STATE OF ARIZONA

Joint Legislative Budget Committee

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MINUTES OF THE MEETING

JOINT LEGISLATIVE BUDGET COMMITTEE

SUBCOMMITTEE ON ARIZONA STATE RETIREMENT RATES

October 21, 2004

The Chairman called the meeting to order at 1:40 p.m., Thursday, October 21, 2004, in Senate Appropriations Room 109. The following were present:

Members:	Senator Burns, Chairman	Representative Huppenthal Representative Burton Cahill
Absent:	Senator Martin Senator Rios	Representative Biggs

Due to a lack of quorum there was discussion only and no motions were made.

JLBC STAFF – Overview of Arizona State Retirement System (ASRS) and Contribution Rates.

Mr. Eric Jorgensen, JLBC Staff, gave an overview of the Arizona State Retirement System.

Ms. Beth Kohler, JLBC Staff, said that the Medicare Modernization Act includes a federal subsidy for employer-sponsored retiree health plans to cover the cost of retiree prescription drugs. It is our understanding that the Executive believes that the ADOA and ASRS retirement system qualifies for the subsidy. We have not received an estimate of how much the subsidy would be but we have heard that the Executive may plan to use it to offset the state agency retirement contributions.

Mr. Charles Chittenden, Principal and Consulting Actuary, Mellon, said that he wanted to comment on the discussion of how ASRS works and who is assuming risk. In a defined benefit system the responsibility to make sure that the assets are in line with liabilities rests with the contributing entity. In ASRS that means it is divided in half between the employers and the employees. They are both guarantors of the benefit that is provided.

Representative Huppenthal asked what the current market value is, in the most recent posting, of ASRS assets. He also asked what the present value of the system's liabilities.

Mr. Gary Dokes, Chief Investment Officer, ASRS, said as of yesterday the market value of ASRS assets was $20.9 billion.

Mr. Chittenden said the value of the liabilities was about $25 billion.

Representative Huppenthal said that we are about $4.1 billion underfunded, going on a market value basis. He noted the money is pouring in and is going against future liabilities associated with the current employee population. You then have the current body of employees that is funded out of stockpiled investment assets.

Mr. Chittenden said the liability is basically divided into 2 parts by the method. The method decides that some of the liability is attributable to future service and some to past service. The future service is paid for essentially 1 year at a time which is the normal cost and that is split evenly between employee and employer. The other part is to take the liability that the method attributes to past service, subtract the actuarial value of assets, what is left over is the unfunded actuarial accrued liability. That is funded over 30 years.

Representative Huppenthal said that when he took over the Retirement Committee, he asked for any fiscal notes associated with the bills in the last 10 years. There was only 1 bill that came out of conference committee, and from what he could tell, the impact on the retirement fund was $3 billion. It was the largest public policy decision in Arizona and it was made with almost no legislator being aware of the massive impact it would have on the system.

Senator Burns said, as he views it, based on the JLBC testimony the worse case is about $149 million. Hopefully there would be some ideas presented to be able to make that a smaller number.

Representative Huppenthal said, in looking through the list of things that have already been implemented, ASRS has done all that they legally can to moderate the rate, including the adoption of a 10-year phase-in. The problem that we have is, we went through a period of 20 years from 1982 to 2002 in which returns on the stock market were at 15% a year and it went on for so long people began to view it as the norm. When in fact, it was unprecedented and is unlikely to repeat itself. The reality is there is more bad new to come in terms of contribution rates.

Senator Burns said, as he understands it, the proposal that the Governor is making would hold the employees harmless. In the JLBC presentation this shows up as a $26 million item, if in fact, it comes through as a salary increase. He asked if there is another mechanism to offset that and not have to pay this out as salary.

<u>Dr. Keith Meredith, Chairman of the Board, ASRS</u>, said that they have been also looking at this to see what information they could provide as alternate solutions. As you look at some of the other state retirement systems, and agencies within our pension funds within the state, one situation they have is, the employee contribution is a fixed value and the risk that is taken on for increased contributions comes from the employers side. There are some advantages from a tax perspective and also a slight advantage in that the employer contribution does not contribute quite as much to the liability. This speaks to the short-term versus the long-term. If you are looking at a long-term solution, one thing that might be discussed in the future is increasing the floor for the contribution rate. With the contribution rates going down as low as 2% in the past, that could have mitigated the current increase.

Senator Burns said that the problem he has with setting a floor is 16 votes in the Senate and 31 votes in the House changes that. That has happened in the past and it has gotten us in the situation we are now. It seems to be a year-to-year plan on a 30-year system and we need to take a longer look at this and put something in place to resolve it. We are going to be faced, very soon, with the short-term side of how do we make this work.

Mr. Regens said that a number of years ago, in lieu of a pay raise for public safety officers, the state contributed part of the employee's share of the retirement rate. That is something that could be considered.

Dr. Meredith said the importance of having discussions, is to look at the long-term implications of these decisions. When ASRS first went to the defined benefit program, the promise was made that employees will not be getting a pay raise so they will receive a reduction in their contribution rate. That got the state into a long-term implication that has expanded since then.

<u>Mr. Pat Klein, Contracts Manager, ASRS,</u> noted that he has responsibility for the retiree health care program. Between ADOA and its consultants and ASRS and its consultants, they have been dealing with some individuals from the Governor's Office of Strategic Planning and Budgeting, with respect to the Medicare Modernization Act. It is a very complex issue. The Medicare statute requires that if there are savings from the part D Medicare, those savings go back to the beneficiaries of the plan. Those who are enrolled in a healthcare plan would be the ones who receive the benefit of any reimbursement or subsidies that would come back to the plan. The application of those premiums could not be used for anything other than reimbursement to the plan.

Mr. Klein, in response to Senator Burns, said that it is correct that it would only come back to those people who were enrolled in that particular medical plan.

Representative Huppenthal said one thing he believed would be helpful to the retirement committees would be a "map" that shows the actuarial benefits in a variety of employee situations versus the actuarial contributions. He said his perception is that there was almost no guidance to the legislators in this regard, in that there are some classes of employees that get an extraordinary benefit relative to their contribution into the system. It is unfair to those employees who put in their 30 years and make the full contribution. That would be a policy tool that would be very helpful. Almost all these calculations use an assumption of an 8% return on investment and now we have gone 7 years where the stock market was at 9.8%. From a standpoint of returns the dividends have been giving us about 3% a year but the equity appreciation has given 0. The 8% has not been true for at least 7 years. He requested having the numbers reworked assuming only getting 5% to see where these employee contributions will max out at.

Mr. Chittenden said that on the first question of equity, the director has had a project in place for the last 1½ years to study equity situations within ASRS. That was one of the reasons they started looking at the service purchase program, because it was a chance to buy service at less than its true cost. That means that the rest of the cost goes to other people in the contribution rates. They found a number of things where the benefit was not favorable for one group of people and have taken steps to change it, if they could. On the investment return issue, the results are very sensitive to the investment return assumption that the actuary uses in the valuation. ASRS has looked at some of the projections, assuming a 8% return but actually only getting 5%. The differences goes into the losses and you have greater increases in contributions and greater decreases to funding status as a result.

Representative Huppenthal commented that he would like to see a more realistic model.

Mr. Richard Stephenson, Deputy Director, External Affairs, ASRS, said that since the inception of ASRS they have averaged 10.2% annually, and last year earned 17.5%. That is now coupled with recognizing huge losses in the market. To clarify equity and costs, last year ASRS brought forth some proposals for legislative consideration that would result in millions of dollars of savings and contribution rates, as well as making the whole program more equitable. The Legislature did implement all of these proposals. He asked Representative Huppenthal if he would like to see that list again or something different from that.

Representative Huppenthal said that people start employment at different ages and at different times so you have a whole variety of situations. Based on a variety of situations, he would like to get a sense of what employee contributions are in the system, and given their retirement, what the actuarial cost is for servicing the retirement.

Mr. Angel Rodrigues, AFSCME Council 97, said the discussion had been very enlightening. However, state employees are losing ground in their paychecks every year. The Arizona Compensation Survey said that state employees are 35% below other public employees in Maricopa County. The Western States Salary Survey said that state employees are 25.9% below the other 12 western states. The increase to 7.5% may be necessary but it is going to be a big hit on the employee's paychecks. As the Governor has proposed, maybe a hold harmless solution would help.

Chairman Burns adjourned the meeting at 2:40 p.m.

Respectfully submitted:

Cheryl Kestner, Secretary

Richard Stavneak, Director

Senator Bob Burns, Chairman

NOTE: A full tape recording of this meeting is available at the JLBC Staff Office, 1716 West Adams.