Commonwealth of Virginia
July 9, 2018

Report to the Governor and the General Assembly of Virginia

VRS Oversight Report

JULY 2018

JLARC
JOINT LEGISLATIVE AUDIT AND REVIEW COMMISSION

Joint Legislative Audit and Review Commission

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Overview

The Virginia Retirement System (VRS) administers retirement plans and other benefits programs for state employees, teachers, and employees of most local governments and political subdivisions. The two largest plans are the Teachers Plan and the State Employees Plan (Figure 1). Other pension plans include the individual retirement plans for 592 local political subdivisions and plans for state police officers (SPORS), other Virginia state law officers (VaLORS), and judges (JRS). VRS also administers several defined contribution retirement plans. In addition to retirement plans, VRS administers post-employment benefit programs. These include life insurance, sickness and disability, long-term care, and the retiree health insurance credit program. VRS also conducts eligibility determinations and fund administration for Virginia's Line of Duty Act.

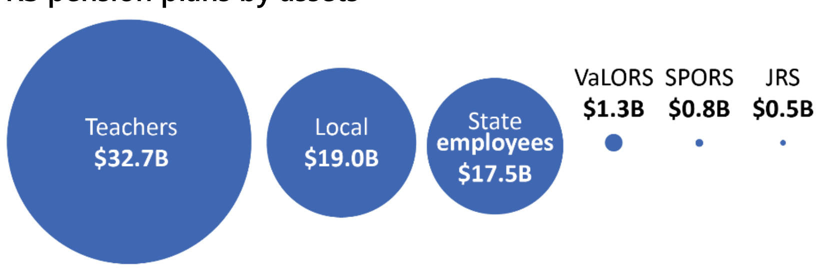
VRS serves approximately 704,000 members, retirees, and beneficiaries. Active members include current state and local employees and teachers in Virginia's public school divisions. Others served by VRS include retirees, their designated beneficiaries, and "deferred" members, who are not actively employed and are not currently collecting benefits.

The financial assets used to pay VRS benefits are pooled in the VRS trust fund, which held $78.1 billion in assets as of March 31, 2018. Ranked by value of assets, VRS is the nation's 20th largest public or private pension fund. In FY17, VRS paid $4.5 billion in retirement benefits and $0.4 billion in other post-employment benefits, not including benefits paid through the defined contribution plans.

VRS receives funds from three main sources: employer contributions, member contributions, and investment income. In FY17, VRS received $6.8 billion in net additions to the trust fund (accounting for expenses and benefits paid out).

Investment income is critical to the health of the VRS trust fund, accounting for two-thirds of total additions in FY17. VRS investments generated a return of 9.9 percent for the one-year period ending March 31, 2018. The total annualized return over the 10-year period was 5.9 percent, which is below the 7.0 percent long-term (30+ year) rate of return that has been assumed by VRS for its investments.

FIGURE 1
VRS pension plans by assets



SOURCE: VRS 2017 valuation report.
NOTE: Figures show total actuarial value of assets attributable to each retirement plan as of June 30, 2017. Trust fund assets attributable to other benefit programs are not shown. Figure for local plans is the aggregate of assets for political subdivisions that participate in VRS. Local plans hold more assets than the State Employees plan because they have typically been fully funded by local employer contributions, whereas the State Employees plan has not been fully funded in the past. The State Employees plan is larger than the local plans as measured by pension obligation.

FIGURE 2
VRS fast facts

MEMBERSHIP as of March 31, 2018

348,946	Actively employed members[a]
205,693	Retired members & beneficiaries
149,375	Inactive members
704,014	Total

NET ADDITIONS for fiscal year ending June 30, 2017[b]

$2.6 billion	Employer contributions
$1.1 billion	Member contributions
$8.2 billion	Net investment income
-$5.1 billion	Benefits paid and other expenses[d]
$6.8 billion	Net additions

ASSETS as of March 31, 2018

$78.1 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of March 31, 2018

	1 year	3 years	5 years	10 years
Total return	9.9%	6.9%	8.1%	5.9%
Benchmark	10.0%	6.6%	7.7%	5.5%
Excess return	-0.1%	+0.3%	+0.4%	+0.4%

SOURCE: VRS 2017 annual report and 2018 membership and investment department data.
[a] Active membership included 152,341 teachers, 108,181 local government employees, and 88,424 state employees, state police, law enforcement officers, and judges. Within the retirement plans are three different benefit groups. Active membership by benefit group included 175,711 in Plan 1, 88,431 in Plan 2, and 84,804 in the Hybrid Plan. [b] Includes all additions and deductions to the trust fund for VRS retirement plans and other benefits programs. [c] Includes approximately $1.1 billion in state contributions. [d] Includes $4.5 billion in retirement benefit payments, $392 million in other benefits, $120 million in refunds, and $64 million in administrative and other expenses.

1. Trust fund investments

Management of the 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 investment department manages investment programs within the guidelines set by the board. The investment department manages approximately one-third of the assets in-house and contracts with external managers to manage other assets.

VRS's long-term return assumption is seven percent. 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 a key factor in determining funded status and in setting employer contribution rates.

The long-term return assumption is developed with input from VRS investment staff, the plan actuary, investment managers, and consultants, and adopted by the board.

Investment performance and asset allocation

The VRS trust fund held $78.1 billion in assets as of March 31, 2018, an increase of $5.6 billion from a year ago. Approximately $27.1 billion of the trust fund was managed in-house, including all fixed income and some public equities, real assets, and cash. The remaining $51 billion was managed by external managers under VRS supervision.

The trust fund's investment returns generally outperformed fund benchmarks but were mixed compared to the long-term return assumption. For the one-year period ending March 31, the trust fund's investments achieved a return of 9.9 percent, just below the 10 percent benchmark for that time period. The total fund returns exceed benchmarks for the three-year, five-year, and 10-year period. The fund's one-year and five-year returns have exceeded the 7.0 percent long-term (30+ year) rate of return that has been assumed by VRS for its investments, while the three-year and 10-year returns were below the long-term rate of return (Figure 3).

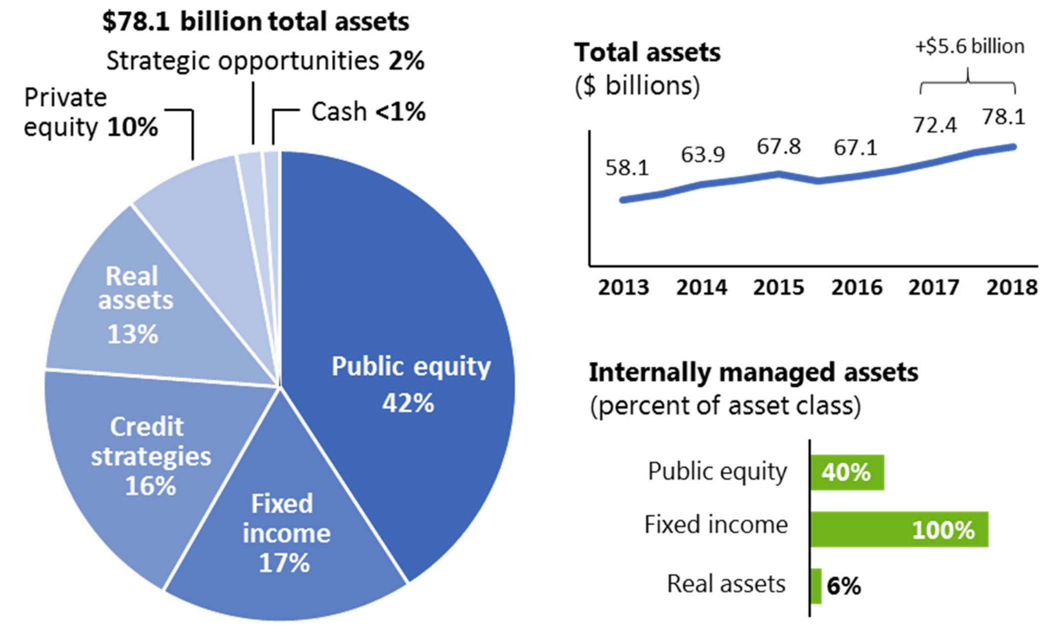
Public equity. The public equity program continues to be the largest VRS asset class, with $32.7 billion in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and abroad. Public equity investments are typically higher-risk investments relative to bonds and are expected to provide long-term capital growth and inflation protection. Forty percent of the program's assets are managed in-house. The program met or outperformed its benchmark for all periods except the one-year and fiscal year to date (first three quarters of FY18). Public equity underperformance over the past year can be attributed to relative underperformance of the defensive and value-oriented equities, equity hedge funds, and emerging market stocks held by VRS.

Credit strategies. The credit strategies program is the second-largest VRS asset class, with $12.5 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 should also provide favorable risk-adjusted returns. All the program's assets are managed externally. The program outperformed its benchmarks for all periods.

Fixed income. The fixed income program is the third-largest VRS asset class, with $12.1 billion of invested assets. The program consists of U.S. dollar-denominated securities, such as bonds and money market instruments, that pay a specific interest rate. Fixed income investments, which are typically lower risk compared to most other asset classes, are expected to perform better than equities when equity markets are down. All fixed income assets are managed in-house. The program outperformed its benchmarks for all periods.

FIGURE 3
Asset allocation and trust fund investment performance

ASSET ALLOCATION as of March 31, 2018



TRUST FUND INVESTMENT PERFORMANCE
for the period ending March 31, 2018

	FY to date	1 year	3 years	5 years	10 years
Total fund	6.6%	9.9%	6.9%	8.1%	5.9%
VRS custom benchmark	6.7	10.0	6.6	7.7	5.5
Public equity	9.1	13.3	7.7	9.8	6.5
Benchmark	9.5	13.5	7.6	9.4	6.1
Fixed income	0.1	1.7	1.8	2.3	4.5
Benchmark	−0.2	1.2	1.2	1.8	3.7
Credit strategies	4.8	6.9	5.5	5.7	6.7
Benchmark	3.7	5.6	5.0	5.1	5.7
Real assets	5.7	8.4	9.9	11.2	6.2
Benchmark	4.5	6.7	8.3	9.3	5.9
Private equity	12.9	21.4	14.4	15.0	9.7
Benchmark	16.4	24.6	13.0	15.4	9.9
Strategic opportunities	7.0	7.2	3.5	3.9	n/a
Benchmark	7.1	9.8	5.6	4.4	n/a

SOURCE: VRS investment department data.
NOTE: Fixed income portion of asset allocation includes the fund's rebalance account. Figures may not sum due to rounding.

Real assets. The real assets program is the fourth-largest VRS asset class, with $10.2 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 to the public equity market. Most VRS 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 $7.5 billion in assets.* Private equity is an alternative to traditional public equity and generally consists of ownership in 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. The program met or outperformed its benchmarks in the three-year period but underperformed in all other periods. The program achieved its intended purpose—to earn higher returns than the public equity program in all periods—including a 21.4 percent return during the one-year period. According to VRS staff, private equity investments tend to be less volatile than public equity investments, therefore, shorter-term underperformance is not uncommon for the private equity portfolio in periods of strong performance by the public equity market (The private equity benchmark reflects public equity market plus a 2.5 percent premium.) Longer-term underperformance of private equity is less common but typically occurs after a particularly strong public equity market run.

Strategic opportunities. The strategic opportunities portfolio is the smallest asset class, with $1.8 billion in assets. The portfolio allows VRS to gain experience with new investment approaches. This portfolio includes three multi-asset class public investment managers and two multi-asset class private investment managers. All strategic opportunities assets are managed externally. The portfolio underperformed its benchmarks for all periods since the portfolio was established in 2013. The portfolio did not fare well against its equity-dominated benchmark in the current strong market environment. VRS staff indicated that this is to be expected, as the portfolio is intended to diversify away from equity and the associated risk, and to focus on absolute returns. Furthermore, according to VRS staff, this portfolio contributes additional value by providing opportunities for the investment department to acquire exposure to new investment opportunities.

Investment policies and programs

The VRS board sets investment policies, and the professionals in the investment department implement programs to fulfill those policies. In recent months, the board

*Performance figures for the real assets and private equity programs do not reflect managers' actual valuations of these investments as of March 31, 2018 because valuations of real assets and private equity have a timing lag behind other assets. Instead, performance figures are based on valuations as of December 31, 2017, adjusted for cash flows during the quarter that ended March 31, 2018.

approved changes to the fund's asset allocation and benchmarking and, with the assistance of a consultant, began a review of compensation for investment professionals.

The **Multi-Asset Public Strategies** portfolio will be composed of (1) Dynamic Strategies, which are multi-asset opportunistic asset allocation approaches, and (2) Risk-Based Investments, which are uncorrelated and diversifying strategies.

The **Private Investment Partnership** portfolio will include multi-asset private investments.

Board adopted changes to asset allocation and total benchmarking

The VRS board adopted changes to trust fund asset allocation and benchmarking that will go into effect beginning July 1, 2018. The changes include ungrouping the Strategic Opportunities Portfolio into its component parts, thereby creating two new portfolios, the Multi-Asset Public Strategies and Private Investment Partnership (sidebar).

The new portfolios will affect the fund's target asset allocation. Previously, the fund's asset allocation policy did not have a target asset allocation for the Strategic Opportunities Portfolio, but instead, had an allowable range of up to five percent of total fund assets. The Strategic Opportunities Portfolio had an allocation of 2.3 percent of the total fund as of March 31, 2018. Beginning July 1, 2018, the two new portfolios—Multi-Asset Public Strategies and Private Investment Partnership—*will* have target asset allocations established in policy. The target asset allocation will be three percent and two percent of the total fund, respectively. According to the VRS CIO, the ungrouping of the Strategic Opportunities Portfolio into its component parts reflects the evolution of the portfolio. Furthermore, the change to the fund's asset allocation allows for easier management of the fund's overall asset allocation because the target asset allocation for other asset classes will now reflect inclusion of the additional portfolios.

Furthermore, the VRS board approved benchmarks for the new Multi-Asset Class Public Strategies and Private Investment Partnership portfolios. According to VRS staff, the benchmarks reflect the investment philosophy and the intended risk parameters within the strategies and provide a good measure of the investment results. The benchmarks of the two new portfolios will be included, on a weighted percentage basis, in the total fund benchmark.

VRS board will conduct review of its compensation plan for investment professionals

The VRS board, with the assistance of McLagan, VRS's compensation consultant, will conduct a comprehensive review of the competitiveness and appropriateness of the VRS investment professionals' pay plan. The review will examine whether

- individual salary and incentive pay is aligned with the competitive market and VRS's pay philosophy;
- the pay plan is considered fair, reasonable and appropriate by key board and employee stakeholders;
- the pay plan reflects market best practices relative to incentive plan design; and
- the pay plan continues to help VRS attract, retain, and motivate qualified investment talent.

As part of the review, McLagan plans to conduct pay level analysis, including peer group analysis, to show how VRS's salary and incentive opportunities compare to the broader market. McLagan will also identify the current pay plan's strengths and opportunities for improvement, then meet with VRS stakeholders to discuss advantages and disadvantages of various alternatives. McLagan will present its findings to the board along with recommendations, if any, for changes to VRS's compensation plan.

VRS's compensation consultant last reviewed the competitiveness of the investment professionals' pay plan in 2014 and again in 2016. The review is prompted, in part, by JLARC members' ongoing interest in the compensation of VRS investment professionals.

VRS began reporting carried interest

VRS began reporting carried interest in response to legislation adopted by the 2017 General Assembly. The legislation implemented a recommendation, made by the Commission on Employee Retirement Security and Pension Reform, to regularly report investment performance and expenses, including carried-interest (often referred to as profit sharing).

Carried interest is a share of profits that private equity or hedge fund managers receive as incentive compensation. Carried interest seeks to motivate a fund manager to work toward maximizing returns.

Allowing external investment managers to share in a portion of the profits through carried interest incentivizes high performance. Carried-interest arrangements apply to VRS's alternative investments such as private equity, real estate, and hedge funds. According to VRS staff, carried-interest arrangements are important in gaining access to top-tier active managers in the area of alternative investment, which can deliver strong absolute returns or protect capital during volatile market conditions. VRS staff indicated that alternative investments, such as private equity and real estate, have generated the highest absolute net returns to the plan over the past 10 years, and hedge fund managers have provided capital protection during volatile market conditions.

VRS staff reviewed historic investment returns to calculate the aggregate carried interest paid by the fund for calendar year 2016 and since fund inception. VRS's carried-interest arrangements typically specify that 80 percent of returns in excess of an annualized eight percent rate of return are kept by VRS. The remaining 20 percent of that excess return is paid to the investment manager in the form of carried interest. The VRS investment department reports that, since inception, carried-interest arrangements have resulted in $21.9 billion in excess returns, of which $18.1 billion was kept by VRS and $3.8 billion was paid to external managers.

2. Defined contribution plans

VRS manages several defined contribution plans for its members. All state employees and many local VRS members may be eligible to participate in one or more of the plans (Table 1). Participants in these plans have their own accounts, and individual participants determine how their money is invested. The defined contribution plans are similar in structure to private sector 401(k) plans or personally owned individual retirement accounts (IRAs).

TABLE 1
VRS defined contribution plans (As of March 31, 2018)

Plan	Description	Assets ($M)
Deferred compensation and cash match	State employees, and some local VRS members, can choose to make voluntary contributions to their Commonwealth 457 deferred compensation plan to supplement their retirement income. Most state employees receive a modest cash match from employers in their Virginia 401(a) cash match plan. [a]	$3,078
Optional retirement plan for higher education [b]	Faculty at public colleges and universities may make an irrevocable one-time decision to participate in this defined contribution plan instead of 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.	$1,020
Hybrid	State and local members of the hybrid plan are required to contribute to their Hybrid 401(a) plan and can choose to make voluntary contributions to their Hybrid 457 plan. Employers make mandatory contributions to participant's 401(a) accounts and match a portion of voluntary contributions made by members. Members are also enrolled in the hybrid plan's defined benefit component.	$287
Other [c]	Optional retirement plans can be offered as alternatives for political appointees (in place of the VRS State Employee plan) and school superintendents (in place of the VRS Teachers plan).	$15

SOURCE: VRS administration and investment department data.
[a] Most political subdivisions do not have a cash match plan. [b] The following institutions administer their own optional higher education plans: George Mason University, Virginia Commonwealth University, the University of Virginia, Virginia Tech and the College of William and Mary. Faculty at these institutions are not eligible to participate in the VRS optional plan for higher education. [c] The amounts held in the other plans are as follows: Optional Retirement Plan for Political Appointees, $14.8 million; Optional Retirement Plan for School Superintendents, $0.2 million; and Virginia Supplemental Retirement Plan for certain educators, $0.1 million.

Some of the VRS defined contribution plans are intended to provide primary retirement benefits, whereas others are intended to supplement pension benefits. The aggregate value of participant accounts held in the VRS-managed defined contribution plans was $4.4 billion as of March 31, 2018.

Plan performance

Participants in the VRS defined contribution plans may choose from 21 different investment options available through the defined contribution plan (DCP). These options include (1) diversified target-date portfolios, (2) individual investment options, and (3) self-directed brokerage accounts. Participants pay a flat administrative fee every year and additional investment fees according to the options they select. Participants in the Optional Retirement Plan for Higher Education may choose to invest in options available through VRS's DCP lineup or in options available under two other providers, TIAA and Fidelity. Participants in these plans pay investment, administrative, and other fees based on the provider they choose and the investment options they select.

Defined contribution plans (DCP)

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, which hold $1.1 billion in assets, met or exceeded all of their performance benchmarks (Table 2).

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 a fund that reflects the investments held by the VRS trust fund. The individual options, which hold $2.2 billion in assets, met or exceeded nearly all of their performance benchmarks (Table 2). One option failed to meet its one-year benchmark.

Self-directed brokerage accounts. The brokerage accounts allow participants to select from thousands of publicly traded mutual funds, exchange-traded funds, and individual securities. Participants who use brokerage accounts have full control over their investments, down to the individual securities held in their portfolio. The brokerage accounts hold $43 million in assets. Because all investment decisions are made by the account holders, no performance benchmarks for the brokerage accounts are used.

Optional Retirement Plan for Higher Education

Participants in the Optional Retirement Plan for Higher Education (ORPHE) can choose from among the DCP options or from options available through TIAA or Fidelity. Under TIAA, participants may select a diversified portfolio option or build a custom portfolio from different types of stock, bond, money market, and real estate funds. Under Fidelity, participants may select a target-date portfolio or build a portfolio from a choice of investment options. Both also offer self-directed brokerage accounts. The TIAA and Fidelity programs hold nearly $1 billion in assets. The investment options under TIAA underperformed a majority of their benchmarks across all periods. The options under Fidelity met or exceeded most benchmarks in the one-, three-, and five-year periods, but have underperformed a majority of benchmarks in the 10-year period (Table 2).

An additional $51 million is held with private providers that VRS no longer partners with under the higher education retirement plan. VRS does not track investment performance for these deselected providers because participants can no longer contribute to them through the plan.

TABLE 2
Investment performance of VRS defined contribution plans

for the period ending March 31, 2018

	1 year	3 years	5 years	10 years
Options available for all plans				
Target-date portfolios				
Met or exceeded benchmark	10	10	9	8
Total number of options	10	10	9	8
Individual options				
Met or exceeded benchmark	9	10	10	9
Total number of options	10	10	10	9
Additional options under the higher education plan				
TIAA				
Met or exceeded benchmark	5	4	4	3
Total number of options	10	10	10	10
Fidelity				
Met or exceeded benchmark	19	17	17	9
Total number of options	21	20	20	19

SOURCE: VRS investment department data.
NOTE: (1) Total number of investment options reported for a given period can change because longer-term performance data is not available for newer options. (2) Performance of target-date and individual options is reported net of investment fees but not administrative fees. Performance of the additional options under the higher education plan is reported net of investment and embedded record-keeping and plan administration fees, where applicable. (3) Some funds are passively managed. Passively managed investment options are expected to trail their benchmarks by the expense ratio (fees) charged by the investment managers. 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 generate returns at or above zero and were assessed relative to that benchmark. (4) Performance for Fidelity' Dividend Growth Fund, Low-Priced Stock Fund, and Diversified International Fund is not included because performance relative to benchmark for those options had not yet been resolved at the time of compilation of this report.

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. Two VRS board members serve on the committee, and the remaining members are appointed by the board. The committee provides guidance to the board and staff.

Higher education employees slow to adopt VRS defined contribution plan

Starting in January 2017, participants in ORPHE were able to select from the defined contribution plan (DCP) investment options available under the deferred compensation, hybrid, and other defined contribution plans. The DCP generally charges lower fees to customers compared to similar investment options offered by TIAA and Fidelity due to how plan fees are structured. VRS made the DCP available to provide lower-cost and more transparent options for higher education employees.

As of March 2018, only 58 ORPHE account holders had selected the DCP option. The vast majority (approximately 11,000) of ORPHE participant accounts are still invested with TIAA and Fidelity. Because of the slow adoption of DCP options, most ORPHE members are likely paying higher investment fees for similar products offered by TIAA and Fidelity.

College of William and Mary opts out of Optional Retirement Plan for Higher Education

The College of William and Mary (CWM) opted out of ORPHE and elected to begin offering its own retirement plan effective January 1, 2018. In doing so, CWM joined several other higher education institutions that administer their own optional plans, including George Mason University, Virginia Commonwealth University, the University of Virginia, and Virginia Tech. Faculty at these institutions are not eligible to participate in ORPHE.

The CWM opt-out resulted in approximately $179 million ($138 million and $41 million in assets from TIAA and Fidelity respectively) being transitioned from ORPHE to CWM's plan.

3. Legislation enacted in 2018

Through legislative action, the General Assembly can adjust contribution rates and funding, benefits and eligibility, and other aspects of VRS retirement plans and benefits programs. In 2018, the General Assembly enacted legislation that will affect VRS (Table 3).

TABLE 3
VRS legislation enacted by 2018 General Assembly

HB 846 **SB 248**	**Technical amendments.** Makes technical amendments to the pensions, benefits, and retirement portion of the Code, Title 51.1, clarifying that the medical board may include "other health care professionals" in addition to physicians; clarifying that only full-time federal civilian service may be purchased as membership credit; and giving flexibility in the type of optional long-term care benefits offered.
HB 908	**Change to FOIA requirement[a] (affects public VRS meetings).** Removes a Freedom of Information Act requirement that the remote locations from which members of a public body participate in meetings through electronic communication means be open to the public. The new provision requires that members of the public be allowed to witness the meeting via electronic communication if a member of the public body is participating remotely.

SOURCE: Virginia Legislative Information System and VRS.
[a] Affects public meetings for all public bodies, not solely VRS.

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. Current topics related to benefits administration and agency management include a decrease in the voluntary contribution rate among hybrid plan members, an update of board governance policy and committee charters, and progress of VRS's information technology modernization effort.

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 also required to contribute to a member's defined benefit component at the actuarially determined rate. Employers are required to contribute 1% of salary toward a member's defined contribution component and up to an additional 2.5% in matching contributions.

Hybrid plan voluntary contribution participation rate declines as new employees are hired

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 constitute 24 percent of the total active VRS membership as of March 31, 2018. (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 provides a lesser defined benefit than the defined benefit plans it replaced. Therefore, it has lower employer costs and liabilities and is expected to gradually reduce costs for the state and most localities as it grows to cover an increasing proportion of the workforce.

To achieve retirement outcomes similar to those of Plan 1 and Plan 2, members of the hybrid plan must make voluntary contributions to the defined contribution component of their plan. Voluntary contributions allow hybrid plan members to benefit from the applicable employer match and thereby enhance their retirement benefit. The percentage of hybrid plan members making voluntary contributions peaked at over 80 percent in early 2017 due to a statutory automatic escalation of the members' voluntary contribution rate (and associated employer match) that took place in January of that year. The statutory escalation brought participants into the voluntary contribution component of the program unless they opted out.

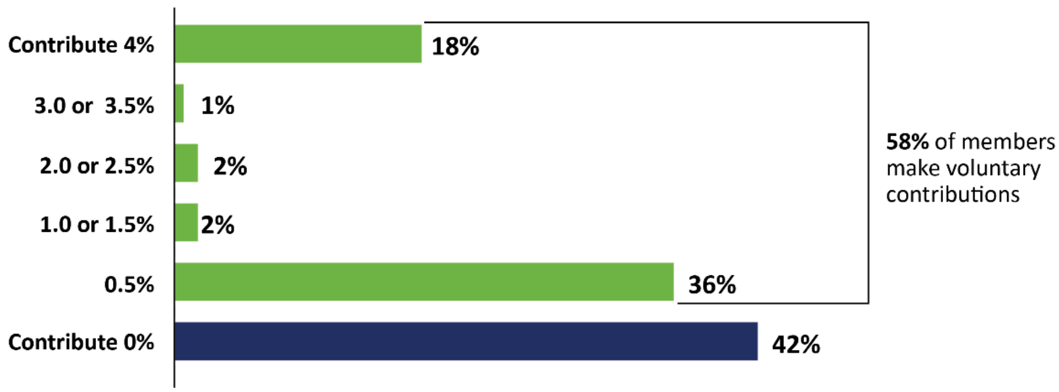
The percentage of hybrid plan members making voluntary contributions has dropped to 58 percent as of March 31, 2018, and will likely continue to decline over the next few years. This is not because a large number of employees stopped contributing, but because employees hired after September 1, 2016, were not subject to automatic escalation in 2017 and will not receive an automatic escalation until the next round in 2020. Therefore, the proportion of members who make voluntary contributions will likely decline until the next automatic escalation takes place in 2020, as most new employees do not initiate the voluntary contribution.

An **automatic escalation** of 0.5 percent occurs every three years for voluntary member contributions to the defined contribution component of the hybrid plan, as required under statute (§ 51.1-169 C.3). Members can opt not to allow the increase, or they can choose a different increase amount.

Most hybrid plan members who are making voluntary contributions only contribute the 0.5 percent of their salary that was initiated by the automatic escalation (Figure 4). For members who do not actively elect to increase their contribution rates, it will take 24 years to reach the maximum contribution amount of 4.0 percent, because the 0.5 percent automatic escalation of their voluntary contribution rate occurs just once every three years.

The percentage of hybrid plan members who *actively* elect to make voluntary contributions beyond the 0.5 percent automatic escalation has risen and is now at 22 percent. Most of those members who have actively elected to contribute are making the maximum contribution of 4.0 percent.

FIGURE 4
Percentage of hybrid plan members making voluntary contributions by contribution amount, March 2018



SOURCE: VRS.
NOTE: Does not sum due to rounding.

VRS continues to explore ways to increase voluntary contribution rates of hybrid plan members through campaigns and online tools designed to educate and increase awareness among employers and employees. VRS has implemented self-directed automated escalation, called SmartStep, that allows members to set a schedule to increase their contributions according to their preferences and sends reminders to encourage action. VRS has also implemented new account access messaging. The messaging requires hybrid members to take action upon signing into their online defined contribution plan account—either increasing voluntary contributions or actively choosing not to do so—before they can proceed to their account information.

Committee charters updated by VRS board

The VRS board amended its board governance policy and all committee charters in November 2017 after a comprehensive review of the board's governance documents by VRS staff. The purpose of the review was to standardize the language across the governance policy and the committee charters, standardize certain provisions in the committee charters to ensure consistency within the documents, and to clarify the duties and responsibilities for individuals and entities that are addressed in the governance policy and committee charters. These changes did not materially change the roles or duties of the board or committees.

New online services launched as part of IT modernization effort

VRS has launched new online services as part of its ongoing IT modernization effort. Online services are meant to reduce the use of paper forms, provide users with greater access to VRS services, and increase efficiency. Recently, VRS started offering several additional services online. These include the ability to purchase prior service, the ability to make ORPHE and ORPPA plan elections, and financial wellness counseling and content.

VRS board

The VRS board is a supervisory board that is directly vested with authority for managing and overseeing most aspects of the retirement system. It includes nine members, five of which are appointed by the Governor and four appointed by the General Assembly. The board delegates day-to-day management responsibilities to the VRS director and chief investment officer.

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