement System
2014 Fiscal Impact Statement

1. **Bill Number:** HB 182

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

2. **Patron:** Farrell

3. **Committee:** Appropriations

4. **Title: Local employees; retirement benefits.**

5. **Summary:** Provides that any locality may establish and maintain a defined contribution retirement plan for its employees in lieu of any other retirement plans for employees hired on or after July 1, 2014.

6. **Budget Amendment Necessary**: No

7. **Fiscal Impact Estimates:** Any such plans established pursuant to this legislation will be administered by localities. For those localities that currently have separately rated retirement plans with the VRS, and have an unfunded liability, closing a plan to future new hires could cause an increase in plan costs for the legacy plan until such time that the unfunded liability is paid down. As employees terminate or retire, there will be less covered payroll over which to spread costs causing an increase in contributions as a percent of covered payroll. In addition, closing a plan to new hires may require modifying the amortization method to a shorter period if retirement benefit cashflows begin to exceed contributions and interest income causing negative cashflow. This would result in accelerated recognition of any unfunded liabilities causing higher contribution rates as a percent of the diminishing covered payroll. These adjustments would need to be handled on a case by case basis.

Below is an example of how closing a plan to new hires could impact contributions and funded status. Note the increased rates and diminishing funded status in later years as the inactive population begins to exceed the number of active members supporting contributions to the plan:

(Thousands)

Sample Muncipality Plan - Ongoing

	June 30, 2015	June 30, 2017	June 30, 2019	June 30, 2021	June 30, 2023	June 30, 2025	June 30, 2027	June 30, 2029	June 30, 2031
Covered payroll	$ 8,814	$ 9,335	$ 9,832	$ 10,304	$ 10,858	$ 11,412	$ 12,006	$ 12,659	$ 13,308
Employer Normal Cost Rate	3.42%	2.75%	2.33%	1.99%	1.80%	1.58%	1.42%	1.28%	1.16%
Amortization Charge	11.46%	11.67%	11.85%	12.08%	11.34%	11.41%	11.54%	11.66%	11.81%
Total Contribution Rate	14.88%	14.42%	14.18%	14.07%	13.14%	12.99%	12.96%	12.94%	12.97%
Funded Status	65.6%	66.1%	66.90%	67.52%	68.40%	69.18%	69.84%	70.65%	71.64%

Sample Muncipality Plan - Closed to New Hires FY 2015

	June 30, 2015	June 30, 2015	June 30, 2017	June 30, 2019	June 30, 2021	June 30, 2023	June 30, 2025	June 30, 2027	June 30, 2029
Covered payroll	$ 8,814	$ 8,415	$ 8,270	$ 8,088	$ 7,953	$ 7,801	$ 7,658	$ 7,534	$ 7,392
Employer Normal Cost Rate	3.42%	3.23%	3.23%	3.23%	3.23%	3.23%	3.23%	3.23%	3.23%
Amortization Charge	11.46%	10.7%	10.62%	11.19%	10.76%	11.87%	13.35%	15.00%	17.46%
Total Contribution Rate	14.88%	14.0%	13.85%	14.42%	13.99%	15.10%	16.58%	18.23%	20.69%
Funded Status	65.6%	69.7%	71.81%	72.53%	72.98%	72.43%	71.29%	70.04%	67.88%

8. Fiscal Implications: House Bill 182 permits every county and city, and town with a population of 5,000 of more, to establish a defined contribution retirement plan in lieu of any other retirement plan, for any employee hired on or after July 1, 2014 who is not already a member of the Virginia Retirement System or the locality's retirement plan, and who is hired on or after the date that the locality has established a plan as provided for in this legislation.

In addition to the impacts discussed above, when a defined-benefit member terminates prior to service retirement and prior to vesting, 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 members' benefits. If a defined contribution plan is established for new hires, there may be fewer of these "forfeited" employer contributions that currently help control the cost of the defined benefit plan.

Since the defined contribution plan will cover new hires only, the employee population covered by the plan will be slow to develop. As a result, it will take many years before a locality may begin to realize any cost savings anticipated by creating a defined contribution plan with lower employer contribution rates. In addition, localities adopting a defined contribution plan will have to continue funding the current unfunded liabilities for the pension plan, the retiree health insurance credit and the life insurance benefits of the current defined benefit plan, although employees in the new plan will not be eligible for these ancillary benefits.

Some key elements to consider when closing a defined benefit plan to new members are: 1) the defined benefit plan will have a shrinking payroll; 2) remaining unfunded liabilities will be amortized over a closed period of time, which could be accelerated if apparent cashflow issues arise; 3) defined benefit rates as a percentage of covered payroll will rise; and 4) the return assumption in the defined benefit plan will likely need to be adjusted at some point in order to account for a shorter time horizon, as well as cash flow and liquidity needs. Furthermore, on an ongoing basis, there are additional costs that must be paid by either the employer or employee. Administrative expenses are greater if the employer has to maintain both a defined benefit and defined contribution plan. Depending on plan design, however, as new hires are placed into the new defined contribution plan over a longer period of time, cost savings can be achieved.

Localities wishing to consider the establishment of their own locally administered defined contribution plan should strongly consider consulting the VRS actuary for an estimate of the future costs of closing the defined benefit plan.

9. Specific Agency or Political Subdivisions Affected: VRS and participating localities that elect to establish a new defined contribution plan under this bill.

10. Technical Amendment Necessary: Yes. A technical amendment will be required for this bill. Currently, Section 51.1-135 states that VRS membership is compulsory for all eligible employees entering service after the effective date of the coverage.

On line 24 insert the additional language provided in bold type:

23 *2. In addition, notwithstanding the provisions of § 51.1-613, in lieu of the retirement programs*
24 *described in subdivision 1,* ***and notwithstanding § 51.1-135 if it is applicable,*** *every county and city, and every town having a population of 5,000 or more,*
25 *is authorized to establish and maintain the type of local cash match plan described in § 51.1-610, except . . .*

11. Other Comments: This bill revises the comparability requirement for counties, cities, and eligible towns that elect to offer a local retirement system so that such local retirement systems must provide a service retirement allowance to employees who retire at age 65 or older that equals or exceeds two-thirds of the service retirement allowance under the provisions of the Virginia Retirement System defined benefit plan. This change clarifies that the local retirement plan benefits must be compared to either the Virginia Retirement System legacy defined benefit plan or the hybrid retirement plan that began on January 1, 2014.

The legislation provides that any county or city, and towns with a population of 5,000 or more, may establish a local cash match defined contribution program to serve as the locality's primary retirement system for its full-time employees hired on or after July 1, 2014 who are not members of the Virginia Retirement System or a locality's retirement plan at the time they are hired, and who are hired after the establishment of such a plan. HB 182 does not affect the eligibility of school teachers and other school board employees to participate in VRS administered retirement programs.

The legislation applies to all eligible localities, including those that currently participate in the Virginia Retirement System. Absent this legislation, a locality's decision to join VRS is irrevocable unless the locality becomes insolvent. The legislation does not affect the eligibility of constitutional officers and their employees to participate in any other retirement plan.

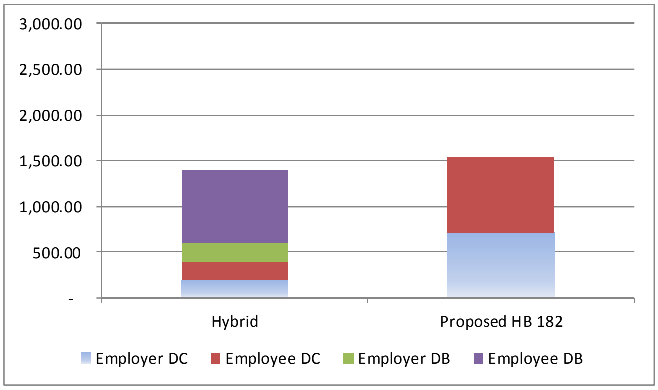
Employer contributions under a cash match retirement program established under this provision must exceed $50 on a semi-monthly basis or fifty percent of the amount that the qualified participant voluntarily contributes to either the VRS Section 457 plan, or, if applicable, the locality's Section 403(b) plan.

The minimum employer contribution of $50 on a semi-monthly basis over time would likely not result in an adequate income replacement ratio. The employer contributions may, but are not required to be, calculated as a percentage of salary. The employer contributions could, therefore, be the same for all employees and would not necessarily have to vary with different salary amounts. In addition, there are no provisions specifying mandatory employee contributions, vesting, age or service requirements for retirement, disability, or other ancillary benefits provided by VRS, such as the Health Insurance Credit and the Group Life Insurance Program. Below is a comparison of the proposed retirement benefits to the VRS hybrid plan.

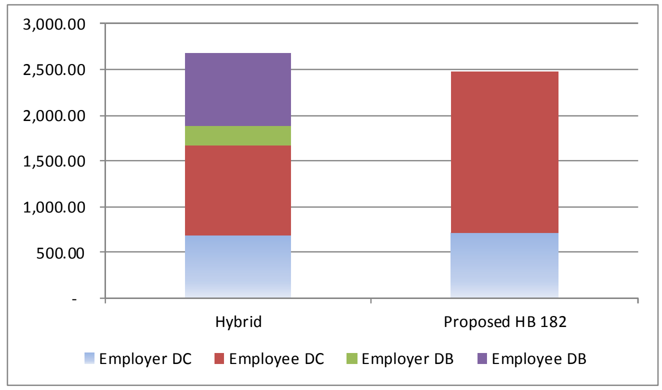
VRS Hybrid versus Proposed HB 182

Employee earning $40,000 retiring at age 67 with 30 years of service

Minimum Monthly Benefit (Total 5% Employee Contribution)

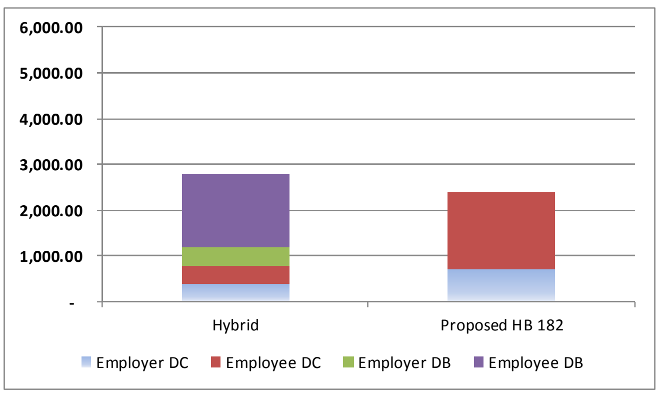


Maximum Monthly Benefit (Total 9% Employee Contribution)

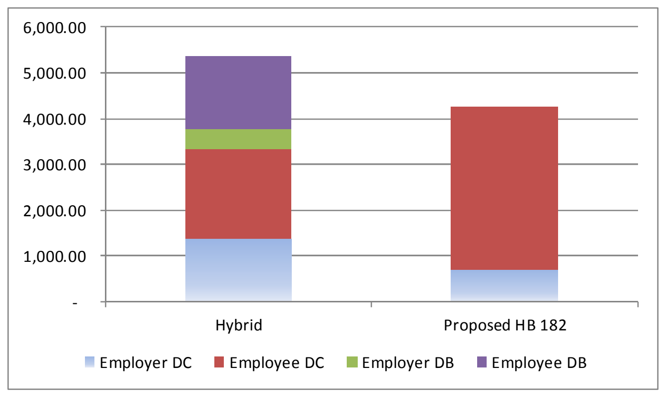


Employee earning $80,000 retiring at age 67 with 30 years of service

Minimum Monthly Benefit (Total 5% Employee Contribution)



Maximum Monthly Benefit (Total 9% Employee Contribution)



DC balances were converted to monthly annuity using RP 2000 Mortality Projected with Scale AA to 2020 and 7% discount rate assuming a 2.25% future cost-of-living adjustment

DC plan balances are assumed to achieve a 6% annual return and salaries are assumed to increase 1% per year

Proposed HB 182 assumes that $100 per month will be contributed to a DC plan by employer. For comparison purposes we assumed employee would contribute same percentage of as they would under VRS Hybrid plan.

In the examples above, we have compared the VRS Hybrid to the proposed benefit under this bill. Since the VRS Hybrid requires an employee to contribute 5% of their pay towards the benefit, we replicated that contribution in the proposed bill. So in addition to the $50 semi-monthly, we also assumed the member would contribute 5% of their pay to a 457 plan. For a member making $40,000 at retirement, the two plans provide a very similar benefit at the Hybrid minimum contribution level. However, this bill does not require any employee contributions, so a plan with the minimum required employer-paid contribution of $100 per month would produce a lower benefit. If the VRS member contributes at the maximum level in the Hybrid, the Hybrid plan provides greater retirement income unless the employer is willing to increase the semi-monthly contribution from $50 to $65. And since this proposed benefit is not based on a percentage of payroll but rather a flat rate, the shortfall between the Hybrid plan and proposed plan under HB 182 becomes more pronounced at higher salary levels. For an employee making

$80,000 at retirement, the employer would need to increase their semi-monthly contribution from $50 to $80 in order to match the minimum Hybrid benefit and from $50 to $135 semi-monthly at the maximum Hybrid contribution level in order to provide the same level of benefit as the VRS Hybrid plan.

This bill also does not provide for local plans to be administered by VRS as a consolidated statewide defined contribution plan. Accordingly, any locality choosing to offer a defined contribution plan would become responsible for all legal and administrative responsibilities of maintaining their respective plans. As these plans would be locally administered on a locality by locality basis, the plans might not be able to take advantage of significant economies of scale and the ease of administration offered by a single consolidated plan. Further, the ease of portability between and among the Commonwealth's political subdivisions and state agencies participating in VRS inherent in the current plan design would likely be eroded by individually administered plans with various provisions, potentially affecting recruitment.

From a benefits perspective, defined contribution plans provide features not usually found in defined benefit plans, such as investment choice, personal responsibility, and lump sum payouts. In addition, defined contribution plans are good vehicles for creating retirement savings. However, whether the savings accumulated under the defined contribution plan will provide adequate retirement income depends on several factors, including a member's savings rate, asset allocation, investment returns, and life expectancy. Under a defined contribution plan approach, it is possible for a retiree to outlive his or her retirement savings. In addition, defined contribution plans do not provide a cost of living increase after retirement.

Hazardous duty members frequently retire with fewer years of service and at younger ages than general employees. Therefore, under a defined contribution plan, hazardous duty members have fewer years to accumulate assets and more years in retirement during which to rely on these assets. Similarly, another issue to consider in the design of a defined contribution plan is that these plans do not provide disability and pre-retirement death benefits. As a result, consideration should be given to establishing separate insured or self-insured programs to provide these benefits, which are currently provided by the VRS.

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