Commonwealth of Virginia
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Report to the Governor and the General Assembly of Virginia

VRS Oversight Report

DECEMBER 2024

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 603 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 844,000 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 $117.2 billion in assets as of September 30, 2024. Ranked by value of assets, VRS is the nation's 14th largest public or private pension fund. In FY24, VRS paid $6.5 billion in retirement benefits and $496 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 $8.3 billion in FY24, partially because of investment earnings of $10.2 billion for the fiscal year (Figure 2). Investment income is critical to the VRS trust fund's health, typically accounting for well over half of total additions in recent years. VRS investments generated a return of 14.0 percent for the one-year period ending September 30, 2024—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 8.0 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 2024 valuation report.
NOTE: Figures show total actuarial value of assets attributable to each retirement plan as of June 30, 2024. 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, 2024

374,444	Actively employed members[a]
248,056	Retired members & beneficiaries
221,919	Inactive members
844,419	Total

NET ADDITIONS for fiscal year ending June 30, 2024[b]

$3.9 billion	Employer contributions
$1.3 billion	Member contributions
$55.0 million	2022 Appropriation Act
$10.2 billion	Net investment income
-$7.2 billion	Benefits paid and other expenses[c]
$8.3 billion	Net additions[d]

ASSETS as of September 30, 2024

$$$

$117.2 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of September 30, 2024

	1 year	3 years	5 years	10 years
Total return	14.0%	5.8%	9.1%	8.0%
Benchmark	16.9%	4.9%	7.8%	7.2%
Excess return	**-2.9%**	**+0.9%**	**+1.3%**	**+0.8%**

SOURCE: VRS 2024 annual report and 2024 membership and investment department data.
[a] Active membership included 163,576 teachers, 120,677 local government and political subdivision employees, and 90,191 state employees, state police, law enforcement officers, and judges. Within the retirement plans are three benefit groups. Active membership by benefit group included 105,110 in Plan 1, 77,695 in Plan 2, and 191,639 in the hybrid plan. [b] Includes all additions and deductions to the trust fund for VRS retirement plans and other benefits programs. [c] Includes $6.5 billion in retirement benefit payments, $496 million in other benefits, $122 million in refunds, and $76 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 37 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 $117.2 billion in assets as of September 30, 2024, an increase of $13.2 billion from a year ago. Approximately $43.6 billion of the trust fund was managed in-house, including nearly all fixed income, approximately half of public equities, and a portion of some private market assets. The remaining $73.7 billion was managed by external managers under VRS supervision. The proportion of assets managed in-house has increased compared to last year because VRS now considers co-investments in private market assets, where VRS has full discretion, to be internally managed. Previously, these assets were considered externally managed.

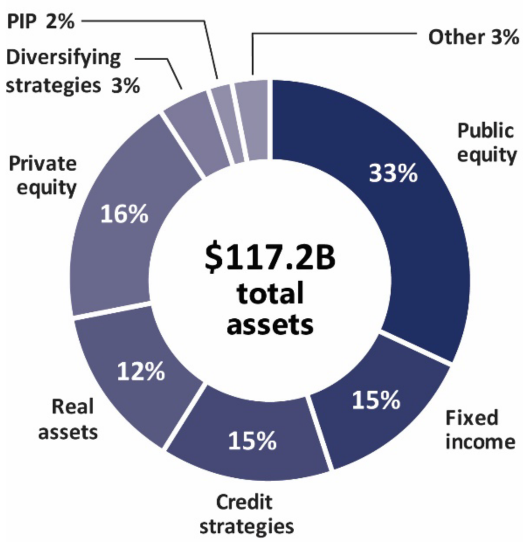
The total fund's investment performance was below its benchmark for the one-year period and the fiscal-year-to-date as of September 30, 2024, but above its benchmarks for the three-, five-, and 10-year periods (Figure 3). The trust fund's investment returns outperformed the 6.75 percent long-term (30+ year) assumed rate of return for the one-, five-, and 10-year periods (sidebar).

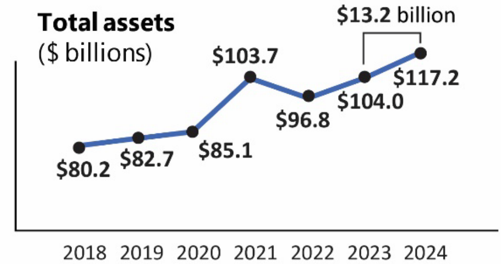
Public equity. The public equity program continues to be the largest VRS asset class, with $39.4 billion in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and globally. Public equity investments are typically higher risk than bonds and are expected to provide long-term capital growth. Approximately 51 percent of the program's assets are managed in-house. The program met or outperformed its benchmarks for the one- and three-year periods but underperformed its benchmarks for the fiscal-year-to-date, five-, and 10-year periods. The underperformance for the five- and 10-year periods was by only 0.1 percent. According to VRS staff, the underperformance for the fiscal-year-to-date is due to value, high earnings quality, and smaller stocks underperforming relative to the benchmark (sidebar). The underperformance for the five-and 10-year periods is largely because the low volatility and value strategies in VRS's portfolio underperformed the benchmark. The board approved inclusion of low volatility stocks in the public equity benchmark in January 2024, so the portfolio and benchmark should be better aligned going forward.

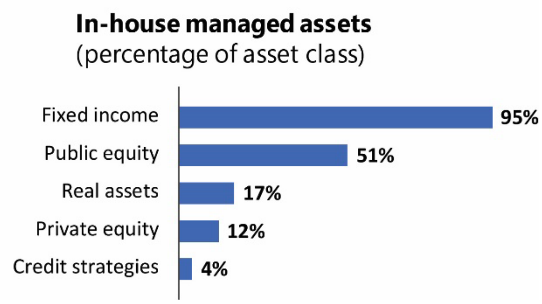
Value exposures are investments in companies whose stock prices do not reflect their intrinsic worth. By investing in these companies, investors believe stock prices will increase to more accurately reflect their intrinsic worth.

FIGURE 3
Asset allocation and trust fund investment performance

ASSET ALLOCATION as of Sept. 30, 2024







TRUST FUND INVESTMENT PERFORMANCE
for the period ending September 30, 2024

	FY to date	1 year	3 years	5 years	10 years
Total fund	3.5%	14.0%	5.8%	9.1%	8.0%
VRS custom benchmark	4.3	16.9	4.9	7.8	7.2
Public equity	6.6	31.3	8.2	12.0	9.4
Benchmark	7.4	31.1	7.8	12.1	9.5
Private equity	0.5	4.1	6.2	14.9	13.8
Benchmark	2.6	20.2	5.5	12.0	11.2
Credit strategies	2.6	11.1	6.3	7.7	6.4
Benchmark	3.2	12.2	4.9	5.4	5.3
Fixed income	5.4	12.6	-0.7	1.6	2.8
Benchmark	5.2	12.1	-1.1	0.5	2.0
Real assets	0.7	-1.7	5.3	5.8	8.0
Benchmark	0.1	-4.5	2.3	3.5	5.9
Diversifying strategies	-0.3	8.4	3.9	5.4	n/a
Benchmark	2.0	11.5	3.1	5.5	n/a
Private investment partnerships (PIP)	2.3	8.9	7.3	9.5	n/a
Benchmark	1.9	8.6	4.8	7.5	n/a

SOURCE: VRS investment department data.
Note: Asset allocation percentages are calculated using gross market value (includes effect of leverage). Percentages may not equal 100 percent because of rounding.

Private equity. The private equity program is the second-largest VRS asset class, with $19.0 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 investments that are "opportunistic" in nature and intended to outperform public equity markets over the long term, thereby enhancing total fund returns. Approximately 12 percent of the program's assets are in co-investments and, as of September 2024, considered to be managed in-house. 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 period. According to VRS staff, near-term private equity returns have underperformed the benchmark because of a valuation reset that is happening in the private equity market.

Credit strategies. The credit strategies program is the third-largest VRS asset class, with $17.8 billion in assets. The program includes investments in high-yield bonds, bank loans, direct lending, asset-backed lending, and other private credit instruments. Credit strategies investments are intended to provide higher income than bonds and better risk-adjusted returns than stocks. Approximately 4 percent of the program's assets are in co-investments and, as of September 2024, considered to be managed in-house. The program underperformed its benchmark for the fiscal-year-to-date and one-year period but outperformed its benchmarks for the three-, five-, and 10-year periods. According to VRS staff, multiple factors led to the recent underperformance, but the largest sources were distressed debt strategies and direct lending.

Fixed income. The fixed income program is the fourth-largest VRS asset class, with $17.6 billion in assets. The program primarily consists of U.S. dollar-denominated securities, such as bonds and mortgages, 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.

Real assets. The real assets program is the fifth largest of the five major asset classes, with $14.4 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. Approximately 17 percent of the program's assets are in co-investments and, as of September 2024, considered to be managed in-house. The program outperformed its benchmarks for all periods.

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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, 2024, because valuations of private assets have a timing lag behind other assets. Instead, performance figures are based on valuations as of June 30, 2024, adjusted for cash flows during the quarter that ended September 30, 2024.

Diversifying strategies. The diversifying strategies program (formerly the multi-asset public strategies program) is relatively new, with $3.9 billion in mostly externally managed assets. It aims to generate returns uncorrelated with equities. The portfolio underperformed its benchmark for the fiscal-year-to-date, one-year, and five-year periods but outperformed its benchmarks for the three-year period. (The portfolio is too new to have performance returns or benchmarks for the 10-year period.) According to VRS staff, the five-year underperformance is from the residual effects of underperformance during the early part of COVID. Recent underperformance results from the defensive nature of the program in an environment of higher short-term interest rates and strong equity returns.

Private investment partnerships. The private investment partnerships portfolio is another relatively new, small exposure program, with $2.4 billion in assets.* The portfolio comprises multi-asset private investments and is managed externally. The portfolio outperformed its benchmarks for all periods. (The portfolio is too new to have performance returns or a benchmark for the 10-year period.)

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 third of its investments in-house. The VRS board recently approved incentive awards for eligible investment and staff.

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

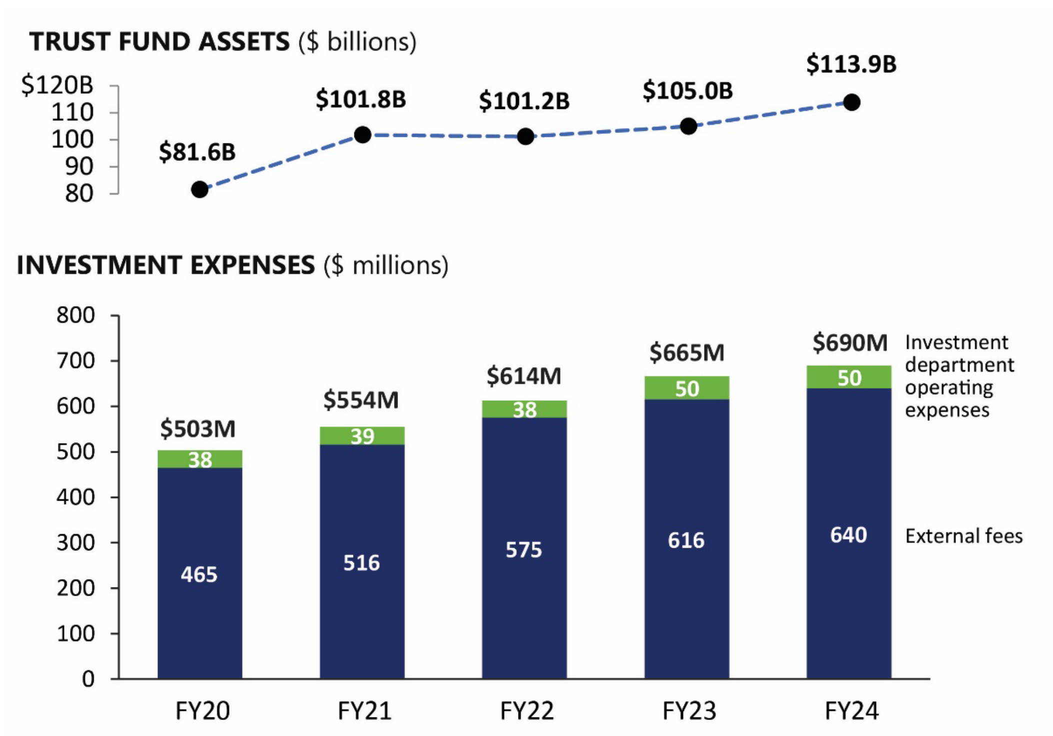
VRS investment expenses include external fees, paid mostly to outside investment managers, and the VRS investment department's operating expenses. External fees account for over 90 percent of investment expenses.

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 8.3 percent each year between FY20 and FY24, for a total increase of $187 million over this period. This growth was driven by the increasing size of the trust fund, which grew an average of 9.1 percent per year over the same five-year period. 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.

*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, 2024, because valuations of private assets have a timing lag behind other assets. Instead, performance figures are based on valuations as of June 30, 2024, adjusted for cash flows during the quarter that ended September 30, 2024.

VRS investment department expenses represent a small part of overall investment expenses. These expenses grew from $38.2 million in FY20 to $50.4 million in FY24, an increase of 32 percent—or an average of 7.9 percent per year. The main growth drivers were related to staffing, data subscriptions, and consulting services. During this time period, VRS added nine full-time positions in the investment department. The cost of data feeds increased, and VRS hired a third party to assist with process improvement. Although investment department expenses increased during this time period, their growth reflects the expansion of the in-house management group, which generally aligns with total fund growth.

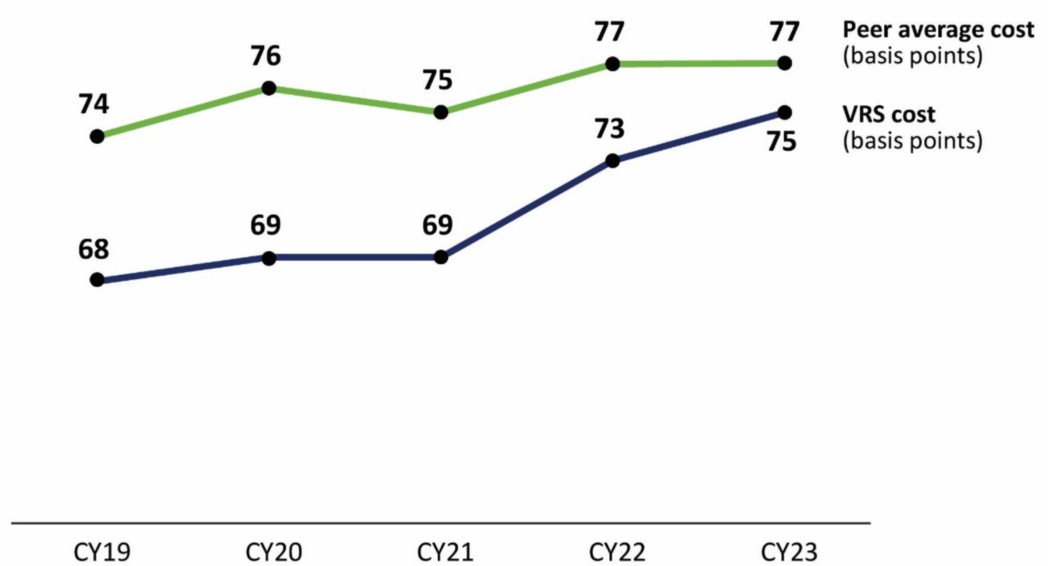
FIGURE 4
VRS investment expenses increased along with trust fund assets



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 FY24 is in draft form because VRS's FY24 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 2023 to 75 basis points. Compared with the peer average adjusted for fund size and asset mix, VRS expenses were two basis points lower in 2023. The gap between VRS's investment expenses and its peers has closed in recent years as VRS has migrated to larger exposures in private market asset classes, which have less of a cost advantage than internally managed public equity and fixed income (Figure 5). Over the last five years, the difference in basis points between VRS and its peers' average ranged from the equivalent of $18 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 adjusts VRS expenses and the assets they are measured against, so they are comparable to peers.

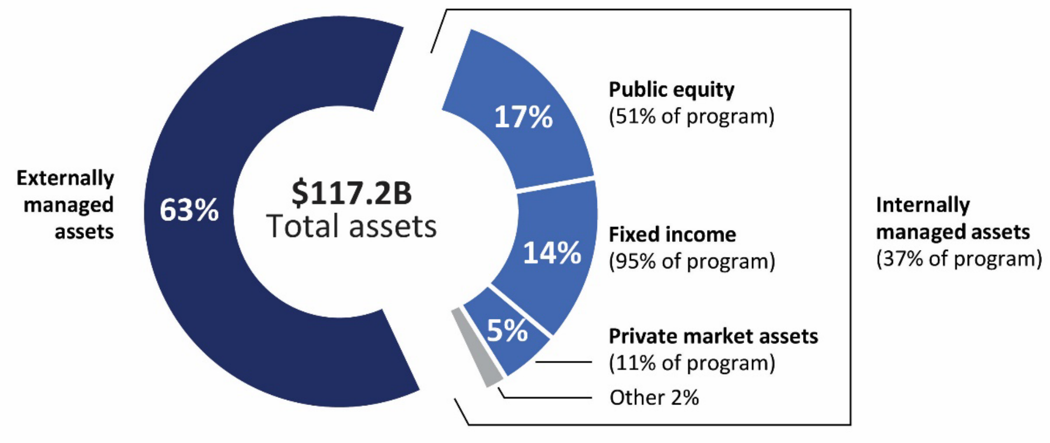
In-house asset management reduced fees paid to external investment managers

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, 2024, approximately 37 percent of the trust fund was managed in-house (Figure 6). In-house managed assets included nearly the entire fixed income program, approximately 50 percent of the public equity program, and approximately 10 percent of the private market programs, which include credit strategies, private equity, and real assets. The proportion of in-house managed assets has increased compared to prior years because VRS now considers co-investments in private market assets to be internally managed.

In-house asset management has resulted in substantial cost savings. According to CEM, VRS saves approximately $122 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, 2024 (compared with the overall public equity program, which underperformed its benchmarks for the five- and 10-year periods). Similarly, in-house managed fixed income assets outperformed their benchmarks for all periods ending September 30, 2024, except for the high yield portfolio, which missed its one-year benchmark.

FIGURE 6
VRS in-house and externally managed assets (as of September 30, 2024)



SOURCE: VRS investment department data, 2024.
NOTE: Other includes cash exposures. Percentages are calculated using net market value and may not equal 100 because of rounding.

Board approved $10.5 million in incentive awards for investment staff

Consistent with VRS's employee pay plans, in September 2024 the VRS board approved $10.5 million in incentive awards for eligible investment staff. Incentive awards for investment staff are mostly based on investment performance of the total fund and asset classes over the three- and five-year periods. The incentive awards approved for FY24 were somewhat larger than the incentive awards approved for FY23, largely reflecting the substantial increase in the total fund's investment returns for FY24 compared with the previous fiscal year.

2. Defined contribution plans

VRS manages several defined contribution plans for its members. All state employees and most 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 supplemental benefits. The aggregate value of participant accounts held in the VRS-managed defined contribution plans was $10.2 billion as of September 30, 2024.

TABLE 1
VRS defined contribution plans (as of September 30, 2024)

	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]	$5,617
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.	$1,551
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.	$2,987
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).	$35

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, $34.4 million; Optional Retirement Plan for School Superintendents, $480,000; and Virginia Supplemental Retirement Plan for certain educators, $234,000.

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 $4.6 billion in assets as of September 30, 2024, exceeded all 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 $4.1 billion in assets as of September 30, 2024, exceeded nearly all 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 $139.6 million in assets as of September 30, 2024. 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, 2024, the TIAA program held $1.2 billion in assets.

TABLE 2
Investment performance of VRS defined contribution plans

for the period ending September 30, 2024

	1 year	3 years	5 years	10 years
Options available for all plans				
Target-date portfolios				
Met or exceeded benchmark	10	10	10	8
Total number of options	10	10	10	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	18	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 benchmarks for all periods, but all other options exceeded their benchmarks for all periods (Table 2). Most TIAA assets (60 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 $160 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.

VRS is transitioning to a new record keeper for the Defined Contribution Plans

VRS is transitioning to a new DCP record keeper, Voya Financial, in early January 2025. The DCP record keeper administers participant accounts, including managing contributions and distributions; interfaces with investment managers; and provides education and support services to participants. The contract for DCP's current record keeper, MissionSquare Retirement, ends in 2024. State law requires VRS to periodically recompete the record keeper contract and seek new proposals. The transition to Voya will begin on December 20, 2024.

3. Trust fund rates and funding

Since 2019, the state has been statutorily required to pay **100 percent of the board-certified employer contribution rates** (§ 51.1-145).

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 603 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.

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 **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.

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

Last year, the VRS board certified the employer contribution rates that were recommended by its actuary for the FY25–FY26 biennium. As of last 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 to streamline administration of the plan (sidebar).

The FY25–FY26 board-certified defined benefit contribution rates, which are expressed as a percentage of payroll, are higher than the FY23–FY24 rates for most state plans (Table 3). They increased partially because of higher-than-expected increases in salaries and cost-of-living adjustments. Another key driver was the board's approval of a revised funding policy that resets the total unfunded actuarial accrued liability (UAAL) of the plans to a single closed 20-year amortization period. This change results in slightly higher contribution rates in the near term but is projected to result in 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.

Even though the contribution rate increased slightly for the Teachers plan for the FY25–FY26 biennium, both the Teachers and State Employees plans are continuing a longer-term trend of declining contribution rates since their peak in the FY15–FY16 biennium (Figure 7). The decline in rates results from strong investment performance, the General Assembly's decision to maintain higher rates than were required for the FY23–FY24 biennium, and special one-time payments by the General Assembly in recent years to help pay down the UAAL. The General Assembly's adoption of the hybrid plan for most teachers and employees hired on or after January 1, 2014, also helps to decrease rates by lowering the future cost of benefits. Rates are expected to continue their general decline for both plans if the plans' actuarial assumptions are met.

Employer contributions are also paid by local governments and political subdivisions to support the 603 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 salary increases, 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.

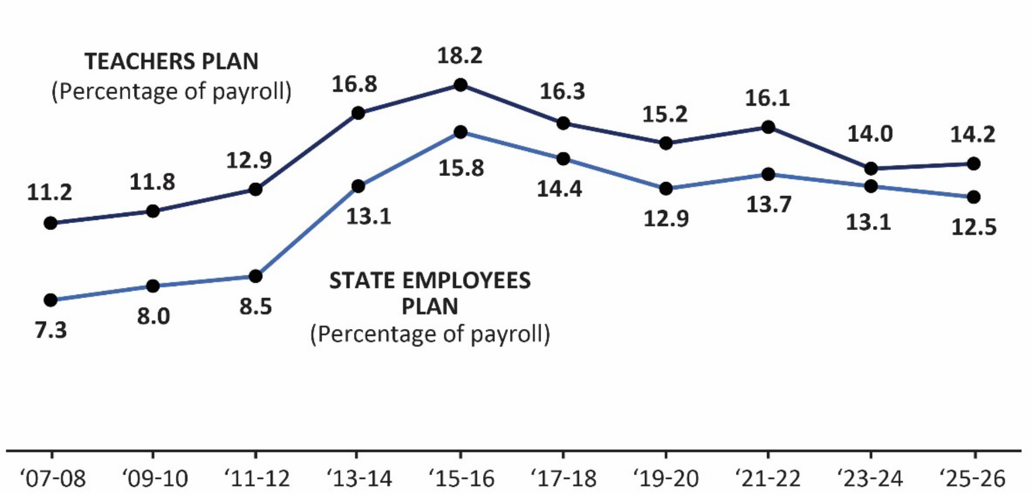
Even though this is not a rate-setting year for state budgeting, the VRS actuary calculated rates as of June 30, 2024, for informational purposes. The informational rates calculated for the Teachers plan (13.63 percent) and the State Employees plan (11.77 percent) were lower than the board-certified rates for the FY25–26 biennium. The rates declined primarily because investment returns (9.9 percent) exceeded the assumed rate of return (6.75 percent), although higher-than-expected salary increases and cost-of-living adjustments offset much of the investment gains.

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



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.

Funded status of most VRS plans increased slightly in FY24

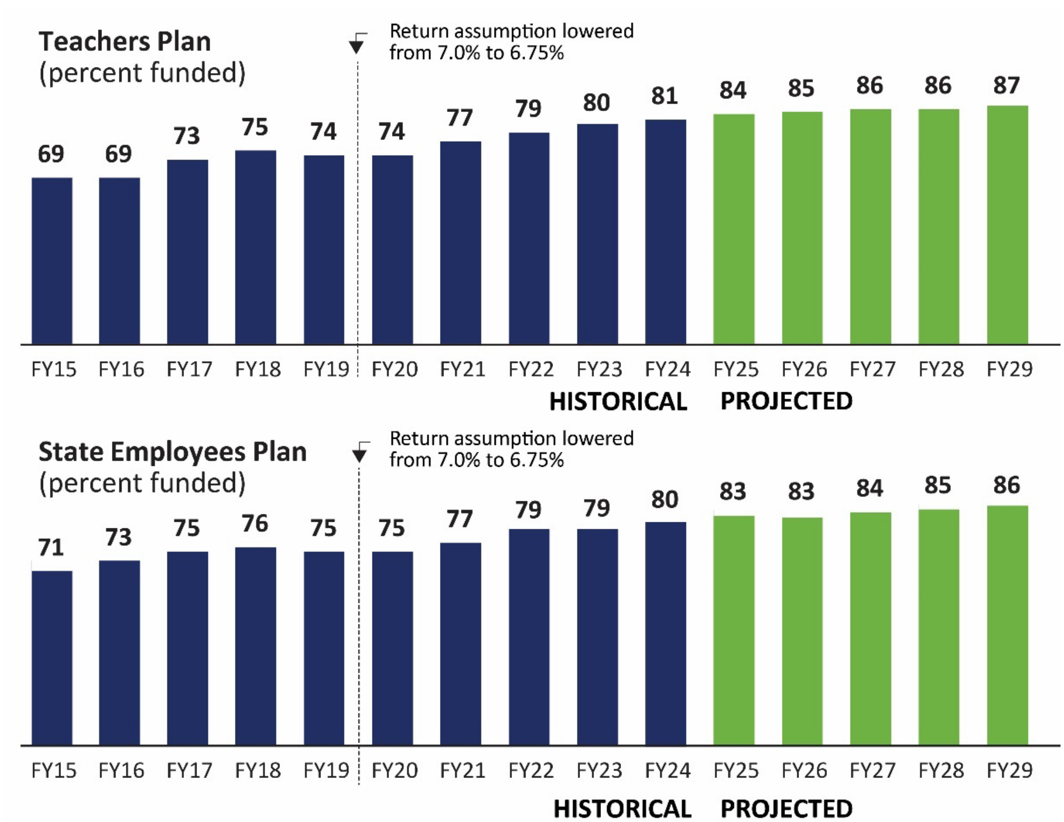
A defined benefit retirement plan's health is commonly measured by its funded status, which is the ratio of plan assets to liabilities. In FY24, there was a slight increase in the actuarial funded status for the Teachers, State Employees, VaLORS, SPORS, and JRS plans. The Teachers plan increased slightly, from 80 percent funded in FY23 to 81 percent in FY24; the State Employees plan increased slightly from 79 percent funded in FY23 to 80 percent in FY24. The increases in funded status for the Teachers and State Employees plans were slightly less than projected for FY24 (82 percent and 81 percent, respectively). This is because of the higher-than-expected salary and cost-of-living increases. The funded statuses for the Teachers and State Employees plans have continually increased since FY20 (Figure 8).

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 continue increasing 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, as well as higher-than-assumed returns for FY23 and FY24, will help mitigate negative impacts on funded status, such as lower-than-expected returns. The General Assembly has also taken significant actions to help improve the funded status of the plans in recent years (sidebar). Most recently, the General Assembly provided $750 million in general funds in June 2022 and $275 million in June 2023 to help pay down plan liabilities. The 2022 Appropriation Act also maintained the higher FY21–FY22 employer contribution rates for the Teachers and State Employees plans for the FY23–FY24 biennium.

The aggregate funded status of the local plans increased slightly from 88 percent in FY23 to 89 percent in FY24. The increase is mostly because investment returns (9.9 percent) exceeded the assumed rate of return (6.75 percent). 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 increased slightly in FY24



SOURCE: VRS actuarial valuation report, 2024, 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 and voluntary contributions of hybrid plan members to the defined contribution portion of their plan.

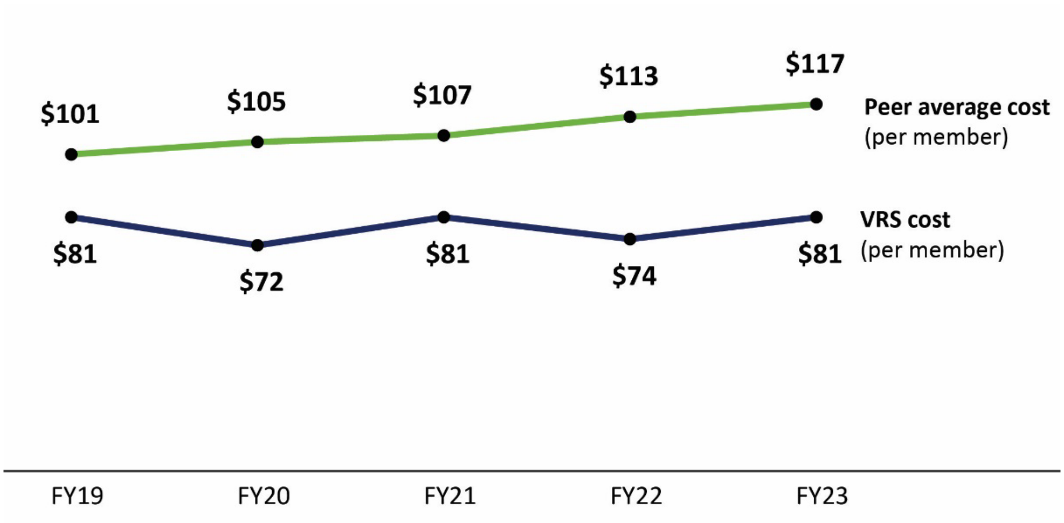
VRS operating expenses generally increased but remained lower than peers

VRS operating expenses include spending related to benefits administration, agency management, and investment department operations (not including external fees). Agency expenses in FY24 were $117 million. Expenses increased $24 million in the five-year period from FY20 to FY24, with an average growth rate of 6.0 percent each year.

VRS expense increases between FY20 and FY24 were attributable to several cost drivers. The primary driver was salary increases for state employees included in the appropriation acts over this time period. (Annual salary increases of 5 percent were provided in several years.) The salary increases, and the associated increases in benefits and incentives paid by VRS, accounted for the majority of the increase in agency expenses. 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, 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 IT 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 FY19 and FY23 (Figure 9). This difference was estimated to be $12 million to $24 million less in administrative expenses per year. VRS administration expenses are lower than its peers primarily because it has fewer front-office staff and lower 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 FY24 are not yet available.

Hybrid plan voluntary contribution participation rate declined between automatic escalations

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. As of September 30, 2024, for the first time hybrid plan members now make up over half (51 percent) of the total active VRS membership. (State employees in the SPORS and VaLORS plans, and local employees with enhanced hazardous duty benefits, are not 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 may 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

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.

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.

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.*

As of September 30, 2024, 65 percent of hybrid plan members were making voluntary contributions to the defined contribution component of their plan, which is a decline from the 77 percent of members who were making voluntary contributions at this time last year. The decline is part of an overall pattern resulting from the statutory design of the plan. Every three years there is an automatic rate escalation, which brings most participants into the voluntary contribution portion of the plan. Consequently, the percentage of members making voluntary contributions peaks in years when there is an automatic escalation (such as 2023) and declines in the intervening years as new members join the plan. This is because new employees tend not to initiate a voluntary contribution when they start employment. 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 more frequently automatically escalate their voluntary contribution rate. However, this would result in increased costs to state and local employers.

*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 vary 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.

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