Commonwealth of Virginia
December 11, 2023

Report to the Governor and the General Assembly of Virginia

VRS Oversight Report

DECEMBER 2023

JLARC
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

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Overview

The Virginia Retirement System (VRS) administers retirement plans and other benefit programs for state and local government employees. The two largest plans are the teachers plan and the state employees plan (Figure 1). Other pension plans include the individual retirement plans for 601 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 other post-employment benefit programs. These include life insurance, sickness and disability, long-term care, and the retiree health insurance credit program.

VRS serves nearly 817,000 members, retirees, and beneficiaries. Active members include current state and local employees and teachers in Virginia's public school divisions. VRS also serves retirees, their designated beneficiaries, and "deferred" members, who are not actively employed and who are not collecting benefits.

The financial assets used to pay VRS benefits are pooled in the VRS trust fund, which held $104 billion in assets as of September 30, 2023. Ranked by value of assets, VRS is the nation's 14th largest public or private pension fund. In FY23, VRS paid $6 billion in retirement benefits and $497 million in other post-employment benefits from the trust fund.

VRS receives funds from three main sources: employer contributions, member contributions, and investment income. Additions to the VRS trust fund exceeded benefits paid out and expenses by $4.8 billion in FY23, partially because of investment earnings of $6.5 billion for the fiscal year (Figure 2). Investment income is critical to the VRS trust fund's health, typically accounting for over half of total additions in recent years. VRS investments generated a return of 9.3 percent for the one-year period ending September 30, 2023—below the benchmark for that period but well above the 6.75 percent long-term (30+ year) rate of return that VRS assumes for its investments. The total annualized return over the 10-year period was 7.7 percent, which is above the benchmark for that period as well as the long-term rate of return.

FIGURE 1
Teachers plan is the largest VRS pension plan by assets

SOURCE: VRS 2023 valuation report.
NOTE: Figures show total actuarial value of assets attributable to each retirement plan as of June 30, 2023. 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 (in aggregate) hold more assets than the state employees plan because political subdivisions have historically fully funded the required contributions. The unfunded liabilities for the local plans (in aggregate) are substantially lower than for the state employees plan.

FIGURE 2
VRS fast facts

MEMBERSHIP as of September 30, 2023

364,031	Actively employed members[a]
243,255	Retired members & beneficiaries
209,340	Inactive members
816,626	Total

NET ADDITIONS for fiscal year ending June 30, 2023[b]

$3.6 billion	Employer contributions
$1.2 billion	Member contributions
$275 million	2022 Appropriation Act
$6.5 billion	Net investment income
-$6.7 billion	Benefits paid and other expenses[c]
$4.8 billion	Net additions[d]

ASSETS as of September 30, 2023

$104 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of September 30, 2023

	1 year	3 years	5 years	10 years
Total return	9.3%	8.9%	7.5%	7.7%
Benchmark	11.6%	5.6%	5.7%	6.6%
Excess return	**-2.3%**	**+3.3%**	**+1.8%**	**+1.1%**

SOURCE: VRS 2023 annual report and 2023 membership and investment department data.
[a] Active membership included 161,453 teachers, 115,219 local government and political subdivision employees, and 87,359 state employees, state police, law enforcement officers, and judges. Within the retirement plans are three benefit groups. Active membership by benefit group included 113,239 in Plan 1, 77,698 in Plan 2, and 173,094 in the hybrid plan. [b] Includes all additions and deductions to the trust fund for VRS retirement plans and other benefits programs. [c] Includes $6 billion in retirement benefit payments, $497 million in other benefits, $127 million in refunds, and $73 million in administrative and other expenses. [d] Does not sum because of rounding.

1. Trust fund investments

Management of trust fund investments is one of VRS's core responsibilities. The VRS Board of Trustees sets investment policies for managing the trust fund, including the desired asset allocation and risk parameters for the fund. The investment department manages investment programs within the guidelines set by the board. The investment department manages nearly 30 percent of the assets in-house and contracts with external managers to manage other assets.

The VRS board adopts a **long-term investment return assumption** based on the advice of the Investment Advisory Committee, VRS investment staff and plan actuary, and surveys from investment managers and consultants. 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 6.75 percent.

Investment performance and asset allocation

The VRS trust fund held $104 billion in assets as of September 30, 2023, an increase of $7.2 billion from a year ago. Approximately $30.4 billion of the trust fund was managed in-house, including nearly all fixed income and close to half of public equities. The remaining $73.5 billion was managed by external managers under VRS supervision.

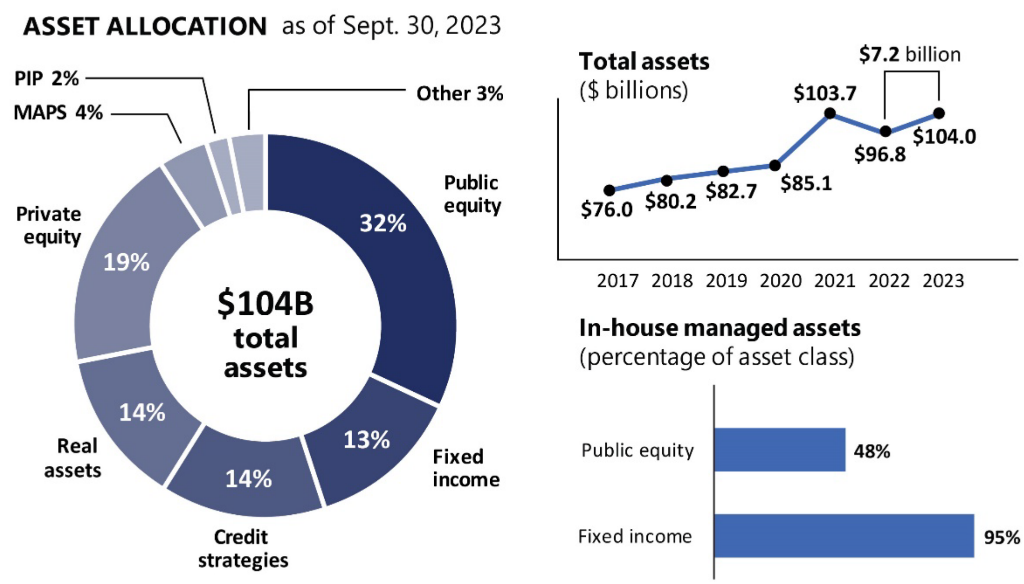
The total fund's investment performance was below its benchmark for the one-year period ending September 30, 2023 but above its benchmarks for the fiscal year to date, three-, five-, and 10-year periods (Figure 3). The trust fund's investment returns outperformed the 6.75 percent long-term (30+ year) rate of return that VRS assumes for the one-, three-, five-, and 10-year periods.

The total fund return for the fiscal year to date (first quarter of FY23) is negative primarily because of negative returns in the public equity and fixed income portfolios for this time period. Longer-term returns are more meaningful when assessing defined benefit retirement plans, but it is still important to track the short-term performance of assets.

Public equity. The public equity program continues to be the largest VRS asset class, with $32.9 billion in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and globally. Public equity investments are typically higher risk than bonds and are expected to provide long-term capital growth. Approximately 48 percent of the program's assets are managed in-house. The program met or outperformed its benchmarks for the fiscal year to date, three-, and 10-year periods, but slightly underperformed its benchmarks for the one- and five-year periods. According to VRS staff, the underperformance for the five-year period largely reflects public equity's underperformance in 2020. The underperformance for the one-year period reflects the portfolio's tilt toward low-volatility and value exposures (sidebar), which did not keep pace with the increases in large capitalization stocks during this period, according to VRS staff.

Value exposures are investments in companies whose stock prices do not reflect their intrinsic worth. By investing in these companies, investors believe stock prices will increase to more accurately reflect their intrinsic worth.

FIGURE 3
Asset allocation and trust fund investment performance



TRUST FUND INVESTMENT PERFORMANCE
for the period ending September 30, 2023

	FY to date	1 year	3 years	5 years	10 years
Total fund	–0.2%	9.3%	8.9%	7.5%	7.7%
VRS custom benchmark	–0.5	11.6	5.6	5.7	6.6
Public equity	–2.5	19.9	8.2	6.2	7.7
Benchmark	–3.3	20.7	7.3	6.5	7.7
Private equity	2.2	5.8	21.4	17.0	15.9
Benchmark	6.0	16.7	11.5	10.0	11.7
Credit strategies	3.1	9.7	7.9	6.6	6.1
Benchmark	1.9	11.1	3.6	4.3	4.8
Real assets	–0.8	–1.0	10.6	7.9	9.6
Benchmark	–1.2	–4.5	7.3	5.8	7.5
Fixed income	–2.9	2.3	–3.9	1.3	2.0
Benchmark	–3.0	1.5	–4.9	0.2	1.2
Multi-asset public strategies (MAPS)	0.8	11.0	6.2	4.1	n/a
Benchmark	–0.2	10.9	3.5	4.5	n/a
Private investment partnerships (PIP)	1.7	4.9	14.0	9.2	n/a
Benchmark	2.1	7.2	8.4	7.2	n/a

SOURCE: VRS investment department data.
Note: Asset allocation percentages may not equal 100 because of rounding.

Private equity. The private equity program is the second-largest VRS asset class, with $19.5 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. The private equity program consists of externally managed investments that are "opportunistic" in nature and intended to outperform public equity markets over the long term, thereby enhancing total fund returns. The program outperformed its benchmarks for the three-, five-, and 10-year periods but underperformed its benchmarks for the fiscal year to date and one-year periods. According to VRS staff, private equity returns are not expected to keep pace with large upswings in the public equity market, as seen over the past year.

Credit strategies. The credit strategies program is the third-largest VRS asset class, with $14.7 billion in assets. The program includes investments in high-yield bonds, bank loans, and direct lending. Credit strategies investments are intended to provide higher income than bonds and better risk-adjusted returns than stocks. All of the program's assets are managed externally. The program underperformed its benchmark for the one-year period but outperformed its benchmarks for all other periods. According to VRS staff, the underperformance for the one-year period was due to a variety of factors over the past year, including that the portfolio has more shorter-duration exposures compared with the benchmark.

Real assets. The real assets program is the fourth largest of the five major asset classes, with $14.1 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. All of the program's assets are managed externally. The program outperformed its benchmarks for all periods.

Fixed income. The fixed income program is the fifth-largest VRS asset class, with $13.8 billion in assets. The program primarily consists of U.S. dollar-denominated securities, such as bonds and money market instruments, which pay a specific interest rate. The fixed income program also includes emerging market debt and high yield securities. Fixed income investments are typically lower risk relative to most other asset classes and are expected to generate steady returns even in down equity markets. Approximately 95 percent of fixed income assets are managed in-house. The program outperformed its benchmarks for all periods.

Multi-asset public strategies. The multi-asset public strategies program is a relatively new, small exposure program, with $3.8 billion in assets. The portfolio, which is managed externally, includes dynamic strategies, which are opportunistic multi-asset allocation approaches. The portfolio also includes risk-based investments, which are uncorrelated, diversifying strategies relative to the rest of the assets in the fund. The

*Performance figures for the real assets and private equity programs, as well as the private investment partnerships portfolio, do not reflect managers' actual valuations of these investments as of September 30, 2023, because valuations of private assets have a timing lag behind other assets. Instead, performance figures are based on valuations as of June 30, 2023, adjusted for cash flows during the quarter that ended September 30, 2023.

portfolio underperformed its benchmark for the five-year period but outperformed its benchmarks for all other periods. (The portfolio is too new to have performance returns or benchmarks for the 10-year period.) According to VRS staff, the underperformance over the five-year period was primarily due to the dynamic strategies portion of the portfolio, where positioning was challenged because of the strong performance of a small number of large stocks.

Private investment partnerships. The private investment partnerships portfolio is another relatively new, small exposure program, with $2.3 billion in assets.* The portfolio comprises multi-asset private investments and is managed externally. The portfolio outperformed its benchmarks for the three- and five-year periods but underperformed its benchmarks for the fiscal year to date and one-year periods. (The portfolio is too new to have performance returns or a benchmark for the 10-year period.) Negative returns in the private equity and credit components of the program were the largest contributors to this underperformance, according to VRS staff.

Investment policies and programs

The VRS board sets investment policies, and the investment department staff implement programs to fulfill those policies. VRS's investment expenses are lower than its peers, in part, because VRS manages more than a quarter of investments in-house. The VRS board recently approved incentive awards and bonuses for eligible investment and administrative staff.

VRS investment expenses increased as the trust fund increased, but expenses remained below peers

VRS investment expenses include external fees, paid mostly to outside investment managers, and the VRS investment department's operating expenses. External fees account for over 90 percent of investment expenses.

VRS investment expenses have increased over time, but this is mostly attributable to the increasing value of assets held in the VRS trust fund (Figure 4). Investment expenses increased an average of 8.2 percent per year between FY19 and FY23, for a total increase of $179 million over this period. This growth was driven by the increasing size of the trust fund, which grew an average of 6.8 percent per year over the same five-year period, even with slight declines in the value of the trust fund in FY20 and FY22. VRS investment expenses as a percentage of total trust fund investments remained relatively stable during this period. Over the five-year period, investment expenses as a percentage of the total trust fund were between 0.54 percent and 0.63 percent. Most of VRS's investment expenses are fees paid to external managers based on the value of the assets they hold. As the trust fund grew, so did the value of assets held by external managers and the total fees paid to them.

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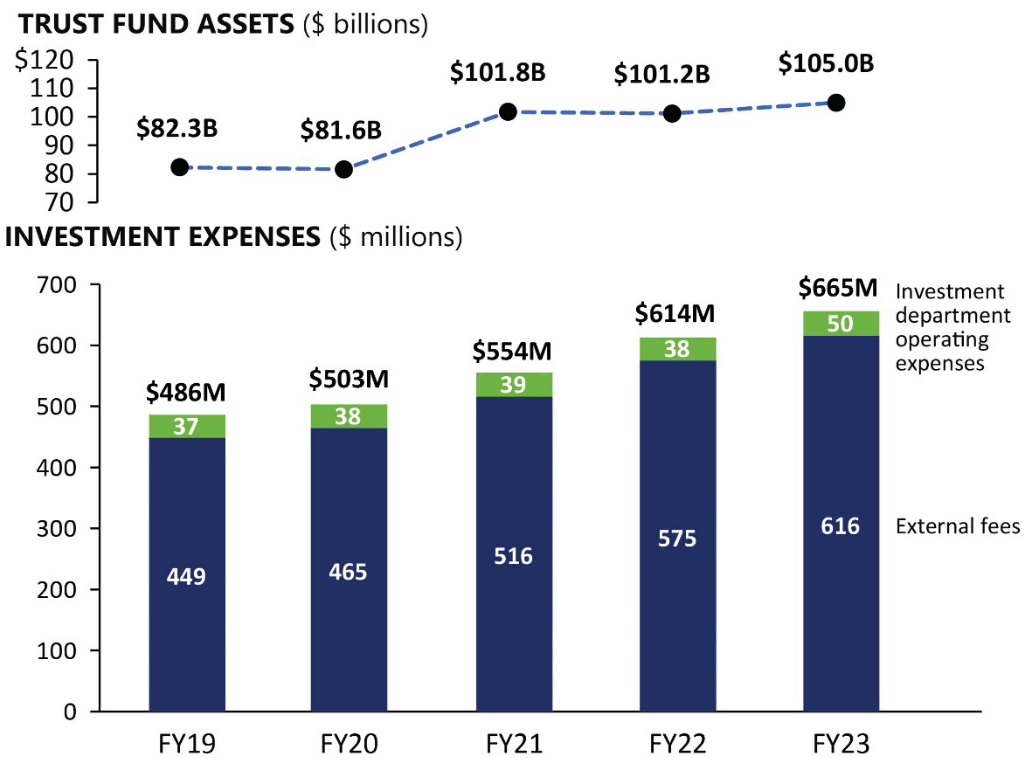
*Performance figures for the real assets and private equity programs, as well as the private investment partnerships portfolio, do not reflect managers' actual valuations of these investments as of September 30, 2023, because valuations of private assets have a timing lag behind other assets. Instead, performance figures are based on valuations as of June 30, 2023, adjusted for cash flows during the quarter that ended September 30, 2023.

VRS investment department expenses represent a small but growing part of overall investment expenses. These expenses grew from $37.1 million in FY19 to $49.5 million in FY23, an increase of 33 percent—or an average of 8.2 percent per year. The main growth drivers were related to staffing, data subscriptions, and consulting services. During this time period, VRS added eight full-time positions in the investment department. The cost of data feeds increased, and VRS hired a third party to assist with process improvement. In addition, overhead expenses for the investment department increased because of changes in VRS's allocation methodology. Although investment department expenses increased during this time period overall, their growth reflects the expansion of the in-house management group, which generally aligns with total fund growth.

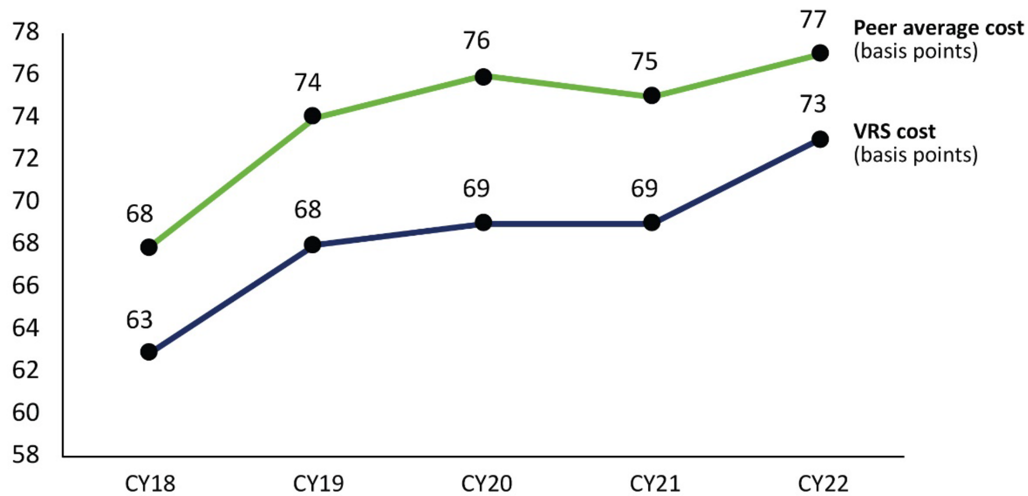
FIGURE 4
VRS investment expenses increased along with trust fund assets



SOURCE: VRS annual reports and investment department data.
NOTE: Trust fund assets are as of June 30 each year. Investment expenses may not equal annual totals because of rounding. Data for FY23 is in draft form because VRS's FY23 Annual Report has not been finalized. External fees include management and performance fees paid to third parties that invest VRS assets. They also include fees paid to the bank that serves as the trust fund's custodian and legal fees. Investment department operating expenses include all staff, IT, facility, and contract services fees (other than those captured in external fees) related to the investment department's routine operations.

Although VRS investment expenses have increased overall, they remain lower than the investment expenses of peer retirement systems. VRS subscribes to and participates with a cost measurement and investment fee benchmarking service, CEM Benchmarking, to annually review its investment expenses and compare them to peers. CEM looked at VRS expenses as a percentage of the trust fund, measured in basis points. CEM reported that VRS investment expenses increased in 2022 to 73 basis points. However, compared with the peer average adjusted for fund size and asset mix, VRS expenses were four basis points lower in 2022. The gap between VRS's investment expenses and its peers has remained relatively steady in recent years (Figure 5). Over the last five years, the difference in basis points between VRS and its peers' average ranged from the equivalent of $35 million to $61 million in lower total investment expenses, depending on the year. (CEM's reported investment expenses are different from those reported by VRS because CEM reports on a calendar year basis and adjusts expenses and assets to allow comparison with peers.)

FIGURE 5
VRS investment expenses remain lower than its peers' expenses



SOURCE: CEM investment benchmarking reports to the VRS board.
NOTE: Peer average cost is an estimate of the cost that VRS's peers would incur if they had VRS's asset mix. In conducting its analysis, CEM makes adjustments to VRS expenses and the assets they are measured against so they are comparable to peers.

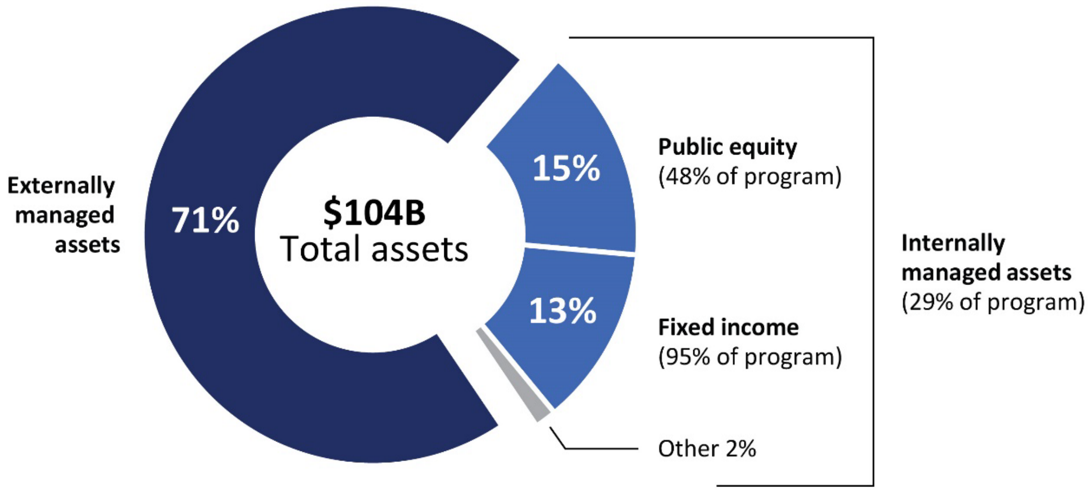
In-house asset management reduced fees paid to external investment managers

VRS manages a portion of the trust fund's assets in-house, with the goal of reducing costs while maintaining a high return on investments. As of September 30, 2023, approximately 29 percent of the trust fund was managed in-house (Figure 6). In-house managed assets included nearly the entire fixed income program and approximately 48 percent of the public equity program.

In-house management of assets has resulted in substantial cost savings. According to CEM, VRS saves approximately $58 million annually by managing assets in-house instead of paying fees to outside managers. These annual savings remain in the fund and are reinvested, which compounds savings over time.

In-house managed public equity assets met or exceeded their benchmarks for the one-, three-, five-, and 10-year periods ending September 30, 2023 (compared with the overall public equity program, which underperformed its benchmarks for the one- and five-year periods). Similarly, in-house managed fixed income assets outperformed their benchmarks for all periods ending September 30, 2023.

FIGURE 6
VRS in-house and externally managed assets (as of September 30, 2023)



SOURCE: VRS investment department data, 2023.
NOTE: Other includes cash exposures. Percentages may not equal 100 because of rounding.

Board approved $10.5 million in incentive awards and bonuses

Consistent with VRS's employee pay plans, in September 2023 the VRS board approved FY23 incentive awards and bonuses for eligible investment and administrative staff totaling $10.5 million. Nearly 90 percent of the overall amount ($9.2 million) was incentive awards for investment staff, which are mostly based on investment performance of the total fund and asset classes over the three- and five-year periods. Total incentive awards approved for FY23 were larger than the incentive awards approved for FY22, largely reflecting the substantial increase in the total fund's investment returns for FY23 compared with the previous fiscal year. Bonuses for administrative employees and investment department operations and administrative staff are based on annual agency performance outcomes, operational measures, and individual performance evaluations.

2. Defined contribution plans

VRS manages several defined contribution plans for its members. All state employees and many local VRS members are 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 from an investment line-up designed by VRS. The defined contribution plans are similar in structure to private-sector 401(k) plans and individual retirement accounts (IRAs).

Some of the VRS defined contribution plans are intended to provide primary retirement benefits, whereas others are intended to be a supplemental benefit. The aggregate value of participant accounts held in the VRS-managed defined contribution plans was $7.8 billion as of September 30, 2023.

TABLE 1
VRS defined contribution plans (as of September 30, 2023)

	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. Eligible state employees receive a modest cash match from employers in their Virginia 401(a) cash match plan. [a]	$4,546
Optional plan for higher education [b]	Faculty and other eligible employees 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.	$1,296
Hybrid	State and local members of the hybrid retirement plan are required to contribute to their Hybrid 401(a) plan and can make voluntary contributions to their Hybrid 457 plan. Employers make mandatory contributions to participant accounts and match a portion of voluntary contributions made by members. Members are also enrolled in the hybrid plan's defined benefit component.	$1,933
Other [c]	An optional retirement plan is offered as an alternative to political appointees (in place of the VRS State Employees plan) and to school superintendents in school divisions that have elected to have the plan (in place of the VRS Teachers plan).	$26

SOURCE: VRS administration and investment department data.
[a] Most political subdivisions do not have a cash match plan. [b] The following higher education institutions administer their own optional 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, $25.6 million; Optional Retirement Plan for School Superintendents, $338,000; and Virginia Supplemental Retirement Plan for certain educators, $182,000.

Plan performance

Participants in the VRS defined contribution plans may choose from 21 investment options available through the defined contribution plans (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 based on the options they select. Participants in the Optional Retirement Plan for Higher Education may invest in options available through VRS's DCP lineup or in options available through another provider, TIAA. Participants pay investment, administrative, and other fees based on the provider and investment options they select.

Defined contribution plans (DCP)

Target-date portfolios. Participants may select a diversified investment portfolio that reflects their target retirement date. These portfolios are the default for members who do not elect an investment option, and they include a broad spectrum of investments, such as 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 held $3.3 billion in assets as of September 30, 2023, exceeded all of their performance benchmarks for the one-, three-, five-, and 10-year periods (Table 2).

Individual options. Participants may select from one or more individual options to build a customized investment portfolio. The options include different types of stock, bond, money market, and real estate funds, and a fund that allows members to purchase units of the investments held by the VRS defined benefit trust fund. The individual options, which held $3.3 billion in assets as of September 30, 2023, exceeded nearly all of their performance benchmarks (Table 2). Two options missed their one-year benchmarks.

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 held $97.1 million in assets as of September 30, 2023. Because all investment decisions are made by the account holders, VRS does not use performance benchmarks for the brokerage accounts.

Optional Retirement Plan for Higher Education

Participants in the Optional Retirement Plan for Higher Education (ORPHE) can choose to invest in the VRS DCP lineup or with TIAA. Under TIAA, participants may select a target-date portfolio (a diversified portfolio option) or a traditional annuity; build a custom portfolio from different stock, bond, money market, and real estate funds; or choose more than one of these options. TIAA also offers a self-directed brokerage account. As of September 30, 2023, the TIAA program held a little over $1 billion in assets.

TABLE 2
Investment performance of VRS defined contribution plans

for the period ending September 30, 2023

	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	8	10	10	10
Total number of options	10	10	10	10
Additional option under the higher education plan				
TIAA[a]				
Met or exceeded benchmark	17	17	17	15
Total number of options	18	18	17	16

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 net of investment fund 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. [a] Performance information does not reflect assets held through legacy TIAA contracts, which were in effect before 2017.

One TIAA option missed its one-, three-, and 10-year benchmarks, but all other options exceeded their benchmarks for all periods (Table 2). Most TIAA assets (64 percent) are held in legacy options that participants can no longer contribute to. VRS no longer tracks performance for these options because they have been deselected by VRS. The proportion of assets in the TIAA legacy options will decrease over time as new participants enter the plan and invest in the new options.

An additional $134 million in the higher education retirement plan is held with private deselected providers with which VRS no longer partners. VRS does not track investment performance for these providers because participants can no longer contribute to them through the plan.

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 defined contribution plan activities are guided 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.

3. Trust fund rates and funding

Virginia's statutory schedule for fully funding rates required the state to pay 100 percent of the board-certified employer contribution rates by FY19 (§ 51.1-145). The schedule, which was enacted in 2012, gradually increased the portion of funding required for each plan in each biennium. The General Assembly fully funded rates ahead of schedule in FY18 for all plans.

Employer contributions, paid by the state and local political subdivisions through contribution rates, are one of the main sources of funding for VRS retirement plans. Every two years, the VRS board certifies the employer defined benefit contribution rates that are needed to pay and fully fund the plans over time, as determined and recommended by its actuary. Employer contribution rates for the teachers plan, state employees plan, and other state-supported plans must be enacted each biennium in the Appropriation Act. For all state-supported plans, the Code of Virginia requires the state to fully fund the board-certified contribution rates. For the 601 local plans that are not supported by the state, the Code of Virginia requires employers to pay the rates certified by the VRS board, with some limited exceptions.

The VRS actuary performs valuations annually, which provide an update on the funded status of the retirement plans. Funded status is a key indicator of the financial health of the plans.

Board-certified employer contribution rates increased for most state plans, including the Teachers plan

The **employer contribution rates** for hybrid retirement plans include a rate for the defined *benefit* component of the plan and a rate for the defined *contribution* component of the plan. The Teachers, State Employees, Judicial, and political subdivision retirement plans include a hybrid plan.

The VRS board certified the employer contribution rates that were recommended by its actuary for the FY25–FY26 biennium. Beginning this year, the employer contribution rates certified by the board are only for the *defined benefit* component of the plans for teachers, state employees, and judges. The 2022 General Assembly passed legislation giving VRS authority to decouple the rates for the *defined contribution* component from the *defined benefit* component of the hybrid retirement plans (sidebar). Decoupling the rates is partially intended to streamline the administration of each component of the hybrid plan and reduce the administrative burden of reconciling actual with estimated costs of defined contribution employer matches.

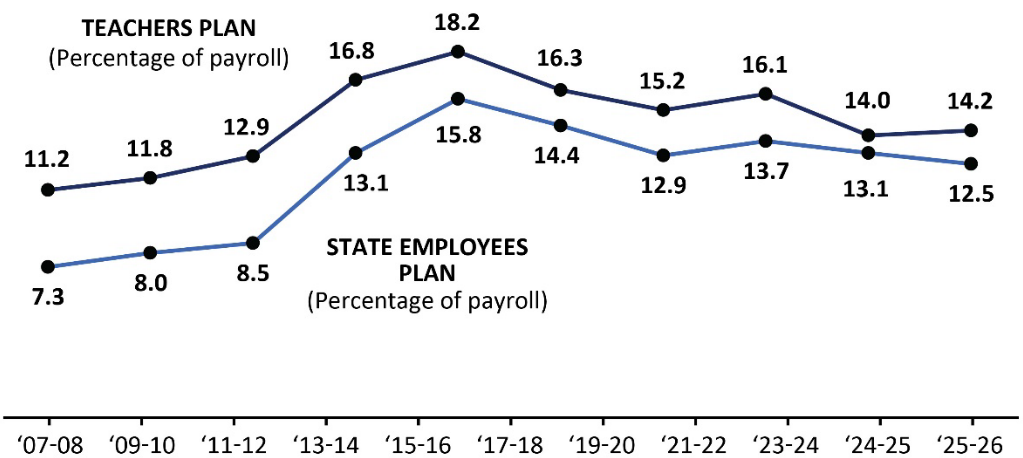
The FY25–FY26 defined benefit contribution rates certified by the board are higher than the FY23–FY24 board-certified rates for most state plans, including the Teachers plan (Table 3), although they are lower for the State Employees and Virginia Law Officers Retirement System (VaLORS) plans. The rates for the Teachers and State Employees plans are part of a longer-term trend of declining contribution rates since their peak in the FY15–FY16 biennium (Figure 7).

TABLE 3
Most FY25–FY26 employer contribution rates certified by the VRS board are higher than the FY23–FY24 rates (defined benefit component only)

	FY23–FY24 [a] (Board-certified)	FY25–FY26 (Board-certified)	Percentage point change
Teachers	13.95%	14.21%	↑ 0.26%
State Employees	13.07	12.52	↓ 0.55
VaLORS	24.60	22.81	↓ 1.79
SPORS	29.98	31.32	↑ 1.34
JRS	28.81	30.66	↑ 1.85
Local plan average [b]	11.62	12.25	↑ 0.63

SOURCE: VRS board meeting documents.
[a] The General Assembly maintained the higher FY21–FY22 rates for the FY23–FY24 biennium in the 2022 Appropriation Act.
[b] Local plan average is a weighted average based on the size of the local plan.

FIGURE 7
Board-certified employer contribution rates for Teachers and State Employees plans have generally declined since FY15–FY16 (defined benefit component only)



SOURCE: VRS annual reports and historical actuarial data.
NOTE: Board-certified rates shown are for the defined *benefit* component of the plans and do not include the defined *contribution* component of the hybrid plan. Rates reflect the percentage of payroll that each VRS-participating employer would need to contribute to VRS to pay off each plan or program's liabilities over time, as calculated by the VRS plan actuary. Rates must be enacted by the governor and General Assembly in the annual Appropriation Act. Prior to the 2017–18 biennium, the governor and the General Assembly did not fully fund the rates, so the rates enacted in the Appropriation Act may not match board-certified rates for all past years. For the 2017–2018 biennium, the defined benefit contribution rate for the State Employees plan was reduced to 13.4 percent after the General Assembly paid the remainder of the 10-year deferred contributions with an accelerated payment.

The FY25–FY26 board-certified contribution rates are generally higher than for FY23–FY24 partially because of higher-than-expected increases in salaries and cost-of-living adjustments. Another key driver of the higher rates is the board's approval of a revised funding policy that is projected to create substantial savings for the state

The **unfunded actuarial accrued liability** of a retirement plan is the amount by which the liability for benefits accrued to date exceeds the value of plan assets.

and many political subdivisions. The revised policy resets the total unfunded actuarial accrued liability (UAAL) of the plans to a single closed 20-year amortization period. Previously, the initial UAAL as of June 30, 2013 was amortized over a closed 30-year period, and each subsequent year's actuarial gain or loss was amortized over a separate closed 20-year period. By consolidating the initial UAAL and subsequent actuarial gains and losses over a single 20-year period, VRS is spreading the actuarial gains between 2013 and 2023 (which occurred in most years) over a longer period while remaining on the same schedule to pay off the initial UAAL. Because the actuarial gains are spread over a longer period, slightly higher contribution rates (less than 1 to a little more than 3 percentage points) are needed in the near term. However, spreading the actuarial gains over a longer period results in more stable and lower contribution rates in the long term, and higher near-term rates bring more money into the fund that can be invested for a longer period. These benefits result in a projected savings of more than $1 billion for the Teachers and State Employees plans over the next two decades if all plan assumptions are met, according to the VRS plan actuary.

Employer contributions are also paid by local governments and political subdivisions to support the 601 local plans. The VRS plan actuary calculates a unique rate for each local plan, and the VRS board certifies the rates. The average of the board-certified employer contribution rates for the defined benefit component of local plans increased from 11.62 percent for FY23–FY24 to 12.25 percent for FY25–FY26. This increase is partially due to the revised funding policy approved by the VRS board, and partially due to larger than expected increases in salaries, cost-of-living increases, and the cost-of-living increase in the hazardous duty supplement. The average rate for local plans is lower than the rates for the state plans because local plans typically have been required to pay the full board-certified contribution rates and consequently have much smaller unfunded liabilities.

Funded status of most VRS plans stayed about the same in FY23

A defined benefit retirement plan's health is commonly measured by its funded status, which is the ratio of plan assets to liabilities. In FY23, there was minimal change in the actuarial funded status for VRS's Teachers, State Employees, VaLORS, SPORS, and JRS plans. The Teachers plan increased slightly, from 79 percent funded in FY22 to 80 percent in FY23. The State Employees plan remained at 79 percent funded. The funded status for each plan is the highest in more than a decade (Figure 8).

There was minimal change in the funded status of the Teachers and State Employees plans largely because the trust fund's substantial investment earnings in FY21 offset other actuarial losses. Investment gains or losses are phased in over five years when calculating the actuarial value of assets, so the FY21 investment earnings are still positively affecting the funded status. The investment gains from FY21 were large enough to offset higher-than-expected salary increases and cost-of-living adjustments in FY23, both of which reflect relatively high inflation rates.

Actions taken by the General Assembly also helped ensure that the funded status of the Teachers and State Employees plans remained steady. State pension and other benefit plans received an additional $275 million in general fund contributions in June

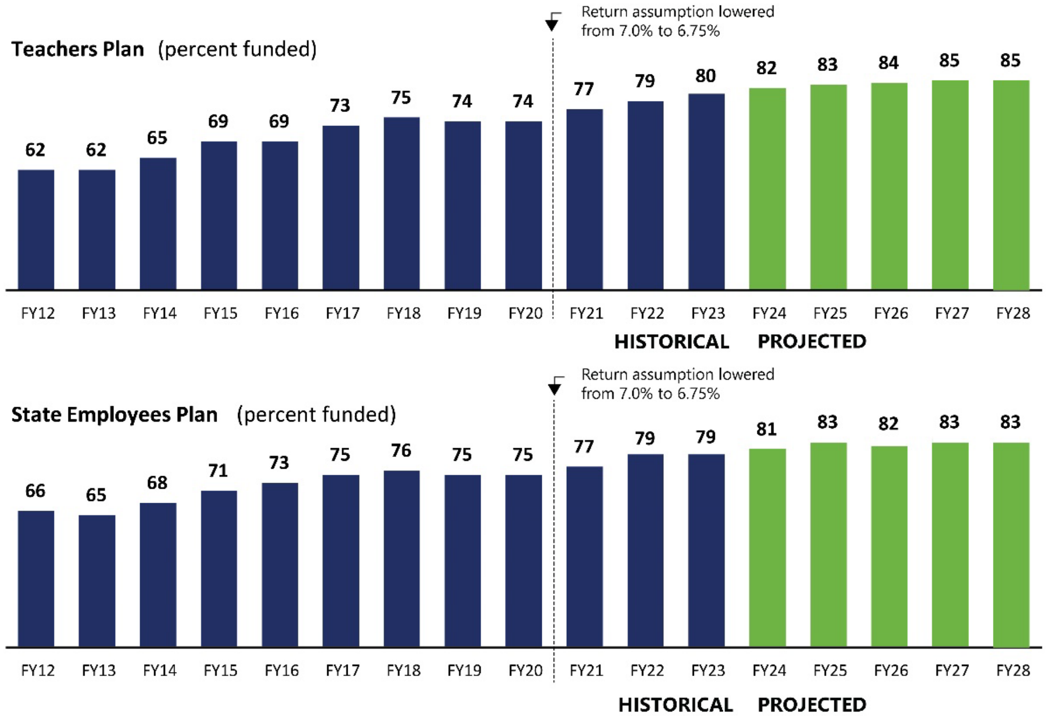
2023 on top of $750 million in general fund contributions in June 2022 (for a total of approximately $1 billion) that was provided by the General Assembly in the 2022 Appropriation Act to help pay down plan liabilities. The 2022 Appropriation Act also maintained the higher FY21–FY22 contribution rates for the FY23–FY24 biennium, resulting in substantially higher employer contributions to the pension plans. The General Assembly took similar steps in recent years to increase the funded status of the Teachers and State Employees plans by accelerating the repayment of deferred contributions (sidebar).

In recent years, the state has **accelerated the repayment of deferred contributions** to the State Employees and Teachers plans. The state deferred more than $1 billion in contributions to these plans during the 2010–2012 biennium after the Great Recession. The state fully repaid deferred contributions to the State Employees plan in the 2016–2018 biennium. The state completed repayment of deferred contributions to the Teachers plan with a $61 million payment in FY21.

The funded statuses of the Teachers and State Employees plans are projected to slowly increase over the next several years if all assumptions are met (Figure 8). Because investment returns are phased in over five years when calculating the actuarial value of assets, the substantial returns for FY21 will continue mitigating negative impacts on funded status if returns are lower than expected or other plan experience differs from expectations through FY25. Maintaining the higher FY21–FY22 employer contribution rates for the current biennium and contributing the additional $275 million in June 2023 will also help improve the funded status.

The aggregate funded status of the local plans declined slightly from 89 percent in FY22 to 88 percent in FY23. The decline mostly reflects larger-than-expected salary increases, cost-of-living increases, and increases in the supplement provided for members receiving hazardous duty benefits. Local plans have maintained a higher average funded status than the Teachers plan or the state-supported plans mainly because local employers have generally been required to fully fund their plan contribution rates. However, because of plan demographics, benefit provisions, and plan experience, the funded status of any individual local plan may be higher or lower than the aggregate funded status.

FIGURE 8
Funded status of Teachers and State Employees plans remained about the same in FY23



SOURCE: VRS actuarial valuation report, 2023, and historical actuarial data.
NOTE: Funded status shown is based on actuarial value of assets using a five-year smoothing period. The VRS board lowered the long-term rate of return assumption from 7.0 percent to 6.75 percent in October 2019, but actuarial calculations of funded status for FY19 assumed a 6.75 percent rate of return. Future funded status projections assume 6.75 percent rate of return on investments and 2.5 percent inflation. The Governmental Accounting Standards Board requires that the funded status of the plans be reported using the market value of assets, which is how they are reported in VRS financial statements.

4. Benefits administration and agency management

Administration of member benefits is one of VRS's core responsibilities. To carry out this and other duties, the agency must be effectively managed. Notable topics related to benefits administration and agency management include agency spending growth, an increase in voluntary contributions by hybrid plan members following the statutorily required auto-escalation in January 2023, an information security incident related to a third-party vendor of VRS, and legislatively required reports on options for expanding the return-to-work opportunities available to retirees.

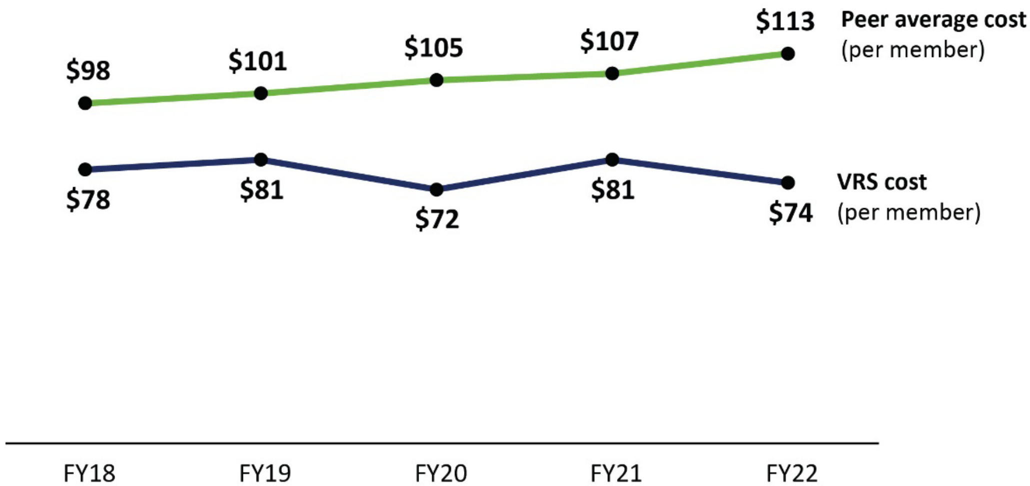
VRS operating expenses generally increased but remained lower than peers

VRS operating expenses include spending related to benefits administration, agency management, and investment department operations (not including external fees). Agency expenses in FY23 were $115 million. Expenses increased $16.3 million in the five-year period from FY19 to FY23, with an average growth rate of 4.1 percent each year (although they decreased between FY19 and FY20).

VRS expense increases between FY19 and FY23 were attributable to several cost drivers. The primary driver was two, 5 percent salary increases for state employees included in annual appropriation acts. The salary increases, and the associated increases in benefits and incentives paid by VRS, accounted for the majority of the increase in agency expenses over this period. Another cost driver was higher IT costs. VRS modernized its IT systems to add new capabilities, such as improving online member services, further strengthening cybersecurity, migrating away from a legacy mainframe system to a new system, and developing a new platform to disburse monthly retiree and beneficiary payments. VRS's IT modernization effort was completed in FY22, but the new systems carry ongoing maintenance costs that also contributed to the overall expense increase. A third cost driver was the expansion of the investment department, including the addition of new staff positions and development of new IT capabilities.

VRS's administrative costs compare favorably to peer retirement systems. The independent benchmarking service that VRS uses, CEM Benchmarking, annually reviews the administration expenses related to its retirement plans and benchmarks them to peers. (This comparison excludes investment expenses and costs associated with administering other benefit programs, such as the retiree health insurance credit program.) CEM reported that VRS retirement plan administration costs were $20 to $39 lower per member than its peer average between FY18 and FY22 (Figure 9). This difference was estimated to be $11 million to $24 million less in administrative expenses per year. Peer average costs increased in FY22 while VRS per-member expenses decreased, largely because of lower IT expenses. More broadly, VRS administration expenses are lower than its peers primarily because it has fewer front-office staff and lower IT and other support costs on a per-member basis.

FIGURE 9
VRS retirement plan administration costs are substantially lower than peers' costs



SOURCE: CEM retirement plan administration benchmarking reports to the VRS board.
NOTE: Benchmark comparisons for FY23 are not yet available.

Hybrid plan members contribute 5 percent to 9 percent of their salary toward their retirement benefits.

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

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

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

Hybrid plan voluntary contribution participation rate increased because of automatic escalation

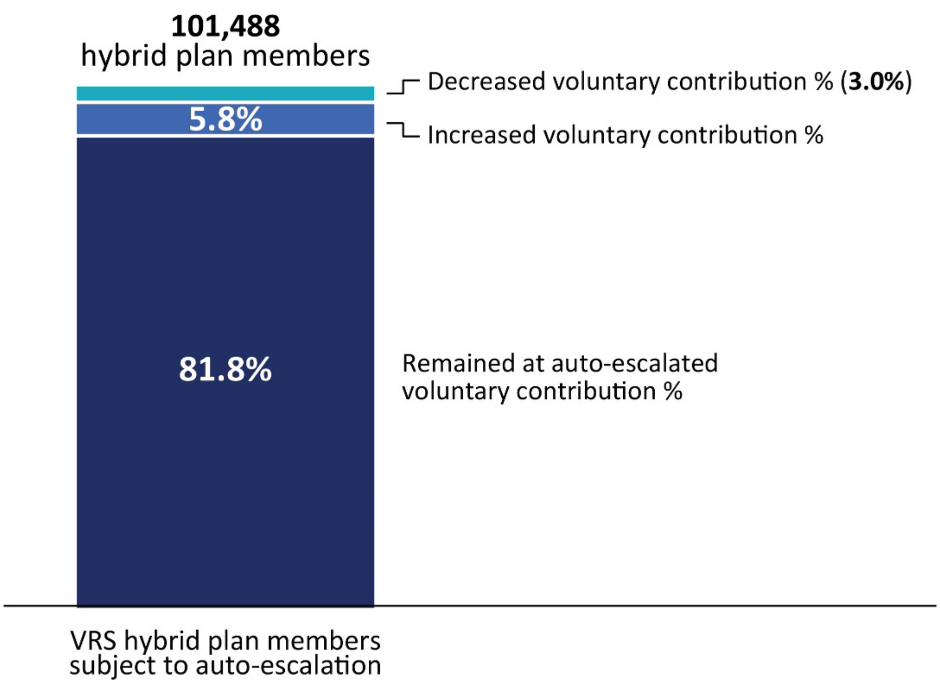
The hybrid plan combines elements of a traditional defined benefit retirement plan with a 401(k)-style defined contribution plan. Hybrid plan members include most state employees, teachers, and local employees hired on or after January 1, 2014, and make up an increasing proportion of state and local employees. Hybrid plan members made up approximately 48 percent of the total active VRS membership as of September 30, 2023. (State employees in the SPORS and VaLORS plans, and local employees with enhanced hazardous duty benefits, are not eligible to participate in the hybrid plan.) The hybrid plan generally has lower costs and liabilities for state and local employers than the defined benefit plans it replaced. Therefore, it is expected to gradually reduce costs for the state and most localities as it covers an increasing proportion of the workforce. The plan also transfers a higher proportion of investment and longevity risk from employers to plan members.

Under the hybrid plan, the defined contribution component of the plan is an important part of a member's benefit. Compared to a traditional defined benefit plan, such as Plan 1 or Plan 2, the defined *benefit* component provides a lower benefit that is complemented by defined *contribution* savings. The defined benefit component of the hybrid plan alone likely will not enable a member to meet an income replacement target of approximately 70–80 percent of the member's pre-retirement income, even when combined with social security benefits. Hybrid plan members are required to contribute 1 percent of their salary to their defined contribution component, and they receive a 1 percent mandatory contribution from their employer. To meet an income replacement target of 70–80 percent, members are encouraged to make additional voluntary contributions of up to 4 percent of their salary. These additional contributions are matched by up to 2.5 percent in additional employer contributions.*

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 are not subject to the automatic escalation if they opt out or if they are already making the maximum 4 percent voluntary contribution.

The hybrid plan's third statutory automatic escalation took place in January 2023 (sidebar). As of September 30, 2023, the vast majority of the more than 100,000 hybrid plan members subject to the January auto-escalation of 0.5 percent have remained at the auto-escalated percentage increase or have increased their voluntary contribution beyond 0.5 percent (Figure 10). Just 3 percent of hybrid plan members *decreased* their voluntary contribution following the auto-escalation.

FIGURE 10
Nearly 90 percent of hybrid plan members subject to auto-escalation maintained or increased their auto-escalated voluntary contribution percentage



SOURCE: VRS administrative department data.
NOTE: Percentages do not equal 100 because of employee separations and job changes.

The January 2023 auto-escalation also increased the percentage of hybrid plan members making voluntary contributions overall. (Automatic escalations increase participation rates because they bring participants into the voluntary contribution component of the plan unless they opt out.) The percentage of hybrid members making voluntary contributions as of September 30, 2023 was 77 percent, a substantial increase from 56 percent as of September 30, 2022. As a result of the statutory plan design, the percentage of hybrid plan members making voluntary contributions is likely to decline before the next

*70–80 percent replacement target takes into account social security benefits and assumes 30 years of service. Actual voluntary contributions needed to reach 70–80 percent income replacement target varies with members' income levels and annual investment returns. Hybrid plan members who make the maximum 4 percent in voluntary contributions would potentially receive retirement benefits greater than Plan 1 or Plan 2 members.

auto-escalation in January 2026, as new members join the plan. New employees tend not to initiate a voluntary contribution when they start employment.

VRS has taken several steps in recent years aimed at increasing the voluntary contributions made by hybrid plan members. VRS developed a tool, called SmartStep, which members can use to increase their savings on their own schedules. VRS has also conducted online campaigns to encourage savings when members log into their accounts and developed tool kits for employers to help encourage member savings. According to VRS staff, the most effective way to increase voluntary contributions is to automatically enroll new members in the voluntary component of the plan and then automatically escalate their voluntary contribution rate. However, this would result in increased costs to state and local employers.

Third-party vendor of VRS experienced information security incident in 2023

A third-party vendor that VRS contracts with experienced an information security incident in summer 2023. The incident involved PBI Research Services (PBI) and its MOVEit Transfer software, which is used by numerous organizations worldwide to transfer and exchange sensitive data. VRS contracts with PBI to identify deceased VRS retirees and beneficiaries, which helps prevent overpayments of benefits or other payment errors when these individuals pass away. A vulnerability in the MOVEit software allowed an unauthorized third party to access and potentially acquire data from numerous organizations, including VRS. The security incident may have included the personally identifiable information of approximately 245,000 VRS retirees, beneficiaries, and survivors. Although the incident did not involve VRS's own IT systems, it could result in identity theft or fraud for these VRS retirees and beneficiaries.

Several steps have been taken since the PBI security incident to protect VRS retirees and beneficiaries. Following the incident, VRS suspended the transfer of any new files to PBI and notified the Office of the Attorney General, Virginia law enforcement, the Auditor of Public Accounts, and external stakeholders of the incident. VRS is also providing basic information about the incident for VRS members on its website. PBI sent notification letters to VRS retirees and beneficiaries whose personal information may have been compromised and is providing free credit monitoring and identity protection services for these individuals. As of November 2023, VRS was not aware of any identity theft or fraud involving VRS members because of the PBI incident.

VRS completed legislative reports on options for expanding return-to-work opportunities for retirees

Return-to-work policies allow retirees to return to work with their employer (or another employer in the VRS system) and continue receiving their full retirement benefits. The policies can help employers address temporary staffing challenges while allowing retirees to earn additional income. Current state law allows VRS retirees to return to work under several specific circumstances. Any VRS retiree can return to work part-time (32 hours or less each week) after a one-month break in service (sidebar). Retirees can return full-time to four types of positions after a six-month break in service:

- K–12 instructional and administrative staff (e.g., teachers, principals) in designated "critical shortage" positions
- K–12 school bus drivers in designated "critical shortage" positions
- K-12 specialized student support staff in designated "critical shortage" positions
- Sworn law enforcement returning to work as school security officers

In addition, with VRS approval a retiree can return to work full time in an interim position for up to six months after a one-month break in service. The option is primarily for executive level positions that can be difficult to fill quickly, such as a county administrator or chief financial officer.

VRS completed two legislative reports in 2023 that analyzed options for expanding return-to-work opportunities for VRS retirees. The first report (sidebar) examined options for school divisions to hire retired instructional or administrative employees, specialized student support employees, bus drivers, and school security officers with at least 25 years of service into temporary or part-time positions during their required six-month break in service. The second report, which VRS completed with the Virginia Department of Criminal Justice Services (DCJS), examined options for allowing law enforcement officers to return to work in full-time law enforcement positions after their retirement.

The reports identified several considerations that policymakers should weigh before expanding return-to-work opportunities in Virginia. First, according to Internal Revenue Service guidance, government plans must require returning retirees to take a break in service to retain the plans' tax-exempt status, which allows members to make pretax contributions to their retirement plans and exempts investment earnings from taxation. Requiring a bona fide break in service also discourages employees from retiring solely to return to work and collect both their salary and pension benefit. Return-to-work policies can harm the actuarial health of a pension plan because they can incentivize employees to retire early and collect pension benefits for a longer period than has been actuarially assumed. In addition, if employees returning to work become a large part of the workforce, higher contributions may be required for non-retired employees. Therefore, consideration should be given to continuing to require employer contributions for employees returning to work. (Current state law requires employer contributions for employees returning to work.) Finally, it is counterintuitive to allow law enforcement officers to retire early because of the demands of their occupation and then allow them to return to the same demanding occupation. The reports identified alternative options to improve the recruitment and retention of difficult-to-fill positions, such as retention bonuses and salary increases.

A **break in service** is a period of time between retiring and returning to work during which an individual is not working. A break in service is required by IRS guidance to ensure there has been a severance of employment and that there is no prearrangement between an employer and employee on returning to work. The IRS requires the break in service to be during a period when the individual otherwise would have normally worked.

The report, ***Return to Work Provisions for Certain Retirees to Work in Temporary Positions***, was required by SB1289 (2023), SB1479 (2023), and HB1630 (2023).

The report, ***Return to Work for Law-Enforcement Officers Retired from VRS***, was required by SB1411 (2023).

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