CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Senate Bill SBX1 20	**Committee on Budget and Fiscal Review (Introduced March 3, 2003)**
Position:	**Oppose**
Proponents:	**Administration**
Opponents:	**CalSTRS, California Retired Teachers' Association**

SUMMARY

SB 20X reduces the General Fund transfer to the California State Teachers' Retirement System (CalSTRS) Supplemental Benefit Maintenance Account (SBMA) by $500 million for the 2003-04 fiscal year. The bill also requires the Teachers' Retirement Board (Board), beginning in 2006 and based on an actuarial valuation, to report to the Legislature and the Director of Finance every four years on whether the full 80 percent purchasing power payment could still be maintained through June 30, 2036, despite the loss of the contributions. If the Board determined prior to July 1, 2036, that the loss of $500 million in contributions resulted in its inability to sustain the current program through 2035-36, then, subject to certification by the Director of Finance, the $500 million, plus interest, would be repaid the following year.

HISTORY

Chapter 840, Statutes of 2001 (AB 135, Havice) increased purchasing power for member and beneficiaries from 75 to 80 percent of the original purchasing power.

Chapter 939, Statutes of 1997 (SB 1026, Schiff) increased purchasing power of up to 75 percent of the benefit recipient's original purchasing power and authorized the Board to decrease the benefit when the 2.5 percent annual General Fund contribution is insufficient to support 75 percent purchasing power.

Chapter 116, Statutes of 1989 (SB 1513, Campbell, et al) requires an annual distribution of the proceeds of the SBMA in non-vested quarterly payments to member and beneficiaries to restore purchasing power up to 68.2 percent of the original purchasing power.

Chapter 115, Statutes of 1989 (SB 1407 C. Green, et al) established the funding mechanism for the SBMA and by requiring an annual transfer from the General Fund to restore purchasing power for CalSTRS retirees. The amount transferred was to increase annually to a maximum of 2.5 percent of the statewide teacher payroll.

CURRENT PRACTICE

Under current law, when a CalSTRS retirement benefit currently being paid is less than 80 percent of the purchasing power of the initial benefit, CalSTRS pays a supplemental benefit on a quarterly basis to that person, to restore the total benefit paid by CalSTRS to 80 percent of the purchasing power of the initial benefit. For example, if a CalSTRS member received an initial $6,000 benefit annually in 1970, CalSTRS would now be paying her $9,840 per year as a result of the annual two percent benefit adjustments. She would, however, have to receive $29,430 in 2002 to be fully compensated for the effects of inflation on the benefit. In order to receive a benefit equal in purchasing power to 80 percent of the initial purchasing power, she would have to receive a total of $23,544 per year (80 percent of $29,430). Consequently, CalSTRS would pay a supplemental benefit equal to the difference between the $23,544 she would need to maintain 80 percent of the purchasing power of the initial benefit and the $9,840 she is actually receiving, or $13,704. This amount would be paid in four equal installments annually, or $3,426 per quarter.

Funding for the supplemental benefit is derived primarily from the General Fund, School Lands Revenue and interest earned on the balance in the SBMA. The General Fund transfer to the SBMA (an account within the Teachers' Retirement Fund (TRF)) is an amount equal to 2.5 percent of the CalSTRS'-covered member payroll in the fiscal year ending in the prior calendar year. This transfer is made annually "pursuant to a contractually enforceable promise to make annual contributions from the General Fund to the Supplemental Benefit Maintenance Account." (Section 22954 of the Education Code). The SBMA provides annual supplemental payments in quarterly installments as long as funds are available. Supplemental payments made for the purpose of maintaining 80 percent purchasing power, however, is a vested benefit to the extent that funds are available in the SBMA to make such payments. This means that if the combined funding from both sources is not sufficient to bring purchasing power up to the 80 percent level, supplemental payments may have to be paid at a lower level.

DISCUSSION

Under current law, in 2003-04, the General Fund transfer to SBMA would be equal to 2.5 percent of the creditable compensation paid to members during 2001-02, or a total of about $562 million. That appropriation and transfer of funds would occur on July 1, 2003.

Funds in the SBMA are credited with interest, based on the actuarially assumed rate of investment earnings of the Defined Benefit (DB) Program. Based on current assumptions adopted by the Board in 2000, the SBMA is currently credited with eight percent annual interest. Under current law, members and beneficiaries have a vested right to the full 80 percent purchasing power benefit, if there are sufficient funds in the SBMA to make the full payment. If there are insufficient funds to make the full payment, the Board may:

- Subject to authorization in the Budget Act, increase the employer contribution by up to 0.25 percent annually and credit that increased contribution to the SBMA;

- Reduce the level of purchasing power protection to a level that could be funded with available SBMA funds;
- Use any actuarial assets in the DB Program in excess of the actuarial obligation of that program to maintain the full purchasing power benefit.

Proposed Reduction

SB 20X proposes to reduce the 2003-04 appropriation to the SBMA by $500 million. The bill also requires the Board, beginning in 2006 and based on an actuarial valuation, to report to the Legislature and the Director of Finance every four years on whether the full 80 percent purchasing power payment could still be maintained through June 30, 2036, despite the loss of the contributions. If the Board determined that the full purchasing power payment could not be maintained through June 30, 2036, then the amount needed to maintain full purchasing power payments, up to $500 million adjusted by the actual rate of return of funds in the SBMA from July 1, 2003 (as opposed to the amount credited to the SBMA which is the assumed actuarial rate of return, currently 8 percent) would be transferred to the SBMA on July 30 of the calendar year following the determination by the Board, and subject to certification by the Director of Finance. In effect, if the Board determined prior to July 1, 2036, that the loss of $500 million in contributions resulted in its inability to sustain the current program through 2035-36, then, subject to certification by the Director of Finance, the $500 million would be repaid, with interest, the following year.

Based on current assumptions and estimates of future expenditures, CalSTRS staff project that the resources currently in the SBMA, plus the contributions and earnings expected to be made in the future, are sufficient to maintain the full 80 percent purchasing power program through 2039-40, or an additional 37 years. Although this suggests that the program funded by SBMA would not be adversely affected by this bill, staff's recent experience with projecting future SBMA expenditures and resources indicates that staff's projections tend to be conservative; that is, the estimate of contributions paid to SBMA tends to be understated and the estimate of expenditures tends to be overstated. This largely reflects higher-than-expected growth in DB Program membership and wages and lower-than-anticipated inflation. In light of recent funding cutbacks to local government and in particular school districts the validity of these assumptions over the long run may change significantly. For example, the growth in teacher salary increases is anticipated to drop which would decrease the amount of the General Fund transfer to the SBMA. Under current projections, the Board would determine that that the full purchasing power program would be inadequately funded for only one year prior to the repeal of the payback provision in 2035-36. If the current projections prove to be even mildly conservative, then the impact of the SB 20X may not result in an inability to fully fund the current purchasing power program until after 2035-36; that is, after the period of time the provision to repay the contributions is applicable. Consequently, if this occurs, the proposed reduction to the SBMA will result in DB Program members and beneficiaries receiving full purchasing power protection for a shorter period of time than they otherwise would have received such benefits.

Actuarial Soundness of SB 20X

The CalSTRS Consulting Actuary determined that the proposed reduction to the SBMA is not actuarially sound, may erode the financial security of the program and may eventually result in lower purchasing power payments to future retirees and beneficiaries. This conclusion was reached by the Actuary because the beneficiaries of the SBMA will be left in a worse financial position as a result of the diversion of the $500 million. The Actuary's primary concern is the time limit for making up the diverted contribution with interest. For example, if the long-term assumptions such as inflation remain steady or favorable at 3.5 percent and then increases after 2036, the availability of a sufficient level of purchasing power funds would not be available resulting in lower purchasing power payments to retirees. As noted above, if in any year between 2003 and 2036 the Board determines the purchasing power payments cannot be maintained, up to $500 million adjusted by the actual rate of return of funds in the SBMA from July 1, 2003 would be transferred to the SBMA. This amount would be less than amount that would be credited to the SBMA under current law. The net effect is that there will be less funds available to maintain 80 percent purchasing power payments.

Legal Implications

The Board voted to oppose this bill because the proposal is not consistent with their fiduciary responsibilities as defined in the California Constitution. Specifically, the Board has sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to participant and beneficiaries. Equally important, the Board must discharge its duties solely in the interest of and for exclusive purposes of (1) providing benefits to participants and beneficiaries, (2) minimizing employer contributions to CalSTRS and (3) defraying reasonable expenses of administering CalSTRS. The Board's duty to beneficiaries and participants takes precedent over any other duty. Consistent with its duties as fiduciaries the Board opposed SB 20X because it potential effects on the benefits of retired members and the actuarial soundness of the proposal, not on the need to balance the California budget. The Internal Revenue Code is also clear on this point that a pension plan must be established and operated for the exclusive benefit of employees and their beneficiaries, in order to be a qualified plan under Section 401(a) of the Internal Revenue Code.

FISCAL IMPACT

<u>Benefit Program Costs</u> – The bill will decrease the amount of reserves in the SBMA by $500 million. If the Board determined prior to July 1, 2036, that the loss of $500 million in contributions resulted in its inability to sustain the current program through 2035-36, then, subject to certification by the Director of Finance, the $500 million, plus interest, would be

repaid the SBMA. If such a determination was not made, the funds would not be repaid, and the length of time that payments could be made form the SBMA would be reduced.

<u>Administrative Costs</u> – No fiscal impact.

POSITION

Oppose. Although, under certain circumstances, reducing General Fund contributions by $500 million to the SBMA would not affect the long-term funding of CalSTRS' purchasing power program, there is no certainty that the program would not be adversely affected.

Reducing next year's General Fund contribution to the SBMA would reduce the funding available to the program, thereby reducing the length of time that CalSTRS members and beneficiaries would receive vested benefits. CalSTRS consulting actuary confirmed this impact. Affected CalSTRS members, however, would receive no offsetting benefit in return. Although reducing General Fund contributions by $500 million does benefit other state-funded programs, it does not benefit CalSTRS members.