Virginia Retirement System
2020 Special Session I Fiscal Impact Statement

1. **Bill Number:** SB 5119

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

2. **Patron:** Ruff

3. **Committee:** Finance and Appropriations

4. **Title:** Virginia Retirement System; average final compensation

5. **Summary**: Virginia Retirement System; average final compensation. Directs the Virginia Retirement System to use a furloughed member's compensation in place the month prior to the declared statewide emergency that resulted in the furlough in calculating a member's average final compensation for purposes of determining retirement benefits.

6. **Summary of Impacts**

<u>Benefit(s) impacted:</u> Potentially all average final compensation formulas for retirement benefit calculations for VRS, SPORS, and VaLORS members who are furloughed, effective the first month in which the bill is effective (January 1, 2021 or later). As Group Life Insurance uses employer reported creditable compensation, it will also be impacted. VRS is interpreting "furlough" to mean a temporary salary reduction.

<u>Impact to unfunded liability (see Item 9 for details):</u> Limited impact to the unfunded liability, because VRS assumes that employers and employees will pay contributions based on the pre-furlough higher salary, which would generally serve to mitigate any resulting potential impact to the unfunded liability.

<u>Impact to contribution rate(s) (see Item 9 for details):</u> All VRS-covered employers (state, school divisions, and political subdivisions) will be required to pay contributions for all furloughed employees based on a higher salary than what is actually being paid to the furloughed member. Similarly, all furloughed members, including Hybrid Retirement Plan members, will have to pay member contributions based on the higher salary versus what they are actually being paid, which could create a hardship for furloughed employees.

<u>Specific Agency or Political Subdivisions Affected (see Item 10):</u> VRS, SPORS, VaLORS, and all state and local VRS-covered employees who are furloughed because of a statewide emergency declared pursuant to § 44-146.17, and employers of all such employees.

<u>VRS cost to implement (see Item 7 and Item 8 for details):</u> Some internal costs are anticipated to communicate this change. It is anticipated that changes will be handled manually.

<u>Employer cost to implement (see Item 7 and Item 8 for details):</u> This provision will require any state and local VRS-covered employers with furloughed employees to pay contributions on a higher salary than is actually being paid, resulting in lower savings from the furlough actions than anticipated. Manual payroll effort would likely be required on the part of employers to address the basis for employer and member contributions.

<u>Other VRS and employer impacts (see Item 7, Item 9, Item 11, and Item 12 for details):</u> VRS and employers will need to handle this largely on a manual basis as there is no clear systematic way to identify individuals who would be affected by the legislation. Employers will need to enter an amount of creditable compensation that is different from the actual amount of salary paid and adjust their payroll entries accordingly.

GF budget impacts (see Item 8 for details): Since employer contributions will be based on the higher salary that is not actually being paid, employers will not realize the full savings anticipated from the temporary salary reductions due to the need to pay contributions on the salaries in place prior to the declared statewide emergency.

NGF budget impacts (see Item 8 for details): Since employer contributions will be based on the higher salary that is not actually being paid, employers will not realize the full savings anticipated due to the temporary salary reductions.

7. Budget Amendment Necessary: No. However, some employers may not realize the same level of anticipated savings from furlough actions due to required contributions.

8. Fiscal Impact Estimates: Indeterminate. Employers report creditable compensation to VRS, but do not report furloughs. Individual employers will see impacts dependent on their use of furloughs.

9. Fiscal Implications: The cost impacts of SB 5119 are difficult to measure as they will vary by employer and member depending upon how close a member is to retirement and the magnitude of the reduction in pay due to the furlough. Furloughs were likely put in place to avoid layoffs in a time when employers are looking to fill budget deficits caused by COVID-19. It is important to understand that a member's average final compensation (AFC) is based on their highest 36 or 60 consecutive months of creditable compensation, depending on benefit tier, during their whole career, and is not always based on their final 36 or 60 months. Exhibit 1 below shows an example of how AFC is calculated for a Plan 1 member retiring October 1, 2020. The AFC would be based on compensation from June 2017 – May 2020 as those would be the highest 36 consecutive months.

Exhibit 1- Monthly creditable compensation in **Bold** currently used to calculate AFC				
	2020	2019	2018	2017
January	**$4300**	**$3900**	**$3900**	$3700
February	**$4300**	**$3900**	**$3900**	$3700
March	**$4300**	**$3900**	**$3900**	$3700
April	**$4300**	**$4300**	**$3900**	$3700
May	**$4300**	**$4300**	**$3900**	$3700
June	$3600 (furlough)	**$4300**	**$3900**	**$3700**
July	$3600 (furlough)	**$4300**	**$3900**	**$3700**
August	$3600 (furlough)	**$4300**	**$3900**	**$3900**
September	$3600 (furlough)	**$4300**	**$3900**	**$3900**
October		**$4300**	**$3900**	**$3900**
November		**$4300**	**$3900**	**$3900**
December		**$4300**	**$3900**	**$3900**

The member's average final compensation does not decrease if they have a lower pay at the end of their career, but it may not grow at whatever expectation they may have had. This is similar to expected pay increases that may not materialize, or continued employment. Future pay is not guaranteed until it is earned.

Exhibit 2 shows how AFC would be calculated under the legislation for a Plan 1 member retiring October 1, 2020. The AFC would now be based on compensation from October 2017 – September 2020 as those would be the highest 36 consecutive months, even though the member would only actually be paid $3,600 per month during the furlough period.

Exhibit 2- Monthly creditable compensation in **Bold** used to calculate AFC under SB 5119				
	2020	2019	2018	2017
January	**$4300**	**$3900**	**$3900**	$3700
February	**$4300**	**$3900**	**$3900**	$3700
March	**$4300**	**$3900**	**$3900**	$3700
April	**$4300**	**$4300**	**$3900**	$3700
May	**$4300**	**$4300**	**$3900**	$3700
June	**$4300*** (furlough)	**$4300**	**$3900**	$3700
July	**$4300*** (furlough)	**$4300**	**$3900**	$3700
August	**$4300*** (furlough)	**$4300**	**$3900**	$3900
September	**$4300*** (furlough)	**$4300**	**$3900**	$3900
October		**$4300**	**$3900**	**$3900**
November		**$4300**	**$3900**	**$3900**
December		**$4300**	**$3900**	**$3900**

* Actual earnings due to furlough are $3,600 per month, but SB 5119 allows creditable compensation reported prior to the declared state of emergency to continue.

While this legislation may help a few members who have been furloughed and who are planning to retire in the near future, it will impact the savings that all VRS-covered employers were trying to generate in order to balance their budgets impacted by COVID-19 since it will require all employers to pay contributions on a higher salary than was actually paid to the employee. All employees will also be required to pay a higher member contribution on the higher salary, thus further lowering their net pay, which has already been reduced due to furlough, thereby potentially creating a hardship for the employee.

As an example, if an employer had an employee making $4,300 per month and they asked the employee to take a 16% reduction in compensation during the furlough period, then the employer would expect to save $9,612 on this one member toward the budget shortfall as shown in the table below. SB 5119 would require the savings associated with the pension costs to revert back to the employer, essentially lowering their savings by 13%.

			Expected Employer Savings toward Funding Gap				
Pre-Furlough Monthly Salary	Furlough Monthly Salary	Monthly Salary Savings	Monthly Pension Savings	Total Monthly Savings	Annual Savings	Annual Savings if SB-5119 is Enacted	Reduction in Employer Savings
$4,300	$3,600	$700	$101	$801	$9,612	$8,400	-13%

Note that the employee would also be required to make contributions to the retirement plan based on the pre-furlough pay, which would further lower the member's take home pay by an additional 1% in this example.

Pre-Furlough Monthly Salary	Furlough Monthly Salary	Reduced Monthly Salary	Pre-Furlough Pension Contribution	Furlough Pension Contribution	Additional Pension Contribution under SB 5119	Reduction In Employee Take Home Pay due to Furlough	Reduction In Employee Take Home Under SB 5119
$4,300	$3,600	$700	$215	$180	$35	-16%	-17%

For Hybrid Retirement Plan members, there are defined contribution plan impacts, in addition to the impacts of the defined benefit portion of the benefit. The member would be expected to make the defined contribution component contribution based on the pre-furlough compensation and the employer would be expected to also include matching contributions to the defined contribution component of the plan based on the pre-furlough compensation. This may cause Hybrid Retirement Plan members to reduce voluntary contributions to the plan due to already reduced compensation. Further, at a time when the employee's salary has been reduced due to furlough, they have to make contributions based on their higher pre-furlough salary. As a result, their retirement contributions will be a greater percentage of the reduced salary they are receiving during the furlough, which could create a greater hardship for the employee.

10. Specific Agency or Political Subdivisions Affected: VRS, SPORS, VaLORS, and any VRS-covered state or local employee who is furloughed because of a statewide emergency declared pursuant to § 44-146.17, and employers of such employees.

11. Technical Amendment Necessary: Yes. Average final compensation is the 36 or 60 highest consecutive months of creditable compensation, which is not always the final 36 or 60 months prior to retirement. Therefore, the proposed amendment should be moved to the definition of "creditable compensation" in order to keep creditable compensation at the pre-furlough level. Strike lines 37-40 and insert the same language at the end of line 57, and insert "creditable" in front of "compensation."

The legislation as drafted is not retroactive. In order to impact creditable compensation prior to the effective date of this legislation, it would need to be retroactive back to the date of the first temporary salary reduction following the state of emergency declared pursuant to § 44-146.17. In general, pension plan changes tend to be prospective due to the significant complexities associated with retroactive application related to tax consequences, payroll management, contribution collection and overall plan administration.

If this legislation is intended to apply only to a state of emergency declared pursuant to § 44-146.17 related to a public health emergency, that should also be specified in order to differentiate it from other declared states of emergency.

In addition, VRS recommends that this language be added since there are many different meanings of a "furlough":
Insert "For purposes of this subsection, 'furlough' means a temporary period of time following an emergency declared pursuant to § 44-136.17 during which a member's salary is reduced."

12. Other Comments: This legislation would require that the creditable compensation of a member in any month in which the member was furloughed because of a statewide emergency declared pursuant to § 44-146.17 be maintained at the amount of such member's compensation in the month immediately preceding the declaration of the statewide emergency.

This assumes that "furlough" means a temporary reduction in salary due to the declared statewide emergency. Because the average final compensation is the highest consecutive 36 (Plan 1) or 60 (Plan 2 and Hybrid) months of creditable compensation, the months during the furlough may not necessarily be included in the months considered for the average final compensation. For example, an employee may have the period of highest compensation earlier in his or her service than the final 36 or 60 months.

While this proposal could serve to benefit a limited number of employees who have been or will be furloughed and who also plan to retire in the near future, its impacts are more widespread to both employers and employees. For furloughed members who do not plan to retire in the near future, this legislation would cause them to pay higher contributions based on pre-furlough earnings at a time when their actual salaries are being reduced due to the furlough action. Accordingly, contributions will be a greater percentage of impacted employee's reduced salary.

Average Final Compensation (AFC) is calculated using the highest consecutive 36 or 60 months creditable compensation, not the last 36 or 60 months of creditable compensation. The existing statutory AFC calculation serves as a protection for members. Although this legislation might benefit employees who have been furloughed but plan to retire in the near future, it requires contributions from all furloughed employees based on higher pre-furlough salaries even if this period will not be included in their AFC and therefore will not impact their AFC.

In order for this legislation to impact creditable compensation prior to the effective date of this legislation, it will need to be specifically made retroactive. Otherwise, it will only apply as of the effective date.

If the legislation is made retroactive, approximately six months of employee and employer contributions will have to be corrected. Because employee contributions are pre-tax, retroactive contributions will cross tax years, and entail tax consequences and potential corrections. This would create challenges for employers and employees which would retroactively need to collect and pay retroactive contributions at a time when they are likely under fiscal stress.

Maintaining creditable compensation at the higher pre-furlough amount, however, will have two important albeit unintended consequences.

The first is that the individual will pay 5% of his or her pre-furlough compensation as employee contributions even though the actual salary will be lower. This will further decrease the member's take-home pay and potentially create additional hardship.

The second is that employers will also be paying contributions on the higher, pre-furlough salary. If the intent of the furlough, or temporary period of lower salary, is to save the employer money, then this proposed legislation will reduce anticipated savings, because the employer will continue to pay contributions on the pre-furlough salary.

The Hybrid Retirement Plan further complicates this legislation as in addition to the impacts of the defined benefit portion of the benefit, both the member and the employer would be expected to also include matching contributions to the defined contribution component of the plan based on the pre-furlough compensation, which likely would cause hybrid members to reduce voluntary contributions to the plan due to already reduced compensation.

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