

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Analysis of Budget Proposal on Contributions to
CalSTRS

ITEM NUMBER: 4

ATTACHMENT(S): 0

ACTION: X

MEETING DATE: February 3, 2005

INFORMATION:

PRESENTER: Ed Derman

On January 10, the Governor submitted his proposed budget for the 2005-06 fiscal year. As part of that budget, he proposed significant changes in the responsibility for making contributions to CalSTRS for the Defined Benefit (DB) and Defined Benefit Supplement (DBS) programs. Staff has not seen the specific statutory provisions of this proposal at this time, but expect to receive such provisions before the Board meeting. Consequently, this analysis is based on staff's understanding of the proposal based on discussions with the Department of Finance. We will highlight any substantive changes to our understanding at the meeting.

CURRENT AND HISTORICAL FUNDING OF THE DB AND DBS PROGRAMS

All full-time and most part-time educators are members of the DB and the DBS programs. The DB Program provides a monthly benefit to members at retirement or when they become disabled, and also provide benefits to survivors of members who die. Retirement benefits are based on the member's age, service credit and final compensation at retirement. In addition, such members also participate in the DBS Program, which provides a supplemental benefit based on the amount contributed into the member's DBS account and interest credited to that account. That benefit can be paid either as a lump sum, or a monthly annuity if there is at least \$3,500 in the account, or a combination of the two.

The DB Program benefit is funded from three sources:

- The member contributes 6 percent of the compensation paid for creditable service, up to 1.000 years of service credit in a school year through 2010. Beginning in 2011, the member contributes 8 percent of his or her compensation to the DB Program.
- The employer contributes 8.25 percent of the compensation paid for creditable service for any service up to 1.000 years of service credit in a school year. In addition, 0.25 percent of the 8.25 percent contributed by the employer for creditable service for any service in excess of 1.000 years of service credit in a school year or for compensation paid for a limited period of time is credited to the DB Program.
- The state has made contributions for CalSTRS since 1915, when the retirement system began. The state General Fund now pays 2.017 percent of the compensation paid for creditable service, up to 1.000 years of service credit, from two fiscal years ago, plus 0.524 percent of that same prior compensation if there is either an unfunded actuarial obligation or a normal cost

deficit associated with benefits in effect on July 1, 1990, for a potential total contribution rate of 2.561 percent. (The General Fund also contributes 2.5 percent on that same prior payroll for purchasing power benefits. That contribution is not affected by this proposal, and is not referred to in the balance of this analysis.) The total General Fund contribution to the DB Program for 2005-06 would be \$469 million, plus an additional \$120 million if there continues to be an unfunded actuarial obligation or a normal cost deficit associated with benefits in effect on July 1, 1990.

The DBS Program is funded from two sources:

- The member contributes 2 percent of the compensation paid for creditable service, up to 1.000 years of service credit in a school year, through 2010. In addition, the member contributes 8 percent of compensation for service in excess of 1.000 years of service credit in a school year or for compensation paid for a limited period of time.
- The employer contributes 8 percent of the compensation paid for creditable service for any service in excess of 1.000 years of service credit in a school year or for compensation paid for a limited period of time.

The General Fund makes no contributions to DBS.

In 2000, the current and projected resources available to the DB Program were greater than the current and projected liabilities of that program. During the summer of 2000, legislators developed a proposal to temporarily reduce the member's contribution to the DB Program. In order to avoid an adverse financial impact to members when that reduction ended in 2010, caused by a reduction in the member's take-home pay when contributions to CalSTRS increased to their prior levels, the DBS Program was created in Chapter 74, Statutes of 2000 (AB 1509—Machado). Under Chapter 74, the member's DBS Account was credited with the reduced DB contribution. Consequently, when the reduced DB contribution ended in 2010, there would be no change in the total contributions being taken from the member's pay. Member organizations did not take a position on that proposal.

Later that same year, a package of other benefit enhancements was approved by the Legislature that further utilized DB Program resources in excess of projected liabilities. At the same time, legislation was enacted which permanently reduced the General Fund contribution to the DB Program, effectively to the current contribution rate. Prior to 1998, the General Fund was contributing 4.3 percent of creditable compensation to the DB Program. That contribution would have continued at that rate until such time as the DB Program was fully funded. At that time, the General Fund contribution would decline by 0.25 percent per year until there was no remaining General Fund contribution. That would take 17 years. In 1998, legislation was enacted to immediately reduce the General Fund contribution to 3.102 percent. That rate was further reduced in 2000, to the current level of 2.107 percent. Those reductions have saved the General Fund a total of almost \$2.7 billion in contributions through 2004-05 that otherwise would have been paid to CalSTRS.

BUDGET PROPOSAL

Under the Governor's Budget, the current 2.017 percent General Fund contribution to the DB Program and the 0.524 percent contribution rate credit to the DB Program when there is an unfunded actuarial obligation or a normal cost deficit from the July 1, 1990 benefit plan would be eliminated in 2005-06, and an additional 2 percent contribution to the DB Program would be imposed at the local level. The impact of this shift on employer and member contributions, and future member benefits, would depend on the outcome of negotiations between employers and employee organizations, and decisions made by individual members.

- The employer could take no additional action, in which case the contributions paid by the employer would increase by 2 percent, from 8.25 percent to 10.25 percent.
- The employer and the employee organization could instead agree that the member contribution to CalSTRS would increase by 2 percent, from 8 percent to 10 percent. According to the Department of Finance, there is no explicit limitation in the ability of the employer and the employee organization to divide up that 2 percent contribution rate.

In addition, regardless of the outcome of any negotiations between the employer and the employee organizations about the payment of the 2 percent increased contribution, individual members could decide not to have 2 percent of their contributions credited to DBS. Under that circumstance, if the members were going to be paying the entire 2 percent increased contribution, a member's contribution to CalSTRS would remain at the current 8 percent, but all of it would be credited to the DB Program, with none of those contributions being credited to the DBS Program. After 2010, when the 2 percent contribution to DBS would have ended under current law, that member's contribution to CalSTRS would increase to 10 percent, all of it credited to the DB Program. Alternatively, if the employer was going to be paying the entire 2 percent increased contribution, the member's contribution would decline to 6 percent through 2010, when it would increase back to 8 percent.

ANALYSIS OF THE PROPOSAL

This proposal potentially affects the funding of the DB Program, plus existing contractual rights of members and their future retirement benefits. It also poses significant administrative burdens on employers, county offices of education and CalSTRS.

DB Program Funding. Under the proposal, the existing General Fund contribution is eliminated and replaced by an increase in the contributions paid either by the employer or its employees. As indicated earlier, the current General Fund contribution is 2.541 of the creditable compensation paid two fiscal years ago, including the amount needed to address the unfunded actuarial obligation for the 1990 benefit plan. Because that percentage is applied against a smaller compensation base, preliminary estimates indicate that it is the equivalent of 2.339 percent of the current payroll. On the other hand, when members terminate service with the DB Program, they generally receive refunds of their contributions. Consequently, based on actuarial assumptions

adopted by the Board in 2004, a 2 percent increase in member contributions is equivalent to a 1.936 percent increase in contributions. As a result, the net impact on the DB Program of this proposed shift depends on whether there is an unfunded actuarial obligation or normal cost deficit associated with the 1990 benefits, and how the 2 percent increased contribution is allocated statewide between employer and members, as summarized in the following table.

	General Fund	Employer Pays	Member Pays
Ongoing DB Program	(1.857%)	2.000%	1.936%
1990 benefits (if needed)	(0.482%)	0.000%	0.000%
Total	(2.339%)	2.000	1.936%
Net DB Program Gain (Loss)			
No unfunded liability on 1990 benefits		0.143%	0.079%
Unfunded liability on 1990 benefits		(0.339%)	(0.403%)

The table indicates that, depending on the funding status of the 1990 benefit structure and how the 2 percent contribution shift to the local level was ultimately divided statewide between employers and members, preliminary estimates indicate that the DB Program would realize a net change in contributions ranging from a reduction of 0.403 percent to an increase of 0.143 percent.

Member Contractual Rights. Public employees who perform service with a governmental employer earn vested rights to the applicable pension benefits for the performance of that service. Under the contract clauses of both the United States and the California Constitutions, these rights cannot be impaired. Specifically, it is staff’s view that the benefits of the existing State Teachers’ Retirement Plan, which consists of both the DB Program and DBS Program as well as the Cash Balance Benefit Program, including the right to accrue benefits from future service and compensation, cannot be reduced for current members, without an offsetting benefit. Staff is of the further view that because there are no provisions in current law that would allow a change in the contribution rate paid by existing members, such members have a similar contractual right to the current contribution level that would prohibit increasing the contribution rate they pay.

As a result, increasing the contribution rate paid by members to the DB Program from 8 percent to 10 percent, as could occur under this proposal, may not be permissible, even if the employee organizations negotiate the increase, unless the members receive some offsetting benefit. It isn't apparent in the proposal what the offsetting benefit to the member would be. Similarly, it isn't clear that a member can be permitted to reduce contributions to his or her DBS account because those reduced contributions are reducing the accrual of DBS benefits.

Impacts on Future Benefits. Even if it is legal to permit a member to reduce his or her contributions to DBS, the result is a lower DBS benefit when the member retires, becomes disabled or dies. Regardless of the legality of this choice, it becomes what is often referred to as a Hobson's choice; the member has to decide whether to experience a reduction in take-home pay or a reduction in future benefits. On the other hand, the contribution rate paid for compensation that is subject to being credited to DBS from service in excess of 1.000 year of service credit or from limited term compensation also will increase by 2 percent. This is because DBS contributions for such compensation are paid by the employer and member, not the General Fund, and the total contribution rate paid by the member and employer for any compensation creditable to CalSTRS is increasing by 2 percent. As a result, members who earn such compensation will see an increase in DBS contributions, which would at least partially offset the decrease in DBS contributions if they elect not to have the existing 2 percent contribution made to their account.

Administrative Impacts. Regardless of any negotiations between employers and employee organizations, employers and CalSTRS will have to make a change in their reporting systems to implement this proposal. If none of the districts negotiate shifting this increased contribution rate to employees, the change is comparatively small; local systems and the CalSTRS corporate database (START) will have to be modified to report a 10.25 percent employer rate, rather than the current 8.25 percent rate. If any employers are able to shift this rate increase to employees, however, the implementation becomes much more complex. Currently, CalSTRS systems are designed under the current funding method in which all creditable compensation is subject to the contribution rate paid by employers and members is the same statewide, regardless of who employs the member. If some employers negotiate a shift in the increased contribution and some do not, START will have to be modified to validate different contribution rates for different employers. This would be made even more complicated if employers and employee organizations divide up the responsibility for paying the 2 percent contribution rate increase. In most cases, district contributions are reported through the county office of education. Different employers within the same county may end up with different member and employer contribution rates. In that case, the county office systems also will have to be able to accept varying contribution rates.

Finally, if members are facing higher DB contribution rates, individual members may elect not to have contributions credited to their DBS accounts. Under that circumstance, each affected district, county office and START will have to be able to report different total contributions rates for different members with a single employer, and START will have to be able to properly

allocate the contribution between DB and DBS, depending on how the individual employees chose.

Moreover, the communications implications of these choices will be significant. CalSTRS will likely be asked to assist individual members in determining the impact of electing not to continue to make contributions to their DBS accounts, in order for the member to make an informed choice. Clearly, efforts by the Board to simplify the existing retirement plan would be undermined by this proposal.

STAFF RECOMMENDATION

If the budget proposal simply shifted the current General Fund contribution to the employer, the proposal would have an adverse impact on district budgets. However, this proposal also raises serious legal issues concerning the funding of the DB Program, contractual rights of members, potential reductions in their future benefits, potentially major administrative burdens on employers and CalSTRS, and significant complications in communication of the plan to members. Under its legislative policy, the Board opposes legislation that, among other things, adversely affects the actuarial balance of the funds administered by CalSTRS, deprives members or participants of vested benefits and does not provide equivalent, compensating benefits, and conflicts with the strategic directions established by the Board. This proposal potentially does all three. As a result, staff recommends the Board oppose this proposal.