2014 ACBO Spring Conference

Pension Update

Presented by

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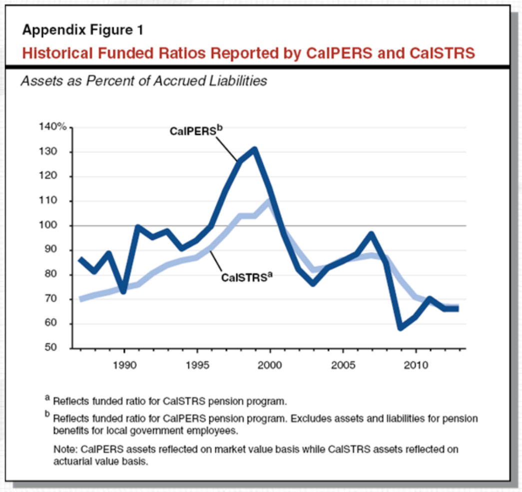
Educators' Pensions

1

- California State Teachers' Retirement System (CalSTRS) and California Public Employees' Retirement System (CalPERS) are vital components of attracting and retaining a high-quality workforce in California's education systems
- The Great Recession and the California Public Employee's Pension Reform Act (PEPRA) were significant recent developments for both CalSTRS and CalPERS, but the changes aren't over yet
- This session will provide updates at all levels:
  - Statewide developments to address CalSTRS unfunded liability
  - Steps that need to be taken at the district level to reflect employer rate increases (and potential rate increases)
  - Developments in CalSTRS creditable service that may affect you at the personal level

CalPERS and CalSTRS

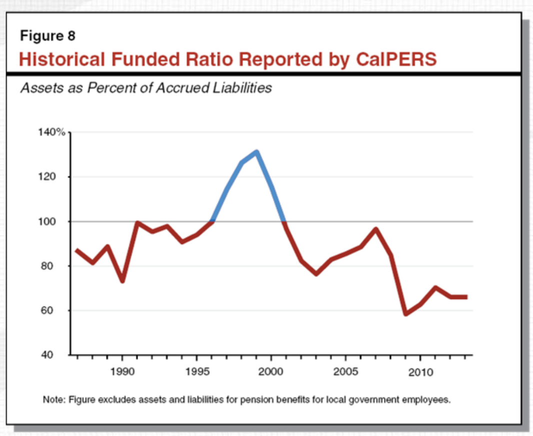
- CalPERS and CalSTRS pension programs had similar funded ratios as of the end of 2012-13
- However, a recent report by the Legislative Analyst's Office (LAO) of key state liabilities is not concerned with CalPERS
  - At the same time, stating the CalSTRS liability should be the Legislature's top priority



Source: LAO, "Addressing California's Key Liabilities," May 7, 2014

Funding Histories – CalPERS

- With assets totaling nearly $300 billion, CalPERS is the nation's largest public pension fund
- While not ideal, the CalPERS system is in a relatively strong funding position
  - Total Fund – 69.6% funded (as of June 30, 2012)
  - Schools and community colleges – 80.5% funded (as of June 30, 2013)



Source: LAO, "Addressing California's Key Liabilities," May 7, 2014

CalPERS – Taking Care of Itself

- CalPERS is able to stay ahead of the curve because it has some authority to increase rates
- In February 2014, CalPERS adopted new demographic assumptions based on member longevity
  - As a result, employer and state contribution rates will increase
    - At Governor's urging, state rate increases immediately, phased in over three years
    - Employer rate increases beginning in 2016-17, phased in over five years
- With new assumptions, CalPERS aims to fully fund the system – eliminating the unfunded liability – in about 30 years

Funding Histories – CalSTRS

- CalSTRS began with an unfunded liability because teachers came in with service credit not adequately covered by the initial contributions
- CalSTRS was last fully funded in 1998
  - If investment returns had equaled the assumed 7.5% return since 2000, the Program would actually be *overfunded*, with 103% of its liabilities covered

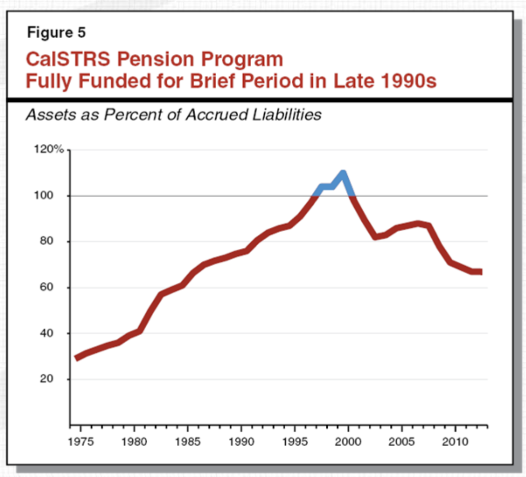


Figure 5
CalSTRS Pension Program
Fully Funded for Brief Period in Late 1990s

Source: LAO, "Addressing California's Key Liabilities," May 7, 2014

Funding Histories – CalSTRS

6

- Unlike CalPERS employer contributions, which are set by the CalPERS Board each year, contributions to CalSTRS are set by statute:
  - The employee contribution rate has been 8% of creditable compensation since 1972
  - The employer contribution rate has been 8.25% since 1990
  - The state's contribution rate has changed frequently over the years and is currently 3.041%
    - Changes to contribution rates require legislation
- Total CalSTRS contribution rate of 21.79% is relatively low
  - CalPERS (and Social Security) rate for school employees is 30.84%
    - And will be increasing
- The pressure is on the Legislature to craft a solution

Scope of the Issue

7

- The latest CalSTRS valuation reflects assets and liabilities as of June 30, 2013:
  - Unfunded liability is $73.7 billion, an increase of $2.7 billion since June 30, 2012
  - Funded ratio (value of assets divided by value of liability) practically unchanged at 66.9%
    - 80% is often cited as a "healthy" ratio, but the gold standard is for the plan to have an "objective of accumulating assets equal to 100% of a relevant pension obligation," according to the American Academy of Actuaries
  - 2046 is the projected depletion date

Questions for the Legislature to Answer

8

- In this spring's legislative informational hearings, CalSTRS posed the questions legislators need to answer:
  - Is the goal 100% funding of the Defined Benefits Program or something less, like an 80% funding target?
  - What is the time frame to meet the target – 20 years, 30 years, or longer?
  - When will contribution increases kick in, and will they occur simultaneously for all parties?
  - What is the speed of the contribution rate increase – slow or steep?
  - How will the increase get allocated among the three parties?
  - When will we re-evaluate the fund to adjust as needed?

Vested Rights Doctrine

9

- One of the constraints in solving the CalSTRS unfunded liability is the "vested rights doctrine"
  - Employee's rate may not be increased unless the employee receives comparable new advantages for the increased contributions
- Based on California case law, the state's ability to impose increases on the employee contribution rate is limited
  - The dilemma – if you provide an increased benefit, the liability increases also

Vested Rights Doctrine

10

- The potential solution – the 2% Annual Benefit Adjustment (or improvement factor) could become contractually guaranteed
  - Provides for an annual benefit increase of 2% after retirement, calculated on a member's initial benefit and not compounded or tied to changes in cost of living
  - A longstanding practice, it could be changed by the Legislature
  - If legislation was enacted to eliminate the vulnerability to legislative change, it would be a benefit that could correspond to an increased contribution rate
    - According to CalSTRS, worth a rate increase of 2.83% for pre-PEPRA and 2.39% for PEPRA members
  - Already assumed in valuations, resulting in no change to the funding projections

Possible Funding Scenarios

11

CalSTRS's Presented Scenarios

Years to Fully Fund	Employer Rate Increase	Total Cost	Probability of Running out of Money in 75 years
20	23.09%	$181.7 billion	1%
30	12.80%	$236.3 billion	26%
40	9.37%	$319.5 billion	36%
50	7.68%	$441.6 billion	44%
60	6.69%	$618.0 billion	47%

The table assumes the state contributes an additional 1.085% of payroll and employee rates increase 2.83% for "classic" members and 2.39% for new members

Source: CalSTRS, "History of CalSTRS Funding and Presentation of Additional Scenarios," March 2014

Governor's Proposal to Fund CalSTRS

12

- In January, the Governor acknowledged the CalSTRS shortfall, but did not provide a proposal to address it
  - Would cost more than $4.5 billion per year to resolve right now
    - Bad news does not get better with age – the shortfall grows by approximately $22 million a day
- Three ways to fix it
  - Reduce benefits – difficult given legal protections for existing members
    - Already in place for new hires starting January 1, 2013
  - Increase earnings – means taking more risk with investment portfolio
  - Increase contributions – most likely solution

Governor's Proposal to Fund CalSTRS

13

- The Governor's May Revision proposes to fully fund CalSTRS by 2045-46
  - Plan kicks in immediately, beginning July 1, 2014
  - Contribution rate increases proposed for all three parties:
    - State contribution rate to increase from the current rate of 3.041% to 6.33% over three years
      - In addition, the state will continue to pay 2.5% of payroll annually for a supplemental inflation protection program
    - Employer contribution rate to increase from 8.25% to 19.1% over seven years
    - Employee contribution rate to increase from 8% to 10.25% over three years
  - Total cost estimated to be $237 billion

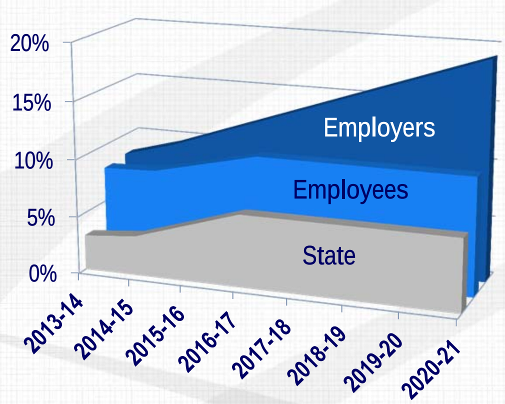
Governor's Proposal to Fund CalSTRS

			Pre-PEPRA	Post-PEPRA	
	Year	Employer	Employee		State*
Current	2013-14	8.25%	8.00%	8.00%	3.041%
Proposed	2014-15	9.50%	8.15%	8.08%	3.45%
	2015-16	11.10%	9.20%	8.56%	4.89%
	2016-17	12.70%	10.25%	9.21%	6.33%
	2017-18	14.30%	10.25%	9.21%	6.33%
	2018-19	15.90%	10.25%	9.21%	6.33%
	2019-20	17.50%	10.25%	9.21%	6.33%
	2020-21	19.10%	10.25%	9.21%	6.33%

*Current law requires the state contribution to increase annually due to the unfunded liability associated with the 1990 benefit program, and is set to increase to a maximum of 3.52% in 2015-16

Governor's Proposal to Fund CalSTRS

Proposed Contribution Rates

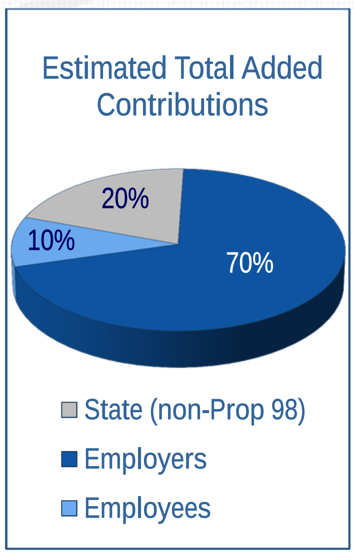


- The burden is clearly on the employers
- Of the current $74 billion CalSTRS unfunded liability:
  - $47 billion will be funded by employers
  - $8 billion will be funded by employees
  - $20 billion will be funded by the state

LAO's Analysis of the Governor's Proposal

17

- The LAO commends the Governor for his "bold proposal"
- Notes there is no "magic formula for determining what portion of the unfunded liability should be paid by the state, districts, or teachers"
- Recommends:
  - Aiming for full funding in about 30 years
  - Preserving full funding once it is achieved
  - Ending the state's "unusual position" in CalSTRS over time



What to Plan for CalSTRS and CalPERS? 18

- The CalPERS Board approved implementation of new assumptions starting in 2016-17, with the cost spread over twenty years and the increases phased in over the first five years
  - Employers should continue to rely on the estimated rates for 2015-16 and beyond
- With the CalSTRS situation in flux, educational agencies have been unsure what to include in multiyear projections
  - The Legislature could choose not to act this year
  - Or they could increase employer rates immediately as the Governor has just proposed
    - Employers should build their budgets and multiyear projections on the Governor's proposal for CalSTRS

Projected CalPERS Rate Increases 19

- The employer contribution to CalPERS for 2014-15 is 11.771%
  - "Classic" members continue to pay 7.00%
  - New members pay 6.00%, which may fluctuate from year to year based on the PEPRA requirement to pay half the normal cost rate
- Estimates of the resulting future contribution rate increases for school and community college employers as follows:

Actual		Projected					
2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
11.442%	11.771%	12.6%	15.0%	16.6%	18.2%	19.9%	20.4%

Proposed CalSTRS Rate Increases

20

- Under the Governor's May Revision, the employer contribution to CalSTRS for 2014-15 is 9.50%
  - Pre-PEPRA members would pay 9.20%
  - Post-PEPRA members would pay 8.56%
- Estimates of the resulting future contribution rate increases for school and community college employers as follows:

Proposed						
2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
9.50%	11.10%	12.70%	14.30%	15.90%	17.50%	19.10%

Collective Bargaining and CalSTRS Unfunded Liability

21

- CalSTRS rate increases take money directly off the negotiating table
  - The state deals the employee a direct pay cut by increasing the employee rate – but the employee retains all retirement entitlements
  - The state deals the district a progressively larger bill for employer contributions to CalSTRS, but with no earmarked funding
- As the employer rate moves from 8.25% to more than 19%, 11% of it would have been available for compensation but goes directly to CalSTRS
- At the same time, the employee rate also rises
- There is likely to be an expectation that the district will somehow make employees whole, but the district will not be able to undo the state's decisions
- This issue will be before the parties every year for seven years

CalSTRS Audits

22

- CalSTRS is actively auditing local educational agencies
  - Developed a list of agencies to audit based upon a risk assessment, including:
    - Significance of pay increases provided to employees right before retirement
    - Excess sick leave days reported
  - Significant findings have been reported
    - Local agencies should conduct internal audits to minimize risk
  - Findings include reclassification of some positions out of CalSTRS
- Certain positions are vulnerable to reclassification
  - District office administrators not responsible for curriculum development or other activities that are CalSTRS creditable
    - Look at human resources, information technology, and business positions

CalSTRS Audits

23

- Since the 1990s, Education Code (E.C.) 22119.5 has defined CalSTRS creditable service for K-14 employees to be used by districts to determine whether an employee is eligible to participate in CalSTRS
- Community colleges classified positions as CalSTRS eligible based on E.C. 22119.5, "under the appropriate minimum standards adopted by the Board of Governors of the California Community Colleges"
- In August 2012, CalSTRS released a Circular to employers that identified examples of educational administrator positions CalSTRS deems NOT to be performing creditable service
  - Prompted by findings at the City College of San Francisco
  - People who believed they had been legitimately in CalSTRS positions found their job titles on this list

Source: CalSTRS Employer Circular EIC12-1, Volume 28, Issue 1: Positions Not Eligible for Creditable Service

CalSTRS Audits and Reclassification

24

- Working with the K-14 community, CalSTRS opened a one-time 180-day window for some of those people to file an election form to stay in CalSTRS
  - This solution works for members who were previously teachers or faculty members or were otherwise performing service that CalSTRS deems creditable
    - Election window to submit a retroactive Election Form ES372 ends on May 23, 2014
  - For those employees who do not have such a previously held position, there is currently no resolution

CalSTRS Audits and Reclassification

25

- Working on behalf of their members, several K-14 statewide administrative organizations approached CalSTRS to seek an administrative remedy like the solution afforded to employees who are now electing to stay in CalSTRS retroactively
  - A solution will require legislation to address administrators previously thought to be performing creditable service that CalSTRS now is determining not to be eligible
  - Stay tuned

CalSTRS Audits and Reclassification

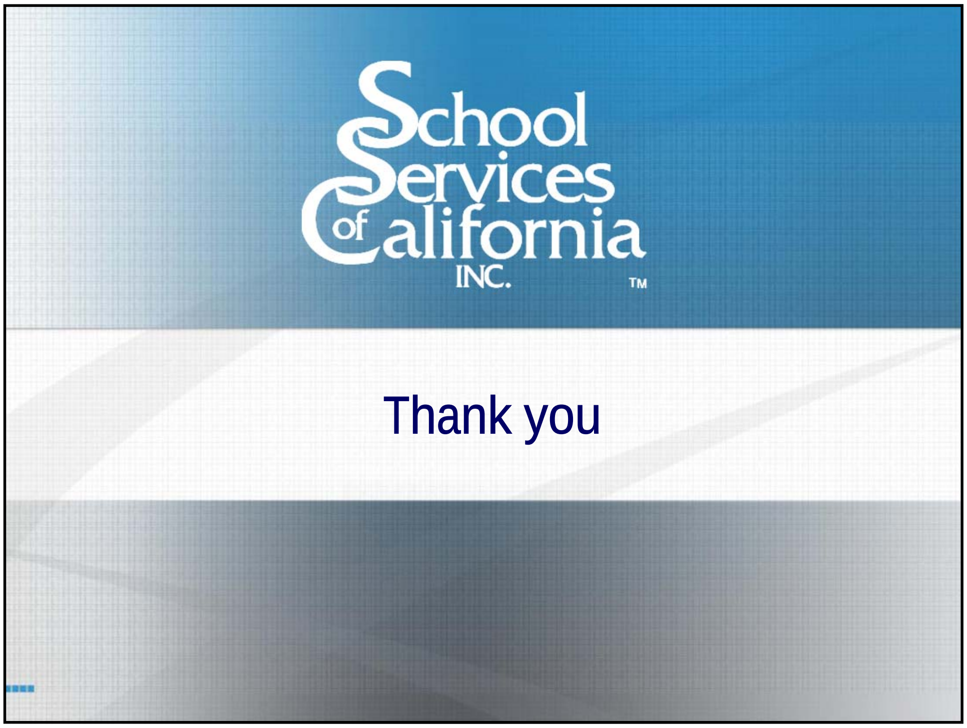
26

- Take a close look at the positions called out by the CalSTRS Circular:
  - Chief of Police
  - Director of Buildings, Grounds, and Maintenance
  - Director of Human Resources
  - Chief Information Technology Officer
  - Director of Payroll Services
  - Chief Financial Officer
- Ask:
  - Is this position an academic position performing duties involved in instruction, curriculum or material development, school health professionals, counselors, librarians, or superintendents?
  - Does the nature of the duties performed by the employee fall under the "Creditable Service" definitions in E.C. 22119.5?
- If not, the position may need to be reclassified

Stay Tuned

27

- Beyond the contribution rates, the details of the Governor's CalSTRS funding proposal are unknown
  - What happens to contribution rates when the liability is fully paid off?
    - The LAO has encouraged the state to get out of the business of funding CalSTRS going forward
  - Will there be an automatic trigger to reevaluate CalSTRS funding to adjust contribution rates – for better or worse – as needed?
- And the Legislature has the opportunity to shape the proposal
  - Should the burden be distributed differently?
  - Should the state infuse one-time money to jump start the solution?
  - Would it be beneficial to provide a specific funding stream to districts within Proposition 98 for these purposes?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Thank you