STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

INTEGRITY • ACCOUNTABILITY • MAKING A DIFFERENCE

Public Safety Personnel Retirement System

REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Our Conclusion

The Public Safety Personnel Retirement System's (System) three defined benefit plans' (plans) ability to meet future retirement obligations is deteriorating because of required annual permanent benefit increases and lower-than-expected investment returns. The System and Legislature have taken actions to improve the plans' long-term sustainability, but their long-term sustainability remains at risk because some actions did not withstand legal challenges and were ruled unconstitutional. Changes in providing annual benefit increases would improve the plans' long-term sustainability but will require statutory and may require constitutional changes. The System also needs a funding improvement strategy that outlines actions that should be taken to improve plans' funded statuses and should consider the feasibility of offering a variety of benefit options that will allow employers to choose pension options they can afford.

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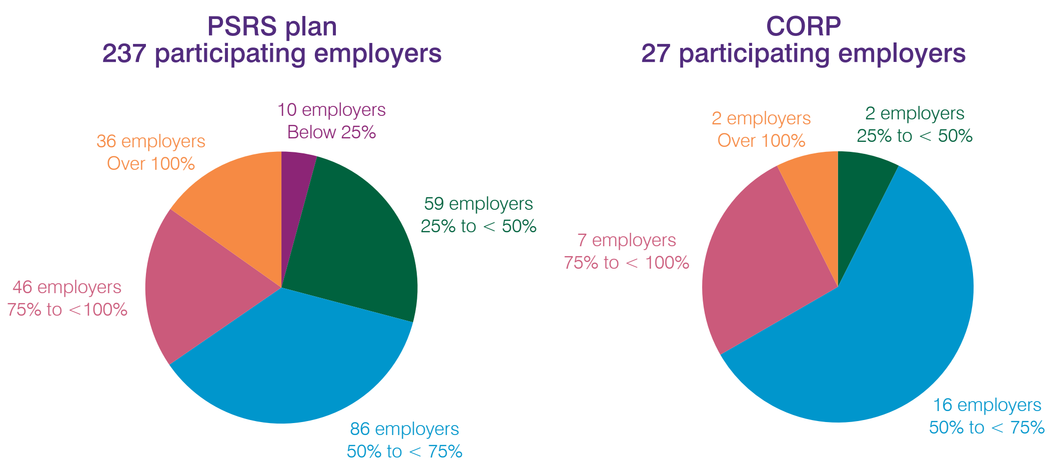
Plans' assets have not kept pace with pension obligations

The System manages three different defined benefit retirement plans that provide a guaranteed life-long pension benefit: the Public Safety Personnel Retirement System plan (PSPRS plan), the Corrections Officer Retirement Plan (CORP), and the Elected Officials' Retirement Plan (EORP). As of June 30, 2014, 282 employers participated in these plans, and there were nearly 55,000 members.

All three system plans' funded statuses have steadily declined—Based on the actuarial value of assets, the three system plans' funded statuses have decreased from June 30, 2005 through June 30, 2014.[1] 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 a pension plan's estimated pension obligations. However, as of June 30, 2014, all three plans' funded statuses were considerably below this level: the PSPRS plan was 49 percent, CORP was 57 percent, and EORP was 39 percent. The PSPRS plan and CORP are agent multiple-employer plans, so in addition to the single funded status reported for each plan, each participating employer is responsible for its own pension obligations and has a funded status, several of which are low.

PSPRS plan and CORP participating employers' funded statuses
As of June 30, 2014



Required permanent benefit increases, which have raised the plans' pension obligations, and lower-than-expected investment returns have contributed to the low funded statuses.

System and Legislature have taken actions, but plans' sustainability remains at risk—Consistent with best practices, the System has changed its investment strategies, adopted a pension funding policy plan to attain a 100 percent funded status, and

1 The actuarial funded status is calculated using the system plans' actuarial value of assets. When determining the actuarial value of assets, the System's actuary recognizes investment losses and/or gains over a rolling 7-year period.

increased employer contributions to the plans. The Legislature also enacted changes in 2011 to increase member eligibility requirements and the length of time used to calculate members' final average salary for individuals who become members on or after January 1, 2012, and provide more stringent criteria for providing permanent benefit increases. However, in February 2014, the Arizona Supreme Court ruled that the benefit increase changes were unconstitutional for members who had retired on or before July 1, 2011.

Changes in calculating and awarding annual benefit increases would help the system plans' sustainability

Recent efforts to address sustainability altered by legal challenges—Although benefit increases are important to maintain the value of retirees' benefits over time, they can be costly. For example, the EORP was required to provide a 4 percent annual compounded benefit increase from fiscal year 2005 through fiscal year 2014. Over 10 years, this would increase a $20,000 annual pension into a $29,605 annual pension. To address the System's sustainability issues, Laws 2011, Ch. 357, made changes to the permanent benefit increase requirements, but the changes were found unconstitutional for persons who retired on or before July 1, 2011. In response, the System established two benefit increase structures for all three plans, one for those retiring on or before July 1, 2011, and one for those retiring after.

Plans' sustainability still impacted by benefit increases—Issues with the two benefit increase structures continue to impact the system plans' sustainability. These issues include that a minimum 60 percent funded status is required before benefit increases can be provided to members who retire after July 2011, but a higher funded status may be more sustainable; benefit increases are compounded, which tend to be more costly to maintain than one that is based on the employee's original benefit at the time of retirement; and benefit increases are not linked to inflation, so an increase may be higher than needed to keep up with inflation.

Recommendation

The System should collaborate with stakeholders to develop sustainable benefit increase structures, including pursuing legislative changes to implement solutions and considering whether proposing a ballot initiative to amend Arizona's Constitution would be warranted.

Additional actions necessary to improve system plans' financial condition and long-term sustainability

Funding improvement strategy needed—The System should develop a funding improvement strategy. Such a strategy outlines the actions that should be taken to improve a plan's funded status, who is responsible for the various actions, and the time frames for completing the actions. Under this strategy, the System should also identify the threshold when a funding strategy is needed, such as when a PSPRS plan or CORP employer or EORP has a 50 percent funded status.

Variety of benefit options may be beneficial—The System should collaborate with stakeholders to consider the feasibility of offering multiple benefit options for employers. Benefit options, such as different service and age requirements, would allow employers to select pension options that align with their fiscal capacity. If different benefit options are feasible, the System should take several actions, including determining the specific options that should be available to employers.

Recommendations

The System should:

- Develop and implement a funding improvement strategy for the plans and their employers; and
- Explore the feasibility of offering multiple benefit options and, if determined feasible, take several actions including determining the specific options that should be available to employers.