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STATE OF CALIFORNIA

EDMUND G. BROWN JR., Governor

STATE TEACHERS' RETIREMENT SYSTEM
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March 2, 1976

TO: The Teachers' Retirement Board

SUBJECT: Financial Condition of the Teachers' Retirement Fund, State Teachers' Retirement System

Considerable concern has been expressed over the long range financial condition of the Teachers' Retirement Fund. That concern is emphasized in the certified public accountant's opinion contained herein. The Teachers' Retirement Board has been studying this issue and an actuarial valuation is in progress to confirm the amount of additional income needed by the Fund. The Senate Committee on Public Employment and Retirement, chaired by Senator James Q. Wedworth, and the Assembly Committee on Public Employee and Retirement, chaired by Assemblyman Wadie P. Deddeh, held extensive statewide hearings on this issue during the 1975 interim.

The State Teachers' Retirement System is in no danger of going broke. Income during fiscal year 1974/75 exceeded $839.3 million while payout was a little over $346.3 million. Money, therefore, is accumulating in the trust fund under the present inadequate level of contributions but not at a rate sufficient to meet the emerging obligations. The obligations accrued during this past fiscal year were approximately $306.3 million to members' account reserves, $306.3 million to employer reserves, $346.3 million to benefits in force, and $344.0 million to interest on the unfunded accrued liability (6½% on $5.3 billion) resulting in total liabilities of $1,302.9 billion after deducting income of $839.3 million there remains an increase in the unfunded accrued liability of approximately $463.6 million for the fiscal year. The concern is long range that when all benefits now promised the presently active teachers become due that funds to pay those benefits will not be on deposit.

As displayed elsewhere in this report, very good progress continues to be made in improving the interest income to the Fund. However, reliance on that source of income to fund the additional accruing liability would be a serious mistake. Investment income can be expected to produce only that portion of income which can be realized under market conditions with prudent investments. A display of the growth in the portfolio and the continuously increasing net rate of return on the investment portfolio can be found on page of this report. The only solution to the financial problem is increased income to the system if the present level of benefits is to be maintained and paid upon retirement, disability or death.

An actuarial valuation of the system performed by A.S. Hansen, Inc., Consulting Actuaries, based on a census of the population covered by the system as of June 30, 1974, indicated the same need for significant adjustments in the assumptions underlying the valuation of the Teachers' Retirement Fund as is being experienced by other public pension funds nationwide. That actuarial report and the assumptions underlying it are being restudied in the actuarial valuation now in progress to confirm the assumptions and the level of need for additional income.

The Hansen report shows that while the system has been operating using the 1965 group annuity mortality table that the 1971 individual mortality table indicating a longer retired life span more accurately reflects the behavior of the teacher population. The improvement in the benefit schedule enacted in the Barnes Bill effective in 1972 together with the reduction in enrollment in the public schools; the unilateral instigation of so-called early retirement incentive plans by local school districts and the more intensive management of the teaching force have reduced the average age of retirement from the planned age 62 down to an average of 61.5 years. The paucity of teacher positions due to reduced enrollment has resulted in a greater reduction in turnover than anticipated. The rate at the time of the adoption of the Barnes Bill was 16,000 and was planned to move down to 14,000 while, in actual practice, it has moved down to approximately 9,000. No economist in the United States forecasted double digit inflation nor did they forecast the extent of the increase in salary scales which has resulted. Statewide average salaries of teachers has moved from $10,500 in 1972 to in excess of $14,300. All of these adverse occurences carry with them a substantial financial impact on the funding of the system. The actuarial valuation report concludes that rather than a 16% of payroll system (8% employee and 8% employer) the required contribution rate may be as high as from 20% to 25% of payroll to fund the current benefits promised by law.

In addition to the foregoing adverse financial experience resulting from the behavior of the population covered by the system which in turn has forced a continued growth of the unfunded accrued liability, there is the problem of holding the unfunded accrued liability level by paying interest only on it, or, as is proposed in pending federal legislation, to amortize it over a forty-year period. As you are aware, the system was operated on a pay-as-you-go basis from 1913 to July 1, 1972. During that entire period, teachers made the contributions required by law but employing school districts were not called upon to contribute on behalf of active teachers to cover the employer costs of benefits as they accrued. There is, therefore, approximately two and one half generations of service credit on the books of the system which is only partially funded. The actuarial report referred to above indicated as a part of the 20% to 25% of payroll, an interest requirement of 9.945% to hold level the unfunded accrued liability as of June 30, 1974, and this amount would do nothing to amortize it.

Should the State desire or the federal government require that the unfunded accrued liability be amortized over a period of years, the contribution requirement to the system would exceed the 20% to 25% level by the amount needed to accomplish such amortization. The certificated teacher payroll subject to contributions to the Teachers' Retirement Fund is approximately $3.773 billion. One percent of payroll, therefore, equates to approximately $38 million at June 30, 1975.

The State Teachers' Retirement System's benefit formula is based upon length of service and "final compensation" and is designed to produce 60% of pay at age 60 with 30 years of service. "Final compensation" is the average of the three highest consecutive years of income. It therefore follows that as salaries progress upward the unfunded accrued liability of the system will continue to increase as will the contribution requirement to fund that obligation. A description of the retirement program and its financing is found under the heading "Summary of System's Accounting Policies", beginning on page   of this report.

In summary, the need for additional contributions is a result of: (1) a pay-as-you-go method of funding prior to July 1, 1972; (2) improvements in benefits over the years without providing the funding on a current basis; (3) disregard of actuarial valuations and their impact over almost two and one-half generations the system existed before the present Board was established; and (4) significant changes in the behavior of the population covered by the system, the major items of which have performed in an unforecastable manner.

It is expected that legislation requesting adjustment in contribution levels will be introduced in the 1977 Session of the Legislature.

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