

## Virginia Retirement System 2016 Fiscal Impact Statement

1. **Bill Number:** HB 1072

**House of Origin**     Introduced     Substitute     Engrossed  
**Second House**     In Committee     Substitute     Enrolled

2. **Patron:** Jones

3. **Committee:** Appropriations

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

5. **Summary:** Modifies the hybrid retirement program by (i) increasing the mandatory employer contribution to the defined contribution component from 1% to 2% of creditable compensation, (ii) decreasing the employer's maximum matching contribution to the defined contribution component from 2.5% to 1.5% of creditable compensation, (iii) increasing the employee's mandatory contribution to the defined contribution component from 1% to 2% of creditable compensation, (iv) decreasing the employee's maximum contribution to the voluntary defined contribution component from 4% to 3% of creditable compensation, (v) decreasing from three years to two years the period in which a new member of the hybrid retirement program is required to make the maximum voluntary contribution to the defined contribution component before auto-escalation begins, and (vi) decreasing the employee's contribution to the defined benefit component from 4% to 3% of creditable compensation. The bill also sets a new employee's voluntary contribution rate to the defined contribution component at 0.5% unless the employee opts out.

6. **Budget Amendment Necessary:** First-year implementation costs resulting from this legislation are estimated to be \$115,893.00 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.

7. **Fiscal Impact Estimates:** Changing the allocation of the 5% member contribution (from 4% to the defined benefit component and 1% to the defined contribution component to 3% to the defined benefit component and 2% to the defined contribution component) is estimated to create an initial employer contribution rate impact of 0.17% of payroll. Ultimately, the State plan's employer contribution rate is estimated to increase by approximately 1.4% of payroll over the next 25 years as a result of these changes. VRS expects the long-term impact of the contribution allocation change to approach 2% of payroll once the plan is fully implemented.

Decreasing the auto-escalation period from three years to two years would initially result in an impact of 0.04% of payroll. The ultimate cost to the State plan is estimated at 0.23% of payroll. Combined with an auto-enrollment of new employees at 0.5%, these two changes

create an initial impact of 0.04% of payroll, with the long-term impact being estimated at 0.47% of payroll for the State plan. These estimates assume that no members opt out of auto-enrollment or the auto-escalation increases, which means that costs could be lower depending on actual experience.

The total cost to add all three design changes (i.e., shifting the defined benefit/defined contribution allocation of member contributions, adding auto-enrollment, and accelerating auto-escalation) are estimated below in Exhibit 1. The first scenario assumes 25% of hybrid members will not opt-out of the auto enrollment or auto-escalation. The second scenario assumes 50% of hybrid members will not opt-out, while the third scenario assumes no one would opt-out of the auto enrollment or auto escalation increases in voluntary contributions to the defined contribution component of the hybrid.

**Exhibit 1**

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

<b>Hybrid Scenario</b>	<b>1st Year</b>	<b>After 5 Years</b>	<b>After 10 Years</b>	<b>After 20 Years</b>	<b>After 25 Years</b>
3% DB/2% DC - 25% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.18%	0.75%	1.11%	1.46%	1.50%
3% DB/2% DC - 50% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.19%	0.80%	1.20%	1.58%	1.62%
3% DB/2% DC - 100% of Members Retain Auto Esc 2 Yr & Auto Enroll	0.21%	0.91%	1.37%	1.81%	1.85%

Exhibit 2 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.

### Exhibit 2

	<u>FY 2017</u>	<u>FY 2018</u>	<u>FY 2019</u>	<u>FY 2020</u>	<u>FY 2021</u>	<u>FY 2022</u>
State - General Fund	\$ 3,207,000	\$ 4,473,000	\$ 11,140,000	\$ 10,972,000	\$ 13,504,000	\$ 15,191,000
SPORS - General Fund	-	-	-	-	-	-
VaLORS - General Fund	-	-	-	-	-	-
JRS - General Fund	120,000	167,000	417,000	410,000	505,000	568,000
Teacher - General Fund	5,805,000	8,097,000	20,165,000	19,860,000	24,443,000	27,498,000
<b>TOTAL General Fund</b>	<b>\$ 9,132,000</b>	<b>\$ 12,737,000</b>	<b>\$ 31,722,000</b>	<b>\$ 31,242,000</b>	<b>\$ 38,452,000</b>	<b>\$ 43,257,000</b>
State - Non-General Funds	\$ 4,298,000	\$ 5,995,000	\$ 14,931,000	\$ 14,705,000	\$ 18,098,000	\$ 20,360,000
SPORS - Non-General Funds	-	-	-	-	-	-
VaLORS - Non-General Funds	-	-	-	-	-	-
<b>TOTAL - Non-General Funds</b>	<b>\$ 4,298,000</b>	<b>\$ 5,995,000</b>	<b>\$ 14,931,000</b>	<b>\$ 14,705,000</b>	<b>\$ 18,098,000</b>	<b>\$ 20,360,000</b>
Teacher - Local Funds	\$ 8,708,000	\$ 12,145,000	\$ 30,248,000	\$ 29,790,000	\$ 36,664,000	\$ 41,247,000
Political Subdivisions - Schools	\$ 982,000	\$ 1,369,000	\$ 3,410,000	\$ 3,359,000	\$ 4,134,000	\$ 4,650,000
Political Subdivisions - Non-Schools	\$ 7,817,000	\$ 10,903,000	\$ 27,154,000	\$ 26,743,000	\$ 32,914,000	\$ 37,028,000
<b>TOTAL Local Funds</b>	<b>\$ 17,507,000</b>	<b>\$ 24,417,000</b>	<b>\$ 60,812,000</b>	<b>\$ 59,892,000</b>	<b>\$ 73,712,000</b>	<b>\$ 82,925,000</b>
<b>Grand Totals</b>	<b>\$ 30,937,000</b>	<b>\$ 43,149,000</b>	<b>\$ 107,465,000</b>	<b>\$ 105,839,000</b>	<b>\$ 130,262,000</b>	<b>\$ 146,542,000</b>

Estimated projections based on employee data and valuation results as of June 30, 2015 and assume a level population throughout projection period.

Payroll projections are assumed to remain level throughout projection period.

## 8. Fiscal Implications:

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

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 burden of paying the normal cost of his or her defined benefit component under the Hybrid Retirement 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 3 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 3

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

<b>State</b>	<b>Plan 1</b>	<b>Plan 2</b>	<b>Hybrid Plan</b>
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%

<b>Teachers</b>	<b>Plan 1</b>	<b>Plan 2</b>	<b>Hybrid Plan</b>
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 4 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 1072. 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 4**

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

<b>State</b>	<b>Plan 1</b>	<b>Plan 2</b>	<b>Hybrid Plan</b>
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%

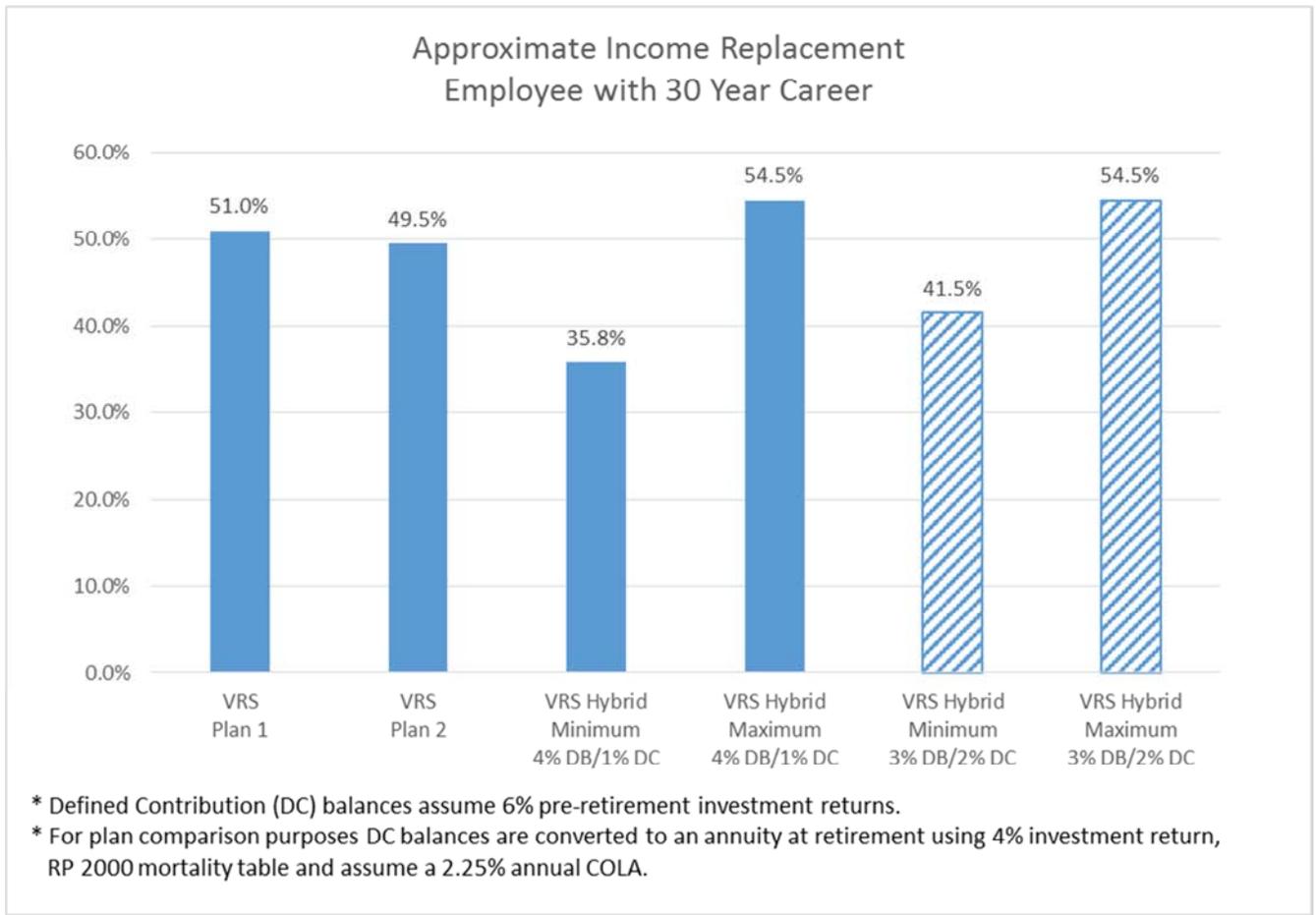
<b>Teachers</b>	<b>Plan 1</b>	<b>Plan 2</b>	<b>Hybrid Plan</b>
Total Normal Cost	11.23%	9.70%	5.68%
Member Contribution	5.00%	5.00%	3.00%
Percentage of Normal Cost Funded by Member	44.52%	51.55%	52.82%

The proposed shift to 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 5 below, is estimated to be approximately 5.7% (assuming that a member makes the minimum contributions).

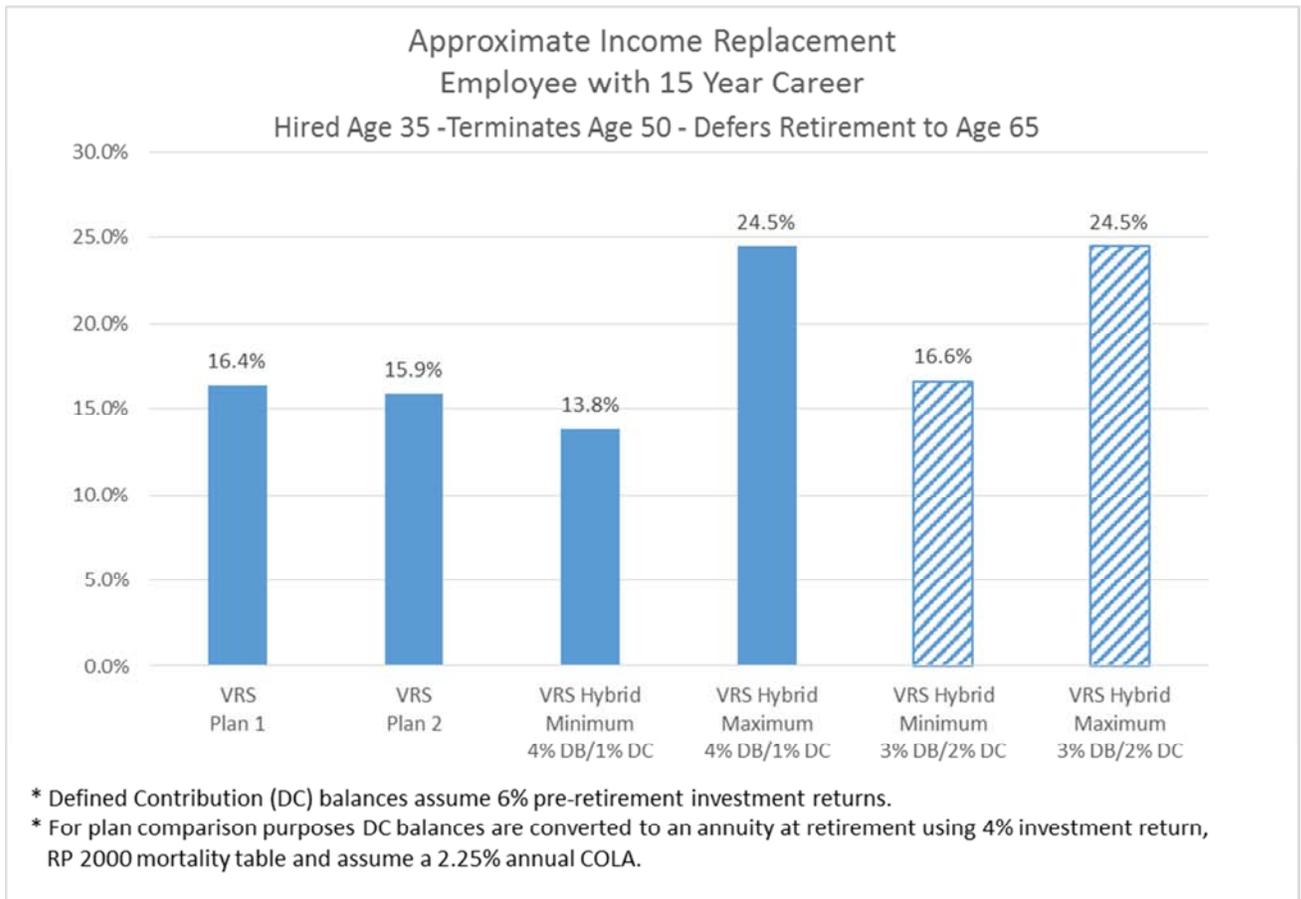
**Exhibit 5**

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



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 6 below demonstrates the estimated replacement ratios under various voluntary contribution levels.

**Exhibit 6**



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.

**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 1072 proposes to shift from 4% to 3%. Under the existing framework, as Exhibit 7 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 7**  
**Current Auto-Escalation Provision**

<b>Date</b>	<b>Auto-Escalation Amount</b>	<b>Voluntary Rate</b>
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%

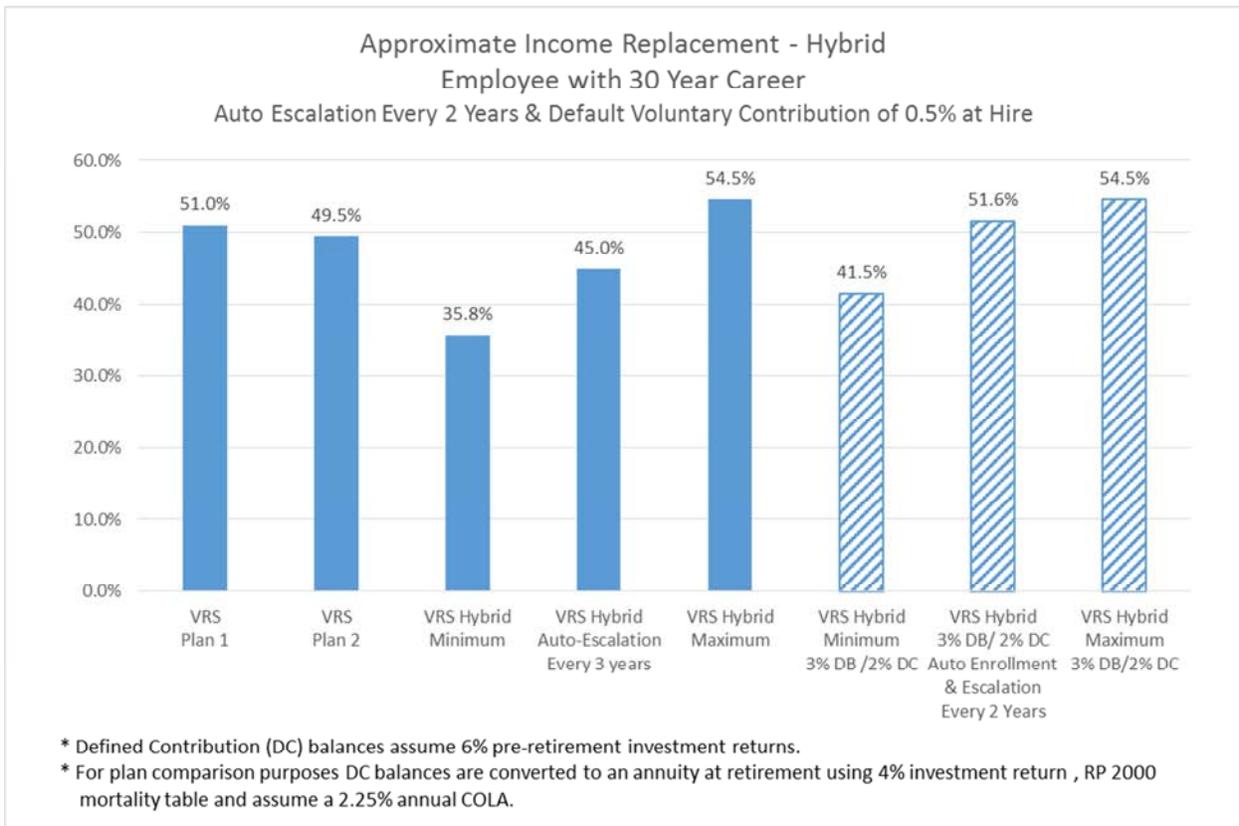
Under HB 1072, shifting an additional 1% of the employee contribution to the defined contribution plan in combination with auto-enrolling new members at 0.5% of payroll at hire and creating shorter periods between auto-escalations would result in a Hybrid member contributing the maximum 3% in voluntary contributions in as few as 10 years assuming the member does not opt out of any of the auto-escalations. This change, demonstrated in Exhibit 8 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 8**  
**Auto-Escalation Every Two Years**  
**with modified allocation 2% Mandatory - 3% Voluntary**  
**and Auto-Enrollment Rate of 0.5% at Date of Hire**

<b>Date</b>	<b>Auto-Escalation Amount</b>	<b>Voluntary Rate</b>
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%

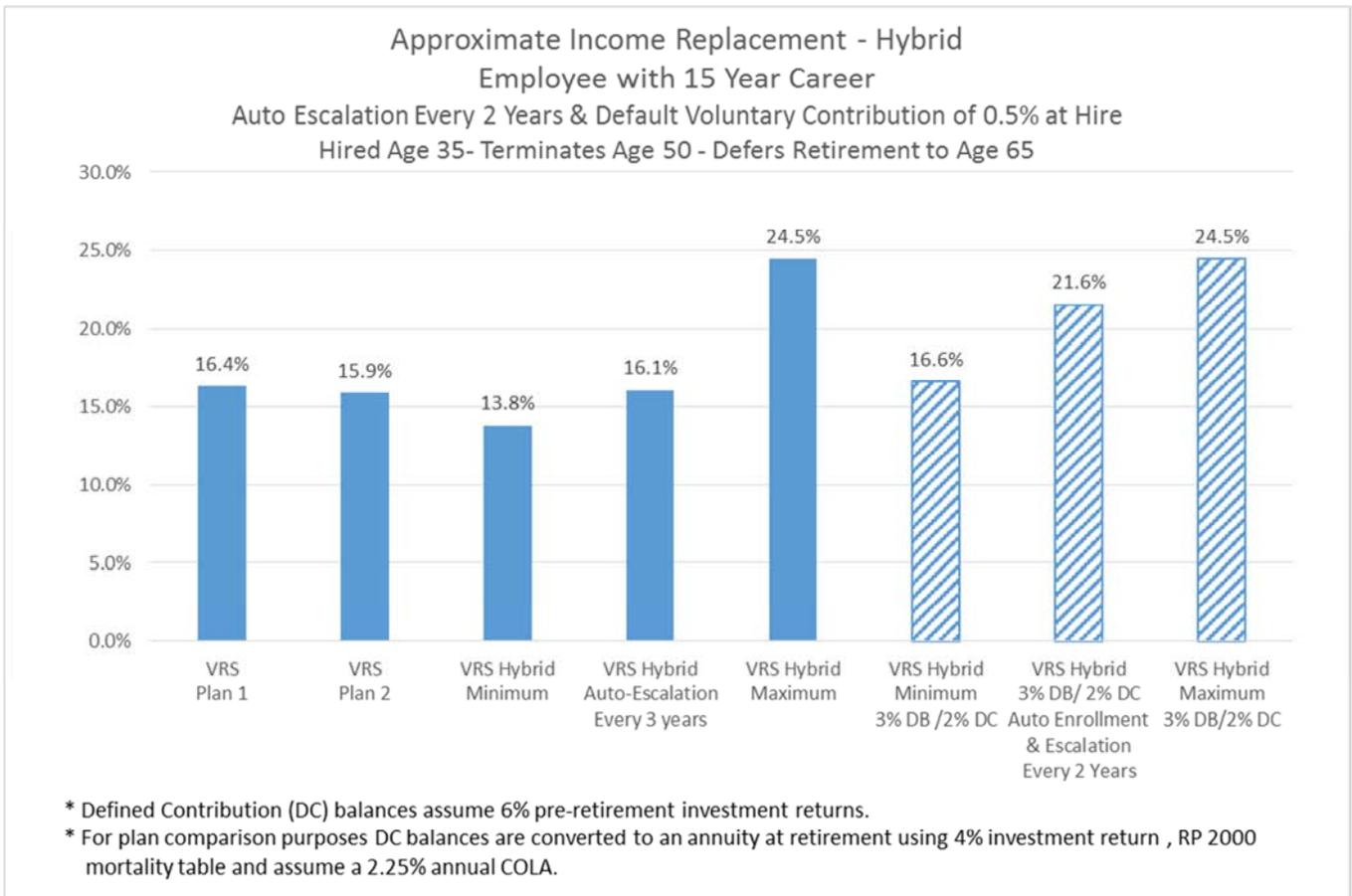
Exhibit 9 shows the potential impact of HB 1072 on a member’s benefit levels. For a member retiring with 30 years of service, the proposed plan modifications could increase a member’s replacement ratio by approximately 6% of final average compensation for members either participating at the minimum level 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 the Exhibit below, VRS Hybrid Minimum represents a member who contributes only the minimum amount to the defined contribution component. Hybrid Auto-Escalation (and Auto-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 9



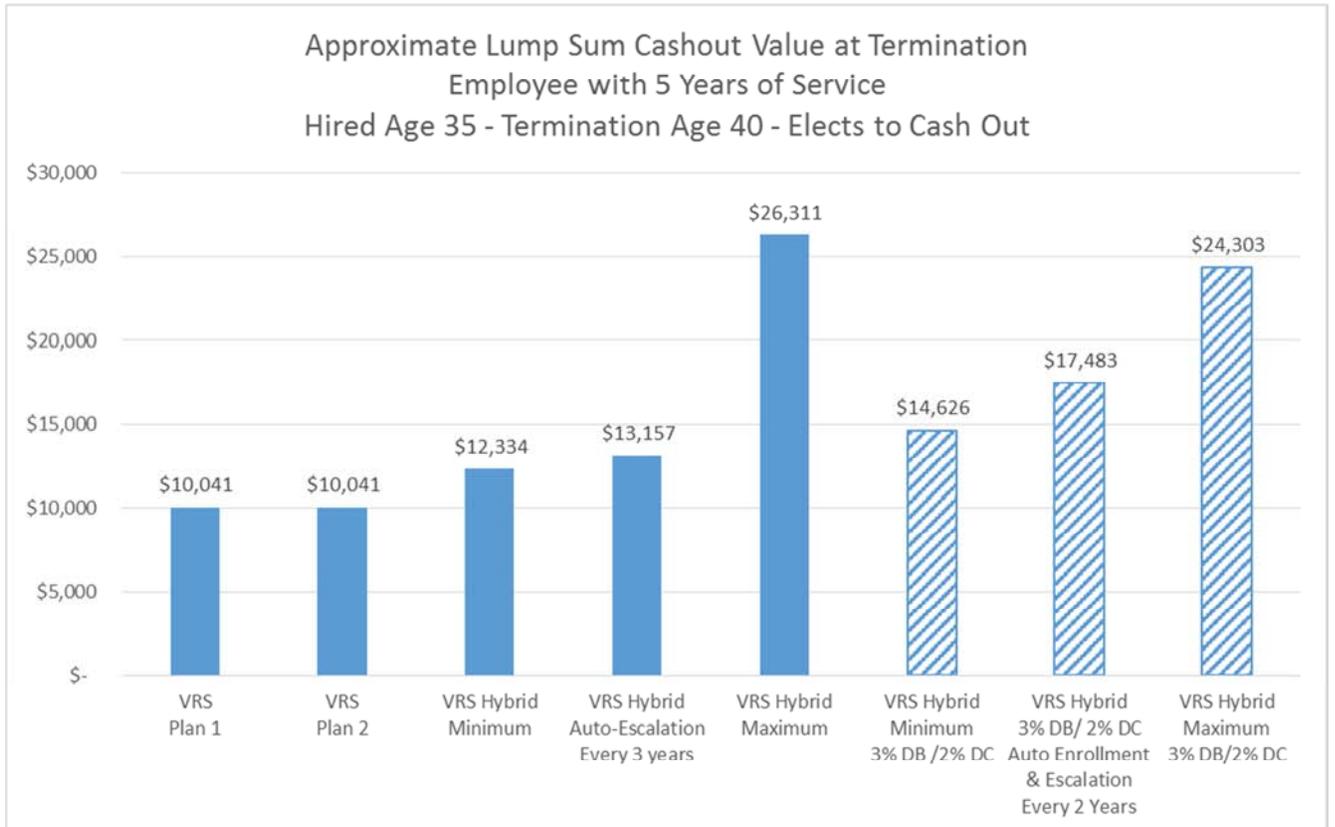
Similarly, a shorter term employee who is a Hybrid plan member who terminates at age 50 with 15 years of service and defers retirement to age 65 could increase the replacement ratio by approximately 5.5% under the proposed plan modifications if he or she followed the auto-escalation schedule. Exhibit 10 below demonstrates the estimated replacement ratios under various voluntary contribution levels.

**Exhibit 10**



For short term employees who would elect to cash out their benefits, Exhibit 11 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 11**



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

**10. Technical Amendment Necessary:** No.

**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 1.0% 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 1072 would decrease the member’s defined benefit contribution to 3%. This would increase the employer contribution to the defined benefit component over time. It would also allow the member to put those funds into the defined contribution component of the Hybrid plan, and receive a corresponding employer match.

The defined contribution component, which HB 1072 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 12 – Current Hybrid Defined Contribution Schedule**

<b>Defined Contribution (DC) Component Contributions</b>			
<b>Employee Mandatory Contributions Hybrid 401(a)</b>	<b>Employer Mandatory Contributions Hybrid 401(a)</b>	<b>Employee Voluntary Contributions Hybrid 457<sup>†</sup></b>	<b>Employer Matching Contributions Hybrid 401(a)<sup>†</sup></b>
1.00%	1.00%	0.00%	0.00%
		0.50%	0.50%
		1.00%	1.00%
		1.50%	1.25%
		2.00%	1.50%
		2.50%	1.75%
		3.00%	2.00%
		3.50%	2.25%
		4.00%	2.50%

HB 1072 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 1072, the total contributions made by a Hybrid member and employer would be as follows:

**Exhibit 13 – Proposed Hybrid Defined Contribution Schedule**

	Defined Benefit Plan	Defined Contribution					Maximum DC Contribution	Maximum Total Contribution
		Mandatory	Mandatory	Voluntary				
Employee	3.00%	1.00%	1.00%	1.00%	1.00%	1.00%	5.00%	8.00%
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 1072 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 0.50% voluntary contribution (with the opportunity to opt out). HB 1072 would implement auto-enrollment for new Hybrid employees in voluntary contributions at 0.50%, still with the opportunity to opt out.

HB 1072 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.

The legislation features two different effective dates. Adjusting the allocation of a member’s 5% contribution from 4/1 to 3/2 would take place on July 1, 2016. However, the auto-enrollment and auto-escalation features of the bill would not occur until January 1, 2017.

**Points of Consideration**

1. The legislation puts the employee/employer sharing of 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 legislation increases the savings rate of employees in the Hybrid Plan. Under the current 4/1 allocation, only 10.57% of Hybrid members were making any voluntary contributions as of January 1, 2016. Since the start of the plan, this percentage has continued to steadily increase each quarter. Of those members participating, higher-paid members tend to participate at higher rates than those who are lower paid. In contrast, this means that 89.43% of Hybrid members were not making any voluntary contributions and were only making the mandatory 1% contribution to the defined contribution component. For this latter category, HB 1072 effectively doubles their defined contribution component savings rate by increasing the member mandatory contribution from 1% to 2% and providing the corresponding employer match (1%) for the additional 1% increase.
4. The bill increases the savings rate without reducing an employee's net salary. Although HB 1072 requires a Hybrid member to double his or her mandatory contribution from 1% to 2%, a member's take-home pay is not affected since the legislation also decreases the member's defined benefit contribution from 4% to 3%.
5. Although the employer will pick up additional costs due to the provisions of this bill, 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:** 01-24-2016

**Document:** HB1072.DOC/VRS