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OVERSIGHT VRS Report

JOINT LEGISLATIVE AUDIT & REVIEW COMMISSION
OF THE VIRGINIA GENERAL ASSEMBLY

Biennial Status Report on the Virginia Retirement System

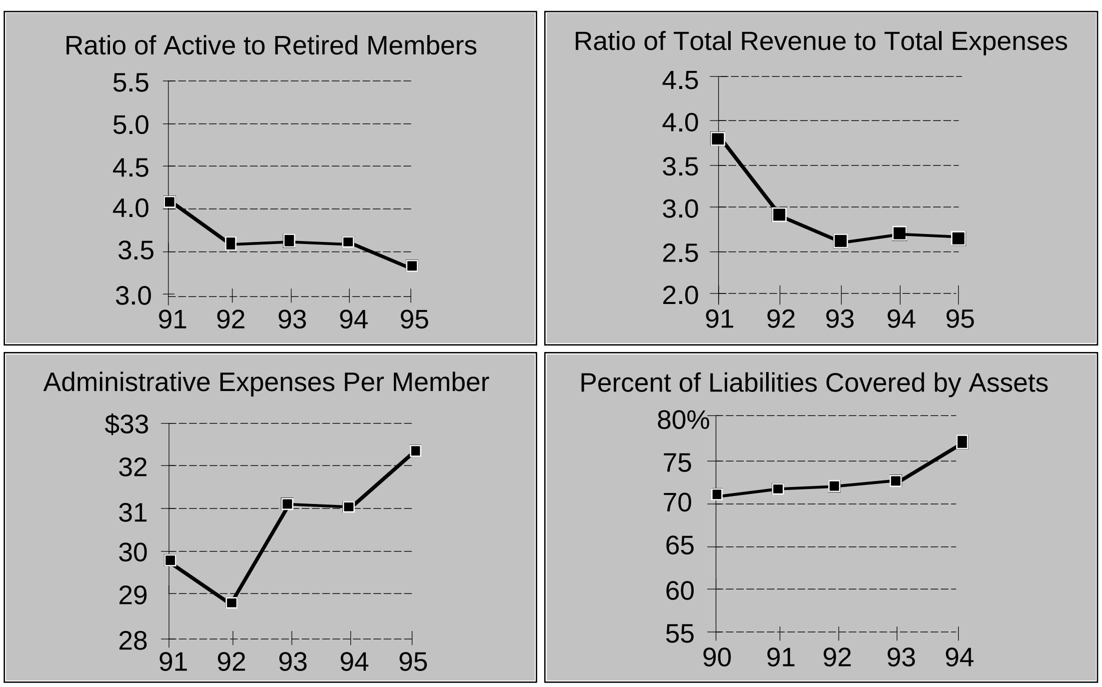
Quick Summary and Contents

The new VRS governing structure is working as intended. However, issues related to the potential personal liability of trustees have recently been raised and will be examined. VRS management is focusing its attention on improving service delivery through a strategic planning process that promotes the use of technology, restructured work processes, and performance measurement. JLARC recommends that VRS develop a plan to address information systems issues related to the year 2000. JLARC also recommends that VRS performance measures conform to specified criteria.

Several benefit programs administered by VRS are in various states of transition. In response to recommendations made by JLARC in 1994, a possible restructuring of the disability retirement system is under review. Due to a number of administrative difficulties, VRS is considering the possibility of no longer serving as group administrator for the State retiree health insurance program. The deferred compensation program was completely restructured in 1995. However, JLARC recommends that VRS improve its monitoring of program participation rates. JLARC also recommends that VRS develop an investment oversight structure for the program.

The State has developed a plan to phase-in prefunding of the cost-of-living adjustment over a five-year period. Overall, VRS pension funding is reasonably sound. However, no progress has been made in pre-funding the group life insurance benefit.

SELECTED INDICATORS



1996 Biennial Status Report on the Virginia Retirement System

INTRODUCTION

The Virginia Retirement System Oversight Act (Section 30-78 et seq. of the *Code of Virginia*) requires JLARC to prepare a biennial status report concerning the Virginia Retirement System (VRS). According to the statute, the biennial report shall include "at a minimum and where appropriate, findings and recommendations and the status of actions, if any, taken in response to prior recommendations."

In 1993, a series of studies by JLARC concerning VRS resulted in numerous recommendations for improved governance, performance, and oversight. These recommendations served as the basis for reform legislation that was enacted by the 1994 General Assembly. Most of the recommendations made in 1993 have been at least partially implemented. However, the statutory changes enacted in 1994 represented only the first step in a much longer process of improving the operations and performance of VRS. For example, certain issues pertaining to VRS benefits administration and agency planning and support functions were not included in the scope of the 1993 study series.

Since the enactment of the reform legislation in 1994, there has been a significant amount of activity and change within VRS agency operations, benefit administration, and investment management. These changes have been due to several factors: (1) independent agency status coupled with broad investment authority; (2) the hiring of a new director and a new chief investment officer (CIO); (3) the hiring of a new actuarial firm; (4) increased workload demands resulting from growing number of retired members, increased fund size and growing complexity within the investment and financial planning industries; and; (5) the need to adapt to information technology advances in order to improve efficiency and effectiveness.

Much of the change - including the reengineering of several internal agency systems and processes - has occurred within the framework of the first strategic planning process in VRS history. VRS is one of a growing number of public employee retirement systems engaged in strategic planning and reengineering efforts. Other changes have taken place within the context of investment policy. Some of these changes have been fully implemented, while many are still works-in-progress. For example:

- The strategic plan and associated agency performance measures are not yet final.
- Recommended technological infrastructure and improvements will take several years to fully implement.
- The revision of the agency's entire personnel, position classification and compensation system is the subject of a pending consultant's study.
- A review of risk management issues, systems, and processes is in progress within the investment department.
- The asset allocation policy, and the policy development process itself, is being revisited.
- The extent to which VRS investments should be actively managed remains an openly debated issue.
- The deferred compensation program was completely restructured just last year, and has been relocated within the agency.

As an independent agency with broad investment authority, VRS appears to be moving in the right direction. Its governing and advisory structure is sound and appears to be working as intended by the General Assembly. Its top management is aggressive in identifying and addressing agency weaknesses, and proactive in planning for the future. However, given that so much change has been undertaken but not yet fully implemented, VRS' ability to successfully achieve all its plans is still relatively unknown. Once implemented, the efficiency and effectiveness of new programs, systems and processes will need to be assessed. Consequently, continued monitoring of VRS by the legislative branch is vital for effective oversight of this independent agency.

OVERSIGHT VRS Report

VRS Oversight Report is published periodically by the Joint Legislative Audit and Review Commission (JLARC) in fulfillment of Section 30-78 *et seq*. of the *Code of Virginia*. This statute requires JLARC to provide the General Assembly with oversight capability concerning the Virginia Retirement System (VRS), and to regularly update the Legislature on oversight findings.

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VRS MANAGEMENT IS FOCUSED ON IMPROVING SERVICE DELIVERY

In the past, benefit administration and related agency-support functions performed by VRS staff have not received as much attention as system governance, investments, and benefit funding. As previously mentioned, issues pertaining to benefit administration and agency support functions were not included in the scope of JLARC's 1993 review of VRS. The VRS governing structure is now operating as intended by the General Assembly. In addition, unlike many other public retirement systems, VRS has a director and a CIO. As a result of its governing and management structure, VRS has been able to focus on improving the delivery of services to its members.

Over the past year, VRS management has undertaken a wide range of initiatives affecting virtually every aspect of operations. These efforts are in response to a combination of (1) increased workload due to a growing number of members, (2) increased complexity within the benefit structure, and (3) the need for new systems and technology. VRS has undertaken these initiatives within the context of its overall strategic planning process.

Governing Structure Is Working as Intended

The 1994 General Assembly enacted several reforms pertaining to the VRS governing structure. These included:

- establishing VRS as an independent State agency,
- providing the General Assembly with trustee appointment authority,
- increasing the size of the Board,
- increasing the amount of investment expertise on the Board while retaining certain trustees to represent members and beneficiaries,
- giving the Investment Advisory Committee and the Real Estate Advisory Committee statutory responsibilities while strengthening membership criteria,
- giving the CIO statutory responsibilities, and
- strengthening the statutory prudence standard while eliminating the legal list of investments.

JLARC staff have spent the past two years observing the workings of the Board and the advisory committees within the new governing structure. The changes enacted in 1994 appear to be working as intended. For example, the investment and financial expertise contributed by several trustees is effectively complemented by the direct sensitivity to member and beneficiary interests on the part of other trustees. In addition, no one individual appears to dominate the deliberations of the Board or either advisory committee. Rather, the meetings of each body are usually characterized by a significant amount of constructive debate and discussion. However, significant differences in the approach to system governance and leadership among the gubernatorial and legislative appointees are not apparent. Furthermore, the Board and the advisory committees do not appear to unduly micromanage the staff. Instead, the staff are given sufficient latitude to operate while still being held accountable. Finally, removing VRS from the executive branch has given agency management greater flexibility in restructuring internal operations.

In order to further strengthen the independence of VRS, the General Assembly approved a proposed constitutional amendment during the 1995 and 1996 Sessions. Among its several provisions, the proposed constitutional amendment would establish VRS funds as separate and independent trust funds. The proposed amendment will be on the ballot for voter consideration in November 1996.

Potential Liability of Trustees Has Been Raised as an Issue. One issue which has been raised as an issue by the Board and the advisory committees since 1994 concerns the potential for personal liability resulting from actions taken on behalf of VRS. The concern over personal liability appears to be related primarily to decisions made in the management of the investment program. Several issues which are related to personal liability include fiduciary responsibility, indemnification, legal representation, and delegation of investment decision making authority within the VRS governance and management structure. These issues were not included in the scope of JLARC's 1993 study, although the appropriate delegation of investment decision making authority was considered in developing recommendations. Because of concerns raised by the VRS trustees, JLARC staff will examine these related issues and report its findings and recommendations to the Commission in the Fall of 1996.

Management Is Refocusing on Service Delivery. Because concerns about governance of the system have been addressed, VRS management has been able to focus on improving agency operations and service delivery. VRS is making two primary efforts in this regard: (1) strategic planning, and (2) agency reengineering. These efforts are ongoing, and have been aided by the fact that VRS has a director and a CIO. Unlike many other public employee retirement systems, where the director is also responsible for managing the investment program, the VRS director is able to focus on benefit administration and agency support. Several significant initiatives designed to improve service delivery are already complete.

Strategic Planning Process Focuses on Improved Customer Service

Until recently, strategic planning was not a priority for VRS. The agency has never had a strategic plan. The current strategic planning process began in April 1994. A subsequent change in approach by the current director, hired in January 1995, assigned the strategic planning process a higher priority and a faster schedule. The VRS strategic planning process addresses three critical questions:

- Where are we now?
- Where do we want to be?
- How do we get there?

VRS has conducted numerous strategic planning activities over the past year. These include employee focus groups; development of mission and vision statements; and surveys of VRS active members, retirees, and employers.

Focus Groups Were Used to Identify Employee Concerns. Early in the strategic planning process, VRS employees participated in focus group discussions. These discussions, which were facilitated by a consulting team from the Virginia Commonwealth University Center for Public Policy, were used as a means to help develop a vision and mission statement for VRS. The VRS mission and vision statements are as follows:

> Our mission is to administer pension benefits and associated services earned by participating Virginia public employees by serving as stewards of the funds in our care and providing superior service to our members.
>
> The Virginia Retirement System seeks to be recognized as a leader among pension systems by employing innovative and efficient approaches which will continually provide our membership with superior service. We believe superior service is inspired through an environment that fosters professional development, teamwork, and ethical behavior. We are committed to the preservation and growth of the funds in our care, thereby fulfilling our responsibility as stewards of the public trust.

The employee focus groups had an additional purpose of identifying organizational strengths and weaknesses. Participants were asked to focus on changes that would make their jobs easier, and on changes that would improve customer relations. Table 1 summarizes the concerns of VRS staff.

Surveys Were Used to Assess Members' Satisfaction with Service. During the spring and summer of 1995, surveys were mailed by VRS to random samples of active members and retirees. The basic purpose of the survey was to assess customer satisfaction with VRS services, and to identify areas for improvement. The survey results indicated that a majority of VRS active members and retirees have never contacted VRS -- either by telephone, letter, or in person. However, the vast majority of those members who have contacted VRS were satisfied with the service that they received.

Active members and retirees were both asked to assess their level of confidence in VRS. Based on the VRS survey results, there is a noticeable difference in confidence between retirees and active members. Among the retirees, 72 percent reported that they were very confident in VRS. In contrast, only 29 percent of active members reported being very confident.

VRS had sent similar, though not identical, surveys to its active and retired members in 1990. Only an approximate comparison of the results of the 1990 and 1995 surveys is possible, since certain questions which appear on one survey do not appear on the other. In addition, many types of questions which appear on both surveys have been worded differently. Nevertheless, the results obtained in 1995 appear very similar to those from 1990. One noticeable difference is the percentage of active members who reported attending the VRS pre-retirement education program. According to the survey results, that percentage increased from nine percent in 1990 to 36 percent in 1995. Tables 2 and 3 (page 6) present a comparison of data concerning topics from the two surveys

Strategic Plan Provides Goals and Action Plan Elements. Following more than 18 months of preliminary work, VRS management and staff have completed a final draft of the strategic plan. The plan, which has not yet been reviewed or approved by the VRS Board, addresses benefit plan structure, service delivery, management and administration, investments, ethics, cost of operations, and internal audit. The key elements of the plan are a set of strategic goals, and action plan elements intended to help achieve those goals (Table 4, pages 7-8). VRS recognizes that full implementation of the strategic plan will require a collaborative effort by management and staff to prioritize goals and strategies, fix reasonable dates for implementation, and assign staff responsibility for specific action plans.

Information Technology Is a Key Aspect of VRS Strategic Plan. In June 1995, VRS initiated a technology assessment and planning project to identify cost effective opportunities to improve service and staff efficiency through the use of technology. The consulting firm of KPMG Peat Marwick (KPMG) was hired to lead the project. KPMG analyzed the current technology environment within VRS, conducted six technology management seminars for VRS staff, and presented a technology strategic plan to VRS.

The technology strategic plan, completed in December 1995, is based on five strategic principles, and three key assumptions. The strategic principles are as follows:

Table 1: VRS Strategic Planning -- Concerns Expressed by Employee Focus Groups

Meeting the Needs of a Changing Environment	People nearing retirement are more sophisticated and creative in their personal financial planning People are planning for retirement earlier than ever Does VRS want to be more than just a processor of pension checks? A revised VRS role has implications for staff training, use of technology and organizational structure
Concern for Customers	Customer needs are shifting dramatically as people plan earlier for retirement and face more complex financial and lifestyle options Members are often facing "trauma" at the time they contact VRS for information and assistance
Technology and Workload Management	Amount of time consumed by repetitive and routine tasks Some tasks could be consolidated and/or automated, freeing staff to deal with more complex administrative and customer issues
Communication and Information Sharing	Desire to understand and participate more with other departments and units in the agency Cross-agency information sharing will enable staff to become more responsive to customers
Training	Training in the use of information technology, team building, and personal/career development
Morale	Morale is highly variable depending on where one works within VRS Units that received majority of inquiries during Workforce Transition Act feel frustrated and stressed

Source: JLARC staff review of *Results of Staff Focus Groups*, prepared by Virginia Commonwealth University Center for Public Policy, May 1, 1995.

- concentrate business on outstanding customer service emphasizing rapid and accurate responses,
- create strategic partnerships with state employers and other agencies,
- constantly evaluate and reform manual and automated business processes,
- move towards an exception processing mentality with a focus on reducing needless paper, and
- measure and report key indicators of success.

The key assumptions are:

- information systems will support the strategic principles,
- continued reliance on the Department of Information Technology mainframe for core applications, and
- no growth in information technology staff during the initial phases of implementing the information technology strategic plan.

The ultimate objective of the technology strategic plan is the implementation of five "strategic projects." These include a call center, an employer access system, an enhanced document imaging system, a data warehouse, and an executive information system. Table 5 (page 9) provides summary information concerning these projects.

In order to fully implement these strategic projects, KPMG made 17 recommendations pertaining to computer networks, document imaging, applications development, and the organizational structure for VRS information technology staff. In its final report, KPMG

Table 2: Comparison of Results of VRS Active Member Survey

Topic	*1990*	*1995*
Understanding of VRS Benefits	78% understand somewhat or very well	68% agree or strongly agree that they have a good understanding
Contact with VRS	88% had never called 89% had never written	70% had never contacted VRS
Pre-retirement Education Program	9% had attended	36% had attended and found the information to be very helpful
Memo to Members	89% reported articles are of value and interest	85% reported it is helpful
Handbook for Members	88% reported it is easy to understand 82% reported it is about right in terms of detail	83% reported it is helpful
Member Benefit Profile (MBP)	97% reported information is useful 23% of respondents had not received MBP within past 12 months	85% reported it is useful 14% never heard of it

Source: JLARC staff review of VRS active member survey documentation.

Table 3: Comparison of Results of VRS Retiree Survey

Topic	*1990*	*1995*
Contact with VRS since Retirement	54% had written 49% had called	42% had contacted VRS since retirement
Adequacy of Customer Service when Calling VRS	49% excellent, 34% good, 11% adequate (94% adequate or better)	93% adequate
Difficulty in Reaching VRS by Telephone	29%	25%
Understanding of VRS Benefits	52% very well 40% somewhat well 7% not well	Average rating of 8.6 out of 10
Pre-retirement Education Program	37% had attended 81 % rated it helpful	33% had attended Average rating of 8.5 out of 10
Rating of Memo to Members	95% reported articles are clear, understandable, valuable, and interesting	Average rating of 8.5 out of 10

Source: JLARC staff review of VRS retiree survey documentation.

Table 4: VRS Draft Strategic Plan

Goal	*Action Plan*
Benefit Plan Structure: Maintain current plan for employees while considering ways to simplify the operation of the benefit plan structure	Evaluate plan costs by monitoring internal costs, consider outsourcing some benefit-related functions, research other states and benchmark VRS against public and private plans, research employee benefit trends, survey members and employers, increase use of the deferred compensation plan.
Education: Provide all members and employers with the type and quality of information needed to make knowledgeable choices about their retirement	Provide information that includes overviews of financial planning for retirement, lifestyle choices, life insurance, health care and long term care options Work with employers to generate interest and knowledge among employees in planning for retirement Develop public information plan with other state and local agencies that encourages early planning for retirement Ensure that service and benefit information is accurate, integrated, and accessible
External Communications: Ensure that customers receive information through methods that are easily accessible, understandable, and accurate	Audit written communications to ensure appropriateness for all members Implement a public information plan through use of media, seminars and conferences, publications, software and videos Engage financial, insurance, adult learning, and gerontology experts in the design and delivery of information Personalize communications with retirees through reduced reliance on voice mail and and more use of personalized letters and one-on-one communications Provide training in adult learning and interpersonal skills to staff who have customer contact Provide each VRS employee with sufficient information to answer components of customer inquiries
Training: Develop staff who are well-informed and who have the necessary skills to perform efficiently and effectively	Foster an environment for decision-making that encourages employees to make decisions in their areas of expertise, while holding them accountable for the results of those decisions Accompany each technology change with clear, comprehensive training and reference material Provide skills training, cross-training, professional/personal development and information sharing opportunities to staff Maintain a skills inventory of all staff, develop a training plan to address skill deficiencies, and facilitate staffs' ability to attend the training

(continues)

Table 4: VRS Draft Strategic Plan (continued)

Goal	***Action Plan***
Organizational Development: Develop into an organization that proactively manages its programs and, to the extent possible, shapes its own destiny.	Develop and implement an ongoing strategic planning process that anticipates system, program and resource needs and develops flexible approaches for managing peak workloads Prepare detailed impact statements on all law and system changes to show effects of the change on VRS members and agency operations as is currently done for fiscal impact on State and local employers Develop a technology plan that integrates all software and hardware needs and incorporates staff training
Internal Communications: Create a work environment that maximizes the effective-ness of staff through accurate, streamlined systems for information-sharing and decision-making	Establish and use an internal communications system that incorporates written, electronic and face to face communications with all staff Commit to sharing information as soon as possible with all staff who need to know it Involve VRS staff, employers and appropriate business partners in planning for system changes
Agency Image: Be perceived by others as an independent, nonpolitical organization which strives for excellence in all aspects of its operations	Publicize positive developments at VRS through regular communica-tions with members, employers, the General Assembly, business partners and the media Ensure the integrity of essential benefit-related data through a continuous review of all data sources and a sampling of data sets Develop benchmarks for measuring the effectiveness of all programs delivered by VRS
Legislative Relations: Have VRS recognized as an informed and collaborative partner in the government and business environments	Develop a public information approach to educate employers, business partners, the General Assembly and the media about system changes and innovations through face to face meetings, seminars, and conferences Involve VRS staff, employers, business partners and the General Assembly in planning for benefit and system changes
Ethics: Have the highest standards of ethics in state government	Careful use of travel funds, reduce use of soft dollars in investment program
Cost of Operations: Associate activities with costs of services and evaluate the performance of each activity to see if it is cost effective	Institute activity-based costing after determining what each service costs to provide Institute performance-oriented accounting by including internal investment staff costs in the determination of total rate of return
Internal Audit: Continue to have Internal Audit be an independent unit	Have Internal Audit assess the highest risk factors at VRS and then review the process of each to assure the risks are controllable and are within acceptable levels

Source: JLARC staff review of VRS strategic planning documentation.

Table 5: VRS Strategic Technology Projects Recommended by KPMG Peat Marwick

Project	Description	Status
Call Center	Telephone center with objective to answer incoming calls within 20 seconds, and to be able to fully respond to 90 percent of all calls without a transfer.	Phase 1 implemented Phase 2 (interactive voice response) in planning
Employer Access System	Enable employers to obtain manuals, technical and benefit updates, policies and procedures electronically. Enable employers to perform basic benefit calculation estimates using real-time accurate data. Allow electronic mail communication with employers.	VRS Internet Homepage for employers under development
Data Warehouse	Data repository where data extracted from the mainframe computer will be stored temporarily in a decision support database. Enable VRS to reduce DIT mainframe transaction costs.	Long term objective
Enhanced Document Imaging System	Expand document storage and retrieval capabilities across the organization. Implement optical character recognition and bar coding as needed to reduce data entry.	Initial phases in planning
Executive Information System	Develop and report on key performance measures. Will enable users to quickly assess how the organization compares to expectations.	Long term objective

Source: JLARC staff analysis of *Information Systems Planning and Assessment*, KPMG Peat Marwick, December 20, 1995, and JLARC interviews with VRS staff.

recognized that VRS had made significant progress toward implementing the network recommendations, and that implementation of the imaging recommendations was planned in the near term. Implementation of the applications development recommendations will take longer for VRS to address. The first such recommendation was that VRS reduce its significant backlog of employee requests for programming and other modifications to VRS information systems. It is estimated that about two to three years of staff time would be required to make all of the requested changes. However, VRS believes that the continued need for many of the change requests will be eliminated once its new retiree payroll system is implemented.

Prior VRS efforts to reduce the backlog have been unsuccessful for two primary reasons. First, there has been an insufficient amount of staff resources within the information systems department. Second, most pending requests continue to be considered necessary by VRS staff despite the passage of time. According to KPMG, information systems staff give the highest priority to implementing the most recent requests. KPMG recommended that VRS utilize outside contractors to get the current backlog under control. KPMG also recommended that VRS form a team of information systems staff and users to examine the remaining list of change requests and to discard all non-critical requests.

The second application development recommendation made by KPMG was that development and maintenance of mainframe-based core business applications should be performed using personal computers within a client/server environment. KPMG believes that this will improve the productivity of information systems staff and reduce charges for use of the DIT mainframe.

The primary impediment to implementation of this recommendation is staff training. VRS applications development staff are not yet trained in the use of personal computer programming languages or client/server technology. Until recently, the staff did even not have personal computers. According to KPMG, the staff's skill set is strictly mainframe-based.

In terms of organizational structure, KPMG recommended that VRS create a unified information technology strategy by placing the operations group and the applications development group under a new Information Technology Director position. Due to salary constraints, KPMG believes that would be extremely difficult to fill the position by external recruitment. KPMG also believes that VRS lacks qualified candidates necessary in order to fill the position internally. Therefore, KPMG recommended that VRS contract the position for two years with yearly performance bonuses written into the contract based on pre-determined performance measures.

The Year 2000 Will Affect VRS Information Systems. One important information systems issue that KPMG did not address in its report involves the computational effect that the year 2000 will have on the VRS retirement information management system (RIMS). The issue, which affects virtually all organizations and computer systems worldwide, involves the absence from computer software of a two-digit century value, that distinguishes dates as either 19XX or 20XX, within a date field. According to information technology literature, this problem was caused by limitations of earlier technology, and by the higher information storage costs that would have resulted by constructing date fields to accommodate the 21st century.

The new retiree payroll system was designed with this issue clearly in mind. Therefore, no such problems are anticipated with that system. However, RIMS was developed in the mid-1980's and did not take this issue into account. RIMS contains subsystems for calculating pension benefits and refunds.

This issue has significant implications for VRS operations. The calculation of a pension benefit, defined in terms of age and years of service, is obviously date-sensitive. The consequences of failing to respond to this issue in a timely fashion could be very damaging for benefit administration. An example illustrates how RIMS can calculate an erroneous value for a member's age:

- Birth Year: 1945
- Expected Retirement Age and Year: Age 55 in the Year 2000
- Age in 1999 according to RIMS: 99 - 45 = 54
- Age in 2000 according to RIMS: 00 - 45 = -45

Calculations for other two-digit year values (which do not include digits for the century) within a date field are similarly affected by this problem.

VRS staff have begun to examine the dimensions of this problem. More than 1800 programs, and more than 700 screens and reports, within RIMS will need to be modified in order to create the appropriate date field. Each of these programs, screens and reports accesses a certain number of date fields. VRS information systems staff have identified three general approaches, each with its own advantages and disadvantages, for addressing this problem:

- change all dates in all files at once,
- change all dates for one file at once, or
- change one date in all affected programs at one time.

According to the information systems manager, no program requests aimed at correcting these problems have yet been submitted by VRS management or staff.

Recommendation (1). The Virginia Retirement System should begin now to develop and implement an action plan to modify the retirement information management system to address problems related to two-digit year values within a date field.

VRS is Developing Agency Performance Measures. VRS is in the process of developing a set of performance measures for the agency. The director has begun the process by proposing a number of potential measures. These are not intended to be the final measures, but merely as a starting point for further discussions with VRS staff. Examples of some of the potential measures identified by the director in February 1996 are listed below:

- volume of telephone call answered within 20 seconds,
- volume of telephone calls answered without a transfer,
- overall customer satisfaction measure,
- ratio of positive to negative letters,
- volume and average time for a refund to be processed,
- volume and average time for retirements to be processed,
- volume and average time for purchase of prior service credit to be processed,
- volume and average time for retirement benefit estimate checks to be processed,
- number of participants in pre-retirement education programs,
- number of deferred compensation participants, and
- investment rate of return against benchmarks.

The development of performance measures continued at a recent VRS management retreat. During the retreat, management sought to develop measures that focus on customer satisfaction with the performance of six critical agency functions:

- maintenance of member and employer records,
- informing and educating employees and employers,
- processing benefits,
- disbursing funds,
- fund stewardship, and
- administrative support.

VRS was not included in the statewide goal setting and performance budgeting project that is being administered by the Department of Planning and Budget (DPB). However, VRS staff have met with DPB to discuss performance measurement issues. In addition, VRS intends to include the use of performance measures within its internal budget process.

At DPB's request, JLARC reviewed and commented on the performance measures proposed by State agencies. In the review of performance measures submitted by State agencies to DPB, JLARC used several criteria which are also applicable to VRS. According to these criteria, performance measures should:

- tend to relate to statutory mandates or administrative priorities,
- relate to a core mission,
- indicate a desired direction of change,
- not create unintended incentives for agency managers,
- focus on outcomes -- not inputs -- within an agency's control,
- have conditions and terms that are well-defined and measurable, and
- utilize data which are reasonably available.

Recommendation (2). The Virginia Retirement System should ensure that its agency performance measures relate to its statutory responsibilities and mission statement. The Virginia Retirement System should also ensure that its agency performance measures focus on well-defined and measurable outcomes within its control, utilize data that are reasonably available, and do not create unintended incentives for management.

Agency Reengineering Intends to Improve Service Delivery

While VRS has been looking to the future through the strategic planning process, it has also been implementing numerous changes in its current work processes, systems, and organizational structure. Several of the changes that have been initiated thus far - such as a new retirement payroll system, a new telephone system, and a new information center, are strategic in nature.

These changes were necessitated by increased workload demands resulting from a growing number of retired members; growing complexity within the VRS defined benefit plan; and VRS technology - particularly the retiree payroll system and the telephone system - which was increasingly inefficient and ineffective.

Membership Growth Outpaced Staffing Increases Until Recently. For many years, from FY 1983 to FY 1994, the number of VRS members increased faster than the number of VRS full-time staff positions. This had the effect of making it more difficult for VRS to manage the workload demands generated by a growing membership. However, the 1994 General Assembly authorized an additional 12 positions for VRS beginning in FY 1995. This happened to coincide with the establishment of VRS as an independent agency. As an independent agency, VRS is exempt from the position levels - but not the overall appropriation for salaries and other expenses - contained in the Appropriation Act. This exemption is dependent upon approval by the VRS Board of Trustees of an increase in the staffing level, and notification of the legislative money committees of the increase.

The significant staffing increase in FY 1995, along with a reduction in active members due to the Workforce Transition Act, helped to bring the percentage growth in staffing levels back in line with the growth in membership levels. Nevertheless, continued rapid growth in the number of retirees poses a constant source of workload pressure for VRS. The number of VRS staff positions is authorized to increase another five percent, to 141 full time positions, by FY 1998. Table 6 (page 12) presents a comparison of VRS staffing and membership growth trends for the periods FY 1983 to FY 1994, and FY 1983 to FY 1995.

VRS Is Developing New Personnel Policies and Procedures. Although VRS is exempt from the State's personnel system, it has continued to administer all of the State's position classification and compensation programs, benefits, and most personnel policies and procedures. The exceptions are a competency-based pay system within the Investment Department, and broad-banded, skill-based pay systems within the Membership Accounting section and the Information Center. In addition, VRS is establishing its own policies in the areas of employment, standards of conduct and grievance procedures, and alternate work schedules.

VRS is beginning a review, with the assistance of a consultant, of its entire human resources system. Through the review, VRS is seeking to develop an integrated human resources system with the following broad characteristics:

- a position classification system that has fewer classes, that has greater flexibility and adapt-

Table 6: VRS Staffing and Membership Growth Trends

	Average Annual Percentage Increase	
	FY 83 - FY 94	FY 83 - FY 95
Full-Time Equivalent Positions	2.5	3.3
Active Members	2.2	2.0
Retired Members	7.5	7.9
Total Members	3.0	2.9

Notes: Staffing data does not include part-time wage employees. Annual average number of part-time wage employees was 22 from FY 1992 to FY 1995. Membership data does not include terminated employees who are vested to receive benefits.

Source: JLARC staff analysis of VRS staffing and membership data.

ability for changes in job duties, and is easier to maintain;

- a compensation system that reflects the value of employees obtaining greater skill and broader job skills or functions;
- a performance evaluation/reward system that rewards high performance and does not create a pattern of longevity pay; and
- a benefits program that is more flexible, cost effective, and efficient to administer.

A New Retirement Payroll System Has Been Developed. In 1994, VRS began a large-scale effort - which is just now being completed - to develop a new retirement payroll system. Several factors drove the decision to replace the old system which was developed in the mid-1970's. First, there were an increasing number of payments of a portion of a pension benefit to third parties pursuant to child support orders, domestic relations orders, bankruptcy judgments and other forms of legal process. These third-party payments all required manual processing. Second, the payroll system could not accommodate the increased administrative complexity of the retiree health insurance program. According to VRS staff, the payroll system did not allow for split coverage between a retiree and a spouse. In addition, initial payroll runs often failed because of problems with the health credit calculation. Finally, the three percent benefit pension benefit increase enacted in 1994 had a significant impact, necessitating changes in virtually all of the 80 computer programs within the system.

The new payroll system corrects the above-mentioned deficiencies. In addition, the new system also has the following capabilities not found in the old system:

- an on-line, real time inquiry and update facility against retirement data;
- reduction in the amount of time required to establish direct deposit for a retiree; and
- ability to balance the payroll on a daily basis.

When RIMS was designed in the mid-1980's, it included an annuitant payroll subsystem. As designed, this subsystem included many of the features found in the new payroll system. However, this subsystem was never implemented. According to some VRS staff, waiting ten years to improve the system made it increasingly difficult and inefficient to administer the retiree payroll.

A New Telephone System Has Been Implemented. In March 1995, VRS installed a new telephone system. The prior system was old and increasingly ineffective in handling an increased level of calls from the growing number of VRS members - particularly retirees. The utility of the system was a frequent source of complaint from individuals needing to contact VRS. The limited capacity of the telephone system was impeding the level and quality of customer service.

On an average day, VRS receives about 2000 telephone calls and makes another 1500 calls. The improvements found in the new system -- all of which are related to being able to handle an increased volume of calls -- include:

- increased number of telephone lines,
- direct inward dial numbers for employers,
- a call processing system enabling callers to be routed to the appropriate unit within VRS,
- automatic distribution of calls to next available employee within the unit in order to minimize time spent on hold,
- pre-recorded announcements to answer frequently asked questions immediately, and
- management reporting capability.

VRS spent a great deal of time following installation of the system revising the scripting of the text, options, and pre-recorded messages that callers heard upon calling VRS. This was done primarily in response to negative feedback that VRS received concerning the new system, primarily from retirees. VRS learned that many retirees were not receptive to automatic call processing, and wanted to immediately hear a real human voice when calling. VRS responded to these complaints by making the telephone scripts shorter and simpler through numerous iterations.

Need to Restructure Workflow Led to Development of Information Center. While the new telephone system made it possible for a significantly increased number of calls to be received, internal work processes continued to impede customer service. For example, many staff were required to simultaneously answer calls from active and retired members, while also performing benefit processing functions. Another impediment to service delivery was the fact that responsibility for answering incoming calls from members was segmented in two units within the agency. The customer service unit of benefit programs department was responsible for retirees. The member services unit within membership accounting section of the finance department was responsible for active and inactive members. Management determined that this overall arrangement was no longer efficient or effective.

In response to this long-standing situation, VRS established an information center in December 1995. Development and implementation of the information center was the result of work done by a team of VRS employees. The team was created by the director in order to develop a mechanism capable of answering all incoming telephone calls within 20 seconds, and capable of fully responding to 90 percent of telephone calls without the need to transfer the call.

An additional purpose of the information center is to enable certain VRS staff to focus exclusively on responding to incoming telephone calls, which typically are made in order to request information. All incoming calls, with the exception of calls made using a direct inward dial number, are received by the information center. The information center also enables other VRS staff to focus more or less exclusively on benefit processing and other administrative functions.

The new telephone system and information center represents a significant investment of more than $600,000 by VRS. The technological capabilities of the information center include improved management reporting concerning telephone calls and information center performance. VRS will also be able to track individuals who call frequently and their reasons for calling, and to develop a profile of callers.

Staffing for the information center consists of one supervisor and eight agents. As previously stated, it is the intention of the director that the information center be capable of answering 100 percent of incoming telephone calls within 20 seconds. The director also wants the information center to be able to fully answer 90 percent of all incoming calls without having to transfer the caller to someone else within the agency. Several types of incoming calls -- concerning benefit programs for which staff have not yet been fully trained -- are now automatically transferred to other units in the agency.

According to some VRS staff, employers continue to express unhappiness with the telephone system and information center. Some staff have suggested that employers become better educated concerning the purpose and function of the information center. Increased staffing within the information center has also been proposed. The information center supervisor is of the opinion that, for now, additional staff are not needed. However, the director has not yet made a final decision on the staffing level. The information center supervisor would like to focus, at this point in time, on the quality as opposed to the quantity of service provided.

Some VRS Staff Functions Have Been Privatized. In 1995, VRS privatized the operation of its mail room and photocopy functions. Preliminary consideration is now being given to the possible privatization of additional agency functions. Two possibilities under discussion are information technology - including data processing - and the pre-retirement education and counseling functions performed by the field services department.

The ease with which components within the information technology function can be privatized varies. For example, the single largest impediment to outsourcing data processing is the extent and quality of documentation concerning VRS information systems. VRS staff have expressed concerns that such documentation may not be very good. On the other hand, according to the Director, local area network administration or the help desk could potentially be easier to privatize.

VRS plans to issue requests for proposals during the 1996-98 biennium to determine the level of interest, and the cost, of outsourcing the pre-retirement education program and counseling services. These functions are currently performed by the field services department. If VRS chooses to pursue any of these options, the costs could be incorporated into the 1998-2000 budget. Whether or not privatization of this function would result in a net benefit to VRS would need to be evaluated.

SOME VRS PROGRAMS ARE IN TRANSITION

Service retirement has always been, and continues to be, the primary benefit that VRS administers. However, there are many other benefits that VRS is required by law to administer. These include - but are not limited to - disability retirement and deferred compensation. VRS also administers group health insurance benefits for State retirees, although it is not legally required to do so.

Over the past few years, VRS has identified and addressed several administrative problems within these programs. In addition, JLARC reviewed the disability retirement program in 1994 and made several recommendations for improvement management of the program. These programs remain in a state of transition, with numerous issues requiring additional attention.

Proposed Restructuring of Disability Program Is Under Review

In 1994, at the request of the Commission on the Management of the Commonwealth's Workforce (the Workforce Commission), JLARC reviewed the VRS disability retirement program. The subsequent report made seven recommendations:

- VRS should consider appointing a psychiatrist to the Medical Board.
- VRS should consider development of administrative regulations.
- VRS should analyze diagnostic data to enhance the process used to select retirees for recall and re-examination.
- VRS should examine the feasibility of establishing an investigative component.
- VRS should review its compliance requirements to ensure that the level of compliance staffing is adequate.
- The Workforce Commission may wish to require VRS and the Department of Taxation to continue the analysis of earned income on the part of disability retirees.

Program Reviewed by a Consultant. VRS expressed general agreement with each of the JLARC recommendations. The next step that VRS took with regard to the recommendations was to hire its own consultant to review the program. The consultant's report, completed in September 1995, verified the previous findings and recommendations made by JLARC. To that end, the consultant recommended that VRS improve administration of the program by: (1) establishing a management information system to track disability cases; (2) mandating employees to request and employers to consider accommodation for minor impairments; (3) working with employers to establish baseline medical reports on employees; (4) incorporating appropriate case management features; and (5) tracking income earned by disability retirees.

The consultant's report also examined issues concerning the statutory structure of the disability retirement benefit. The consultant recommended that VRS explore ways to

- clarify the statutory definition of disability,
- simplify the benefit formula,
- reduce financial differentials within the various statutory formulae,
- improve consistency with social security disability benefits and workers compensation benefits, and
- limit liability for pre-existing conditions.

VRS and the General Assembly Will Continue to Review the Program. The disability retirement program, and the State's overall approach to providing disability coverage to its employees, continues to be under review. The key issues are the type of benefit structure that should be provided, and the manner in which the benefit program should be administered.

VRS has established an employee process improvement team, led by the Deputy Director, to continue its examination of the disability retirement program. The Director has instructed the team to have a legislative proposal for necessary changes in the program ready in time for presentation to the 1998 General Assembly. The team may hire an additional consultant to aid it in developing a legislative proposal. The current administration of the program remains very similar to that which existed at the time of JLARC's study in 1994.

The 1996 General Assembly instructed the Workforce Commission to continue its work on development of a plan for providing short and long term disability benefit coverage to State employees. One of the issues to be examined is the interaction of any new benefit program with the existing VRS disability retirement program. In December 1994, an actuarial consulting firm retained by the Workforce Commission presented several alternatives, along with cost estimates, for providing short and long-term disability benefits. However, legislation concerning disability benefits and the disability retirement program was not proposed at that time.

Deferred Compensation Plan Requires Increased Monitoring

VRS has statutory responsibility for administration of the State's deferred compensation program. The program was created in 1980 under authority granted by section 457 of the U.S. Internal Revenue Code, and is often referred to as a 457 plan. The plan, which was completely restructured in February 1995, provides State employees with an opportunity to supplement their future VRS benefit. The restructured plan offers clear benefits to program participants. However, VRS needs to develop a systematic process -- including written policies and procedures -- for oversight of the plan's investment managers. Monitoring of program participation rates can also be improved.

Program Has a History of Administrative Problems. In the years following its establishment, the program suffered from a number of administrative difficulties. Prior to July 1, 1987, the Hartford Life Insurance Company (Hartford) was the sole plan provider. During the 1987 Session, the General Assembly modified the program in several ways. First, administrative responsibility for the program was transferred from the Deferred Compensation Board to the VRS Investment Department. Second, all new program participants were required to enroll in a new plan that was required to have specific types of investment options. The contract for administration and investment management of the new plan was subsequently awarded to Mellon Bank (Mellon). Employees who had been participating in the Hartford plan were given the option of remaining in that plan, suspending their Hartford account and enrolling with Mellon, or transferring their Hartford account to Mellon.

For many years the deferred compensation program was characterized by limited marketing of the program to potential participants. Mellon's contract did not require that it perform any marketing activities for the plan. Consequently, from 1987 until February 1995, the program was not marketed except for limited activities that VRS staff were able to perform by working with State agencies.

The amount of paperwork also increased during that period. Much of the paperwork was being performed by State agency benefit administrators. The Department of Accounts was also performing a great deal of recordkeeping. Much of the paperwork, according to VRS, was redundant.

During this lengthy period of time, VRS realized that administrative changes were needed in the plan. However, Hartford was under a ten-year contract. If the State had tried to end the contract early, program participants would have had to pay a three percent surrender charge. VRS decided to match implementation of major changes in program administration with the expiration date of the Hartford contract.

The Program Was Completely Restructured in 1995. Based on recommendations made in 1993 by the consulting firm of Gabriel, Roeder, Smith & Company, VRS decided to hire a third-party plan administrator and individual investment managers. Under this type of structure, VRS has the ability - which it previously lacked - to replace individual investment managers or the third party plan administrator without affecting other aspects of the program. In 1994, VRS prepared and distributed requests for proposals for third-party administrative services and for investment management services. The Copeland Companies (Copeland) was hired as third-party administrator. The following firms were hired as investment managers: Metropolitan Life Insurance Company, Mellon Capital Management Corporation, Merrill Lynch Asset Management, Fidelity Management and Research Corporation, and The Vanguard Group, Inc. T. Rowe Price Associates, Inc. was hired in January 1996. The effective date of the newly structured plan was February 1, 1995.

As the third-party plan administrator, Copeland has extensive contractual responsibilities. These include enrolling new participants in the plan, marketing the plan to prospective participants, producing consolidated plan statements for participants, preparing and publishing all plan literature, and processing distributions from participant accounts.

Copeland has a three-year contract, and VRS has the option of granting two one-year renewals. Copeland is paid a fee equivalent to 35 basis points applied to total plan assets on an annual basis. Based on data that VRS staff have collected, the plan administration fees paid to Copeland are low compared to those paid to deferred compensation plan administrators in other states. VRS staff expect to receive national survey data this fall that should help them make a current assessment of how fees paid by VRS compare to those paid by other states.

Participation Rates Have Increased, But Are Below Recommended Level. The 1993 consultant study found that the program's participation rate was significantly lower than the national average for state-sponsored deferred compensation plans. The consultant recommended that a realistic participation rate goal for the program would be 25 to 30 percent of eligible participants. According to the consultant, this goal should exclude those State employees who are also eligible to participate in 403(b) sponsored by institutions of higher education. Given the choice between participation in 403(b) plan and a 457 plan, individuals usually elect the 403(b) plan. According to VRS staff, there are three reasons for this:

- 403(b) plans have a higher maximum annual deferral than do 457 plans.
- 403(b) deferrals are portable to plans sponsored by private colleges and universities, whereas 457 deferrals are not.
- 403(b) deferrals can be rolled over into an individual retirement account, whereas 457 deferrals cannot.

The participation rate for the deferred compensation plan has been increasing in recent years. However, the magnitude of the increase and the exact participation rate at this point in time depends on how participation is defined and calculated. According to the VRS director, program participants are defined to include employees who are actively making deferrals, as well as individuals who have accumulated account balances through prior deferrals. On this basis, the program's participation rate increased from 8 percent in FY 1991 to about 12.2 percent in FY 1995. If participation is defined only as employees actively making deferrals, the participation rate increased from 6.3 percent to 9.7 percent over the same period. The number of employees actively making deferrals increased by 29 percent from June 30, 1994 to March 1, 1996. However, according to either view of program participation, it still remains well below that recommended by the consultant in 1993.

The contract with Copeland includes a goal of approximately 13,500 program participants by the end of the third year of the contract, which would be in February 1998. That goal corresponds to a participation rate of approximately 25 percent of eligible employees, based on the current number of full-time State employees. While this goal exists, the deferred compensation program has thus far not been specifically included in the effort by VRS to develop performance measures for the agency.

VRS estimates that there are currently between 97,000 and 98,000 State employees eligible for the program, but notes that 42,000 of those are also eligible to participate in 403(b) plans. Therefore, VRS staff use an estimate of approximately 55,500 State employees as being eligible to participate. According to VRS staff, that estimate is based on State employment data found in a 1993 JLARC study of the Department of Personnel and Training (DPT), adjusted for subsequent employment reductions from the 1995 Workforce Transition Act. VRS has not systematically utilized current data on the number of permanent, salaried State employees in order to assess program participation rates. In order to more precisely analyze program participation, VRS needs to better utilize current, actual State employment data. Future surveys by VRS of its active members could also include questions designed to identify and analyze the factors which tend to increase or decrease participation in the program.

Recommendation (3). The Virginia Retirement System should include the deferred compensation program participation rate as one of its agency performance measures. The Virginia Retirement System should determine how best to define program participation, and should calculate program participation rates using current, actual State employment data.

Investment Oversight Structure Needs to Be Developed. The plan's six investment managers provide a total of eight different investment options. Each investment manager has a one year contract. Investment management fees range from ten basis points applied to total assets (Mellon daily liquidity stock index fund) to 102 basis points (Fidelity blue chip stock growth fund). Program participants can allocate their deferral between more than one investment option. If they wish, participants can change the allocation of their accumulated deferrals from one fund to another on a daily basis. Table 7 summarizes the investment options under the plan.

Following implementation of the new plan in February 1995, VRS staff recognized that the next essential task was to design and implement a structure for effective oversight of the investment managers. Such a structure would reasonably include development of written policies and procedures, and systems - including an investment manager database - to monitor actual investment performance against established performance objectives. Such formal policies, procedures, and systems would enhance the ability of VRS to effectively and efficiently monitor the investment practices, operational and support systems, and fee structures used by each investment manager. The oversight objective should be to ensure that use of the manager is cost effective, and that the manager is in compliance with all contractual investment guidelines. However, as of March 1996, such a formal structure had not yet been developed.

In April 1996, VRS transferred the deferred compensation plan administrator position from the administrative side of the agency - where it reported to the deputy director - back into the investment department. The position had, up until 1990, been located in the investment department. The plan administrator now reports to the Managing Director for Equity and Fixed Income. However, all aspects of the program will continue to be overseen by the benefits and actuarial committee of the Board, and not the IAC. Nevertheless, transfer of the position should promote a better quality of investment oversight within the program than otherwise would have been the case.

Copeland produces a regular newsletter for program participants. Recent issues of the publication, which is subject to editorial review by VRS, have focused on providing participants with information concerning the fundamentals of investment planning and asset allocation. The articles are well written and provide useful information.

The newsletter also provides information comparing the historical investment performance of the specific funds within the program to three different indices: S&P 500, Lehman Brothers Aggregate Bond Index, and the 90 day Treasury Bill. However, the reported indices are not fully reflective of the contractual performance objectives established for each of the investment managers. Specifically, the contractual benchmark investment returns for the following funds have not been reported to date:

- Mellon Balanced Portfolio Fund,
- Fidelity Blue Chip Growth Fund,
- Merrill Lynch Global Bond Fund, and
- Vanguard Explorer Fund.

Historical investment returns for the actual fund benchmarks, especially for the actively managed funds, is essential information for current and potential program participants and should be routinely reported.

VRS recently received its first full year of investment return data under the new program. During the first year of operation, none of the managers met their performance objectives. However, as previously indicated, four of the managers are evaluated relative to their benchmarks over a three-year market cycle. Table

8 (page 18) summarizes the recent performance of the investment managers.

Recommendation (4). The Virginia Retirement System should develop and implement an investment oversight structure for the deferred compensation program. This structure should include written policies and procedures, a system to monitor and report actual investment performance relative to benchmarks, and regular due diligence to monitor the investment practices, operational and support systems, and fee structures used by each investment manager.

Table 7: Deferred Compensation Program Investment Options

Fund/ Manager	*Contractual Benchmark*	*Benchmark Time Frame*	*Management Style/ Investment Restrictions*
Stable Value Fund/ Metropolitan Life	80% Merrill Lynch Government Bond Index/20% Merrill Lynch High Quality Corporate Bond Index	Annual	Active (Guaranteed Investment Contract) No leverage or short sales; Forward contracts and futures trading permitted for portfolio balancing, duration adjustment, and diversification
Bond Index Fund/ Vanguard	Lehman Brothers Aggregate Bond Index	Annual	Passive No leverage or short sales; futures trading and cash investments permitted
Daily Liquidity Stock Index Fund/ Mellon	S&P 500 Index	Annual	Passive No leverage, short sales, or purchase of securities not traded on U.S. exchanges; futures trading and cash investments permitted
Balanced Portfolio Fund/ Mellon	60% S&P 500 Index/ 40% Lehman Brothers Aggregate Bond Index	Annual	Passive No leverage or short sales; futures trading and cash investments permitted
Blue Chip Growth Fund/ Fidelity	S&P/BARRA large capitalization growth index plus 100 basis points	Three-year market cycle	Active No leverage, short sales, or purchase of securities not traded on U.S. exchanges; futures trading and cash investments permitted
Explorer Fund/ Vanguard	Russell 2000 small capitalization stock index plus 150 basis points	Three-year market cycle	Active No leverage, short sales, or purchase securities not traded on U.S. exchanges;
Global Bond Fund/ Merrill Lynch	Salomon Brothers World Government Bond Index (unhedged)	Three-year market cycle	Active No leverage or short sales; futures trading and cash investments permitted
International Stock Fund/ T. Rowe Price	Morgan Stanley EAFE Index (unhedged)	Three-year market cycle	Active No leverage, short sales, or currency hedging; futures trading and cash investments permitted; VRS is to be promptly informed of the use of any hybrid instruments

Source: JLARC staff analysis of VRS documents.

Table 8: Deferred Compensation Program -- Investment Performance and Fee Structure (for 12 Months Ending January 31, 1996)

Fund	Investment Return	Contractual Benchmark Return	Fee (Percent of Total Assets)
Mellon Daily Liquidity Stock Index Fund	38.37	38.46	0.10
Fidelity Blue Chip Growth Fund	33.47	40.47	1.02
Mellon Balanced Portfolio Fund	29.29	30.06	0.20
Vanguard Explorer Fund	26.17	27.36	0.70
Vanguard Bond Index Fund	16.71	17.65	0.10
Metropolitan Life Stable Value Fund	13.41	14.53	0.40
Merrill Lynch Global Bond Fund	12.70	16.12	0.84
T. Rowe Price International Stock Fund	N/A	N/A	0.96

Source: JLARC staff analysis of VRS documentation.

VRS Retiree Health Insurance Administration Function May Be Reduced

As a service to its retirees, VRS acts as the group administrator for retirees enrolled in the State's group health insurance program. DPT has statutory responsibility for administration of the State health insurance program. Therefore, DPT has final approval over any actions that VRS wishes to take concerning administration of retiree health insurance. VRS has no statutory responsibility or authority concerning the administration of health insurance benefits. Expenses incurred by VRS in the administration of health insurance benefits are charged against all its members, even though the benefit is available only to State employees.

VRS has served as the group administrator for retirees since 1989. The initial decision to become group administrator was made at the request of DPT. The original functions that VRS performed were determination of eligibility and data entry into DPT's benefit eligibility system. At the time, it was the expectation of VRS that DPT would continue to update all of the necessary forms and publications for VRS. However, VRS soon made a determination that DPT's open enrollment literature, written for active employees, was not very helpful for retirees. In response, VRS developed its own open enrollment literature for retirees in 1992.

Administrative Difficulties Have Increased in Recent Years. In subsequent years, VRS has assumed increased responsibility for performance of additional health insurance functions. Notable among these is performance of a liaison role between the retiree, the insurance carrier, and DPT in an effort to resolve questions of coverage and claim payments. In performing this function, VRS staff report that they frequently get verbally "beat up" by retirees. According to VRS, this particular function consumes a significant, and increasing, amount of staff time.

Over the past year, VRS has become increasingly frustrated in terms of its ability to efficiently and effectively administer retiree health insurance. This frustration arises from the fact that VRS has no control over the program. DPT retains full control and discretion. In addition, VRS management and staff do not believe that they have received an appropriate amount of support from DPT. VRS attributes this to a lack of staff, but not a lack of effort, on the part of DPT. Furthermore, the VRS director believes that resources expended to service the State's retiree health insurance program is impeding service delivery to non-State employers within VRS.

VRS' Future Role as Administrator Is Unclear. As its level of frustration has increased, VRS has begun to consider whether its continued administration of the program is appropriate. VRS has internally debated the merits of its continued involvement with health benefit administration. Some VRS staff would like to continue to provide retirees with this service, but recognize that a greater degree of control over program policy is necessary for efficient and effective administration. However, the director and other staff are of the opinion that VRS should get out of the health insurance arena, and limit its involvement to simply deducting the amount of health insurance premiums from pension checks.

VRS continues to examine its options in this area. One option under active consideration is formally notifying DPT that VRS will no longer serve as the group administrator.

The 1996 General Assembly instructed the Workforce Commission to study the multi-employer health insurance benefit program administered by DPT. The study shall include, but not necessarily be limited to, "the operation of the current program and alternative program sponsors for such a multi-employer system." VRS and DPT are required to provide such assistance during the study as the Workforce Commission may require.

RECENT DEVELOPMENTS IN VRS BENEFIT FUNDING

Benefit funding policy and practice is vitally important to the future viability of the defined benefit program administered by VRS. However, like virtually all public employee retirement systems, VRS has relatively minimal control over this area. DPB and the two legislative money committees - within the established statutory and budgetary framework - have the primary roles in implementing VRS benefit funding policy on behalf of the State. However, while VRS lacks ultimate control in this area, it can have considerable influence if it chooses to exercise it.

Prefunding of Cost of Living Adjustment Will Be Phased In

Current statutory language requires that the VRS employer contribution rate be determined in a manner so as to remain relatively stable from year to year. Section 51.1-145 of the *Code of Virginia* states that VRS board shall "certify to each employer the applicable contribution rate and any changes in the rate." That section also requires that the amount of State contributions "shall be based on the contribution rates certified by the Board...."

During the 1996 Session, the General Assembly approved a proposed constitutional amendment concerning VRS. Among the amendment's provisions is one concerning VRS benefit funding. If the amendment is approved by voters in the November referendum, VRS benefits will be required to be funded in accordance with generally-accepted actuarial principles. A similar requirement already exists in statute.

The process used to establish the employer contribution rates for the 1996-98 biennium began with the June 30, 1994 VRS actuarial valuation. Table 9 (page 20) summarizes the interim results of each key step in the rate-setting process. VRS instructed its actuary to perform the valuation based on full prefunding of the COLA beginning in FY 1997. As a result, the contribution rates determined by the valuation were significantly higher than the rates recommended by the 1992 actuarial valuation. In the Fall of 1994, in response to a request by the General Assembly, VRS began to examine alternative approaches to funding the COLA.

VRS Board Did Not Certify a State Employer Rate. The VRS Board did not certify a specific employer contribution rate for the State for the 1996-98 biennium. Rather, in July 1995 it presented the Governor and the chairmen of the two legislative money committees with three options for funding the COLA. The options presented were based on (1) continued pay-as-you-go funding of the COLA; (2) partial prefunding of the COLA, with a phase-in period leading to eventual full prefunding; and (3) full prefunding of the COLA.

The July 1995 letter from VRS to the Governor and the chairmen of the legislative money committees concluded as follows:

> The Board of Trustees has the fiduciary responsibility to advise the Governor and General Assembly of the employer contributions necessary to adequately fund the retirement system. The consensus of the Board of Trustees is that our statutory responsibility is to provide the information contained in Column 1 (pay-as-you-go). Our fiduciary responsibility, however, suggests that Columns 2 (partial prefunding) and 3 (full prefunding) are prudent methods of addressing the COLA issue. Any funding level less than Column 3 will result in future pay-as-you-go contributions increasing each year and will ultimately significantly exceed the rates of full prefunding.

State Budget Provisions Include Phase-In. The executive budget proposal for VRS contribution rates was based on a partial approach to COLA prefunding. The key aspect of the proposal was a five-year phase-in period. Under the proposal, 20 percent of the total rate increase required to fully prefund the COLA beginning in FY 1997 -- as stated in VRS option 3 -- would be phased in each year beginning in FY 1998.

The executive budget proposal for partial prefunding of the COLA differed from a similar proposal developed by VRS is two key respects. First, the partial prefunding option presented by VRS (option II) envisioned a phase-in period beginning in FY 1997. Second, the partial prefunding rate for FY 1998 in the executive budget was slightly understated due to a failure to recognize the actuarial effect of delaying the start of COLA prefunding for one year, from FY 1997 to FY 1998. The General Assembly enacted the employer contribution rates proposed by the Governor for FY 1997 and FY 1998. However, the General Assembly also passed legislation codifying the five-year phase-in approach contained in the executive budget.

Table 9: VRS Employer Contribution Rate Setting Process, 1996-1998 Biennium

	June 30, 1994 Actuarial Valuation	VRS Board Letter to Governor and Legislative Money Committees, July 1995 (Three Options)			Governor's Budget Submission		VRS Actuary's Revaluation for FY 1998 Using DPB's Five Year Phase-In Methodology	Appropriation Act	
		I	II	III	FY97	FY98		FY97	FY98
VRS State	8	4.85	6.38	8	4.85	5.48	5.6	4.85	5.48
VRS Teacher	10.79	6.41	8.10	10.79	6.41	7.28	7.45	6.41	7.28
SPORS	18.66	12.07	13.49	18.66	12.07	13.38	13.63	12.07	13.38
JRS	33.55	27.99	29.02	33.55	27.99	29.10	29.31	27.99	29.10

Notes: Rates are expressed as a percent of payroll. Rates do not include the five percent member contribution rate, which is currently paid by the State. Actuarial valuation based on full prefunding of COLA with no phase in period. Three options presented to Governor by VRS Board: (I) continued pay-as-you-go funding of COLA, (II) partial prefunding of COLA, with phase in period leading to full prefunding, and (III) full prefunding of COLA with no phase in period. Each option was designed for implementation beginning 7/1/96.

Source: JLARC staff analysis of VRS documents.

VRS Pension Funding Is Reasonably Sound

According to JLARC's actuarial consultant, Foster Higgins, VRS is a reasonably well-funded pension plan. Foster Higgins bases its opinion on the fact that VRS assets cover more than 70 percent of liabilities. Public employee retirement systems, including VRS, typically report their funding status using two different conventions: the actuarial basis and the GASB basis. Table 10 shows the VRS funding status as of June 30, 1994 under both the actuarial and GASB bases.

Solvency Test. The solvency test is a variant of the actuarial basis for measuring funding status. The solvency test calculates the portion of accrued pension liability that is covered by assets. However, it does so in a way that reflects the statutory order of precedence - contained in Section 51.1-124.7 of the *Code of Virginia* - for distributing trust fund assets in the event of termination of the retirement system. First in the order of precedence is payment to active members of their accumulated member contributions. Next is payment to current retirees and beneficiaries of the actuarial present value of their future retirement benefits. Last in order of precedence is payment to active employees of the actuarial present value of their future retirement benefits. Table 11 compares the results of the solvency test as of June 30, 1994 with that of June 30, 1992.

Increase in Unfunded Liability. The steep decline in funding of accrued future benefits for active members is due to the fact that the 1994 actuarial valuation was performed based on full prefunding of the COLA beginning in FY 1997. This resulted in a significant increase, of more than $5 billion, in the amount of unfunded accrued liability. The current plan is for VRS to amortize its accrued unfunded liability over a 30-year period.

VRS Compares Fairly Well with Other Public Employee Retirement Systems. While the funding status of VRS is reasonably sound, it is somewhat lower than the average of 28 other state-sponsored public employee retirement systems examined by JLARC staff. However, the VRS funding status is close to the sample median. The ratio of VRS revenues to expenses is also lower than average, but VRS compares favorably on the ratio of active to retired members. Table 12 (page 22) compares the funding status of VRS to the average and median funding status of other public employee retirement systems.

JLARC Will Assess Actuarial Soundness. The Virginia Retirement System Oversight Act requires JLARC to prepare an actuarial report on VRS once every four years. JLARC plans to conduct that study in 1997 with the assistance of an actuarial consultant. The study will include a detailed examination of the status of action on technical recommendations that JLARC's actuarial consultant made in 1993. It will also include an assessment of VRS funding status and policy based on the results of the June 30, 1996 actuarial valuation.

Table 10: VRS Pension Funding Status

Measure of Funding Status	Funding Percentage	Liability Valuation	Asset Valuation	Comments
Actuarial Basis = (Valuation Assets / Actuarial Accrued Liability)	VRS: 73.0% SPORS: 72.7% JRS: 58.1% Aggregate: 72.8%	$20,880,340,000 Aggregate accrued liability calculated using entry age normal cost method	$15,207,118,000 Valuation assets calculated using modified market method, which smoothes increases and decreases in market value over a five year period.	More conservative valuation of liability More aggressive valuation of assets
GASB Basis = (Net Assets Available for Benefits / Pension Benefit Obligation)	VRS: 77.4% SPORS: 72.5% JRS: 55.5% Aggregate: 77.1%	$19,339,900,000 Pension benefit obligation calculated using projected unit credit method	$14,919,100,000 Net assets available for benefits calculated using cost basis	Less conservative valuation of liability Less aggressive valuation of assets This measure of funding status will no longer be reported by VRS beginning in FY98.

Source: JLARC staff analysis of information contained in VRS Actuarial Valuation performed as of June 30, 1994, and 1995 VRS Annual Report.

Table 11: Results of VRS Solvency Test

Actuarial Valuation Date	Active Member Contributions			Future Benefits for Current Retirees and Beneficiaries			Future Benefits for Current Active Employees		
	VRS	SPORS	JRS	VRS	SPORS	JRS	VRS	SPORS	JRS
June 30, 1992	100	100	100	100	100	100	96.4	103.7	49.25
June 30, 1994	100	100	100	100	100	96.91	46.9	52.4	0

Source: VRS Annual Reports.

No Progress in Group Life Insurance Funding

In 1993, JLARC examined the funding status of the group life insurance program. The study, performed with the assistance of an actuarial consultant, resulted in several findings. First, prefunding of future life insurance benefits for current employees enhances the security of those benefits. Second, the suspension of premiums for FY 1994 decreased the amount of prefunding and reduced the actuarial soundness of the benefit. Third, the program's funding objective should be based on fully funding the future benefits of all program participants. In response to the study findings, JLARC made several recommendations:

- VRS should perform an actuarial valuation prior to July 1, 1994 to identify the effect of the premium suspension.
- VRS should fully fund future benefits for all program participants.
- An independent evaluation should be performed prior to changing the program's funding methodology or rates.
- VRS should adopt a formal funding policy for the program.

VRS performed an actuarial valuation of the program as of June 30, 1994. The valuation, based on full prefunding of all future benefits, calculated a contribution rate of 0.72 percent of payroll for FY 1997 and

Table 12: VRS Funding Status Compared to Other Public Employee Retirement Systems

	Funded Percentage	*Ratio of Active to Retired Members*	*Ratio of Revenues to Expenses*
VRS	77.14	3.36	2.48
PERS Average	81	2.95	2.84
PERS Median	78	2.89	2.61
PERS Maximum	108.5 (Tennessee Consolidated Retirement System)	5.21 (Texas Employees Retirement System)	5.89 (Missouri Public School Retirement System)
PERS Minimum	52.7 (Illinois Teachers Retirement System)	1.83 (South Dakota Retirement System)	1.03 (Texas Employees Retirement System)

Notes: Funded percentage calculated as net assets available for benefits divided by pension benefit obligation. Average and median funded percentage using data from 28 state-sponsored public employee retirement systems that use same asset valuation basis for calculation purposes. Average and median active/retiree ratio and revenue/expense ratio calculated using data from 45 state-sponsored public employee retirement systems.

Source: JLARC staff analysis of FY 1995 annual reports for VRS and other state-sponsored public employee retirement systems.

FY 1998. This rate was higher than the 0.65 percent of payroll recommended by the actuarial valuation made prior to the premium suspension.

The executive budget proposal for group life insurance funding contained a premium suspension for FY 1997 and a contribution rate of 0.35 percent for FY 1998. An independent evaluation was not performed as part of developing the budget proposal. These rates were approved by the General Assembly, and applied to all of the political subdivisions, in the Appropriation Act. VRS did express its concern over the proposed level of funding to the Secretary of Finance. According to VRS, "the pattern is not consistent with the goal of fully funding the life insurance program on an actuarially-determined basis." It is fair to conclude that no progress has been made in fully funding the group life insurance benefit since the 1993 JLARC study.