

Addressing the CalSTRS Unfunded Actuarial Obligation: What You Need to Know

by Carolyn Widener

This year, the threat to retirement security has moved into the media, as pundits in a wide range of publications warn taxpayers that they or their children could well be on the hook for billions of dollars in “unfunded obligations” run up by public plans. In the midst of this hostile climate, the California State Teachers' Retirement System (CalSTRS) Board of Trustees is considering options to address our system's 20 billion dollar unfunded actuarial obligation (UAO). Some of these options would reduce benefits, especially for new teachers. Other options would raise contributions from employees or employers. The board's choice of options could affect the ability of California's public K-12 and community college districts to recruit and retain experienced educators for many years to come.

Why does CalSTRS have an unfunded actuarial obligation?

The very expression, “Unfunded Actuarial Obligation” sounds ominously dangerous — like the fund owes money or is close to going under. Neither interpretation is correct. Pension funds have two streams of income: one is from employee and employer contributions; the other is from interest earned by investments.

Periodically, in order to measure whether there will be sufficient money to pay the benefits promised over the next thirty years, a pension fund conducts an actuarial study which assumes such variables as the expected rate of return on investments, rate of inflation, and wage increases for members. CalSTRS is actuarially under funded today, because we have assumed the fund would earn an average of 8 percent on investments. Instead, CalSTRS, and all public pension funds, fell well short between 2001 and 2004, as they absorbed a stock market decline exceeded only by the one during the great depression of the thirties. Although CalSTRS’ investments have done better than expected for the last two years, those three bad years have the current funding level down to 86 percent — a \$20.3 billion unfunded actuarial obligation.

Another way to express the difference between what we need and what we have is to consider the resources needed to amortize the unfunded actuarial obligation as percent of pay: the difference is equal to 3.753 percent of creditable salaries over 30 years.

This 80 percent income replacement ratio is only sufficient to maintain the same standard of living a member had while working if the retired member continues to receive other employer-based benefit, particularly health benefits. Unfortunately, between the rising cost of health care and new GASB regulations, employer-paid retiree health care benefits are disappearing, especially for new teachers.

Dave Elder, the former Chairman of the Assembly Public Employees Retirement & Social Security Committee, had this to say about cutting benefits at the February 3, 2006 meeting of the CalSTRS Board:

Teachers’ pensions are far from adequate and far from equal with other public employees. Any thought of reducing retirement benefits of California teachers with the lowest pension benefit of almost any California public employee, is a bad idea particularly in light of the huge projected teacher shortage in the next several years. One other aspect of the plight of teachers is that about 40 percent of school districts do not provide health insurance to retired teachers.

Can’t CalSTRS just invest its way out of this problem?

To solve this shortfall only through investment earnings, the rate of return on investments would need to average more than eight percent. However, in order to achieve a higher assumed rate of return, the allocation of CalSTRS investments would have to be changed to place more money in asset classes with higher levels of risk. If the additional risk from a changed asset allocation resulted in lower rates of return, then the funding deficiency would only increase.

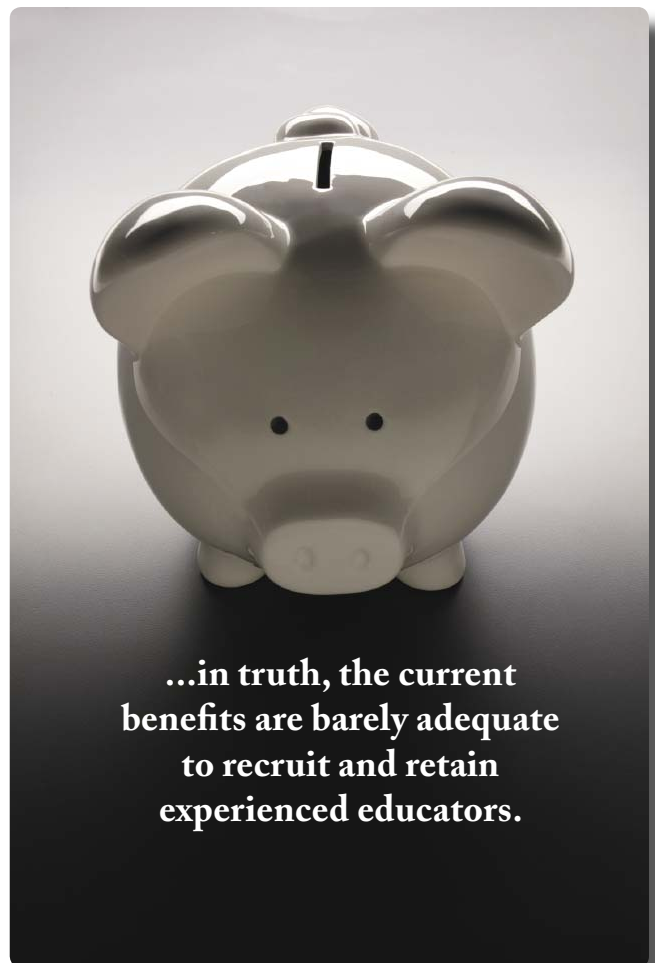
Should “core” benefits be cut?

Sensational journalists, often relying on Assemblyman Keith Richman as a source, erroneously lump teachers and all public employees together as “retiring at 50 with 90 percent of their pay.” They say, “Just cut benefits.” However, in truth, the current benefits are barely adequate to recruit and retain experienced educators.

Reducing or eliminating the core benefits would create a two-tier system, because the following benefits cannot legally be reduced for current members:

- An increase in the age factor for members retiring after age 60
- A career factor that is added to the age factor for members retiring with 30 or more years of service
- A longevity bonus for members who have at least 30 years of service credit by 2011
- Converting unused sick leave to service credit

These benefit enhancements have fulfilled their public policy objective: experienced teachers are working longer. But even after working longer, for only 40 percent of recent retirees (2003-04) with at least 20 years of service credit, was the benefit paid by the DB program equal to at least 80 percent of final compensation.



Should the two percent COLA be eliminated? Should the SBMA be incorporated into the regular Defined Benefit Program?

The two percent (simple, un compounded) COLA adjustment is paid on a member's pension. Unlike the "core benefits," COLA could be eliminated for all members – current and future – because Ed. Code Section 22140 reserves the right of the Legislature to adjust it up or down depending on economic circumstances.

However, eliminating the COLA benefit, as inflation continued, would just force retirees to more quickly access the Supplemental Benefit Maintenance Account. The 80 percent purchasing power protection benefit of SBMA is vested only to the extent that funds are available and, without the COLA, they would be used up much more quickly.

Currently, SBMA is a separate account to which the state makes an annual contribution. It is projected to have sufficient resources to pay 80 percent purchasing power to currently retired members for many decades to come. One option under consideration would credit the current assets and future state contributions of the SBMA to the regular DB program with the benefit paid from the DB program. This move would guarantee 80 percent purchasing power for all benefit recipients by shifting the risk of inflation from the benefit recipient to the DB program. 80 percent purchasing power would become another "core benefit." Many current retirees oppose this move – in the hope that under the current arrangement, purchasing power may someday be increased above 80 percent.

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Should contributions be raised?

Raising the employer contribution is the option with the most impact – for every one percent it is raised, one percent of the amortization cost is reduced. Since 1990, the employer contribution rate to CalSTRS has been 8.25 percent for teachers. Because no contribution is made to Social Security for teachers, it's considerably less than the total employer retirement contribution for other California public employees. State and school CalPERS employers have contributed an average total of 16.25 percent and 10.8 percent, respectively, since 1989-90. The employer's 8.25 percent for teachers is also well below the average contribution of 10 percent made by employers across the nation for employees not in Social Security. Representatives from teacher groups have cautioned the CalSTRS board that any bill to raise employer contributions should be written to insure that any increase is phased in incrementally, gradually, and predictably.

A related option with a smaller impact would impose employer contribution on postretirement service. Currently, districts have an incentive to hire retirees, rather than full- or part-time faculty, because they make no contribution for them. A third option would reduce or eliminate the eight percent employer contribution credited to the Defined Benefit Supplement Account and instead credit it to the DB program.

Increasing the member contribution rate does not have as much value as increasing the employer rate, because a large percentage of members who leave teaching take their own contributions out of the fund. Nonetheless, people who believe in "sharing the pain" can point out that CalSTRS members have lower total contribution rates than CalPERS school classified or state miscellaneous members (8 percent compared to 13.2 and 11.2 including Social Security.)

The state contribution rate from the general fund has decreased from 4.3 percent of the prior calendar year's compensation in 1992-97 to its current level of 1.1975 percent of the prior calendar year. However, the obstacles to raising it, funding a pension bond, or even extending the amortization period seem formidable in today's political climate.

So, what's going to happen?

We learned last year, when our defined benefit retirement system was under attack, just how valuable it is to our retirement security. We need to preserve it – strong and well funded – to help California recruit and retain experienced educators, both now and in the future.

The CalSTRS board, unlike PERS and many other boards, does not have the authority to raise contribution levels. The majority of options the board is considering ultimately will require legislative approval to implement. This process means that there will be ample opportunity for input – from both individual teachers and the organizations that represent them. FACCC members are fortunate to have their able government affairs director, Jennifer Baker, and their retirement committee members actively studying these issues and advocating on their behalf.

Let them know your thoughts and preferences on dealing with the CalSTRS unfunded actuarial obligation, or let me know at Carolyn.Widener@comcast.net. ■

FACCC member Carolyn Widener currently serves as vice president of the Teachers' Retirement Board and chairs its Benefits and Services Committee. After originally being appointed to the Board in 2001, she was elected to represent community college educators in 2004. She is a professor of english at West Los Angeles College and has been the executive vice president of the Los Angeles College Faculty Guild since 1996.