Virginia Retirement System (VRS): Local Impacts, Options and Roles

VACO - Board Member Orientation

Joe Casey, Henrico County

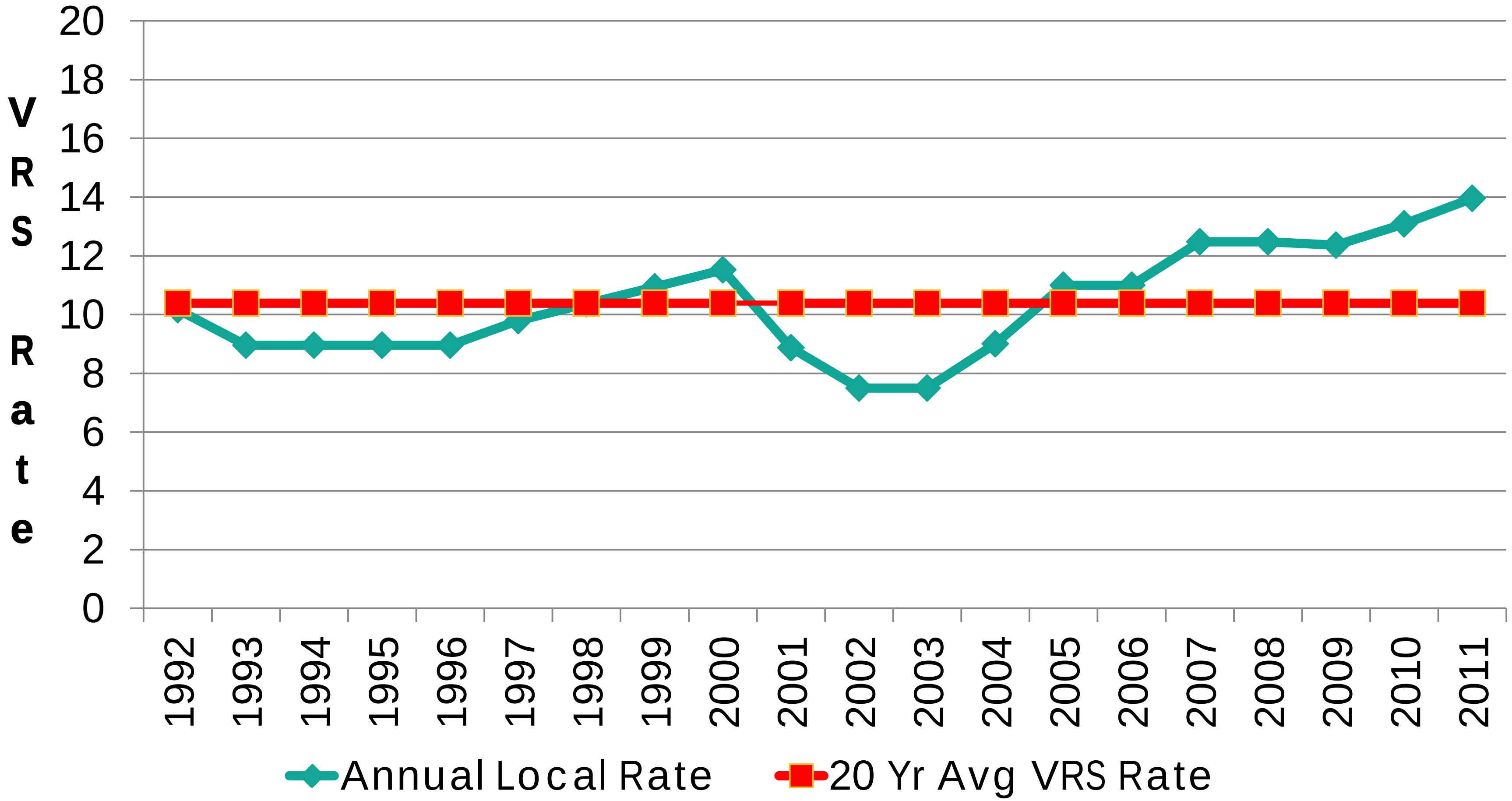
Defined Benefit vs. Defined Contribution Plans

- Defined benefit based upon years of service and $ earned over period of time
  - Need to become vested in order to attain benefit
  - Monthly benefit paid to retiree , then surviving spouse
  - Actuarially determined rates based upon portfolio value, scope of members and defined benefits
- Defined contribution – rate deposited in employees name, their asset
  - Asset drawdown by retiree with any balance becoming part of their estate
  - Rate set and doesn't need to fluctuate based upon changes in membership or portfolio investment return
- Portability amongst VRS participants and others through reciprocity agreements with VRS

VRS Defined Benefit – Key Actuarial Assumptions

- Payroll growth: 3%/year
- Asset valuation method: 5-year smoothed
- Investment rate of return: 7%/year
- Salary increases: 3.5% - 5.35%/year
- COLA adjustments: 2.25% - 2.5%/year
- Unfunded amortization: 20-30 years

Average Rates over Past 20 Years ~10%



Membership Profile

- 629,000 members of VRS
  - 341,000 total active members
    - Majority from local govt: 146,000 teachers and 105,000 local govt
  - 169,000 retirees and 118,000 inactive members
- Member profile (averages):
  - 46 year old w/ 11 service years earning $41,000/year
  - Retiree: 62 year old w/20 service years and $15,000 benefit/year (34.7% of final pay)
- 2013 Rates (average)
  - Employer 9.9%
    - LEOS employees 12.5% and non-LEOS 8.5%
  - Employee 5.0% (effective July 2012)
    - Some local governments and schools phased in over 2-5 years

2010 State Mandate – Plan 2 Employees

- New classification of employee for all new employees hired after July 2010
  - Reduced benefit assumptions
  - Goal - slowly reduce VRS rate impact as new workers are hired with lower benefit assumptions

2012 State Mandate – 5%/5% Program and Hybrid Plan

- 5/5% Program (effective July 2012)
  - All local government employees contribute 5% of their salary to VRS with employer contribution rate declining 5%
  - Many local governments offset higher employee impact with 5% higher salary
  - Unfunded mandate as FICA and related taxes cause additional cost to employer and lower net pay to employee
    - Average $250 net pay cut to employee (.7% negative impact)
  - Pension obligation is actually higher w/ higher salaries
- Hybrid Program (effective January 2014)
  - 1% employer and employee defined contribution
  - Up to an addition 4% employee voluntary contribution; employer match for first 1% and up to 1.5% for the next 3% employee contribution

Future VRS Challenges

- Hybrid Plan (biggest impact in reducing rates) exempts public safety workers
  - Highest pension liability employees
  - Mandates VRS as vendor for employees
- State process for teacher pension liability will have escalated rates through 2020
  - Goal = 100% of VRS certified rates by July 2018
  - July 2012: 69.5%
  - July 2014: 79.%
  - July 2016: 89.9%

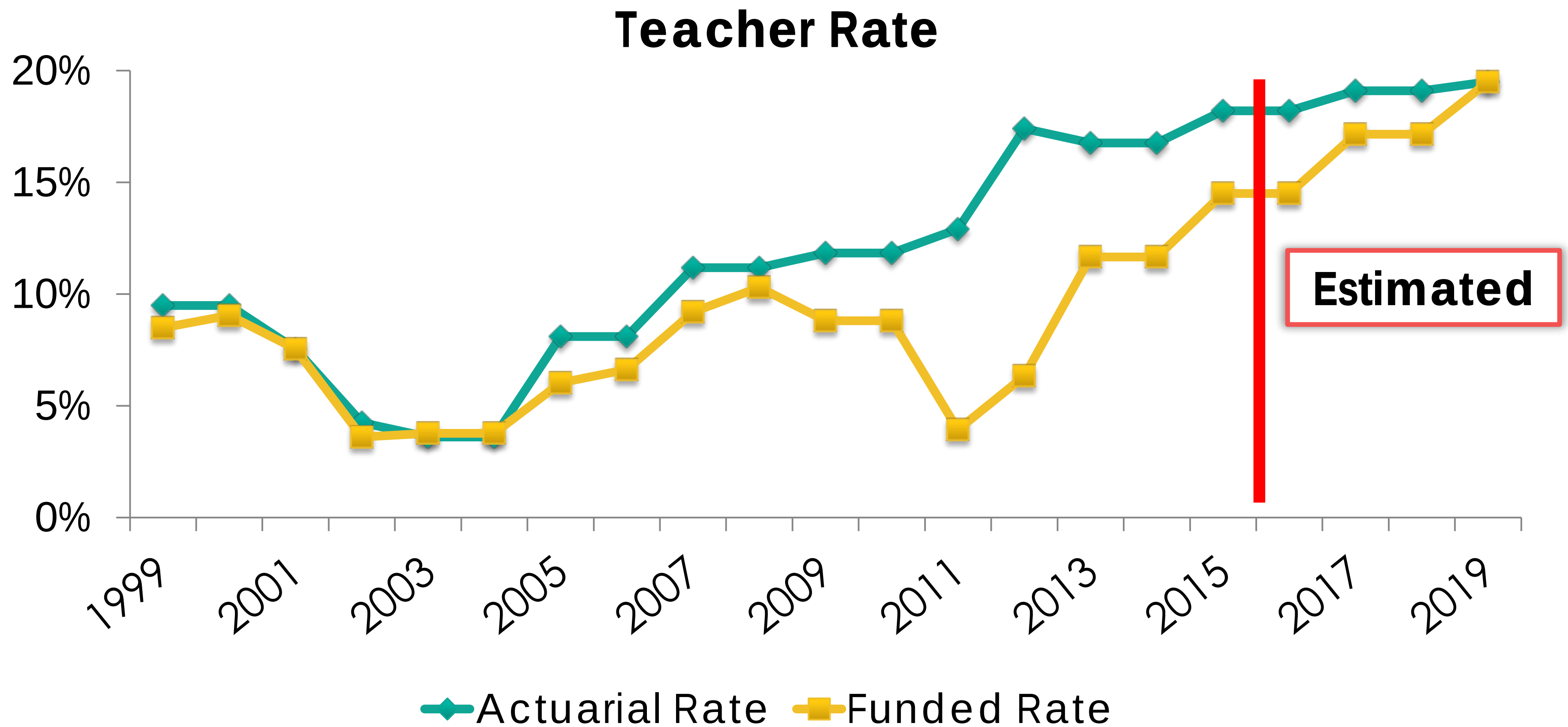
How Does an Unfunded Ratio Arise?
(and Correlation to Higher Future VRS Rates)

- Unfunded liabilities may arise at any year-end due to VRS investment portfolio fluctuations occurring after rate calculation
- Actuarial calculation changes raised rates-liability
  - FY10: Lowered invest income assumption from 7.5% to 7.0%
  - FY13: Rolling five-years had FY13's 11.8% investment return, but also had FY09's 21.1% investment loss
  - Annual salary increase assumption still at 3%; yet trends have been much lower (<.5%/year average since 2008)
- Other impacts to unfunded liability and rates
  - Timing difference between underperforming investments and actuarial reports (remedied by future higher rates)
  - State's lower VRS rate for teachers than actuarial rate
    - 3 separate "loans" with interest to account for past and future liability from lower VRS rates

GASB68 and Bond Ratings – Local Roles to Mitigate Impact

- Who is GASB? (recognized accounting standard authority)
- GASB 68 balance sheet liability and bond rating agency higher weight will be assigned to such liability
  - To recognize that a large unfunded pension liability will impact Virginia (as a State and collective localities)
  - To best position Virginia to reflect this liability in ability to record-reduce w/ citizen-business impact focus
- To position Virginia-localities for fiscal sustainability
  - Intergenerational equity in cost of services
  - Taxpayers today pay and not pass cost to next generation
  - Economic development positioned to create jobs and sustain essential services (schools, public safety)

Retirement Contribution Rate: Actuarial Rate vs. Funded Rate



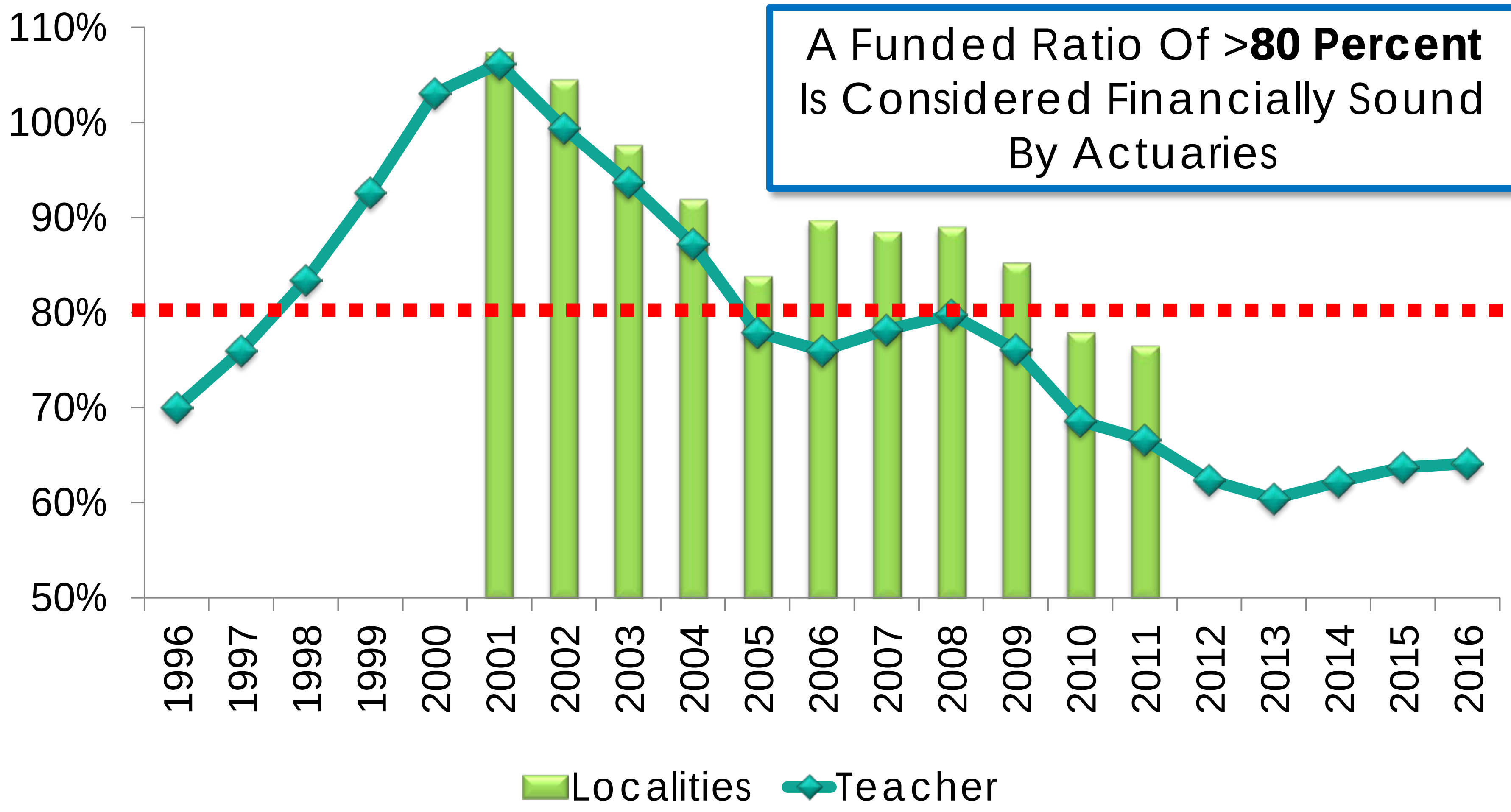
Locality Rates Funded Are Always 100% Of Actuarial Rate

FY15 and FY16 VRS Rates

	Board Certified Full Employer Contribution Rate	FY15 % to be Adopted by General Assembly	Estimated Employer Contribution Rate to be Adopted	FY13 and FY14 Employer Contribution Rates
Teachers	18.20%	79.69%	14.50%	11.66%

- "% to Be Adopted" gives rise to the new 20 year liability loan
- Contribution rates are net of 5% employee contribution rate
- FY15 increased rates are ~ 24% higher
  - Funding $: Local: $122 million (60%), State $82 million (40%)
  - $1300/teacher impact (~= to any proposed raise)
  - Local funding constraints may raise student: teacher ratio
- FY15: Total teacher liability $15 billion; 62.1% unfunded
- Future "% to Be Adopted" = 89.9% in FY17 and 100% in FY19

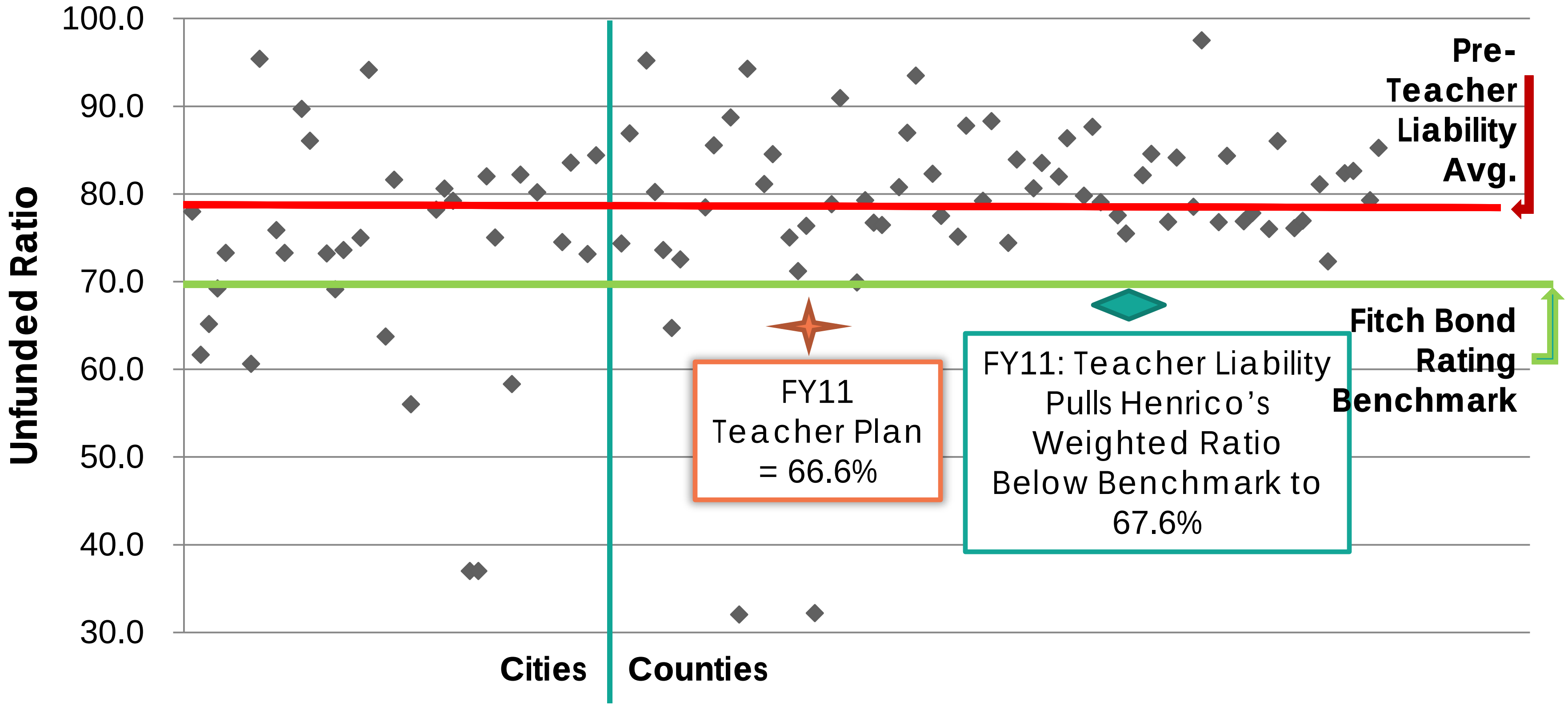
Teacher and Localities Ratio Funded Status



Who Should Record the Teacher's Liability?

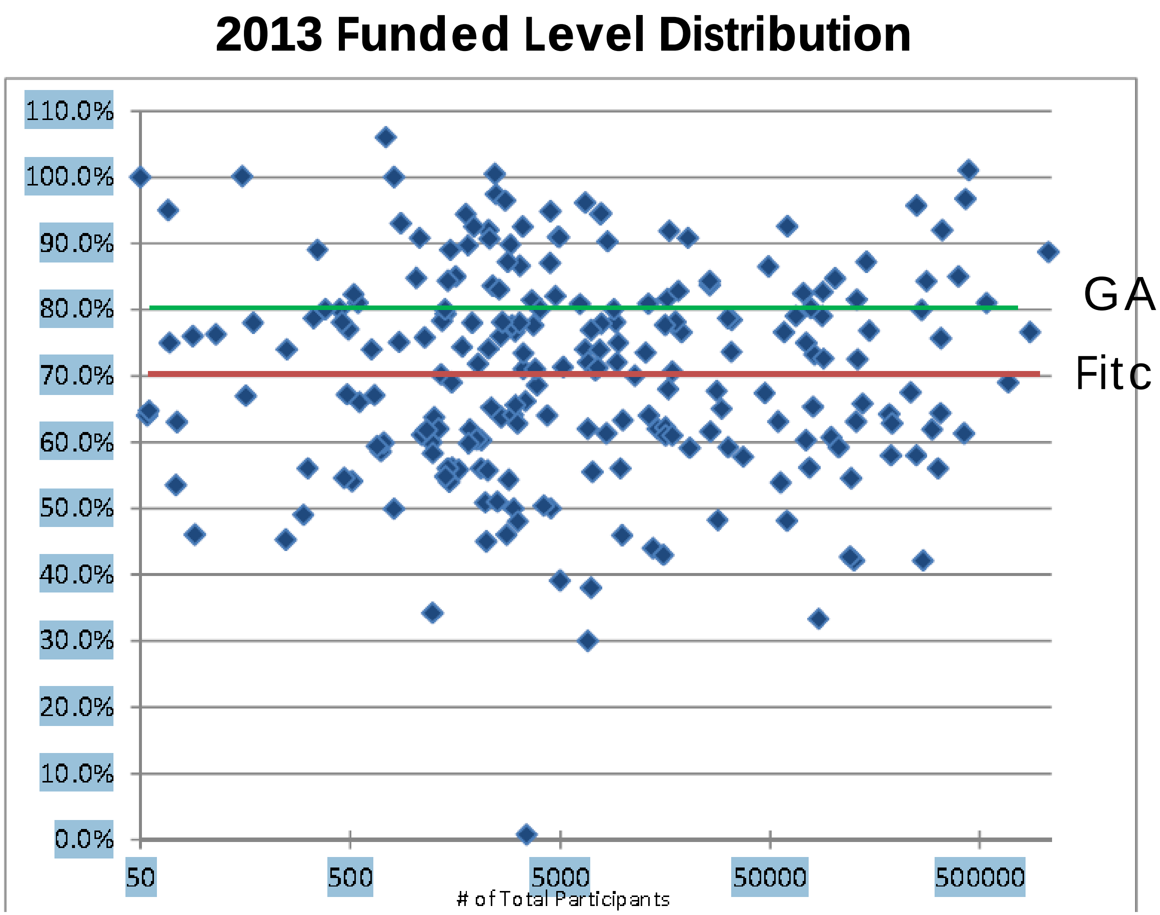
- Localities prefer proportional responsibility
  - Share of VRS costs: Local 60%, State 40%,
  - Recognizes teacher VRS system is a shared State program meeting intentions of GASB68 recordation
  - State's selection of arbitrary and lower rates illustrates at least a shared responsibility (if not 100% ownership)
  - Administratively simple to record liability
    - State's payment to localities changed to direct payment to VRS
- State prefers locality record 100%
  - Technically can shift 100% liability with localities' payment to VRS (even if State is $ origin)
  - Teachers are 100% local employees (at least for this topic)

Threat of Local Governments Crossing Below the Line with Lower Unfunded Teacher Ratio



- Pre-teacher Liability: FY11 Chart shows localities generally above the "rating line" (pre-teacher liability)
- Post-teacher Liability: teacher unfunded ratio now 62.4% in FY13 may push many below the "rating line"
- Local impact high - Teachers 62.2% of total local workforce

Virginia is Not Alone in this Challenge, But Can Position Itself Ahead



GAO Target

Fitch Target

~250 State and local pension plans

New Paradigm: How to Position State and Local Best for New Jobs

- Is the whole (State) > then the sum of the parts (localities) for recurring, retaining and expanding business and new jobs or are we one goal-oriented team?
- Questions asked by prospects to locality may be more in-depth in seeking a stable locality for their business
  - What are the taxes my business will pay (today, tomorrow)?
  - How good are the local schools for my employee's children and future employees?
  - How safe is the locality for my company and my employees?
  - What's the quality of life in your locality for my employees?
  - What is your bond rating?
- How do rating agency "negative outlooks" or downgrades as result of teacher liability affect business decisions?
  - If State impact < local impact of teacher liability, then shouldn't that be a consideration in proportional sharing of liability?

Locality Role in Job Creation

- Small to mid-sized business development primarily local
  - Many small businesses move to locality based upon own due diligence without local Econ Dev efforts
  - Prospects call locality first and may not call State
  - Largest volume of activity and # of new jobs in total
- Large companies may want State incentives
  - Infrequent in volume and lower jobs in total
  - Prospects may call State first, but not always
  - State defers to locality to "close the deal"
    - Infrastructure, zoning, local incentives, tax structure changes
    - Due diligence factors:
      - Quality of life attributes (Schools, safety, housing)
      - Fiscal health (balance sheet, income statement, bond ratings)

Economic Development Impact Analysis Has Not Been Done

- Proportional liability impact to bond ratings and correlation to new business investment
- State bond rating impact vs. aggregate local government bond rating impact
  - Per VRS: “Could affect local government bond ratings”
- Question not Answered:
  - If 100% local government liability recordation is more adverse to economic development and job creation than proportional liability, why wouldn’t State recognize proportional liability?

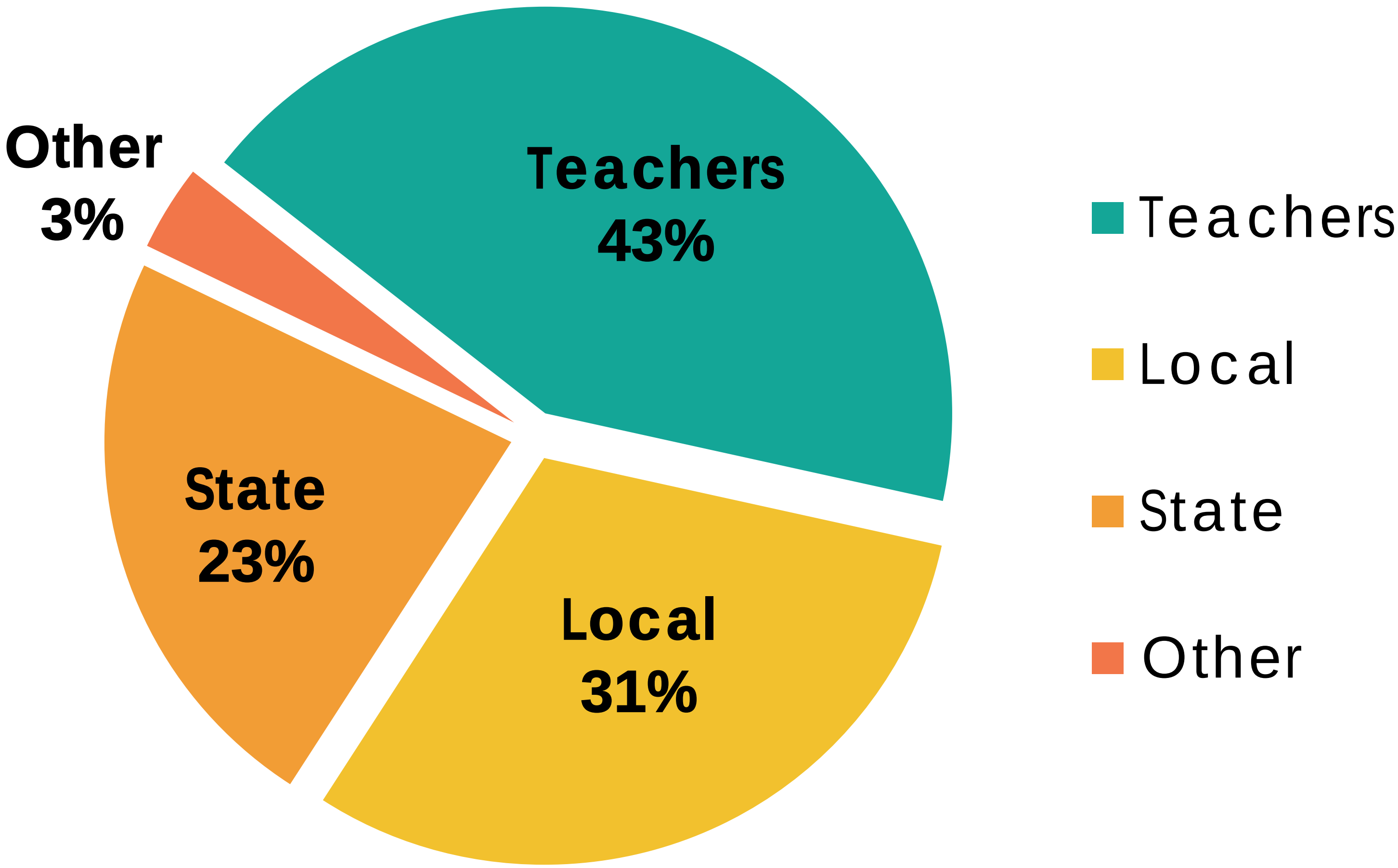
Local Government Employees

- One commonality - all local government
- Employees don't know who is grant funded, part of SOQ formula, part of Compensation Board funding, local tax
- Prefer uniform rationale for salary and benefit programs
- Want to serve their local citizens, students, businesses

If State Now Considers Teacher 100% Local, Then Other Considerations?

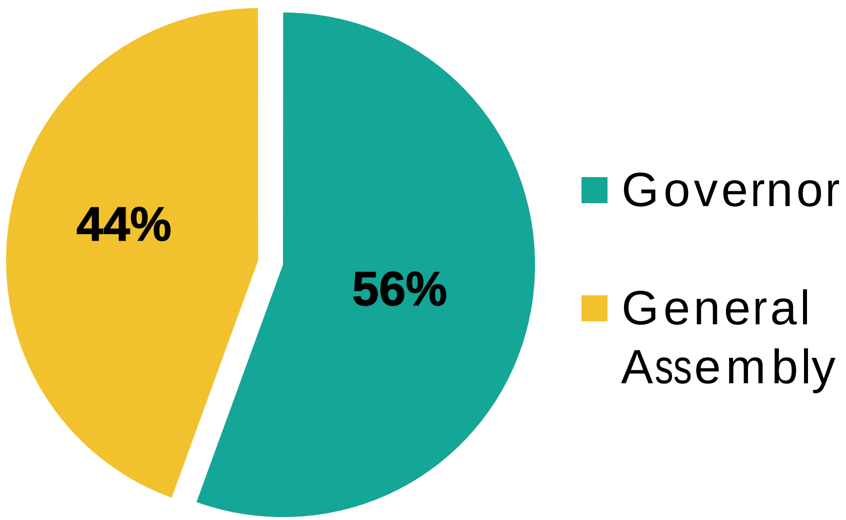
- Easier-flexible school funding formula on how best to spend at school level
  - Avoid salary initiative challenges (“use it or lose it”)
  - Consistency amongst school, compensation board, and grant positions funding of salary-benefits
    - Opportunity to reform all with simple funding formula w/out all the paperwork
- Local VRS Bd representation if teacher liability
  - Future input into Board, role, local customer service
    - Customer service even more important w/ hybrid plans

If This Is How Customers of VRS are Represented, Then…

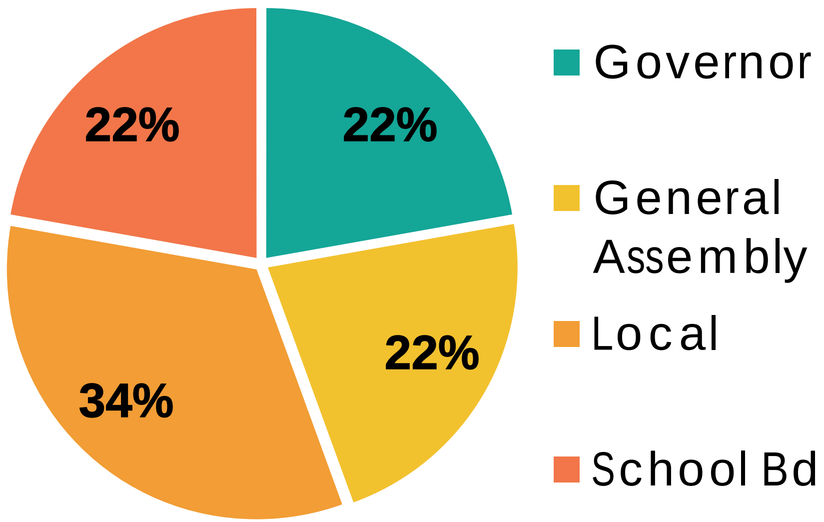


Should VRS Board Reflect Proportional Oversight and Liability?

How Currently Selected



Proportional Selection?



Proportional Representation Still Favors State

State representation 44% (23% of employees)

Local representation 56% (74% of employees)

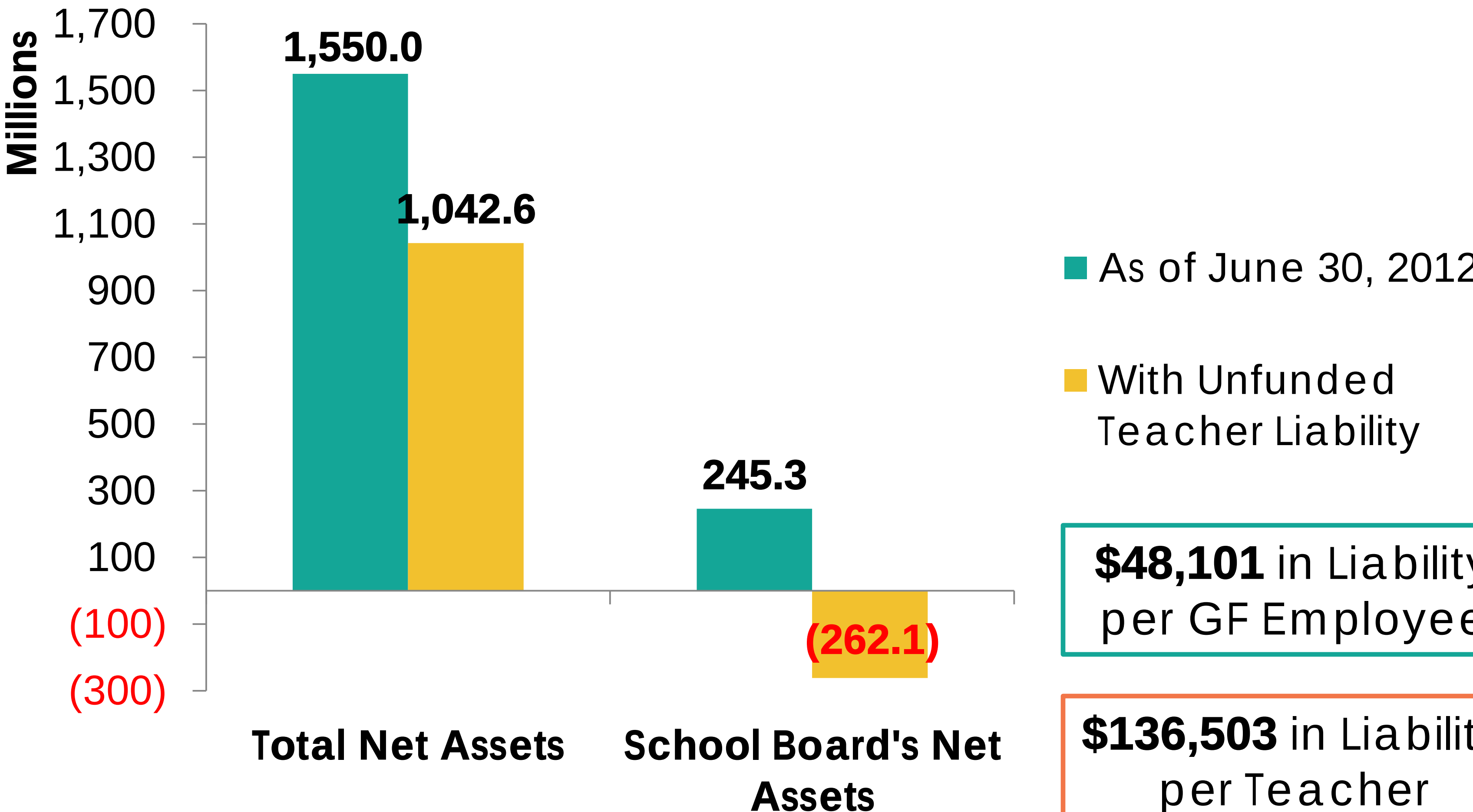
VACO 2014 Legislative Program for Unfunded Teacher Pension Liability

- Local governments and the state share responsibility for paying the cost of teacher pensions, but under GASB 68, Virginia local governments will have to begin accounting for both the state and local unfunded liabilities for teacher retirement plans after June 15, 2014 on their financial statements. VACo urges the state to account for its proportional share of liability shift by paying its current share of teacher pension contributions directly to VRS. This would demonstrate to credit rating agencies and localities that the state is committed to paying its proportional share of unfunded teacher pension liabilities. It would also better protect the bond ratings of Virginia's localities by more accurately reflecting the local share of the unfunded liability.

Mandates Commission Nov 1

- Supports VACO preliminary legislative position statement
- Also supported classification of VRS Board as being 100% State appointed as a <u>**mandate**</u> with adverse impact to local government

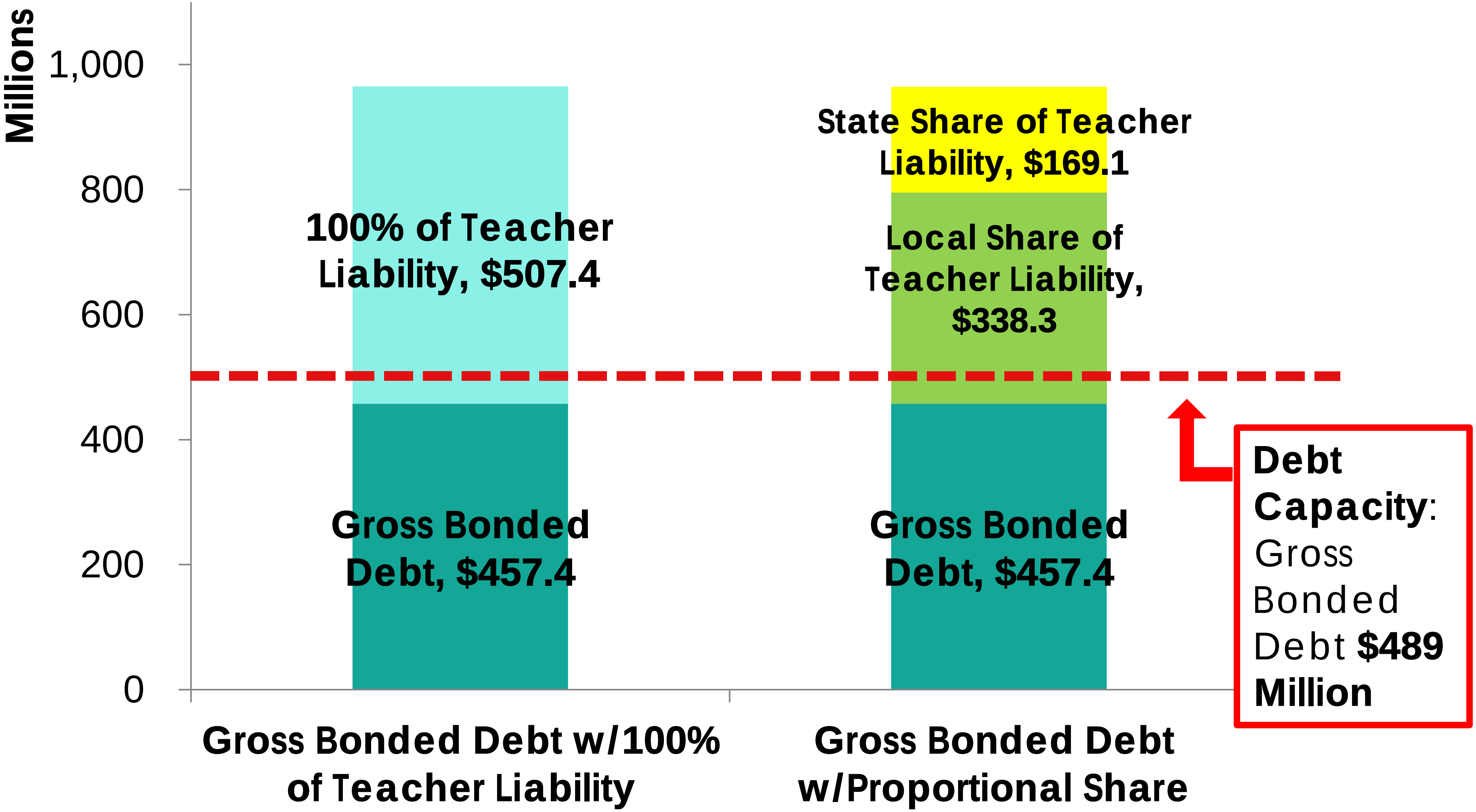
Henrico's Impact of $507 Million Unfunded Teacher Liability – Net Assets



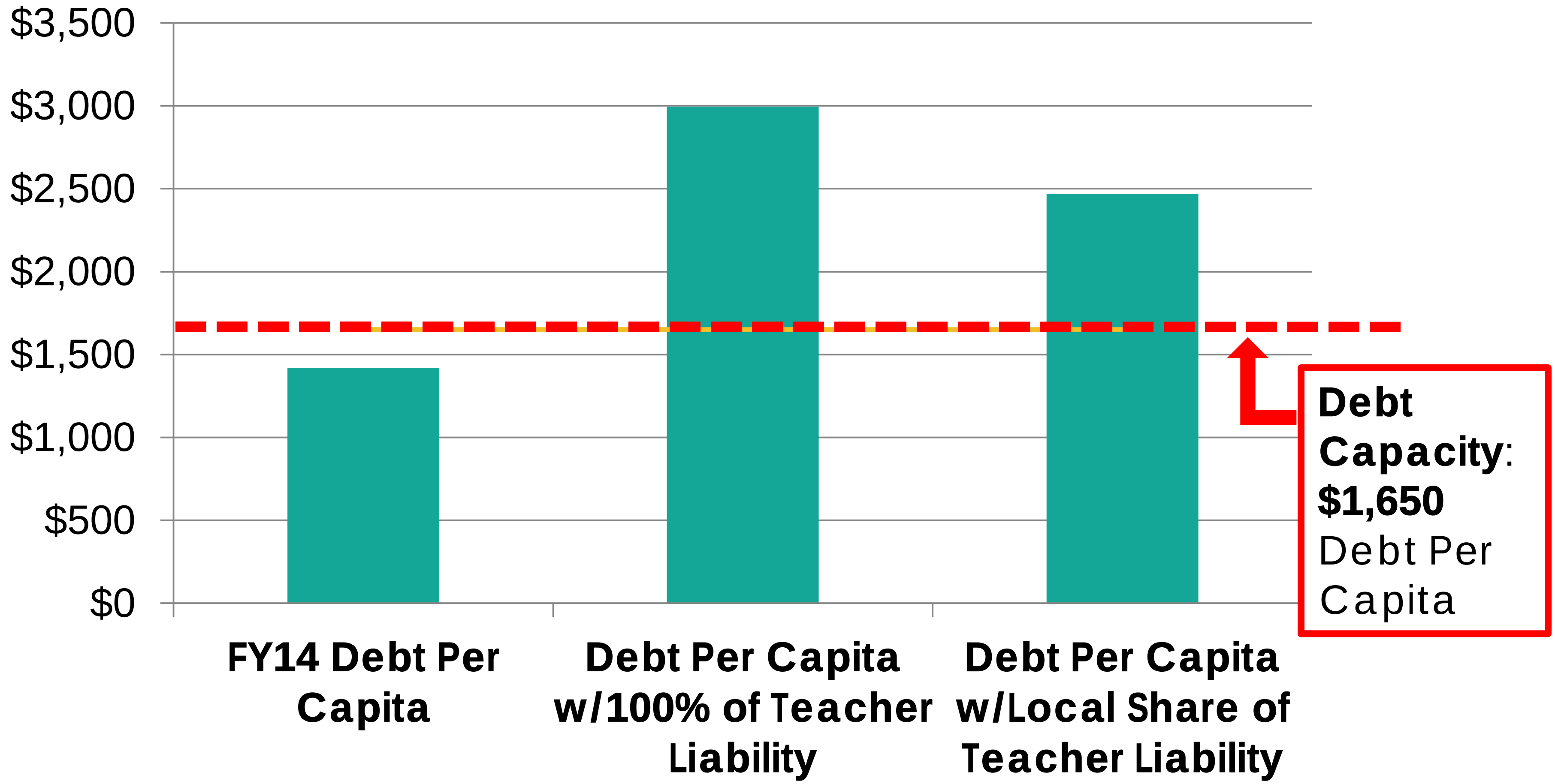
$48,101 in Liability per GF Employee

$136,503 in Liability per Teacher

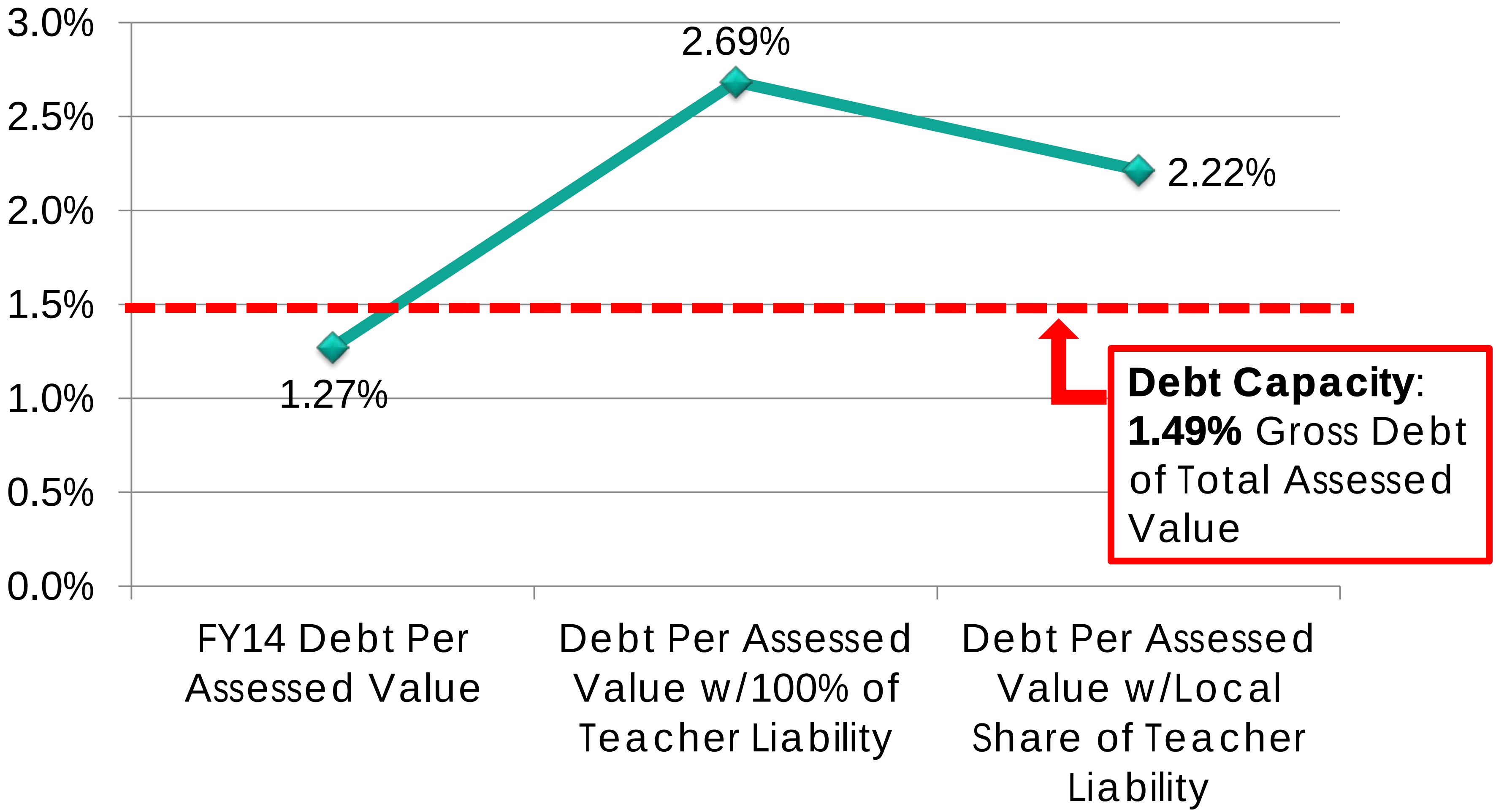
Henrico's Impact – Gross Bonded Debt



Henrico's Impact – Debt Per Capita



Henrico's Impact – Debt to Assessed Value Ratio



Proposed Moody's Criteria

	Economy	Finances	Management	Debt-Pensions
Existing	40%	30%	20%	10%
Proposed	30%	30%	20%	20%

Proposed Factors (Each 5%)	AAA	AA	A	Baa
Net Pension Liab/Value	<1.1%	1.1 – 2.6%	2.6 – 6.0%	6.0 – 15%
Net Pension Liab/Rev	<.5x	.5 – 1.0x	1.0 – 4.5x	4.5 – 7.5x

- Pension factors are proposed to be 10% of debt-pensions 20% criteria

Proposed Collective Analysis – Effect Upon Bond Rating Calculation

NPL/Value and NPL/Rev	Pre-Liability	Post-Not Shared	Post-Shared	# of New Jobs Created
State	??	??	??	??
AAA Localities	??	??	??	??
AA Localities	??	??	??	??
A Localities	??	??	??	??

- Other factors can also be analyzed
  - Net asset impact and other financial indicators
  - Other metrics of economic development
- If shared liability is least impacting, then support for shared liability has a rationale

Proposed Collective Analysis – Effect Upon Bond Rating Calculation

School Board	Estimated GASB NPL (in millions)	Bond Rating	2013 Job Growth as a Share of State Total
Fairfax	$ 2,658.22	AAA Aaa AAA	25%
Prince William	$ 967.11	AAA Aaa AAA	1%
Loudoun	$ 885.26	AAA Aaa AAA	4%
Virginia Beach	$ 816.24	AAA Aaa AAA	3%
Chesterfield	$ 543.90	AAA Aaa AAA	2%
Henrico	$ 507.38	AAA Aaa AAA	9%
Arlington	$ 490.04	AAA Aaa AAA	1%
Chesapeake	$ 450.94	-	3%
Norfolk	$ 431.11	-	1%
Newport News	$ 328.25	-	2%
Total Teacher Plan	**$15,160.26**	**-**	**51% of State-wide Job Growth**

Aggregate Funded Status	61.2%

Strategic VRS-Related Issues Worthy of Further Discussion

- Flexibility to enable local government determine benefits package to achieve goals to recruit, retain and reward employees for current and next generation workers
- If defined contribution, then provide it as a local option to select and determine contribution rate
  - Should VRS be the "vendor" by default or compete with other vendors currently serving local government
- Portability possibility from defined benefit to defined contribution limited to 5% "employee" share because of underfunded total balance
  - Consideration of enabling portability for actual % share of funded portion
- Address continuing challenge of losing good employees who have met VRS retirement age to non-VRS employers
  - Also challenge in finding experienced employees from non-VRS employers or employees who prefer 100% defined contribution

If 100% local government liability recordation is more adverse to economic development and job creation than proportional liability, why wouldn't State recognize proportional liability?

QUESTIONS