STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

Arizona State Retirement System

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

ASRS plan is not fully funded, but steps have been taken to improve its long-term sustainability

Our Conclusion

The Arizona State Retirement System (ASRS) defined benefit plan's (ASRS plan) ratio of assets to estimated pension obligations (i.e., the ASRS plan's funded status) declined between June 30, 2005 through June 30, 2012, similar to the nation-wide trend for that time period. The decline was partially the result of unmet investment return expectations during this period. The ASRS and Legislature have taken several steps to improve the ASRS plan's funded status and long-term sustainability by increasing contribution rates and, for recent ASRS plan members, raising eligibility requirements and eliminating permanent benefit increases. In line with best practices, the ASRS should continue with its plans to adopt a funding policy, which outlines how it will improve the ASRS plan's funded status. The ASRS should also develop a method to ensure that future benefit increases do not impact the ASRS plan's sustainability. Finally, the ASRS should implement additional controls to minimize the impact of non-promotional salary increases.

2015

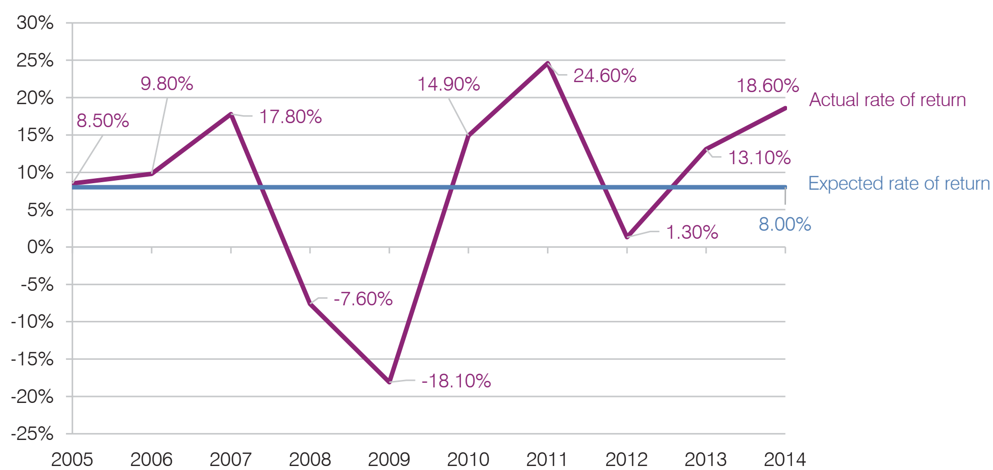
August • Report No. 15-106

The ASRS plan is a defined benefit retirement plan that provides a guaranteed life-long pension benefit. This is in contrast to a defined contribution retirement plan, such as a 401(k), where the employee directs where the contributions are invested, and benefits depend on the investments' financial performance. As of June 30, 2014, there were over 550,000 ASRS plan members, including over 119,000 retirees.

Decline of ASRS plan's funded status not as severe as most peers' and is improving—Based on the actuarial value of assets, the ASRS plan's funded status decreased from 86.1 percent as of June 30, 2005, to 75.3 percent as of June 30, 2012.[1] This decline is similar to the decline experienced by public pension plans nation-wide during the same time period. Also, of the four peer states we identified, Arizona's decline was less severe than three of the four peers'. A pension plan's funded status is the ratio of assets to estimated pension obligations and is a measure of the financial health of the pension plan at a point in time. Ideally, the funded status should be 100 percent; in other words, assets are sufficient to cover all of the estimated pension obligations of a pension plan's members. As of June 30, 2014, the ASRS plan's funded status had increased slightly to 76.3 percent.

One reason for the decline in the ASRS plan's funded status is that the ASRS did not always meet its 8 percent expected rate of return on its investments. The average investment return rate for the ASRS plan from June 30, 2005 through June 30, 2014, was 7.53 percent. Although the 8 percent expected rate reflects the investment return that the ASRS plan expects to achieve on average over a rolling 20-year period of time, if the ASRS plan does not meet this rate in any year, its funded status may decline.

ASRS plan's actual and expected rates of investment returns
As of June 30, 2005 through June 30, 2014



[1] The actuarial funded status is calculated using the ASRS plan's actuarial value of assets. When determining the actuarial value of assets, the ASRS' actuary recognizes investment losses and/or gains over a rolling 10-year period.

ASRS and Legislature have taken steps to improve ASRS plan's sustainability—Consistent with best practices, the ASRS has taken several steps to improve the ASRS plan's funded status, including increasing the number and complexity of its investment strategies and developing a draft pension funding policy that identifies strategies for achieving a 100 percent funded status by fiscal year 2037. The ASRS plans to formally adopt the draft funding policy in August 2015. In addition, the ASRS increased contribution rates when recommended by its actuary. From June 30, 2005 to June 30, 2014, the combined employer and employee contribution rate for the pension plan rose from 9.3 percent to 22 percent to help improve the ASRS plan's funded status and sustainability.

The Legislature has also amended statutes to improve the ASRS plan's sustainability. Beginning with employees hired on or after July 1, 2011, they must be older or work longer to be eligible for pension benefits. According to the ASRS' actuary, this change will result in an estimated future cost savings of about $587 million over 30 years. The Legislature also eliminated permanent benefit increases, which are increases to retired members' pension benefits, for employees who become members on or after September 13, 2013.

Recommendation

The ASRS should continue with its plan to formally adopt its draft pension funding policy.

Additional actions can enhance ASRS plan's financial condition and long-term sustainability

ASRS should ensure permanent benefit increases do not impact ASRS plan's sustainability going forward—ASRS plan members who were hired before September 13, 2013, may receive a permanent benefit increase to their pensions if specific conditions outlined in statute are met, including investments exceeding the 8 percent expected rate of return on average over a rolling 10-year period. As of June 2015, there were 491,220 members who were eligible for a permanent benefit increase sometime in the future. Because permanent benefit increases are likely in the future and a large number of members remain eligible for such increases, the ASRS should work with its actuary to develop a method for ensuring that the cost of any future benefit increases do not impact the ASRS plan's sustainability.

Additional controls are needed to minimize the impact of preretirement salary increases—Pension benefits are calculated using a member's average salary over the last 3 or 5 years of employment depending on the date an employee was hired. Because the salary is averaged over 3 or 5 years, a normal promotional salary increase before retirement would not have much impact on a retiree's pension benefits—however, employer termination incentive programs, such as providing anything of value conditioned on a person's retirement or nonpromotion salary increases of 30 percent or more, would. To determine the ASRS plan's estimated pension obligations and contributions necessary to meet those obligations, the ASRS' actuary uses statistical data to estimate various factors, including mortality rates and increases in members' compensation over time. When a member's compensation experiences a greater-than-expected increase during the time period that determines average salary, this increase may generate an unfunded liability to the ASRS plan. Statute permits the ASRS to require the employer to cover the unfunded liability created. The ASRS indicated such increases are rare, but it should enhance its procedures for identifying them and assessing the employer the costs of any unfunded liabilities created.

Recommendations

The ASRS should:

- Work with its actuary to develop a method for ensuring that the cost of any future benefit increases do not impact the ASRS plan's sustainability; and
- Enhance its procedures for identifying employer termination incentive programs and assessing the cost of unfunded pension liabilities to the employers.