**ARIZONA STATE RETIREMENT SYSTEM**

3300 NORTH CENTRAL AVENUE • PO BOX 33910 • PHOENIX, AZ 85067-3910 • PHONE (602) 240-2000
7660 EAST BROADWAY BOULEVARD • SUITE 108 • TUCSON, AZ 85710-3776 • PHONE (520) 239-3100
TOLL FREE OUTSIDE METRO PHOENIX AND TUCSON 1 (800) 621-3778
EMAIL ADDRESS: ASKMAC@AZASRS.GOV • WEB ADDRESS: WWW. AZASRS.GOV

*Paul Matson*
*Director*

## ARIZONA STATE RETIREMENT SYSTEM

## MEMORANDUM

**TO:** Mr. Doug Ducey, Chair, Defined Contribution and Retirement Study Committee

**FROM:** Mr. Paul Matson, Director, Arizona State Retirement System (ASRS)

**DATE:** November 6, 2012

**RE:** ASRS Liability Reductions

**Purpose**
To discuss ASRS initiated cost savings already implemented, initiatives currently being implemented and initiatives that will be brought to the legislature for the 2013 session. These are separated in the following three categories:

1. Pension
2. Health Benefit Supplement
3. Long-Term Disability

# Pension Plan: Background Information

The ASRS Pension Plan is a public pension program for qualified employees. Membership includes the State of Arizona, school districts and charter schools, cities and towns, all Arizona counties and numerous special districts. The primary pension program is a 401(a) defined benefit plan, which means that a member's pension is determined by a formula (Final Average Salary x Graded Multiplier x Years of Service), rather than by the amount of money in the member's account and current interest rates.

Members are eligible for Normal Retirement (the earliest a member may retire with an unreduced benefit) at the earliest of the following situations:

- For member's hired on or before June 30, 2011:
  - At age 65
  - At age 62 with 10 or more years of credited service
  - At any combination where years of credited service plus age total 80 points.

- For members hired on or after July 1, 2011:
  - At age 65
  - At age 60 with 25 or more years of credited service
  - At age 62 with 10 or more years of credited service
  - At age 55 with 30 or more years of credited service

Members who are at least age 50 with 5 or more years of credited service may retire before reaching normal retirement, but with a reduced benefit to account for the early retirement.

In addition to a Straight Life annuity where the benefit is paid to the member for the remainder of their life, the ASRS offers the following optional forms of retirement:

- Joint and Contingent Annuity (with pop-up) with either 100%, 66-2/3% or 50% of the reduced retirement income payable for the life of the contingent annuitant upon the death of the retiring member.
- Period Certain and Life Annuity (with pop-up) with five, ten or fifteen years of payments guaranteed.
- A Social Security Leveling Option combined with any other forms of payment. This option will not be available to retirees whose retirement commences on or after July 1, 2013.

Pertinent actuarial information as of June 30, 2012 is listed below:

| | **Market Value** | **Actuarial Value** |
|---|---|---|
| **Asset Amounts** | $26,401,667,918 | $28,948,010,913 |
| **Liabilities** | $38,450,288,740 | $38,450,288,740 |
| **Funded Status** | 68.7% | 75.3% |
| | **Employee** | **Employer** |
| **Contribution Rate** | 11.30% | 10.70% |

## Initiatives: Implemented

**Cost basis for service purchase**
In 2003 the ASRS proposed changing the cost basis for service purchase from normal cost to actuarial present value (APV) which accurately represents the value of the additional service credit.

- Cost Savings: $971.9 million to $1,748.6 million

**Decrease interest credited on withdrawn contributions**
In 2003 the ASRS proposed changing the interest rate credited to account balances for purposes of withdrawal from 8 percent to 4 percent.

- Cost Savings: $437.4 million to $786.9 million

**Reimbursements for early retirement incentives**
In 2003 the ASRS proposed an initiative to allow the ASRS to collect from employers any unfunded liability created by employers offering an early retirement incentive program.

- Cost Savings: $291.5 million to $524.5 million

**Interest rate charged on payroll deduction agreements**
In 2004 the ASRS proposed increasing the interest rate on payroll deduction agreements, installment payments for service purchase deducted from member's pay on a pre-tax basis, from 0 percent to 8 percent.

- Cost Savings: $259.4 million to $466.5 million

**Pop-up restrictions**
In 2005 the ASRS proposed changing post retirement elections by retired members to only allow a member who had elected a retirement option that included a survivor with a death benefit to rescind the option and pop-up to a straight life annuity once and disallow an election to "pop down" to a death benefit option.

- Cost Savings: $574.5 million to $1,129.2 million

**Rescind modified Deferred Retirement Option Plan (mDROP)**
In 2005 the ASRS proposed rescinding a program that would have permitted an employer to offer a member who was eligible to retire under the Rule of 80 (age + years of service) a contract to work an additional three years of employment. No contributions would be made to the ASRS during the contract. Upon completion of the contract the member would receive an additional three years of service with the option to purchase three more years of service.

- Cost Savings: $682.7 million to $1,329.3 million

**Recapture of unclaimed monies**
In 2007 the ASRS proposed an exemption for the ASRS from unclaimed property statutes.

- Cost Savings: $8.0 million to $16.3 million

**Dual employment**
Members who met 20/20 Rule eligibility, where a member must be engaged to work at least 20 hours per week for at least 20 weeks, at one ASRS employer were eligible to contribute at subsequent employers even if the member did not meet the 20/20 Rule eligibility requirements at the subsequent employer. In 2009 the ASRS proposed requiring members to meet 20/20 Rule eligibility requirements at each ASRS employer to be eligible to contribute.

- Cost Savings: $33.2 million to $81.2 million

**Elimination of enhanced refunds**
Enhanced refunds included a refund of 25 percent of the employer contribution balance when the separated member had five years of service, the employer contribution percent increased by increments of 15 percent for each year of service over five years to a maximum of 100 percent of the employer balance for 10 or more years of service. In 2005 the ASRS proposed eliminating the enhance refund, thereby eliminating the employer portion of the refund for new members.

- Cost Savings: $0 to $316.7 million

**Replacing Rule of 80 with Rule of 85**
The Rule of 80 defined normal retirement as 80 points (age + years of service). The ASRS proposed changing the Rule of 80 to a Rule of 85 beginning in 2006. This proposal was adopted in 2010 for new members.

- Cost Savings: $0 to $593.7 million

Note: The rule of 85 was subsequently replaced by Age 55 & 30 years of service or age 60 & 25 years of service, this change resulted in additional savings of up to, approximately, $13 million depending on the rate which new members join the system.

**Replacing 36-month average salary with 60-month average salary**
A member's final average salary (FAS) used to determine the monthly retirement annuity had been calculated using the average of the highest consecutive 36 months of salary in the last 120 months of salary history. Beginning in 2006 the ASRS proposed changing the FAS calculation to the average of the highest consecutive 60 months of salary in the last 120 months of salary history. This proposal was adopted in 2010.

- Cost Savings: $0 to $494.8 million

**Alternative Contribution Rate (ACR)**
In 2011 the ASRS proposed a change that would require an employer to pay an ACR for retired members who returned to work, in any capacity and in a position ordinarily filled by and

employee of the employer. The ACR represents the unfunded liability payment that would apply to a non-retired member in the same position.

- Cost Savings: $0 to $454.4 million

**Total Cost Savings**: $3.26 billion (Closed Group[1]) to $7.94 billion (Open Group[2])

[1]Closed Group: The pension plan is closed to new entrants but existing members continue to accrue benefits.

[2]Open Group: The pension plan is open to new entrants and as members retire they are replace by new members.

## Initiatives: In Progress

**Decrease interest credited on withdrawn contributions**
The ASRS Board, at its October 19, 2012 meeting, moved to reduce the interest rate applied to account balances for the purpose of withdrawal from 4 percent down to 2 percent. The ASRS is currently in the rule making process required for implementation. The ASRS anticipates this change will be implemented beginning July 1, 2013.

- Cost Savings: Up to $470 million

**Elimination of Partial Lump Sum (PLS) for service purchase**
Members are eligible to take up to 36 months of their annuity as a lump sum payment at retirement and have their annuity actuarially reduced. A member could also elect to apply a portion or all of the PLS payment to purchase service. The ASRS Board, at its May 18, 2012 meeting, moved to eliminate PLS as a payment option for service purchase. The ASRS is currently in the rule making process required prior to implementation and anticipates the rule making process will be completed in January 2013.

- Cost Savings: Up to $88.8 million

**Reduction of Actuarial Assumed Rate for service purchase**
Members with eligible service are able to purchase the service with the ASRS at a cost equal to the increase in the actuarial present value of their benefit as a result of the extra years of service. The ASRS Board, at its May 18, 2012 meeting, moved to reduce the actuarial assumed rate used to determine the increase in the member's benefit from "Actuarial Assumed Rate" to "Actuarial Assumed Rate minus 2 percent" (from 8 percent to 6 percent).

- Cost Savings: Up to $109.4 million

**Initiatives: Current**

**Amortization Period**
The period in which unfunded liabilities are amortized over is currently set in statute to be a rolling thirty year period. The ASRS is proposing a change to allow the ASRS Board to determine the amortization period consistent with generally accepted actuarial standards. If adopted this proposal would grant the Board the authority to reduce the amortization period resulting in paying off the deficit more quickly and reduce volatility in the contribution rate.

**Permanent Benefit Increase (PBI)**
Currently a PBI is awarded when the yield rate on the actuarial value of ASRS assets is in excess of 8 percent. The ASRS is proposing eliminating PBI for new members. Elimination of PBI for new members will reduce upward pressure on the contribution rate and lower liability. The ASRS's current deterministic forecasting does not predict any cost associated with future PBI awards (because the forecasts assume an 8 percent return every year). However, using stochastic forecasting and taking the mean of the distribution of the results, the ASRS actuary predicts that eliminating PBIs for new members will save approximately $263 million. The savings will not appear in the valuation results, but instead will emerge as smaller liability losses in future years when PBIs occur.

**Non-Retired survivor benefits**
The ASRS is proposing changes to the non-retired survivor benefit calculation including, elimination of the present value calculation and limiting the annuity option to a straight-life annuity. These changes would eliminate payment calculations for beneficiaries that are not otherwise offered to member and would make the criteria equitable across member groups.

- Cost Savings: Up to $43.7 million

## Long-Term Disability Plan: Background Information

The ASRS Long-Term Disability (LTD) Plan began on July 1, 1995 and is a monthly benefit designed to partially replace income that might otherwise be lost during periods of disability resulting from a covered injury or sickness. All public officers and employees who are participants in the ASRS Pension Plan are eligible.

Long-Term Disability benefits commence on the day following a waiting period during which the member has been totally disable for six consecutive months. The basic monthly benefit is 66-2/3 percent of the member's monthly compensation as of the date the member became disabled.

The basic monthly benefit is offset, or reduced, if a member receives benefits from any of the following sources:

- Sixty-four percent of the initial benefits the member receives from Social Security Disability or the United States Railroad Retirement Act when paid because of the disability. For members who become disabled on or after July 1, 2008 the offset percentage is increased to 85 percent. This amount does not include:
    - The amount of attorney fees approved by Social Security rules and reasonable documented costs paid to an attorney to secure the Social Security disability benefit.
    - Any Social Security Disability or United States Railroad Retirement Act cost of living adjustments that are granted after LTD benefits commence.
- Eighty-three percent of the retirement benefit a member receives from Social Security or United States Railroad Retirement Act. For members who become disabled on or after July 1, 2008 the offset percentage is increased to 85 percent.
- All benefits, including sick pay, retirement benefits, unemployment compensation benefits or disability provided by any other group insurance contract or benefit arrangement which are finance in whole or in part by the member's ASRS employer. This does not include any retirement benefit that is received by the member pursuant to a state retirement system or plan other than ASRS. Vacation pay and annual leave are also not considered deductions from the monthly LTD benefit.
- All benefits for disability under any Workers' Compensation Act, non-occupational disability benefit law, the maritime doctrine of maintenance, wages, and cure, or similar legislation.
- Payments for a veteran's disability to the participant, if the payment is for the same condition or a condition related to the condition currently causing the total disability and is due to, or a result of, service in the Armed Forces of the United States.
- Fifty percent of any salary, wages or commissions or other employment related pay that a participant receives or is entitled to receive from any gainful employment.

Long-Term Disability monthly benefits cease to be payable to a member at the earliest of the following:

- The date the member ceases to be totally disabled;
- The date the member ceased to be under the direct care of a doctor or refuses to undergo any medical examination requested by the company selected by the Board to

administer the LTD program;

- The date the member withdraws employee contributions with interest from the Plan and ceases to be a member; and
- The later of the following:
    - The member's normal retirement date;
    - The month following 60 months of payments if the disability occurs before age 65;
    - The month following attainment of age 70 if disability occurs at age 65 or after but before age 69;
    - The month following twelve-months of payment if disability occurs at or after age 69.

Pertinent actuarial information as of June 30, 2012 is listed below:

| | **Market Value** | **Actuarial Value** |
|---|---|---|
| **Funded Status July 1, 1995** | 0.00% | 0.00% |

| | | |
|---|---|---|
| **Asset Amounts** | $257,324,263 | $295,785,765 |
| **Liabilities** | $439,706,059 | $439,706,059 |
| **Funded Status** | 58.5% | 67.3% |
| | **Employee** | **Employer** |
| **Contribution Rate** | 0.24% | 0.24% |

**<u>Initiatives: Implemented</u>**

**Various changes to the Long-Term Disability program**
In 2004 the ASRS proposed making several changes to the program including: modification to the pre-existing condition limitations, ending benefits for a member that refused to participate in a work rehabilitation program for which the member is reasonably qualified, clarify benefits be offset by both primary and dependent social security benefits received by the member, requiring a member to pursue social security disability benefits, clarifying totally disabled, and suspending benefits to benefit recipient's convicted of criminal offense and sentenced to more than 6-months in any penal institution.

- Cost Savings: $32.9 million to $58.7 million

**Social Security offsets and pre-existing condition period**
In 2005 the ASRS proposed increasing the offset percentages for Social Security disability benefits and Social Security retirement benefits for new disabled members. Additionally the ASRS proposed increasing the pre-existing condition period for newly hired members. The proposed changes were adopted in 2007.

- Cost Savings: $186.1 million to $380.3 million

**Initiatives: Current**

**Long-Term Disability program plan design changes**

The ASRS is proposing for consideration, changes to the plan design of the Long-Term Disability plan:

- Lowering the income replacement level from 66-2/3 percent to 60 percent, and
- Implementing a 60-month average salary calculation similar to the final average salary calculation used to determine retirement benefits for new members.

These changes would be for members who become disabled after the implementation date of the changes and will reduce upward pressure on the contribution rate and will provide benefits that are more comparable with other states and the private sector.

- Cost Savings: Up to $227.8 million

## Health Benefit Supplement Plan: Background Information

The ASRS Health Benefit Supplement (HBS) Plan is a pre-funded Premium Benefit that is added to the disabled or retired member's monthly benefit check that partially offsets the cost of retiree health insurance premiums. Retired and disabled members with five or more years of credited service who have health insurance through the ASRS or their former employer are eligible for a monthly premium benefit, which is paid to the ASRS health insurer or the member's former employer.

The HBS Plan is similar to a defined benefit pension plan in that the benefit is easily determined and based on a formula. However, the HBS plan does not have any Cost of Living Adjustment mechanism.

The monthly benefits for members with ten or more years of service are:

- With respect to premiums paid for retirees with member only coverage:
    - $150 per month if the retiree is under age 65
    - $100 per month if the retiree is 65 or over
- With respect to premiums paid for retirees with family coverage:
    - $260 per month if the member and dependent are under age 65
    - $170 per month if the member and dependent are 65 or over
    - $215 per month if the member is over age 65 and the dependent is under age 65
    - $215 per month if the member is under age 65 and the dependent is over age 65
- For members with five to nine years of service, the benefits are the same dollar amounts as above multiplied by a vesting fraction equal to 10 percent for each completed year of service (i.e., 50 percent to 90 percent).

Pertinent actuarial information as of June 30, 2012 is listed below:

| | **Market Value** | **Actuarial Value** |
|---|---|---|
| **Asset Amounts** | $1,167,345,698 | $1,281,566,359 |
| **Liabilities** | $1,502,082,451 | $1,502,082,451 |
| **Funded Status** | 77.7% | 83.3%* |
| | **Employee** | **Employer** |
| **Contribution Rate** | 0.00% | 0.60% |

<u>Note</u>: Per "The Widening Gap," PEW Center on the States, June 2012; Arizona has the highest funded status for health insurance plans among the 50 states.

## Past Initiatives

**Ending Health Benefit Supplement payments to retirees on an active employer plan:** Ceases payment of the Health Benefit Supplement for new retirees and disabled members who are covered under an ASRS employer's active employee insurance plan, either as the insured or as a dependent, if the premium paid by the retiree or disabled member is subsidized by the ASRS employer. This was proposed and adopted in 2012.

- Cost Savings: Up to $2 million