Commonwealth of Virginia
July 6, 2020

Report to the Governor and the General Assembly of Virginia

VRS Oversight Report

JULY 2020

COMMISSION DRAFT

JLARC
JOINT LEGISLATIVE AUDIT
AND REVIEW COMMISSION

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Commission draft

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Joint Legislative Audit and Review Commission
July 6, 2020

Overview

The Virginia Retirement System (VRS) administers retirement plans and other benefit programs for state and local government employees. The two largest plans are the Teachers Plan and the State Employees Plan (Figure 1). Other pension plans include the individual retirement plans for 598 local political subdivisions and plans for state police officers (SPORS), other Virginia state law officers (VaLORS), and judges (JRS). VRS also administers several defined contribution retirement plans. In addition to retirement plans, VRS administers post-employment benefit programs. These include life insurance, sickness and disability, long-term care, and the retiree health insurance credit program. VRS also conducts eligibility determinations and fund administration for Virginia's Line of Duty Act.

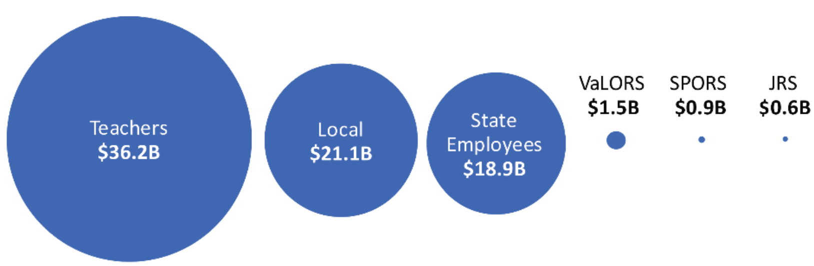
VRS serves approximately 743,000 members, retirees, and beneficiaries. Active members include current state and local employees and teachers in Virginia's public school divisions. VRS also serves retirees, their designated beneficiaries, and "deferred" members, who are not actively employed and are not yet collecting benefits.

The financial assets used to pay VRS benefits are pooled in the VRS trust fund, which held $76.9 billion in assets as of March 31, 2020. Ranked by value of assets, VRS is the nation's 18th largest public or private pension fund. In FY19, VRS paid $5.0 billion in retirement benefits and $414 million in other post-employment benefits, not including benefits paid outside of the trust fund through the defined contribution plans.

VRS receives funds from three main sources: employer contributions, member contributions, and investment income. In FY19, VRS received $3.7 billion in net additions to the trust fund (accounting for expenses and benefits paid out).

Investment income is critical to the health of the VRS trust fund, accounting for over half of total additions in FY19. VRS investments generated a return of -2.2 percent for the one-year period ending March 31, 2020. The total annualized return over the 10-year period ending March 31, 2020 was 6.9 percent, which is above the 6.75 percent long-term (30+ year) rate of return that VRS has assumed for its investments.

FIGURE 1
VRS pension assets by plan



SOURCE: VRS 2019 valuation report.
NOTE: Figures show total actuarial value of assets attributable to each retirement plan as of June 30, 2019. Trust fund assets attributable to other benefit programs are not shown. Figure for local plans is the aggregate of assets for political subdivisions that participate in VRS. Local plans (in aggregate) hold more assets than the State Employees plan because political subdivisions have historically fully funded the required contributions. The liabilities for the local plans (in aggregate) and the State Employees plan are similar.

FIGURE 2
VRS fast facts

MEMBERSHIP as of March 31, 2020

354,106	Actively employed members[a]
222,818	Retired members & beneficiaries
165,598	Inactive members
742,522	Total

NET ADDITIONS for fiscal year ending June 30, 2019[b]

$2.9 billion	Employer contributions
$1.1 billion	Member contributions
$5.2 billion	Net investment income
-$5.6 billion	Benefits paid and other expenses[c]
$3.7 billion	Net additions[d]

ASSETS as of March 31, 2020

$76.9 billion
Total VRS trust fund assets

INVESTMENT PERFORMANCE as of March 31, 2020

	1 year	3 years	5 years	10 years
Total return	-2.2%	4.0%	4.6%	6.9%
Benchmark	-1.4%	4.0%	4.4%	6.5%
Excess return	-0.8%	+0.0%	+0.2%	+0.4%

SOURCE: VRS 2019 annual report and 2020 membership and investment department data.
a Active membership included 155,964 teachers, 111,495 local government and political subdivision employees, and 86,647 state employees, state police, law enforcement officers, and judges. Within the retirement plans are three benefit groups. Active membership by benefit group included 150,155 in Plan 1, 84,297 in Plan 2, and 119,654 in the hybrid plan. b Includes all additions and deductions to the trust fund for VRS retirement plans and other benefits programs. c Includes $5.0 billion in retirement benefit payments, $414 million in other benefits, $118 million in refunds, and $64 million in administrative and other expenses. d Does not sum because of rounding.

1. Trust fund investments

Management of the trust fund investments is one of the core responsibilities of VRS. The VRS Board of Trustees sets investment policies for managing the trust fund, including the desired asset allocation for the fund. The investment department manages investment programs within the guidelines set by the board. The investment department manages approximately one-third of the assets in-house and contracts with external managers to manage other assets.

Investment performance and asset allocation

The VRS trust fund held $76.9 billion in assets as of March 31, 2020, a decrease of $3.5 billion from a year ago. The decrease in assets reflects the recent market volatility from the COVID-19 pandemic. Approximately $24.4 billion of the trust fund was managed in-house, including nearly all fixed income and some public equities, real assets, and cash. The remaining $52.5 billion was managed by external managers under VRS supervision.

The total fund met or exceeded its investment benchmark for all periods ending March 31, 2020, except the one-year period (Figure 3). However, with the exception of the 10-year period, the trust fund's investment returns were below the 6.75 percent long-term (30+ year) rate of return that VRS assumes for its investments. Returns ranged from -4.9 percent for the fiscal year to date (first three quarters of FY20) to 6.9 percent for the 10-year period.

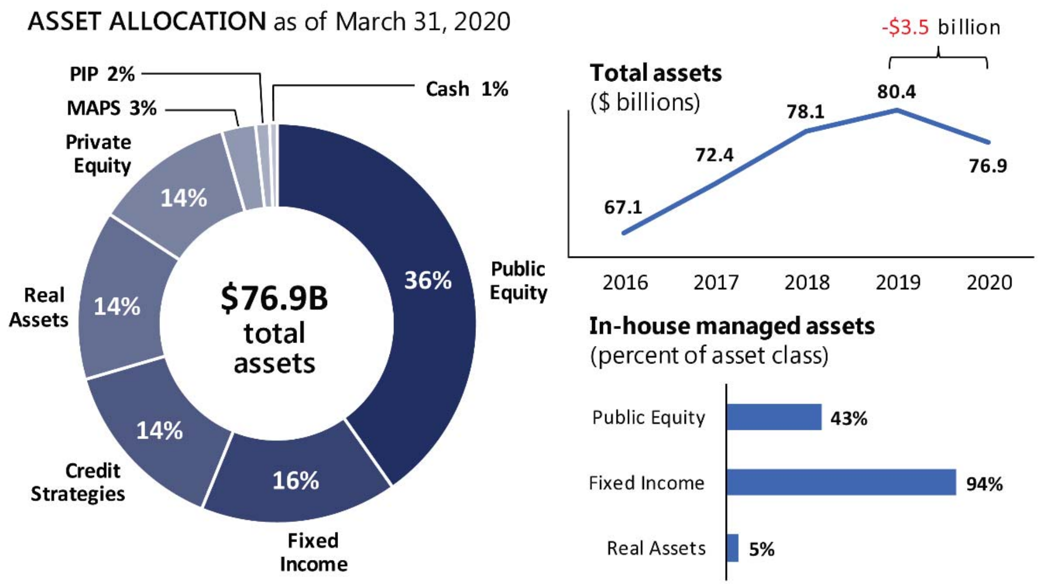
The VRS board adopts a **long-term return assumption** based on the advice of the Investment Advisory Committee, VRS investment staff and plan actuary, and surveys from investment managers and consultants. This is the rate of return expected over the next 30+ years, based on projections of future market performance.

The long-term return assumption is one of the key assumptions used to determine the plan's funded status and employer contribution rates. The current long-term return assumption is 6.75%.

Public equity. The public equity program continues to be the largest VRS asset class, with $27.5 billion in assets. The program consists of stocks and other equity securities for publicly traded companies in the U.S. and globally. Public equity investments are typically higher risk than bonds and are expected to provide long-term capital growth. Forty-three percent of the program's assets are managed in-house. The program underperformed its benchmarks for all periods except the 10-year period. The underperformance was largely because of value strategies underperforming during these periods, according to VRS. The first quarter of 2020 was one of the worst recorded quarters for value strategies on record.

Fixed income. The fixed income program is the second-largest VRS asset class, with $12.3 billion in assets. The program includes U.S. dollar-denominated securities, such as bonds and money market instruments, that pay a specific interest rate. Fixed income investments are typically lower risk relative to most other asset classes and are expected to generate steady returns even in down equity markets. Ninety-four percent of fixed income assets are managed in-house. All fixed income assets were managed in-house in recent years until 2020, when VRS moved several external managers from the credit strategies program to fixed income. The program met or exceeded its benchmarks for all periods except the fiscal year to date. The near-term underperformance was largely due to underperformance in the mortgage-backed securities markets during March's economic downturn, according to VRS. VRS also liquidated some treasury holdings during March to meet collateral-related liquidity needs.

FIGURE 3
Asset allocation and trust fund investment performance



TRUST FUND INVESTMENT PERFORMANCE
for the period ending March 31, 2020

	FY to date	1 year	3 years	5 years	10 years
Total fund	-4.9%	-2.2%	4.0%	4.6%	6.9%
VRS custom benchmark	-5.1	-1.4	4.0	4.4	6.5
Public equity	-16.0	-13.9	-0.2	1.9	6.1
Benchmark	-15.6	-13.0	0.6	2.2	5.9
Fixed income	3.9	7.2	4.5	3.5	4.3
Benchmark	4.0	7.2	4.3	3.0	3.8
Real assets	1.9	3.7	7.3	8.6	11.3
Benchmark	0.6	2.2	5.6	7.0	9.5
Private equity	11.2	16.4	16.4	14.2	14.2
Benchmark	15.0	29.0	15.8	12.5	14.2
Credit strategies	-5.4	-2.3	2.7	3.6	5.5
Benchmark	-7.6	-4.7	1.7	2.9	4.7
Multi-asset public strategies (MAPS)	-9.5	-8.0	n/a	n/a	n/a
Benchmark	-4.2	-0.7	n/a	n/a	n/a
Private investment partnerships (PIP)	5.9	8.0	8.5	7.9	n/a
Benchmark	5.2	12.5	8.3	7.7	n/a

SOURCE: VRS investment department data.
NOTE: Asset allocations do not sum to 100 percent because of rounding.

Real assets. The real assets program is the third-largest VRS asset class, with $11.2 billion in assets.* The program includes investments in real estate, infrastructure, and natural resources such as timber. Real assets investments are expected to reduce volatility of the total fund by offering returns that do not have a high statistical correlation to the public equity market. Most VRS real assets are managed externally. The program outperformed its benchmarks for all periods.

Private equity. The private equity program is the fourth-largest asset classes, with $11.0 billion in assets.* Private equity is an alternative to traditional public equity and generally consists of ownership in companies that are not listed on public exchanges. Private equity investments are "opportunistic" investments that are intended to outperform public equity markets over the long term and enhance total fund returns. All private equity assets are managed externally. The program met or exceeded its benchmarks in the three-year, five-year, and 10-year periods, but underperformed in the one-year period and the fiscal year to date (first three quarters of FY20). The underperformance in the near-term is the result of strong upward revaluations of public equity markets relative to the private equity portfolio. The program has achieved its intended purpose and outperformed the public market on an annualized basis over the 10-year period.

Credit strategies. The credit strategies program is the smallest of the five major asset classes, with $10.6 billion in assets. The program includes investments in emerging market debt, high-yield bonds, convertible bonds, bank loans, and direct lending. Credit strategies investments are intended to provide higher income than bonds and better risk-adjusted returns than stocks. All of the program's assets are managed externally. The program outperformed its benchmarks for all periods.

Multi-asset public strategies. The multi-asset public strategies program is a relatively new, small exposure program, with $2.3 billion in assets. The portfolio includes dynamic strategies, which are opportunistic multi-asset allocation approaches. The portfolio also includes risk-based investments, which are uncorrelated, and diversifying strategies relative to the rest of the assets in the fund. The portfolio is managed externally and underperformed its benchmark for the one-year period and the fiscal year to date (first three-quarters of FY20). The underperformance is largely due to the market volatility in the first quarter of 2020 because of the COVID-19 pandemic. The portfolio entered the calendar year with a pro-risk stance to benefit from the strong economic environment, but the market downturn led to reduced performance across all asset classes. The portfolio is too new to have performance or benchmarks for additional periods.

*Performance figures for the real assets and private equity programs, as well as the private investment partnerships portfolio, do not reflect managers' actual valuations of these investments as of March 31, 2020 because valuations of private assets have a timing lag behind other assets. Instead, performance figures are based on valuations as of December 31, 2019, adjusted for cash flows during the quarter that ended March 31, 2020.

Private investment partnerships. The private investment partnerships portfolio is another relatively new, small exposure program, with $1.3 billion in assets. The portfolio comprises multi-asset private investments and is managed externally. The portfolio exceeded its benchmark for the fiscal year to date (first three-quarters of FY20), three-year period, and five-year period, but it underperformed in the one-year period. The portfolio is too new to have performance or benchmarks for the 10-year period.

Investment policies and programs

The VRS board sets investment policies, and the professionals in the investment department implement programs to fulfill those policies. The VRS board recently accelerated the phase-in of the trust fund's new asset allocation policy and made changes to the benchmarks for several asset classes. These changes reflect the results of an asset liability study that VRS hired an external consultant (Verus) to complete in 2019.

Board accelerated phase-in of strategic asset allocation policy

In April 2020, the VRS board accelerated the phase-in of the trust fund's new strategic asset allocation policy, which became effective January 2020. The board had intended to incrementally phase in the new long-term asset allocation policy in July 2020 and July 2021. However, market activity caused by the COVID-19 pandemic brought the fund's asset allocation close to the previously planned July 2021 target (Table 1). In response, the board retroactively adopted a policy target effective April 1, 2020, which is similar to the planned July 2021 target. The acceleration of the policy changes allowed VRS to avoid trades and their associated costs that would have been required to stay close to the planned July 2020 policy target. In addition to accelerating the phase-in of the asset allocation policy, the board reduced the allowable range for fixed income, in part to reflect the addition of cash to the policy, and increased the allowable range for PIP to address flexibility needs within the asset class.

TABLE 1
VRS strategic asset allocation policy

Asset class	April allocation	Previously planned July 2020 target	Previously planned July 2021 target	Accelerated April 2020 target[a]
Public equity	36%	39%	36%	37%
Fixed income	16	15	15	16
Credit strategies	14	14	14	14
Real assets	14	14	14	14
Private equity	14	12	13	13
Private investment partnerships (PIP)	2	2	3	2
Multi-asset public strategies (MAPS)	3	4	5	3
Cash	1	0	0	1

SOURCE: VRS board meeting documents.
a. April 2020 target will remain in effect through FY21. The board reapproved the accelerated April 2020 target at its June meeting because of an inadvertent transposition in the April Request for Board Action.

VRS modified asset class benchmarks

VRS modified the benchmarks for the total fund and all asset classes, except real assets, effective January 2020. The board approved the modifications in 2019. The purpose of the modifications is to ensure that the benchmarks for each of the portfolios align with the current investment approach of the portfolio.

VRS also conducted a study of the appropriateness of each asset class's benchmark with an external consultant, Verus. Verus recommended changes to two of VRS's recently modified benchmarks. Verus recommended removing the aspirational component of the private equity benchmark so that it is benchmarked only to a global public equity index. According to Verus, this approach is used by other institutional investors, and any outperformance of private equity relative to public equity is considered beneficial to the fund. Verus also recommended modifying the benchmark for the PIP asset class. In addition to reviewing the benchmarks, Verus recommended several changes to the outperformance VRS investment staff must achieve to receive incentive compensation. In most cases, Verus recommended increasing the required outperformance compared to the benchmark. Because of the decrease in the private equity benchmark, private equity investment staff will start receiving incentive compensation at lower levels of outperformance. However, their maximum incentive payout will remain the same. The board adopted the recommended changes to both the benchmarks and the investment staff compensation plan at its June 2020 meeting.

2. Defined contribution plans

VRS manages several defined contribution plans for its members. All state employees and many local VRS members are eligible to participate in one or more of the plans (Table 2). Participants in these plans have their own accounts, and individual participants determine how their money is invested from an investment line-up designed by VRS. The defined contribution plans are similar in structure to private-sector 401(k) plans and individual retirement accounts (IRAs).

Some of the VRS defined contribution plans are intended to provide primary retirement benefits, whereas others are intended as a supplement benefit. The aggregate value of participant accounts held in the VRS-managed defined contribution plans was $4.9 billion as of March 31, 2020.

Plan performance

Participants in the VRS defined contribution plans may choose from 21 investment options available through the defined contribution plans (DCP). These options include (1) diversified target-date portfolios, (2) individual investment options, and (3) self-directed brokerage accounts. Participants pay a flat administrative fee every year and additional investment fees based on the options they select. Participants in the Optional Retirement Plan for Higher Education may choose to invest in options available through VRS's DCP lineup or in options available through another provider, TIAA.

Participants pay investment, administrative, and other fees based on the provider and investment options they select.

TABLE 2
VRS defined contribution plans (as of March 31, 2020)

Plan	Description	Assets ($M)
Deferred compensation and cash match	State employees, and some local VRS members, can choose to make voluntary contributions to their Commonwealth 457 deferred compensation plan to supplement their retirement income. Most eligible state employees receive a modest cash match from employers in their Virginia 401(a) cash match plan. [a]	$3,335
Optional plan for higher education [b]	Faculty and other eligible employees at public colleges and universities may make an irrevocable one-time decision to participate in this defined contribution plan instead of the State Employees Plan. Employers are required to make contributions to participant accounts, and employees hired after July 1, 2010, are also required to contribute.	$991
Hybrid	State and local members of the hybrid plan are required to contribute to their Hybrid 401(a) plan and can choose to make voluntary contributions to their Hybrid 457 plan. Employers make mandatory contributions to participant accounts and match a portion of voluntary contributions made by members. Members are also enrolled in the hybrid plan's defined benefit component.	$591
Other [c]	An optional retirement plan is offered as an alternative to political appointees (in place of the VRS State Employee plan) and to school superintendents in school divisions that have elected to have the plan (in place of the VRS Teachers plan).	$16

SOURCE: VRS administration and investment department data.
[a] Most political subdivisions do not have a cash match plan. [b] The following higher education institutions administer their own optional plans: George Mason University, Virginia Commonwealth University, the University of Virginia, Virginia Tech, and the College of William and Mary. Faculty at these institutions are not eligible to participate in the VRS optional plan for higher education. [c] The amounts held in the other plans are as follows: Optional Retirement Plan for Political Appointees, $16 million; Optional Retirement Plan for School Superintendents, $200,000; and Virginia Supplemental Retirement Plan for certain educators, $100,000.

Defined contribution plans (DCP)

Target-date portfolios. Participants may select a diversified investment portfolio that reflects their target retirement date. These portfolios are the default for members who do not elect an investment option, and they include a broad spectrum of investments, such as stock, bond, and real estate funds. The mix of investments is automatically adjusted over time to become more conservative as the participant approaches retirement age. The target-date portfolios, which hold $1.6 billion in assets, met or exceeded all of their performance benchmarks (Table 3).

Individual options. Participants may select from one or more individual options to build a customized investment portfolio. The options include different stock, bond, money market, and real estate funds, and a fund that allows members to purchase units of the investments held by the VRS defined benefit trust fund. The individual options, which hold $2.4 billion in assets, met or exceeded most of their performance benchmarks (Table 3). Two options failed to meet their one-year benchmark, and one option failed to meet its three-year benchmark.

Self-directed brokerage accounts. The brokerage accounts allow participants to select from thousands of publicly traded mutual funds, exchange-traded funds, and individual securities. Participants who use brokerage accounts have full control over their investments, down to the individual securities held in their portfolio. The brokerage accounts hold $49 million in assets. Because all investment decisions are made by the account holders, VRS does not use performance benchmarks for the brokerage accounts.

TABLE 3
Investment performance of VRS defined contribution plans

for the period ending March 31, 2020

	1 year	3 years	5 years	10 years
Options available for all plans				
Target-date portfolios				
Met or exceeded benchmark	9	9	9	7
Total number of options	9	9	9	7
Individual options				
Met or exceeded benchmark	8	9	10	10
Total number of options	10	10	10	10
Additional option under the higher education plan				
TIAA[a]				
Met or exceeded benchmark	17	17	16	15
Total number of options	17	17	17	15

SOURCE: VRS investment department data.
NOTE: (1) Total number of investment options reported for a given period can change because longer-term performance data is not available for newer options. (2) Performance of target-date and individual options is reported net of investment fees but not administrative fees. Performance of the additional options under the higher education plan is reported net of investment and embedded record-keeping and plan administration fees, where applicable. (3) Some funds are passively managed. Passively managed investment options are expected to trail their benchmarks by the expense ratio (fees) charged by the investment managers. Actively managed options are expected to outperform the market and were measured against the benchmark net of investment fund fees. Capital preservation investment options, such as stable value and money market funds, are expected to generate returns at or above zero and were assessed relative to that benchmark. a. Performance information does not reflect assets held through legacy TIAA contracts, which were in effect before 2017.

Optional Retirement Plan for Higher Education

Participants in the Optional Retirement Plan for Higher Education (ORPHE) can choose to invest in the VRS DCP lineup or with TIAA. Under TIAA, participants may select a target-date portfolio or a diversified portfolio option, or they can build a custom portfolio from different stock, bond, money market, and real estate funds. TIAA also offers a self-directed brokerage account. As of March 31, 2020, the TIAA program held $775 million in assets.

VRS updated the TIAA investment menu with new options in January 2020. The new options met or exceeded their benchmarks, with the exception of one option that failed to meet the five-year benchmark (Table 3). Most TIAA assets (73 percent) are held in legacy options that are not available under the new menu. VRS no longer tracks performance for these options because they have been deselected by VRS. The proportion of funds in the TIAA legacy options will decrease over time as new participants enter the plan and invest in the new options.

An additional $116 million in the higher education retirement plan is held with private deselected providers with whom VRS no longer partners. This includes Fidelity, which became a deselected provider for new hires on June 1, 2019 and existing participants on January 1, 2020. VRS does not track investment performance for deselected providers because participants can no longer contribute to them through the plan.

Plan management

VRS manages the defined contribution plans through contracts with private companies. These companies provide account administration and investment management services to plan participants. VRS's defined contribution plan activities are guided by the Defined Contribution Plans Advisory Committee. Two VRS board members serve on the committee, and the remaining members are appointed by the board. The committee provides guidance to the board and staff.

New TIAA Investment Menu Expected to Benefit Participants

VRS implemented new TIAA investment options in January 2020 that are expected to be more beneficial to participants than the previous TIAA line-up. The VRS board approved the change in May 2019, which was motivated by historical underperformance and higher fees in the previous line-up. Seventeen new investment options replaced nine previous options; one previous option was retained as part of the new menu of options.

So far, the new TIAA investment options are performing better relative to their benchmarks than the previous options in the TIAA line-up. For the period ending on March 31, 2020, all of the options met or exceeded their benchmarks, with the exception of one option that failed to meet the five-year benchmark. This performance exceeds the previous TIAA options, which failed to meet approximately 60 percent of their benchmarks in the periods ending in September 30, 2019 and March 31, 2019. The total fees for the new options are also considerably lower than for the previous options.

3. Legislation enacted in 2020

Through legislative action, the General Assembly can adjust contribution rates and funding, benefits and eligibility, and other aspects of VRS retirement plans and benefits programs. In 2020, the General Assembly enacted legislation and budget language that affect VRS (Table 4).

TABLE 4
VRS legislation and budget language enacted by 2020 General Assembly

HB 351/SB 324	**School bus drivers (return to work)** Allows school bus drivers to be designated as a critical shortage position, and qualified retired VRS members to return to work as a school bus driver after a 12-month break in service while continuing to receive a retirement benefit.
HB 536/SB 109	**College savings accounts (felonious assault death of VRS member)** To reflect statutory changes in the Virginia College Savings Plan and the Internal Revenue Code, changes the formula determining the required VRS funding amount for a college savings account for children of VRS members who die in service as a result of a felonious assault.
HB 1495/SB 54	**School security officers (return to work)** Allows retired sworn law enforcement officers to return to work as a school security officer after a 12-month break in service while continuing to receive a retirement benefit.
HB 1513	**Health insurance credit** Beginning July 1, 2021, requires school divisions that provide benefits to non-teacher employees to provide a health insurance credit of $1.50 per year of service to non-teacher employees with at least 15 years of creditable service. School divisions may elect an additional $1.00 credit.
HB 51/SB 40	**Line of Duty Act (LODA)** Provides that children born or adopted after the death of an employee covered by LODA are eligible for health insurance coverage if their birth or adoption occurred after the time of the employee's death or disability but before July 1, 2017.
HB 783/SB 9	**Workers' Compensation disease presumptions** Adds cancers of the colon, brain, and testes to the list of cancers that are presumed to be an occupational disease for firefighters or certain other employees. Does not apply to diagnoses made before July 1, 2020.

HB 169/SB 345	**Workers' Compensation presumptions for correctional officers and Department of Motor Vehicles** Adds state correctional officers and full-time sworn members of the Department of Motor Vehicles to the presumption for infectious diseases.
HB 438/SB 561	**Workers' Compensation post-traumatic stress disorder** Adds post-traumatic stress disorder as a compensable disorder for law enforcement officers and firefighters. Applies to qualifying events that occur on or after July 1, 2020.
Item 477 (2020–2022 Appropriation Act)	**VRS employer contribution rates** Fully funds the VRS board-certified retirement contribution rates for teachers, state employees, and JRS plans. Additional funding was added beyond the board certified rates for SPORS and VaLORS. Fully funds the VRS board-certified other post-employment benefit contribution rates.
Item 477 (2020–2022 Appropriation Act)	**LODA contribution rates** Funds increased LODA contribution rates to reflect legislative changes.
Item 477 (2020–2022 Appropriation Act)	**Transitional Benefits Program** Extends the Transitional Benefits Program through June 30, 2022. This program allows school divisions and VRS-participating political subdivisions to provide a transitional severance benefit or enhanced retirement benefit to employees who are involuntarily separated from employment.
Item 477 (2020–2022 Appropriation Act)	**Unfunded liability for state employee retiree health insurance credit** Provides funding to reduce the amortization period for the legacy unfunded liability by five years. (Funding unallotted until state revenue reforecast in summer 2020)

SOURCE: Virginia Legislative Information System and VRS.
NOTE: Workers eligible for workers' compensation benefits may be eligible for other benefits overseen by VRS, including LODA and disability benefits.

4. Benefits administration and agency management

Administration of member benefits is one of the core responsibilities of VRS. To carry out this and other duties, the agency must be effectively managed. Notable topics related to benefits administration and agency management include an increase in the proportion of hybrid plan members making voluntary contributions and new VRS board member reappointments.

Hybrid plan members contribute 5 percent to 9 percent of salary toward their retirement benefits.

Members must contribute 4 percent of salary toward their defined benefit component.

Members are required to contribute 1 percent of salary to their defined contribution component and may voluntarily contribute up to an additional 4 percent.

Employers also are required to contribute to a member's defined benefit component at the actuarially determined rate. Employers are required to contribute 1 percent of salary toward a member's defined contribution component and up to an additional 2.5 percent in matching contributions, based on a member's voluntary contributions.

Hybrid plan voluntary contribution participation rate increased to nearly 90 percent because of automatic escalation

The hybrid plan combines elements of a traditional defined benefit retirement plan with a 401(k)-style defined contribution plan. Hybrid plan members include most state employees, teachers, and local employees hired on or after January 1, 2014, and make up 34 percent of the total active VRS membership as of March 31, 2020. (State employees in the SPORS and VaLORS plans, and local employees with enhanced hazardous duty benefits, are not eligible to participate in the hybrid plan.) The hybrid plan has lower costs and liabilities for the state and other participating employers than the defined benefit plans it replaced. Therefore, it is expected to gradually reduce costs for the state and most localities as it covers an increasing proportion of the workforce. The plan also transfers a higher proportion of investment and longevity risk from employers to plan members.

To help ensure adequate savings at retirement, members of the hybrid plan should make voluntary contributions to the defined contribution portion of their plan. Hybrid plan members are required to contribute 1 percent of their salary to their defined contribution component. Hybrid plan members may make additional voluntary contributions of up to 4 percent of their salary and receive an employer match, thereby enhancing their retirement savings. Hybrid plan members who do not make adequate voluntary contributions will likely not meet an income replacement target of approximately 80 percent of their pre-retirement income.*

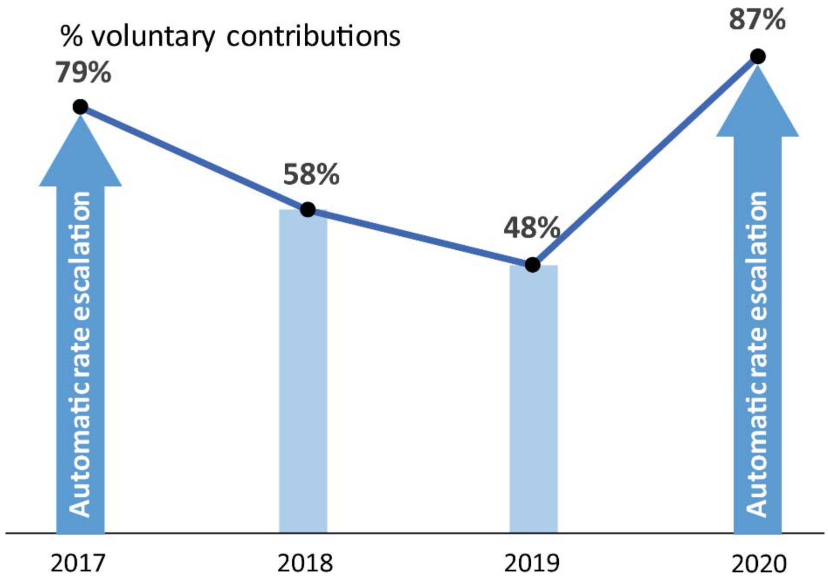
An **automatic escalation** of 0.5 percent occurs every three years for voluntary member contributions to the defined contribution component of the hybrid plan, as required under statute (§ 51.1-169 C.3). Members are not subject to the automatic escalation if they opt out or if they are already making the maximum 4 percent voluntary contribution.

The percentage of hybrid plan members making voluntary contributions increased to a high point (87 percent) in 2020 because of an automatic rate escalation in January 2020 (Figure 4). Automatic rate escalations increase participation rates because they bring participants into the voluntary contribution component of the plan unless they opt out. Only 1 percent of members opted out of the recent escalation. (Members making the maximum 4 percent voluntary contribution are not subject to the automatic escalation.) The plan's first statutory automatic rate escalation took place in January 2017, bringing the percentage of members making voluntary contributions to 79 percent. However, the percentage of members making voluntary contributions declined over the next two years as new hybrid members joined the plan. New employees tend not to initiate a voluntary

*80 percent replacement target takes into account social security and assumes 30 years of service. Actual voluntary contributions needed to meet income replacement target vary with members' income levels and annual investment returns. Hybrid plan members who make the maximum 4 percent in voluntary contributions could potentially receive retirement benefits greater than Plan 1 or Plan 2 members.

contribution when they start employment. The percentage of members who make voluntary contributions will likely decline again until the next automatic escalation takes place in January 2023 unless changes are made to the plan, such as automatically enrolling new employees at a minimum voluntary contribution rate or having more frequent automatic escalations.

FIGURE 4
Percentage of hybrid plan members making voluntary contributions since last automatic rate escalation in 2017



SOURCE: VRS.
NOTE: Data as of March 31 in 2017, 2018, 2019, and 2020.

VRS board member appointments

The VRS board is a supervisory board that is directly vested with authority for managing and overseeing most aspects of the retirement system. The board includes nine members, five of whom are appointed by the governor and four of whom are appointed by the General Assembly. The board delegates day-to-day management responsibilities to the VRS director and chief investment officer.

Chief William A. Garrett was appointed to the board by the governor in February 2020, subject to confirmation by the General Assembly. His term will expire in 2023. Chief Garrett was formerly with the Winchester Fire and Rescue Department and serves as the statutorily required local employee.

O'Kelly E. McWilliams III was appointed board chair by the governor in February 2020, subject to confirmation by the General Assembly. He was originally appointed to the board in March 2017. His term will end in 2022. McWilliams is a partner with the law firm Mintz. He serves as the board's statutorily required member with benefits experience.

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