Virginia Retirement System

New GASB Accounting Rules:
The Impact to Local Governments

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VRS Overview

VRS Total Membership

	Plan 1	Plan 2	Hybrid	Total
Teachers	101,144	43,271	1,006	145,421
Political Subdivisions	67,074	35,823	2,477	105,374
State Employees	53,364	23,596	1,922	78,882
State Police Officers' Retirement System (SPORS)	1,527	493	–	2,020
Virginia Law Officers' Retirement System (VaLORS)	5,606	3,809	–	9,415
Judicial Retirement System (JRS)	318	69	–	387
Total Active Members	**229,033**	**107,061**	**5,405**	**341,499**

Total Active Members	Retirees/ Beneficiaries	Inactive/ Deferred Members	VRS Total Population
341,499	**177,126**	**126,243**	**644,868**

As of June 30, 2014

Benefit Comparison

	State	Teachers	Local
Actives:			
Average Age	48.3	45.2	46.3
Average Service	12.7	12.0	11.2
Average Salary	$50,902	$50,095	$42,101
Retirees:			
Avg. Age @ Retirement	63.1	62.2	62.4
Avg. Service @ Retirement	21.7	22.4	19.6
Avg. Benefit @ Retirement	36.9%	38.1%	33.5%
Avg. Annual Benefit	$19,256	$22,088	$15,290
Avg. Social Security Benefit at Age 62	$17,796	$18,240	$14,988

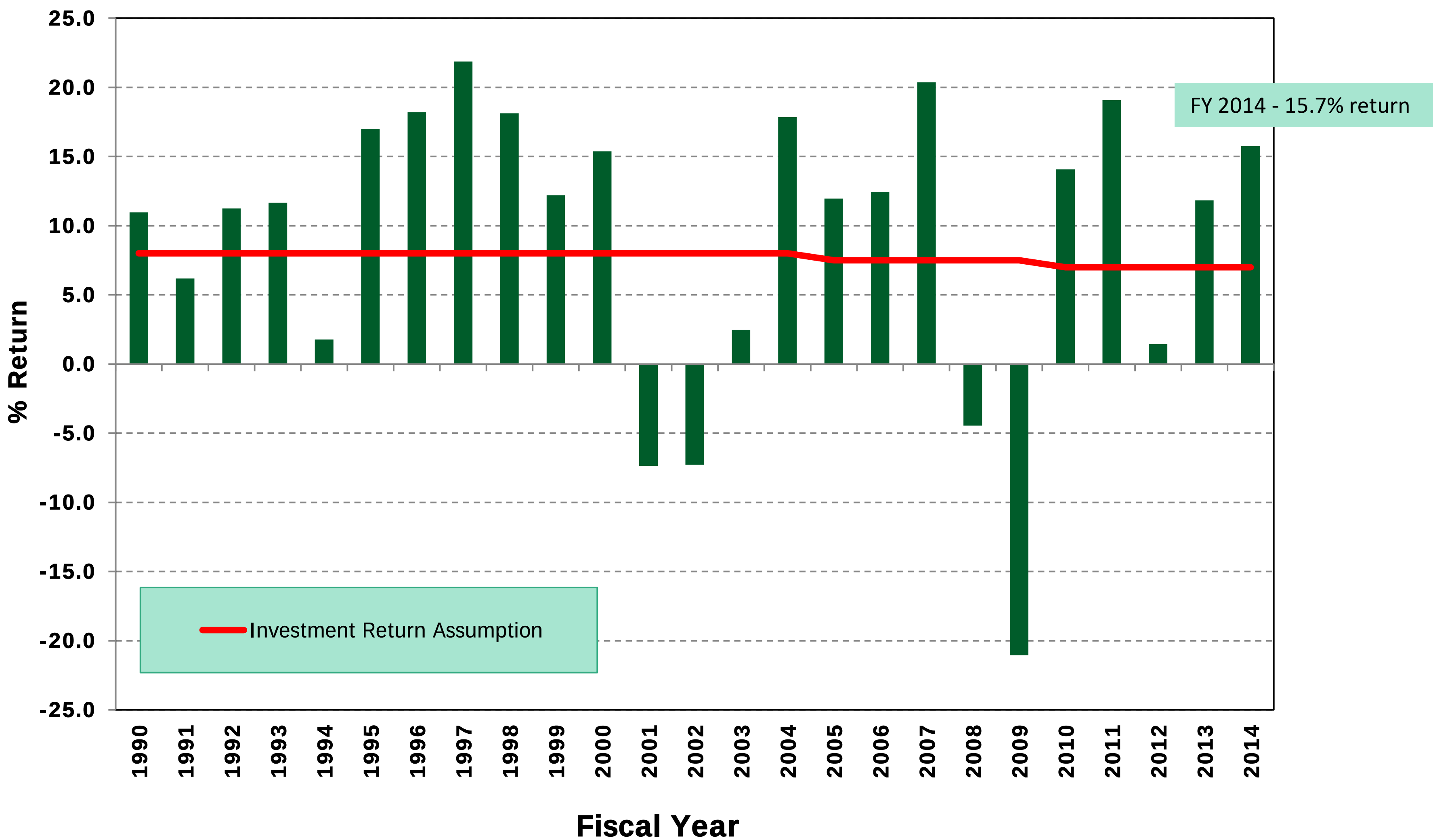
Information above obtained from the June 30, 2014, Actuarial Valuations.

What Is a Hybrid Retirement Plan?

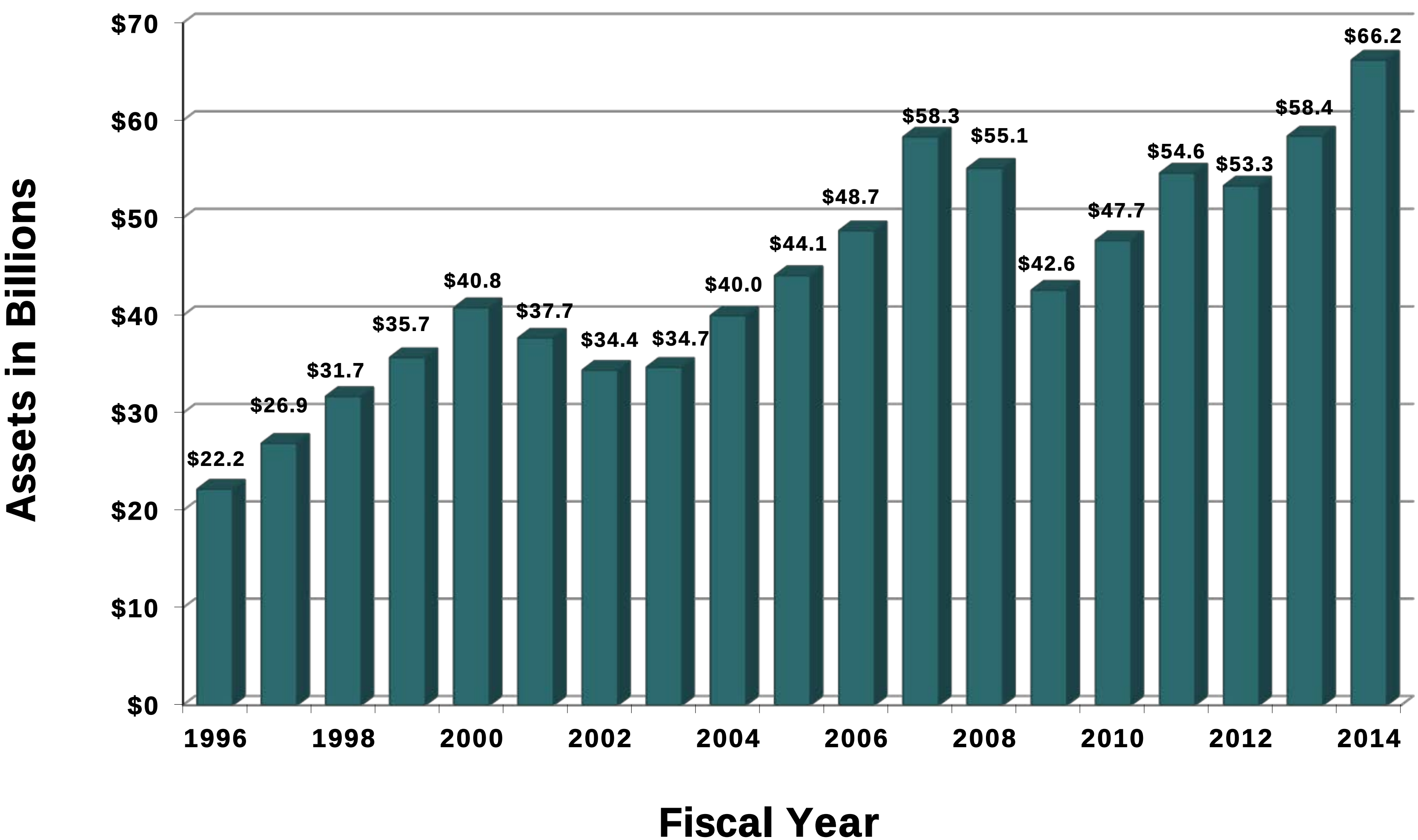
A defined benefit plan and a defined contribution plan form the components of the VRS Hybrid Retirement Plan:

Defined Benefit Component	Defined Contribution Component	Disability Coverage
Provides the foundation of member's future retirement benefit when he/she qualifies.	Provides tax-deferred savings plans to build on the benefit under the defined benefit component.	Virginia Local Disability Program, or employer-provided comparable plan.
VRS manages the investments and related risk for this component.	The member manages the investments and related risk for this component.	Short-Term Disability – ER paid benefit; income replacement begins at 60%; one-year waiting period
Mandatory EE/ER contribution: 4.0% (EE) + actuarial determined rate (ER)	Mandatory EE/ER contribution: 1.0% (EE) + 1.0% (ER) = 2.0% min. contribution	Long-Term Disability – begins after 6 months; provides 60% of pre-disability income; paid from trust
1.0 x years of service x AFC = Benefit Amount	Voluntary contributions up to a 4.0% (EE) + 2.5% (ER) match = 6.5%	Long-Term Care – nursing/in-home care; not required in employer comparable plan

VRS Fiscal Year Returns



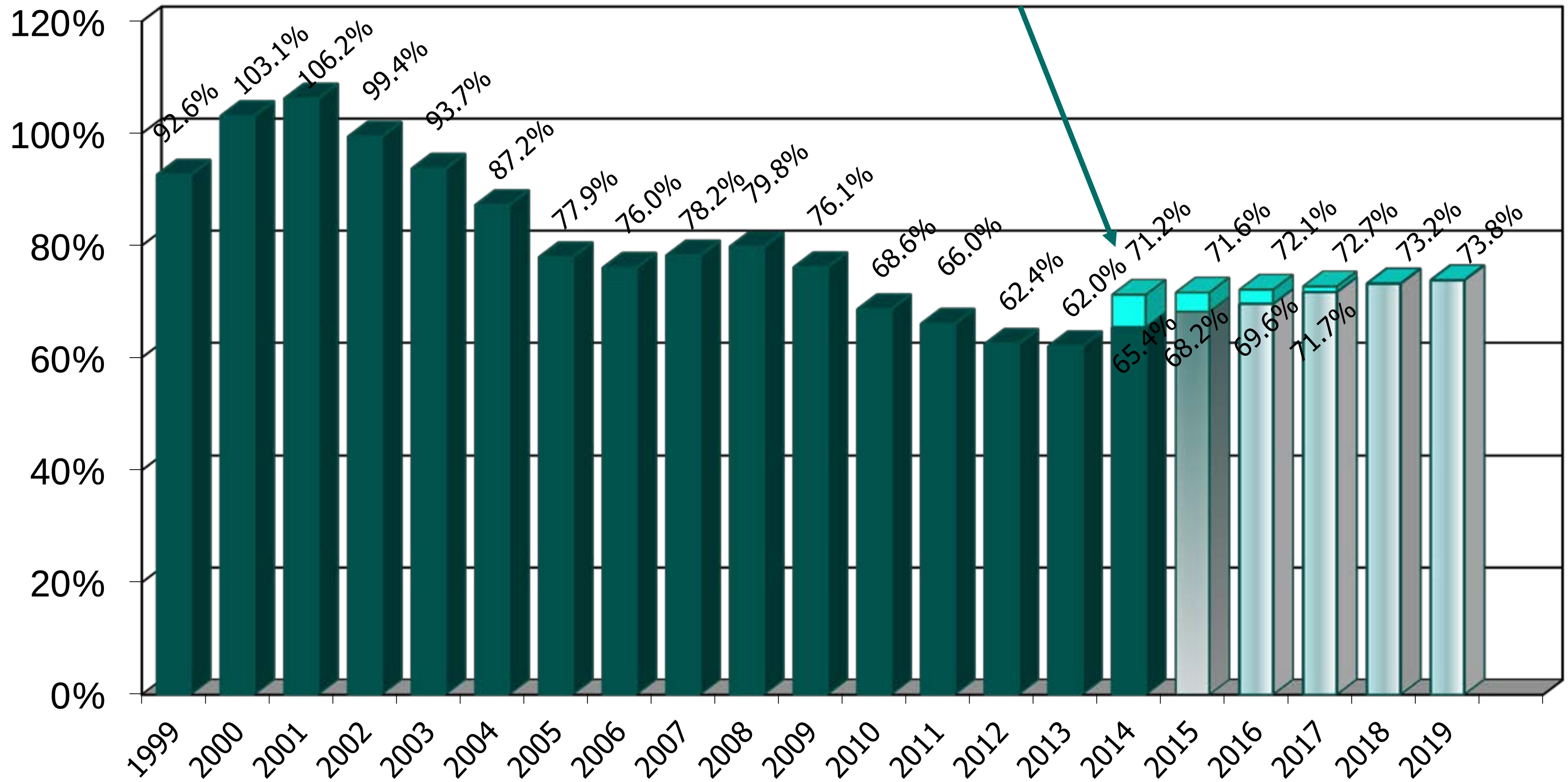
VRS Assets



$70
$60
$50
$40
$30
$20
$10
$0
Assets in Billions
$22.2
$26.9
$31.7
$35.7
$40.8
$37.7
$34.4
$34.7
$40.0
$44.1
$48.7
$58.3
$55.1
$42.6
$47.7
$54.6
$53.3
$58.4
$66.2
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Fiscal Year

Funded Status: Teachers

New GASB Accounting Rules will reflect funded status using Market Value of Assets effective 6/30/14 for Plan Reporting and 6/30/15 for Employer Reporting.

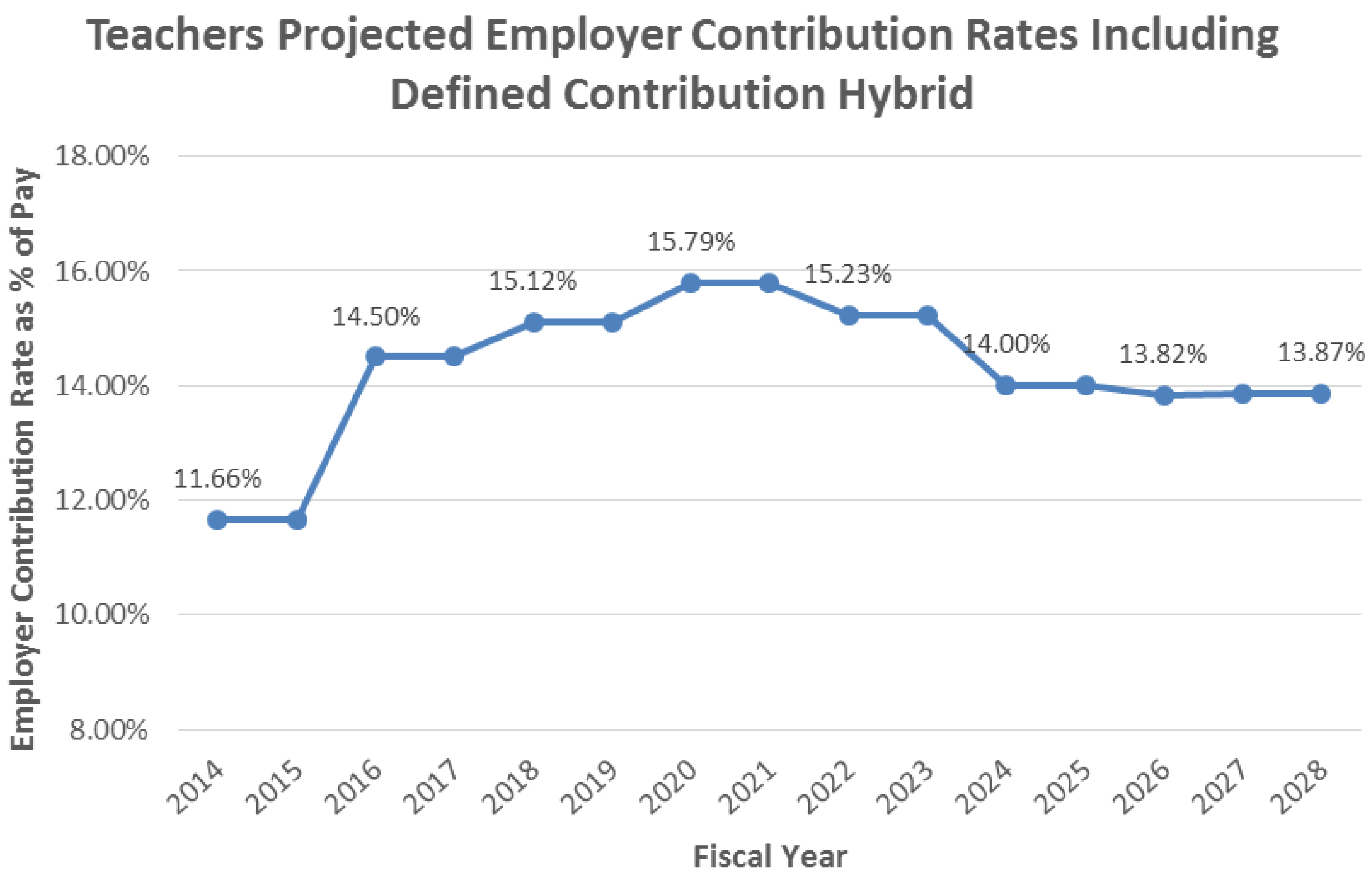


Projected Funded Status using Market Value of Assets (New GASB Standard)

Projected Funded Status using Actuarial Value of Assets (Funding Standard)

Assumptions:
- Fiscal Year 2014 investment return at 15.7%.
- Other projected years' investment returns assume 7.0% with 2.5% inflation rate.
- Assets estimated at actuarial value of assets (five-year smoothing).

Projected Teacher Contribution Rates



Assumes employer match to defined contribution portion of hybrid plan of 1.5% of payroll for members in the hybrid plan.

New Pension Accounting Rules

Upcoming GASB Accounting Changes

- GASB changing standards for financial reporting for pension plans:
  - Standards are effective for financial statement (CAFR) as of June 30, 2014 for VRS and as of June 30, 2015 for employers
- Reported liabilities may increase if the General Assembly does not stick with phasing in the contribution rates. A discount rate that blends long-term investment assumption with municipal bond rate would be required if full contribution is not funded.
- Standards will require mark-to-market (asset smoothing no longer used)
- Unfunded liabilities of cost-sharing plans (school teachers) must be apportioned among participating employers

Upcoming GASB Accounting Changes

- GASB is eliminating ARC and is requiring pension administrators to develop their own funding standards
- Brings sharper focus to funding standards
  - Full funding of ARC avoids higher liabilities caused by blended discount rates
  - Raises questions about non-employer entities (state government) sharing in liabilities otherwise apportioned to local governments
- Employers have greater stake in funding progress as it may affect their borrowing capacity
- VRS Board of Trustees recently adopted new funding standards:
  - Actuarial Cost Method – Entry Age Normal level of pay
  - Asset Smooth Method – Five-year smoothing of investment experience
  - Amortization Policy – Two-part amortization
    - 30-year fixed on legacy liabilities
    - 20-year tiered amortization of liabilities for each year after

Financial Reporting and Credit Ratings

- GASB 68 is an **accounting** issue, *not* a budget issue:
  - Local governments will not have to pay more for pensions because of GASB 68.
  - Rating Agencies will be focused on budget impact of pension *contributions* and ability of locality to pay, not balance sheet impact of GASB 68.
- Moody's rates over 8,000 local governments in the United States. Less than 1% of those with general obligation or equivalent ratings have been placed under review because of the new pension adjustments.
  - Affected ratings will be for those local governments whose adjusted pension obligations relative to their resources place them as significant outliers in their current rating categories.
- Moody's has said that for the majority of U.S. governments, pension obligations remain manageable in the context of their revenues and resources.

Guidelines Will Create Complexity

State and local governments will need to distinguish several separate pension calculations that will be derived in different manners for distinct purposes.

	Books	Bonds	Budgets
Purpose	Standardized financial reporting of pensions for accounting	Testing the degree to which pension obligations impact the government ability to repay bonded debt	Determining pension contributions to properly fund benefits
Primary Audience	Users of government financial documents	Rating agencies	Policymakers
Methodology	Pensions are accounted for through Net Pension Liability (NPL), i.e., the difference between the market value of pension fund assets and benefit obligations as of a specific date	Varies by rating agency, as pensions are just one of many metrics used to determine a bond rating	Actuarially determined contributions as a level percentage of payroll to fully fund benefits earned each year and to amortize unfunded liabilities

Comparison of Standards

	Books	Bonds		Budget
	GASB	**Moody's**	**Fitch**	**VRS**
Discount Rate	7% (Adjusted downward if projected assets not expected to cover projected liabilities)	5.47% - 2010 5.67% - 2011 4.13% - 2012 4.81% - 2013 4.33% - 2014	7%	7%
Amortization Period	Some expensed immediately, some over future working lifetimes, investment returns over 5 years	17 years	Not Calculated	30-year closed period - (Legacy unfunded as 6/30/13) 20-year closed period – (Tiered amortization of new unfunded after 6/30/13)
Asset Value	FMV	FMV	5-year smoothing	5-year smoothing
Annual Pension Expense	Difference between prior year Net Pension Liability(NPL) and current year NPL Consists of: Normal Cost plus Amortization of change in NPL amortized over various time periods depending on source of change	Normal Cost at new discount rate plus Amortization of unfunded liability over 17-year period	Not Calculated	Normal Cost plus Amortization of unfunded liability (see amortization period above for details)

Virginia Retirement System Liabilities

Unfunded Liabilities by Plan

Plan	6/30/2013 Funding Smoothed Assets	6/30/2014 Funding Smoothed Assets	6/30/2014 GASB** Market Assets	6/30/2014 Moody's** Market Assets
State Employees (includes SPORS, JRS, VaLORS)	$8.78	$8.33	$6.76	$16.63
Teachers	$15.13	$14.27	$12.08	$27.94
Local Political Subdivisions*	$4.47	$3.78	$2.50	$9.83
Total	$28.38	$26.38	$21.34	$54.40

* Local Political Subdivision information is *estimated* based on results of other statewide systems. Actual results will be available after Nov. 18.
** GASB and Moody's unfunded liabilities are estimates based on guidance provided to date. Moody's unfunded liability is based on 4.33% discount rate.

Teacher Cost-Sharing Plan

- Localities are concerned that apportionment of Teacher Plan liabilities will lead to downgrades from credit-rating agencies.

- Local resources contribute 60% of teacher pension contributions and Commonwealth of Virginia resources contribute the remaining 40% through “Standards of Quality” formula.
  - Localities feel Commonwealth of Virginia should own 40% of Teacher Plan liability.

- In order for Commonwealth to take on portion of Teacher Plan liability, state law would need to be changed to require Commonwealth of Virginia to pay its share of teacher contributions directly to VRS, rather than indirectly through SOQ formula.

Teacher Cost-Sharing Plan Unfunded Liabilities

Top 10 Largest Localities

School Board	Total Estimated Net Pension Liability	Percent of Total Employer Contribution
Fairfax County	$ 2,173,808,000	18.00%
Prince William County	765,838,000	6.34%
Loudoun County	722,754,000	5.98%
Virginia Beach	639,076,000	5.29%
Chesterfield	435,072,000	3.60%
Arlington County	413,424,000	3.42%
Henrico County	403,363,000	3.34%
Chesapeake	354,031,000	2.93%
Norfolk	350,762,000	2.90%
Newport News	252,298,000	2.09%
Total Teachers Plan	**$ 12,079,888,000**	

Impact of Changes

- Significant liability will be brought onto the face of the financial statements
- Funded ratios will be impacted, particularly by Moody's proposed changes
- Mark-to-market will increase volatility of accounting expense and liabilities
- Impact to local governments:
  - Apportionment of teacher cost-sharing plan liabilities will add to local liabilities, reflected on financial statements
  - Pension liability incorporated into local government bond rating
- Accrued pension expenses will increase significantly due to shorter amortization and unfunded liabilities
- Users of financial information will likely be confused over conflicting accounting standards

Thanks