

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

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SUBJECT: Analysis of Mandatory Defined Contribution  
Pension Plan for Future Public Educators

ITEM NUMBER: 5

ATTACHMENT(S): 0

ACTION: X

MEETING DATE: February 3, 2005

INFORMATION:     

PRESENTER: Ed Derman

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**EXECUTIVE SUMMARY**

There currently are three proposals, each of which would require voter approval to amend the California Constitution, to (1) prohibit all non-federal public employees in California hired on or after July 1, 2007 from enrolling in a defined benefit plan, (2) permit enrollment in an employer-sponsored defined contribution (DC) retirement plan, and (3) allow current public employees to rescind membership in their existing defined benefit retirement plan by transferring assets to the new DC plan. All would establish maximum employer contribution rates and allow employers to select their DC plan provider.

The first proposal, **ACA 5 (Richman)** was introduced December 6, 2004, the opening day of the Legislature's 2005-2006 Regular Session. The second proposal, **ACA 1X**, also by Assembly Member Richman and sponsored by Governor Schwarzenegger, was introduced January 6, 2005, the opening day of the First Extraordinary Session of the 2005-2006 Legislature. Finally, the Howard Jarvis Taxpayers Association, in conjunction with Assembly Member Richman, presented "**The Fair and Fiscally Responsible Public Employee Retirement Act**" to the Attorney General for title and summary on January 5, 2005. This represents the first step in moving a proposed ballot initiative through the official process of drafting, analysis, signature qualification, and voter approval.

Although the retirement plan-related text of Assembly Member Richman's two legislative proposals are substantively the same, the provisions of the proposed ballot initiative are more detailed and provide a better understanding of the sponsors' intent. All three proposals affect certificated employees in school districts, community college districts, and county offices of education who are members of the California State Teachers' Retirement System's (CalSTRS) Defined Benefit and Cash Balance Benefit programs. Assembly Member Richman has indicated he intends to introduce legislation designed to provide the detailed statutory provisions necessary to implement these proposed constitutional amendments. While such legislation may be introduced either before or after voter approval, the provisions of and concepts surrounding these proposed constitutional amendments are examined in greater detail in this item.

## **BACKGROUND**

CalSTRS administers the State Teachers' Retirement Plan, a federally tax-qualified defined benefit plan that consists of the CalSTRS Defined Benefit (DB), Defined Benefit Supplement (DBS), and the Cash Balance Benefit (CB) programs. These programs provide guaranteed retirement, disability and survivor benefits to California's public school teachers from kindergarten through community college, serving more than 750,000 members and their families. In addition, CalSTRS is the third-largest public pension fund in the United States, with a current market value of \$125 billion. The Board applies strict guidelines for investing these assets, including standards of safety, diversification and liquidity, in order to protect the Teachers' Retirement Fund and the benefits of CalSTRS members.

Benefit Structure. The retirement benefit provided by the DB Program is determined by a formula based on the age, years of service and final compensation of the member at retirement. Enhancements are provided, in the form of an increase in the age factor and a dollar increase in the monthly benefit, for members who retire with 30 or more years of service. Disability benefits are also provided by the program, equal to 50 percent of final compensation, plus an additional 10 percent per eligible dependent child, up to a total of 90 percent. Finally, survivor benefits are paid to the eligible surviving family or other beneficiaries of members who die either before or after retirement. Monthly benefits are increased by 2 percent of the original benefit each year, and an additional benefit is paid quarterly if the purchasing power of the current benefit is less than 80 percent of the value of the original benefit. The average benefit paid to a member retiring in 2003-04 was \$3,606 per month.

DB members also receive DBS benefits at retirement, death or disability to supplement the DB benefit. The DBS Program is a hybrid plan, combining features of a defined contribution plan and a defined benefit plan. Similar to a defined contribution plan, the DBS benefit is determined by the amount contributed to the member's account, plus interest credited on those contributions. Like the DB Program, however, the benefit is guaranteed, regardless of any downturns in the market. Benefits can be paid as a lump sum or, if the member has at least \$3,500 in the account, a monthly annuity, or both. In 2003-04, the average DBS account balance at retirement was \$5,331. For those with sufficient balances to have elected an annuity, the average monthly annuity was \$102.

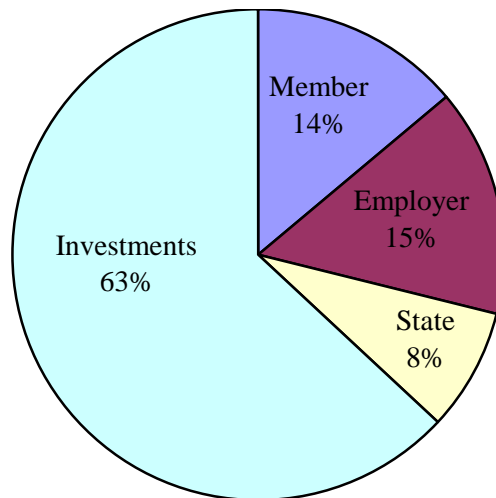
The CB Program is an alternative program available to part-time educators who work for districts offering the program. Participation in this program is in lieu of participation in the DB Program. The design of the CB Program is identical to the DBS Program, although the amount contributed to CB is different. In 2003-04, the average lump-sum benefit paid was about \$2,000, and the average monthly annuity paid to the 3 people who elected a CB annuity in 2003-04 was \$134.

CalSTRS members do not participate in Social Security. Consequently, the benefits provided by CalSTRS are the only benefits available to public school educators from their public service. In

fact, due to provisions of federal law, Social Security benefits that CalSTRS members might otherwise receive from other employment or through their spouse may be reduced because they receive a CalSTRS benefit.

Benefit Program Funding. The DB Program is funded from three sources. The General Fund generally contributes 2.017 percent of the total creditable payroll from two fiscal years ago, plus an additional 2.5 percent of that same payroll for the purchasing power benefit. Employers pay a contribution rate of 8.25 percent of the member’s pay, and the member pays a contribution rate of 8 percent. The income received by CalSTRS from 1990-91 through 2003-04 from contributions and investment earnings during that period was distributed as follows:

**Distribution of DB Program Sources of Assets  
1990-91 through 2003-04**



The chart indicates that, during that time period, contributions from public agencies represented only 23 percent of the resources made available to the DB Program. The balance of the resources came either from member contributions or investment earnings.

The DBS Program is funded from contributions made by the member and employer, but not the General Fund. The member contributes 2 percent of compensation paid for service, up to 1.000 year of service in a school year. This contribution expires in 2010. In addition, if the member works in excess of 1.000 year in a school year, or earns compensation that is paid a limited number of times, contributions paid by the member and the employer on that compensation also is credited to the member’s DBS account.

Participants in CB generally contribute 4 percent of compensation to their CB account. The employer generally contributes an additional 4 percent of compensation. The General Fund does not contribute to the CB Program.

## **DESCRIPTION OF PROPOSALS**

The three proposals

- Permit anyone hired on or after July 1, 2007 as a new employee of a state or local government agency, including a school or community college district, to enroll only in a defined contribution plan as their primary employer-sponsored retirement program; and prohibit enrollment in any defined benefit retirement plan, such as the CalSTRS DB or CB programs.
- Allow members of defined benefit, retirement plans such as the CalSTRS programs, to switch to the new defined contribution plan offered by their employer during a six-month period beginning July 1, 2007. The employee would transfer the “net present value of that member’s interest in the defined benefit plan” to the newly-established defined contribution plan, thereby giving up all rights to retirement, disability and survivor benefits earned through their existing retirement program.
- Authorize government employers to establish their own defined contribution plans, and permit them to outsource administration of the plans and investment of plan assets to private sector financial companies.

In addition, under the initiative, the maximum employer contribution could not exceed 3 percent of salary unless the employee contributed an amount equal to at least 50 percent of the employer contribution. The maximum employer contribution for educators, assuming employee matches, could not exceed 9 percent, if educators remained out of Social Security. If educators began to participate in Social Security, the maximum contribution could not exceed 6 percent. Employees could make additional unmatched contributions up to the federally-allowed limits. Contributions could only be made on base salary, excluding overtime, sick leave and vacation pay. These limits could be increased by a vote of 2/3 of the local voters.

## **EXPERIENCES WITH OTHER PUBLIC PLANS**

These measures are not the first instance in which establishing a DC plan for public employees has been proposed. Unlike these proposals, which eliminate the defined benefit option for new employees, most have made that a choice of the employee. One exception is Michigan. In Michigan, those hired on or after March 31, 1997 must participate in a 401(k) plan in lieu of a defined plan. Those who were hired before that date could elect to terminate their participation in the defined benefit plan and transfer to the 401(k) plan during a four month window in 1996. Only six percent of the members of the Michigan defined benefit plan elected to transfer to the DC plan.

The State Teachers’ Retirement System of Ohio provides a choice among a defined benefit plan, a DC plan and a combined plan to educators who are hired on or after July 1, 2001. In each plan,

the member contributes 10 percent of salary and the employer contributes 14 percent (3.5 percent of the employer contribution for DC plan participants is used to amortize the unfunded actuarial obligation of the defined benefit plan.). The defined benefit plan and the DC plan each offer a benefit structure that is comparable to other defined benefit plan and DC plans, respectively. The member's contribution to the combined plan funds a reduced defined benefit, while the employer's contribution (net of the unfunded actuarial obligation contribution) is credited to a DC plan. Of the existing members, less than three percent opted into the DC plan. Less than seven percent of the new employees have elected the DC plan.

In Florida, current public employees were given the option of continuing in the existing defined benefit plan or enrolling in a DC plan. Future employees are given a similar choice when hired. The state expected 25 to 30 percent of the employees to enroll in the DC plan. Instead, only four percent of current employees and, in 2004, 18 percent of new employees elected to join the DC plan in lieu of the defined benefit plan.

This isn't even the first DC plan proposal made in California. AB 3252 (Kaloogian) was introduced in 1996 to establish a Public Employees' Defined Contribution Retirement Plan for state and local public agency employees whose employers elected to participate in the plan, and permitted current and future state and public employees to voluntarily and irrevocably elect into the plan. The plan would have been funded by employer and employee contributions negotiated between employers and employees. That bill failed in the Senate.

## **ANALYSIS OF PROPOSALS**

### **Responses to Arguments Put Forward for the Proposals**

Supporters of mandatory DC plans for new public employees identify a number of reasons why defined benefit plans should no longer be available to public employees and why such plans should be replaced with defined contribution plans. The contrast between the arguments put forth by proponents and the experience at CalSTRS, however, can be summarized by this quote from Rebecca Taylor at a symposium convened by CalSTRS after a similar proposal to establish a DC plan for public employees failed in 1996. At the time, Ms. Taylor was Senior Vice-President of the California Taxpayers Association (Cal-Tax), which now supports ACA 5

“Defined contribution plans for [Cal]STRS must be reviewed within the unique circumstances that apply to teachers' retirement. To begin with, regular teaching is not covered for Social Security purposes. Thus the 2 percent at 60 program, whose normal cost to taxpayers is slightly over 8 percent of salary, is clearly in line with retirement expenditures in the private sector, where according to the U.S. Chamber of Commerce, employer retirement contributions average 7.2 percent of payroll. (This number includes expenditures for defined benefit programs, as well as defined contribution plans such as 401 K plans.)”

“This means that the Cal-Tax argument about excessive pensions in the public sector does not apply to [Cal]STRS’ benefits, since taxpayers are not funding a full and generous benefit on top of Social Security. I am always reminded of this argument when I compare retirement benefits for classified employees with those for certificated employees. In both cases, there is a 2 percent at 60 formula. [Note: This has now changed for classified employees to a 2 percent at 55 formula.] In the case of classified employees, this is additive to taxpayer-financed Social Security benefits; in the case of teachers, it is not.”

“The second point of major consideration is the fixed nature of employer contributions. Unlike most other systems in the state, [Cal]STRS’ contribution rates do not fluctuate. This means that the actuarial “surprise” that characterizes so many defined benefit plans is not in the future of the teachers’ system. By surprise, I am referring to the change in contribution rates that is visited upon public agencies when actuaries determine that contribution rates must be increased, which could occur for a host of reasons. [Cal]STRS has been spared that experience.

As discussed in more detail below, the distinctions that Cal-Tax drew between CalSTRS and other public pension plans in 1996 still apply.

Proponents’ argument #1—Defined benefit plans are disappearing in the private sector. CalSTRS and other significant public pension systems have very large memberships—more than 750,000 in the case of CalSTRS. Most of the decline in the number of private sector defined benefit plans has occurred among employers who employ fewer than 250 employees. A significant reason for this reduction in small company defined benefit plans is that private sector defined benefit plans are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA), and the cost of complying with those regulations can be burdensome. Public sector defined benefit plans are not subject to ERISA. Moreover, changes in federal law during the 1980’s reduced or eliminated incentives for private sector employers to offer defined benefit plans, and increased the cost and liability associated with maintaining a defined benefit plan. Much of the reduction in the number of private sector defined benefit plans occurred shortly after the federal law changes were enacted. Nonetheless, a 2002 survey by Watson Wyatt of the Fortune 100 companies found that 50 percent of the companies offered a defined benefit plan as their primary retirement plan option, while only 17 percent offered a DC plan as their primary retirement plan. The rest of the companies offered a cash balance plan, which is a hybrid plan that offers guaranteed benefits.

Recent news reports discuss the efforts by United Airlines and others to discontinue their defined benefit plans. The result of these efforts, if successful, would not so much discontinue the defined benefit pension as shift the responsibility for funding those benefits to the Pension Guaranty Benefit Corporation, a federal agency that insures pension plans subject to ERISA.

Proponents’ argument #2— Benefits paid by public defined benefit plans have become excessive. Proponents refer to benefits in other plans that provide retirement benefits that equal 3

percent of final compensation per year of service at age 60 for some local public employees or 3 percent at 55 for police and firefighter personnel. The CalSTRS DB Program, however, has a different benefit structure. The DB Program continues to pay 2 percent at age 60, but benefit enhancements enacted in 1998 increased the age factor for those who retired after age 60 to 2.4 percent at age 63. There were no increases in the age factor for members who retired before age 60. In fact, every significant benefit enhancement enacted by the Legislature and approved by Governors of both parties in 1998 and 2000 had as a primary state objective an incentive to retain qualified educators. These enhancements become available only to members who work a full career as an educator, generally 30 years, or who perform additional service. Such members receive an increase in their age factor, longevity bonuses, an increase in the calculation of their final compensation, and increased opportunities to supplement their retirement benefit through the DBS Program.

A key measure of the value of a retirement benefit is the percentage of income that is replaced by the retirement benefit. Analyses by CalSTRS indicate that if 81 percent to 88 percent of a member's employment income was paid to the member in retirement, the member could maintain in retirement the standard of living he or she experienced while employed, assuming the member continued to receive other benefits, particularly health benefits, that were received while working. The current CalSTRS service retirement benefit, excluding the impact of DBS account balances and additional savings, currently is sufficient to meet the target replacement ratio for members retiring with 32 or more years of service. Although career members who retire with many years of service can receive a benefit equal to well over 80 percent of their final salary in the DB Program, the average unmodified benefit paid to a member retiring today equals 65 percent of that member's final compensation, which is hardly an excessive percentage.

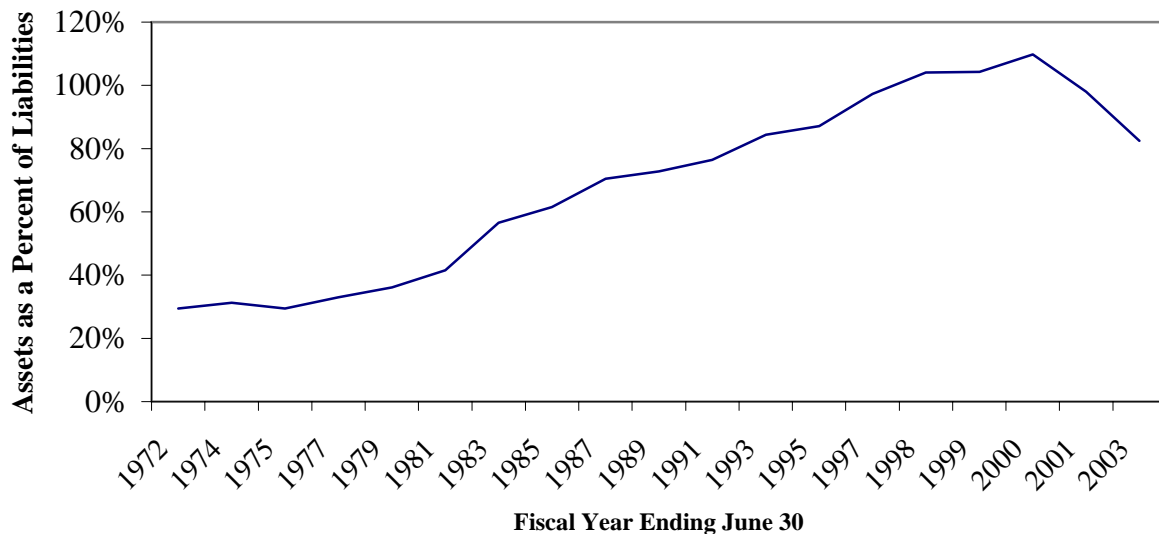
Proponents' argument #3—Defined benefit costs have become a burden to employers. In many public pension plans in California, the retirement board has the authority to set the contribution rate paid by the employer. As a result, many pension plans significantly reduced, if not eliminated the employer contribution rate in the late 1990's and early 2000's when investment returns increased the funding level of their plans. Since the plans experienced substantial investment losses earlier this decade, which have eliminated actuarial surpluses, they are significantly increasing the employer contribution, just as public agency budgets are being adversely affected by reduced revenues. For example, the state contribution for CalPERS for state miscellaneous employees declined from 13.106 percent in 1995-96 to no contribution in 2000-01 to an increase to 17.022 percent in 2004-05. Similar variations have been seen in other plans.

In contrast, the contributions paid to the DB Program by the employer and the General Fund are fixed in statute. Any changes in contributions must be approved by the Legislature and the Governor; the Board has no authority to set rates. As a result, the contribution rate paid by the employer has remained at 8.25 percent since 1990, when the state shifted a state cost to the program to the district by increasing the employer contribution rate by 0.25 percent. In addition, the General Fund contribution has gone down from prior levels. The General Fund contribution

rate in the early 1990's was 4.3 percent of the compensation paid in the prior calendar year. The current General Fund contribution rate is only 2.017 percent of the compensation paid two fiscal years ago. This reduction in General Fund contributions will have saved the General Fund a total of almost \$2.7 billion through 2004-05 from the levels it would have paid if the rate reductions had not been enacted in 1998 and 2000 in return for the benefit enhancements discussed earlier.

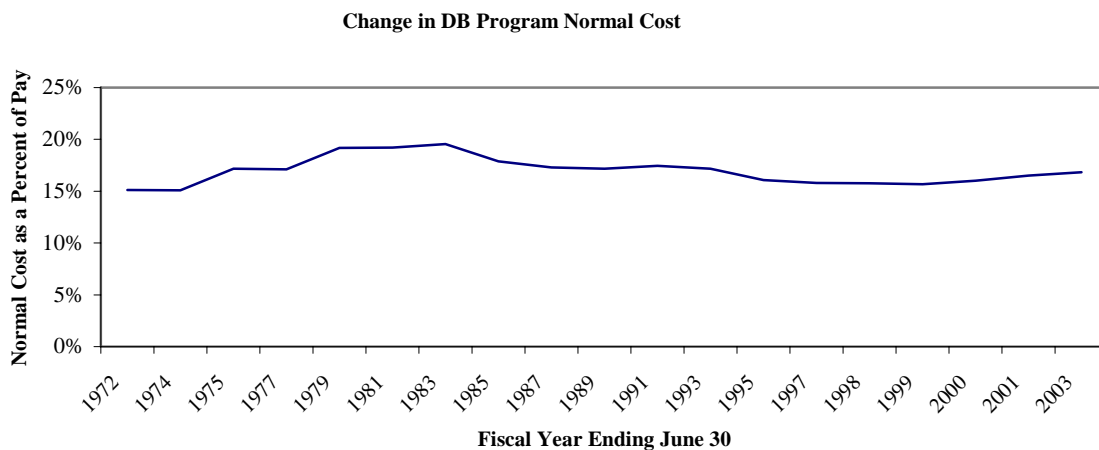
Proponents' argument #4—Defined benefit plan financing is collapsing. The funding status of defined benefit programs has diminished with the major downturns in the investment markets. Moreover, despite recent increases in investment earnings, this funding status may continue to decline for a couple of more years as systems recognize losses from prior years through their asset smoothing method. CalSTRS benefit programs are no different. As indicated in the chart below, the funding status of the DB Program has declined from a high of 109.8 percent in 1999-2000 to 82.5 percent in 2002-03. Nonetheless, although some changes need to be made in the program benefit structure and/or financing to address this deficiency, the DB Program funding status is better than the status of the program as recently as 1990-91. Moreover, in contrast to the major increases in contributions required to address funding deficiencies in other retirement plans, such as the increase from 0 percent to 17 percent at CalPERS discussed earlier, the unfunded actuarial obligation in the DB Program would be eliminated if total contributions increased 4.438 percent.

**Change in DB Program Funding Status**



Not only has the funding status of the DB Program not collapsed, but the costs of the program have not increased substantially, despite the increase in benefits. The chart below shows the relatively steady normal cost of the program. The normal cost, expressed as a percentage of pay, represents the cost associated with an average member's increased benefit over the member's

career. This steadiness reflects the fact that the increase in liabilities associated with benefit enhancements have been offset by other beneficial changes in economic and demographic conditions, particularly the decreased rate of inflation over time.



Proponents’ argument #5—Defined benefit programs are experiencing abuses in disability benefits. Several articles have appeared in newspapers about perceived abuses in disability programs, particularly those plans that cover safety employees. In some public plans, the rate of industrial disability retirements, which often result in benefits that are at least partially tax-free, may approach or exceed the rate of service retirements. No such systemic problem exists in the DB Program. According to the June 30, 2003 actuarial valuation of the DB Program, the percentage of program liabilities associated with current and future disability benefits is only 2.3 percent of the present value of all DB Program costs.

Proponents’ argument #6—DC plans can provide as much in retirement as defined benefit plans. The retirement benefits provided by the DB Program are guaranteed and based on a formula that reflects the age at retirement, years of service and final salary. In contrast, the benefits provided by a DC plan are entirely dependent on how much was contributed to an account and, more importantly, how successful the participants are in investing their account balances. In contrast to the DB Program, in which the assets are invested by professionals whose sole responsibility is to manage those assets, a DC plan is managed by the individual member who, in the case of CalSTRS, has a primary responsibility for educating students. Moreover, in a defined benefit plan, the risk associated with investing assets is pooled across the entire plan; because the benefit is guaranteed, the entire plan bears the risk of not meeting investment objectives. In contrast, each individual DC plan participant assumes the entire risk; if the market is down at the time of retirement, the benefit is adversely affected.

Generally, employees who manage their own retirement assets are too conservative in their asset allocation choices, investing in stable value and other fixed income assets, rather than equity

assets, which generate greater returns. As a result, the investment returns realized in a DC plan will likely be less than the return realized in a DB plan. As an example, the State of Nebraska formerly required their employees to participate in a DC plan. (Beginning in 2003, new employees participate in a cash balance plan, which, like CalSTRS' DBS and CB programs, is a hybrid plan.) A study conducted in 2000 for the Nebraska system determined that from 1983 through 1999, employees in their mandatory DC plan posted an average investment return of 6 percent, while the professional managers of their older defined benefit plans earned 11 percent. Other studies have indicated a smaller spread between DC investment returns and defined benefit investment returns, but still generally show that the investment returns of a defined benefit plan will be greater than a DC plan. Even a 2 percent difference in the annual rate of return can reduce the amount available at retirement by 40 percent or more over a 30 year career.

An additional reason why the proposed DC plan would likely not pay a higher benefit than the current CalSTRS programs is the fact that, under the proposals, only the base contract salary and not overtime is subject to employer DC plan contributions. This limitation ignores the significant amount of service that CalSTRS members perform that exceeds their base contract, such as teaching summer school and intersession and assisting students in after-school activities. Under the current CalSTRS benefit structure, compensation performed in excess of 1.000 years of service in a school year, which would be earned if a member fulfilled his or her full-time contract and taught summer school, for example, would be credited to DBS. If a teacher fails to fulfill the entire contract, that additional service can be used to bring the total service credit for the school year to the 1.000 year maximum service credit authorized. If any compensation earned outside the base contract is not subject to an employer contribution under these proposals, then the benefit payable to the educator will be further reduced as compared to the current benefit structure.

One final difference between defined benefit and DC plans is the disposition of assets at retirement. In a defined benefit plan, the participant receives a monthly benefit that is paid for life, or additional lives if a joint and survivor annuity option is selected. In a DC plan, participants who want to use those assets as retirement income have two choices—the participant can rollover the funds and purchase an immediate annuity to receive a monthly income for life, or the participant can draw down the assets from the account each month. In the first case, the amount of monthly income that would be paid from an immediate annuity is likely to be significantly less than the amount paid from a defined benefit plan. The benefits paid under the CalSTRS DB Program, for example, reflect an assumption that the program will earn 8 percent annually on its investments. In contrast, immediate annuities purchased from private insurance firms are based on a significantly lower assumed interest rate. An online comparison of the amount paid monthly from an actual private immediate annuity versus an annuity based on an 8 percent interest rate indicated that the amount paid by an 8 percent annuity would be over 11 percent higher. If, alternatively, the participant decided to leave his or her assets in the DC account and draw it down on a regular basis, there is the real possibility that the participant could outlive the account assets. That could not happen in the DB Program.

The reduction in disability and survivor benefits paid to active employees or their survivors under a DC plan probably will be even greater than the reduction in retirement benefits. Because these benefits also will depend on the DC account balance at the time of the disability or death, the benefits available to participants or their beneficiaries if the disability or death occurs earlier in the career will be substantially lower. In contrast, the disability and survivor benefits paid under the DB Program can be 40 or 50 percent of the compensation being paid to the member at the time of disability or death, and even more if there are dependent children. A DC plan could not likely provide that level of benefit. Given that CalSTRS members do not participate in Social Security, it is critical that disability and survivor benefits be available to them. If a DC plan was mandated, disability and survivor benefits coverage would have to be provided from outside disability and insurance plans, at additional cost to the member and/or employer.

Proponents' argument #7—DC plans are less costly. Both with respect to the cost of funding a given benefit and administering the benefit program, experience indicates that defined benefit plans are less costly. As indicated above, the value of the DC benefit is entirely dependent on the success of the investments made by the DC participant, and experience indicates that defined benefit investment returns are greater. The cost of administering a defined benefit plan also is less than the cost of administering a DC plan. DC plan assets typically are invested in mutual funds. According to Morningstar, the average expense ratio of a domestic equity fund is 149 basis points, and 114 basis points for a taxable bond fund. This cost does not include other costs of recordkeeping the individual accounts and providing education to participants. In contrast, the total cost of CalSTRS administration, including managing investments and benefit accounts, administering retirement, disability and survivor benefit programs and counseling and educating members is less than 17 basis points.

Proponents' argument #8—DC plans are portable. Tax-qualified DC plans can be rolled over to other tax-qualified plans when the participant terminates service with the employer. Thus, it is argued, DC plans are more suitable for public employees, who have greater mobility than such employees had in the past. Defined benefit plans, however, also have their portability features. Currently, a DB Program member who moves to or from another California public employer can typically have the CalSTRS benefit calculated based on the highest compensation paid by any of the California public employers. In addition, if an educator worked in a public school in another state, terminated his or her employment and his or her membership in that other school's retirement system and became employed in the California public schools, that person could purchase credit for that out-of-state service, using funds from the other retirement system and other assets to pay the cost of that service. Moreover, CalSTRS members aren't as mobile as other employees, either public or private. In 2003-04, the average member retiring from the DB Program had over 27 years of service credit in the program. This contrasts with the less than 20 years for all CalPERS members, including only 16 years for classified school employees.

Finally, encouraging portability is not necessarily desirable. For one, California has a need for qualified teachers, and the DB Program benefit structure, which creates incentives for teachers to work longer in order to earn additional retirement benefits, supports those efforts. In addition,

studies by different consulting groups have found that about two-thirds of employees, including public employees, who terminate their DC plans cash out their accounts rather than roll these funds over to another qualified retirement account. This will severely jeopardize the financial security of the participant when it is time to retire.

There is, however, one significant difference between most DC plans and most defined benefit plans. In both a defined benefit plan and a DC plan, when an employee terminates participation in the plan, the employee generally can withdraw the entire account balance. In most DC plans, however, the account balance includes not only the contributions made by the employee and the associated investment earnings, but also the employer contributions in to the account plus earnings. This is also true with the DBS and CB programs. With some DC plans, the amount of employer contributions that may be withdrawn may be phased in with years of service, such that the longer an employee participates in a plan, the greater the percentage of employer contributions the employee can withdraw. In the DB Program, like most defined benefit plans, the terminating member can only withdraw the member's own prior contributions and credited interest; the employer and General Fund contributions remain in the DB Program.

### **Other Implications of the Proposals**

Enactment of a mandatory DC benefit program will have other implications to existing CalSTRS benefit programs, members and employers.

Impact on CalSTRS investments. If enacted, any of these proposals would reduce future contributions that CalSTRS would otherwise receive. Nonetheless, because a young educator who begins employment before July 1, 2007 may work for 35 years before retiring, name his or her son or daughter as an option beneficiary and live for 30 years, with the beneficiary living for another 30 years, CalSTRS could continue to administer its existing benefit plan for perhaps another 100 years or more. Although CalSTRS will continue its programs for many years, the change in the flow of contributions under these proposals would likely affect the long-term allocation of CalSTRS funds. This is because as members become eligible to receive retirement and other benefits in the future, there will be less contributions coming in to make benefit payments. This is demonstrated by the table below, which compares the projected change in compensation subject to coverage by the DB Program under existing law, with the change under the proposals, based on actuarial assumptions about changes in membership.

**Projected Compensation Subject to Retirement Plan Coverage  
(Dollars in billions)**

	<b>Current DB Program</b>	<b>Closed DB Program</b>	<b>New DC Plan</b>	<b>Percent of Employees in DC Plan</b>
<b>6/30/08</b>	\$30.2	\$29.2	\$0.9	3%
<b>6/30/18</b>	\$45.8	\$30.1	\$15.7	34%
<b>6/30/28</b>	\$69.5	\$25.7	\$43.8	63%
<b>6/30/38</b>	\$105.3	\$11.9	\$93.4	89%

As a result, CalSTRS will likely have to start using invested assets sooner to pay benefits. This need for increased liquidity would reduce the long-term investment return that CalSTRS could anticipate earning from its funds, increasing the cost of the benefit plans.

Addressing current funding deficiency. The June 30, 2003 Actuarial Valuation of the DB Program identified a \$23 billion unfunded actuarial obligation in that program. That obligation could not be amortized given the current benefit and funding structure. At the Board's direction, the staff developed many options for the Board to consider as a means to addressing this deficiency. Among the options identified for the Board at the December 2004 meeting were (1) reductions in benefits to future members, (2) increases in contributions paid by employers, the General Fund or future members, and (3) mechanisms to amortize the deficiency at a lower cost. If future educators would no longer be able to enroll in the DB Program, the options available to the Board, and therefore the Legislature and Governor, to address this deficiency get lowered substantially. If there are no future members, there can be no impact of reducing benefits paid to future members. The only remaining practical alternative to address the deficiency is to increase the contribution rate imposed on either employers or the General Fund. In addition, because current contribution rates by members, employers and the General Fund are slightly higher than the normal cost of benefits accrued by members, that difference in future contributions and future liabilities marginally helps reduce the impact of addressing the deficiency. As a result, the required increase in contributions would have to be that much higher, if there were no future DB Program members.

CalSTRS' consulting actuary has calculated the impact of this proposal on future employer and General Fund contributions, reflecting both the need to amortize the unfunded actuarial obligation and the cost of contributions for future employees, based on the maximum 9 percent employer contribution rate. The actuary estimates that, even assuming no change in the assumed rate of investment return resulting from a more liquid asset allocation, total required employer and General Fund contribution would increase by 3.051 percent of future compensation to reflect the decline in future payroll. This would be expected to increase employer and state contributions by a total of \$833 million for the fiscal year ending June 30, 2008. The following table indicates the cumulative impacts over time.

**Projected Total Employer and General Fund Contribution Payments after July 1, 2007  
 (Dollars in billions)**

	<b>10-year Total</b>	<b>20-year Total</b>	<b>30-year Total</b>	<b>40-year Total</b>
<b>Current DB Program</b>	\$53.0	\$129.9	\$246.6	\$359.5
<b>Proposed Constitutional Amendments</b>				
<b>Closed DB Program</b>	\$53.1	\$101.1	\$136.4	\$145.4
<b>Proposed DC Plan</b>	\$5.8	\$30.3	\$87.4	\$197.7
<b>Totals</b>	\$58.9	\$131.4	\$223.8	\$343.1
<b>Net Cost/(Savings)</b>	\$5.9	\$1.5	(\$22.7)	(\$16.4)

The actuary's estimates indicate that these proposals will increase total employer and General Fund contributions until the end of 2019-20, and there would not be a cumulative net savings until 2028-29. In the long run, assuming the employer paid the maximum allowable contribution rate, employer costs would again be higher because the maximum allowable contribution rate under the proposed DC plan is higher than the 8.25 percent contribution rate currently imposed on employers in the DB Program.

Permitting existing members to transfer to DC plan. The proposals permit existing CalSTRS members and participants to terminate their membership in their existing retirement program during the period from July 1, 2007 until January 1, 2008, and enroll in the DC plan. In doing so, the proposals provide for the transfer of the "net present value of that member's interest in the defined benefit plan" into the new DC plan. Staff interprets this provision to mean that the present value of the accrued benefit liability for that member would be transferred to the DC plan. To the extent that members may have retired under the DB Program, permitting a person to transfer assets from the DB Program to the new plan would not have a significant net actuarial impact. However, if the person would have terminated membership in the DB Program, the only funds paid to the terminating member under the current program would be the accrued member contributions and interest credited to those contributions. The employer and General Fund contributions, the earnings from those contributions and the investment earnings on member contributions in excess of the credited interest rate would not be paid to the member. For these members, transferring assets to the DC plan under these proposals could have a significant actuarial impact on the DB Program. Presumably, a disproportionate number of members who would elect to transfer to the DC plan would be those members who would not anticipate receiving a substantial or any benefit from the DB Program in the future.

In addition, the decision by existing members whether to continue in the DB Program or transfer the assets to the DC plan is a major one requiring very careful thought on their part. CalSTRS is going to have to be prepared, through counseling and other educational mechanisms, to assist members in making this decision. This will require a significant increase in resources.

Impact on members. Requiring future educators to participate in a DC plan will have a fundamental change in their financial security. This is because, rather than having a guaranteed

benefit as under the DB Program, the benefit would be based on their ability to manage their retirement account and the status of the investment market at the time they retire or otherwise receive a benefit. As such, their financial security would be largely dependent on the market; because California public educators do not participate in Social Security for their public service, they do not have that safety net that private workers who participate in a DC plan have. Although future educators could become subject to the Social Security payroll tax, and earn Social Security credits toward retirement for their service, such a payroll tax will result in a further increased cost to the employer and the employee, even accounting for the reduction in the maximum authorized DC plan employer contribution rate for employees participating in Social Security. For employers, the total contribution rate would be as much as 48 percent higher than the rate they are currently paying.

One other issue associated with these proposals is to whom the mandatory participation in a DC plan applies. The proposals state that “on or after July 1, 2007, any person hired as a new employee by a public agency may enroll only in a defined contribution plan of a public pension or retirement system, and shall not enroll in a defined benefit plan.” Clearly, any new educator, or any previous member of a CalSTRS program who terminated membership in that program and returned to service on or after July 1, 2007 would be subject to these provisions. What is not clear is whether an existing member of the DB Program who terminates employment with one district after July 1, 2007 and begins employment with another district would be required to enroll in the DC plan. Normally, the contractual rights of members of CalSTRS to the benefits provided under CalSTRS programs are not affected because they change employment from one school employer to another. However, the provisions of the proposal refer to new employees, not new members. Therefore, it is conceivable that the new employee, even if already a member of CalSTRS, could be subject to these provisions.

On the other hand, the proposals prohibit a new employee from enrolling, not participating in a defined benefit plan. Existing CalSTRS members do not have to enroll in CalSTRS when they change employment; they are already a member. Moreover, the proposals permit, but do not require the new employee to enroll in a defined contribution plan. Therefore, arguably, an existing member who obtains new employment after July 1, 2007 could elect not to enroll in the DC plan and continue to participate in the DB Program because no enrollment in the DB Program for that member after July 1, 2007 is required.

Impact on employers. Eliminating the existing CalSTRS benefit programs for future employees, and replacing them with a DC plan also will have a significant impact on employers. Currently, the contribution rate that employers pay for the DB Program is set in statute; there is no local discretion. In contrast, under the proposal, subject to limitations imposed by the proposals, the employer contribution rate into the DC plan will be a subject of collective bargaining. Similarly, there will be a need for employees to replace the existing disability and survivor benefit programs currently offered in the DB Program; a DC plan cannot effectively offer a meaningful benefit for such events. The provision of such benefits also could become a subject to collective bargaining.

The role of the employers in providing retirement benefits also will change. Currently, CalSTRS has fiduciary responsibility for actions associated with the administration of the retirement system. Under these proposals, however, the employer is responsible for the provision of the retirement plan for its employees. Even if the employer elects to contract with another party to provide plan administration, the employer will have the fiduciary duty to make a prudent selection of the plan administrator and the selection of investment options.

Finally, replacing the existing DB Program with a DC plan may affect the supply of teachers. The current DB Program has specific incentives to encourage members to perform additional service and retire later. The incentives under a DC plan are less powerful, and may make it more difficult for an employer to retain its employees.

#### **STAFF RECOMMENDATION**

Staff recommends the Board oppose ACA 5 and ACA 1X. They represent a repudiation of CalSTRS' mission to secure the financial future and sustain the trust of California's educators. They would jeopardize future educators' income security by eliminating their disability and survivor benefits, and abandoning guaranteed levels of lifetime retirement income and protections against the negative impact of inflation on retirees' fixed incomes. In addition, the proposals adversely affect the actuarial balance of the funds administered by the System and result in adverse selection against CalSTRS' retirement programs.