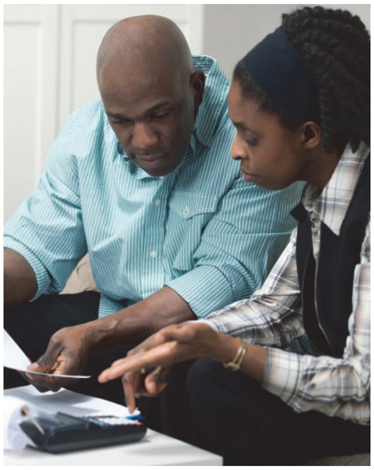


VRS Oversight Report

July 2015

CONTENTS

JLARC
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

Overview

The Virginia Retirement System (VRS) administers retirement plans for employees of state and local governments. The two largest plans are the Teachers Plan and the State Employees Plan. Other plans include those for state police officers (SPORS), other Virginia state law officers (VaLORS), judges (JRS), and individual retirement plans for 585 local political subdivisions. In addition to retirement plans, VRS administers several other benefit programs. These include life insurance, sickness and disability programs, and other post-employment benefit programs, such as the retiree health insurance credit program.

Overall, VRS serves approximately 660,000 members, retirees, and beneficiaries. Active members include current state and local employees and teachers in Virginia's public school divisions. Others served by VRS include retirees, their designated beneficiaries, and deferred members who are not actively employed and are not collecting benefits.

The financial assets used to pay VRS benefits are pooled in the VRS trust fund. The fund held $67.8 billion in assets as of March 31, 2015. Based on the value of these assets, the retirement system ranks as the nation's 22nd largest public or private pension fund. In FY 2014, VRS paid $3.9 billion in retirement benefits and $0.3 billion in other post-employment benefits.

VRS receives funds from three sources: employer contributions, member contributions, and investment income. In FY 2014, after accounting for expenses, VRS received net additions of $7.8 billion to the trust fund.

Investment income is critical to the health of the VRS trust fund, accounting for three-fourths of total additions in FY 2014. VRS investments provided a return of 8.1 percent for the one-year period ending March 31, 2015. The total return over the past 10 years was 6.9 percent, which is slightly below the seven percent long-term rate of return that has been assumed by VRS for its investments.

VRS pension plans

PLAN SIZE BY TOTAL LIABILITY as of June 30, 2014 ($ billions)

Source: VRS 2014 valuation report.
*Local liability is the aggregate for local governments and political subdivisions that participate in VRS.
Note: The total liability is the sum of all plan obligations and does not account for plan assets. A separate calculation is used to determine the unfunded liability, or the portion of total liability that cannot be paid from current assets.

VRS fast facts

MEMBERSHIP as of March 31, 2015

342,524 Actively employed members[a]

184,074 Retired members & beneficiaries

131,754 Inactive members

658,352 Total

NET ADDITIONS for fiscal year ending June 30, 2014

$2.1 billion Employer contributions

$1.0 billion Member contributions[b]

$9.1 billion Investment income

($4.4 billion) Benefits paid and other expenses[c]

$7.8 billion Net additions

ASSETS as of March 31, 2015

$67.8 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of March 31, 2015

	1 year	3 years	5 years	10 years
Total return	8.1%	10.0%	9.4%	6.9%
Benchmark	7.3%	9.6%	8.7%	6.3%
Excess return	+0.8%	+0.4%	+0.7%	+0.6%

Source: VRS 2014 annual report and investment department data.
[a] Active membership included 147,316 teachers, 105,845 local government employees, and 89,363 state employees and judges.
[b] $96,192 of member contributions were covered by local employers. These employers elected to phase in a 2012 legislative requirement that their employees begin to pay the five percent member contribution rate.
[c] Includes $3.9 billion in retirement benefit payments, $343 million in other benefits, $103 million in refunds, $43 million in administrative expenses, and $9 million in other costs.

1. Trust Fund Investments

Management of the VRS trust fund investments is one of the core responsibilities of VRS. The Board of Trustees sets investment policies for managing the trust fund, including the desired asset allocations for the fund. The VRS investment department implements investment programs under the oversight of the board. The investment department manages some assets internally and contracts with external managers to manage other assets.

Investment performance and asset allocation

The VRS trust fund held $67.8 billion in assets as of March 31, 2015, representing an increase of $3.9 billion over the year before (Figure 1). Approximately $24.7 billion was managed internally, and included fixed income, public equities, and real assets. The remaining $43.1 billion was managed by external managers under VRS supervision. For the one-year period ending March 31, the fund's investments achieved a return of 8.1 percent.

The investment performance of the total trust fund and its individual asset classes have largely outperformed the benchmarks adopted by VRS. The total fund's performance exceeded its benchmark in all periods. However, the fund's 10-year return of 6.9 percent was slightly below the seven percent long-term rate of return that has been assumed by VRS for its investments.

Public equity. The public equity program continues to be the largest VRS asset class, with $29.0 billion in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and abroad. Public equity investments are typically higher risk investments relative to bonds and are expected to provide long-term capital growth and inflation protection. Over one-third of the program's assets are managed internally. The program outperformed its benchmarks for all periods.

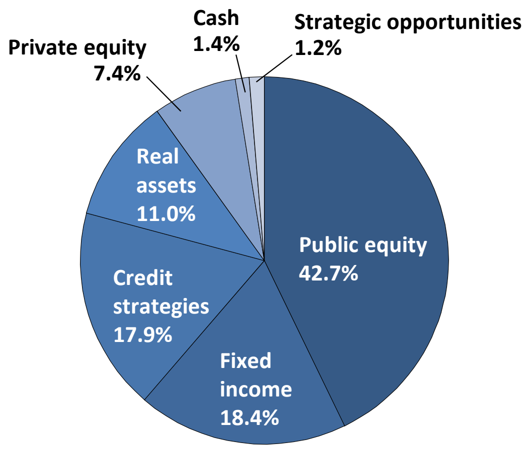
Investment-grade fixed income. The fixed income program is the second largest VRS asset class, with $12.5 billion in assets. The program consists of U.S. dollar-denominated securities that pay a specific interest rate, such as bonds and money market instruments. Fixed income investments are typically lower risk relative to most other asset classes and are expected to provide steady returns even in down markets. All fixed income assets are managed internally. The program outperformed its benchmarks for all periods.

Credit strategies. The credit strategies program is the third largest VRS asset class, with $12.1 billion in assets. The program includes investments in broad sub-categories such as emerging market debt, high yield bonds, convertible bonds, bank loans, and direct lending. Credit strategies investments are intended to provide good risk-adjusted returns relative to traditional stock and bond investment options. All of the program's assets are managed externally. The program underperformed its

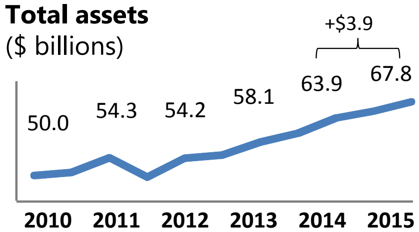
FIGURE 1
Pension investment performance and asset allocations

ASSET ALLOCATION
as of March 31, 2015

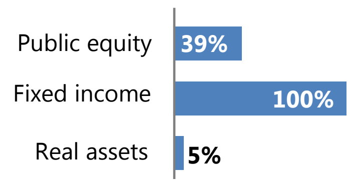
$67.8 billion total assets



Total assets
($ billions)



Internally managed assets
(percent of asset class)



PENSION INVESTMENT PERFORMANCE
for the period ending March 31, 2015

	Fiscal year to date	1 year	3 years	5 years	10 years
Total Fund	4.3	8.1	10.0	9.4	6.9
VRS Custom Benchmark	3.9	7.3	9.6	8.7	6.3
Public Equity	4.9	9.6	12.9	10.5	7.1
Benchmark	3.7	8.3	12.0	9.6	6.6
Investment-Grade Fixed Income	3.6	6.0	3.4	5.2	5.5
Benchmark	3.6	5.7	3.1	4.5	5.1
Credit Strategies	0.5	3.7	7.5	7.5	6.7
Benchmark	1.0	4.0	6.5	6.6	5.8
Real Assets	10.0	13.9	12.8	14.1	9.2
Benchmark	7.8	11.0	11.0	12.1	8.8
Private Equity	5.1	10.2	15.1	14.1	13.2
Benchmark	6.2	8.4	19.1	15.9	9.4
Strategic Opportunities	4.9	5.8	n/a	n/a	n/a
Benchmark	2.8	3.5	n/a	n/a	n/a

Source: VRS investment department data.

benchmarks for the fiscal-year-to-date and one-year periods, but outperformed benchmarks over the longer term.

Real assets. The real assets program is the fourth largest VRS asset class, with $7.4 billion in assets.* The program includes investments in real estate and infrastructure and in natural resources such as timber. Real assets investments are expected to reduce volatility of the total fund by offering returns that do not have a high statistical correlation with the public equities market. Most real assets are managed externally. The program outperformed its benchmarks for all periods.

Private equity. The private equity program is the smallest of the five major asset classes, with $5.0 billion in assets.* Private equity is an alternative to traditional public equity and generally consists of equity securities for companies that are not listed on the public exchange. Private equity investments are "opportunistic" investments that are intended to outperform public equity markets over the long term and enhance total fund returns. All private equity assets are managed externally.

The program underperformed its benchmarks for the fiscal-year-to-date, three-, and five-year periods, but outperformed benchmarks for the one- and 10-year periods. Private equity investments can lag near-term benchmarks because it can take several years before an investment begins generating profits. Despite this drawback, the private equity program achieved its intended purpose of earning higher returns than the public equity program, for all periods.

Strategic opportunities. The strategic opportunities program is the smallest overall asset class, with $0.8 billion. The program is not considered a major asset class. It was created in 2012 for investments that have a compelling potential for competitive returns but do not fit neatly into any of the five major classes. Individual investments in this portfolio include a global asset allocation hedge fund, a currency management investment, and a joint venture in commercial mortgages. All strategic opportunities assets are managed externally. The program outperformed its benchmarks for the two time periods it has been in existence.

Investment policies and programs

The VRS board sets investment policies, and the professionals in the investment department implement programs to fulfill those policies. Notable policy and program initiatives include the board's adoption of a formal investment beliefs statement, changes to several investment performance benchmarks, the modification of target asset allocations, and the investment department's decision to begin internally managing a portion of emerging market equities, one of the three major types of VRS public equity assets.

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* Performance figures for the real assets and private equity programs do not reflect managers' actual valuations of these investments as of March 31, 2015, because this data has not yet been made available to VRS. Instead, performance figures are based on valuations as of December 31, 2014, adjusted for cash flows during the quarter that ended March 31, 2015.

Board planning to adopt formal statement of VRS investment beliefs

The VRS board is planning to adopt a formal statement of VRS investment beliefs at its September meeting. The board reviewed a draft statement in June. According to the statement, VRS's guiding belief is that the trust fund needs to seek strong returns in equity markets and maintain long-term returns, with some investments in diversified and risk-reducing assets. The statement also expresses support for an active management strategy for most of the trust fund's assets. According to the consultant that assisted VRS in developing the statement, the investment risks taken by VRS are similar to those taken by other large public pension plans, but VRS places a greater reliance on active management than its peers.

The statement of investment beliefs will be used to guide the board's periodic discussions of how the trust fund's assets should be allocated and what the risk tolerance of the fund should be. The statement is also intended to provide guidance in case of future financial crises, when board members or outside parties may call for actions that are not in line with the long-term investment goals that have been set for the fund. Additionally, the statement further defines the framework that the investment department staff must work within when making investment decisions. The statement was developed by the board with input from the Investment Advisory Committee and the investment department staff, and with the assistance of a consultant.

Board changed benchmarks for measuring the performance of public equity investments

The VRS board reviewed the performance benchmarks for the trust fund's investments and approved changes to two public equity benchmarks. VRS uses investment benchmarks to report on the fund's performance and determine incentive awards for its investment professionals. The benchmark changes are intended to provide more accurate targets for assessing performance. VRS indicated that the new benchmarks were historically more difficult to meet than the old benchmarks.

The board changed the benchmark it uses to measure the performance of the public equity asset class as a whole. Public equity performance was being measured against a public equity market index, with a risk adjustment made by VRS's official third-party record keeper. (The record keeper is responsible for calculating investment performance relative to the benchmarks.) The risk adjustment was intended to capture the risk-reducing effect of the program's hedge fund investments. The new benchmark will compare VRS performance to a blend of the same public market index and a new hedge fund index. The hedge fund index takes the place of the risk adjustment. The consultant that developed the new benchmark indicated that using a hedge fund index, which shows how peer hedge funds have performed, is the current best practice in the finance industry.

The board changed the benchmark for measuring the performance of internally-managed public equities, which constitute about a third of the VRS public equity program. This subset of public equities is monitored to ensure that internal management is adding value and for determining incentive awards for internal investment managers. The old benchmark was a blend of several different public equity indices, with an adjustment made by VRS's record keeper to account for "low volatility" investment strategies that are included in the internal management group's portfolio. The new benchmark eliminates the adjustment and blends in two additional market indices that are designed for measuring low volatility investments.

The new benchmarks were developed by Aon, VRS's benchmark consultant. The benchmarks were reviewed by the board's Administration and Personnel Committee and approved by the board. The board's Investment Advisory Committee did not review the new benchmarks. VRS staff indicated that they did not believe the committee needed to review the new benchmarks because only minor changes were made.

Board modified the scheduled adoption of new asset allocation policy and increased the limit on hedge fund investments

VRS is starting the third year of a five-year phase-in to a new asset allocation policy for the trust fund. Under the new policy, VRS is increasing assets allocated to private equity and real assets, and decreasing assets allocated to fixed income and credit strategies. The board expects that the new asset allocation policy will allow the VRS portfolio to achieve slightly higher returns at similar risk levels compared to the previous policy. To achieve the new asset mix, the board approved annual targets to be phased in over five years.

In June, VRS adjusted the schedule for phasing in the new asset allocations. This is the second year in a row that the schedule has been adjusted. Last year, the board modified its year-two target for private equity because market conditions made it challenging to increase investment in this asset class. This year, the board modified its year-three targets to reflect continued challenges in increasing private equity investments (Table 1). VRS has already committed money to its private equity partners. However, those partners have been slow to draw down these funds because they have found few good investment opportunities at today's prices. VRS staff indicated they believe market conditions are likely to change, which would allow the final new asset allocations to be achieved as planned by the end of FY 2017.

In addition to asset allocation changes, the board increased the limit on the portion of the trust fund that can be invested in hedge funds from 10 to 15 percent. VRS staff indicated they mostly use hedge funds to lower the trust fund's risk level. The board established a limit on hedge fund investments as a risk control measure, much like the board sets limits for the major asset classes. Currently, 9.5 percent of the trust fund is invested in hedge funds, with most of those investments held in the public equity program. The Chief Investment Officer requested an increase in the limit on hedge fund investment because they can be used to manage the balance between the fund's risk and returns.

TABLE 1
Modifications to the scheduled phase-in of new asset allocations

	Original year-three allocation	Modified year-three allocation	Full phase-in of new allocations
Public equity	42.0%	43.0%	42.0%
Fixed income	17.0	18.0	15.0
Credit strategies	17.0	18.0	15.0
Real assets	12.5	12.0	15.0
Private equity	10.5	8.0	12.0
Strategic opportunities	0.0	0.0	0.0
Cash	1.0	1.0	1.0

Source: VRS board materials and minutes for April 2013 and June 2015.

Investment department plans internal management strategy for emerging market equities

The VRS investment department is preparing to launch a new internal emerging market strategy within the public equity portfolio. VRS staff indicated that the investment department is continually investigating the potential for new internally managed investment strategies because they have found significant cost savings from managing assets in-house. VRS already internally manages many of its public equity holdings in domestic and non-U.S. companies, including those in developed markets such as Europe, Canada, Japan, and Australia.

The new emerging markets strategy will target public equity investments in companies in developing economies, such as China and Brazil, which VRS has not internally managed before. Initial funding for the new emerging markets strategy will be approximately $100 million and will come from a reduction in externally managed accounts. Over time, VRS will likely increase the amount invested in the new internally managed strategy.

2. Defined Contribution Plans

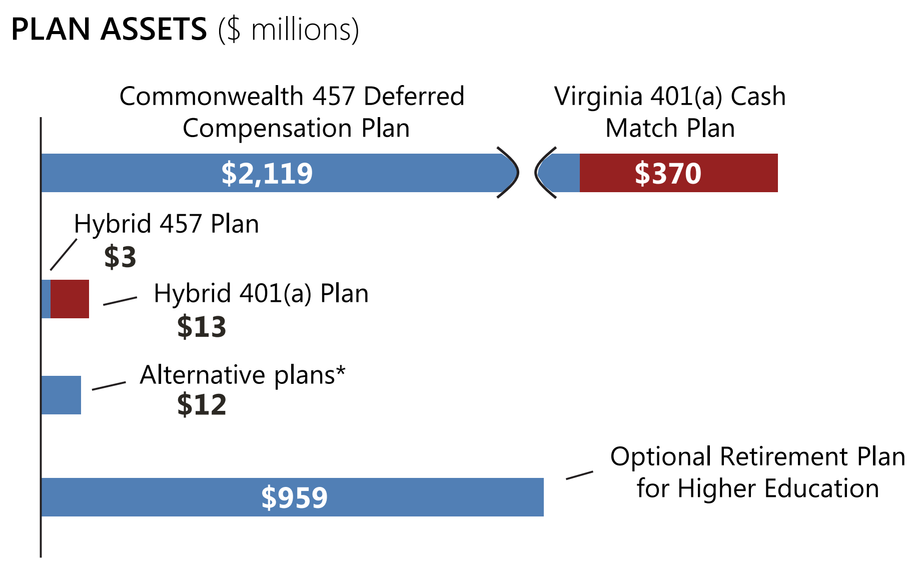
VRS manages several defined contribution plans for its members. Participants in these plans have their own individual accounts, and each participant determines how their money is invested. These accounts accrue funds that the account holder can use in retirement. The defined contribution plans are similar in structure to private sector 401(k) plans or personally-owned individual retirement accounts (IRAs). Some plans are intended to serve as primary retirement benefits, whereas others are intended to supplement VRS pension benefits. The aggregate value of participant accounts held in the VRS-managed defined contribution plans was $3.5 billion as of March 31, 2015.

Types of plans

All state employees and many local VRS members may be eligible to participate in one or more of the defined contribution plans managed by VRS (Figure 2). Each plan has its own eligibility requirements, which determines who can participate.

All state employees and many local VRS members have the option to participate in the Commonwealth of Virginia 457 Deferred Compensation Plan. Most state employees who participate in the Commonwealth 457 plan are also enrolled in the Virginia 401(a) Cash Match Plan and are eligible to receive a modest cash match from their employers. Some local employers also offer employees a cash match on their contributions. The two plans are intended to supplement employee retirement income, not to serve as primary retirement plans.

FIGURE 2
VRS defined contribution plans



Source: VRS administration department data.
*Includes the Optional Retirement Plan for Political Appointees ($11.7 million), Optional Retirement Plan for School Superintendents ($0.4 million), and Virginia Supplemental Retirement Plan for certain educators ($0.1 million).

Members of the state's Hybrid Retirement Plan are required to participate in the Hybrid 401(a) Cash Match Plan and have the option to make voluntary contributions to the Hybrid 457 Deferred Compensation Plan. Each member contributes a mandatory one percent of salary, plus a one percent employer match, to the Hybrid 401(a) plan. Members can also make voluntary contributions to their Hybrid 457 plans and receive additional employer matching funds in the Hybrid 401(a) plan. Taken together, these defined contribution plans are intended to be one of the main sources of retirement income for Hybrid Plan members. The other major source of retirement income for these members is their pension benefit. Hybrid Plan members include most state and local employees hired on or after January 1, 2014.

Alternative defined contribution plans are available for political appointees, school superintendents, and certain groups of educators. The Optional Retirement Plan for Political Appointees and the Optional Retirement Plan for School Superintendents are offered in lieu of the standard State Employees or Teachers plans. School divisions may choose to offer the Virginia Supplemental Retirement Plan to turnaround specialists and teachers hired through the Virginia Middle School Teacher Corps. These supplemental benefits are provided in addition to the standard Teachers Plan benefits.

The Optional Retirement Plan for Higher Education is available for faculty and staff at public colleges and universities. Once hired, faculty and staff must make an irrevocable one-time decision to participate in this plan or in the standard State Employees Plan. Employers are required to make contributions to participant accounts, and employees hired after July 1, 2010 are also required to contribute.

Plan performance

Participants in the VRS defined contribution plans have several options for investing their assets. Participants in the Commonwealth 457, Virginia 401(a), Hybrid 457 and 401(a), and alternative defined contribution plans, select from the same group of investment options. Participants in the Optional Retirement Plan for Higher Education select from two separate groups of investment options.

Commonwealth 457, Virginia 401(a), Hybrid, and alternative plans

Participants in the Commonwealth 457, Virginia 401(a), Hybrid 457 and 401(a), and alternative defined contribution plans may choose from a group of 21 investment options. These options include (1) diversified target date portfolios designed by investment professionals, (2) individual investment options, for participants who would like to build their own customized portfolios, and (3) self-directed brokerage accounts, for participants who would like full control over their investments.

VRS has contracted with separate companies to manage investments and administer participant accounts for these plans. This approach is used to minimize costs to participants, improve the transparency of fees, and to maximize VRS control over the investment options that are offered to participants. Participants pay a flat administrative fee every year and investment fees based on the options they select.

Target date portfolios. Participants may select a diversified investment portfolio in accordance with their target retirement date. These portfolios include a broad spectrum of investments, such as different types of stock, bond, and real estate funds. The mix of investments is automatically adjusted over time to become more conservative as the participant approaches retirement age. The target-date portfolios hold $580 million in assets. The portfolios met or exceeded most of their performance benchmarks (Figure 3).

Individual options. Participants may select from one or more individual options to build a customized investment portfolio based on their personal preferences. The options include different types of stock, bond, money market, and real estate funds. Participants may also select a diversified portfolio option, the VRS Investment Portfolio. This portfolio reflects the investments held by the VRS trust fund. The individual options hold $1.9 billion in assets. The individual options met or exceeded most of their performance benchmarks (Figure 3).

Self-directed brokerage account. The brokerage account option allows participants to select from thousands of publicly-traded mutual funds, exchange traded funds, and individual securities. Participants in this option have full control over their investments, down to the individual securities held in their portfolio. The self-directed

FIGURE 3
Investment performance for Commonwealth 457, Virginia 401(a), Hybrid and alternative defined contribution plans

for the period ending March 31, 2015

	Calendar year to date	1 year	3 years	5 years	10 years or since inception
Target date portfolios					
Met or exceeded benchmark	10	9	9	8	8
Total number of options	10	9	9	8	10
Individual options					
Met or exceeded benchmark	7	8	8	10	9
Total number of options	11	11	11	11	11
Self-directed brokerage account*					

Source: VRS investment department data.
*There are no benchmarks for measuring the performance of the self-directed brokerage accounts because all investment decisions are made by the account holders.
Note: The total number of portfolio options can change because longer-term performance data is not available for newer options. Performance is reported net of investment fees, but not administrative fees.

brokerage account holds $29 million in assets. There are no benchmarks for measuring the performance of the self-directed brokerage accounts because all investment decisions are made by the account holders. Participants who use a brokerage account pay additional fees for setting up their accounts and brokerage transactions.

Optional Retirement Plan for Higher Education

Participants in the Optional Retirement Plan for Higher Education may select from up to 35 investment options offered by two private investment managers: TIAA-CREF and Fidelity. Participants must choose one of these as their plan provider, and then can select from that provider's investment options. Many participants in the higher education plan also have accounts with providers that VRS no longer partners with, or "deselected" providers.

The higher education plan's providers manage investments and administer accounts for their participants. This is different from the approach used to manage the other defined contribution plans, where separate companies are used for investments and administration. Participants in the higher education plan pay investment, administrative, and other fees based on the provider and investment options they choose.

The fees charged to participants by the higher education plan's providers are generally higher than those charged to participants in the other VRS defined contribution plans. Fees are higher because administration and investment fees are tied together and cannot be separately negotiated. Investment fees are also higher because many of the investment options use higher-cost active management strategies. Several of these investment options are annuities, which carry additional fees. VRS staff indicated that higher fees are one reason why many of the plan's investment options have underperformed their benchmarks.

TIAA-CREF options. Participants in TIAA-CREF may select one or more individual options to build a customized investment portfolio based on their personal preferences. The individual options include different types of stock, bond, money market, and real estate funds. Participants may also select a diversified portfolio option, the Vanguard Balanced Index Fund, which provides exposure to both stocks and bonds. The TIAA-CREF program holds $718 million in assets. The TIAA-CREF investment options underperformed most of their performance benchmarks (Figure 4).

Fidelity options. Participants in Fidelity may select from several investment options. Participants may select one of several target-date portfolios which provide a diversified mix of investments that change over time as the participant approaches retirement age. Participants may also select from one or more individual options to build a customized investment portfolio based on their personal preferences. The individual options include different types of stock, bonds, money market, and real estate funds. The Fidelity program holds $192 million in assets. The Fidelity investment options underperformed most of their performance benchmarks (Figure 4).

FIGURE 4
Investment performance for the Optional Retirement Plan for Higher Education

for the period ending March 31, 2015

	Calendar year to date	1 year	3 years	5 years	10 years or since inception
TIAA-CREF options					
Met or exceeded benchmark	6	3	4	3	2
Total number of options	11	11	11	11	11
Fidelity options					
Met or exceeded benchmark	18	4	13	8	7
Total number of options	24	23	23	22	24
Deselected providers*					

Source: VRS investment department data.
* VRS does not track the performance of investment options from the deselected providers because these options are no longer available to participants.
Note: The total number of portfolio options can change because longer-term performance data is not available for newer options. Performance is reported net of investment, administrative, and other provider fees.

Deselected provider options. Participants may have accounts with providers that VRS no longer partners with. Participants can keep these accounts but cannot contribute new funds through the higher education plan. Because the investment options offered by these providers are no longer available to participants, VRS does not track their performance. The deselected providers hold $48 million in assets.

Plan management

VRS manages the defined contribution plans through contracts with private companies. These companies provide investment management and account administration services to plan participants. VRS's management activities are overseen by the Defined Contribution Plans Advisory Committee. The committee is appointed by the VRS board, and provides guidance to the board and staff.

VRS is restructuring the Optional Retirement Plan for Higher Education to lower costs and improve plan management

VRS is restructuring the Optional Retirement Plan for Higher Education to lower the fees paid by participants and improve plan management. Currently, the plan's two private providers, TIAA-CREF and Fidelity, are responsible for administering participant accounts and managing investments. This structure, which "bundles" investment and administration services, generally reduces VRS control over the plan. For example, VRS cannot easily negotiate for lower investment and administrative fees because the fees and services of each provider are bundled together. Similarly, VRS cannot easily move some participant accounts to new providers because of contract provisions that restrict control over these accounts.

VRS staff indicated that their goal is to restructure the higher education plan by separating the investment and administrative functions into separate contracts and retaining a single plan administrator. Once the functions are separated, VRS will be in a better position to negotiate for lower fees and improved services for participants. By moving to a single administrator, VRS will gain greater control over the plan's accounts, among other administrative functions. VRS staff indicated they will make changes to the investment options offered under the plan after the functions are separated.

VRS is moving forward on restructuring through a procurement for new third-party administrator services. VRS will solicit vendor proposals for account administration services that fit within its proposed new structure for the higher education plan. VRS released a request for proposal in July and expects to award a contract by October.

VRS staff indicated that they have implemented some limited reforms under the current contracts with TIAA-CREF and Fidelity. These changes are an effort to improve the plans during the interim period before a new contract is awarded. For example, VRS staff negotiated caps on administrative fees with both providers. Any revenue generated by the providers in excess of their cap is then rebated to plan participants.

Local representatives are being added to the Defined Contribution Plans Advisory Committee

The VRS board is in the process of adding two local representatives to the Defined Contribution Plans Advisory Committee, increasing the committee's membership from seven to nine members. The new representatives are being added because the Hybrid Retirement Plan brings a growing proportion of school and local government workforces into the VRS defined contribution plans. Previously, few local employees participated in the defined contribution plans, so there was no need for local representation.

Of the two new committee members, one will represent Virginia school divisions and the other will represent local governments that participate in VRS. The new committee members will be required to be active or retired VRS members and have demonstrated expertise with administration of retirement benefits. This latter requirement is being included because the board wants the new members to provide the local employers' perspective, in addition to the employees' perspective.

3. Recent Legislation

The General Assembly annually enacts legislation that makes changes to the VRS retirement plans. Legislation can change contribution rates and funding, benefits and eligibility, and other aspects of VRS retirement plans and benefits programs. These changes can have a substantial impact on VRS costs and agency management.

General Assembly accelerated funding schedule for state plans and made sizeable one-time payment to teacher plan

In 2012, the General Assembly enacted a requirement that it must fully fund the employer contribution rates that are certified by the VRS board. Employer contributions are one of the major sources of funding for the VRS retirement plans, but the General Assembly had historically approved lower employer contributions than were recommended by the VRS board and actuary. Under the 2012 requirement, the board-certified rates must be fully funded by FY 2019.

The General Assembly's 2012 action to require full funding of the employer contribution rates included codification of a schedule for achieving this goal (Table 2). Under the schedule, the legislature is required to provide funding equal to a growing portion of the board-certified rate each biennium until the rates are 100 percent funded in the 2019-2020 biennium. The state will then be required to pay 100 percent of the board-certified rates in perpetuity.

TABLE 2
Statutory funding schedule for state supported plans

	Percent of employer contribution to be funded (by fiscal year biennium)			
	2013-14	**2015-16**	**2017-18**	**2019-20**
Teachers	69.53%	79.69%	89.84%	100%
State Employees	67.02	78.02	89.01	100
VaLORS	75.82	83.88	91.94	100
SPORS	75.84	83.90	91.95	100
JRS	83.98	89.32	94.66	100

Source: § 51.1-145 of the Code of Virginia.
Note: There is no statutory funding schedule for local political subdivision plans, as these employers have generally been required to fully fund their board-certified contribution rates. However, from FY 2013 to FY 2018, the Appropriation Act allows local employers to pay alternate rates that are lower than those currently certified by the VRS board.

Employer contribution rates for several state-supported plans increased one year ahead of schedule

In the 2015 Appropriation Act, the General Assembly provided an additional $32 million to increase the employer contribution rates for the State Employees Plan and plans for state police officers (SPORS), other Virginia state law officers (VaLORS), and judges (JRS). The additional funding increases the FY 2016 rates to 90 percent of the board-certified rates, one year ahead of the statutory funding schedule. For example, the current board-certified rate for the State Employees plan is 15.79 percent of payroll. Under the schedule, the state is required to pay a 12.33 percent rate for FY 2016, which is equal to 78 percent of the board-certified rate. The additional funding will increase the rate paid by the state to 14.22 percent of payroll, or 90 percent of the board-certified rate. (Rates enacted by the General Assembly for each state-supported plan are presented in Table 3.)

TABLE 3
Employer contribution rates enacted by the General Assembly

	Rate set in Appropriation Act (fiscal year)			
	2013	**2014**	**2015**	**2016**
Teachers	11.66%	11.66%	14.50%	14.06%
State Employees	8.76	8.76	12.33	14.22
VaLORS	14.80	14.80	17.67	19.00
SPORS	24.74	24.74	25.82	27.83
JRS	45.44	45.44	51.66	50.02

Source: Appropriation Acts, 2012-2015.
Note: The 2015 Appropriation Act increased the FY 2016 employer contribution rate for the State Employees, VaLORS, SPORS, and JRS plans based on higher than expected revenue. The rate was increased to 90% of what the actuarially-recommended rate would be, taking into account past one-time payments to the VaLORS and SPORS funds and changes made to the JRS plan in the 2015 session. The Act reduced the rate for the Teachers Plan in FY 2016 because a one-time payment of $193 million was made to the plan, which reduced the unfunded liability and therefore the contribution rate.

By increasing rates earlier than originally scheduled, the state is expected to improve the funded status of the affected plans. Paying higher rates now will also lower the future employer contributions required for the plans. VRS indicated that lower future rates could potentially save the state $85 million over the next twenty years, provided all other assumptions are met. The FY 2016 rate increase is contingent on the revenue forecast remaining positive at the end of FY 2015.

Teachers Plan costs reduced by special one-time contribution of $193 million

The 2015 General Assembly approved a special one-time contribution of $193 million to the Teachers Plan. These funds were from the sale of unclaimed property held by the

Treasury of Virginia. By law, profits from the sale of unclaimed property must be deposited in the state's Literary Fund. The Literary Fund is to be used for public school purposes only, including payments to the Teachers Plan retirement fund.

The one-time payment is expected to save the state and local governments $34 million over the next six years (FY 2016–FY 2021). Savings will be reflected in lower employer contribution rates for the Teachers Plan during this time period. The contribution rate for FY 2016 was reduced from 14.50 percent of payroll to 14.06 percent.

2015 General Assembly enacted legislation making changes to VRS retirement plans and benefits programs

The General Assembly enacted legislation in 2015 that made several changes to the VRS retirement plans. The most notable change was to the program options offered to Hybrid Plan members in the Teachers Plan. The General Assembly also directed VRS to lead or participate in several studies.

School divisions allowed to offer additional defined contribution plans to Hybrid Plan members

The most substantial change to VRS benefits and eligibility is a new law that allows school divisions to offer additional defined contribution plans to Hybrid Plan members. Previously, Hybrid Plan members were only allowed to enroll in the VRS-sponsored Hybrid 457 and 401(a) defined contribution plans. Mandatory employee and employer contributions will continue to go to the VRS-sponsored plans. However, under the new law, school divisions may choose to sponsor their own additional 403(b) plans for members' voluntary contributions and related employer matches. Members will have the choice to participate in any additional plans sponsored by their school division, participate in VRS-sponsored plans, or not make voluntary contributions at all.

VRS indicated that implementing the new law will be administratively complex and carry additional costs. VRS must modify its technology systems and administrative processes to implement the change. These modifications are needed to ensure that member and employer contributions are properly managed and accounted for. For example, controls are needed to ensure members are not enrolled in both the VRS-sponsored 457 plan and a local 403(b) plan, which could result in erroneous double contributions from employers. VRS must also revise its educational materials and provide training and information to school divisions. The expected cost to VRS of implementing the new law is $440,000 in one-time expenses, plus $110,000 in ongoing expenses.

VRS indicated that it has started to make changes to implement the new law, and that it plans to complete work in time to meet the January 1, 2016 implementation deadline. All school divisions must submit a resolution to VRS by November of this year indicating if they will be offering additional defined contribution plans to their Hybrid Plan members. VRS will send out guidance on how to submit resolution packages in July of this year.

VRS is leading or participating in several studies

The 2015 General Assembly passed several bills requiring VRS to lead or participate in studies and work groups. House Bill 1969 directed VRS to study cash balance retirement plans and provide the General Assembly with a proposal outlining how such a plan could be implemented. VRS is to report on potential plan costs, risks, administrative impacts, effect on employee benefits, and a funding structure that would allow employers to still meet funding requirements of other VRS plans. VRS's report is due in November.

VRS has started work on the cash balance plan study. VRS staff indicated they have gathered information on the five other states that offer these types of plans. The VRS actuary is currently estimating the projected costs of a Virginia cash balance plan. Cost projections will be based on the plan structures used by other states. VRS also intends to discuss implementation and administration issues related to cash balance plans with representatives from other states.

House Bill 1998 directed VRS to convene a work group to review current state and federal laws and regulations that encourage Virginia citizens to save for retirement. The work group is to review savings options for the general population, including people who are self-employed or do not have retirement benefits through their employers. The work group representatives are to include the Department of Taxation, the Virginia College Savings Plan (VA529), small businesses, and individuals who are self-employed. VRS has developed a workplan for carrying out the study and has begun organizing the work group.

House Bill 2204 directed VRS and the Department of Human Resource Management (DHRM) to examine recommendations in JLARC's report on the Line of Duty Act and propose ways to simplify and clarify the program and ensure its long-term financial viability. VRS and DHRM were further directed to meet with all relevant stakeholders, including representatives from public safety groups and localities, to discuss these issues. At least four stakeholder meetings have been planned, with two completed so far. VRS and DHRM are to report their proposals to the Chairmen of the House Appropriations Committee and Senate Finance Committee no later than October 1, 2015. The 2016 General Assembly may then enact the proposed changes.

General Assembly passed additional legislation affecting VRS

The General Assembly passed several other bills that make changes and technical adjustments to one or more aspects of the VRS retirement plans and other benefit programs. (See Table 4 for a complete list of VRS-related legislation from the 2015 session.)

TABLE 4
VRS legislation passed in 2015 legislative session

Benefits and eligibility	
Senate Bill 813	Made technical amendments to VRS programs. Added required IRS language, added disability retirement for judges in the Hybrid Plan, and clarified Virginia Local Disability Program requirements
Senate Bill 942	Allowed members on leave for the death of a child to purchase up to one year of service credit upon their return to employment.
House Bill 1890	Simplified the purchase of prior service, making it more cost-neutral to the VRS trust fund and more in-line with other states.
House Bill 2277	Provided that basic life insurance coverage for retirees with 30 years or more of creditable service cannot be reduced to less than $8,000, with the amount adjusted annually for cost-of-living.
House Bill 2020	Extended the sunset date to July 1, 2020 on provisions permitting retired teachers and administrative employees to elect to continue receiving a retirement benefit while filling an eligible critical shortage teacher position.
House Bill 2178 Senate Bill 1162	Allowed school divisions the option of offering employer-sponsored 403(b) plans to Hybrid Retirement Plan members, in place of VRS-sponsored plans, for the voluntary portion of employee contributions and their associated employer matching funds.
House Bill 1984 Senate Bill 1196	Increased mandatory retirement age under the Judicial Retirement System from 70 to 73 years of age, with some restrictions.
Rates and funding	
Appropriation Act	Provided special one-time payment of $193 million to the teacher plan on June 30, 2015, to be applied to the repayment of deferred contributions from 2010.
Appropriation Act	Provided $32 million to accelerate the funding schedule for employer contribution rates, increasing the portion of the rates that is funded to 90 percent of the board-certified rate for FY 2016. Affects the State Employees, VaLORS, SPORS, and JRS plans.

TABLE 4 *continued*
VRS legislation passed in 2015 legislative session

Studies	
House Bill 1969	Directed VRS to study cash balance retirement plans and provide a proposal to the General Assembly no later than November 1, 2015.
House Bill 1998	Directed VRS to convene a work group to review current state and federal laws and regulations that encourage Virginia citizens to save for retirement.
House Bill 2204	Directed VRS and the Department of Human Resource Management (DHRM) to examine recommendations in JLARC's report on the Line of Duty Act (LODA) and propose ways to simplify and clarify the program and ensure its long-term financial viability. If reenacted by the 2016 General Assembly, the bill will move LODA administration to VRS and health benefit administration to DHRM.
Appropriation Act	Required VRS to assist the Department of Forestry in studying the cost and feasibility of providing retirement credits for special forest wardens who participate directly in extinguishing forest fires.
Other	
House Bill 1885 Senate Bill 1173	Allowed the Town of Damascus to prospectively revoke its participation in VRS.
House Bill 2222 Senate Bill 1360	Established the Commonwealth's Attorneys Training Fund to be used for supporting prosecutor and law-enforcement training. VRS is to manage fund investments.

Source: Virginia Legislative Information System; VRS presentations to the Board of Trustees, 2015.

4. Benefits Administration and Agency Management

Administration of member benefits is one of the core responsibilities of VRS. In order to carry out this and other duties, the agency must be effectively managed. Notable issues relating to benefits administration and agency management include the appointment of a new VRS director, changes in voluntary contributions by Hybrid Plan members, the impact of new pension accounting rules, delays in technology modernization, and appointments to the VRS board.

New VRS director appointed

The VRS board named Patricia Bishop as the new VRS director in June. Bishop has been with VRS since 2008, first as director of policy, planning and compliance, and then as deputy director, and most recently as acting director. Patricia Bishop replaces Robert Schultze, who left VRS in February.

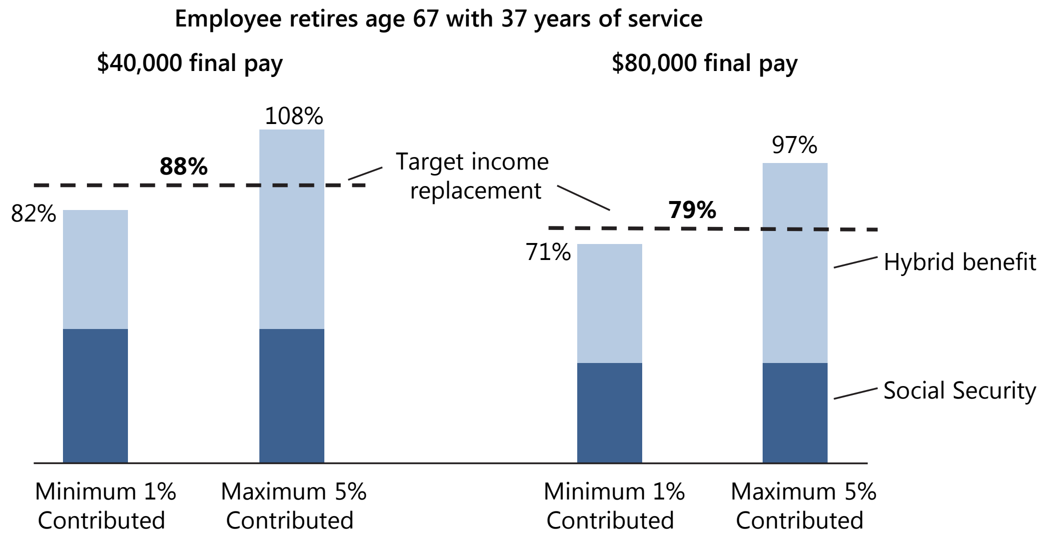
The VRS board conducted a nationwide search to fill the VRS director position, and the search appears to have been appropriately conducted. The board retained the services of a major national recruitment firm to lead the search. The recruiter identified and evaluated potential candidates. Final candidates were selected and interviewed by the board's Administration and Personnel Committee. The committee's meetings were well attended by board members, and qualified candidates were given appropriate consideration.

Voluntary member contributions to hybrid plan have increased but remain low overall

Voluntary member contributions to the defined contribution component of the Hybrid Plan have increased over the past year but remain lower than expected. Since enrollment in the Hybrid Plan began in January 2014, only eight percent of members have elected to make voluntary contributions. The eight percent rate represents an improvement over a year ago, when only four percent of members were electing to make voluntary contributions. However, the overall proportion of members making voluntary contributions is still lower than expected. VRS originally assumed that 20 percent of members would make voluntary contributions.

The low rate of voluntary contributions raises concerns that many Hybrid Plan members may not have adequate savings to retire. Those members who contribute only the minimum required one percent rate throughout their careers will replace from 71 to 82 percent of their income at retirement, if they work for 37 years and retire at age 67. This level of income replacement is lower than what these employees are expected to need in retirement (Figure 5).

FIGURE 5
Projected income replacement under Hybrid Plan



Source: VRS Hybrid Retirement Plan update, 2014.
Note: Target income replacement from JLARC's 2011 review of retirement benefits. Minimum and maximum contribution amounts refer to the amount of salary that is contributed by employees to their defined benefit accounts. Employees are required to contribute a minimum of 1% of salary, and can voluntarily contribute up to a maximum of 5% of salary. Employers match a minimum of 1% and a maximum of 3.5% of the employee's salary. Employer contributions to defined contribution accounts, and the income provided from the defined benefit component of the Hybrid Plan, are factored into calculations of the benefit amounts.

To address concerns about low voluntary contribution rates, VRS implemented a communications campaign to promote increased contributions. VRS provided materials and education to its employers and directly reached out to Hybrid Plan members. The campaign may have contributed to the increase in voluntary contributions that occurred over the past year.

VRS is examining other ways to further increase voluntary contributions. One approach would be to change the default for new employees so that voluntary contributions are automatically deducted unless the employee actively chooses to opt out. Currently, newly-hired Hybrid Plan employees must actively choose to make voluntary contributions. By statute, each member's voluntary contributions are scheduled to increase automatically by half a percent every three years. However, under this schedule, the member's voluntary contributions may not be maximized until as many as 24 years after they are hired.

New accounting rules will change how state and local governments report their pension liabilities

The Governmental Accounting Standards Board (GASB) has adopted new standards (GASB Statement 68) that require state and local governments to report net pension liabilities in their annual financial statements. The net pension liability is the portion of future benefits that are owed to a retirement system's members and are not covered by its current assets, based on the fair market value of those assets. GASB previously required some information pertaining to net pension liabilities to be reported in the notes of the financial statements of state and local government employers. Starting with FY 2015, GASB requires more comprehensive reporting of net pension liability on the face of each employer's financial statements. Many employers are now required to report liabilities that they have never before reported.

The new GASB requirement will add new liabilities to the financial statements prepared by state agencies and reduce the state's reported net financial position. For the first time, individual state agencies will be required to report their proportionate share of the net pension liability for the plans they participate in, such as the State Employees, VaLORS, SPORS, and JRS plans. The sum total of the net pension liabilities for these plans will be reported in the state's Consolidated Annual Financial Report, as part of the state's statement of net position. The addition of pension liabilities could reduce the state's reported net position by as much as $6.8 billion, based on last year's net pension liability.

The new GASB requirement will also result in a substantial increase in the liabilities reported by local governments in their financial statements. For the first time, local governments will be required to report a portion of the net pension liability for the Teachers Plan in their financial statements. Although these liabilities have always existed, they were not previously captured in local government financial statements. Local governments will also begin reporting the entire net pension liability associated with their individual retirement plans, including those that are administered independently or by VRS, on the face of their financial statements. This information was previously only reported in the notes of statements.

The aggregate new liabilities reported by Virginia local governments for VRS-administered plans could be up to $14.6 billion statewide, based on last year's liabilities. The aggregate total will be even higher once the net pension liabilities associated with independent retirement plans, such as those operated by Fairfax County or Richmond City, are accounted for. The independent plans are not administered by VRS

VRS and the Auditor of Public Accounts will help localities implement the new financial reporting requirements related to their VRS-administered plans. VRS holds much of the enrollment and financial data that localities need to satisfy reporting requirements, especially for the Teachers Plan. VRS will provide the necessary data to localities after the close of the fiscal year. The Auditor of Public Accounts will provide assurances that VRS data is accurate and complete. These assurances will allow localities to satisfy the requirements of their independent auditors.

Although state and local governments will begin reporting net pension liabilities in their financial statements, the inclusion of these liabilities does not reflect any material change in the financial well-being of these entities. Nationwide, many governments have raised concerns that the reporting of pension liabilities may affect their bond ratings. However, the bond rating agencies have signaled that they do not intend to downgrade ratings solely because of the new reporting requirement.

Modernization project delayed to accommodate completion of other initiatives

VRS reported that the final phase of its technology modernization project has been delayed to accommodate various legislative and agency initiatives. Under this final phase, VRS will develop new technology systems to support interactions with VRS members. For example, new systems will allow members to electronically request refunds, manage beneficiaries, and file for retirement. The new systems are expected to benefit VRS members by making it faster and easier to get information and carry out transactions. The final phase of the project began in July 2014.

In June, VRS reported that the schedule for the final phase of modernization would be extended by an additional two months. The extension will push the expected completion date for the project from October to December 2017. It will also add an estimated $1 million to the current $21.5 million project costs (not including VRS staff costs).

VRS indicated that the schedule is being extended to accommodate the completion of legislatively-mandated and agency initiatives. For example, VRS technology resources are needed to implement the new legislative requirement that school divisions can choose to offer their own employer-sponsored 403(b) plans to Hybrid Plan members. VRS indicated that it does not have the resources to meet the implementation deadline for this program change, and other initiatives, without extending the modernization schedule.

New board chair selected and member reappointed

Robert Greene was appointed chair of the VRS board by Governor McAuliffe in May 2015. He was originally appointed to the board in 2008 and most recently served as vice-chair. His current term will expire in 2017. Greene is President and CEO of the National Association of Investment Companies.

Diana Cantor was reappointed by Governor McAuliffe to the VRS board in January 2015. She was originally appointed to the board in 2010, and she served as chair from 2010 to 2015. Her new term will expire in 2020. Cantor is a partner at Alternative Investment Management.

The VRS board is a supervisory board that is directly vested with authority for managing and overseeing most aspects of the retirement system. The board delegates day-to-day management responsibilities to the VRS director and Chief Investment Officer.

The VRS Oversight Report is published semi-annually by the Joint Legislative Audit and Review Commission in fulfillment of the Virginia Retirement System Oversight Act (Chapter 10 of Title 30 of the Code of Virginia). The statute requires JLARC to oversee and evaluate the Virginia Retirement System and regularly update the legislature on VRS investments and oversight findings.

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