

## 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:** Prior to Substitute- Watkins

**3. Committee:** Passed both Houses

**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:** No.

**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 or change their decision and notify VRS by November 1, 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. Each eligible employee in a political subdivision that has elected to allow the use of a local 403(b) plan for voluntary Hybrid contributions must make an annual election, by November 30, to contribute his voluntary Hybrid contributions to one or more of the local 403(b) plans the employer offers or to the VRS Hybrid 457 and VRS Hybrid 401(a) Cash Match plans. An employee who does not change his annual election by November 30 of each year will be deemed not to have made a change from the prior year. Elections by either the local school division or employees made by November 1 or 30, respectively, will be effective January 1 of the following year.

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.

The substitute bill deletes the provision that would have allowed loans and hardship distributions from the voluntary employee hybrid contributions and matching employer contributions made to local 403(b) accounts administered by a school division.

The substitute bill also requires employers that allow their employees to use locally administered 403(b) accounts for voluntary hybrid contributions to provide those employees who elect to use the 403(b) accounts with a side-by-side comparison of the long-term effects of generic expense ratios on investments.

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 and the vesting schedule, forfeiture accounts, 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 November 1, to become effective the subsequent January 1.

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. This substitute bill incorporates an amendment for an annual employee election period. Each employee of a local school division that provides a 403(b) plan or plans will have the opportunity to choose whether to use the VRS Hybrid 457 plan, or a local 403(b) account for voluntary hybrid contributions. The initial employee election period will expire on November 30, 2015.

Each year thereafter, the bill provides that each employee of a local school division that offers a 403(b) plan or plans must make an election by November 30, to become effective the subsequent January 1, to direct their contributions to the VRS Hybrid 457 Plan, or to the school division's 403(b) plan(s). The bill also provides that if no change is made, the employee continues in the plan elected for the previous 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 an adjustment 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.

#### 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. 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 to make themselves familiar with 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, as amended by the House committee, is identical to HB 2178, as amended.

**Date:** 02-18-2015

**Document:** SB1162H1.DOC