Virginia Retirement System
2015 Fiscal Impact Statement

1. **Bill Number:** HB1890

House of Origin	☐	Introduced	☐	Substitute	☒	Engrossed
Second House	☐	In Committee	☐	Substitute	☐	Enrolled

2. **Patron:** Jones

3. **Committee:** Appropriations

4. **Title:** Virginia Retirement System; purchase of service credit for prior service.

5. **Summary:** Makes numerous changes to the purchase of service credit program to simplify it and make it more cost-neutral to the fund and more in line with other states' programs. The engrossed bill has a delayed effective date of January 1, 2017.

6. **Budget Amendment Necessary**: Yes. VRS estimates that implementing HB 1890 will cost approximately $552,500, not taking into account the savings generated by the legislation. This figure includes the cost of programming VRS internal systems, temporary staffing to support a transition phase from the old rules to the new rules, updating VRS publications, and communicating the changes and transition to VRS members. While VRS is unable to quantify the exact future savings of the proposed bill, historical analysis of the impact of purchases of prior service on the fund suggests that $552,500 would represent a fraction of what we expect in savings over the next ten to 15 years if this legislation is implemented.

7. **Fiscal Impact Estimates:** The purchase of prior service (PPS) program does not directly impact the normal cost rates of pension funds, but indirectly impacts costs through actuarial losses generated by members' purchase activity. Therefore, while the costs of PPS are not immediate, they are incurred over the long run.

8. **Fiscal Implications:** Section 51.1-142.2 of the *Code of Virginia* outlines the rules regarding the PPS program for VRS. Under the current rules, employees are given a window of time from date of hire, or re-hire, to purchase eligible forms of service. During this window, the cost to purchase service is either 5% of a member's compensation (Plan 1) or an approximate normal cost percentage of a member's compensation (Plan 2 and Hybrid). After the initial "window period," the cost to purchase prior eligible service moves to actuarial equivalent cost. One exception to this rule is "refunded VRS service," which under the current rules is always available to purchase at 5% of an employee's compensation for all plan members. Service related to periods of workers' compensation leave will remain at 5% under the proposed legislation.

   Under the current structure, allowing members to purchase service credits, even former refunded service, comes at a cost to the VRS plans. Since 2004, VRS has had over 90,000 members retire who are still receiving benefits today. Over one-third of those retirees, approximately 34,000 members, purchased some form of eligible service before retirement.

Exhibit 1 below shows that the difference between what was paid by members to purchase additional service versus the true actuarial cost of the service for those 34,000 members increased the unfunded liability of VRS plans by approximately $875 million.

Exhibit 1 – Additional Unfunded Liability Generated by Current PPS Provisions

($Millions)

Employer Group	Actuarial Equivalent Cost of Purchased Service	Amount Paid by Members	Shortfall to Fund / Additional Unfunded Liability
State	$ 300.7	$ 68.9	$ 231.8
Teachers	$ 578.3	$ 130.3	$ 448.0
SPORS	$ 8.1	$ 1.5	$ 6.6
VaLORS	$ 18.9	$ 3.7	$ 15.2
JRS	$ 4.1	$ 1.0	$ 3.1
Political Subdivisions (Aggregate)	$ 222.1	$ 52.2	$ 169.9
Total	**$ 1,132.2**	**$ 257.6**	**$ 874.6**

The shortfall in funds is due to several reasons and varies by individual circumstances, but historically most shortfalls are due to the implicit subsidy in the purchase price, or more importantly, the timing of the purchases.

The normal cost rate of a pension plan can be viewed as the rate of pay that must be contributed each year for a member so that as it accumulates with interest over the member's career enough money will be available to pay for the member's retirement benefit. The normal cost rate has historically been shared between the employee and the employer, with the employee contributing 5% of compensation and the employer paying the balance of the cost. When members are allowed to purchase service credit by contributing only 5% of compensation, this generates a shortfall to the fund because the employer is not required to make a contribution. This shortfall then becomes unfunded liability that the employer is charged with paying off over a longer period of time, historically somewhere between 20-30 years. This issue was addressed in part for Plan 2 and Hybrid members by increasing the cost to purchase prior service to the approximate normal cost rate.

Under the proposed legislation the rate to purchase prior service will be based on approximate normal cost rate for all members (Plan 1, Plan 2, and Hybrid) during a two-year window. Cost after the two-year window will be based on true actuarial cost. This methodology is more cost neutral to the Plan while still providing the member the ability to apply non-VRS service to his or her prospective retirement benefit. The one exception to this policy is for refunded VRS service, which will be discussed further below.

The most common category of purchased service has consistently been refunded VRS service. Refunded service means that an employee has terminated service earlier in his or her career and received a refund of his or her member account. If that member later returns to a covered position, he or she has the opportunity to purchase that prior service. Current Plan provisions allow members to restore previously refunded service credit by paying either 5% of current compensation for Plan 1 or Plan 2 members, or 4% for Hybrid plan members. While it may seem that repaying the employee contribution on current compensation should be sufficient to restore service credit since the employer's contributions for the member remained in the Plan, in most cases those employer contributions are absorbed by the Plan to cover the costs of new employees replacing those who left. More importantly, when the funds are withdrawn VRS loses the ability to capitalize on future investment gains, which typically account for nearly two-thirds of the Plan's funding requirements.

History has shown that due to the timing of a majority of these purchases late in an employee's career, the 5% contribution to restore refunded service is inadequate to cover the increase in liability that is being created by the purchase of service close to a member's retirement date. For members who have retired since 2004 and who purchased refunded service, the average length of time between receiving a refund from the Plan and re-purchasing the service was over 20 years. Assuming a 7% investment rate of return, a $10,000 investment would accumulate to nearly $40,000 over 20 years. By waiting until they retire to purchase the service, the additional liability cannot be worked into the normal cost rate and funded while the employee is working. It becomes an unfunded liability that is subsequently amortized over anywhere from 20-30 years, thus ensuring that employers will be paying for a benefit well after an employee has retired.

The only way to fully isolate the plan from increases in liability would be to charge members the full actuarial cost to add back the service. However, this method appears to be less common among public sector employers. VRS has found that a majority of State retirement systems require plan members to repay the refund with interest in order to restore the refunded service. The interest charged is usually a prescribed statutory rate set by their respective boards. We believe that this method may be easier for members to understand, and may also change habits of waiting until retirement to purchase the service.

Though this method does not fully address the total liability generated by the repurchase of service, it will at least help mitigate the lost opportunity for investment earnings while the refund is outside of the fund rather than just keep up with inflation, which the current 5% method favors.

Under the proposed legislation if a member wants to repurchase prior refunded service, it will require paying back the refund plus interest at the Plan's current discount rate of 7%, compounded from the date of refund to the date of repurchase. This method is prevalent with other State plans.

To illustrate, below we have modeled the impact of purchasing service at different times in an employee's career. We have shown the impact under the following cost methods:

- Current cost structure using 5% of compensation
- Return of refund with interest (assumed 7%)
- Full actuarial cost

Plan 1 Employee – Purchase of Prior Service Just Prior to Retirement

Employed from 7/1/84 - 7/1/88, 48 Months
Terminated at age 35 and 10 months and Elected Refund of $6,370

Rehired 7/1/1989 at age 36 and 10 months
Projected Retirement Date 9/1/2017, Age 65 with 28.1667 Years of Service

Purchase of Refunded Service in September 2012 - 48 Months of Service
Elapsed time between refund and repurchase is just over 24 years
New Projected Retirement Date 7/1/2015, Age 62.8333 with 30 Years of Service

Date	Years of Service	Age at Purchase	Current Salary	Value of Accrued Benefit	Value of Projected Benefit
Value of Benefit before Purchase	23.1667		$ 55,000.00	$ 204,300	248,400
Value of Benefit after Purchase	27.1667	60	$ 55,000.00	$ 294,200	$ 324,800

Current Cost	$ 11,000.00
Return of Refund plus interest	$ 32,680.00
Actuarial	$ 76,400.00

VRS will collect more with the refund of contributions with interest, but it is still far below the true increase in cost.

Plan 2 Employee – Purchase of Prior Service Shortly After Returning to Work

Employed from 7/1/2011 - 7/1/2014, 36 Months
Terminated at age 36 and Elected Refund of $8,493

Rehired 7/1/2018 at age 40
Projected Retirement Date 7/1/2043, Age 65 with 25 Years of Service (Rule of 90)

Purchase of Refunded Service in July 2021 - 36 Months of Service
Elapsed time between refund and repurchase is 7 years
New Projected Retirement Date 1/1/2042, Age 63.5 with 26.5 Years of Service (Rule of 90)

Date	Years of Service	Age at Purchase	Current Salary	Value of Accrued Benefit	Value of Projected Benefit
Value of Benefit before Purchase	3		$ 55,000.00	$ 8,000.00	66,300.00
Value of Benefit after Purchase	6	43	$ 55,000.00	$ 18,400.00	$ 81,100.00

Current Cost	$ 8,250.00
Return of Refund plus interest	$ 13,600.00
Actuarial	$ 14,800.00

The return of refund with interest will vary by individual and will not always exceed the current cost method. It will depend on the amount of the refund, changes in compensation, and the amount of time in between termination and rehire.

9. **Specific Agency or Political Subdivisions Affected:** VRS and all participating VRS employers and members.

10. **Technical Amendment Necessary:** No.

11. **Other Comments:** The VRS Board of Trustees requested this legislation. Section 51.1-142.2 of the *Code of Virginia* outlines the rules regarding the PPS program for the Virginia Retirement System (VRS). In its current form, the PPS program rules distinguish among the various benefit tiers (i.e., Plan 1, Plan 2, and Hybrid). That means that there is currently a separate set of rules, costs, and timeframes for each benefit tier. In an effort to streamline the PPS program and reduce its long-term fiscal burden on the VRS Trust Fund, VRS conducted a yearlong review of the program and proposed this legislation.

    This bill proposes to bring most purchases of prior service under a more uniform set of rules. In general, a VRS member, regardless of benefit tier, will have a two-year window of active service in which he or she may purchase prior service at an approximate normal cost. The two-year window begins to run upon the member's date of hire or upon the date of return from a leave of absence or break in service, and only runs while the member is active. After the expiration of the two-year window, the member may purchase eligible prior service at any time, but at the actuarial equivalent rate.

    These general rules would apply to the following categories of eligible prior service: an educational leave of absence, a new category of service for certain FMLA leaves of absence, up to one year per occurrence of a leave of absence for the birth or adoption of a child, service with another state or with a political subdivision or school system of this or another state, federal service, ported service (see cost exception below), civilian service, service at a private institution of higher education if the institution goes public, and non-qualified service. This is a change for birth/adoption and educational leaves. Language was added in HB 1890 to address service from another state that has a hybrid or DC plan and therefore does not have a benefit related to the service to be purchased. Purchase is not allowed for such service if there is a remaining balance in the DC plan related to a primary retirement plan. Purchases of all of these categories of eligible prior service are limited to four years of total service credit. For example, a member could purchase one year of service credit due to an educational leave of absence, one year of service credit for prior service with a federal employer, and two years of service credit for prior service with a political subdivision of another state. If the same member purchased these four years, he or she would be prohibited from purchasing further service credit under the categories of service mentioned in this paragraph.

    Other categories of eligible prior service will not count against a member's overall four-year cap, including active duty military leave, prior active duty military service, workers' compensation leave, and service credit due to a sick leave conversion. This legislation does not amend § 51.1-142.3, relating to purchases of prior service credit by school superintendents. A separate four-year cap will apply, however, to prior active duty military service purchases. Therefore, a member could purchase four years of prior active duty military service in addition to the four years of service credit attributable to the categories referenced in the preceding paragraph.

Another feature of this bill is that it removes the purchase order restrictions. Under current law, a member who is eligible to purchase more than one period of prior service must purchase the most recent service period first. Any older period of prior service may not be purchased until a member purchases all periods that occurred more recently. HB 1890 removes this purchase order restriction. If enacted, this bill would allow a VRS member to purchase any period of eligible prior service regardless of how recent the period is in relation to other periods of service.

HB 1890 allows payroll deduction agreements for all purchase of service transactions. Under current law, payroll deduction agreements for purchase of service transactions are allowed only for service being purchased during windows.

This bill also proposes a change to the cost for purchasing refunded service credit. Refunded service is VRS service for which the member has received a refund of contributions after his or her termination of employment. Currently, a VRS member may purchase refunded service at a cost of 5% of his or her creditable compensation at any time during his or her subsequent employment in a covered position. HB 1890 proposes a transition to a cost structure that is used by a majority of public pension plans across the country. Under this bill, the cost of any purchase of refunded service, regardless of the member's benefit tier, would be the sum of i) the amount of money refunded to the member when he or she initially received a refund of contributions and ii) interest on that amount from the time of the refund to the date of purchase. The applicable interest rate would be the assumed rate of return set by the VRS Board at the time of the purchase. That rate is presently set at 7%. There is no limit on the amount of refunded service that a member is allowed to purchase, as is the case under current law.

This bill does not change the cost of sick leave conversion or the cost of any service credit pursuant to a portability agreement between VRS and a member's prior employer. The cost for these two categories of prior service will remain at an actuarial equivalent rate.

As previously mentioned, HB 1890 provides VRS members with a new category of service credit to purchase, which will be based on a Family and Medical Leave Act (FMLA) (29 U.S.C. § 2601, et seq.) leave of absence for the purpose of caring for the employee's spouse, son, daughter, or parent who has a serious health condition. For purposes of the FMLA, a "serious health condition" is defined as "an illness, injury, impairment, or physical or mental condition that involves (A) inpatient care in a hospital, hospice, or residential medical care facility, or (B) continuing treatment by a health care provider." 29 U.S.C. § 2611(11). Employees are entitled to up to 12 workweeks of leave in a 12-month period to care for an immediate family member with a serious health condition.

In order to purchase such a period of FMLA leave, a member must provide proof that his or her employer at the time of the leave certified the absence under FMLA. A leave of absence that could have been eligible for FMLA designation but was never certified by the member's previous employer will not be eligible for purchase under this legislation.

In order to allow for systems changes and for notification to members that the PPS program will be undergoing changes, the engrossed legislation has a delayed effective date of January 1, 2017. VRS will also launch a communications campaign to alert employers and members of the change.

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