Commonwealth of Virginia
July 2016

Report to the Governor and the General Assembly of Virginia

VRS Oversight Report

JULY 2016

JLARC
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

JLARC staff for this report
Kimberly Sarte, Assistant Director for Ongoing Oversight and Fiscal Analysis
Mark Gribbin, Principal Legislative Analyst

Information graphics: Nathan Skreslet

Report no. 483

http://jlarc.virginia.gov

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 584 local political subdivisions. In addition to retirement plans, VRS administers several other benefit programs. These include life insurance, sickness, disability, long-term care, and post-employment benefit programs, such as the retiree health insurance credit program.

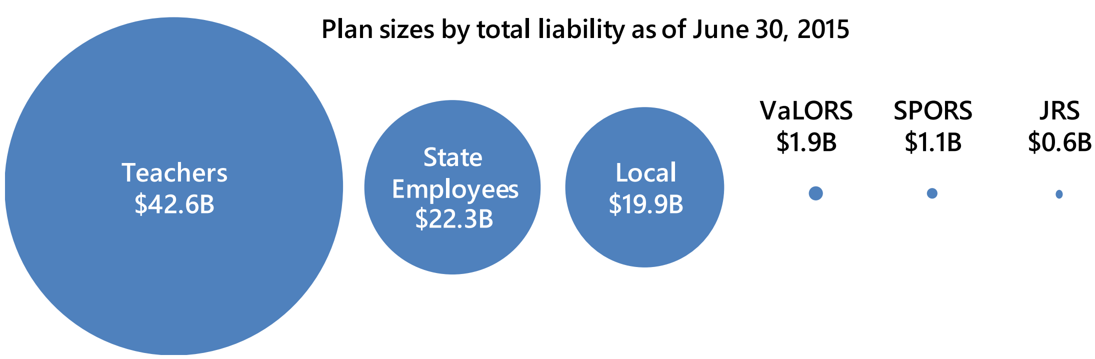
Overall, VRS serves approximately 676,000 members, retirees, and beneficiaries. Active members include current state and local employees and teachers in Virginia's public school divisions. Others served by VRS include retirees, their designated beneficiaries, and deferred members who are not actively employed and are not collecting benefits.

The financial assets used to pay VRS benefits are pooled in the VRS trust fund, which held $67.1 billion in assets as of March 31, 2016. Based on the value of these assets, the retirement system ranks as the nation's 22nd largest public or private pension fund. In FY15, VRS paid $4.1 billion in retirement benefits and $0.4 billion in other post-employment benefits.

VRS receives funds from three main sources: employer contributions, member contributions, and investment income. In FY15, VRS received $2.0 billion in net additions to the trust fund (accounting for expenses).

Investment income is critical to the health of the VRS trust fund, accounting for almost half of total additions in FY15. VRS investments provided a return of 0.5 percent for the one-year period ending March 31, 2016. The total return over the 10-year period was 5.4 percent, which is below the seven percent long-term (30+ year) rate of return that has been assumed by VRS for its investments.

FIGURE 1
VRS pension plans



SOURCE: VRS 2015 valuation report.
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. Local liability is the aggregate for local governments and political subdivisions that participate in VRS.

FIGURE 2
VRS fast facts

MEMBERSHIP as of March 31, 2016

343,482	Actively employed members[a]
191,475	Retired members & beneficiaries
141,074	Inactive members
676,031	Total

NET ADDITIONS for fiscal year ending June 30, 2015[b]

$2.7 billion	Employer contributions[c]
$0.9 billion	Member contributions
$3.0 billion	Investment income
($4.6 billion)	Benefits paid and other expenses[d]
$2.0 billion	Net additions

ASSETS as of March 31, 2016

$67.1 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of March 31, 2016

	1 year	3 years	5 years	10 years
Total return	0.5%	6.7%	6.8%	5.4%
Benchmark	-0.1%	6.2%	6.3%	4.8%
Excess return	+0.6%	+0.5%	+0.5%	+0.6%

SOURCE: VRS 2015 annual report and 2016 membership and investment department data.
[a] Active membership included 148,830 teachers, 105,851 local government employees, and 88,801 state employees, state police, law enforcement officers, and judges. Within the retirement plans are three different benefit groups. The Plan 1 group has 201,550 members, Plan 2 has 94,749, and Hybrid Plan has 47,183. [b] Includes all additions and deductions to the trust fund for VRS retirement plans and other benefits programs. [c] Includes $1.2 billion in state contributions. [d] Includes $4.1 billion in retirement benefit payments, $368 million in other benefits, $106 million in refunds, and $47 million in administrative and other expenses.

1. Trust fund investments

Management of the VRS trust fund investments is one of the core responsibilities of VRS. The VRS Board of Trustees sets investment policies for managing the trust fund, including the desired asset allocation for the fund. The VRS investment department manages investment programs within the guidelines set by 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 $67.1 billion in assets as of March 31, 2016, representing a decrease of $748 million from the year before. Approximately $24 billion of the trust fund was managed internally, including all of fixed income and some public equities, real assets, and cash. The remaining $43.1 billion was managed by external managers under VRS supervision.

The trust fund's recent investment returns were below the long-term return assumption, but the fund has outperformed its benchmarks. For the one-year period ending March 31, the trust fund's investments achieved a return of 0.5 percent. The fund's 10-year return of 5.4 percent was below the seven percent long-term (30+ year) rate of return that has been assumed by VRS for its investments. However, the total fund outperformed its benchmark for all periods, including both the short and long term (Figure 3).

Public equity. The public equity program continues to be the largest VRS asset class, with $27 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. Forty-one percent of the program's assets are managed internally. The program outperformed its benchmarks for all periods.

Fixed income. The fixed income program is tied for the second largest VRS asset class, with $12 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 equity markets. All fixed income assets are managed internally. The program outperformed its benchmarks for all periods.

Credit strategies. The credit strategies program is tied for the second largest VRS asset class, with $12 billion in assets. The program includes investments in emerging market debt, high yield bonds, convertible bonds, bank loans, and direct lending. Credit strategies investments are intended to provide higher income than traditional stock and bond investments and attractive, risk-adjusted returns. All of the program's assets are managed externally. The program met or outperformed its benchmarks except the one-year and fiscal year to date, when it underperformed by less than one percentage point.

Long-term return assumption

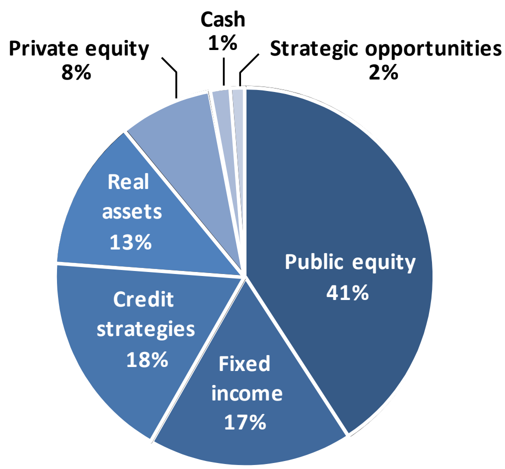
The VRS board adopts a long-term return assumption based on the recommendations of the VRS investment staff and actuary. This is the rate of return expected over the next 30+ years, based on projections of future market performance.

The long-term return assumption is one of the key assumptions used to determine the plan's funded status and employer contribution rates. The current long-term return assumption is seven percent.

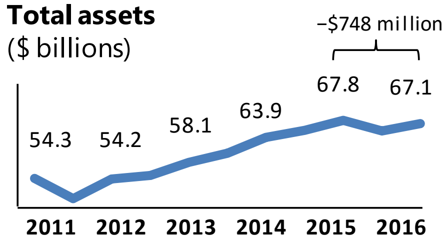
FIGURE 3
Asset allocation and trust fund investment performance

ASSET ALLOCATION
as of March 31, 2016

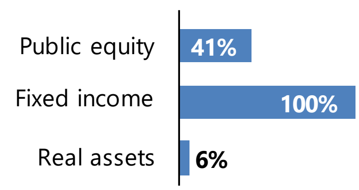
$67.1 billion total assets



Total assets
($ billions)



Internally managed assets
(percent of asset class)



TRUST FUND INVESTMENT PERFORMANCE
for the period ending March 31, 2016

	FY to date	1 year	3 years	5 years	10 years
Total fund	0.1%	0.5%	6.7%	6.8%	5.4%
VRS custom benchmark	−0.4	−0.1	6.2	6.3	4.8
Public equity	−3.8	−3.2	7.4	7.0	4.9
Benchmark	−4.3	−4.1	6.4	6.1	4.4
Fixed income	3.9	2.2	2.7	4.1	5.5
Benchmark	3.7	2.0	2.5	3.9	5.0
Credit strategies	−2.1	−1.5	3.4	4.5	5.6
Benchmark	−1.4	−1.3	3.0	4.2	4.8
Real assets	8.7	10.4	12.2	12.2	7.3
Benchmark	8.9	10.7	10.8	11.2	7.2
Private equity	6.1	9.3	13.8	12.9	11.8
Benchmark	−1.9	2.6	13.4	12.4	8.8
Strategic opportunities	−3.2	−5.1	1.1	n/a	n/a
Benchmark	−1.8	−2.1	1.0	n/a	n/a

SOURCE: VRS investment department data.

Real assets. The real assets program is the fourth largest VRS asset class, with $9 billion in assets.* The program includes investments in real estate, infrastructure, and 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 VRS real assets are managed externally. The program outperformed its benchmarks except the one-year and fiscal year to date, when it underperformed by less than half a percentage point.

Private equity. The private equity program is the smallest of the five major asset classes, with $5 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 public exchanges. 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. This program outperformed its benchmarks for all periods and 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 asset class, with $1 billion. The program allows VRS to gain experience with new investment approaches that are not widely used. Individual investments in this portfolio include two hedge funds, one tactical asset allocation strategy, and two private investment partnerships. All strategic opportunities assets are managed externally. This program outperformed its three-year benchmark but underperformed its one-year and fiscal-year-to-date benchmarks.

Investment policies and programs

The VRS board sets investment policies, and the professionals in the investment department implement programs to fulfill those policies. The board recently made small adjustments to the trust fund's asset allocation targets, and the CIO made minor changes to the structure of the investment division.

VRS board adjusted the trust fund's asset allocation targets

VRS recently concluded a review of the overarching investment strategy for the trust fund. The VRS board, investment advisory committee, and investment department staff worked with a consultant to review the fund's strategic asset allocation and evaluate whether they should be changed. They examined the potential risk and returns anticipated under the current asset allocation and compared them to possible outcomes that could be achieved under different allocations.

The board ultimately decided to make minor changes to the asset allocation targets to further diversify equity risk, while generally keeping the fund's overall risk and return philosophy in place. Under the new targets, cash and a small portion of public equity would

---

*Performance figures for the real assets and private equity programs do not reflect managers' actual valuations of these investments as of March 31, 2016, because valuations of real and private assets lag behind other assets. Instead, performance figures are based on valuations as of December 31, 2015, adjusted for cash flows during the quarter that ended March 31, 2016.

be shifted to private equity (Table 1). According to the VRS consultant, this shift is likely to provide the trust fund with slightly higher long-term returns than the current targets while keeping a similar risk profile. The board considered other allocation options, but this approach would minimize the transition costs associated with shifting assets from one class to another. The consultant estimated that the new allocation could provide $500 million in savings over the next 20 years relative to the current policy because slightly higher returns are expected regardless of market conditions.

TABLE 1
Trust fund's new asset allocation targets

	Previous target	Change made	New target
Public equity	42%	−2%	40%
Fixed income	15	0	15
Credit strategies	15	0	15
Real assets	15	0	15
Private equity	12	+3	15
Cash	1	−1	0

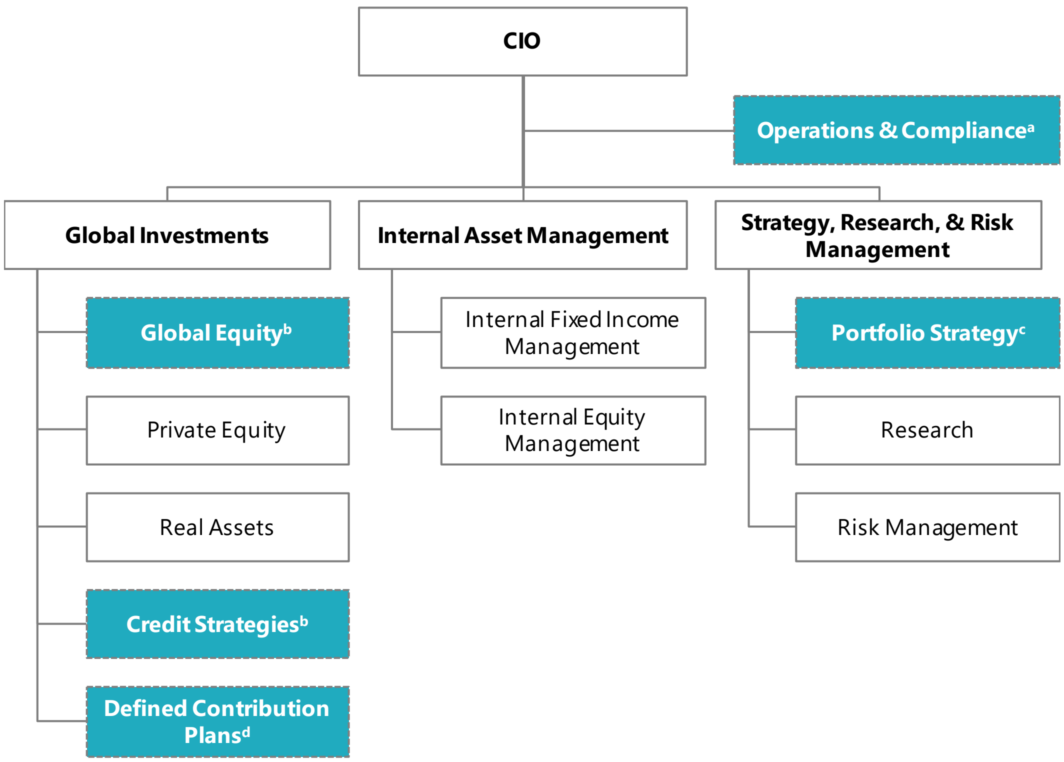
SOURCE: VRS board materials.
NOTE: Previous targets set by board in June 2013, following a prior review of the fund's strategic asset allocation.

Minor changes made to investment department duties and leadership

The VRS investment department is led by the CIO, who oversees three major divisions: global investments, internal asset management, and strategy, research and risk management. VRS recently made several minor changes to division responsibilities and leadership (Figure 4).

VRS restructured the strategy, research and risk management division to allow the division to better focus on its core responsibilities. Previously, this division was responsible for operations and compliance and for overseeing investments held in the VRS defined contribution plans and the strategic opportunities portfolio. In the fall of 2015, the operations and compliance function was moved directly under the CIO and investment oversight responsibilities for the defined contribution plans were moved into the global investments group. A new portfolio strategist position was then created to identify and develop strategies that can be applied across asset classes. The CIO indicated that these actions will allow the group to focus more on research activities that can help guide the department's investment decisions.

FIGURE 4
New VRS investment department structure



SOURCE: VRS investment department.
[a] Operations & Compliance moved here from the Strategy, Research, and Risk Management (SRRM) division. [b] Global Equity and Credit Strategies groups now responsible for strategic opportunities portfolio, which was previously under SRRM. [c] Portfolio Strategy function created in SRRM. [d] Defined Contribution Plans moved from SRRM.

The leadership of two of the three divisions changed in late 2015. The managing director for strategy, research and risk management resigned in 2015, leaving a vacancy. The managing director for internal asset management was transferred into the vacant position. The director of internal equity management was then promoted to managing director of internal asset management.

2. Defined contribution plans

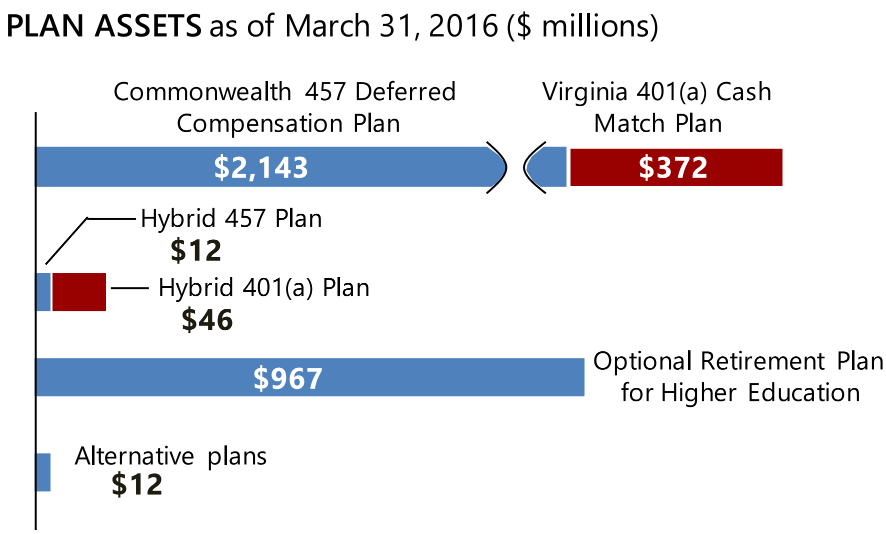
VRS manages several defined contribution plans for its members. Participants in these plans have their own individual accounts, and each participant determines how their money is invested. These accounts accrue funds that the account holders can use in retirement. The defined contribution plans are similar 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 $3.6 billion as of March 31, 2016.

Types of plans

All state employees and most local VRS members may be eligible to participate in one or more of the defined contribution plans managed by VRS (Figure 5). Each plan has its own eligibility rules.

All state employees and some 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. The two plans are intended to supplement employee retirement income, not to serve as primary retirement plans.

FIGURE 5
VRS defined contribution plans



SOURCE: VRS administration department data.
NOTE: Alternative plans include the Optional Retirement Plan for Political Appointees ($12 million), Optional Retirement Plan for School Superintendents ($0.3 million), and Virginia Supplemental Retirement Plan for certain educators ($0.1 million).

Members of the state's Hybrid 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.* Members who make voluntary contributions receive additional cash match contributions from their employers. Together, these plans are intended to be one of the main sources of retirement income for Hybrid Plan members. The other main source of retirement income for these members is their Hybrid Plan defined benefit component.

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 as alternatives to the State Employees or Teachers plans. School divisions may choose to offer the Virginia Supplemental Retirement Plan to certain employees, in addition to the Teachers Plan benefits.

The Optional Retirement Plan for Higher Education is available for faculty at public colleges and universities. Once hired, faculty must make an irrevocable one-time decision to participate either in this plan or in the 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 currently 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. Participants pay a flat administrative fee every year and additional investment fees according to 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

*Hybrid Plan members include most state and local employees hired on or after January 1, 2014. Starting January 2016, hybrid members in the Teachers Plan were given the option to make voluntary contributions to a 403(b) plan that is sponsored by their school division instead of VRS, if their school division elected to offer this option.

investments is automatically adjusted over time to become more conservative as the participant approaches retirement age. The target-date portfolios, which hold $652 million in assets, met or outperformed all of their performance benchmarks.

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, and an option that reflects the investments held by the VRS trust fund. The individual options, which hold $1.9 billion in assets, met or outperformed almost all of their performance benchmarks.

Self-directed brokerage accounts. 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 brokerage account holds $30 million in assets. Because all investment decisions are made by the account holders, there are no performance benchmarks for the self-directed brokerage accounts presented.

TABLE 2
Investment performance for Commonwealth 457, Virginia 401(a), Hybrid and alternative defined contribution plans

for the period ending March 31, 2016

	1 year	3 years	5 years	10 years
Target date portfolios				
Met or exceeded benchmark[a]	10	9	9	4
Total number of options	10	9	9	4
Individual options				
Met or exceeded benchmark[a]	11	11	10	9
Total number of options	11	11	11	9
Self-directed brokerage account[b]				

SOURCE: VRS investment department data.
NOTE: The total number of investment 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.
[a] Passively managed investment options are expected to trail their benchmark indices by the expense ratio (fees) charged by the investment managers. Returns for these options were adjusted to remove the estimated effect of these fees. Actively managed options are expected to outperform the market and were measured against the benchmark without any adjustment for manager fees. Capital preservation investment options, such as stable value and money market funds, are expected to provide returns at or above zero and were assessed relative to that benchmark. [b] There are no benchmarks for measuring the performance of the self-directed brokerage accounts because all investment decisions are made by the account holders.

Optional Retirement Plan for Higher Education

Participants in the Optional Retirement Plan for Higher Education must select one of two private investment managers: TIAA or Fidelity. Participants can then select from among that provider's investment options. Together, TIAA and Fidelity offer 35 different investment options. Some participants in the higher education plan also have accounts with providers that VRS no longer partners with, or "deselected" providers. Participants in the higher education plan pay investment, administrative, and other fees based on the provider and investment options they choose.

TIAA options. Participants in TIAA may select one or more individual options to build a customized investment portfolio according to their personal preferences. The individual options include different types of stock, bond, money market, and real estate funds, and one diversified portfolio option. The TIAA program holds $730 million in assets. The investment options in the TIAA program underperformed most of their performance benchmarks.

Fidelity options. Participants in Fidelity may select from several investment options. Participants 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 according to 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 investment options in the Fidelity program underperformed most of their benchmarks.

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 $44 million in assets.

TABLE 3
Investment performance for the Optional Retirement Plan for Higher Education

for the period ending March 31, 2016

	1 year	3 years	5 years	10 years
TIAA options				
Met or exceeded benchmark[a]	3	3	3	3
Total number of options	10	10	10	10
Fidelity options				
Met or exceeded benchmark[a]	7	7	8	7
Total number of options	24	23	22	20
Deselected providers[b]				

SOURCE: VRS investment department data.
NOTE: Performance is reported net of investment, administrative, and other fees. Total number of investment options can change because longer-term performance data is not available for newer options. One investment option, the TIAA Traditional Annuity, is not included in this investment performance analysis because the rates of return provided to participants are fixed depending on when the participant contracts for the annuity.
[a] Passively managed investment options are expected to trail their benchmark indices by the expense ratio (fees) charged by the investment managers. Returns for these options were adjusted to remove the estimated effect of these fees. Actively managed options are expected to outperform the market and were measured against the benchmark without any adjustment for manager fees. Capital preservation investment options, such as stable value and money market funds, are expected to provide returns at or above zero and were assessed relative to that benchmark. [b] VRS does not track performance of investment options from deselected providers because they are no longer available to participants.

Plan management

VRS manages the defined contribution plans through contracts with private companies. These companies provide account administration and investment management 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 finalizing changes to Optional Retirement Plan for Higher Education

VRS is restructuring the Optional Retirement Plan for Higher Education. Under the plan's current structure, participants choose from two private companies (TIAA and Fidelity) who provide "bundled" administration and investment services. Following a two-year review, VRS determined they should change this structure by (1) shifting to a single plan administrator and a single line-up of investment options and (2) separating the administration and investment functions into discrete contracts. VRS determined that these changes would benefit participants by reducing fees, improving the transparency of fees, and improving management. VRS uses a separate single administrator and investment line-up for its other defined contribution plans.

VRS began to implement structural changes in October 2015 but paused after member institutions and participants raised concerns about losing access to the two existing providers. Member institutions stressed that keeping the existing providers was important for recruiting and retaining faculty. VRS revised its restructuring approach to keep the two existing providers alongside a third option.

Although the revised restructuring approach does not fully address the original goals set by VRS, it will provide participants with an additional choice. The two current providers, and their "bundled" administration and investment structure, will remain in place. Participants will also be able to choose the administrator and investment options that are available under the other VRS defined contribution plans. VRS is currently negotiating fees and investment options with the providers.

VRS has increased its outreach efforts to better communicate changes to the higher education institutions and faculty that participate in the Optional Retirement Plan for Higher Education. VRS staff met with representatives from major institutions, the Faculty Senate of Virginia, and the committee for Virginia Fiscal Officers of Colleges and Universities – State Supported. At these meetings, VRS discussed concerns raised by administrators and faculty about VRS's restructuring approach. VRS also held employer outreach meetings with higher education human resources officers to discuss the new plan structure and implementation. VRS staff are developing materials, including a new website, to better communicate plan options to participants. VRS staff will also visit university campuses during the fall open enrollment period so that they can further discuss the plan's options with participants.

3. Recent legislation

The General Assembly annually considers legislation affecting 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 the retirement system and its costs.

General Assembly accelerated VRS funding schedule by fully funding rates and paying off deferred contributions

Employer contributions are one of the major sources of funding for the VRS retirement plans. The state has historically paid lower employer contribution rates than recommended by the VRS board and actuary. In 2016, the General Assembly passed legislation that begins fully funding employer contributions and pays off the majority of contributions that were deferred from the 2010-2012 biennium.

Employer contribution rates fully funded ahead of schedule

In the 2016 Appropriation Act, the General Assembly chose to fully fund the employer contribution rates that were certified by the VRS board for the 2016-2018 biennium. Rates for the State Employees Plan and plans for state police officers (SPORS), other Virginia state law officers (VaLORS), and judges (JRS) will be funded at 100 percent of the board-certified rates in FY17 and FY18. Rates for the Teacher's plan will be funded at the statutorily required minimum of 89.84 percent of the board-certified rate in FY17, and then 100 percent in FY18. The rate increases represent an additional $283 million contribution to the retirement system over the 2016-2018 biennium.

The General Assembly's decision to fully fund the employer contribution rates starting in FY17 and FY18 puts the state one to two years ahead of its statutory schedule, which requires that rates be fully funded by FY19. By fully funding the rates earlier than scheduled, the state is expected to improve the funded status of the VRS retirement plans and reduce future employer contributions. The fully funded rates will increase plan assets and avoid unfunded liabilities that would otherwise have been incurred. Future contribution rates will be lower, potentially saving the state and localities $242 million in contributions over the next 20 years, provided all other assumptions are met.

Even though the General Assembly has begun fully funding rates, the rates for most plans are close to, or lower than, the partially funded rates that were paid in prior years. Rates enacted for the State Employees Plan and JRS for FY17 are slightly lower than those enacted for FY16. Rates for VaLORS and SPORS are slightly higher. The relatively flat rate-levels are in part attributable to the continued reduction of VRS's unfunded liabilities.

TABLE 4
Employer contribution rates enacted by the General Assembly

	Rate set in Appropriation Act (fiscal year)			
	2015	2016[a]	2017[b]	2018[b]
Teachers	14.50%	14.06%	14.66%	16.32%
State Employees	12.33	14.22	13.49	13.49
VaLORS	17.67	19.00	21.05	21.05
SPORS	25.82	27.83	28.54	28.54
JRS	51.66	50.02	41.97	41.97

SOURCE: Appropriation Acts, 2014-2016.
[a]2015 Appropriation Act increased FY16 employer contribution rates for State Employees, VaLORS, SPORS, and JRS plans to 90% of actuarially recommended rate, after taking into account past one-time payments to the VaLORS and SPORS funds and changes made to the JRS plan in the 2015 session. Act reduced rate for Teachers Plan in FY16 because a one-time $193 million payment was made to the plan, which reduced unfunded liability. [b]2016 Appropriation Act increased FY17 and FY18 employer contribution rates for State Employees, VaLORS, SPORS, and JRS plans to 100% of actuarially recommended rate, after taking into account repayment of deferred contributions from the 2010-2012 biennium. Rate for the Teachers Plan set at statutory minimum 89.84 percent of actuarially recommended rate in FY17 and 100 percent in FY18.

Majority of deferred contributions from 2010-2012 biennium paid off five years ahead of schedule

In 2010, the General Assembly reduced the employer contribution rates paid to VRS to help balance the budget in the aftermath of the recession. The rates that were affected were those in place for the 2010-2012 biennium. The rates paid for most plans during this time span were less than half of the actuarially recommended rates. By deferring rate contributions, the General Assembly created a $1.1 billion unfunded liability. The General Assembly required these deferred contributions to be repaid within 10 years, with final payment due by the end of FY21.

The 2016 General Assembly approved a special one-time payment of $189 million to pay off the remaining balance of deferred contributions for the State Employees, VaLORS, SPORS and JRS plans. The one-time payment is expected to save the state $26.5 million. Savings are reflected in the lower actuarial rates for these plans. For example, the rate for the State Employees Plan was reduced from 14.46 percent of payroll to 13.49 percent of payroll.

The Teachers Plan is now the only VRS plan for which deferred contributions are still owed. The unfunded liability from deferred contributions for this plan is expected to be $269 million at the end of FY16. Although the Teachers Plan was not included in this year's one-time payment, it received a special one-time contribution of $193 million through an appropriation by the 2015 General Assembly.

2016 General Assembly enacted legislation making changes to VRS retirement plans and benefits programs

The General Assembly enacted legislation in 2016 that made several changes to the VRS retirement plans. The most notable changes were the transfer of administrative duties for the Line of Duty Act program to VRS and the Department of Human Resource Management (DHRM), and the establishment of a legislative commission to study and make recommendations relating to the VRS retirement plans.

Line of Duty Act amended to reflect recommendations and options identified in 2014 JLARC study

The 2016 General Assembly made broad changes to Virginia's Line of Duty Act (LODA) program (House Bill 1345). The LODA program provides a lump sum death benefit and lifetime health insurance benefits to public safety officers who are killed or permanently disabled in the line of duty. In an effort to improve the administration and financial sustainability of the LODA program, the legislation

- transferred responsibility for making benefit eligibility determinations from the Department of Accounts (DOA) to VRS;
- created an administrative appeals process for eligibility determinations;
- transferred responsibility for administering health insurance benefits from the DOA to DHRM;
- created a separate, standardized health insurance plan for LODA beneficiaries, which will be administered by DHRM; and
- eliminated benefits when beneficiaries reach the age of 65, except for the most severely disabled individuals. This provision only applies to individuals who become eligible on or after July 1, 2017.

The changes made to the LODA program in 2016 were developed by a workgroup that included representatives of VRS, DHRM, DOA, JLARC, localities, and public safety groups. The workgroup originated with a 2014 JLARC report, which had identified options for improving the LODA program's administration and financial sustainability.

Legislative commission established to review VRS retirement plans and government workforce issues

The 2016 General Assembly created the Commission on Employee Retirement Security and Pension Reform to study and make recommendations relating to the VRS retirement plans and workforce issues (House Bill 665). The commission has been tasked with examining the following:

- Financial soundness of the VRS retirement plans for state and local employees;
- Strategies for reducing unfunded liabilities under the VRS plans;

- Suitability of the VRS plans for the current workforce;
- Retirement plan attributes that will be suitable for the future workforce;
- Impact of the anticipated retirement of state and local government employees between 2016 and 2026;
- Strategies for replacing retiring employees; and
- Elements of compensation and benefits packages that are essential to attracting and retaining a highly productive state and local government workforce.

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.

TABLE 5
VRS legislation enacted by 2016 General Assembly

Benefits and eligibility

HB 1245	**Extend mandatory retirement age for judges.** Extends the mandatory retirement age for all judges from 70 to 73, regardless of when elected by the General Assembly. The mandatory age was previously extended for some, but not all, judges. Effective June 1, 2017.
HB 1345	**Line of Duty Act revisions.** Enacted several changes to the Line of Duty Act, including transferring overall administration responsibilities from the Department of Accounts to VRS and health insurance benefits to the Department of Human Resources. Created separate health benefit plans. Effective July 1, 2017.
Appropriation Act item 269	**Regional jail opt-out of Line of Duty Act.** Allows the Rappahannock, Shenandoah, and Warren Regional Jail Authority to opt out of the VRS-administered Line of Duty Act fund.

Rates and funding

Appropriation Act item 467(Z) § 3-1.01(DDD)	**Repayment of $189 million deferred contributions.** Provides funds to repay $189 million in employer contributions deferred from the 2010-2012 biennium. Item 467(Z) directs payment of $172.7 million and § 3-1.01(DDD) directs payment of $16.2 million and $0.6 million.
Appropriation Act item 475(H-K)	**VRS rates for 2016-2018 biennium.** Sets employer contribution rates for Teachers, State Employees, VaLORS, SPORS, and JRS defined benefit plans; requires political subdivisions to adopt actuarial rates, with some exceptions; sets rates for other benefits programs

VRS legislation enacted by 2016 General Assembly – *continued*

Studies

HB 665	**Commission on Employee Retirement Security and Pension Reform.** Establishes legislative commission to study and make recommendations relating to the VRS retirement plans and workforce issues. VRS will provide staff and financial support, and the VRS director will serve on the commission in an ex officio nonvoting capacity.
Appropriation Act item 491(B)	**Support for Commission.** Allows VRS to provide up to $300,000 in financial support, per fiscal year, to the Commission on Employee Retirement Security and Pension Reform.

Other

HB 409 SB 51	**Technical corrections.** Makes technical corrections to terms used in descriptions of the purchase of prior service program and Hybrid Retirement Plan
HB 1343	**Virginia Research Investment Committee.** Establishes the Virginia Research Investment Committee, and Fund, to provide grants and loans to promote research, development, and commercialization in the state. The General Assembly may specifically designate a portion of the moneys appropriated to the fund to be invested by VRS.
Appropriation Act item 428(B)(U)	**Real estate sale proceeds directed to GO Virginia.** Directs the proceeds from sales of state-owned real estate to be deposited in the Virginia Research Investment Fund, to be managed by VRS.
Appropriation Act item 489(D)	**VOLSAP reimbursement.** Restores a previous general fund appropriation that reimburses VRS for the cost associated with managing funds for the Volunteer Firefighters' and Rescue Squad Workers' Service Award Program (VOLSAP) fund. Also allows VRS to use any funds forfeited under the program to help pay for fund management.
Appropriation Act § 4-5.02(a)	**Foreign securities litigation.** Allows VRS to enter into agreements to seek recovery of investment losses in foreign jurisdictions without having to conduct an open negotiation with a law firm for services.
Appropriation Act item 489(E)	**Notification of political subdivisions in arrears.** Requires VRS to notify the chairmen of the House Appropriations Committee and Senate Finance Committee when a political subdivision becomes more than 60 days in arrears in their contributions to VRS.

SOURCE: Virginia Legislative Information System.

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 electronic posting of board materials, the continued implementation of the Hybrid Plan, and the appointment of board members.

Information on VRS board meetings will be posted electronically

VRS is high-profile agency with a statewide constituency. The VRS board routinely makes decisions that affect the system's members, participating employers, and the state and local governments who share responsibility for funding the VRS plans. The board's decisions are therefore of great interest to many parties throughout Virginia.

The VRS board conducts its business in an open and transparent manner. Board and committee meetings are open to the public, and printed materials are made available at the start of each meeting. Members of the public may request copies of meeting materials. VRS also provides advance copies of materials to the Office of the Attorney General, legislative staff, state agencies, and governmental associations. To discuss sensitive issues, such as personnel decisions, legal matters, and pending procurements, the board and its committees enter into closed sessions, as allowed under the state's Freedom of Information Act. VRS has established an internal process for determining if and when closed sessions are needed.

Following a recommendation by JLARC staff, VRS will begin electronically posting its board and committee meeting agendas and minutes. Electronically posting agendas in advance of meetings allows constituents to quickly and easily determine if they should attend the meeting. Posting minutes allows constituents to determine what actions were taken by the board, or its committees, and the rationale behind them. Constituents can currently request this information from VRS, but making the information readily available on the VRS website will make it more accessible. Posting materials electronically will align VRS with other public bodies in Virginia and public retirement funds in other states.

Proportion of Hybrid Plan members that make voluntary contributions is small but growing

The Hybrid Plan combines elements of a traditional defined benefit retirement plan with a 401(k)-style defined contribution plan. Hybrid Plan members include most state employees, teachers, and local employees hired on or after January 1, 2014, and now constitute 14 percent of the total active VRS membership. (State employees in the SPORS and VaLORS plans, and local employees with enhanced hazardous duty benefits, are not part of the Hybrid Plan.) The Hybrid Plan has lower costs and liabilities than the defined benefit plans it replaced, and is expected to gradually reduce state and local retirement costs as it grows to cover an increasing proportion of the workforce.

Voluntary member contributions to the defined contribution component of the Hybrid Plan have increased steadily since the plan opened but remain low overall. As of March

Hybrid plan contributions

Hybrid plan members contribute a total of 5% to 9% of salary toward their retirement benefits.

Members must contribute 4% of salary toward their defined benefit component.

Members are required to contribute 1% of salary to their defined contribution component and may voluntarily contribute up to an additional 4%.

Employers are required to match member contributions to their defined contribution component. Employers match the mandatory 1% of salary and provide up to an additional 2.5% in contributions, based on members' voluntary contributions.

31, almost 13 percent of members have chosen to make voluntary contributions. The level of participation has increased steadily since the plan was implemented, but only a small portion of hybrid plan members make voluntary contributions.

The low rate of voluntary contributions raises concerns that many Hybrid Plan members may not have adequate savings to retire. A Hybrid Plan member who only makes the minimum required one percent contribution to the defined contribution component, and retires at 65 with 30 years of service, would receive a benefit equal to about one-third of their final salary. This benefit may not be enough to allow the member to retire, even after social security benefits are included. By comparison, members in the traditional Plan 1 and Plan 2 pension groups would receive benefits equal to about half of their final salary and would be better able to retire.

VRS has continued its campaign to educate members and participating employers on the importance of voluntary contributions. For its website, VRS developed an online "toolkit" that employers can use to better educate members, and a "benefits calculator" that members can use to see how increased contributions will affect their retirement savings over time. VRS also continues to contact members through a mailing campaign.

Voluntary contribution rates should increase in the near future due to the automatic rate escalation that will occur in January 2017. Under this automatic escalation, the voluntary contributions made by each member will increase by 0.5 percent unless the member actively decides to not allow the increase. The increase applies to all members, regardless of hire date, unless they already contribute the maximum four percent in voluntary contributions. VRS has developed a communications campaign to make members aware of the approaching automatic escalation. The escalation provisions were set forth in the statute that created the Hybrid Plan.

In 2015, VRS examined ways that voluntary contributions could be increased by changing aspects of the Hybrid Plan's design. These changes are expected to be taken into consideration by the newly created Commission on Employee Retirement Security and Pension Reform.

Board members appointed

J. Brandon Bell, II was appointed to the VRS board by the governor in April 2016, subject to confirmation by the General Assembly. His term will expire in 2021. Bell is the principal manager of Brandon Bell Financial Partners and is a certified retirement planning counselor. He serves as one of the board's statutorily required investment professionals.

Wallace G. "Bo" Harris was reappointed to a second term by the General Assembly's Joint Rules Committee in April 2016. He was originally appointed to the board in 2012. His new term will expire in 2021. A professor at the University of Richmond, Harris is a retired state employee and serves as the board's statutorily required state employee representative.

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.

VRS OVERSIGHT REPORT JULY 2016

JLARC.VIRGINIA.GOV

General Assembly Building

201 N. 9th Street, Suite 1100 Richmond, VA 23219