

SENATE OF VIRGINIA

# Senate Finance Committee

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# VRS Unfunded Liability

February 9, 2012



# Key Issues to Address

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- **Stop short payment of VRS Board rates.**
- Stem excessive negative cash flow.
- Investment returns are not controllable by the Commonwealth.



# Plan for Success

- **Patience on VRS investment returns.**
  - Long-term economic cycles at play.
  - Leave investment policy to the professionals.
- Plan design modifications *and* guaranteed payment of Board Rates.



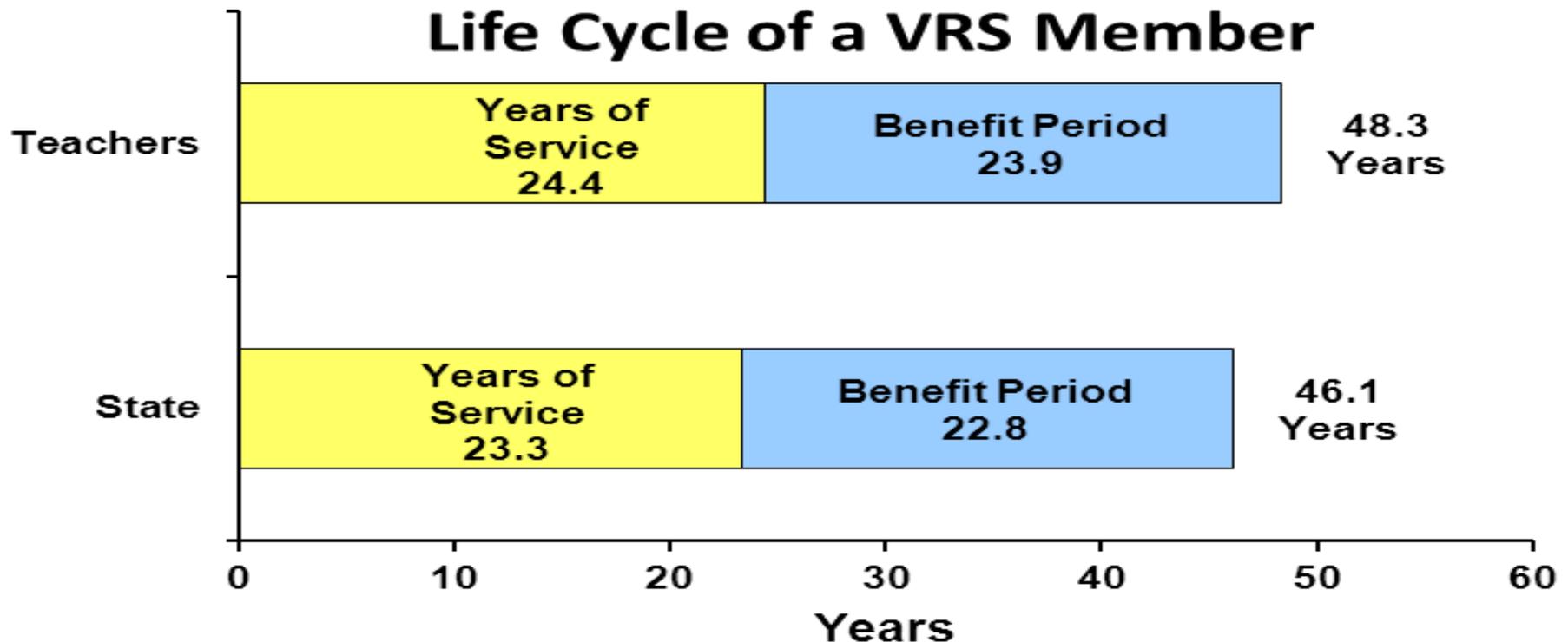
# What is the Unfunded Liability?

- **Unfunded Liability** is short for *Unfunded Actuarial Accrued Liability (UAAL)*.
  - Measures the difference between the *Actuarial Assets* and *Actuarial Liabilities*.
- **Actuarial Assets:** The market value of assets smoothed over five years to minimize the impact of swings in value.
- **Actuarial Liabilities:** The amount that must be set aside to pay for the promised retirement benefits expressed in current dollars.
  - Ideally set aside over the employee's career (VRS Average = about 15 years).
  - Lifetime costs for all members.
  - Discounted at the VRS **Board's** Rate of Return.

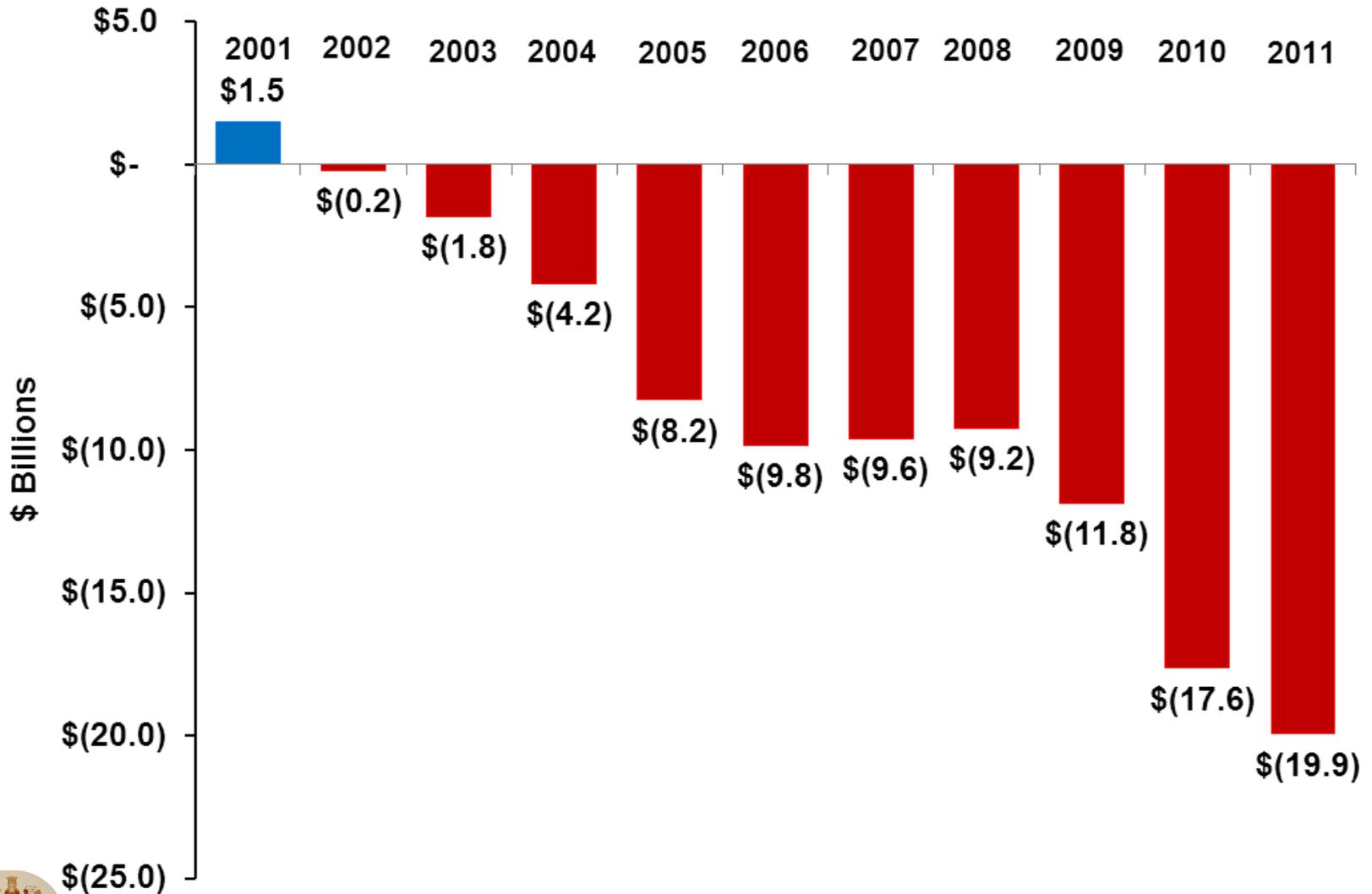


# VRS Unfunded Liability

- The VRS time horizon is very long.

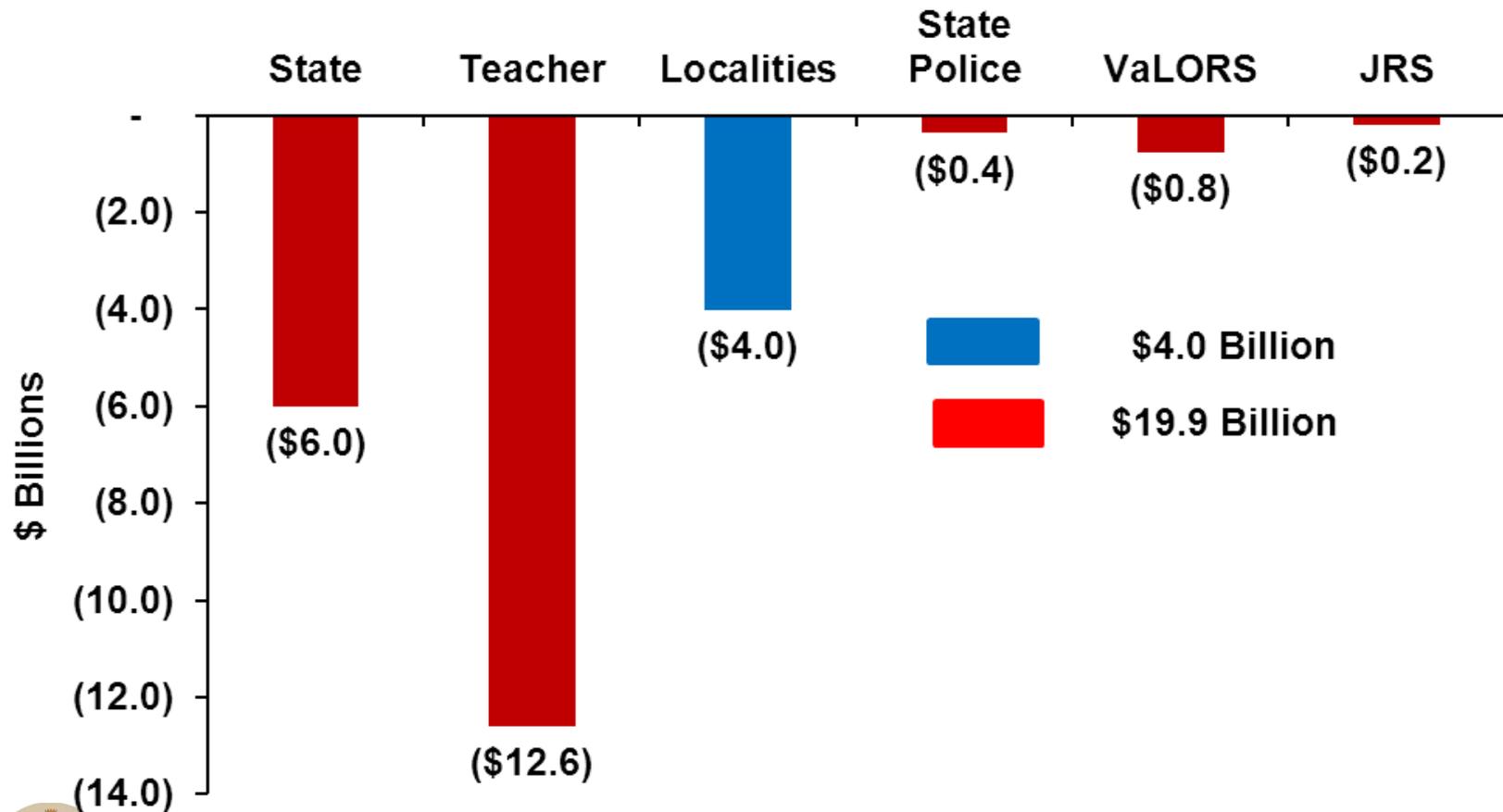


# VRS Funded Status 2001 to 2011

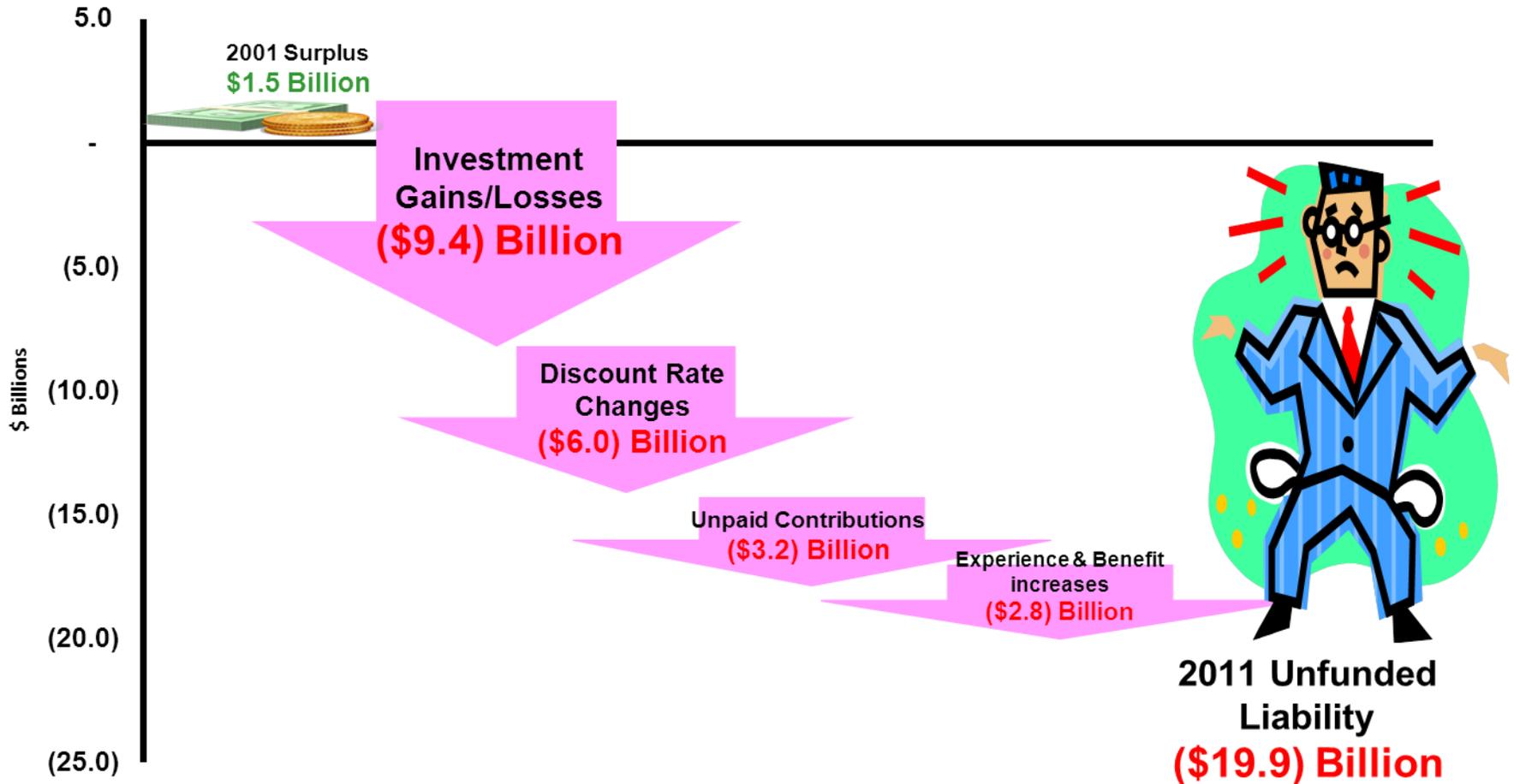


# Are all Unfunded Liabilities created equal?

## Unfunded Liability by Plan or Pool \$ Billions



# Contribution to Change in VRS Funded Status 2001 to 2011



# What does this mean?

- Resolving the VRS Unfunded Liability issue requires a focus on the cause: financial and investment performance issues.
- The *existing* Unfunded Liability will cause VRS contribution rates to increase and remain high.
- Long-term trend is unsustainable:
  - 18% - Teachers
  - 17% - State
- Reductions in benefits and financing reform are both needed to resolve the VRS Unfunded Liability issue.



# Major VRS Board Constraints

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- **Prudent Person Rule**
  - (§ 51.1-124.30.C. Code of Virginia)
  - Minimize Risk (§ 51.1-124.30.C. Code of Virginia)
  - Limited Personal Liability (§ 51.1-124.30.D. Code of Virginia)
- **Contribution Rate Stability**
  - (§ 51.1-1145 Code of Virginia)



# VRS Board Considerations

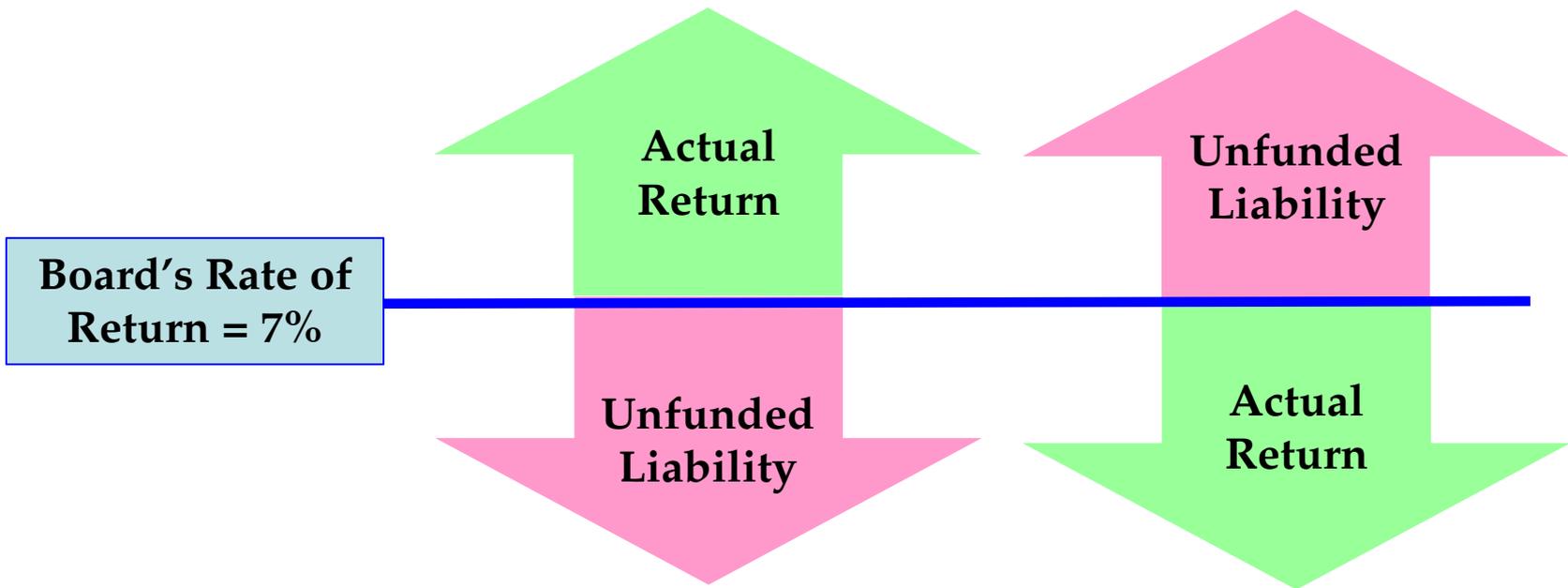
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- The VRS Board rate of return is forward looking.
  - Extensive analysis by VRS staff.
  - Comparison to outside benchmarks.
  - “Prior returns are no guarantee of future results.”
- VRS Board rates are designed to suit VRS’s long-term investment goals.
  - Not necessarily valid for other states.



# Investment Performance & the Unfunded Liability

- Investment performance only affects the Unfunded Liability when it varies from the Board's rate of return.



# Opportunities: Investment Performance

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- Predicting major recessions is not possible.
- VRS's performance meets or exceeds its peers.
- **Establishing achievable rates of return is essential.**
- **Positive investment experience will reduce the impact of this factor over time.**



# Discount Rate & the Unfunded Liability



**\$1,240  
Today**



**Discount Rate = 7%  
For 30 years**



**\$3,000  
Over 30 Years**



**\$1,125  
Today**



**Discount Rate = 8%  
For 30 years**



**\$3,000  
Over 30 Years**



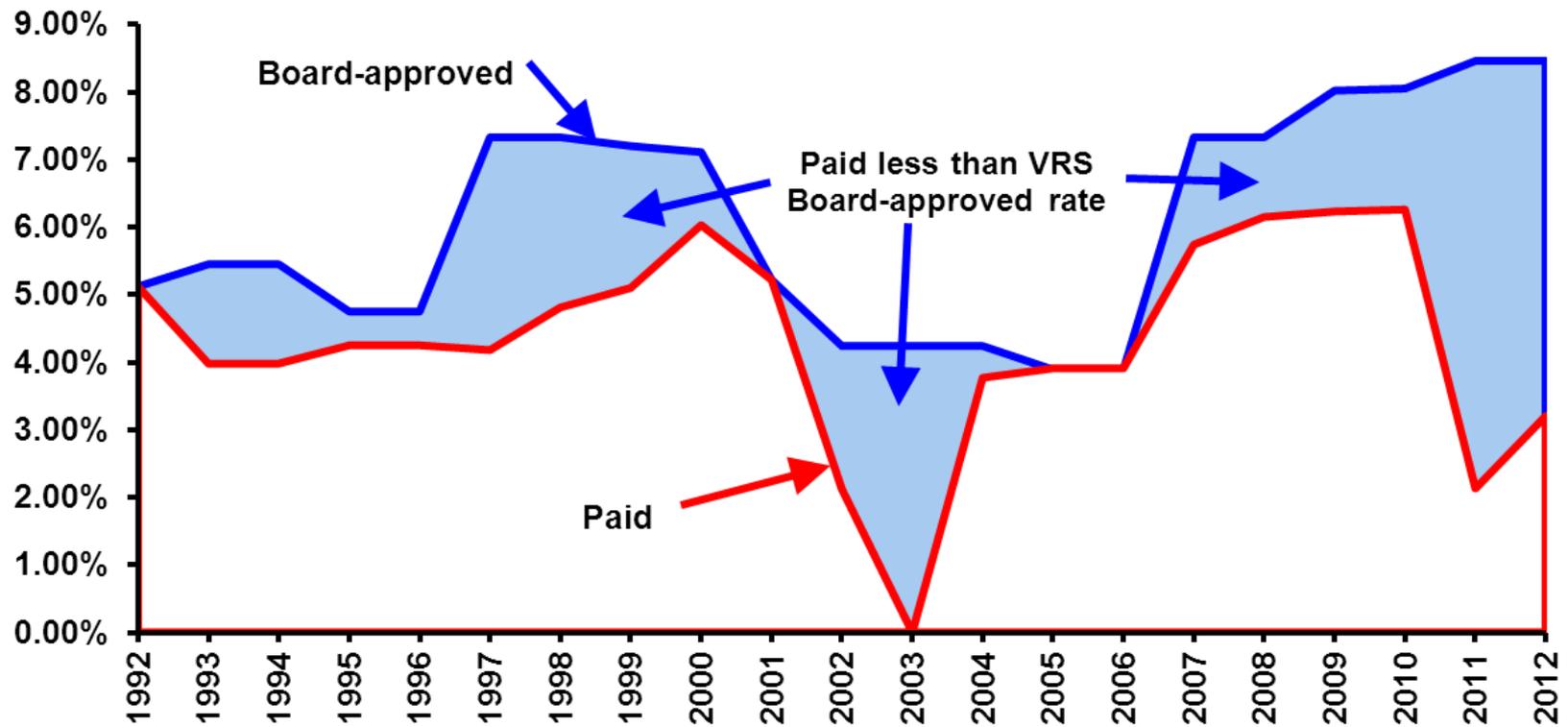
# Opportunities: Discount Rate

- The link between the **Discount Rate** and the **Unfunded Liability** makes it imperative that the VRS Board use the highest *prudent* rate of return.
- **Establishing an achievable rate of return should make future reductions in the discount rate unnecessary.**



# Unpaid Contributions

Comparison of VRS Board-Approved to Actually Paid Employer Contribution Rates for State Employees



# Opportunities: Unpaid Contribution

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- Unpaid Contributions are controllable over time.
- **Payment of the VRS Board Rates is essential for long term reduction of the Unfunded Liability.**



# VRS Board Rates are the “Gold Standard”

- Governmental Accounting Standards Board (GASB) rules **require** the Commonwealth to use the VRS Board Rates:
  - When measuring the Unfunded Liability, and
  - When reporting liabilities in the Commonwealth’s Annual Report.
- Bond Rating agencies have begun to take both types of retirement-related liabilities into account.
- **Unpaid Contributions = Liability**



# Can the Board adopt better rates?

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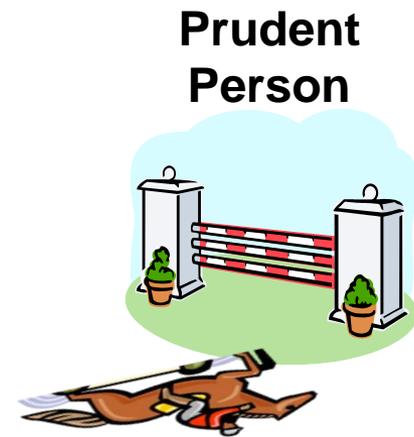
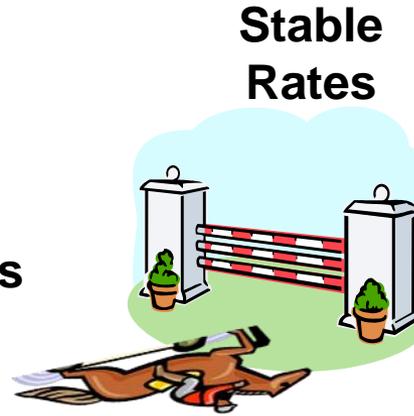
- Higher investment yields would produce lower rates, or a better funded system.
- The current investment and regulatory environments *do not* lend themselves to higher investment yield.
  - GASB accounting rules.
  - Prudent Person Standard.
  - Stable rate requirement.



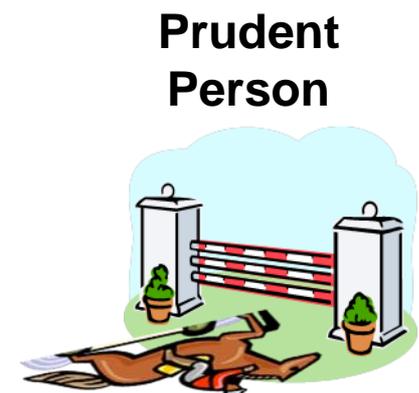
# Can the Board adopt better rates?



8% return =  
95% Equities



3% return =  
Government  
Bonds



# Negative Cash Flow

- **Negative Cash Flow** for a pension plan occurs when expenses exceed contributions.
  - Some **Negative Cash Flow** is expected for a mature retirement plan such as the VRS.
- VRS's **Negative Cash Flow** in recent years has been excessive.
  - \$2 billion per year.
  - Prevents positive investment returns from reducing the Unfunded Liability.
- Continued Excessive Negative Cash Flow could force VRS to adopt a shorter term investment strategy.
  - Reduced Rate of Return.
  - Higher Employer Contribution Rates.



# Plan for Success

- **Patience on VRS investment returns.**
  - Long-term economic cycles at play.
  - Leave investment policy to the professionals.
- Plan design modifications *and* payment of Board Rates are needed.
- Plan design modifications:
  - Retain Plan 1 and Plan 2 for current members.
  - New *Mandatory* Hybrid Plan for new employees.
  - Current employees have the option to move to new plans.
  - Applies to state employees, local employees, and teachers.
  - No changes for SPORS, VALORS, LEORS, JRS, or faculty ORP.
  - Effective January 1, 2014.
- Phase-in full payment of Board's Rates for state employee and teachers over three biennia.



# Key Features: Hybrid Retirement Plan

- The Hybrid Retirement Plan has two key components:
  1. A **Defined Benefit (DB)** retirement “Backbone”, and
  2. A **Defined Contribution (DC)** component.
- The **Defined Benefit (DB)** retirement “Backbone”.
  - Provides a *guaranteed* retirement benefit.
  - 1% multiplier = 30% of AFC after 30 years.
  - 4% employee contribution with the remainder contributed by the employer.
  - Allows continued amortization of the current Unfunded Liability.
- The **Contribution (DC)** component.
  - Employee: Mandatory contribution of 1% with up to 4% additional.  
(Maximum = 1% + 4% = 5%).
  - Employer: Match of 100% up to 2%, and 50% of the next 3% up to a total of 2.5%.  
(Max = 1% + 1% + 1.5% = 3.5%).
  - Automatic contribution escalator with employee opt-out feature.
  - Multiple VRS-sponsored investment options.
- Disability Coverage.
  - Continue VSDP for state employees.
  - Extend VSDP for to local employees and teachers.



# Key Features:

## Phase-in VRS Board Rates

- VRS Board-Approved Employer Contribution rates will be phased-in over three biennia.
  - Two-thirds vote of the members elected to each chamber will be required to pay less.

SB 498 (Substitute) Phase-in of Employer Retirement Contribution Rates						
VRS Retirement Plan or Pool	2012-14		% of Board Rate			
	VRS Board	HB/SB 30	2012-14	2014-16	2016-18	2018-20
VRS (State Employees)	13.07%	8.76%	67.02%	78.02%	89.01%	100.00%
VRS (Teachers)	16.77%	11.66%	69.53%	79.69%	89.84%	100.00%
State Police Officers Retirement System (SPORS)	36.62%	24.74%	67.56%	78.37%	89.19%	100.00%
Va. Law Officers Retirement System (SPORS)	19.52%	14.80%	75.82%	83.88%	91.94%	100.00%
Judicial Retirement System (SPORS)	54.11%	45.44%	83.98%	89.32%	94.66%	100.00%



# Key Features: Fiscal Impact

- VRS will require a NGF appropriation in FY 2013 and FY 2014.
- No fiscal impact on state agencies or local governments in 2012-14.
- Savings range from \$23.8 million (All Funds) in FY 2015 to \$200.2 million (All Funds) FY 2034.
  - Assumes a ratio of 4:1 employees at minimum to maximum employee contribution to the DC component

