

March 20, 2013

Addressing CalSTRS' Long-Term Funding Needs

LEGISLATIVE ANALYST'S OFFICE

Presented to:

Assembly Public Employees, Retirement, and
Social Security Committee

Hon. Rob Bonta, Chair

Senate Public Employment and Retirement Committee

Hon. Jim Beall, Chair





Overview of CalSTRS

- ☑ ***State's Second Largest Pension System.*** Established 100 years ago, the California State Teachers' Retirement System (CalSTRS) now serves about 862,000 members—about 2 percent of California's population. CalSTRS members include current, former, and retired teachers and administrators, as well as their beneficiaries.

- ☑ ***Constitutional Duties.*** Under Proposition 162 (1992), CalSTRS' duties to its members take precedence over any other duties of the system, including minimizing employer contributions. In addition, CalSTRS is required "to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries."

- ☑ ***What Is CalSTRS' Defined Benefit (DB) Program?*** For many decades, CalSTRS has administered its main pension program, which (1) receives contributions from members, school and community college districts, and the state; (2) invests those contributions; and (3) uses its assets to provide a specific monthly pension benefit to retirees and their beneficiaries. Retirement programs of this kind are known as DB programs.



Overview of CalSTRS' Current Funding

- ☑ **Contribution Rates Set in Statute.** Unlike the California Public Employees' Retirement System (CalPERS)—which has the authority to set employer contribution rates—contribution levels to CalSTRS from members, districts, and the state are set in statutes adopted by the Legislature.

- ☑ **Estimated \$5.7 Billion of Contributions in 2012-13.** In 2012-13, school and community college district employees, districts, and the state are expected to contribute a total amount of \$5.7 billion to CalSTRS. Contribution rates set in current law are as follows:
 - **Employees (\$2.1 Billion).** Employees contribute 8 percent of their pay to CalSTRS' DB Program.
 - **Districts (\$2.2 Billion).** Districts contribute 8.25 percent of payroll to the DB Program.
 - **State (\$1.4 Billion).** The state currently pays about 5 percent of teacher payroll (measured on a two-year lag) to the DB Program and a companion program—the Supplemental Benefit Maintenance Account—combined. (This percentage will grow slightly in future years, but not enough to address a substantial part of CalSTRS' funding problem.)



Estimated Unfunded Liabilities of About \$70 Billion

- ☑ ***What Are Unfunded Pension Liabilities?*** An unfunded liability is an estimate of the amount, in excess of assets, needed for pension benefits earned up to that point in time but not yet distributed.

- ☑ ***Estimated Unfunded Liabilities of About \$70 Billion.*** As of its valuation for June 30, 2011, CalSTRS' consulting actuaries estimated that the DB Program's liabilities exceeded its assets by \$64 billion. In February 2013, the actuaries released an initial estimate—subject to change—that the unfunded liabilities grew to \$73 billion as of June 30, 2012.
 - ***Estimated "Funded Ratio" of 66 Percent.*** The \$73 billion of unfunded liabilities indicate that system assets equal about 66 percent of benefits accrued to date.

- ☑ ***All Assets Depleted by 2044.*** The actuary also made an initial estimate that, absent corrective action, the DB Program would deplete its assets by 2044.



What Factors Led to the Unfunded Liability?

- In the Late 1990s, DB Program Was Fully Funded Briefly.*** For most of its history, CalSTRS has had unfunded liabilities. The appellate decision in *CTA v. Cory* (1984) made clear the state had various contractual obligations to fund CalSTRS. In 1990, state contributions were increased to aim for full funding within about 40 years. Due in part to strong investment returns during the 1990s, the DB Program was fully funded by 1998. At that time the DB Program's assets essentially were greater than the present value of future benefits earned at that time by current and past teachers.

- Weak Investment Results and Program Changes Produce Unfunded Liabilities.*** Within a few years of the program reaching full funding, the state increased certain member benefits and reduced its contributions. Weak investment results in the early 2000s combined with these actions to produce unfunded liabilities of about \$23 billion by the 2003 valuation. The liability remained around \$20 billion for a few years before the recent recession caused it to swell to the most recent estimate of \$73 billion.

- In Retrospect, Actions of Late 1990s Were Problematic.*** During the "dot-com bubble," the state decided to reduce its contributions and change certain aspects of CalSTRS' benefits. Last year's pension legislation reduces the chances that similar choices will recur by limiting future benefit increases and prohibiting "retroactive" pension increases, among other changes. In the future, we advise policymakers to avoid changing pension contributions or benefits based on any short period of strong investment gains.



Recent CalSTRS Funding Report



Resolution Chapter 123, Statutes of 2012 (SCR 105, Negrete McLeod)

- Stated the intent of the Legislature to enact legislation during the 2013-14 Regular Session that addresses the long-term funding needs of the DB program.
- Encouraged CalSTRS to develop at least three options to address those needs.



Key Findings From CalSTRS' Report

- **Full Funding in 30 Years or Less “the Definitive Approach.”** CalSTRS identified full funding in 30 years or less as the definitive approach to addressing the DB Program’s long-term funding needs. In addition, CalSTRS’ consulting actuaries believe that “a 30-year amortization of the funding shortfall should be the minimum funding target.”
- **Definitive Approach Would Cost About \$4.5 Billion Per Year Initially.** Fully funding benefits already earned within 30 years would require *additional* payments from one or more sources estimated by CalSTRS’ actuaries at 15.1 percent of teacher payroll annually, if implemented on July 1, 2014. CalSTRS estimates that this 15.1 percent of teacher payroll would equal around \$4.5 billion per year (a dollar amount that will grow over time).
- **Only One of CalSTRS’ Options Consistent With Its Definitive Approach.** Of the eight scenarios in the CalSTRS report, only one—“Scenario 1”—is consistent with the system’s definitive approach. Scenario 1 would begin to implement rate increases in 2014-15, totaling 3 percent of payroll per year, until additional contributions total 17.2 percent of teacher payroll in 2019-20. An extra 17.2 percent of payroll could be over \$5 billion per year initially—roughly an 80 percent increase in aggregate contributions to CalSTRS.



More Costly the Longer We Wait

- CalSTRS Unfunded Liability May Be State's Most Difficult Fiscal Challenge.*** If the state's current \$1.4 billion annual contribution to CalSTRS were combined with the \$4.5 billion additional contribution that may be necessary to achieve full funding in 30 years, the sum would exceed state spending on the University of California and California State University systems combined. The additional CalSTRS contribution alone would represent about one-half of state corrections spending.

- Waiting Increases Risks of Fund Depletion in the Future.*** Investment returns compound over time. Therefore, the longer it takes for the state to increase contributions to the CalSTRS system, the more costly it generally will be to erase the unfunded liability. Similarly, the smaller the increase in contributions in the near term, the less the investment gains over the long term. Waiting to address the funding problem would leave the system with fewer assets in the meantime—making it much more vulnerable to sharp, future declines in the stock market. If CalSTRS' assets were depleted, benefits would have to be paid on a pay-as-you-go basis.

- Pay-As-You-Go Method Much More Costly.*** In general, because investment returns compound over time, prefunding pension benefits is significantly less costly than funding benefits on a pay-as-you-go basis. To illustrate, the normal cost of current hires under the DB Program—that is, the amount actuaries estimate is needed to be paid now to cover the cost of future benefits earned this year by these teachers—is 15.9 percent of teacher payroll. CalSTRS currently estimates that the annual cost of providing benefits under a pay-as-you-go method could be about 50 percent of teacher payroll.



Major Piece of State’s Long-Term Liabilities

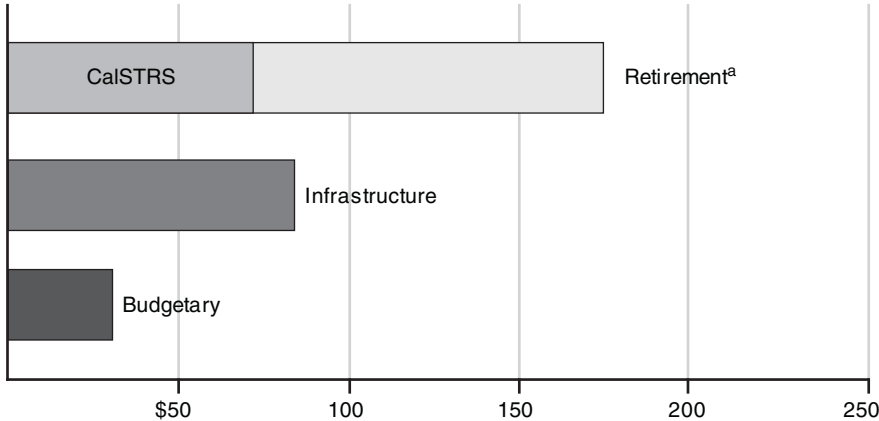


Largest Part of California’s Retirement Liabilities.

The estimated unfunded liability for CalSTRS is the largest component of California’s retirement obligations, and is among the largest parts of the state’s long-term liabilities along with the general obligation bond portion of infrastructure debt. In addition, the unfunded liability is more than twice the size of the Governor’s so-called “wall of debt.”

CalSTRS Major Component of California’s Long-Term Obligations

General Fund and Special Funds (In Billions)



^a Based on pension systems’ valuations of liabilities. CalSTRS liabilities based on June 30, 2012 preliminary valuation.
CalSTRS = California State Teachers’ Retirement System.



Unfunded Liability Grows Faster Than Other State Debt



Grows Faster Than Infrastructure, Budgetary Debts

- ***Infrastructure Obligations.*** The state owes interest—generally around 4 percent to 6 percent per year—on bonds it sells for infrastructure projects. Because the state makes regularly scheduled payments on these debts, however, the amount of bonds outstanding shrinks each year absent additional bond offerings.
- ***Budgetary Obligations.*** Most budgetary obligations, such as payment deferrals, loan amounts due to special funds, and mandate reimbursements due to local governments are either fixed or grow at relatively low interest rates, generally under 4 percent. Over time, total budgetary obligations will shrink because the state makes quarterly payments on its prior deficit financing bonds.
- ***CalSTRS and Other Retirement Obligations.*** The state's retirement obligations generally grow faster than infrastructure and budgetary obligations. Left unaddressed, CalSTRS' unfunded liabilities, for example, tend to grow at something like the system's assumed annual rate of investment return—currently 7.5 percent. This is because each year the state delays action on the unfunded liability, the state loses another 7.5 percent return under the actuarial assumptions, an amount that compounds over time. In addition, CalSTRS' unfunded liabilities are also affected by market conditions. For example, a change in the stock market decreases (or increases) the DB Program's assets and can cause a commensurate change in CalSTRS' unfunded liabilities.



Most Extra Funding Likely From State, Districts



Full Funding Through Investment Returns Unlikely. Over the last 20 years, CalSTRS met its current 7.5 percent average annual investment return assumption. To fully fund CalSTRS in 30 years without changes in contributions or benefits, investment returns would need to average roughly 10 percent over this period. We agree with CalSTRS that such a high rate of return over a long period is very unlikely to occur.



Difficult to Increase Contributions of Current Teachers Under Case Law

- ***State May Have One Limited Option in This Area.*** In its report, CalSTRS highlights one option that could produce additional contributions from current employees. Specifically, CalSTRS says the state may be able to increase employee contribution rates by about 2.6 percent of payroll in exchange for vesting a program (already counted in system valuations) that adjusts pension amounts upward by a simple 2 percent amount annually. Such an increased contribution—if applied to both current and future teachers—would comprise about one-seventh of the 17.2 additional percentage point contribution identified in CalSTRS' Scenario 1. (Note that, by definition, none of the current unfunded liabilities relate to benefits of future and newly hired teachers.)



Most Extra Funding Likely From State, Districts *(Continued)*

- Reducing Future Teachers' Benefits Unlikely to Be Major Funding Solution.*** The Legislature could consider savings from reductions of benefits (beyond those already enacted in last year's pension legislation). This group of future teachers will remain a minority of CalSTRS members for years to come. As such, significant additional benefit reductions for this group would be required to address a large portion of the funding problem over the next 30 years.

- Bulk of Increased Contributions Likely From State or Districts.*** Because investment returns are unlikely to be sufficient and increased employee contributions can only address a small part of the unfunded liability, the bulk of the funding needed likely will have to come from additional payments by the state and/or districts.



Recommend Aiming for Full Funding in About 30 Years

- Recommend Enacting Plan by End of 2014 Legislative Session.** We recommend that the Legislature adopt a plan that begins to provide additional funding to CalSTRS beginning in 2014-15 and aims to fully fund CalSTRS' unfunded liabilities in about 30 years. If the current-law budget surpluses we forecasted in November 2012 materialize, these might soften the near-term budgetary impact of the additional payments. Such surpluses would require continued economic growth and ongoing spending restraint by the state.
- Will Require Difficult Budgetary Choices . . .** Even if current-law budget surpluses materialize, there is no way to avoid these additional payments complicating the state's budget situation during the next economic downturn.
- . . . Whether Payments Come From Districts or the State.** Whether the bulk of the additional contributions comes from districts or the state, the Legislature will be faced with difficult choices in future downturns: reducing education funding, reducing funding for other programs, or increasing revenues more than otherwise would be required at that time. While delaying or gradually phasing-in contributions may lessen the severity of cuts in the next economic downturn, such a plan would be more costly in the long run, leaving fewer resources for other programs over the long run.
- Perhaps More Important Than the Wall of Debt.** The state makes regular payments on some items in the wall of debt (such as deficit financing bonds), and it can make payments on the school and community college elements of the wall of debt from funds guaranteed annually by Proposition 98. The state, however, has much more flexibility in determining how to repay other items in the wall of debt, which tend to grow more slowly than CalSTRS' unfunded liabilities. Accordingly, adopting a plan to address these unfunded liabilities might be considered a greater priority than repaying these other items in the wall of debt.



Concerns Regarding CalSTRS' Scenarios 2 Through 8

- Less Than the Definitive Approach.*** Scenarios 2 through 8 in the CalSTRS funding report aim for a system that has substantial remaining unfunded liabilities in the future and/or aim for fully funding existing liabilities 75 years from now. All of these scenarios fall far short of CalSTRS' so-called definitive approach.
- Should Pensions Result in Systematic Transfer of Costs to Future Generations?*** Scenarios 2 through 8 would codify, potentially for much of the next century, the practice of systematically deferring tens of billions of dollars of costs to each future generation at very high effective rates of interest.
- These Scenarios May Not Meet Requirement for Sound System.*** The Legislature has granted CalSTRS members a contractual right in statute to a "financially sound" system. The Legislature should consider whether a plan with less than full funding within about the next three decades is consistent with that contractual right.



Key Opportunity to Increase Local Control of Teacher Pensions

- Local Program Has No Local Control or Responsibility.** For several decades now, our office has identified problems with the current method of providing teacher retirement benefits. Under the current system, school districts have no flexibility to provide different pension options to meet local needs. Further, because the state sets contribution rates, there is no local accountability for funding pensions during the careers of system members.
- Legislature Could Treat CalSTRS Similar to Other Local Retirement Programs.** Shifting program responsibility exclusively to teachers and school districts would place decision making and responsibility at the local level for future teachers, similar to other local retirement programs. Under this system, districts and teachers could be given flexibility at the bargaining table to choose among DB plans that meet their needs within available resources. As the state reconsiders funding of CalSTRS, there may never be a better opportunity to adopt a comprehensive package that also makes these changes.
- Shift Would Reduce State's Long-Term Fiscal Risks.** In the long run, a shift to local control could mean that the state would no longer be responsible for pensions of future teachers. This would reduce the risk associated with the current system in which the state can be viewed as CalSTRS' guarantor of last resort.
- CalSTRS' Rate-Setting Authority.** Unlike CalSTRS, CalPERS increases the amount that the state and local member agencies must pay when employee salaries are increased, investment returns are lower than expected, or other factors increase the cost of providing pension benefits. CalSTRS currently does not have this authority as its contribution rates are set in statute by the Legislature. A shift to local control of CalSTRS likely would require giving the system the authority to set and adjust district contributions.