

Mandatory Defined Contribution Pension Plans for Future Educators

Summary of Proposed Changes

- Public employees hired on or after July 1, 2007 may enroll in DC plan
- May not enroll in defined benefit plan

Summary of Proposed Changes

- Existing members may enroll in DC plan from July 1, 2007 through December 31, 2007
 - Net present value of member's interest in defined benefit plan transferred to DC plan
- Employers may establish own plan and contract out with third party administrators
 - ACA 1X requires third party be private

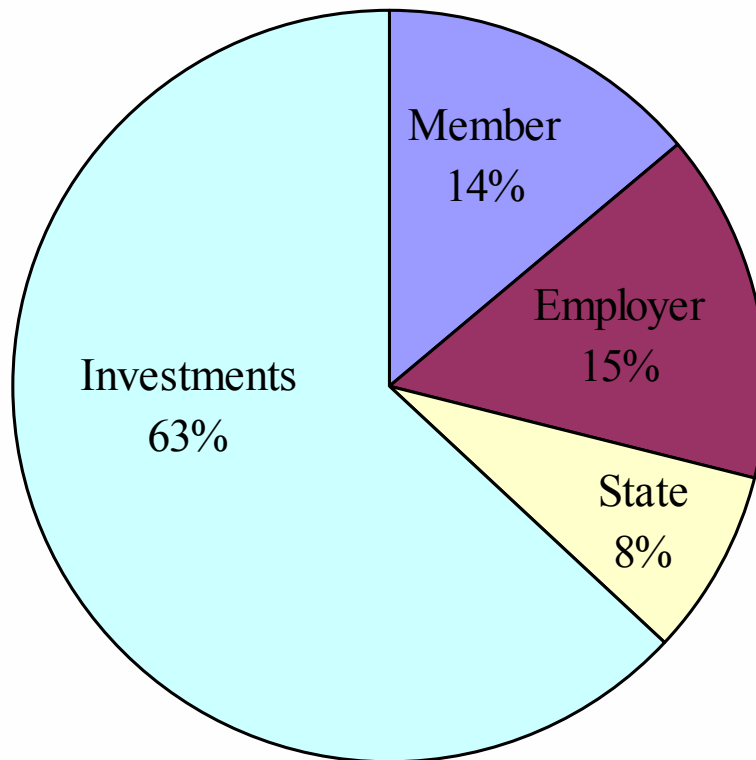
Contribution rates

- Employers—Unspecified maximum contribution in ACA 5
- Employee—Federal law prohibits individual employee contribution choice
- Limits can be increased by 2/3 of voters

Experiences with Other Plans

- Most public DC plans are voluntary
 - Michigan one exception
- Vast majority of employees generally remain in or choose defined benefit plan

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



Basis for Proposal

- Proponents offer many reasons why public employees should no longer be offered defined benefit plans
- Reasons generally don't apply to CalSTRS benefit programs

Defined Benefit Plans Disappearing in Private Sector

- 2002 survey by Watson Wyatt found that 50 percent of Fortune 500 companies offer defined benefit plan as primary retirement plan
 - Only 17 percent offered DC as primary plan
- SBC Communications brought back its defined benefit plan to reward long-term employees and encourage its workforce to remain in company

Myth: Defined Benefit Plans Disappearing in Private Sector

- Much of reduction in defined benefit plans from smaller companies who don't want to contend with regulatory issues not applicable to CalSTRS

Myth: Defined Benefit Plan Benefits Have Become Excessive

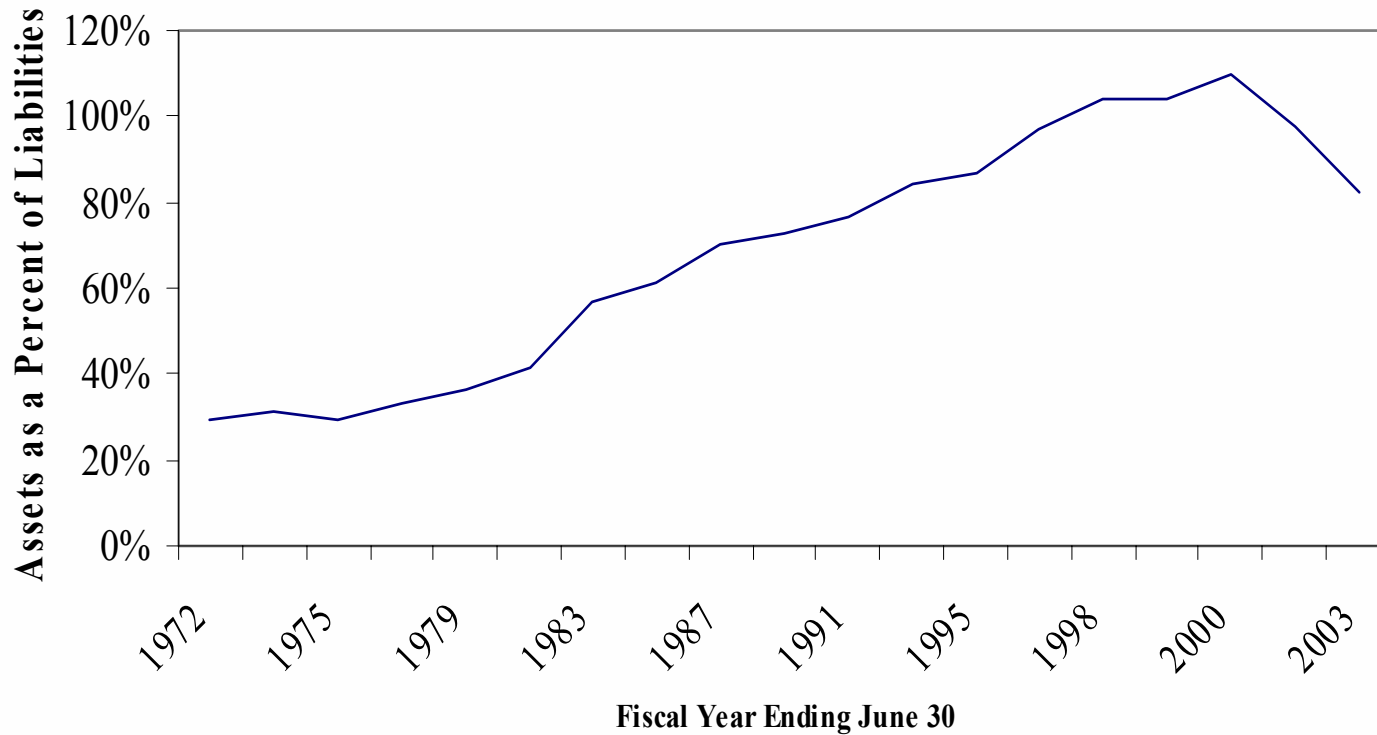
- While other California plans pay benefits equal to 2 or 3 percent of final compensation per year of service at age 50 or 55, CalSTRS benefits are based on 2 percent at age 60
- CalSTRS benefit enhancements targeted to members with long careers or retiring after age 60
- Average member retires with 65 percent replacement ratio

Myth: Defined Benefit Costs Have Become Burden on Employers

- Contributions paid by employers has remained the same since 1990, when it increased 0.25 percent
- Contributions paid by the state have declined from 4.3 percent in 1997 to current 2.017 percent
 - Total state savings of \$2.7 billion through 2004-05

Myth: Defined Benefit Plan Financing is Collapsing

Change in DB Program Funding Status

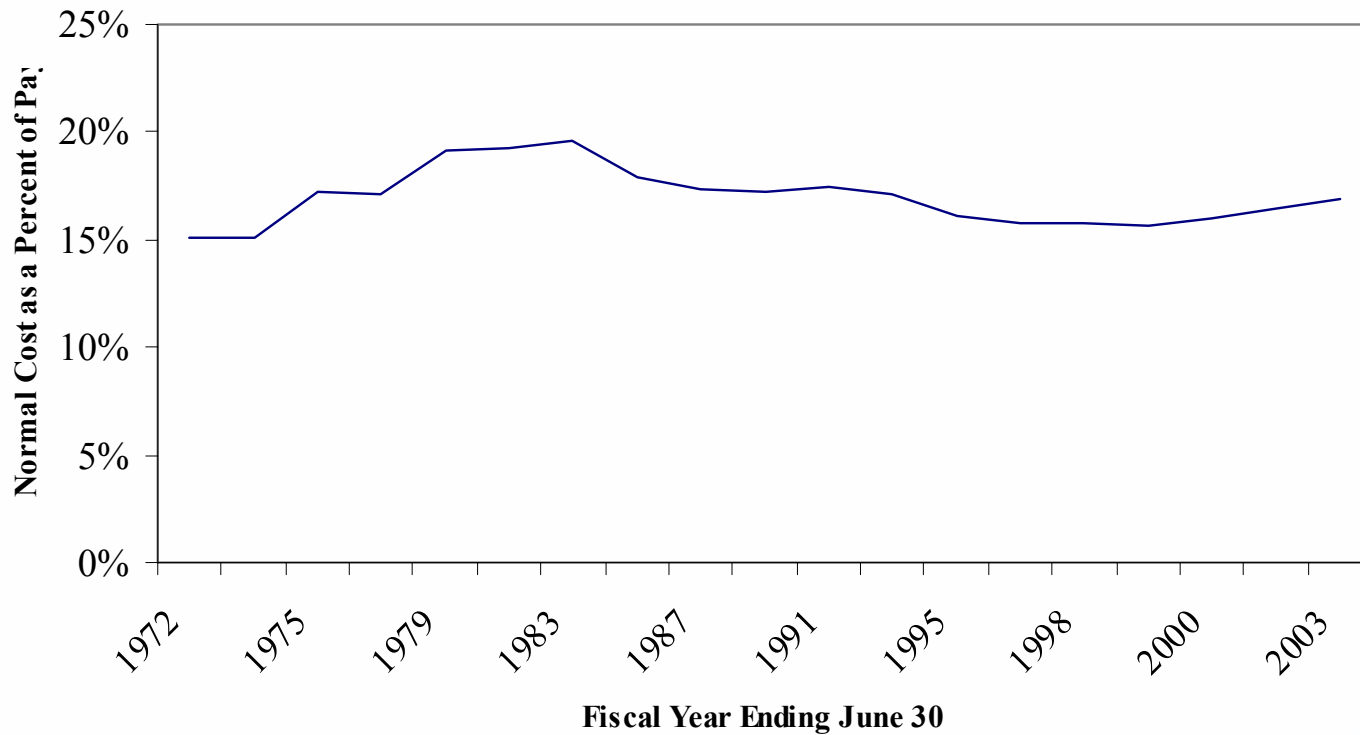


Myth: Defined Benefit Plan Financing is Collapsing

- Funding status at 82 percent
 - Higher funding status than prior to 1990's
 - Amortizing unfunded actuarial obligation requires 4.438 percent increase in contributions

Myth: Defined Benefit Plan Financing is Collapsing

Change in DB Program Normal Cost



Myth: Defined Benefits Plans Have Abuses in Disability Benefits

- Disability costs in DB Program represent only 2.3 percent of present value of all DB Program costs
- Board reduced assumed rate of disability by 15 percent because recent experience is less than previously expected

Myth: DC Plans Can Provide Benefits As High As Defined Benefit Plans

- Benefit paid by DC plan entirely dependent on success of investments
 - In defined benefit plan, risk is pooled
 - In DC plan, each participant bears an individual risk

Myth: DC Plans Can Provide Benefits As High As Defined Benefit Plans

- In Nebraska, employee DC plans earned 6 percent from 1983 through 1999, while system-managed defined benefit plans earned 11 percent
 - 2 percent difference over 30 years can affect retirement benefit by over 40 percent

Myth: DC Plans Can Provide Benefits As High As Defined Benefit Plans

- Annuitizing DC account will likely result in a lower monthly benefit than the amount paid by CalSTRS
- DC plans pay inadequate disability and survivor benefits early in career
 - Additional cost to insure against risk

Myth: DC Plans Are Less Costly

- Average stock mutual fund costs 149 basis points
- Average taxable bond fund costs 114 basis points
- Total CalSTRS costs of 17 basis points

Myth: DB Plans Aren't Portable

- DC plans are very portable
 - Subject to vesting requirements, employer and employee contributions can be rolled to other qualified plan
- Defined benefit plans also portable
 - Member contributions in DB can be rolled over to qualified plan
 - Member and employer contributions in DBS and CB can be rolled over
 - New members from out of state can purchase DB credit for prior service

Myth: DB Plans Aren't Portable

- DB Program members not as mobile as other public employees
 - Average service at retirement over 27 years
 - Less than 20 years of service for all retiring CalPERS members
 - 16 years of service for classified employees

Myth: DB Plans Aren't Portable

- Nationally, when employees terminate participation in plan, two-thirds cash out accounts rather than roll over
 - Jeopardizes retirement security

Impact on CalSTRS Investments

- Reduced contributions to the closed DB Program will require change in asset allocation
 - Incoming contributions source of cash for current benefit payments
 - Permits continued investment of existing assets

Impact on CalSTRS Investments

- Greater liquidity needs will reduce expected investment return
- Cost of DB Program will increase
 - 25 basis point reduction in assumed investment return increases normal cost and unfunded actuarial obligation by \$10 billion

Impact on Current DB Program Funding Deficiency

- Current \$23 billion unfunded actuarial obligation could be amortized by reducing benefits paid to future members or increasing contributions
- Eliminating any future DB Program members reduces options largely to either increased state or employer contribution
 - Impractical to discuss addressing funding deficiency until DC issue is resolved

Impact on Current DB Program Funding Deficiency

- \$23 billion unfunded actuarial obligation will remain the same
- Required state or employer contribution will increase from 4.438 percent of the current law payroll to 7.489 percent of smaller payroll
 - Total increased cost to employer and General Fund through 2019-20
 - No cumulative net savings until 2028-29

Impact of Permitting Existing Members to Transfer to DC Plan

- Existing DB Program members could convert “net present value of member’s interest” in DB Program
 - Interpret to mean that member can transfer to DC plan present value of benefit accrued to date

Impact of Permitting Existing Members to Transfer to DC Plan

- Permitting existing DB members to transfer to new DC plan could mitigate some costs to DB Program
 - 5 percent conversion reduces costs by \$1.3 billion over 10 years and \$3.5 billion over 40 years
 - 10 percent conversion reduces costs by \$2.5 billion over 10 years and \$6.7 billion over 40 years

Impact of Permitting Existing Members to Transfer to DC Plan

- Reduction in cost from conversions reflects difference between accrued liability at the time of conversion, which would be transferred to DC plan, and higher amount of assets accrued on member's behalf at that time
 - Also indicates, however, that member would be better off remaining in DB Program rather than converting

Impact on Members

- Loss of financial security from having retirement based entirely on investment success
- No Social Security means no guaranteed benefit from any source
 - One of the few employees in country, public or private, facing this vulnerability
 - Putting new members into Social Security increases employer cost by 48 percent from current levels

Impact on Members

- Not clear if existing members of DB Program can remain in current program if change employers
- Potential impacts on current members
 - Reduction in purchasing power contributions reduce lifespan of program
 - Reduction in options to address funding deficiency jeopardizes annual benefit adjustment

Impact on Employers

- Each employer will be administering its own retirement plan
- Can contract out with third party administrator
 - CalSTRS could not administer plan under ACA 1X
- Fiduciary responsibility to administer plan appropriately

Impact on Employers

- Increase in collective bargaining issues
 - Employer contribution rate
 - Replacement of disability and survivor benefits
- Potential impact on teacher supply
 - No incentives to achieve high level of service similar to current DB Program

Staff Recommendation

- Oppose ACA 5 and ACA 1X
 - Repudiation of CalSTRS mission
 - Jeopardizes future educators' income security through loss of disability and survivor benefits
 - Jeopardizes retirement security by abandoning guaranteed income and inflation protection
 - Adversely affects the actuarial balance of funds administered by CalSTRS

California State Teachers' Retirement System

CALSTRS

HOW WILL YOU SPEND YOUR FUTURE?

*Securing the financial future
and sustaining the trust of California's educators.*