Review of State Public Retirement Systems

House Appropriations Committee Retreat

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Review of State Public Retirement Systems

- ☑ Overview of Pension System Structures
- ❑ Review of Virginia Retirement System Plan
- ❑ Overview of Other States' Plan Structures
- ❑ Comparison to Other States' DB Plan Structures
- ❑ Review of VRS Defined Contribution Plans
- ❑ Review of VRS Deferred Compensation Plan
- ❑ Current Issues for VRS

General Overview of Retirement Systems

- Historically retirement plans have fallen into 2 categories: Defined Benefit (DB) plans and Defined Contribution (DC) plans

- DB plans are the “traditional” pension plans under which:
  - Employee is guaranteed a specific benefit for life at the time of retirement
  - Benefit amount is generally formula driven
  - Formula normally factors in years of service and salary of employee
  - Employer is responsible for ensuring the system has sufficient funds to provide the benefits stipulated under the plan

- DC plans are IRAs or 401k type plans under which:
  - Employee is not guaranteed a specific benefit at retirement
  - Instead the employer and/or employee contributes a specific amount (or percentage of salary) into an individual employee account each pay period or month
  - Funds are generally invested on behalf of the employee with the employee being responsible for the decisions
  - Value of a DC plan at retirement is based solely on the amount of contributions deposited in the account and the rate of return on the investments

Strengths of the Two Types of Plans

- Strengths of DB plans are:
  - Provide genuine retirement security because they guarantee benefits for life
  - Reward long-time employees of a company
  - More cost effective (for a DC plan to provide the same level of benefits they generally require higher contribution rates)

- Strengths of DC plans are:
  - Empowers the employee
  - Tends to be more portable
  - Generally has shorter vesting period
  - Easier to administer for employers
  - Provides cost certainty for employers (contribution rates are set by employer)

Trends in Pension Plan Coverage

- In the private sector:
  - The general trend has been a movement from traditional DB to DC plans
  - Approximately 1/3 of private sector employees covered under a retirement plan are covered under a DB plan (around 22 million employees)
    - In 1978 approximately 2/3 of private sector workers covered in a retirement plan were covered in a DB plan
  - Approximately 2/3 of private employees covered under a retirement plan are covered in a DC plan (around 47 million employees)
  - Reasons for this shift include:
    - Desire for cost savings/cost certainty
    - Increased cost incurred by private companies from the requirement beginning in the 1970's to pay pension insurance to the Pension Benefit Guaranty Corporation
      - Currently $35 per employee per year for single employer plans
    - Easier for employer to administer (including less government regulation)
    - Response to more transient workforce

- In the public sector:
  - Approximately 90% of state and local government employees are covered under a DB plan

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Review of Virginia Retirement System

- Constitution of Virginia (Article X, § 11) requires that the General Assembly maintain

  …a retirement system for state employees and employees of participating political subdivisions and school divisions…. The retirement system shall be subject to restrictions, terms, and conditions as may be prescribed by the General Assembly

- Virginia Retirement System (VRS) established in 1942 to administer a statewide retirement system
  - 235 state agencies, 157 cities and towns, 93 counties, 144 school boards, and 192 special authorities
    - 346,929 active members as of June 30, 2009
      - 26.8% are state employees, 42.8% are teachers and 30.4% from political subdivisions

- VRS also administers the Virginia Sickness and Disability Program, group life insurance, retiree health insurance credit, disability retirement benefits, long-term care insurance, the deferred compensation plan and the alternative defined contribution plans for college faculty and political appointees

Overview Virginia Retirement System

	Regular VRS Benefit
Employee Group	Most state employees, teachers, and most employees of political subdivisions
Regular Unreduced	65 Years of Age & 5 Years of Service
Early Unreduced	50 Years of Age & 30 Years of Service
Vesting Period	5 years
Benefit Multiplier	1.7%
Average Final Compensation (AFC)	Average of highest 3 consecutive years of salary
Formula	Benefit = 1.7% x AFC x Years of Service
Cost of Living Adjustment	Equal to CPI up to 3%; Between 3% and 7% - COLA increases 0.5% for every 1% increase in CPI Cannot exceed 5%
Employee Contribution	5.0% - Paid by employer on behalf of employees for state employees (since 1983) in lieu of a pay raise. School divisions and political subdivisions also have this option

Overview of Other State Employee Retirement Programs

	SPORS	VaLORS	JRS*
Employee Group	State Police & Elected Sheriffs	Other state law enforcement employees	Judges including SCC and WCC
Regular Unreduced	60 Yrs of Age 5 Yrs of Service	60 Yrs of Age 5 Yrs of Service	65 Yrs of Age 5 Yrs of Service
Early Unreduced	50 Yrs of Age 25 Yrs of Service	50 Yrs of Age 25 Yrs of Service	60 Yrs of Age 30 Yrs of Service
Hazardous Duty Supplement	$12,456 yr until full Soc Sec	$12,456 yr until age 65	None
Multiplier	1.85% of AFC	2.0% w/o Supplement (all new employees) or 1.7% with supplement	1.7% of AFC

* For judges the years of creditable service are increased by a factor of 2.5 (i.e. 5 years of service equates to 12.5 years of creditable service). For judges who were in service prior to 1995 the factor is 3.5. The benefit for judges is capped at 78% of AFC.

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Overview of Other States' Plan Structures

- The majority of states continue to provide retirement benefits to their employees in traditional DB programs
- Eleven states and the District of Columbia provide retirement benefits using different structures for at least one of their employee groups
- 2 states and the District of Columbia automatically enroll some employees in defined contribution (DC) plans
  - Alaska - all employees (effective July 1, 2006)
  - Michigan - state employees hired on or after March 31, 1997 in DC plan (state police and teachers remain in DB plan)
  - District of Columbia - all employees except for teachers, police officers and firefighters
- Beginning in 1991, West Virginia automatically enrolled teachers in a DC plan, but closed the plan in 2005 and reverted back to a DB plan

Other States' Plans

- 2 states mandate combination plans
  - Indiana – state employees and teachers
  - Oregon – all public employees (effective August 28, 2003)

- 4 states currently provide employees the option of a DB or DC plan
  - Florida – all public employees have the option of a DC or DB
  - South Carolina – state employees, except for police officers, and teachers have the option
  - Colorado – state employees (effective January 2006)
  - Montana – state employees, except for law enforcement personnel (effective July 2002)

- Washington - state employees and teachers choose between DB and combination plan

- Ohio - All public employees have the option of a DC, DB, or a combination plan (effective January 2003)

- Nebraska – State employees hired on or after January 1, 2003 are covered under a cash balance plan.
  - A cash balance plan has features of a DB plan (it guarantees a benefit for life) and a DC plan (individual employee accounts and portability)
  - Prior to 2003, state employees were in a DC plan. Teachers and police officers are in a DB plan

States with DB Plans Not in Social Security

- When initially enacted, Social Security did not include state and local public employees
  - Federal law was later amended to give states the option to include employees covered in public pension plans in Social Security
  - According to a GAO report in 2005, about ¼ of public employees are not in Social Security

- DB plans for employee groups not covered under Social Security generally have higher benefit multipliers and contribution rates to reflect the absence of the Social Security cost and benefit

- 12 states and the District of Columbia have at least one group of public employees that are not covered under Social Security
  - Average benefit multiplier for these plans is 2.33%
  - Average employee contribution rate for these plans is 8.83%

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Benefit Multipliers

- Virginia's benefit multiplier of 1.7%, provides 51% of salary after 30 years of service

- A review of state DB plans for teachers and/or state employees, excluding those not participating in social security, shows the average benefit multiplier is 1.923%
  - A 1.923% multiplier provides 57.68% of salary after 30 years of service

Benefit Multiplier	Number of Plans
Less than 1.7%	13
1.7%	4
Between 1.7% and 1.99%	7
2.0%	17
Greater than 2.0%	12

State Benefit Formulas With a Cap

- State Employees and Teachers
  - Vermont – limited to 50% of AFC
  - Iowa - limited to 65% of AFC
  - Wisconsin - limited to 70% of AFC
  - Illinois – limited to 75% of AFC
  - Massachusetts - limited to 80% of AFC

- Teachers
  - Connecticut - limited to 75% of AFC
  - New York - limited to 79% of AFC

- State Employees
  - Georgia - limited to 90% of highest year

Employee Contributions

- While Virginia's plan has a lower than average benefit multiplier, it is one of only 7 of the plans where the employee does not actually pay a contribution
  - 5 states do not include an employee contribution as part of their plan
  - In North Dakota (4%) and Virginia (5%), the state pays the contribution on behalf of the employee

Employee Contribution	Number of Plans
0%	5
Less than 3%	3
Between 3% & 4.99%	7
Between 5% and 5.99%	14
Between 6% and 6.99%	11
7% or higher	13

Service/Age – Unreduced Retirement

- There is a significant variation across states in the age/service requirements for unreduced retirement

- Of the states that have an age requirement, Virginia is one of only a few states with the age limit as low as 50 years of age
  - For regular VRS, the age/service requirements for unreduced retirement are 50/30 or 65/5
  - There are around 20 plans that only have a service requirement, with no age requirement (with the service requirement being between 20 and 35 years of service
  - For the states that do have age requirements, the age requirements are generally between 55 and 62

- Approximately 20 plans allow retirement based on the employee meeting a specific total for their combined age and years of service
  - "Rule of 90" allows unreduced retirement once an employee's age plus years of service equals 90
  - For states using these provisions, the requirement varies from 90 to 75

AFC & COLAs

- Most states use a 3 year period when calculating Average Final Compensation (AFC)
  - 3 plans have an AFC based on less than 3 years
  - 12 plans use more than 3 years

- The longer the time period used, the lower the AFC and the lower the benefit

- Virginia's COLA is linked to CPI and capped at 5%
  - Equal to CPI up to 3%; Between 3% and 7% - COLA increases 0.5% for every 1% increase in CPI

- Survey of pension system COLA methodology shows
  - 22 states have limits on COLA that are 3% or less
  - Many states set COLA on an ad hoc basis based on legislative action
  - A few stated COLA is tied to investment earnings or funded status

Comparison to Surrounding States

State	Benefit Multiplier	Employee Contribution	COLA
Virginia	1.7%	5% (Paid by Employer)	Linked to CPI Capped at 5%
Maryland	1.8%	5%	Linked to CPI Capped at 3%
North Carolina	1.82%	6%	Ad Hoc
Tennessee	1.5% & additional 0.25% above SSIL*	5% for Teachers 0% for State Employees	Linked to CPI Capped at 3%
West Virginia	2.0%	4.5%	No COLA

* SSIL is the social security integration level ($54,000 for 2009).

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Virginia's Defined Contribution Plans

- Virginia offers the option of participating in the VRS DB plan or a DC plan, often referred to as an ORP (Optional Retirement Plan) to there groups of employees:
  - Higher education administrative, research and teaching faculty
  - Political appointees
  - School superintendents

- The employer contributes 10.4% of the employee's income into the DC plan

- As of June 2009, 13,686 faculty members participate in the ORP for higher education (the largest plan)

Higher Education Peer Group Comparison

- VRS, along with the State Council for Higher Education (SCHEV), compared Virginia's ORP for higher education to those offered at peer institutions (reported in December 2008)
  - SCHEV has identified 25 peer institutions for each of Virginia's 16 universities

- VRS surveyed the peer institutions
  - The average contribution rate for the institutions that responded is lower than the 10.4% rate for the ORP

	All Peers	Public	Private
Average	8.9%	8.5%	9.4%
Median	9.3%	8.3%	10.0%

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Virginia’s Deferred Compensation Plan

- As a supplement to the VRS DB plan, the Commonwealth provides the 457 Deferred Compensation plan
  - The 1999 General Assembly approved and funded an employer cash match component
  - The legislation allows a state match up to $50 per pay period ($1,200 per year)
  - Currently the Commonwealth matches 50% of an employee’s contribution up to $20 per pay period ($480 per year)
  - The 2007 General Assembly approved changing the program from an “opt-in” to an “opt-out” program
    - Participation in the program has dramatically increased to approximately:
      - 4,600 participants in 1994
      - 38,200 participants in 2004
      - 59,900 participants in September 2009

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Contribution Rates

	VRS State	VRS Teacher	SPORS	VaLORS	JRS
2010 Current Rates Employee * Employer Total Rate	 5.00% 6.26% 11.26%	 5.00% 8.81% 13.81%	 5.00% 20.05% 25.05%	 5.00% 14.23% 19.23%	 5.00% 34.51% 39.51%
VRS Recommended 2011 Total Rate (20 Yr Amortization, 7.5% ROR, 2.5% COLA)	13.46%	17.91%	30.56%	20.93%	51.79%
2011 Total Rate Current Actuarial Assumptions (30 Yr Amortization, 8% ROR, 3% COLA)	11.58%	15.50%	26.24%	18.19%	47.58%

* The 5% employee rate has been paid by the employer since 1983 in lieu of a salary increase

Potential Impact from Contribution Rates

- Estimated additional fiscal impact of adopting VRS Board certified rates (annual cost)
  - State Employees: $98 million total funds - $54 million GF
  - Teachers - State share of SOQ cost $95 million GF

- Estimated additional fiscal impact of adopting contribution rates using current actuarial assumptions (30 year amortization, 8% rates of return and 3% inflation)
  - State Employees: $14.0 million total funds - $7.7 million GF
  - Teachers - State share of SOQ cost $38.0 million GF

Potential Prospective Program Changes

- Potential changes that could reduce long-term costs to Commonwealth of maintaining VRS benefit
  - Require new employees to pay 5% employee contribution
  - Modify COLA formula to guarantee first two percent of CPI increase plus one-half of each additional percent increase up to six percent
  - Modify age/service requirements for unreduced retirement. Adopt the "Rule of 90"
  - Reduce benefit multiplier
    - Prior to 1998, the benefit multiplier was 1.50% on the first $13,200 of AFC and 1.65% on the AFC in excess of $13,200
      - Benefit multiplier was raised to 1.70% to compensate retirees for increased tax burden resulting from Davis v. Michigan (decided by the US Supreme Court in 1989)