

# OVERVIEW OF VSERS PENSION CROSS- SUBSIDIZATION

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# What is Cross-Subsidization?

- The cost of every member's retirement benefits will vary based on their own career experience (salary history, years of service, entry and exit age, longevity, etc).
- In addition, the different benefit packages from group to group cost different amounts (different benefit multipliers, normal retirement eligibility, AFC caps, etc).
- It is impossible to know exactly what these costs will be in the future for every individual because we cannot predict every employee's longevity. Reasonable assumptions must be made.
- It is also impossible to budget pension costs to specifically account for every member's individual actuarial profile. Instead, **blended rates** are used. Blended rates inherently lead to some degree of cross-subsidization because actual member experience will vary higher/lower than assumptions, and costs vary by pension group.
- **VSERS uses one blended employer contribution rate across all employee groups.** Departments that employ Group C members, therefore, pay the same pension charge as a percentage of payroll as departments that employ Group F members.

# Total Normal Cost

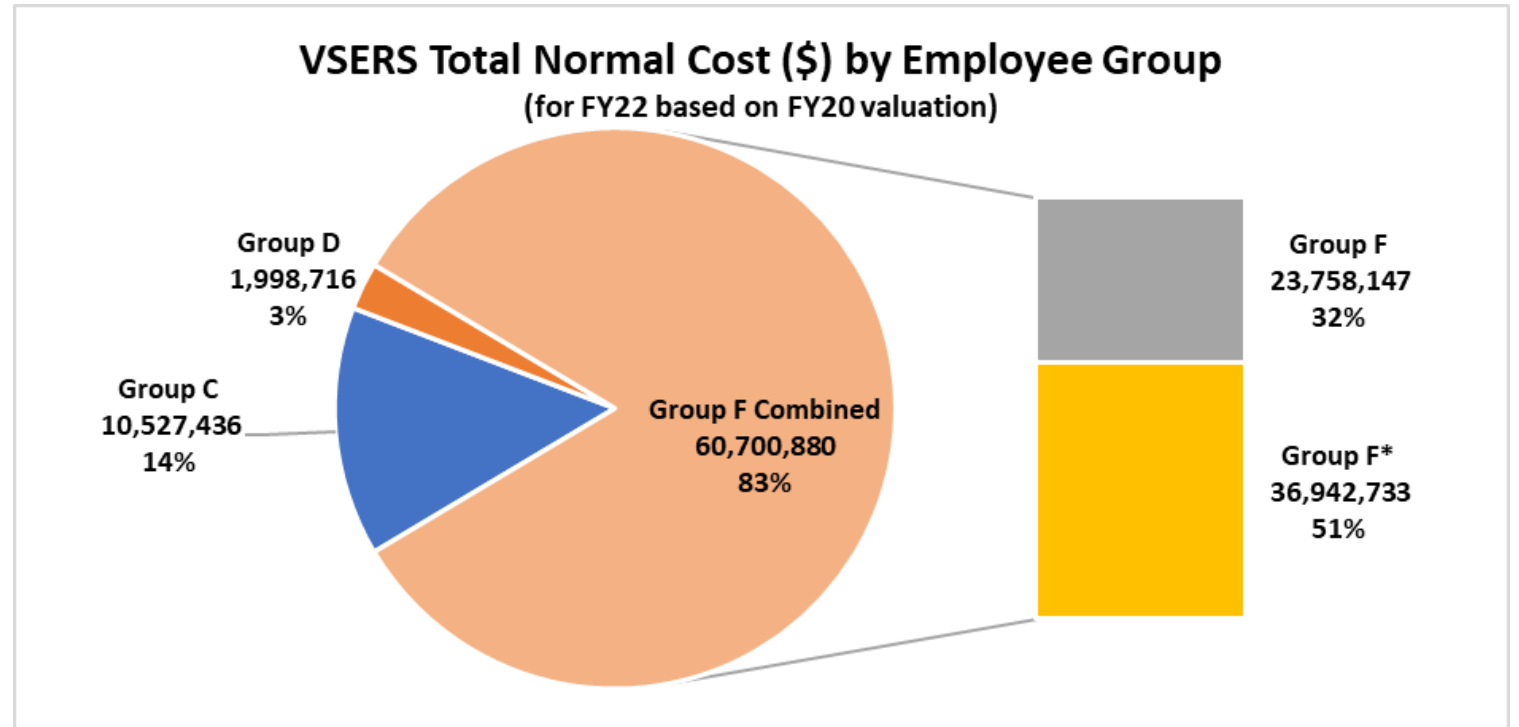
- The **Total Normal Cost** represents the present value of the cost of the benefits earned by the active workforce each year. It is paid by employee contributions and the employer through the ADEC, and calculated as a percentage of pay.
- Theory: If paid annually across the course of the employee's career, the normal cost contributions (plus investment gains on those contributions) should be sufficient to fund that employee's retirement (if all assumptions are met).
- Normal Cost is a useful proxy to represent the relative cost of each retirement benefit package. When all else is equal, more expensive retirement benefits = higher normal costs.
- Entry and exit age can skew the normal cost, particularly if there are few active members or if the active members' entry and exit ages are relatively old. This occurs to an extent with Group D (judges).
- The VSERS employer normal cost and unfunded liability amortization payment are included in the blended retirement charge paid by employing agencies/funds of the active workforce as a percentage of covered payroll. All employing agencies/funds pay the same rate regardless of how many of their employees are enrolled in which groups.
- Since the total normal cost varies by employee group, using the blended rate leads to cross-subsidization.

# Total Normal Cost (\$) by Employee Group

Most of the total VSERS normal cost across all employee groups is attributed to Group F because Group F contains the vast majority of the active workforce.

Across all groups, the total VSERS normal cost is \$73.2 million, or 12.67% of pay (FY22).

Employees pay: \$39.2M (6.79% of pay)  
Employers pay: \$34.0M (5.88% of pay)



Note: All data in this presentation reflects FY22 estimates based on the FY20 actuarial valuation.

# Comparing Normal Costs by Group (as % of payroll)

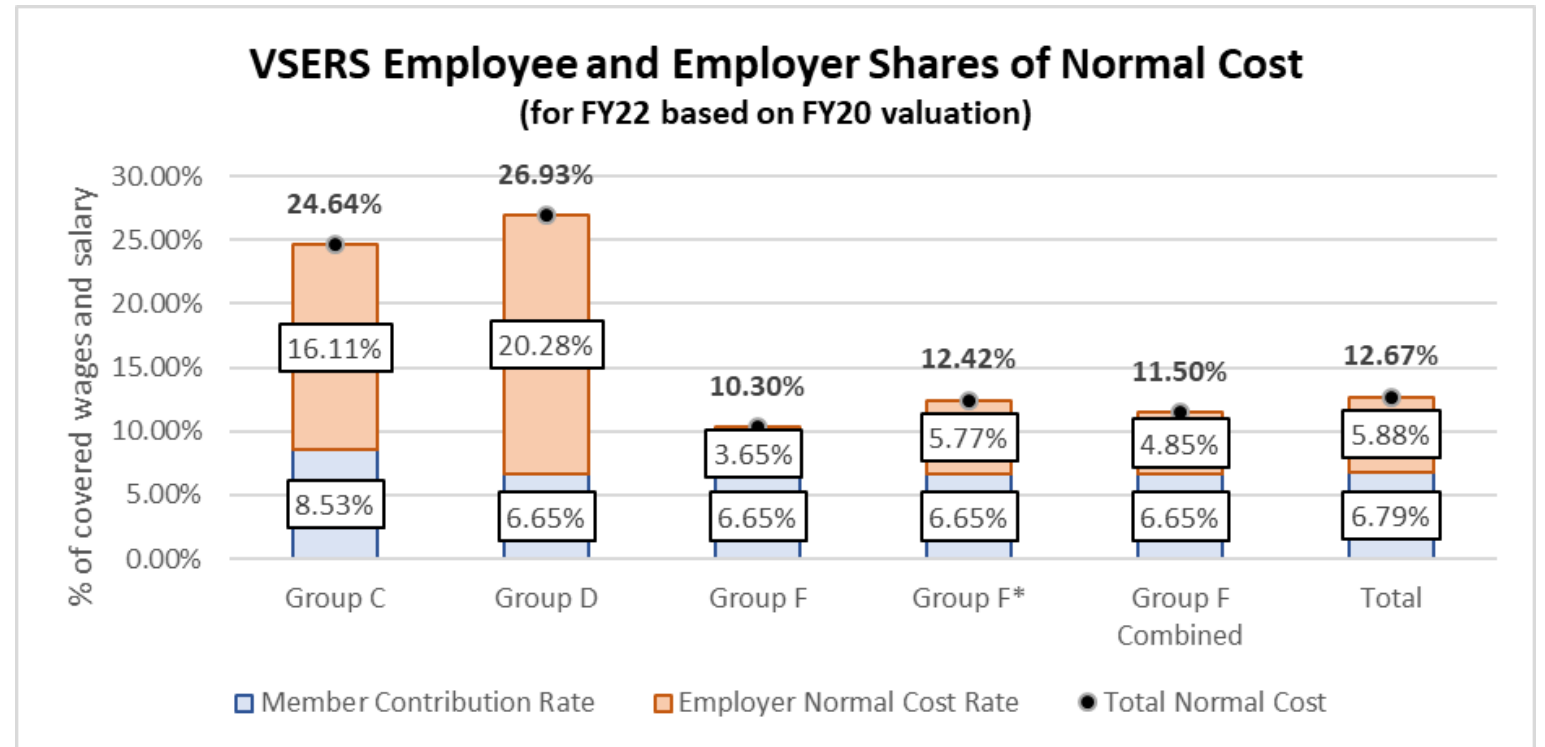
Across all groups, the blended *employer* normal cost is 5.88% of payroll and the *total* normal cost is 12.67% of payroll (per FY20 valuation).

However, there is significant variation between the normal costs of Groups C/D and Group F.

**By using a blended employer normal cost rate of 5.88% across all groups, the employing agencies/funds of Group F members are subsidizing the employing agencies/funds of Group C and D members.**

**But – keep in mind the relative size of these groups!**

- If the normal cost was NOT cross-subsidized, agencies/funds employing Group F members would pay 1.03% less than the blended rate. But agencies/funds employing Group C members would pay 10.23% more than the blended rate.
- Group D normal costs are particularly high but the small number of entering and exiting members (and the later age at which they enter) skew these costs upward.



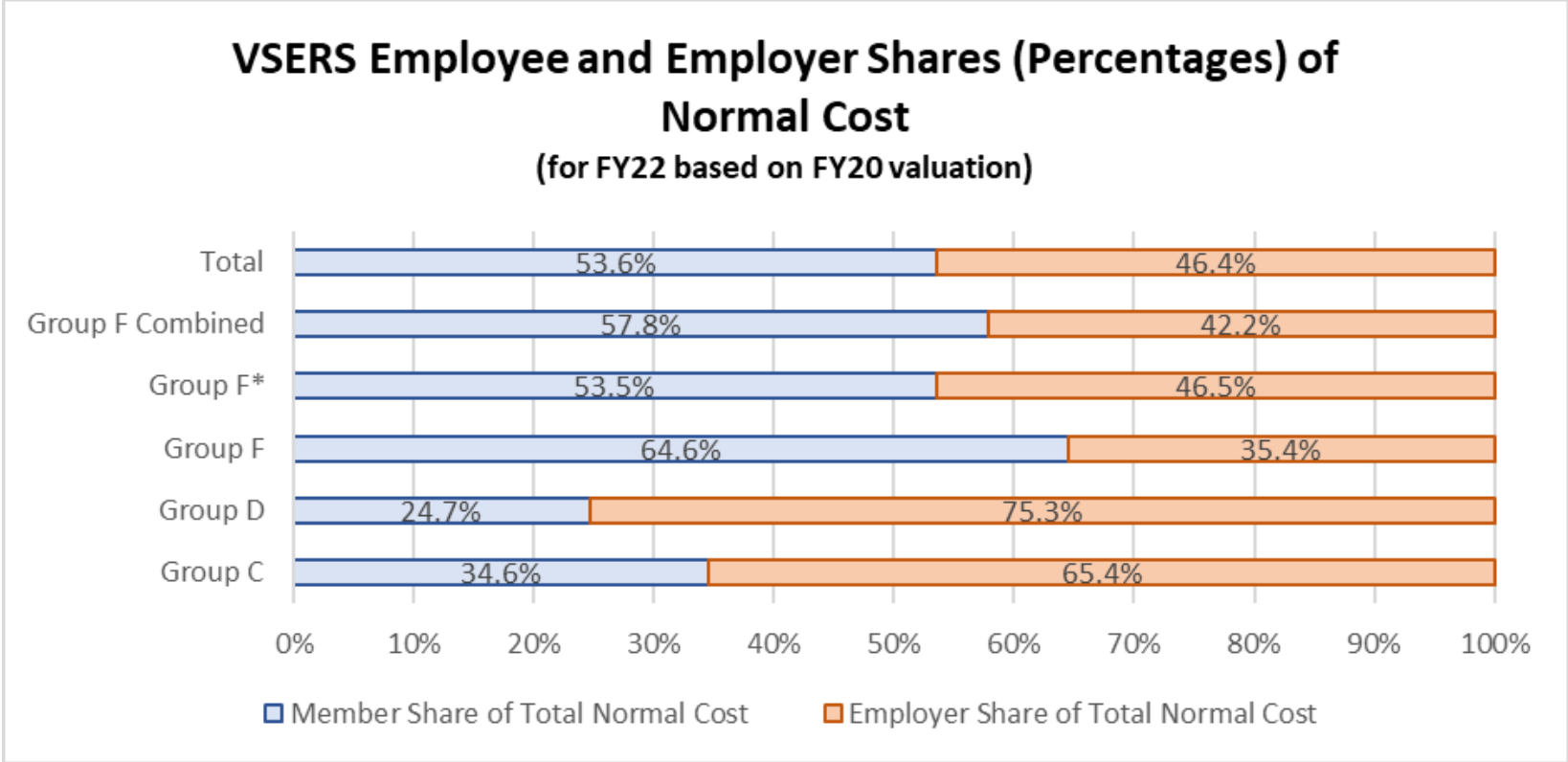
# Comparing Employee/Employer Share of Normal Costs by Group

The normal cost is subsidized by the employer for all groups. In other words, member contributions do not fully pay for the normal costs of any group's benefits.

Across all groups, employees/members pay 53.6% of the total normal cost.

Group F members pay the highest share of the total normal costs of their group's benefits, and Group F's total normal cost is lowest of all groups.

Group C and D members pay the lowest shares of the total normal costs of their group's benefits, and their total normal costs are the highest of all groups.

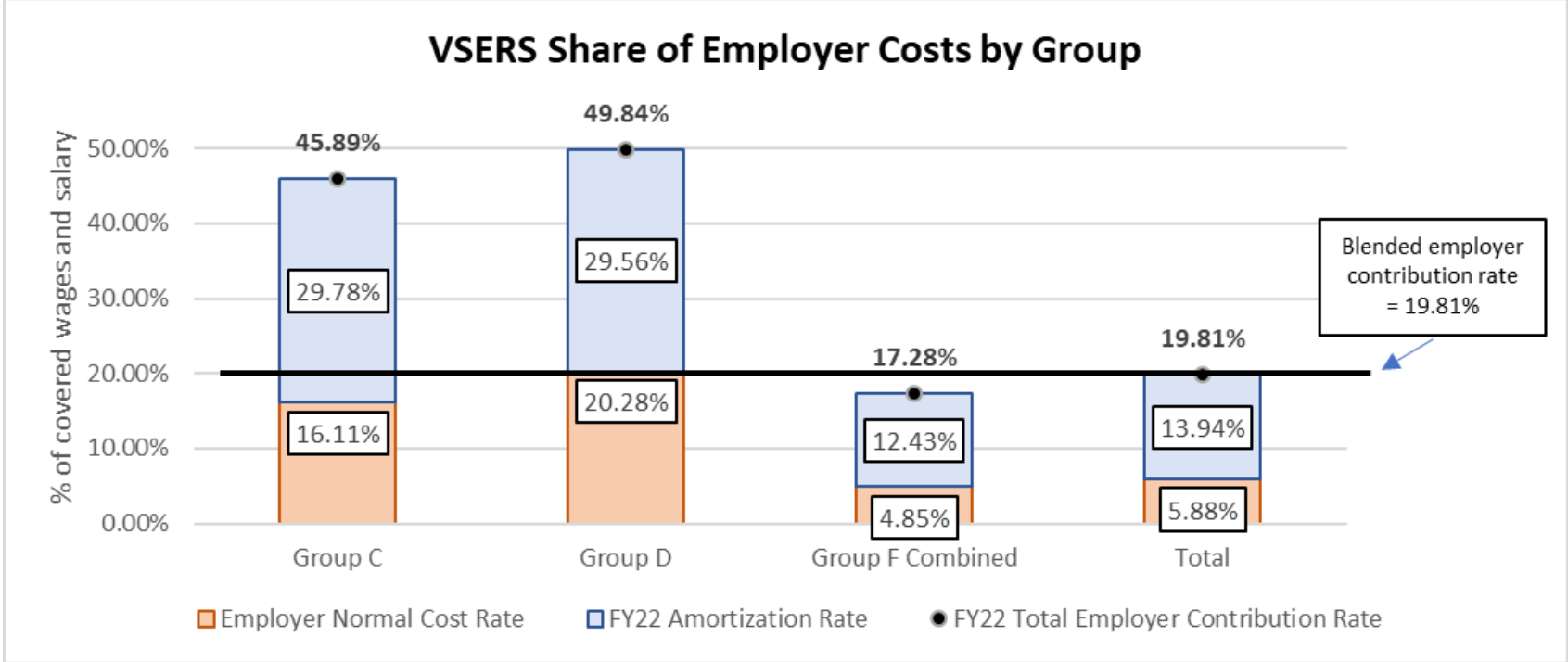


# Unfunded Liability Employer Costs

Like the Normal Cost, the unfunded liability also varies by group but is paid by the employer through a blended rate that reflects the amortization payment across all groups.

If there was no cross-subsidization of either employer cost, and the recommended state contribution was instead developed on a group-by-group basis:

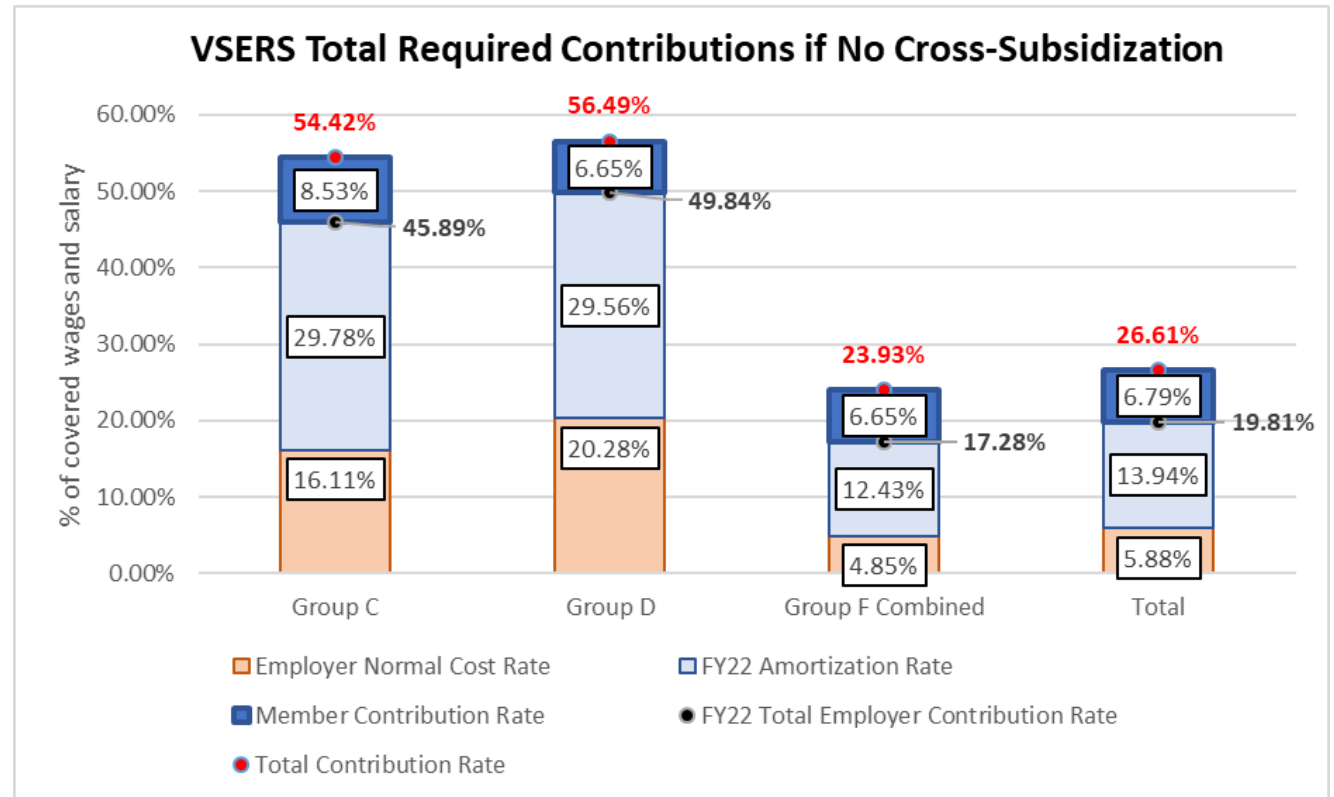
- Agencies/funds employing Group F members would pay approx. 2.53% less than the blended rate
- Agencies/funds employing Group C members would pay 26.08% more than the blended rate.



*Note: To calculate each group's portion of the unfunded liability, the actuaries allocated plan assets in proportion to each group's accrued liability as of FY20.*

# What if there was no cross-subsidization?

- Total blended pension costs (employee + employer) are 26.61% of pay across all VSERS groups, but are much higher for Groups C and D, and slightly lower for Group F.
- If employee contributions are held constant and the employer stopped using the blended rate and instead charged different rates specific to each group, the total required pension contributions for Group C would be 54.42% of pay and for Group D would be 56.49% of pay – much higher than the 23.93% for Group F.





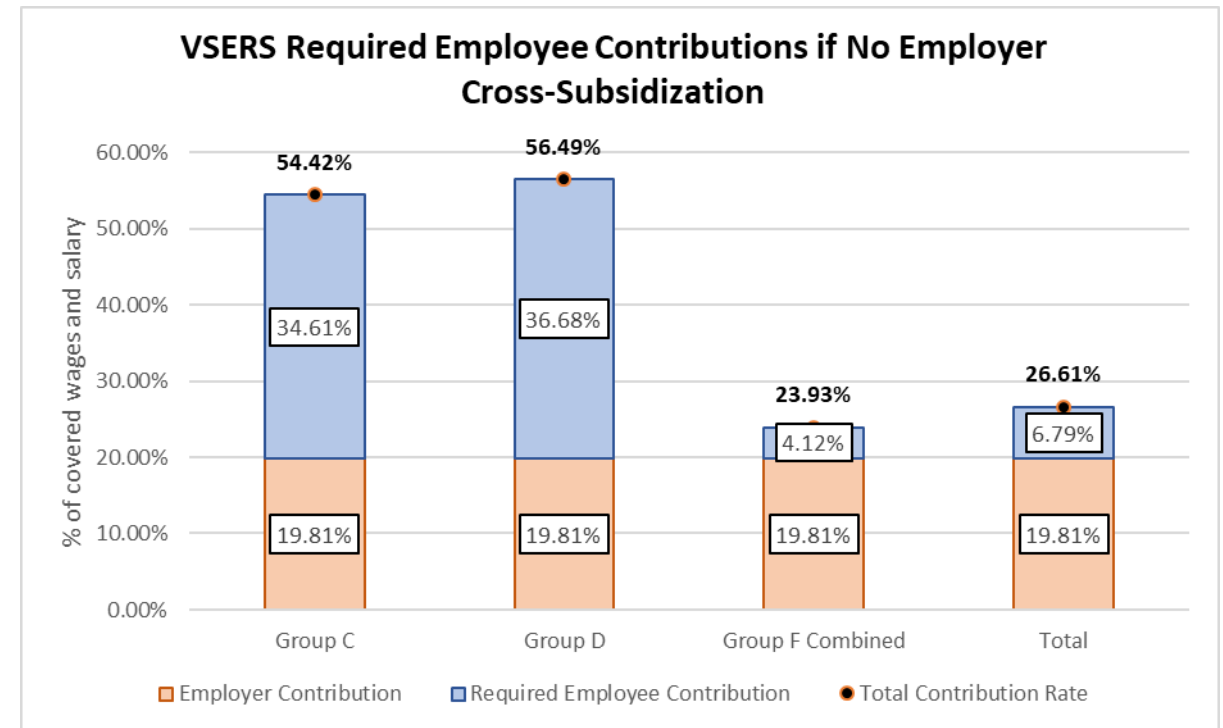
# What if there was no cross-subsidization?

Looking at this from another angle...

What would employee contributions need to be if the employer paid a flat 19.81% (the current blended employer rate for both the NC and UL) and those funds were attributed to each specific group's NC and UL instead of cross-subsidizing both the normal cost and amortization payment across all groups?

Group F employee contributions would decrease from 6.65% to 4.12% because the employer contribution for Group F would increase from 17.28% to the new rate of 19.81%. The employer, therefore, would pay a greater portion of the total normal cost of Group F's benefits.

Group C and D employee contributions, however, would increase significantly to more than 1/3 of salary.



# Key Take-Aways

- VSERS uses a blended employer contribution rate across all agencies/funds regardless of which group their active members belong to. This is efficient for budgeting and actuarial purposes.
- However, when disaggregated, the normal cost and unfunded liabilities vary significantly among the groups.
  - Group F employees pay for a greater share of the cost of their benefits (normal cost) than Group C and D, and have the lowest total cost of benefits vs. other groups.
  - Groups C and D have relatively larger normal costs and shares of the unfunded liability, but represent relatively small shares of the active payroll.
- Using a blended rate, therefore, leads to employer cross-subsidization.
  - Agencies/funds that employ Group F subsidize the employer pension costs of those that employ Group C and D. But the relative size of these groups matters. The “cost” to Group F employers from this practice is relatively small, but the “gain” to Group C and D employers is very significant.
- If there was no blended rate or cross-subsidization, agencies/funds that employ Group F would see rather small savings but agencies/funds that employ Group C and D would see very significant cost increases (if employee contribution rates are held constant).
- If employer contributions were held constant at the current 19.81% blended rate and these contributions were credited to each group’s specific normal cost and unfunded liability at 19.81% (rather than credited system-wide across all groups):
  - Group F employees would see their required contributions decrease from 6.65% to 4.12% because the employer’s 19.81% payment would be higher than what Group F’s employer costs currently are (17.28%).
  - However, Group C and D employees would see their required contributions increase to more than 34% to fully fund their group’s respective obligations because the employer’s 19.81% payment would be much lower than those group’s true actuarial costs.