



Sustaining Retirement Security for Future Generations: Funding the California State Teachers' Retirement System

An Update to the Legislature Pursuant to Senate Concurrent
Resolution 105

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Testimony of

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Information included in this testimony is an update to the report CalSTRS submitted to the Legislature last year pursuant to SCR 105, and it is intended to assist the Legislature as they develop a plan to close the CalSTRS \$71 billion funding shortfall through increased contributions.

Good morning Chairman Bonta, Vice Chairman Allen and distinguished members of the Assembly Public Employees, Retirement and Social Security Committee. Thank you for your thoughtful intent to enact legislation this year to address the long-term funding needs of the CalSTRS Defined Benefit Program. Last year, CalSTRS submitted a detailed report on our funding status to the Legislature pursuant to Senate Concurrent Resolution 105. The initial reactions to the report from various stakeholders have resulted in constructive recognition of the need to move forward to strengthen CalSTRS funding. Upon your invitation, CalSTRS has prepared today's testimony to update the Legislature on relevant considerations since the submission of our report last year that include:

- The current status of the Defined Benefit Program;
- The impact of the Public Employees' Pension Reform Act of 2013;
- A framework for legislative considerations necessary to develop and enact a funding policy for CalSTRS; and,
- Important legal considerations surrounding contribution increases on current members.

The definitive approach to addressing the long-term funding needs of the Defined Benefit Program is to fully fund the program in 30 years or less. However, this testimony acknowledges that other options may be considered by the Legislature. With that in mind, the most significant consideration for the Legislature and the Governor in developing a funding policy is the short-term costs versus the long-term costs and the risks associated with each.

History of the Program

Created to provide California teachers with a secure financial future during their retirement years and to incentivize teachers to stay in the teaching profession, CalSTRS was established in perpetuity by the Legislature in 1913. All certificated public school teachers, teaching superintendents, supervising executives and educational administrators automatically became members of the retirement system. Today, CalSTRS has grown to become the world's largest educator-only pension fund supporting upwards of 862,000 members and beneficiaries with a portfolio valued at \$181.1 billion as of December 31, 2013.

CalSTRS members receive no Social Security benefits for their CalSTRS-covered employment. Generally, CalSTRS retired members do not receive employer-paid health care benefits after age 65. The benefits provided to current Defined Benefit Program members are not excessive. Any additional reductions to the benefits paid to members would have a limited impact on the Defined Benefit Program funding and would likely significantly undermine the retirement security for those members.

All CalSTRS contribution rates are set in statute. Benefits are paid by contributions from members, school employers and the State of California. CalSTRS investment earnings on those contributions also fund benefits. The resources generated from contributions made by members, employers and the State are projected to be more than sufficient to cover the ongoing costs of the Defined Benefit Program, known as the "Normal Cost", if assumed investment returns of 7.5 percent are realized. As of January 31, 2014, the CalSTRS total investment return has been 7.59 percent over 20 years and 7.02 percent over 10 years.

By 1998, CalSTRS' assets were more than sufficient to meet current and future obligations, and for the first time in the fund's history, the Defined Benefit Program was more than 100 percent

funded. Shortly after, several benefit improvements, designed to attract and retain teachers at a critical juncture when schools were mandated to have no more than 20 students to a classroom were enacted. Some of the benefit improvements were designed by the Legislature to sunset within 10 years.

What subsequently occurred in the years that followed 1998 was significant global, financial market volatility. Since then, state legislatures around the country have struggled to deal with the financial challenges facing public employee retirement plans. CalSTRS is no exception, with the current \$71 billion funding shortfall caused primarily by the weak financial markets that occurred between the dot com bust and the Great Recession.

CalSTRS' independent actuary, Milliman, conducted an analysis of the change in CalSTRS' funded status from 2000 to 2012. The conclusion was that two thirds of the decline during that period was due to investment-related asset performance. The shortfall has been exacerbated by contributions not being adjusted earlier to offset investment losses that occurred between 2000 and 2008.

Absent any changes in contribution rates or liabilities, current calculations show the Defined Benefit Program will deplete its assets by as early as 2043. At that point, CalSTRS would be on a pay-as-you-go basis, and the State would be obligated to ensure that the guaranteed benefits continue being paid. The Teachers' Retirement Board lacks the authority to raise contribution rates – only the Legislature and the Governor can do so, which is why the state must act to adopt a responsible funding strategy. The longer it takes to secure a long-term funding plan, the greater the risk of significant financial consequences to CalSTRS members, employers and ultimately the State's General Fund.

Although recent investment performance above the 7.5 percent assumed rate of return has had a positive impact on the fund, there is still no reasonable expectation that CalSTRS could invest its way out of the shortfall. Moreover, if a considerable market downturn occurs over the next few years, the funded ratio could drop to a level that makes it substantially more expensive to provide long-term viability for program funding. CalSTRS estimates that for every day that goes by without a funding strategy in place the unfunded liability increases by \$22 million.

Recent reports by the State Auditor, the Legislative Analyst's Office and notable ratings agencies characterize CalSTRS' funding shortfall as a high-risk issue that if left unaddressed poses a substantial financial risk to school districts and the State. Therefore, swift action, whether to initiate a funding plan or to fully execute it, reduces the total cost of the increased contributions that will need to be made.

Current Status of the Defined Benefit Program

CalSTRS evaluates its unfunded liability in an annual valuation report which is a snapshot of the fund's assets and liabilities. The primary purpose of a valuation is to determine the adequacy of the current contribution structure and identify any needed contribution changes. CalSTRS' June 30, 2012, actuarial valuation shows the Defined Benefit Program is 67 percent funded with an unfunded liability of \$71 billion.

Source of Resources

Contributions to the Defined Benefit Program by school district employers of 8.25 percent have not increased since 1986 and the employee rate of 8 percent since 1972. The State total contribution amount of 5.541 percent includes the State contribution to the Defined Benefit Program of 3.041 percent for Fiscal Year 2013-14 and 2.5 percent to the Supplemental Benefit Maintenance Account. Contributions by the State of California to the Defined Benefit Program actually declined from 4.607 percent in 1997 to the current level of 3.041 percent. Contributions by employers and the State have been less than the contributions required for the Annual Required Contribution (ARC), which are the required contributions needed to eliminate the unfunded liability and fully fund the Defined Benefit Program, since 2002. In 2002, the ARC was 90 percent paid. In Fiscal Year 2012-13, the ARC was 44 percent paid.

Since 1984-85, member contributions represented about 17 percent of the total resources that pay benefits; school district employers, about 17 percent; and, the State General Fund, approximately 9 percent. Investment earnings based on those contributions were 58 percent. In fiscal year 2012-13, \$11.4 billion was paid in benefits, which includes the Supplemental Benefit Maintenance Account.

Cumulative Savings to the State Since 1997

Because the State's contribution rate is lower than it was in the past, the State has realized considerable savings, which has benefitted other General Fund programs. The cumulative savings through 2013-14 total \$3.3 billion.

Contribution Rate Comparison for the 2013-14 Fiscal Year

The State contribution amount of 5.541 percent includes the State contribution to the Defined Benefit Program and Supplemental Benefit Maintenance Account. The payroll rate for the Defined Benefit Program is equivalent to 3.041 percent for the 2013-14 Fiscal Year. The State contribution rate of 2.5 percent to the Supplemental Benefit Maintenance Account is also included in the chart below.

	Employee Defined Benefit	Employee Social Security	Employer Defined Benefit	Employer Social Security	State	Total
CalSTRS	8.00%	N/A	8.25%	N/A	5.541%	21.79%
CalPERS School	7.00%	6.20%	11.44%	6.20%	N/A	30.84%
CalPERS State Misc (Tier I)	8.00%	6.20%	21.12%	6.20%	N/A	41.52%

Benefit Replacement Ratio for PEPPRA Members

CalSTRS 2% at 60 members (those not subject to the California Public Employees' Pension Reform Act of 2013), in fiscal year 2012-13, on average retired at age 62 after about 25 years of service with a pension that replaced about 54 percent of their highest salary.

CalSTRS 2% at 62 members (those hired on or after January 1, 2013, subject to the California Public Employees' Pension Reform Act of 2013) are estimated to retire with a pension that replaces about 47 percent of their highest three years' salary, assuming that members retire at the same age and with the same service credit as recent retirees.

Impact of 2012-13 Returns on Required Contributions

A recent analysis by CalSTRS' outside actuarial firm, Milliman, indicates that the 13.8 percent return CalSTRS earned in Fiscal Year 2012-13 had a positive impact on the long-term funding needs of the Defined Benefit Program. Specifically, to pay off the \$71 billion unfunded liability over a 30-year period beginning July 1, 2015, the calculated additional revenue needed would have been a 16.1 percent increase in payroll. However, because the actual return for CalSTRS significantly exceeded the assumed 7.5 percent return, CalSTRS preliminary estimates show an increase of 14.2 percent of payroll to pay off the \$71 billion unfunded liability over a 30-year period beginning July 1, 2015, which translates into an additional \$4.2 billion in the first year, would still need to occur.

Clarification of Unfunded Liability Value Differences and Similarities

Recently, several widely divergent figures have been used to describe the CalSTRS' unfunded liability. Both the \$71 billion figure CalSTRS uses and the \$80.4 billion value cited in the Governor's 2014-15 Budget Proposal are derived from the CalSTRS June 30, 2012, actuarial valuation. Another figure, \$167 billion, is an estimation of the Net Pension Liability (NPL) required as part of the new Governmental Accounting Standards Board requirements. All three of the values are associated with the CalSTRS' \$71 billion unfunded liability, but only two, the \$71 billion and \$80.4 billion values, could be used to estimate the required increase in contributions needed to address the funding shortfall.

Market Value vs. Actuarial Value - Both the \$71 billion and \$80.4 billion CalSTRS unfunded liability values are accurate, as reported in the June 30, 2012, valuation report. The \$80.4 billion, referenced in the Governor's 2014-15 Budget Proposal, represents the difference between the **market** value of assets and actuarial liabilities as of June 30, 2012. The \$71 billion value of the unfunded liability cited by CalSTRS represents the difference between the **actuarial** value of assets and actuarial liabilities as of June 30, 2012. Both could be used to determine the cost of addressing the funding shortfall as either figure would result in the same required increase in contributions.

The actuarial value of assets reflects the smoothing of investment gains and losses relative to CalSTRS' 7.5 percent investment assumption, a methodology that is generally used by public pension plans to lessen the impact of short-term fluctuations in the value of assets. In any given year CalSTRS recognizes one-third of the investment gains or losses, which diverge from our 7.5 percent investment assumption.

The market value of assets does not reflect any smoothing; all gains and losses are recognized in the year they occurred. The market value of CalSTRS assets as of June 30, 2012, was \$143.1 billion, and the \$9.4 billion difference between the market value and the actuarial value explains the different numbers cited by the Governor and CalSTRS. In estimating the required increase in contributions to address the funding shortfall, however, the market value of assets would be used. This is because a long-term contribution rate where investment gains and losses are fully smoothed is applied and, therefore, reflects the market value of assets.

GASB Value - New Governmental Accounting Standards Board (GASB) requirements add an NPL, which is not intended to be used as part of a budgetary process, to financial statements. GASB's NPL and the CalSTRS' unfunded liability are similar in that both are a representation of the obligation associated with future payment of benefits already earned.

Because CalSTRS' projections indicate the Defined Benefit Program will deplete its assets in the future, GASB's new requirements implement a drastically lower, blended discount rate to represent a part of the obligation associated with future payment of benefits already earned. Historically, CalSTRS uses a 7.5 percent annual rate of return on its investments to forecast earnings, discount future obligations and determine any unfunded liabilities. Based on that assumption, the June 30, 2012, snapshot of the CalSTRS fund's assets and liabilities shows an unfunded liability of approximately \$71 billion. CalSTRS estimates that using GASB's new standards more than doubles the appearance of unfunded liability for accounting purposes only to about \$167 billion.

GASB's standards do not change CalSTRS' funding status as reported in actuarial valuations or what is needed to address the CalSTRS' funding shortfall. This is why, outside of financial statements, the GASB standards may not provide relevant information to governments struggling with how to address unfunded pension liabilities. In fact, GASB has said that it does not intend for policy makers to use the new accounting requirements as part of the governmental budget process.

Moreover, any attempt to restore CalSTRS long-term viability based on the GASB standards overly inflates the amount of contributions needed from members, school employers and the State and could needlessly subject them to significant and unnecessary financial strain. However, if a funding plan were to be enacted by the Legislature, the magnitude of the unfunded liabilities reported in financial statements would significantly decrease.

Legislative Considerations for a Funding Policy

Define Objective - The first issue that must be decided is the financial objective. As stated by the Teachers' Retirement Board, the definitive approach to addressing the long-term funding needs of the Defined Benefit Program is to fully fund the program over a period of 30 years or less. Having sufficient funds on hand minimizes the long-term cost of the Defined Benefit Program and allows those funds to grow from investments when they would otherwise need to be generated from contributions alone, ultimately reducing the need for future employer and/or State contributions to pay for benefits associated with prior service.

Determine Period of Time to Achieve Objective - This consideration best illustrates the implications of short-term vs. long-term costs and the risks associated with each. Lengthening the number of years available to achieve the financial objective reduces the contribution increases needed because the unfunded liability is being paid off over more years but ultimately requires higher total contributions. This approach is analogous to a 30-year home mortgage versus a 15-year home mortgage. Although the 30-year mortgage homeowner has a lower monthly payment because he or she is paying off the mortgage over twice as long a period of time, he or she is actually contributing less to the mortgage principal and, therefore, paying more in the long run than the 15-year mortgage homeowner.

To give an example of how a longer timeframe affects costs and risks, fully funding the Defined Benefit Program over 30 years beginning in 2015 would require an increase in contributions equal to 14.2 percent of pay. If the funding period were lengthened to 40 years, the required increase contribution rate would decline to 11.8 percent, reducing the first year additional costs of the increased contributions by about \$700 million. However, because the increased contributions would be paid over 10 additional years, the total costs of fully fund the program would be \$86 billion higher. Also of significance, the number of years in which the ratio of fund assets to liabilities would be below 70 percent is 13 years, or 68 percent longer, under a 40-year funding plan, and there would be a 27 percent greater likelihood that investment returns would result in a depletion of assets over 75 years.

Determine When Contribution Rate Increases Begin - The earlier contribution increases take effect, the lower the long-term costs. A secondary issue is how an earlier enactment of a funding plan, even with delayed implementation, could greatly benefit public agency finances by reducing the net pension liability that would be disclosed in financial statements under the new GASB standards.

Establish Speed of Rate Increases - Just as earlier implementation of contribution rate increases would result in lower long-term costs, so would faster phasing-in of contribution rates. This is because with almost 60 percent of CalSTRS resources being derived from investment earnings, the sooner that CalSTRS has contributions to invest, the more it can earn from the investments and the lower the long-term costs to members, employers and the State.

Decide How Contribution Rate Increases Get Allocated among Stakeholders - CalSTRS has retained outside legal counsel to conduct extensive research regarding the extent to which member contribution rates could increase, and under what circumstances, and would be able to share that analysis with the committee if requested. The conclusion of the outside counsel was that, although there are no contractual impediments to increasing the contribution rates paid by future members, employers and the State, the ability to increase the contributions paid by current members is limited by the contractual nature of that contribution rate. Case law prohibits changing contributions paid by Defined Benefit Program members unless a corresponding, offsetting advantage is offered in exchanged for the increase.

One example of an offsetting advantage that meets the legal restrictions would be to guarantee the 2 percent Annual Benefit Adjustment. As it stands now, this benefit is not contractually guaranteed because the Legislature has the right to reduce or eliminate the 2 percent Annual Benefit Adjustment. In this example, if the Legislature were to guarantee this benefit, its actuarial cost could be represented as an increase to current members' contributions of about 2.8 percent (or an increase from the current 8 percent contribution rate to 10.8 percent). Also, there are potential implications of higher employer contributions on the State's obligations under Proposition 98.

Determine How and When Contribution Rates Gets Re-evaluated - Although CalSTRS has a reasonable assumption for how investments will perform over the long-term, it is possible that investments will generate returns below expectations, in which case further increases in contribution rates would be required, or investment returns could exceed expectations, in which case some of the enacted increases in contributions could be reversed. The Legislature needs to

include some mechanism for addressing needed adjustments to the funding plan, in case future investment returns significantly differ from expected returns.

Closing Remarks

CalSTRS administers fair, hard-earned pension benefits for California's educators and their families and has successfully done so for more than 100 years. The age of CalSTRS alone is testament to the enduring benefit structure and soundness of the fund. Dependable pension benefits that span another century exist but not without a plan to secure the long-term funding needs of the Defined Benefit Program.

Although contribution increases can be deferred and gradually implemented, the benefits of enacting a funding strategy that increases contributions earlier are several:

- The risk to the Defined Benefit Program decreases, particularly if a substantial market downturn occurs in the near future;
- The costs to all parties involved is considerably less; and,
- The impact of a public agency's ability to implement its own financial plan is less severe.

The Teachers' Retirement Board recognizes that solving the funding shortfall through shared responsibility, as the Speaker and Chairmen Bonta propose, will have a financial impact on members, employers and the State. However, the sooner the shortfall is addressed, the lower that impact will be in the long run.

Again, thank you for your consideration of a long-term funding plan for the Defined Benefit Program; CalSTRS stands ready to assist the Legislature and the Governor as requested to help them enact a solution to provide long-term viability in this important component of a public educator's retirement security.