OFFICE OF THE
ARIZONA STATE TREASURER

DOUG DUCEY
TREASURER

December 21, 2011

Hon. Jan Brewer
Governor, State of Arizona

Hon. Steve Pierce, President-elect
Arizona State Senate

Hon. Andy Tobin, Speaker
Arizona House of Representatives

Dear Governor, Mr. President and Mr. Speaker,

Laws 2011, Chapter 357, Sec. 56 created the Defined Contribution and Retirement Study Committee consisting of the five members of the State Board of Investment, six members of the Arizona Legislature appointed by the President of the Senate and the Speaker of the House and a member from each of the boards of the Arizona State Retirement System (ASRS) and the Public Safety Retirement System (PSPRS).

The committee was given five tasks, a requirement to meet at least twice in calendar year 2011, produce an interim report by December 31, 2011 and a final report by December 31, 2012. The committee has met four times in 2011, reviewing 26 presentations and accumulated 24 articles or reports on retirement related issues. This interim report provides highlights of what the committee has studied under each of the five tasks.

Task 1:

> *The feasibility and cost of transferring existing members of a public retirement system or plan to a new defined contribution plan as well as providing for a defined contribution plan for newly hired public employees. The committee shall examine public and private defined contribution plans in other states, including their plan designs, and the federal tax issues that affect a defined contribution retirement plan.*

The first task of the committee is to examine the cost and feasibility of moving existing and or new employees to a Defined Contribution (DC) plan. As part of this task, the committee took testimony from Utah State Senator Dan Liljenquist who sponsored legislation in Utah that implemented a new hybrid retirement program that began July 1, 2011.

The committee also reviewed the 16 states that have switched to mandatory DC plans, allow employees the option of a DC plan or provided a hybrid Defined Benefit (DB) plan or DC plan. Further staff research is ongoing to examine how states that have made the switch are financing the unfunded status of their legacy DB plans.

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Finally, as part of task one, the committee was presented presentations on the funded status of the ASRS, PSPRS, Correction Officers Retirement Program (CORP) and the Elected Officials Retirement Program (EORP). Combined, the four plans have an unfunded status of $16.2 billion as of June 30, 2011, with approximately $3.7 billion of that burden falling on State Government employers and employees. This is an improvement from the prior year, when the combined unfunded status of the four plans was $19.5 billion as of June 30, 2010.

Task 2:

All the existing supplemental retirement plans in the public safety personnel retirement system and the Arizona state retirement system, the advantages and disadvantages of these supplemental retirement plans and the feasibility of merging these supplemental retirement plans to achieve maximum effectiveness and minimization of costs to members and employers.

The committee was given presentations on the six supplemental plans offered by PSPRS, ASRS and the Department of Administration and examined the charges and costs of each of these plans. Based on the information presented, there doesn't appear to be any cost savings to either members or employers by consolidating these plans at the state level.

However, while not part of the committee charge, there does exists the issues of each political subdivision in the state – including the 230 plus school districts – can offer their own supplemental retirement system plan. The Legislature did address this in 2009 by allowing ASRS to offer a new supplemental plan on a voluntary basis for each school district and charter school to participate.

Task 3:

The definitions of compensation, average yearly salary and salary as used by the Arizona state retirement system, the elected officials' retirement plan, the public safety personnel retirement system and the corrections officer retirement plan to ascertain the actuarial effect of these definitions on the respective retirement systems and plans, particularly the ability and actuality of "spiking" compensation.

The committee received presentations under two methodologies to examine if spiking exists in the retirement system. One method was the percentage of retirees that had their compensation increase by more than 25 percent during the last three years of employment. The second method was looking at pay increases over three year intervals over a nine-year period to see if compensation increases were higher in the last three years of employment, or the three and six years prior to employment.

As a result of the findings, the committee is asking the retirement systems for more data to determine what drove the higher compensation for those retirees.

Task 4:

In regards to the public safety personnel retirement system and the corrections officer retirement plan, the advantages and disadvantages of the local board system, the advantages and disadvantages of the agent multiple-employer public retirement system model and the feasibility of establishing a single employer public retirement system model.

The committee has been given historical background on this issue and asked PSPRS to survey the 260 plus members in PSPRS and CORP for additional information on the costs of each board system. As for as the feasibility of establishing a single employer model, information on the actuarial impact in regard to collapsing large employers versus small employers, and collapsing the State of Arizona's several boards into a single board, has been requested. The PSPRS administrator has provided 5 different scenarios of consolidating the plan around 1) large employers; 2) State of Arizona entities only; 3) county employers; 4) State and county employers separate; and 5) State and County employers combined. Each scenario presents winners and losers amongst all the plans in terms of rate increases or decreases. The smallest rate increase would occur if the State consolidated all of its PSPRS employers into a single entity.

Task 5:

In regards to the public safety personnel retirement system and the corrections officer retirement plan, the procedures, determinations and granting of accidental and ordinary disability retirements to members, the effect of the local boards in providing adequate cost controls for these disability retirements, the establishment of another medical disability tier that provides for those members who cannot perform a reasonable range of duties within the member's job classification or department but who are not totally disabled and the elimination of the local boards in making such determinations and replacing the determinations of granting medical disabilities with a single determination board in the administrative offices of the public safety personnel retirement system.

Data provided by the administrator of PSPRS indicates that the dollar level of pension distributions for PSPRS has held steady between 10.2% of benefits paid to 12.8% of benefits paid since FY 1995 and currently is at 11.6%. Likewise the total number of those receiving a disability pension has ranged between 11.9% of those receiving a pension and 15.1% of pension recipients since FY 1995, with the current level at 13.8%.

For CORP, the numbers indicate a decline in those receiving disability pensions from a high of 5.9% in FY 2000 to just 3.2% in FY 2011. As a result total amount of benefits paid each for disabilities has

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decreased from 8.6% in FY 1995 to just 2.6% of benefits paid in FY 2011. The committee is waiting further data from PSPRS on this issue and will be addressed in the final report.

In conclusion, the committee is dedicated to doing a thorough job in studying these issues and is on target to meet the charge of the Legislature and Governor to have a final report by December 31, 2012.

Sincerely,

Doug Ducey
Treasurer, State of Arizona
Chairman of the Defined Contribution and Retirement Study Committee

Enclosures (2)

cc: David Byers, Representative Chad Campbell, Hon. Beth Ford, Senator Linda Gray, Senator Jack Jackson, Jr., Lauren Kingry, Alan Maguire, Representative Justin Olson, Scott Smith, Representative David Stevens, Brian Tobin, Senator Steve Yarborough

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APPENDIX

September 27, 2011

Presentations:

- Presentation Master DC Study Committee 9-27-11 - (ASRS)
- Study Committee 2011-09-20 Financial Retrospective and Prospects for the Future - (PSPRS)
- Utah Pension Reform Presentation - Hon. Daniel Liljenquist, Utah State Senator

Articles or Reports:

- Memorandum on Actuarial Modeling from Gabriel Roeder Smith & Company to Sen. Liljenquist

October 25, 2011

Presentations:

- Presentation Salary History Analysis Retired and Active - Compensation and Pension Analysis of Active and Retired Members of the Arizona State Retirement System - (ASRS)
- Presentation State, ASRS and PSPRS DC Plans - Informational Presentation on Defined Contribution Plans Administered by the State of Arizona, the Arizona State Retirement System and Public Safety Personnel Retirement System - (ASRS)
- Study Committee Analysis and Report on Spiking-Revised - (PSPRS)
- Study Committee Power Point Presentation on Spiking - (ASRS)
- DC and Hybrid Retirement Plans in Other States - Committee Staff Presentation

Articles or Reports:

- Decisions, Decisions: Retirement Plan Choices for Public Employees and Employers; Mark Ollerman FSA, MAAA, EA and Ilana Boivie, Milliman; National Institute on Retirement Security; Sept. 2011
- Defined Benefit versus Defined Contribution Plans - Presentation to the 2011 National Institute for Public Finance; Lance Weiss, Gabriel Roeder Smith & Company; August 2011
- Issue Brief; A role for Defined Contribution Plans in the Public Sector; Alicia H. Munnell, Aubry, Hurwitz and Quinby; Center for State & Local Government Excellence April 2011
- Key Elements of State Hybrid Retirement Plans; National Association of State Retirement Administrators; Keith Brainard; February 2011
- State Defined Contribution and Hybrid Pension Plans; Ronald Snell, National Conference of State Legislatures; June 2010
- Public Fund Survey – Summary of Findings for FY 2009; Keith Brainard, NASRA; Nov. 2010

November 22, 2011

Presentations:

- Side by Side Comparison of Spiking by ASRS, PSPRS, CORP and EORP - Committee Staff
- Study Committee Spiking Analysis Police vs. Fire and Metro vs. Rural - (PSPRS)
- Study Committee Spiking Analysis using the ASRS Methodology - (PSPRS)
- ASRS Salary Spiking – PSPRS Methodology - (ASRS)

- ASRS Actuarial Update for June 30, 2011 - (ASRS)
- Study Committee FY'11Actuarial Valuation Summary - (PSPRS)
- Study Committee FY'13 PSPRS and CORP Final Employer Rates - (PSPRS)
- FY'11 Financial Report 11-15-11 - (PSPRS)
- ASRS Board Structure and Governance - (ASRS)
- ASRS Long Term Disability Approval Process - (ASRS)
- PSPRS Board Structure and Governance - (PSPRS)
- Multi-Employer vs. Pooled Plans and Disability Stats - (PSPRS)

Articles or Reports:

- Rhode Island Legislators OK Hybrid Retirement Plan; Kevin Olson, Pensions and Investments Nov. 18, 2011
- NASRA Issue Brief: State Hybrid Retirement Plans; Keith Brainard, NASRA; Nov. 2011
- GFOA Governance Guidelines; Adopted March 5, 2010
- Stanford Institutional Investors' Forum, Committee on Fund Governance Best Practice Principals, Peter Clapman, May 31, 2007
- Canadian Association of Pension Supervisory Authorities, Guidelines, Oct. 25, 2004
- ASRS Board Governance Handbook, Revised July 15, 2011
- Myths and Misperceptions of Defined Benefit and Defined Contribution Plans, White Paper; Keith Brainard, NASRA; Nov. 2002; updated Feb. 2005
- Defusing the Pension Bomb: Making Retirement Plans Solvent for all Public Workers, Policy Brief; Byron Schlomach, Ph.D., Goldwater Institute's Center for Economic Prosperity, April 27, 2011
- $50 Billion Tidal Wave: How Unfunded Pensions Could Overwhelm Arizona Taxpayers; Goldwater Institute Policy Report, Andrew Biggs, resident scholar American Enterprise Institute, March 31, 2010
- The Crisis in Local Government Pensions in the United States; Robert Novy-Marx University of Rochester and NBER, and Joshua Rauh, Kellogg School of Management and NBER, Oct. 2010
- A comparative Analysis of Defined Benefit and Defined Contribution Retirement Plans, Paul Matson and Susanne Dobel, ASRS, September 22, 2006
- A Better Bang for the Buck, the Economic Efficiencies of Defined Benefit Pension Plans, Betha Almeida and William B. Fornia, FSA, National Institute on Retirement Security, August 2008.
- OECD Guidelines for Pension Fund Governance, June 5, 2009
- A comparison of Arizona's Public Pension Plans, ASRS Summer 2011

December 13, 2011

Presentations:

- Review and Follow-up Questions - Committee Staff Presentation
- DC v DB Survey Results - Committee Staff Presentation
- Data & Projection Refinements - (PSPRS)
- Actuarial Projections - (ASRS)
- Cash Flows - (ASRS)
- Salary Spiking - Reasons for Increases - (ASRS)

Articles or Reports:

- Arizona Private Sector DC vs. DB Retirement Plan Survey Results

- Mackinac Center Public Policy Brief – *Estimated Savings from Michigan's 1997 State Employees Pension Plan Reform*
- Towers-Watson-Accounting-for-Pension and Other Postretirement Benefits, 2011

Statement from Board of Investment member Alan Maguire:

"There are no savings from the mere conversion from a Defined Benefit system to a Defined Contribution system. Any savings, or lower costs to employers and employees, occur as a result of lower benefits.

Lower contribution levels will result in lower benefit levels (lower post-retirement income levels) that may prove to be inadequate.

Defined Contribution plans that rely on self-directed investment decisions will almost definitely have lower long-term rates of investment return relative to collectively invested Defined Benefit plans. This will result in lower post-retirement income levels, even with comparable contribution rates, and such lower income levels may prove to be inadequate.

Conversion from a Defined Benefit system structure to a Defined Contribution system structure does not eliminate any liability for either previously accrued, unfunded benefit liabilities or currently accruing benefit liabilities.

The Arizona public employee retirement systems are structurally and financially different that many public retirement plans in other states. Therefore, comparisons to national statistics have little or no relevance to Arizona and consequently, are frequently misleading.

Most private sector Defined Contribution plans have lower current contribution amounts and consequently lower future post-retirement income levels that may prove to be inadequate. This issue is exacerbated by the likely lower investment rates of return. Therefore, comparisons of Arizona's public employee retirement systems to private sector Defined Contribution plans have little relevance and consequently, frequently misleading."