TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Addressing the Unfunded Actuarial Obligation — ITEM NUMBER: 5

CONSENT: _____ — ATTACHMENT(S): 1

ACTION: X — MEETING DATE: December 7, 2006 / *60 mins.*

INFORMATION: ___ — PRESENTER: Ed Derman

PURPOSE OF THE ITEM

The purpose of this item is to provide the Board the specific statutory language to execute a strategy for addressing the unfunded actuarial obligation of the Defined Benefit (DB) Program in accordance with principles adopted by the Board at the September 2006 meeting, and provide other information requested by the Board on related issues.

SUMMARY

The unfunded actuarial obligation of the DB Program as of June 30, 2005 was $20.3 billion, representing a Funded Ratio of 86 percent. Although the funding status has improved since the prior valuation, the unfunded actuarial obligation does not amortize over any time period. In order to reach full funding, the DB Program must attain the equivalent of an increase of 3.753 percent of creditable salaries over 30 years.

At the September 2006 meeting, the Board directed staff to develop specific statutory language that would implement a strategy consistent with the recommended changes made by the staff. These recommendations included

- No changes to existing benefits, other than to guarantee the current annual two percent benefit adjustment
- A potential increase in member contributions of up to ½ percent
- A potential increase in the General Fund support of the DB Program of up to 1.25 percent
- A potential increase in the employer contribution rate to be determined by the Board as necessary to fully fund the DB Program within 30 years, not to exceed a specified percentage
- Employer contributions for post-retirement employment
- The use of excess employer contributions to fund retiree health care liabilities

Any increase in contributions would be phased in over time, and deferred to July 1, 2009.

THE NEED TO TAKE ACTION

Since the June 30, 2003 actuarial valuation first indicated that there was a long-term funding shortfall in the DB Program, actual investment returns earned by CalSTRS have exceeded the 8

percent rate of return assumed in the DB Program by an average of 5.7 percentage points per year. There have been suggestions that, rather than adopting a strategy to directly address the unfunded actuarial obligation, the Board should wait and see if investment returns eliminate the problem.

An Investment-only Approach

Based on the June 30, 2005 actuarial valuation, Milliman, CalSTRS' Consulting Actuary, estimates that CalSTRS would have to earn 8.7 percent each year in order to eliminate the unfunded actuarial obligation in the DB Program over a 30-year period, as compared to the 8 percent assumed rate of return. Although this might not appear to be difficult to achieve, especially considering the rate of investment return CalSTRS has earned over the last few years, Milliman estimates that, given CalSTRS asset allocation at the last valuation, there was only a 40 percent chance that the rate of return would be sufficient to eliminate the funding shortfall over thirty years. (According to Milliman, the recently adopted changes in asset allocation would not materially change that estimate.) If this occurred, then there would be no need to increase the contribution rate paid by employers, members and the state. There would, however, be a 60 percent chance that the investment returns would not reach the necessary levels at the end of the 30-year period. If this occurred, the funding shortfall would not be addressed, and the cost of addressing the problem would likely increase. For example, if CalSTRS earned the 8 percent return that it assumes, the unfunded actuarial obligation would double by 2014, and the cost of eliminating the shortfall over the following 30 years would be over 30 percent higher.

The Recommended Funding Strategy

Alternatively, the funding strategy that the Board directed the staff to develop would address the funding shortfall with much greater certainty, failing only if investment returns were well below the 8 percent rate of return. (Even that concern could be eliminated by increasing the maximum employer contribution that the Board could set.) If CalSTRS earned the 8 percent return assumed, the funding shortfall would be addressed in 30 years, with relatively modest increases in contribution rates. Under the funding strategy, the contribution rates are entirely self-regulating, and will increase or decrease as necessary to achieve full funding. As a result, if CalSTRS earned the type of return necessary to eliminate the shortfall on investment returns alone, there would be no long-term increase in contribution returns.

A summary of options and their impact is indicated in the following table

	Sufficient investment returns (10% probability)	**Other investment returns (90% probability)**
Investment-only	No increase in contribution rates	Increased unfunded actuarial obligation (requiring larger increased contribution rates)
Recommended strategy	No long-term increase in contribution rates	Greater probability of fully funded DB Program

As the table indicates, the recommended strategy results in the same long-term contribution rates as relying on investment returns if investment returns are adequate to fully address the shortfall, and fully funds the DB Program, with lower contribution rates, if investment returns don't fully address the shortfall.

THE SPECIFIC FUNDING STRATEGY

In this item, the specific changes reflected in the statutory language are summarized, followed by the language itself, which is indented. Provisions that are added to existing sections are underlined, while provisions that are being deleted are shown in strike out.

Changes in the Annual Benefit Adjustment

Currently, each benefit recipient who has been receiving a benefit for one year receives an increase in the monthly benefit or ad-hoc benefit equal to two percent of the original monthly benefit or original ad-hoc benefit. This amount is paid beginning with the check received in October. Under Sections 22140 and 22141, the Legislature explicitly reserves the right to modify the amount as economic conditions dictate, although the adjustment could not reduce the benefit below the original amount. Under the proposal, that explicit provision is deleted, effectively guaranteeing that the Legislature could not reduce the benefit adjustment. Nothing would preclude the Legislature from enacting legislation that increased the adjustment.

> Section 22140 of the Education Code is amended to read:
>
> 22140. (a) "Improvement factor," with respect to the Defined Benefit Program, means an increase of 2 percent in monthly allowances. The improvement factor shall be added to a monthly allowance each year on September 1, commencing on September 1 following the first anniversary of the effective date of retirement, or the date on which the monthly allowance commenced to accrue to any beneficiary, or other periods specifically stated in this part.
>
> (b) The improvement factor may not be compounded nor shall it be applicable to annuities payable from the accumulated annuity deposit contributions or the accumulated tax-sheltered annuity contributions. ~~The Legislature reserves the right to adjust the amount of the improvement factor up or down as economic conditions dictate. Any adjustment of the improvement factor may not reduce the monthly retirement allowance or annuity below that which would be payable to the recipient under this part had this section not been enacted.~~
>
> Section 22141 of the Education Code is amended to read:
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> 22141. Notwithstanding Section 22140, "improvement factor" means an increase of 2 percent in benefits provided under Sections 24408 and 24409 for each year commencing on September 1, 1981, and under Section 24410.5 for each year commencing September 1, 2001, and under Sections 24410.6 and 24110.7 for

each year commencing September 1, 2002. The factor shall not be compounded nor shall it be applicable to annuities payable from the accumulated annuity deposit contributions or the accumulated tax-sheltered annuity contributions. ~~The Legislature reserves the right to adjust the amount of the improvement factor up or down as the economic conditions dictate. No adjustments of the improvement factor shall reduce the monthly retirement allowance or benefit below that which would be payable to the recipient under this part had this section not been enacted.~~

Changes in Contributions

Member Contributions. Currently, members pay a contribution rate of 8 percent pursuant to Section 22901. A quarter of those contributions are being credited to the member's Defined Benefit Supplement (DBS) account through 2010 pursuant to Section 22901.5. In addition, under Section 22703, if the member performs service in excess of 1.000 year in a school year, or is paid compensation on a limited-term basis, the member's contributions and the contributions paid by the employer (except an amount equal to 0.25 percent of compensation) on that compensation, a total of 16 percent of compensation, is credited to the member's DBS account. This latter provision is permanent.

Under the proposal, the member's contribution could increase by up to ½ percent, effective July 1, 2009. The actual increase in the member contribution rate could not exceed the increase in the employer contribution rate, which would be determined based on the actuarial valuation of the DB Program. All of the increased contributions would be credited to the DB Program, even for compensation that is otherwise credited to the DBS Program. Thus, the total contribution rate for DBS service remains at 16 percent.

Section 22703 of the Education Code is amended to read:

22703. (a) Service performed by a member and contributions on creditable compensation paid to a member shall be credited to the Defined Benefit Program, except as provided in subdivision (b).
(b) A member's creditable service that exceeds 1.000 in a school year shall not be credited to the Defined Benefit Program. Commencing July 1, 2002, contributions by the employer that are deposited in the Teachers' Retirement Fund that are equal to 8 percent of the creditable compensation paid to the member under the circumstances specified in subdivision (b) of Section 22905 and contributions by the member that are equal to 8 percent of the creditable compensation paid to the member under the circumstances specified in subdivision (b) of Section 22905, ~~on creditable compensation paid to the member~~ ~~for that service, exclusive of contributions pursuant to Section 22951,~~ shall be credited to the Defined Benefit Supplement Program.
(c) In lieu of any other benefits provided by this part, any member who performed service prior to July 1, 1956, shall receive retirement benefits for that service at least equal to the benefits that the member would have received for that service under the provisions of this part as they existed on June 30, 1956. This

subdivision shall not apply to service that is credited in the San Francisco Employees' Retirement System.
~~(d) The amendments to this section made during the second year of the 1999-2000 Regular Session shall become operative on July 1, 2002, if the revenue limit cost-of-living adjustment computed by the Superintendent of Public Instruction for the 2001-02 fiscal year is equal to or greater than 3.5 percent. Otherwise the amendments to this section made during the second year of the 1999-2000 Regular Session shall become operative on July 1, 2003.~~

Section 22901 of the Education Code is amended to read:

22901. <u>(a)</u> Each member of the Defined Benefit Program shall contribute to the retirement fund an amount equivalent to 8 percent of the member's creditable compensation.
<u>(b) This section shall become inoperative on July 1, 2009, and shall be repealed on January 1, 2010.</u>

Section 22901 is added to the Education Code, to read:

(a) Each member of the Defined Benefit Program shall contribute to the retirement fund an amount equivalent to the percentage, as determined pursuant to subdivision (b), of the member's creditable compensation.
(b)The contribution rate shall be equal to 8 percent, plus the contribution rate imposed pursuant to Section 22950 in excess of a contribution rate of 8.25 percent. The contribution rate shall not exceed 8.5 percent of the member's creditable compensation.
(c) This section shall become operative on July 1, 2009.

Section 22901.5 of the Education Code is amended to read:

22901.5. (a) ~~Notwithstanding Section 22905, 25 percent of the~~ ~~an amount~~ <u>From the amount</u> contributed by a member pursuant to Section 22901 <u>and notwithstanding Section 22905, an amount equal to</u> ~~(~~2 percent of creditable compensation~~)~~ <u>not specified in subdivision (b) of Section 22905</u> shall be credited to the member's Defined Benefit Supplement account pursuant to Section 25004.
~~(b) Any member contributions for service performed during the 2000-01 school year with a service period ending after December 31, 2000, shall be subject to subdivision (a).~~
~~(c)~~ <u>(b)</u> This section shall remain in effect only until January 1, 2011, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2011, deletes or extends that date.

<u>Employer Contributions.</u> Currently, Section 22950 imposes an employer contribution rate of 8 percent of the compensation on which the member pays contributions. Some of those contributions are credited to the Teachers' Health Benefits Fund or the Replacement Benefits

Fund when needed to fund other benefit programs authorized by law. In addition, beginning in 2007, the Board may authorize the diversion of an additional amount to fund the development costs associated with new benefit programs, to be repaid with interest from the revenue proceeds from those new programs. All other employer contributions are deposited in the Teachers' Retirement Fund. In addition, Section 22951 imposes an additional employer contribution rate of 0.25 percent as a result of the liability associated with the conversion of unused sick leave to service credit when a member retires. These two sections result in a total employer contribution rate of 8.25 percent.

Under the proposal, the separate contribution rate for unused sick leave is eliminated on July 1, 2009. It is replaced with a single employer contribution rate based on an actuarial valuation of the DB Program. The proposal authorizes the Board to determine the employer contribution rate within limits specified in the statute, with the specific rate based on the funding needed to maintain the financial integrity of the DB Program. After the completion of the June 30, 2007 actuarial valuation, in Spring 2008, the Board would adopt a resolution that would set the contribution rate at the percentage needed to eliminate any unfunded actuarial obligation as of June 30, 2038. The increased contribution rate, however, could not be greater than 0.5 percent, and would take effect on July 1, 2009.

The existing Section 22950 is eliminated on July 1, 2009 and replaced with a new Section 22950 to address contribution rates after July 1, 2009. After each subsequent valuation, the Board would adopt a resolution to make further adjustments to the contribution rate, which would result in full funding of the DB Program 30 years after the valuation date. As a result, the amortization period would be a rolling 30 year period, as opposed to a period ending on a specific date in the future. The increased contribution rate in any one year could not exceed 0.5 percent, and would take effect on July 1 of the calendar year after the valuation was adopted by the Board. The total employer contribution rate could not exceed 13 percent. Based on the June 30, 2005 actuarial valuation, the maximum employer rate would be 11.881 percent.

Individual employers could elect to pay CalSTRS a lump sum of money from, for example, the proceeds of pension obligation bonds issued by the employer, in lieu of paying its share of the June 30, 2007 unfunded actuarial obligation through increased contributions to CalSTRS. CalSTRS would determine the maximum amount of money it could prudently invest from a lump sum payment, and each employer's share of the obligation, based on each employer's relative share of DB Program creditable compensation. The amount of money an individual employer could pay as a lump sum in lieu of the contribution rate increase would be based on its proportion of unfunded actuarial obligation multiplied by the total amount of funds that CalSTRS determined could be prudently invested in a lump sum. Employers would have to notify CalSTRS of its intent to make such a payment by January 1, 2009 and make the payment prior to July 1, 2009.

If the funding condition of the DB Program should improve to permit a reduction in the employer contribution rate, the reduction in the employer contribution rate to the DB Program would be offset by an employer contribution pursuant to Section 26933 to the Teachers' Health Benefits Fund, for a health benefit purpose to be determined later. The contribution rate would

apply to compensation credited to both the DB Program and the DBS Program. This health benefit contribution would also apply to employers who make the lump-sum payment of its share of the unfunded actuarial obligation in lieu of increased contributions to CalSTRS. As a result, although such employers would still be paying a lower overall contribution rate to CalSTRS than would an employer that did not make such a payment, all employers would be subject to the same employer contribution rate for health benefits.

In addition, under Section 24214, retired DB Program members may work for a school employer, but if their compensation exceeds a specified amount, their retirement benefit is reduced by the excess compensation, unless the member is subject to one of many statutory exemptions. This limit applies whether the member is directly employed by the employer, employed as an independent contractor, or as an employee of as third party.

Neither members nor employers currently make contributions on that compensation. Under the proposal, the school employer makes contributions for any compensation paid to a retired DB Program member at the same rate that employers make contributions for any other creditable compensation. This contribution is imposed regardless of whether the member is directly employed by the employer, employed as an independent contractor, or as an employee of as third party. All of these additional contributions are credited to the DB Program.

> Section 22950 of the Education Code is amended to read:
>
> 22950. (a) Employers shall contribute monthly to the system 8 percent of the creditable compensation upon which members' contributions under this part are based.
> (b) From the contributions required under subdivision (a), there shall be deposited in the Teachers' Retirement Fund an amount, determined by the board, that is not less than the amount, determined in an actuarial valuation of the Defined Benefit Program pursuant to Section 22311.5, necessary to finance the liabilities associated with the benefits of the Defined Benefit Program over the funding period adopted by the board, after taking into account the contributions made pursuant to Sections 22901, 22951, and 22955.
> (c) The amount of contributions required under subdivision (a) that is not deposited in the Teachers' Retirement Fund pursuant to subdivision (b) shall be deposited directly into the Teachers' Health Benefits Fund, as established in Section 25930, and shall not be deposited into or transferred from the Teachers' Retirement Fund.
> (d) (1) Notwithstanding subdivisions (b) and (c), there may be deposited into the Teachers' Retirement Program Development Fund, as established in Section 22307.5, from the contributions required under subdivision (a), an amount determined by the board, not to exceed the limit specified in paragraph (2).
> (2) The balance of deposits into the Teachers' Retirement Development Fund, minus the subsequent transfer of funds, with interest, into the Teachers' Retirement Fund pursuant subdivision (e) of Section 22307.5, shall not exceed 0.01 percent of the total of the creditable compensation of the fiscal year ending

in the immediately preceding calendar year upon which member's contributions to the Defined Benefit Program are based.

(3) The deposits described in this subdivision shall not be deposited into, or transferred from, the Teachers' Retirement Fund.

(e) Upon adoption of an actuarial valuation of the Defined Benefit Program pursuant to Section 22311.5, reflecting the assets and liabilities of the Defined Benefit Program as of June 30, 2007, the board shall adopt a resolution establishing a contribution rate to be applied to the creditable compensation upon which member’s contributions under this part are based that would, based on the actuarial assumptions and valuation adopted by the board, result in the actuarial liabilities of the Defined Benefit Program being equal to the actuarial value of assets as of June 30, 2038. In no event shall the adopted contribution rate be more than 8.75 percent, nor shall the adopted contribution rate be less than 8.25 percent. The rate adopted by the board shall be effective for all creditable compensation upon which members’ contributions under this part are based that are earned on or after the July 1, 2009.

(f) This section shall become inoperative on July 1, 2009, and shall be repealed on January 1, 2010.

Section 22950 is added the Education Code, to read:

22950. (a) Employers shall contribute monthly to the system an amount equivalent to the percentage, as determined pursuant to this section, of sum of the following

(1) The creditable compensation upon which members’ contributions under this part are based and

(2) The compensation earned by a member retired for service for performing activities identified in paragraphs (1) to (9), inclusive, of subdivision (a), or subdivision (b), of Section 22119.5 as an employee of the employer, as an employee of a third party, or an independent contractor, within the California public school system.

(b) The contribution rate in effect as of July 1, 2009 shall be the rate adopted by the board pursuant to subdivision (e), as this section read on June 30, 2009.

(c) Upon adoption of an actuarial valuation of the Defined Benefit Program pursuant to Section 22311.5, the board shall adopt a resolution establishing a contribution rate that would, based on the actuarial assumptions and valuation adopted by the board, result in the actuarial liabilities of the Defined Benefit Program being equal to the actuarial value of assets 30 years after the date upon which the actuarial valuation was based. In no event shall the sum of the contribution rates adopted pursuant to this section and Section 25933 be more than 0.5 percentage points higher than the sum of the most recent contribution rates imposed on employers pursuant to this section and Section 25933, nor shall the sum of the contribution rates adopted pursuant to this section and Section 25933 be less than 8.25 percent or more than 13 percent.

(d) The rate adopted by the board shall be effective for all creditable compensation upon which members' contributions under this part are based that are earned on or after the July 1 in the year beginning on January 1 following the adoption of the resolution.
(e) In addition to the amount credited to the Teachers' Health Benefits Fund pursuant to Section 25933, there shall be credited to the Teachers' Health Benefits Fund, and shall not be deposited into or transferred from the Teachers' Retirement Fund, the amount determined by the board as the amount necessary to pay liabilities and administrative costs incurred pursuant to Section 25940.
(f) (1) Notwithstanding any other provision of this section, there shall be deposited into the Teachers' Retirement Development Fund, as established in Section 22307.5, from the contributions required under subdivision (a), an amount determined by the board, not to exceed the limit specified in paragraph (2).
(2) The balance of deposits into the Teachers' Retirement Development Fund, minus the subsequent transfer of funds, with interest, into the Teachers' Retirement Fund pursuant subdivision (e) of Section 22307.5, shall not exceed 0.01 percent of the total of the creditable compensation of the fiscal year ending in the immediately preceding calendar year upon which member's contributions to the Defined Benefit Program are based.
(3) The deposits described in this subdivision shall not be deposited into or transferred from the Teachers' Retirement Fund.
(g) The amount of contributions required under subdivision (a) that is not deposited in the Teachers' Health Benefits Fund pursuant to subdivision (e) or into the Teachers' Retirement Program Development Fund pursuant to subdivision (f) shall be deposited directly into the Teachers' Retirement Fund.
(h) This section shall become operative on July 1, 2009.

Section 22950.5 is added to the Education Code to read:

22950.5. (a) On or before July 1, 2008, the system shall calculate each employer's proportionate share of the unfunded actuarial obligation to the Defined Benefit Program as of June 30, 2007, and make the results of that calculation available to all employers on the system's Internet site. The proportionate share for each employer shall be equal to the total unfunded actuarial obligation of the Defined Benefit Program as of June 30, 2007 multiplied by the ratio of that employer's creditable compensation credited to the Defined Benefit Program in 2006-07 to the total creditable compensation credited to the Defined Benefit Program in 2006-07.
(b) On or before September 30, 2008, the system also shall calculate the total amount of money that it reasonably believes it could invest in a short period of time without adversely affecting its risk and investment return.
(c) An employer may enter into an irrevocable contract with the system to pay the system its share of the unfunded actuarial obligation by notifying the system on or before January 1, 2009, on a form provided by the system, of its intent to make such payment.

(d) On or before March 1, 2009, the system shall inform each employer of its adjusted proportionate share of the unfunded actuarial obligation, which shall be equal to the lesser of
(1) The result of the calculation made pursuant to subdivision (b) multiplied by the proportionate share of the unfunded actuarial obligation to the Defined Benefit Program as of June 30, 2007 for that employer as a percentage of the total amount of proportionate shares for all employers entering into the contract pursuant to subdivision (c) and
(2) The proportionate share of the unfunded actuarial obligation to the Defined Benefit Program as of June 30, 2007 for that employer
(e) Any employer entering into a contract pursuant to subdivision (c) shall make a full payment of its adjusted proportionate share of the unfunded actuarial obligation, as determined pursuant to subdivision (d) on or before July 1, 2009. Notwithstanding subdivisions (b) and (c) of Section 22950, any employer making the payment pursuant to this section shall have the contribution rate determined pursuant to Section 22950 reduced by the actuarially determined percentage rate.

Section 22951 of the Education Code is amended to read:

22951. (a) In addition to any other contributions required by this part, employers shall, on account of liability for benefits pursuant to Section 22717, contribute monthly to the Teachers' Retirement Fund 0.25 percent of the creditable compensation upon which members' contributions under this part are based.
(b) This section shall become inoperative on July 1, 2009, and shall be repealed on January 1, 2010.

Section 25933 is added to the Education Code, to read:

25933. (a) In addition to the amount contributed pursuant to Section 22950, employers, including employers who make a payment to the system pursuant to Section 22950.5, shall contribute monthly to the system an amount equivalent to the percentage, as determined pursuant to subdivision (b), of the creditable compensation upon which members' contributions under Part 13 (commencing with Section 22000) are based.
(b) If the contribution rate adopted by the board pursuant to Section 22950 is less than the sum of the contribution rate imposed pursuant to Section 22950 and the contribution rate imposed pursuant to this section that would be in effect on June 30 in the year beginning on January 1 following the adoption of the resolution pursuant to Section 22950, the board shall adopt a resolution establishing a contribution rate equal to the difference between the contribution rate adopted by the board pursuant to Section 22950 and the sum of the contribution rate imposed pursuant to Section 22950 and the contribution rate imposed pursuant to this section that would be in effect on June 30 in the year beginning on January 1 following the adoption of the resolution pursuant to that section.

> (c)The amount contributed pursuant to this section shall be credited to the Teachers' Health Benefits Fund, and shall not be deposited into or transferred from the Teachers' Retirement Fund.

State Contributions. Currently, under Section 22955, the General Fund contributes an amount equal to 2.017 percent of the compensation credited to the DB Program (but not the DBS Program) in the fiscal year two years prior. This is a reduction from the contribution rate of 4.3 percent of compensation paid in the prior calendar year that was paid until 1999. In addition, if there is an unfunded actuarial obligation or a normal cost deficit associated with the benefit program in effect as of July 1, 1990, there is an additional General Fund contribution of 0.524 percent, with that rate increasing as necessary, up to an additional 1.505 percent.

Under the proposal, if the actuarial valuation determines that additional contributions are needed to maintain the financial integrity of the DB Program, the General Fund contribution rate increases at the same rate that the employer contribution rate increases, although the total General Fund contribution can not exceed 3.25 percent. This maximum rate is less than the rate imposed prior to 1998, but slightly more than the rate imposed before 2000. Because the Board would have the authority to adjust employer contribution rates if there is an increase in the unfunded actuarial obligation, the supplemental General Fund contribution for the 1990 benefit structure is eliminated.

> Section 22955 of the Education Code is amended to read:
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> 22955. (a) Notwithstanding Section 13340 of the Government Code, commencing July 1, 2003, a continuous appropriation is hereby annually made from the General Fund to the Controller, pursuant to this section, for transfer to the Teachers' Retirement Fund. The total amount of the appropriation for each year shall be equal to 2.017 percent of the total of the creditable compensation of the fiscal year ending in the immediately preceding calendar year upon which members' contributions are based, to be calculated annually on October 1, and shall be divided into four equal quarterly payments.
> (b) Notwithstanding Section 13340 of the Government Code, commencing October 1, 2003, a continuous appropriation, in addition to the appropriation made by subdivision (a), is hereby annually made from the General Fund to the Controller for transfer to the Teachers' Retirement Fund. The total amount of the appropriation for each year shall be equal to 0.524 percent of the total of the creditable compensation of the fiscal year ending in the immediately preceding calendar year upon which members' contributions are based, to be calculated annually on October 1, and shall be divided into four equal quarterly payments. The percentage shall be adjusted to reflect the contribution required to fund the normal cost deficit or the unfunded obligation as determined by the board based upon a recommendation from its actuary. If a rate increase is required, the adjustment may be for no more than 0.25 percent per year and in no case may the transfer made pursuant to this subdivision exceed 1.505 percent of the total of the creditable compensation of the fiscal year ending in the immediately preceding

calendar year upon which members' contributions are based. At any time when there is neither an unfunded obligation nor a normal cost deficit, the percentage shall be reduced to zero. The funds transferred pursuant to this subdivision shall first be applied to eliminating on or before June 30, 2027, the unfunded actuarial liability of the fund identified in the actuarial valuation as of June 30, 1997.
(c) For the purposes of this section, the term "normal cost deficit" means the difference between the normal cost rate as determined in the actuarial valuation required by Section 22311 and the total of the member contribution rate required under Section 22901 and the employer contribution rate required under Section 22950, and shall exclude (1) the portion for unused sick leave service credit granted pursuant to Section 22717, and (2) the cost of benefit increases that occur after July 1, 1990. The contribution rates prescribed in Section 22901 and Section 22950 on July 1, 1990, shall be utilized to make the calculations. The normal cost deficit shall then be multiplied by the total of the creditable compensation upon which member contributions under this part are based to determine the dollar amount of the normal cost deficit for the year.
(d) Pursuant to Section 22001 and case law, members are entitled to a financially sound retirement system. It is the intent of the Legislature that this section shall provide the retirement fund stable and full funding over the long term.
(e) This section continues in effect but in a somewhat different form, fully performs, and does not in any way unreasonably impair, the contractual obligations determined by the court in California Teachers' Association v. Cory, 155 Cal.App.3d 494.
(f) Subdivision (b) shall not be construed to be applicable to any unfunded liability resulting from any benefit increase or change in contribution rate under this part that occurs after July 1, 1990.
(g) The provisions of this section shall be construed and implemented to be in conformity with the judicial intent expressed by the court in California Teachers' Association v. Cory, 155 Cal.App.3d 494.
(h) ~~This section shall become operative on July 1, 2003, if the revenue limit cost-of-living adjustment computed by the Superintendent of Public Instruction for the 2001-02 fiscal year is equal to or greater than 3.5 percent. Otherwise this section shall become operative on July 1, 2004.~~ This section shall become inoperative on July 1, 2009, and shall be repealed on January 1, 2010.

Section 22955 is added to the Education Code, to read:

22955. (a) Notwithstanding Section 13340 of the Government Code, commencing July 1, 2009, a continuous appropriation is hereby annually made from the General Fund to the Controller, pursuant to this section, for transfer to the Teachers' Retirement Fund in four equal quarterly payments. The total amount of the appropriation for each year shall not exceed the percentage specified in subdivision (b), applied to the total of the creditable compensation of the fiscal year ending in the immediately preceding calendar year upon which members' contributions are based, to be calculated annually on October 1.

> (b) The contribution rate shall be equal to 2.017 percent, plus the contribution rate imposed pursuant to Section 22950 in excess of a contribution rate of 8.25 percent. The total contribution rate shall not exceed 3.25 percent.
> (c) Pursuant to Section 22001 and case law, members are entitled to a financially sound retirement system. It is the intent of the Legislature that this section shall provide the retirement fund stable and full funding over the long term.
> (d) This section continues in effect but in a somewhat different form, fully performs, and does not in any way unreasonably impair, the contractual obligations determined by the court in California Teachers' Association v. Cory, 155 Cal.App.3d 494.
> (e) The provisions of this section shall be construed and implemented to be in conformity with the judicial intent expressed by the court in California Teachers' Association v. Cory, 155 Cal.App.3d 494.
> (f) This section shall become operative on July 1, 2009.

INCREASED FUNDING FOR EMPLOYERS

At the April Board meeting, the Board inquired as to whether the state would be required to increase school aid if employer contributions were increased. Proposition 98 of 1988 amended Article XVI of the California Constitution to establish a minimum level of state funding for K-12 and community college education. To provide guidance to the Board on this issue, staff requested an opinion from the Attorney General and, through a legislator, Legislative Counsel on how a future increase in employer contributions would affect the minimum funding level required by Proposition 98 and how an increase in state contributions to the DB Program would affect this issue.

In early November, the Attorney General issued his opinion, which is attached. The Attorney General opined that "[t]he Legislature's increase of the employers' contribution rate paid by school districts… by itself, would not cause an increase in the obligation of the state to fund public education [under Proposition 98]". What this indicates is that, in the opinion of the Attorney General, the state has no legal obligation to offset the increased employer contributions being imposed by this strategy. This does not preclude, however, a policy decision being made to increase state funding to offset the higher employer costs.

There are two approaches that could be made. The first approach would increase the total amount of state funding paid to school employers. However, given the potential increases and decreases in employer contributions, in contrast to the fact that the funding base provided under Proposition 98 never declines, the mechanics of such an approach could be complicated. If a decision were made to increase the total state funding for education in response to an increase in the employer's contribution rate, it would probably make more sense to increase the state's direct contribution to the DB Program in lieu of the employer contribution rate increase.

Alternatively, the amount of unrestricted funding paid to school employers could be increased, without changing the minimum funding guarantee. This is the approach currently utilized to reflect changes in contribution rates paid by K-12 (but not community college) employers for

their classified employees performing service under CalPERS. When CalPERS school employer rates are increased, the revenue limit per student (which determines how much state assistance is paid to each K-12 employer) is increased to offset that cost, and the revenue limit goes down if CalPERS contribution rates decline. A similar mechanism (applicable to all school employers) could be applied if CalSTRS employer contributions increased.

Apart from the differences in how funding is adjusted, the primary difference between these two latter approaches is that, under the first option, General Fund expenditures for education clearly increase; under the second option, total General Fund spending on education remains the same, but funding available for categorical and other educational programs, which may reflect state funding priorities, declines as unrestricted funding is increased.

COMMUNICATING THE FUNDING STRATEGY

Executing this funding strategy would represent one of the more significant efforts ever undertaken by CalSTRS. As a result, CalSTRS should be prepared to undertake extensive communication to achieve success in this effort. CalSTRS will secure the services of a communication firm to assist in developing a comprehensive strategy. The potential approaches include staff working closely with organizations representing CalSTRS members to help them communicate the benefits of this strategy to their membership, including preparing articles for inclusion in organization publications explaining the reasons behind the funding strategy and how it affects the member. In addition, staff can prepare opinion pieces for the Board chair to submit to general circulation newspapers that explains how CalSTRS programs protect the financial security of public educators, who do not earn Social Security benefits for their service, but does so in a cost effective manner. Moreover, staff will be prepared to respond to any negative articles that may appear. Finally, staff is initiating an initiative to communicate to legislators the value of CalSTRS benefit programs to their individual legislative districts. This will lay the foundation for communicating to legislators the importance of this funding strategy in maintaining the financial strength of the retirement program.

REMAINING BENEFIT-RELATED ISSUES

At the September meeting, staff identified three issues that the Board had identified that could increase liabilities to the DB Program. These issues, and their cost as a percentage of compensation are

Benefit issue	Cost (if paid by employer)
Extending eligibility for Longevity Bonus	1.143% (1.237% if paid by member contribution increase)
Benefit enhancements for surviving spouses	0.069%
Post-retirement employment limitation reform	0.021%

CONCLUSION AND RECOMMENDATION

Staff recommends the Board adopt the proposal for consideration by the Legislature next year. The enactment of the recommended statutory provisions will address the unfunded actuarial obligation of the DB Program. It will not require any degradation of benefits, enabling CalSTRS to continue to provide the level of financial security provided under current law, and in fact will enhance the security of annual adjustments to benefits. Moreover, whatever increases in contribution rates that are required to maintain the financial integrity of the DB Program will be borne collectively by members, employers and the state, and the costs of solving the problem will be implemented in a manner that is deferred, gradual and predictable for those affected.

This strategy provides a mechanism for the Board to address its funding situation if it should get worse, while still imposing a constraint on the Board's authority to increase contribution rates beyond a specified level without further legislative authorization. Finally, it provides a mechanism to provide funding for retiree health care if pension costs should decline in the future, without increasing employer costs above prior levels.

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OFFICE OF THE ATTORNEY GENERAL
State of California

BILL LOCKYER
Attorney General

OPINION of BILL LOCKYER Attorney General GREGORY L. GONOT Deputy Attorney General	No. 06-510 November 9, 2006

THE CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM has requested an opinion on the following question:

Would the Legislature's increase of the employers' contribution rate paid by school districts to the California State Teachers' Retirement System for its Defined Benefit Program cause an increase in the obligation of the state to fund public education under the terms of section 8 of article XVI of the Constitution?

CONCLUSION

The Legislature's increase of the employers' contribution rate paid by school districts to the California State Teachers' Retirement System for its Defined Benefit Program, by itself, would not cause an increase in the obligation of the state to fund public education under the terms of section 8 of article XVI of the Constitution.

ANALYSIS

The question presented for resolution concerns the relationship, if any, between two different financial obligations to fund public education in California. The first involves the specific obligation of school districts to make contributions to the California State Teachers' Retirement System ("CalSTRS") for its Defined Benefit Program. The other obligation is the state's more general obligation to fund education programs under the terms of article XVI, section 8, of the Constitution. We conclude that, in the circumstances presented, a change in the first obligation would not cause a change in the second obligation.

The Legislature has enacted the State Teachers' Retirement Law (Ed. Code, §§ 22000-28101)[1] to provide a retirement benefits program for public school teachers throughout the state. Under this statutory scheme, specified monthly contributions are made to the State Teachers' Retirement Fund ("Fund") by school districts, teachers, and the state. School districts pay an amount equal to 8.25 percent of teacher salaries (§§ 22950, 22951), teachers pay an amount equal to 8 percent of their salaries (§ 22901), and the state contributes an amount equal to 2.017 percent of teacher salaries (§ 22955). If the Legislature were to mandate an increase in the amount paid by school districts to, for example, 10 percent of teacher salaries, would such an increase cause a change in what is known as the state's "Proposition 98" school funding obligation?

At the November 1988 General Election, California voters approved Proposition 98, amending section 8 of article XVI of the Constitution to provide a minimum level of state funding for the public school system -- from kindergarten through the community college level. (See Ballot Pamp., Gen. Elec. (Nov. 5, 1988) p. 78; *White v. Davis* (2002) 108 Cal.App.4th 197, 219-221; *County of Sonoma v. Commission on State Mandates* (2000) 84 Cal.App.4th 1264, 1289-1290; *California Teachers Association v. Hayes* (1992) 5 Cal.App.4th 1513, 1517-1518.)[2] Proposition 98 does not appropriate funds; rather, it provides formulas for determining the minimum to be appropriated every budget year by the Legislature. (*County of Sonoma v. Commission on State Mandates*, *supra*, 84 Cal.App.4th at p. 1290; accord, *White v. Davis*, *supra*, 108 Cal.App.4th at pp. 220-221.) One of three formulas, commonly referred to as "tests," is applied annually depending upon varying economic and fiscal conditions. Proposition 98 "necessarily requires the Legislature

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[1] All further references to the Education Code are by section number only.

[2] In *White v. Davis* (2003) 30 Cal.4th 528, 579, the Supreme Court reversed the judgment of the Court of Appeal in *White v. Davis*, *supra*, 108 Cal.App.4th 197, but ordered that the Court of Appeal's opinion be published so that it could constitute citable authority for issues not considered by the Supreme Court.

to make a determinate appropriation of funds *every year* that meets or exceeds the specified minimum; otherwise, the second and third formulas cannot fix a minimum level for the *following year*." (*White v. Davis*, *supra*, 108 Cal.App.4th at p. 221.)

The Legislature has implemented the requirements of Proposition 98 in several ways. (§§ 41200-41209; see *California Teachers Association v. Hayes*, *supra*, 5 Cal.App.4th at p. 1519.) The one statute critical to our analysis is section 41204, subdivision (c), which provides:

> "Programs that existed in the 1986-87 fiscal year, and were not the functional responsibility of school districts or community college districts in that fiscal year, shall not be shifted to the responsibility or financial support of school districts or community college districts without appropriate corresponding adjustment to the calculations made pursuant to subdivision (b) of Section 8 of Article XVI of the California Constitution. . . ."

If the Legislature were to increase the contribution rate that school districts must pay to CalSTRS from 8.5 percent to 10 percent, for example, would such additional financial support constitute the "shifting" of a "program" to the "financial support of school districts," thus necessitating an "appropriate corresponding adjustment to the calculations made pursuant to subdivision (b) of Section 8 of Article XVI of the California Constitution" as required by section 41204, subdivision (c)? Since the state's Proposition 98 school funding obligation fluctuates annually in relation to General Fund *revenues* (see *County of Sonoma v. Commission on State Mandates*, *supra*, 84 Cal.App.4th at p. 1290), the additional *costs* of school districts to contribute to CalSTRS would not cause an adjustment in the state's constitutional funding obligation unless the conditions of section 41204, subdivision (c), were present.

In our example, the overall structure of program responsibility would remain unchanged: CalSTRS would continue to bear the functional responsibility, and the financial support would continue to be provided by school districts, teachers, and the state. However, the school districts' amount of contributions would increase above the level of their contributions without the change in the rate.

In analyzing the terms of section 41204, we may rely on well-settled principles of statutory construction. "When interpreting a statute, our primary task is to determine the Legislature's intent. [Citation.]" (*Freedom Newspapers, Inc. v. Orange County Employees Retirement System* (1993) 6 Cal.4th 821, 826.) "In determining such intent, a court must look first to the words of the statute themselves, giving to the language its usual, ordinary import and according significance, if possible, to every word, phrase and sentence in

pursuance of the legislative purpose." (*Dyna-Med, Inc. v. Fair Employment and Housing Com.* (1987) 43 Cal.3d 1379, 1387.) "The words of the statute must be construed in context, keeping in mind the statutory purpose, and statutes or statutory sections relating to the same subject must be harmonized, both internally and with each other, to the extent possible." (*Ibid.*) "When the language is susceptible of more than one reasonable interpretation, . . . we look to a variety of extrinsic aids, including the ostensible objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part." (*People v. Woodhead* (1987) 43 Cal.3d 1002, 1008.)

Here, the Defined Benefit Program maintained by CalSTRS for public school teachers "existed in the 1986-87 fiscal year, and [was] not the functional responsibility of school districts or community college districts in that fiscal year." (§ 41204, subd. (c).) While the Defined Benefit Program must be considered a "program" for some purposes, is it a "program" for which, in our hypothetical example, financial support has been "shifted" to school districts for purposes of section 41204, subdivision (c)?

We have examined in detail the legislative history of section 41204, subdivision (c). (Stats. 1992, ch. 427, § 26; Stats. 1989, ch. 92, § 3.5; Stats. 1989, ch. 83, § 8; Stats. 1989, ch. 82, § 8.) The language was intended to prevent the state from cutting back on its benchmark fiscal support of education by transferring educational programs to the financial responsibility of school districts in a manner that would "circumvent the funding requirements of [Proposition 98]." (Sen. Rules Com., Off. of Sen. Floor Analyses, Analysis of Assem. Bill No. 198 (1989-1990 Reg. Sess.) as amended June 29, 1989, p. 2.)

Accordingly, we may resolve the issue presented by considering whether an increase in contributions made to the Fund by school districts would cause a net decrease in state funding for public education guaranteed under Proposition 98. The answer is "no." The state's responsibility for making contributions to the Fund would not be decreased or "shifted" to the districts in the proposed circumstances. The state's funding obligation under Proposition 98 would be unaffected by an increase in the school districts' payroll obligations. Since we are not given that the state's contributions to the Fund would be decreased as a result of the increased contributions made by the districts, we find the language of section 41204, subdivision (c), to be inapplicable here.

We conclude that an increase in the employers' contribution rate paid by school districts to CalSTRS for its Defined Benefit Program, by itself, would not cause an increase in the obligation of the state to fund public education under the terms of section 8 of article XVI of the Constitution.

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