

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Strategic Packages for Addressing Unfunded Actuarial Obligation ITEM NUMBER: 6

CONSENT: _____ ATTACHMENT(S):

ACTION: X MEETING DATE: September 8, 2006 / 90 mins.

INFORMATION: _____ PRESENTER: Ed Derman

PURPOSE OF THE ITEM

The purpose of this item is to enable the Board to adopt a strategy to address the unfunded actuarial obligation of the Defined Benefit (DB) Program. At the conclusion of the item, staff makes recommendations that establish a framework for a long-term funding strategy that include

- No changes to existing benefits, other than to guarantee the current annual two percent benefit adjustment
- An increase in member contributions of ½ percent
- An increase in the General Fund support of the DB Program of up to 1.25 percent
- An increase in the employer contribution rate to be determined by the Board as necessary to fully fund to 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.

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 last year, 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.

In December 2005, staff presented to the Board 13 options (some of which had variations on them) to consider in addressing the unfunded actuarial obligation in the DB Program. These options were:

- Issue pension obligation bonds to finance the unfunded actuarial obligation.
- Amortize the unfunded actuarial obligation over 40 years, rather than over 30 years.
- For new members:
 - Determine final compensation based on three consecutive school years of salary rates.

- Eliminate the career factor.
- Reduce the age factor to two percent after age 60.
- Do not convert unused sick leave to service credit.
- Eliminate the two percent member contributions to the Defined Benefit Supplement (DBS) Program.
- Reduce or eliminate employer contributions to DBS for excess service and credit contributions to the DB Program.
- Reduce or eliminate the annual two percent benefit adjustment.
- Incorporate the purchasing power account into the DB Program.
- Do not extend the Medicare Premium Payment Program.
- Impose employer contributions when members work after retirement.
- Increase the contribution rate for members, employers and/or the State.

At the February 2006 Board meeting, staff presented follow-up information regarding the options to address the system's current unfunded actuarial obligation. At the direction of the Board, staff compiled a decision matrix for Board members to independently indicate their preferred course of action. This same decision matrix was provided to organizations representing CalSTRS members and other stakeholders, in order to provide them an opportunity to provide the Board their perspective on these options. The results of this survey were provided to the Board at the April 2006 meeting.

STRATEGIC PACKAGES

At the April Board meeting, staff presented four strategies for the Board to consider in addressing the unfunded actuarial obligation. Staff indicated at that time that it would determine, based on the June 30, 2005 actuarial valuation, the impact on member benefits and on contribution rates of each strategy in fully funding the DB Program over a 30 year period. At the direction of the Board, staff did not incorporate any changes to the two percent annual benefit adjustment in any of the strategies. Staff subsequently developed five modifications to the original four strategies.

Each strategy reflected an increase in contributions paid by the employer, the state and each active member. In addition, in each strategy, the employer would be required to pay contributions on compensation paid to retired members. The primary difference in the strategies was the impact on member benefits. The magnitude of those contribution rates would vary depending on the impact of other aspects of the strategy on addressing the unfunded actuarial obligation. The specific changes to benefits under each strategy are summarized on the next page.

	Contributions and Benefit Changes					Contributions and Purchasing Power Changes			
	STRATEGY #1	STRATEGY #2	STRATEGY #3	STRATEGY #4	STRATEGY #5	STRATEGY #6	STRATEGY #7	STRATEGY #8	STRATEGY #9
CONTRIBUTIONS									
Increase member contribution rate	X	X	X	X	X	X	X	X	X
Increase employer contribution rate	X	X	X	X	X	X	X	X	X
Increase state contribution rate	X	X	X	X	X	X	X	X	X
Impose employer contribution on postretirement employment	X	X	X	X	X	X	X	X	X
BENEFITS									
Three year final compensation*		X	X	X	X				
Eliminate career factor*					X				
Reduce age factor to 2% at age 60*					X				
No unused sick leave conversion*					X				
Eliminate 2% DBS contribution*			X	X	X				
Eliminate employer DBS contribution for excess service*			X	X	X				
No Medicare Premium Payment Program extension					X				
Incorporate purchasing power into DB Program				at 80%		at 80%	at 85%	at 85% for pre-1999	Increase to 85%, and transfer \$1 billion to DB**
OTHER									
Increase amortization period to 35 years			X	X					

*New members only

**Purchasing power financing structure not changed

HOW OTHER RETIREMENT SYSTEMS ADDRESSED THEIR FUNDING ISSUES

The impact of financial market declines earlier in the decade had a profound effect on many public retirement systems—not just CalSTRS. Like the DB Program, pension plans throughout the nation experienced declines in their funding status, to an extent that many systems took action to reduce benefits or increase contributions, or both, to try to improve their funding levels.

In an effort to provide the Board some context on how the actions necessary to fully fund the DB Program compares to the actions taken by other retirement systems, staff contacted a number of teacher retirement systems, plus CalPERS, to identify the specific actions they have taken in recent years. The results of that inquiry are summarized below.

	Funding Ratio (Valuation Date)	Amortization Period	Benefits Changed	Employee Contribution Changes	Employer Contribution Changes
Alaska (Figures are for the Pension and Retiree Healthcare)	60.9% (6/30/05)	Infinite	Mandatory DC for new employees	No	5% increase (statutory maximum)
CalPERS (School)	93.3% (6/30/05)	20 to 30 years	No	No	Increase from 0% in 2001-02 to 10.42% in 2003-04. Now 9.124%
Colorado	73.3% (12/31/05)	30 years	Increase in retirement age, reduction in COLA	0.5% annual increase for 6 years	0.5% annual increase for 2 years, 0.4% annual increase for 6 years
Connecticut	65.3% (6/30/04)	30 years	No	No	3.23% increase for two years
Florida	107.33% (6/30/05)	N/A	No	Noncontributory	No
Illinois	60.8% (6/30/05)	90% of the UAAL in 30 years	No	0.4% increase	Gradual increase from 7.64% to 21.99% by 2013
Kentucky	76.3% (6/30/05)	30 years	No	No	1.02% increase + additional 1.32% increase recommended to maintain 30 year amortization

	Funding Ratio (Valuation Date)	Amortization Period	Benefits Changed	Employee Contribution Changes	Employer Contribution Changes
Louisiana	63.6% (6/30/05)	30 years	No	No	No
Maine	68.25% (6/30/05)	23 years	No	No	0.08% decrease
Massachusetts	67.6% (1/1/05)	36 years	No	No	No
Missouri	82.7% (6/30/05)	Infinite	No	0.5% increase	0.5% increase
Nevada	77.3% (6/30/05)	30 years	No	Noncontributory	0.5% decrease for 2 years
Ohio	72.8% (6/30/05)	55.5 years	No	0.7% increase effective 7/1/03	3.5% increase effective 7/1/03
Texas	87.1% (8/31/05)	Infinite	Increased final compensation period from 3 to 5 years; increased reduction for early retirement; increased normal retirement age	No	No

IMPACT OF INCREASED EMPLOYER CONTRIBUTIONS ON PROPOSITION 98

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. Section 41204 of the Education Code, which was enacted to implement Proposition 98, however, addresses how shifts in the responsibility for educational programs from the state to local education agencies affects the amount of money the state must pay under Proposition 98.

As part of the proposed 2005-06 budget, the Administration proposed to eliminate the state's contribution to the DB Program and increase the employer's contribution by a similar amount. At the request of a state legislator, Legislative Counsel issued an opinion on the implications of that proposal on the minimum funding level under Proposition 98. In that opinion, Legislative Counsel noted that Section 41204 provides, in part, that

[p]rograms 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.

As a result, Legislative Counsel opined that the minimum funding guarantee to local school districts would have to be increased by the amount that the state's responsibility for making contributions to the DB Program was shifted to local school districts. Specifically, Legislative Counsel opined that "[w]e think that these provisions reflect the view that, because Proposition 98 was presumably approved by the voters to guarantee a minimum level of state funding to support the programs for which the schools were responsible when the proposition was approved, subsequently requiring the schools to assume new functional or financial responsibilities would dilute the funding guarantee unless the Proposition 98 funding minimum is increased to accommodate the resulting expense to the schools." The Legislature rejected the budget proposal, in part because of this opinion, although it should be noted that the Department of Finance did not agree with Legislative Counsel's view on this issue.

The circumstances that exist in the current situation are not identical to the prior proposal, but there are enough similarities to raise the issue whether a funding strategy that was enacted that increased employer contributions would require an increase in the state's minimum funding guarantee under Proposition 98. This is because, as a result of legislation enacted in 1998 and in 2000, the state's contribution to the DB Program has declined from 4.3 percent of the compensation paid in the prior calendar year to 2.017 percent of the compensation paid two fiscal years earlier, a decrease of over 50 percent (although under the provisions of legislation in effect at the time of the first reduction, there would have been a reduction in the state's contribution anyway, albeit a lesser one.) If employer contributions were increased in future years as a result of an adopted funding strategy, would those two independent events represent an effective shift of functional responsibility that, under the Legislative Counsel's analysis of the earlier budget proposal, would require an increase in state funding under Proposition 98?

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. As of mid-August, neither office had completed its analysis of this question.

INCREASING STATE FINANCIAL PARTICIPATION IN THE DB PROGRAM

There are three mechanisms by which the state could increase its participation in the financing of the DB Program. The first is to increase the direct contribution the General Fund makes to the DB Program. As indicated above, the General Fund currently contributes 2.017 percent of creditable compensation paid two fiscal years earlier to fund DB Program benefits. This represents a decrease from the level paid prior to 1998, when the General Fund contribution rate

was 4.3 percent of the compensation paid in the prior calendar year. A second approach would be to increase the employer's contribution, and offset that either by increasing the state's minimum funding level required by Proposition 98 or to increase the amount of unrestricted money provided to K-12 and community college employers within the existing level of funding provided under Proposition 98.

The impact on DB Program funding is the same whether the state makes a direct contribution or the employer pays a higher contribution, which is offset by higher payments from the state to the school employer. The contribution rate paid by the state would have to be higher than would be required from the employer in order to generate an equal amount of contribution revenue, because the General Fund contribution is based on a two-year older payroll, but there is no other impact to the DB Program of either choice.

If the employer contribution gets increased further, whether the minimum funding guarantee should be increased is the issue currently being evaluated by Legislative Counsel and the Attorney General. Even if not required by law, however, that is a choice the Legislature and Governor could make. An alternative approach is to increase the amount of unrestricted funding paid to school employers, 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 colleges) 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. 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 remains the same, but funding available for categorical and other educational programs, which may reflect state funding priorities, declines as unrestricted funding is increased.

IMPACT OF INFLATION IF PURCHASING POWER MERGED WITH DB PROGRAM

When the inflation-adjusted value of the current monthly DB benefit is less than 80 percent of the value of the initial benefit, a quarterly payment is made from a special account in the Teachers' Retirement Fund to restore purchasing power to the 80 percent level. The program is primarily funded from an annual General Fund contribution, which is guaranteed by contract. The benefit payment to recipients is guaranteed to the extent there are sufficient funds in the special account to pay the benefit. Currently, about 57,000 of the 201,000 benefit recipients receive a purchasing power benefit payment. The average purchasing power payment is equal to \$325 per month.

One component of four of the strategies is incorporating the purchasing power program into the DB Program. (A fifth strategy would shift funds from the purchasing power program to the DB Program in return for a higher purchasing power benefit, but would otherwise not change the

financing structure of the purchasing power program.) Incorporating the purchasing power benefit program into the DB Program has two effects. First, the current assets and future contributions for the purchasing power program will be reflected in the valuation of the DB Program. Although the liability of the DB Program would be higher than under current law, this increased liability would be more than offset by the assets and contributions that would now be reflected in the DB Program. Incorporating the current assets and future state contributions for purchasing power into the DB Program would result in a net reduction in the amortization cost of 0.908 percent. There are no foreseeable administrative implications concerning this change.

The projected impact of this proposal on the DB Program assumes that future inflation is consistent with current assumptions, equal to 3.25 percent. If inflation increases to the point that the increased liability exceeds the value of the additional resources, then the DB Program will experience a net increase in its liability, further exacerbating the funding of the program. On the other hand, under current law, the purchasing power payments made to benefit recipients in the future would be reduced if inflation increased sufficiently, whereas those payments would now continue to be made under this option. In effect, the risk of inflation would be shifted from benefit recipients to the DB Program.

Different assumptions on future inflation have several different effects on the financing of the DB Program, including assumed future wage growth and future investment return. Staff evaluated the changes in the California Consumer Price Index, upon which the purchasing power payments are based, from 1952 through 2005. During that period of time, the average annual rate of inflation was 3.4 percent, and the highest average annual rate of inflation for a 30-year period was 4.4 percent, which occurred in four of the 20 periods. As a result, if this prior history is indicative of future experience, it is reasonable to assume that the assumed rate of inflation in the DB Program would not exceed five percent in the future. The Consulting Actuary evaluated the impact of incorporating the purchasing power program into the DB Program, with no change in the SBMA benefit, based on five different sets of assumptions with respect to inflation and investment return. The impact of these alternative assumptions on DB Program financing would be as follows:

	2 percent annual inflation, 6.75 percent investment return	3.25 percent annual inflation, 8 percent investment return (Current assumption)	4.5 percent annual inflation, 9.25 percent investment return	4 percent annual inflation, 8 percent investment return	5 percent annual inflation, 8 percent investment return
Unfunded actuarial valuation as of June 30, 2005 (in millions)	\$35,655	\$24,427	\$19,679	\$35,275	\$ 55,737
Funded ratio	78 percent	84 percent	86 percent	78 percent	69 percent
Total cost rate	26.959 percent	22.713 percent	21.015 percent	27.367 percent	35.296 percent
SBMA savings (cost)	2.559 percent	0.908 percent	(2.454 percent)	(1.651 percent)	(6.535 percent)
Remaining DB Program shortfall	7.000 percent	2.485 percent	1.236 percent	7.517 percent	15.470 percent

As is indicated above, a higher rate of inflation could result in a net cost to the DB Program if the purchasing power program were integrated into the core benefit program. On the other hand, under that circumstance, and assuming no change in real wage growth and investment return, the overall strength of the DB Program would be greater under that higher inflation than it is under lower rates of assumed inflation. If, however, a higher rate of inflation occurred and the rate of return on investments remained at 8 percent annually (that is, the real rate of return declined), then the overall strength of the DB Program would be substantially reduced. Rather than a remaining shortfall equal to 2.485 percent of salaries under the current assumptions, the remaining shortfall would increase to 15.470 percent of salaries under the worst case scenario evaluated.

There is a second issue associated with incorporating the purchasing power program into the DB Program. Different member organizations, particularly those representing retired members, expressed significant concerns about the impact of this possible change on future opportunities to increase the purchasing power benefit. If the purchasing power benefit was a feature of the DB Program, rather than funded from separate funds, the cost of increasing the purchasing power benefit from the current 80 percent level would be borne directly by the DB Program, with the potential implications to future contribution rates. As a result, the member organizations expressed concerns that this approach would substantially reduce, if not eliminate entirely, any opportunity to increase the purchasing power benefit in the future.

POSSIBLE IMPACT OF HEALTH CARE LIABILITIES ON PENSION LIABILITY FINANCING

New accounting disclosure rules imposed by the Governmental Accounting Standards Board (GASB) require governmental entities to disclose their liabilities for other post-employment benefits, such as health care. This will have a major impact on California's school districts. According to a recent Legislative Analyst Office report:

The average district that provides lifetime benefits currently faces liabilities for retiree health benefits of about \$4,000 per student. To fund this amount over 30 years, a district would have to set aside roughly \$400 per student each year. This represents about 8 percent of general purpose funds districts receive in state funds and local property taxes. Fully funding both the normal cost and a share of unfunded liabilities by redirecting existing district revenues would significantly affect the quality of education offered by districts.

There are two impacts that such rules could have on the ability of school districts to address any pension obligation imposed by the Board's strategy. First, employers that pay at least a portion of their retiree health care benefits could initiate a program to begin funding that liability. This could be in the form of increased contributions or the issuance of bonds, similar to pension obligation bonds, or both. Either increased contributions or the debt service associated with the bonds would increase the annual spending of the district. This increased spending would have an

impact on the district's ability to pay increased pension contributions or debt service associated with pension obligation bonds.

A second consideration is whether the disclosure of the health care liability affects a school district's bond rating and, as a result, its ability to issue pension obligation bonds. According to bond underwriters, the concerns of municipal ratings agencies, such as Standard and Poor's and Moody's, would most likely be similar to those that they have with regards to unfunded pension liabilities. Specifically, the ratings agencies would be concerned about the district's liability for retiree health care but would realize that immediate full funding—that is, reaching the annual required contribution prescribed by GASB—is entirely unreasonable. Nevertheless, the districts would need to recognize their liabilities and demonstrate that they have some type of a plan to pre-fund these benefits at a reasonable point in the near future. This could potentially involve restructuring benefit packages in order to reduce liabilities—Fresno Unified School District recently negotiated a two tiered benefits plan in order to accomplish this. Exactly when this “near future” would need to be is unclear. The GASB rule requiring the disclosure will be phased in over the next three years. Exactly how long after disclosure a funding plan should be established in order to avoid a ratings downgrade is unknown, although like pension obligations, the sooner this liability is addressed, the lesser the long-term impact on the employer.

OTHER CONSIDERATIONS IN ADOPTING A FUNDING STRATEGY

During the time that the Board has been considering a strategy for funding the DB Program, other issues that affect program liabilities have been identified that the Board needs to consider in determining the magnitude of increased contributions or reduced liabilities it wishes to pursue.

Longevity Bonus

Under current law, DB members who retire with at least 30 years of credited service receive an increase in their allowance. That increase is \$200 per month if they retire with at least 30 years of service, \$300 per month if they retire with at least 31 years of service and \$400 per month if they have at least 32 years of service. In order to be eligible for the bonus, however, they must have at least 30 years of service credit by 2011.

This increase is one of the more popular benefit enhancements that was enacted in the past several years, because the increase is not tied to the member's final compensation; a teacher could get the same amount of enhancement that a highly-paid administrator would get. It also is an enhancement that is relatively easy to communicate. Moreover, it appears that the enhancement had some desirable impact on member decisions to defer their retirement. Prior to 2000-01 (when the longevity bonus first became available), the median service credit for retiring members was consistently below 30 years. For the next three years, the median service credit was over 31.3 years each year, and continues to exceed prior median levels of service credit. Although a number of enhancements were enacted in 1998 and 2000 that encouraged members to work longer, the longevity bonus was the only enhancement that was enacted in 2000 that was specifically directed at members with 30 or more years of service.

As indicated earlier, eligibility for receiving the longevity bonus expires after 2010. If the Board wishes to continue the enhancement, there would be an additional cost to the DB Program, equal to 1.143 percent of compensation for 30 years. If this increased cost was paid entirely from increased member contributions, the required increase would be 1.237 percent of member compensation, due to the fact that member contributions get returned to those members who terminate employment and their DB Program membership.

Benefit Enhancements for Surviving Spouses and Partners

Currently, the benefit enhancements, such as the longevity bonus, are paid to members who retire for service. If the retiring member has elected an option, the enhancement continues to be paid to the surviving option beneficiary. If the member died before retirement, and the member had elected a pre-retirement option, the option beneficiary is paid a benefit, including enhancements, as if the member had retired for service on the date of death. If the member had not made a pre-retirement election of an option to prior to death, however, a surviving spouse or registered domestic partner can receive a monthly benefit, but CalSTRS has administered the law so as to not enhance the benefit by the longevity bonus, even if the member had 30 years of service at death.

In discussing how survivor benefits should reflect career-based enhancements, the Board approved a proposal to clarify the law to reflect current practice, but directed staff to bring this issue back to the Board when it considers its long range funding strategy. Including benefit enhancements in survivor benefits would cost an additional 0.039 percent of pay, increasing to a total increase of 0.069 percent of pay if the longevity bonus is made available to all members who retire with at least 30 years of service, regardless of when they achieve that level of service.

Postretirement Earnings Limitations

Currently, retired members are subject to a limitation in their earnings that would be creditable to the DB Program if the member was still active. Any earnings paid in excess of a specific dollar amount (equal to \$27,060 in 2006-07) reduce the benefit in that school year by an equal amount. There are a number of exemptions to this limit, largely based on when the person retired, the type of job being performed and how long the member was retired without working. In addition, neither the member nor the employer pay contributions on earnings paid after retirement.

The current program regulating postretirement employment is complicated, but portions of it are needed to maintain the DB Program's federal tax qualification. In an effort to simplify the administration of the DB Program, and still maintain the program's tax qualification, the Board adopted a strategy developed by staff that permits any retired member who is 60 years or older to work without any limit, and permit any retired member under age 60 to work without limit if the member had not worked for at least 12 consecutive months after retirement.

In order to address the anticipated increased program costs from this proposed change, estimated to equal 0.021 percent of compensation, the strategy also requires employers to pay contributions for any member working after retirement. That requirement is also included in the strategies the Board is considering to address the unfunded actuarial obligation. Consequently, in addressing the total funding needed to fully fund the DB Program, the Board should recognize the impact of this proposed approach to postretirement earnings on achieving its full funding strategy.

FISCAL IMPLICATIONS OF STRATEGIC PACKAGES

The impact on member, employer and state contributions in any strategy will depend not only on the effect of other aspects of the strategy on addressing the unfunded actuarial obligation, but also on how the increased contributions are allocated among members, employers and the state. To give the Board an idea of the implications of different allocation approaches, staff estimated the final contribution rate for members, employers and the state based on three different allocation methods.

	Scenario #1	Scenario #2	Scenario #3
Member	1/3 of total contribution increase	25 percent of total contribution increase	40 percent of total contribution increase
Employer	1/3 of total contribution increase	50 percent of total contribution increase	40 percent of total contribution increase
State	1/3 of total contribution increase	25 percent of total contribution increase	20 percent of total contribution increase

As indicated earlier, there are legal constraints on the ability to increase contributions to members without an offsetting increase in benefits. Consequently, although there are means to increase benefits under the DB Program to current members without increasing liabilities, these means are limited. As a result, to the extent that the member’s contribution rate that would result from application of one of the scenarios to a strategy exceeded that legal limit, the excess contribution would be imposed on the employer in that scenario and strategy.

In addition, the impact of benefit changes and increased member contribution rates will be different for each member, depending on his or her individual circumstances, and may have no impact at all if the member is not eligible for the benefit being affected. For the purpose of illustrating the impact of those options that are applicable to people who are members or become members in the future, staff created three different prototypical member profiles based on low, medium and high levels of service, age and salary for those retiring in 2004-05 and those active in 2004-05, and calculated the impact of each strategy on those members. For purposes of comparison, the final compensation amounts have been projected to 2008-09, the first full fiscal year any benefit changes could be in effect, and the salary amounts have been projected to 2009-10, the first year any contribution increases would take effect.

For each type of member retiring for service under the strategy, the strategy assumed the member retired:

- With one year of unused sick leave (members with unused sick leave average 0.549 years of service credit from the unused leave)
- With three percent annual salary increases in the two years prior to retirement
- After earning \$3,000 in excess earnings for each of the first 10 years of teaching
- With five percent annual interest on Defined Benefit Supplement (DBS) account balances (the minimum interest rate for DBS accounts this year)
- Is eligible for CalSTRS to pay the member’s Medicare Part A premium

	Low impact (25th percentile member)	Medium impact (50th percentile member)	High impact (75th percentile member)
Years of service at retirement	17 years	29 years	33 years
Age at retirement	58 years	60 years	63 years
Projected final compensation at retirement	\$6,177 per month	\$6,975 per month	\$7,878 per month
Projected salary of active member	\$4,182 per month	\$5,839 per month	\$7,329 per month

In addition, for purposes of identifying the net cost of increased member contributions, the marginal federal and state total tax rate of active members was assumed to be 32 percent. Finally, the impact of increased contributions on employers and the General Fund are based on the projected 2009-10 total compensation of \$29.5 billion and the projected 2007-08 total compensation of \$27.1 billion, respectively.

The tables beginning on the next page summarize the impact of each scenario on members, employers and the state. The first section shows what the final contribution rate paid by members, employers and state would be for each strategy, after considering the impact of the respective benefit changes, and the contribution rates are fully phased in. In addition, because contribution rates could be allocated among members, employers and state in many different ways, the table shows those final rates based on the three allocation scenarios identified earlier. The next section of the table shows the dollar impact of those final contribution rates for each strategy and under each contribution allocation scenario. For members, the amount shown is the net monthly reduction on the increased contribution for an active member with low, medium and high salary levels on his or her take-home pay, assuming the contribution is paid on a pre-tax basis. For employers and the state, the amount shown is the annual increase in contributions paid (In millions of dollars) as a result of the increased contribution rate.

The final part of the chart shows the impact of each strategy on a future member retiring with low, medium and high service credit, age and projected final compensation (based on the characteristics of those who retired in 2004-05). In addition, it indicates the percentage of future members whose benefits would be affected by the benefit changes described in the strategy. For example, Strategy #5 would reduce all benefits paid to a future member whose age, service credit and projected final compensation was in the middle of those who retired in 2004-05 by \$1,203 per month, and the Defined Benefit allowance would be reduced for 93 percent of future members.

	STRATEGY #1			STRATEGY #2			STRATEGY #3		
	Contribution Scenario			Contribution Scenario			Contribution Scenario		
Final contribution rates	#1	#2	#3	#1	#2	#3	#1	#2	#3
Member	0.500%	0.500%	0.500%	0.500%	0.500%	0.500%	0.500%	0.500%	0.500%
Employer	3.077%	3.523%	3.792%	2.869%	3.287%	3.539%	1.917%	2.187%	2.366%
State	1.789%	1.341%	1.073%	1.685%	1.263%	1.010%	1.209%	0.896%	0.717%
Net annual costs									
Active member									
Low	\$251	\$251	\$251	\$251	\$251	\$251	\$251	\$251	\$251
Medium	\$350	\$350	\$350	\$350	\$350	\$350	\$350	\$350	\$350
High	\$440	\$440	\$440	\$440	\$440	\$440	\$440	\$440	\$440
Employer (millions)	\$907	\$1,039	\$1,118	\$846	\$969	\$1,044	\$565	\$645	\$698
State (millions)	\$485	\$364	\$291	\$457	\$343	\$274	\$328	\$243	\$195
	Low	Medium	High	Low	Medium	High	Low	Medium	High
Dollar impact on all monthly retirement benefits	\$0	\$0	\$0	\$0	\$133	\$185	\$138	\$271	\$323
Percent reduction on all monthly retirement benefits	0%	0%	0%	0%	3%	3%	7%	6%	5%
Percent of all retired members (Defined Benefit allowance) affected	None			60%			60%		

	STRATEGY #4			STRATEGY #5			STRATEGY #6		
	Contribution Scenario			Contribution Scenario			Contribution Scenario		
Final contribution rates	#1	#2	#3	#1	#2	#3	#1	#2	#3
Member	0.770%	0.563%	0.919%	0.500%	0.500%	0.500%	1.000%	0.970%	1.000%
Employer	0.770%	1.126%	0.919%	1.439%	1.652%	1.795%	1.597%	1.940%	2.104%
State	0.770%	0.563%	0.460%	0.970%	0.718%	0.574%	1.299%	0.970%	0.776%
Net annual costs									
Active member									
Low	\$386	\$283	\$461	\$251	\$251	\$251	\$502	\$487	\$502
Medium	\$540	\$394	\$644	\$350	\$350	\$350	\$701	\$680	\$701
High	\$677	\$495	\$808	\$440	\$440	\$440	\$879	\$853	\$879
Employer (millions)	\$227	\$332	\$271	\$424	\$487	\$529	\$471	\$572	\$621
State (millions)	\$209	\$153	\$125	\$263	\$195	\$156	\$353	\$263	\$211
	Low	Medium	High	Low	Medium	High	Low	Medium	High
Dollar impact on all monthly retirement benefits	\$138	\$271	\$323	\$634	\$1,203	\$1,907	\$0	\$0	\$0
Percent reduction on all monthly retirement benefits	7%	6%	5%	26%	23%	27%	0%	0%	0%
Percent of all retired members (Defined Benefit allowance) affected	60%			93%			None		

	STRATEGY #7			STRATEGY #8			STRATEGY #9		
	Contribution Scenario			Contribution Scenario			Contribution Scenario		
Final contribution rates	#1	#2	#3	#1	#2	#3	#1	#2	#3
Member	1.500%	1.482%	1.500%	1.500%	1.127%	1.500%	0.500%	0.500%	0.500%
Employer	2.453%	2.964%	3.242%	1.540%	2.253%	2.121%	2.867%	3.285%	3.537%
State	1.977%	1.482%	1.186%	1.520%	1.127%	0.906%	1.684%	1.262%	1.010%
Net annual costs									
Active member									
Low	\$753	\$744	\$753	\$753	\$566	\$753	\$251	\$251	\$251
Medium	\$1,051	\$1,038	\$1,051	\$1,051	\$790	\$1,051	\$350	\$350	\$350
High	\$1,319	\$1,303	\$1,319	\$1,319	\$991	\$1,319	\$440	\$440	\$440
Employer (millions)	\$723	\$874	\$956	\$454	\$664	\$626	\$846	\$969	\$1,043
State (millions)	\$536	\$402	\$322	\$412	\$306	\$246	\$457	\$342	\$274
	Low	Medium	High	Low	Medium	High	Low	Medium	High
Dollar impact on all monthly retirement benefits	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Percent reduction on all monthly retirement benefits	0%	0%	0%	0%	0%	0%	0%	0%	0%
Percent of all retired members (Defined Benefit allowance) affected	None			None			None		

As the above table indicates, the increases in contribution rates required of any of the three stakeholders—members, employers and state, are relatively modest, especially in comparison to the rate increases experienced by school employers for CalPERS benefits. Depending on the specific strategy selected and the percentage of resulting contributions allocated to employers, the employer contributions rate would increase by a total ranging from 0.770 percent to 3.792 percent. Including the impact of the imposition of employer contributions for post-retirement employment, the resulting increase in employer contributions would range from \$227 million annually to \$1.1 billion. Similarly, for a medium salaried employee, the contribution rate would result in a net cost, after taxes, ranging from \$350 per year to \$1,051 per year. The increase in contributions for the state would cost from \$125 million to \$536 million. All of these increased costs would be phased in over time. But given these strategies, assuming that current actuarial assumptions held, the DB Program would be fully funded by June 30, 2038.

ADOPTING A FUNDING STRATEGY

In adopting a strategy to fully fund the DB Program, the Board has to make decisions on five issues:

1. What changes, if any, should be made to the benefit structure?
2. How should the increased contribution rates be allocated among employers, members and the state?
3. How should the increased contribution rates be phased in?
4. What authority should the Board have to adopt the contribution rates?
5. To the extent that unexpected improvements in demographic or economic conditions permit a decline in contribution rates, what should be done with those excess contributions?

Changing the DB Program Benefit Structure

There are two components of the DB Program benefit structure that warrant separate consideration for changes: the benefits of the DB Program itself and the DBS Program benefits that supplement that core benefit. The DB Program is the exclusive source of monthly benefits for the service performed by a member; no Social Security credits are earned for such service. Consequently, it has to represent a large percentage of the income needed after retirement to maintain a standard of living. Analyses by CalSTRS indicates that retirement benefits have to replace over 80 percent of the working income in order to maintain the retired member's standard of living, assuming the retired member continues to receive comparable benefits, particularly health benefits, that were paid while employed. Currently, the average benefit paid to a newly-retired member is about 65 percent of final salary. Assuming that members participate in supplemental retirement savings programs while employed, such as 403(b) plans, this benefit should be sufficient to enable a career educators to maintain the standard of living enjoyed while working.

This suggests, however, that there is little room to reduce benefits while still meeting that objective. In fact, under current law, future career members will already be facing reduced benefits because they will not be eligible to receive the Longevity Bonus that is paid to members

who retire with 30 or more years of service. Further declines in the core benefit will only contribute to additional erosion in financial security.

The only change to the DB Program that might warrant consideration is determining final compensation based on the highest three consecutive years for all future members. This is the basis that was in effect until 2001, when the highest single year began to be used for members with 25 or more years of service. As has been indicated before, California is the only state that commonly uses a single year to determine final compensation. Although not a major problem in the DB Program, single year final compensation does invite efforts for members to seek very short-term increases in compensation in order to generate a permanent increase in lifetime benefits.

Other California retirement systems are beginning to see changes in how final compensation is determined. Many of the state employee unions have recently negotiated three-year final compensation for their new members covered by CalPERS. At the present time, however, CalSTRS staff is not aware of any proposal to return classified school employees to three-year final compensation. In addition, although determining final compensation in the DB Program based on three years, rather than a single year, would benefit the funding of the program, the impact is not substantial, representing only 0.188 percent of compensation over 30 years.

Although, if necessary, reducing the supplemental benefits provided by the DBS Program would be a more desirable means to manage liabilities in order to address the funding situation, that is not a recommended solution at this time. There are two sources of DBS benefits that could be reduced—the two percent contribution paid by all active members, and the member and employer contributions paid for service in excess of 1.000 year of service credit in a school year. The first source is going to sunset at the end of 2010; by the time an earlier sunset could be become effective, applicable only to new members, there would be only three years left in that part of the program. This would have a very small impact on the funding of the DB Program, but would noticeably affect the benefits paid to those new members. The provision imposing contributions for excess service has no sunset, so reducing or eliminating the employer contribution, and crediting them to the DB Program, would have a more significant impact on DB Program funding, equal to 0.152 percent of compensation over 30 years. Doing so would, however, undermine one of the objectives of that part of the program. Prior to the DBS Program, summer school and other extra activities had no impact on a member's retirement benefit, even though such service was becoming as important to the educational system as service during the school year. Crediting member and employer contributions for such service was intended to provide a meaningful retirement benefit for such service without imposing obligations on the DB Program. Reducing or eliminating the employer contribution to the DBS Program would undermine that objective.

Finally, the option to incorporate the purchasing power payment program into the DB Program has a number of virtues for the members; particularly providing a stronger guarantee that such purchasing power payments get made if inflation should increase in the future. That increased security, however, has the opposite impact on the DB Program itself. To the extent that inflation

increases in the future, the DB Program would experience an increase in its unfunded actuarial obligation. As the earlier table indicates, depending on the rate of inflation and investment return, the net cost to the DB Program of this proposal, while potentially a net savings, could also result in a net cost to the program of over five percent of compensation. **Given the fact that the adjustments needed to fully fund the DB Program are not significant enough to warrant the types of changes to members or the financing of their retirement program that changes in the benefit structure would impose, staff does not recommend any reductions to the benefit structure as part of a funding strategy. Staff does recommend, however, that the existing two percent annual adjustment be guaranteed in statute.** As will be discussed in greater detail below, this would provide a basis for increasing contribution rates paid by current members, without increasing the liabilities of the program.

Allocating Increased Contribution Rates

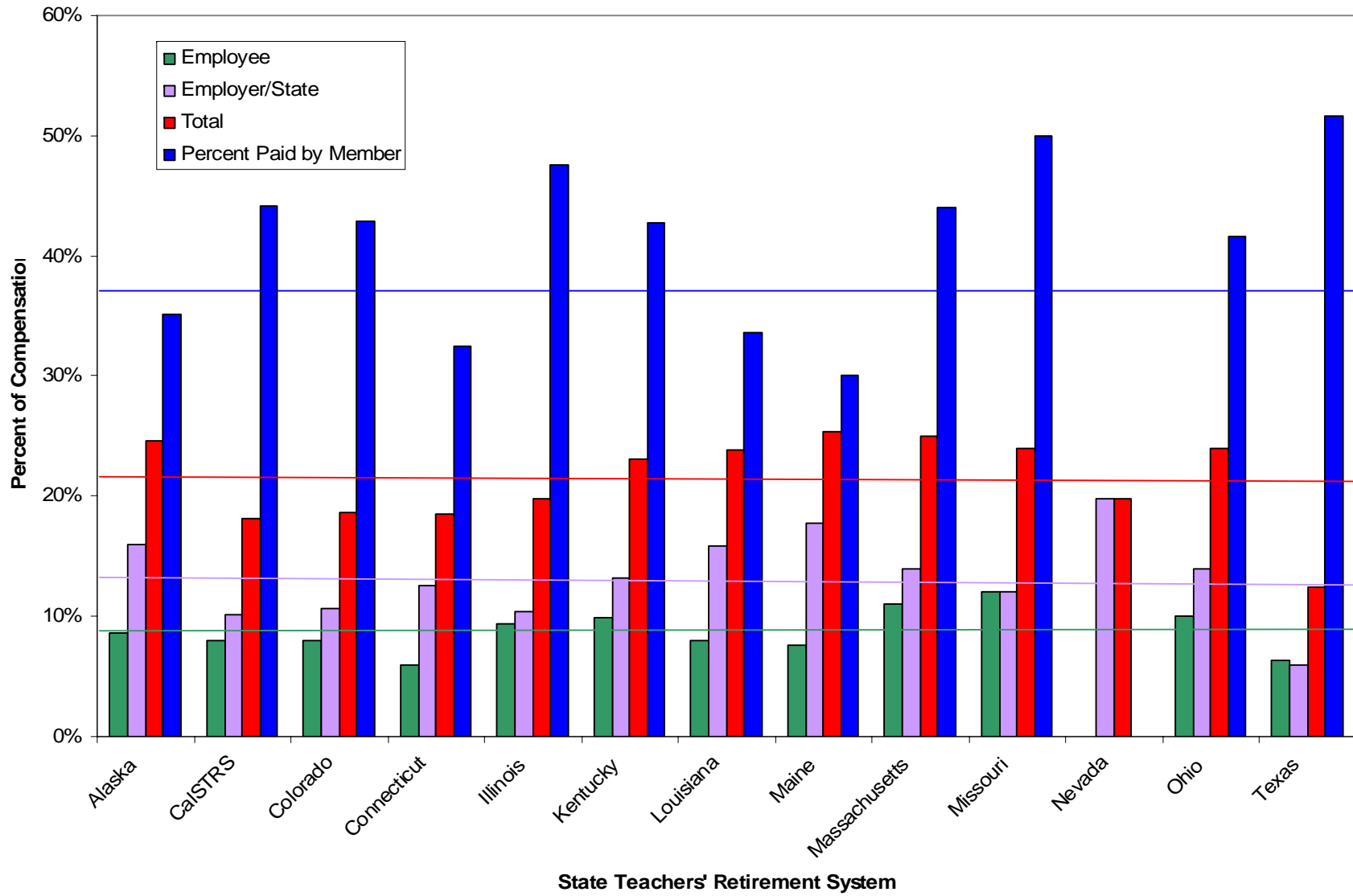
Although increased contributions could be distributed among members, employers and the state in many different ways, staff identified the consequences of three different distribution methods—equal increases across the board, equal increases between members and employers, and half that amount to the state, and 50 percent of the increase paid by employers and the remainder equally shared between members and the state. The impact of a different distribution method is somewhat mitigated by the legal constraint on increasing contributions to currently active members. Due to the contractual rights of current members, the contribution rate generally cannot be increased in the absence of some offsetting comparable advantage. Although there are some comparable advantages that do not result in a corresponding increase in program liabilities, those are limited. As a result, in determining how much contributions for members can increase, staff has limited that increase to ½ percent to 1.5 percent, depending on other aspects of the particular strategy.

In determining an appropriate distribution of the contribution rates, there were two considerations—what should be the responsibility of the state in financing the retirement benefit, and how does the relative burden on CalSTRS members, as opposed to employers, compare with similar retirement systems in other states? As reflected in the principles guiding the development of the strategies, the state has a very strong interest in the public education system and its retirement system. CalSTRS was established by state law, its governing Board is composed of a mix of elected state officials, Governor’s appointees, and employee representatives, and its structure and plan design is ultimately governed by the state Legislature. As a result, the state is considered to be the ultimate guarantor of DB Program benefits in the event that there are insufficient resources to pay existing benefits. Although DB Program members are generally employees of local school employers, the state has a level of responsibility for financing of California public education, and California as a whole benefits substantially from the outcomes of a public education. Therefore it is only fair that if the districts are required to increase contributions, the state should also be required to increase its participation in funding the program, either directly through increased contributions, or indirectly with additional state funding for employers to partially offset the increased employer contribution.

In addition, the state has been realizing reductions in its obligation to the DB Program. Prior to 1998, the state's contribution was equal to 4.3 percent of the compensation paid in the prior calendar year. That amount has been reduced to the current contribution rate of 2.017 percent of the compensation paid two fiscal years before.

Notwithstanding that strong state interest in public education, however, CalSTRS members are, in the end, employees of the school district, and the school district determines most of the compensation paid to their employees, of which the retirement benefits is a part. **Consequently, it is appropriate that more of the burden fall on the employer than on the state.**

The second consideration is how much of a burden is falling on the member compared to the employer. Staff compared the contribution rate paid by a CalSTRS member to those paid by members of other teacher retirement systems not covered by Social Security, and compared them to the rates paid by the employer and/or the state. The results of that comparison are shown on the next page. First, it shows that the total contribution paid for the DB Program is less than the average paid by all other systems. More important to this issue, however, the CalSTRS member pays a relatively higher proportion of the total contribution than do members of comparable teacher retirement systems. **As a result, imposing a relatively greater increase on the employer as compared to the member would put the relative burden of CalSTRS members and employers closer to the burden imposed on comparable retirement systems.**



Another issue is whether all active members should pay an increased contribution rate or only people who become members in the future. As a matter of equity, all active members performing service under the same benefit structure should be subject to contribution rates that are as equal as possible. **Therefore, staff recommends the increase be applied to all active members.** Generally, in the absence of any previously existing statutory authority to increase member contribution rates, the contractual rights of existing members to a fixed contribution rate would preclude applying an increased rate to existing members. Normally, the only way such increases could be applied to existing members, in the absence of a declared emergency, would be to provide an offsetting advantage to the affected member, such as by increasing benefits by an offsetting amount. The increased liability associated with such a benefit increase would, however, offset any fiscal value of increasing the contribution rate. Consequently, the offsetting benefit to the members could not result in an increased liability to the DB Program.

There are, however, two means by which this could be achieved in the DB Program without causing an offsetting increase in liabilities. The first is to remove the existing statutory authority for the Legislature to reduce or eliminate the two percent annual benefit adjustment paid on benefits. This would effectively guarantee the annual adjustment. Similarly, if the purchasing power account were incorporated into the DB Program, the resulting guarantee associated with the purchasing power benefit, regardless of the rate of inflation and the fiscal impact on the DB Program, would also provide an advantage not currently offered to members. If either or both changes were adopted, these improved guarantees would provide a legal basis to increase contribution rates on existing members. The extent that such rates could increase under such circumstances would be subject to judicial review, but staff believes that a one percent increase in the contribution could be justified if both benefits were improved as described, and ½ percent increase if only one improvement was made.

Phasing In Increasing Contribution Rates

One of the impacts that were felt by employers in CalPERS, and likely with other retirement systems, was the dramatic increase in contribution rates earlier in the decade. For its general employees, the state's contribution went from 0 percent in 2000-01 to over 17 percent in four years, while the contributions paid by CalPERS school employers for their classified employees went from 0 percent in 2001-02 to over 10 percent in two years. These increases came very suddenly, and with as little as two months notice. As a result, employers had to quickly adjust their budgets to accommodate the increased contribution rate.

In recognition of the implications of increased contribution rates to employers and to members, **staff recommends the increased contributions be deferred long enough to enable employers and members to adjust their spending plans to the upcoming increase, and to phase in the increase over a period of time, to permit the budget impact to be more moderate and better enable the impact to be reflected in bargaining discussions.** Specifically, if the legislation authorizing the increases is enacted in 2007, the rate increase would first be imposed in July 2009, 18 months after the effective date of the legislation. Although the increase could be imposed a year earlier, an earlier implementation would provide only six months after the

effective date of the legislation for employers and members to adjust to the upcoming increases. In addition, in order to moderate the impact of the increases in any one year, **staff recommends that contribution rate increases to any one stakeholder in any one year be limited to ½ percent.**

Adjusting Contribution Rates in the Future

Currently, the contribution rates for CalSTRS employers are determined by statute, and the Board has no authority to adjust those rates to reflect changing actuarial needs, both positive and negative. (Interestingly enough, the Board does have limited authority to increase employer contributions to the Cash Balance Benefit Program, if recommended by the actuary to maintain the program's actuarial soundness. That authority has never been exercised.) In contrast, the CalPERS Board has complete authority to set the contribution rates for employers in response to changing actuarial conditions. In a survey of the 13 other non-social security state teacher retirement plans, staff identified nine other plans in which contribution rates could vary depending on the funding status of the plan; this variability either was determined by the governing board or the statute itself varied the rate.

This flexibility permits the funding status of the plan to maintain stability. In addition, if properly structured, the impact on the employer can be moderated, in order to avoid the widely fluctuating rates that can be disruptive to sound budgetary planning. As a result, **staff recommends the Board be given authority to adjust employer contribution rates in the future to reflect changing actuarial requirements of the DB Program. In order to moderate the effect of the changes on employers, staff recommends that this authority be limited to a specific window of permissible contribution rates.** Specifically, the employer contribution rate could not be reduced below the current 8.25 percent, nor increased beyond a rate specified in statute, without enactment of authorizing legislation. In this way, the DB Program would be guaranteed to receive contributions generally at least equal to its ongoing, normal costs, provide the Board some authority to increase contributions beyond currently needed levels if the program's financing requires further increases, but limit the impact of the increases on employers. Similar to the initial imposition of the increased contributions, **staff recommends that any change be limited to ½ percent per year, and not become effective until the beginning of the plan year that begins in the year after the Board adopts the new contribution rate.**

Use of Available Contributions

The cost of a defined benefit plan will change over time, in response to changes in both economic conditions, such as assumed investment returns, salary increases or inflation, or demographic changes, such as changes in mortality. In some cases, those changes in funding needs may be temporary if, for example, a sustained period of high investment returns is followed by a period of lower-than-assumed returns. Although staff has recommended that any reductions in contribution rates be limited to ½ percent annually, such reductions could take place, and future increases in contributions would have an effect on spending plans.

There are a couple of options to address the disposition of reduced contribution requirements for employers. One option would be to reduce the total amount paid by employers, and provide employers some spending relief. If contribution rates had to increase in the future, however, the employer might be faced with making tradeoffs between this increased contribution rate and other uses of funds made available by the spending relief. If that alternative use imposed an ongoing obligation to the employer, the increased pension obligation, coupled with the use of the resources for other purposes, could be disruptive to its educational program. Alternatively, state statute could provide an automatic use of the unneeded pension contribution for specific purposes in which annual changes in the amount of resources made available would have less impact on program objectives.

This is similar to the approach taken when the Defined Benefit Supplement (DBS) Program was first established. In 2000, the DB Program had an actuarial surplus, and therefore, DB Program contributions were higher than necessary to fully fund the DB Program. One option considered by the Legislature was to reduce the member's contribution to CalSTRS by 2 percent for 10 years, from 8 percent to 6 percent, to provide contribution relief for the member. It was hoped that members might use these available resources to supplement their retirement savings in 403(b) plans. It was recognized, however, that in 10 years the contribution rate for the DB Program would have to return to its prior level. To the extent that members had used that available resource for other purposes that had an ongoing impact, increasing the member's contribution by another two percentage points would have been disruptive. As a result, the DBS Program was established to maintain the total amount contributed by the member to CalSTRS, but provide a vehicle for members to generate supplemental retirement savings. Once the 10 year contribution period ended for DBS, the members would continue to contribute to CalSTRS the same total amount they had been contributing, but they would now have additional retirement resources.

An example of how this approach could be applied to varying employer rates would be use the unneeded pension contribution to amortize any unfunded retiree health benefit liability. If, for example, an employer had an unfunded actuarial obligation for its retiree health equal to 2 percent of pay, any decrease in its pension contribution could be offset by an increase in its retiree health care contribution. The total amount paid by the employer would remain the same; the trade-off would be between applying the money to overfund its pension obligations and beginning to address its health benefit obligation. The automatic contribution to retiree health care would be a minimum required contribution; employers could put additional amounts into its retiree health contributions in order to amortize the unfunded obligation over a specific period of time. If the employer had no unfunded retiree health obligation, or its obligation was being funded over a reasonable period of time, the unneeded pension obligation could be credited to fund health benefit accounts for use by current employees when they retire, to provide a tax-free source of funds to pay health care premiums, co-pays and other health care expenses in retirement. The current work plan for the Benefits and Services Committee indicates that a presentation on such health benefit savings accounts will be provided in February.

SUMMARY OF RECOMMENDATIONS

Staff recommends the Board sponsor legislation that

1. **Benefit changes.** Deletes the existing provision of the annual two percent benefit adjustment that permits the Legislature to reduce or eliminate the adjustment, effectively providing a statutory guarantee of the benefit.
2. **Member contributions.** Increases contribution rates paid by all active members by ½ percent, to 8.5 percent, effective July 1, 2009.
3. **General Fund contributions.** Increases the General Fund spending related to retirement contributions in an amount equivalent to about 1 to 1.25 percent of compensation paid two fiscal years earlier. That amount could be paid either as a direct contribution to CalSTRS, or in the form of increased General Fund assistance to education with a corresponding increase in employer contributions.
4. **Employer contributions.** Authorizes the Board to establish an employer contribution rate by plan amendment within a range specified in statute, with any increase becoming effective on July 1 of the year following the adoption of the plan amendment, with the first increase becoming effective on July 1, 2009, and the increase in any one fiscal year not exceeding ½ percent, such that the DB Program is projected to be 100 percent funded within 30 years of the plan amendment. The employer contribution rate could not fall below the current 8.25 percent. The maximum contribution rate would depend on how an increased General Fund spending related to retirement contributions is resolved, but would range from 13 percent and 14.25 percent. Based on the June 30, 2005 actuarial valuation, under current assumptions, the employer contribution would equal about 12 percent to 13.25 percent once fully implemented. Employers would be permitted to determine whether they want to pay that increased contribution directly to CalSTRS, or remit the present value of the increased contribution to CalSTRS, financed from a pension obligation bond issued by the employer, presumably at a lower effective interest rate.
5. **Contributions for post-retirement employment.** Imposes contributions on employers for all post-retirement employment, whether as an employee, independent contractor or employee of a third-party contractor.
6. **Contributions for health care.** Provides that any decrease in the employer contribution rate needed to achieve full funding of the DB Program from the levels in effect at the time such a determination is made be offset by an increase in the employer contribution rate for retiree health care. This increase could be used to amortize unfunded obligations associated with the employer's retiree health benefits program or to fund health benefit savings accounts.

Finally, if the Board wishes to continue the eligibility for the Longevity Bonus beyond the existing requirement that the member have at least 30 years of service credit by 2011, staff recommends the Board sponsor legislation to accomplish this, including an additional increase in member contribution rates of 1/2 percent each year for two years (to a total of 9.5 percent) beginning on July 1, 2010.

If these recommendations are adopted, the one remaining issue to be addressed is how the increased contributions are allocated between the General Fund and the employer, and how any increased General Fund payment is actually paid. These are issues that are of greater concern to the state and other stakeholders, and would be of less concern to the Board. Nonetheless, it is an important issue that needs to be resolved as execution of the strategy moves forward in the Legislature.