A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit and Sunset Review

Public Safety Personnel Retirement System

The System's Three Retirement Plans' Funded Statuses Have Declined and Additional Actions Are Needed to Improve Their Long-term Sustainability

September • 2015
Report No. 15-111

Debra K. Davenport
Auditor General

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AUDITOR GENERAL

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September 18, 2015

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. Jared Smout, Administrator
Public Safety Personnel Retirement System

Transmitted herewith is a report of the Auditor General, *A Performance Audit and Sunset Review of the Public Safety Personnel Retirement System*. This report is in in response to an October 3, 2013, resolution of the Joint Legislative Audit Committee and was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting within this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Public Safety Personnel Retirement System agrees with all of the findings, except one related to internal audit policies and procedures, and it plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

Sincerely,

Debbie Davenport
Auditor General

Attachment

cc: Public Safety Personnel Retirement System Board of Trustees

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State of Arizona
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AUDITOR GENERAL
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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.

2015

September • Report No. 15-111

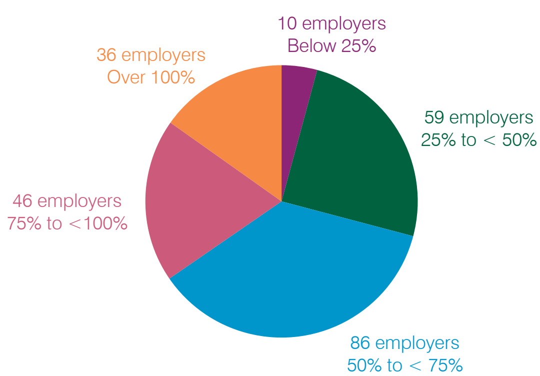
Plans' assets have not kept pace with pension obligations

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.

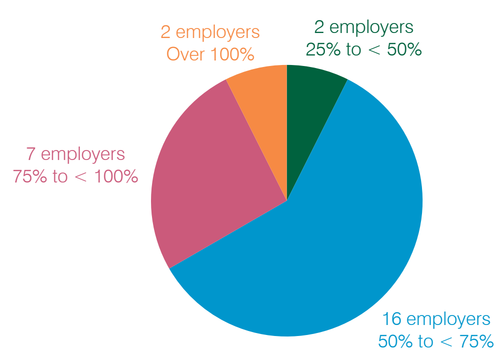
All three system plans' funded statuses have steadily declined—Based on the actuarial value of assets, the three system plans' funded statuses have decreased from June 30, 2005 through June 30, 2014.[1] A pension plan's funded status is the ratio of assets to estimated pension obligations and is a measure 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

PSPRS plan
237 participating employers



CORP
27 participating employers



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.

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INTRODUCTION
Scope and Objectives

The Office of the Auditor General has conducted a performance audit and sunset review of the Public Safety Personnel Retirement System (System) pursuant to an October 3, 2013, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq. This performance audit and sunset review:

- Reports on the deteriorating ability of the System's three retirement plans to meet pension obligations despite actions taken by the System and the Legislature (see Finding 1);
- Analyzes ways to better sustain the System's plans through changes in how annual benefit increases are determined (see Finding 2);
- Recommends additional actions the System and/or the Legislature should take to improve the long-term sustainability of the System's plans (see Finding 3); and
- Provides responses to the statutory sunset factors.

System manages retirement plans for public safety personnel, correctional employees, and elected officials

The System manages three different retirement plans: the Public Safety Personnel Retirement System plan (PSPRS plan), the Corrections Officer Retirement Plan (CORP), and the Elected Officials' Retirement Plan (EORP). These three retirement plans were established for different purposes, serve different types of employers and members, and vary in terms of structure.

PSPRS plan established to consolidate various public safety retirement plans—According to A.R.S. §38-841, the PSPRS plan was established in 1968 to provide a uniform, consistent, and equitable statewide retirement program for various local, municipal, and State of Arizona public safety personnel, such as firemen and policemen, and Arizona highway patrol officers. Prior to the PSPRS plan's establishment, public safety personnel were covered under various local, municipal, and state retirement programs that were not uniform or consistent in terms of employee contribution rates, benefit eligibility provisions, benefit protections, and benefit formulas.

To participate in the PSPRS plan, members must be employed by a participating employer, be under the age of 65, and work at least 40 hours each week for more than 6 months of each year. As of June 30, 2014, the System reported that it served 32,172 PSPRS plan members. See Table 1, page 3, for the number of members by membership type, including active, retired, and survivors of members.

State, county, and municipal employers of public safety personnel may participate in the PSPRS plan, and as of June 30, 2014, there were 237 participating employers. The five largest PSPRS plan employers, in terms of active plan membership, are the City of Phoenix Police Department, City of Phoenix Fire Department, Arizona Department of Public Safety, City of Tucson Police Department, and the City of Mesa Police Department.

The PSPRS plan is an agent multiple-employer plan, which means that employers' pension assets are pooled for investment purposes, but each employer is responsible for its own pension obligations, including its own actuarial assessment of the soundness of its particular pension program (see textbox, page 2, for more information about plan types). The System is responsible for investing and managing the PSPRS plan's pension assets. However, A.R.S. §38-847 requires that a local board be established for each employer and places certain administrative responsibilities with the local board, such as following applicable statutes to make eligibility determinations and calculating benefit amounts. Each local board is composed of five members who are either elected by secret ballot of member employees or appointed by government officials.

Agent multiple-employer plans—A type of retirement plan that pools the assets of participating government employers solely for investment purposes. The plan maintains a separate account for each employer where each employer's assets, pension obligations, contributions, shares of investment earnings, and paid pension benefits are individually recorded. Also, the plan assesses each employer a relative share of plan administration costs. Each participating plan employer has its own actuarial assessment of pension obligations and required contributions, and employers may be required to pay different contribution rates.

Cost-sharing multiple-employer plan—A type of retirement plan that pools the assets of participating government employers for all purposes. The plan records all assets, pension obligations, contributions, investment earnings, paid pension benefits, and plan administration costs in a single account. The plan has one overall actuarial assessment of pension obligations and required contributions. All participating employers pay the same contribution rates, and all members' benefits are paid from the pooled assets.

Source: Auditor General staff review of Government Accounting Standards Board. (n.d.). Agent employer- Pension fact sheet, and Cost-sharing employer- Pension fact sheet. Retrieved October 25, 2012, from www.gasb.org.

CORP established for corrections officers and employees—CORP was established in 1986 to manage the pension assets of and pay retirement benefits to state and local corrections officers and other statutorily designated employees. CORP members are full-time employees of participating employers in statutorily designated positions such as detention and corrections officers, parole and probation officers, corrections administrators, and dispatchers. As of June 30, 2014, the System reported that it served 20,372 CORP members (see Table 1, page 3, for the number of members by membership type).

State, county, and municipal employers with one or more employees in a designated position may participate in CORP, and as of June 30, 2014, there were 27 participating employers. The five largest CORP employers, in terms of active plan membership, were the Arizona Department of Corrections; Arizona Supreme Court, Administrative Office of the Courts; Maricopa County; Arizona Department of Juvenile Corrections; and Pima County.

Like the PSPRS plan, CORP is an agent multiple-employer plan in which each participating employer is responsible for its own pension obligations. CORP's assets are combined with PSPRS plan assets and are managed by the System, which maintains a separate account for each employer. A.R.S. §38-893 also requires five-member local boards to be established to carry out similar functions as the boards for the PSPRS plan. Board membership is similarly determined by secret ballot or appointment.

EORP established for elected officials and judges—EORP was originally established in 1985 to provide retirement benefits for elected officials and judges of certain state, county, and local governments.[1] As of June 30, 2014, the System reported that it served 2,045 EORP members (see Table 1, page 3, for the number of members by membership type).

[1] Laws 2013, Ch. 217, §5, closed EORP to new members as of January 1, 2014. This legislation also enacted a new defined contribution plan for eligible elected officials and judges employed by a participating employer on or after January 1, 2014, per A.R.S. §38-831 et seq.

Table 1: PSPRS plan, CORP, and EORP member types and numbers As of June 30, 2014

Member type	Description	Number of PSPRS plan members	Number of CORP members	Number of EORP members
Active	Members who work for a contributing employer and are actively contributing.	18,526	14,595	843
Retirees	Members who are retired and receive a lifetime monthly benefit.	7,689	3,402	837
Retirees–disabled	Members who are disabled and receive a lifetime monthly benefit.	1,460	122	16
Survivors of members	Deceased members' surviving beneficiaries, including spouses and children with guardians, who are receiving a lifetime monthly benefit.	1,375	566	200
Inactive	Members who are not retired and have not withdrawn their contributions, but are not currently making contributions through a participating employer.	1,563	1,687	149
Deferred retirement option program (DROP)	Members who joined the PSPRS plan before January 1, 2012, with at least 20 years of credited service who opt to work for up to 5 years but divert contributions during that time toward a lump sum collected at retirement.	1,559	N/A	N/A
	Total members	32,172	20,372	2,045

Source: Auditor General staff review of PSPRS plan, CORP, and EORP statutes and actuarial valuations as of June 30, 2014.

As of June 30, 2014, there were 38 participating employers. Unlike the PSPRS plan and CORP, EORP is a cost-sharing multiple-employer plan (see textbox, page 2) in which the System does not account for pension plan assets or estimated pension obligations by each employer. Instead, EORP assets may be used to pay the pensions for members from any participating employer. Under this approach, and unlike the PSPRS plan and CORP, statute does not designate a local board for each employer to handle certain administrative functions. Rather, the System is responsible for performing these functions, such as making eligibility determinations and calculating benefit amounts according to statutory requirements. The System is also responsible for managing EORP's assets, which are combined with the PSPRS plan's and CORP's assets for investment purposes.

PSPRS plan, CORP, and EORP provide retirement, disability, survivor benefits, and retiree health insurance premium subsidies to members

The PSPRS plan, CORP, and EORP provide retirement and other benefits to their members. Specifically, each plan includes a defined benefit pension, with eligibility for retirement and benefit amounts varying by plan and date of membership. The plans also provide disability benefits, survivor benefits for spouses and children, and retiree health insurance premium subsidies to plan members. The cost of the three plans' pension payments and other benefits are funded through employer and employee contributions and investment earnings.

Plans provide defined benefit pensions

Each of the three plans provides a defined benefit pension for its members. A defined benefit plan is distinct from a defined contribution plan in part because it provides a guaranteed life-long pension benefit (see textbox). During fiscal year 2014, the average annual pension payment to retired members was $52,977 for the PSPRS plan, $27,673 for CORP, and $53,598 for EORP.

Defined benefit plan—An employee retirement plan that provides a guaranteed lifetime retirement benefit of an amount calculated by a predetermined formula. The plan directs how contributions are invested.

Defined contribution plan—An individual retirement account, such as a 401(k), where the employee directs how contributions are invested. Retirement income is based solely on the amount contributed and is dependent on investment performance.

Source: Auditor general staff review of Olleman, M., & Boivie, I. (2011). *Decisions, decisions: Retirement plan choices for public employees and employers*. Washington, DC: National Institute on Retirement Security and Seattle, WA: Milliman.

Plans have various retirement requirements and benefit determination formulas

The PSPRS plan, CORP, and EORP each have different retirement eligibility criteria and different statutorily required formulas for determining pension benefit amounts. Under each plan, a member's eligibility for retirement is generally based on a combination of a minimum number of service years and a minimum age requirement. Although each plan has a different formula for calculating a member's retirement benefit, these formulas include the following three main elements:

- **Credited service years—**Years a member worked for a participating employer. Members may also purchase other qualifying years of service by working for employers other than participating employers, such as another state's governmental entity.

- **Credited service multiplier—**A set percentage multiplied by a member's credited service years.

- **Average monthly/yearly compensation—**A member's average highest compensation during a consecutive 36- or 60-month period during the member's last 10 years for CORP and EORP or 20 years for the PSPRS plan.

Table 2 presents an example retirement benefit calculation for a PSPRS plan member hired before January 1, 2012.

Table 2: Example of a PSPRS plan monthly retirement pension benefit calculation for a member hired before January 1, 2012

Average monthly benefit compensation	Credited service years and multiplier	Monthly retirement benefit formula		
Highest paid average salary during a consecutive 36-month period during the last 20 years: • $4,000 per month	22 consecutive years at a participating employer: • 20 years qualifies for 50 percent of average monthly compensation • 2 years qualifies for 2 percent per additional year, which equals an additional 4 percent		50 percent 4 percent 54 percent X $ 4,000 $ 2,160	for first 20 years for last 2 years Total credited service multiplier average monthly compensation per month pension benefit
		=		

Source: Auditor General staff illustration of benefit calculation requirements outlined in A.R.S. §§38-842(7) and 38-845(A).

Other benefits—The System also provides disability benefits, survivor benefits for spouses and children, and retiree health insurance premium subsidies to its members. Although there are some statutory differences between the PSPRS plan, CORP, and EORP regarding how these benefits are determined and applied, the following broad benefit categories are available to employees who participate in the three plans. Specifically:

- **Accidental, catastrophic, ordinary, and temporary disability benefits—**Members who become unable to perform their job duties may apply for disability benefits. Members of the PSPRS plan and CORP apply to their local boards for disability determinations, while members of EORP apply to the System. If a local board or the System determines a member is eligible for disability benefits, the member will receive pension benefits for a period of time that is consistent with the severity and duration of disability as defined by statute.

- **Health insurance premium subsidy benefit—**The System provides retired members and their survivors who choose health insurance through the Arizona Department of Administration (ADOA) or their former employer with monies to defray the costs of their medical and dental insurance premiums. As of November 2013, this benefit ranged from $100 to $260 per month, depending on whether the member is insuring him/herself only or a family, and if the member is receiving Medicare.

- **Spouse and child survivor benefit—**If an active or retired member dies, the surviving spouse receives a portion of the member's pension or average monthly salary each month for the spouse's lifetime.[1] If a PSPRS plan or CORP member dies in the line of duty, the surviving spouse receives 100 percent of the deceased member's pensionable salary less the benefit for any surviving children. Survivor pensions for children vary among the three plans. The PSPRS plan pays each eligible child up to 10 percent of the member's pension amount, but the total amount paid to all eligible children will not exceed 20 percent. CORP and EORP divide the surviving spouse pension among the member's children if there is no eligible surviving spouse. For all plans, children are generally eligible for survivor benefits until the age of 18 (or until the age of 23 if the child is an unmarried full-time student).

- **Cancer insurance—**The System administers a Cancer Insurance Program for eligible fire fighters, peace officers, and corrections and detention officers that pays out-of-pocket expenses and other lump sum benefits if an active member is diagnosed with cancer. This benefit is funded by premiums and investment earnings.[2] A member who is already retired is eligible to receive coverage at no cost for a specified amount of time based on credited years of service. After this time, the member may continue coverage if he/she was already receiving benefits, but he/she must pay the premium costs.

Board membership and staffing

Statute establishes the System as an independent trust fund (Fund) and provides a Board of Trustees (Board) the authority to administer and protect it. The Board appoints an administrator to oversee agency staff.

Statute establishes specific board membership requirements and authority—

According to statute, the Board is composed of seven members appointed by the Governor for 5-year terms. The Board consists of the following members:

- Two members from local boards to represent employees;
- One member who represents the State as an employer of public safety personnel and who must have at least 10 years' substantial financial experience;
- One member who represents the cities as employers of public safety personnel;
- One elected county or state official or a judge of the superior court, court of appeals, or supreme court; and
- Two public members who must have at least 10 years' substantial financial experience.

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1 For the PSPRS plan members, the surviving spouse receives 80 percent of the member's pension. The EORP surviving spouse benefit is 75 or 50 percent of the member's pension, depending on the date of membership. For CORP members, surviving spouses of deceased retired members also receive 80 percent of the member's pension, but surviving spouses of deceased active members receive 40 percent of a member's average monthly salary.

2 Participating PSPRS plan employers that employ firefighters or peace officers are required to participate in this program. The PSPRS plan employers pay members' premiums. Participating CORP employers that employ corrections or detention officers may participate in this program. Members of participating CORP employers pay premiums, unless the employer chooses to do so. However, the Arizona Department of Corrections and Arizona Department of Juvenile Corrections are not permitted to pay their members' premiums.

The Board is responsible for providing direction to and overseeing the System. This includes establishing investment objectives and policies, allocating assets, approving investment strategies to meet investment objectives and policies, and appointing investment managers to invest the plans' assets. In addition, the Board is empowered to take whatever actions are necessary to properly administer and protect the plans and the Fund, where all three plans' monies and other assets are held and deposited.[1] This includes establishing policies and procedures or other guidance; researching, developing, and implementing solutions for ensuring plan sustainability; and recommending statutory and other changes for legislative consideration.

System administrator and staff—The Board appoints an administrator to oversee agency staff and system operations. As of May 2015, the System reported that it had 49.25 full-time equivalent (FTE) positions, of which 3 were vacant. The System is organized into the following nine departments:

- **Administration (7.25 FTE, 1 vacant)—**Administration management and staff oversee business operations that support the System's staff, members, and other stakeholders. It also assists PSPRS plan and CORP local boards through outreach and education, and in the processing of member benefits in accordance with system policies and procedures. System administration also ensures compliance with laws as well as the System's mission, strategic initiatives, and performance measures.

- **Investment (7 FTE, 2 vacant)—**Investment staff are responsible for managing system assets. The System employs staff who select and manage investments for a portfolio designed to meet the board-approved investment policy's goals and objectives. The System competes with private investment firms for professionals to staff this department. Although authorized by statute to offer incentive compensation, the System opts to offer a competitive base salary to recruit and retain investment staff.[2]

- **Retired Members (9 FTE)—**The Retired Members Department is responsible for processing pension payments for all three plans' retired, survivor, and disabled members as well as assisting local boards in processing new retirement applications. The department also facilitates retired members' enrollment in health insurance plans and processes applications for survivor benefits and disability claims.[3]

- **Active Members (6 FTE)—**The Active Members Department is responsible for processing membership applications for new members of all three plans, as well as collecting and maintaining records of all active members' contributions. The department also assists active members with programs such as service purchase, transfer between employers, and changing beneficiaries.

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1 A.R.S. §38-848 establishes a public safety personnel retirement system depository where the Board may comingle employer assets but maintain separate records of each employer's receipts, earnings, and payments. The Board may opt to use these assets to purchase investments or disburse them to third parties for investment management.

2 For fiscal year 2014, six Investment Department staff earned base salaries of between about $84,000 and $268,000. Salaries are determined with ADOA oversight.

3 The System does not contract with an insurance plan, but retired members may choose health insurance coverage from their prior employer, through the ADOA, COBRA, or from the ASRS. According to system management, the Retired Members Department facilitates enrollment in these plans and calculates the health insurance premium subsidy benefit amount for each retired and disabled member.

- **Systems Development and Information Technology (IT) Operations (8 FTE)—**The Systems Development and IT Operations Departments are two separate departments that maintain the information technology the System and its members use. For example, systems development staff develop Web sites that members use to obtain account and benefit information and local boards use to retrieve member contribution history and estimate monthly pension benefit payments for retiring members. IT operations staff manage networks and the computers that system staff use.

- **Accounting (4 FTE)—**Accounting staff are responsible for producing comprehensive annual financial reports for the three plans and the Cancer Insurance Program. Staff also audit transactions and statements issued by the System's custodial bank used for investments and issue tax information.

- **Communications (3 FTE)—**The Communications Department is responsible for a call center that fields phoned and walk-in inquiries from active and retired members as well as local boards. These inquiries include questions about statutes, death benefits, taxes, refunds, benefit increases, medical and dental insurance, the Web site members use to access account information, and account information for retired and active members.

- **Internal Audit and Compliance (2 FTE)—**The Internal Audit and Compliance Department is responsible for planning and performing internal audits of the System's internal controls. In addition, department staff ensure compliance with the System's investment policies and procedures, laws, and contract terms.

The System also contracts with professional advisors for services to assist its staff with operations and investments. For a list of these services, see Sunset Factor 12, pages 57 through 58. These include actuarial services such as annual actuarial valuations of estimated pension obligations and assets for the PSPRS plan and each of its participating employers, CORP and each of its participating employers, and EORP. To calculate the plans' and employers' estimated pension obligations, the System's actuary uses statistical data to estimate various factors, including inflation, changes in member salaries, and mortality rates. To calculate how well-funded the plans and their participating employers are, its actuary measures estimated pension obligations against their assets. For more information on the financial condition of the System's three plans, see Finding 1, pages 13 through 24.

Budget

As illustrated in Table 3 (see page 9), PSPRS plan, CORP, and EORP revenue consist of member and employer contributions and investment income. Fiscal year 2014 net revenues totaled approximately $1.3 billion for the PSPRS plan, $331 million for CORP, and $82 million for EORP. The System estimates its net revenues for fiscal year 2015 will be lower for each of the three plans, but the fiduciary net position for the PSPRS plan and CORP, which is the fair value of the Plan's net assets, will be higher overall. EORP's estimated fiscal year 2015 fiduciary net position is expected to be slightly lower than in fiscal year 2014. Although not separately shown in the table, included in EORP's fiscal year 2014 revenues is a $5 million appropriation from the

Table 3: PSPRS plan, CORP, and EORP schedules of changes in fiduciary net position Fiscal years 2013 through 2015 (In thousands) (Unaudited)

	2013 (Actual)	2014 (Actual)	2015 (Estimate)
PSPRS plan			
Revenues (additions)[1]			
Total contributions and service purchase	$ 501,663.1	$ 585,402.6	$ 654,287.4
Net investment income	541,980.1	757,181.0	254,220.4
Transfers into system	744.7	775.3	355.1
Total additions	1,044,387.9	1,343,358.9	908,862.9
Expenses (deductions)[1]			
Benefits	565,540.1	640,117.8	700,856.1
Transfers to other plans and refunds	514.2	50.5	23.1
Administrative expenses	5,104.5	5,826.3	5,597.5
Total deductions	571,158.8	645,994.6	706,476.7
Net increase in net position	473,229.1	697,364.3	202,386.2
Net position restricted for benefits, beginning of year	5,055,828.0	5,529,057.1	6,226,421.4
Net position restricted for benefits, end of year	$ 5,529,057.1	$ 6,226,421.4	$ 6,428,807.6
CORP			
Revenues (additions)[1]			
Total contributions and service purchase	$ 117,074.5	$ 136,682.0	$ 128,612.4
Net investment income	138,267.5	194,516.9	63,746.9
Transfers into system	184.6	296.8	191.2
Total additions	255,526.6	331,495.7	192,550.5
Expenses (deductions)[1]			
Benefits	125,992.9	140,571.1	135,588.7
Transfers to other plans and refunds	840.6	498.7	689.4
Administrative expenses	1,266.7	1,437.7	1,418.1
Total deductions	128,100.2	142,507.5	137,696.2
Net increase in net position	127,426.4	188,988.2	54,854.3
Net position restricted for benefits, beginning of year	1,282,153.6	1,409,580.0	1,598,568.2
Net position restricted for benefits, end of year	$ 1,409,580.0	$ 1,598,568.2	$ 1,653,422.5
EORP			
Revenues (additions)[1]			
Total contributions and service purchase	$ 30,214.9	$ 39,906.9	$ 34,545.8
Net investment income	30,737.2	41,567.9	12,561.2
Transfers into system	16.9	98.6	25.9
Total additions	60,969.0	81,573.4	47,132.9
Expenses (deductions)[1]			
Benefits	45,596.1	55,089.5	50,802.4
Transfers to other plans and refunds	36.7	23.6	-
Administrative expenses	299.7	315.9	325.5
Total deductions	45,932.5	55,429.0	51,127.9
Net increase in net position	15,036.5	26,144.4	(3,995.0)
Net position restricted for benefits, beginning of year	295,896.2	310,932.7	337,077.1
Net position restricted for benefits, end of year	$ 310,932.7	$ 337,077.1	$ 333,082.1

1 In accordance with governmental accounting standards for financial reporting for pension plans, the plans' financial statements report revenues as additions and expenses as deductions.

Source: Auditor General staff analysis of the PSPRS plan, CORP, and EORP fiscal years 2013 and 2014 financial statements audited by an independent certified public accounting firm and system-prepared estimates for fiscal year 2015.

State General Fund to pay a portion of this plan's unfunded liabilities.[1] This was the first of 30 annual payments to the System required by the legislation that closed EORP to new members in 2014. Aside from the appropriation for EORP, the System's monies are not subject to legislative appropriations. Statute allows the System to use contributions to the three system plans to pay operational and administrative expenses and does not establish a limit on these expenditures. In fiscal year 2014, expenditures were about $646 million for the PSPRS plan, $143 million for CORP, and $55 million for EORP. Expenditures included retirement and disability benefits, health insurance subsidies, refunds to terminated members, and funds transferred to other plans. Expenditures also include administrative expenses for personnel and professional and outside services. The net position restricted for benefits as of June 30, 2014 was $6.2 billion for the PSPRS plan, $1.6 billion for CORP, and $337 million for EORP.[2]

System's investments

As shown in Table 3 (see page 9), investment income generally is the System's largest source of revenue and is used along with contributions to cover the System's benefits and other costs. As of June 30, 2014, the System held investments with a value of about $8.1 billion (this is the most recent fiscal year end information available). The PSPRS plan's, CORP's, and EORP's shares of the System's investments were about $6.2 billion, $1.6 billion, and $337 million, respectively.

The System invests this money according to a board-approved investment policy that is required to be consistent with statutory requirements.[3] As shown in Figure 5 (see Finding 1, page 18), from June 30, 2005 through June 30, 2014, the System's annual returns on investments have ranged from a low of -17.73 percent to a high of 17.37 percent.

The Board's asset allocation strategy establishes ten investment classes (see Figure 1, page 11). Specifically, as of June 30, 2014, system assets were invested as follows:

- **Equities—**This category, which represents about 44 percent of the System's portfolio, comprises three investment classes: U.S. equities, non-U.S. equities, and private equity. Equities are shares of ownership in businesses. U.S. equities are publicly traded in domestic stock markets, non-U.S. equities are publicly traded in foreign stock markets, and private equity shares are not publicly traded but are instead purchased through partnership agreements. Private equity partnerships vary depending on contract terms but typically require investors to make long-term investments to purchase a company with the objective of reselling the company for a profit in the future.

- **Real estate—**This investment class represents about 11 percent of the System's portfolio and includes investments in residential and commercial real estate (office, retail, and industrial).

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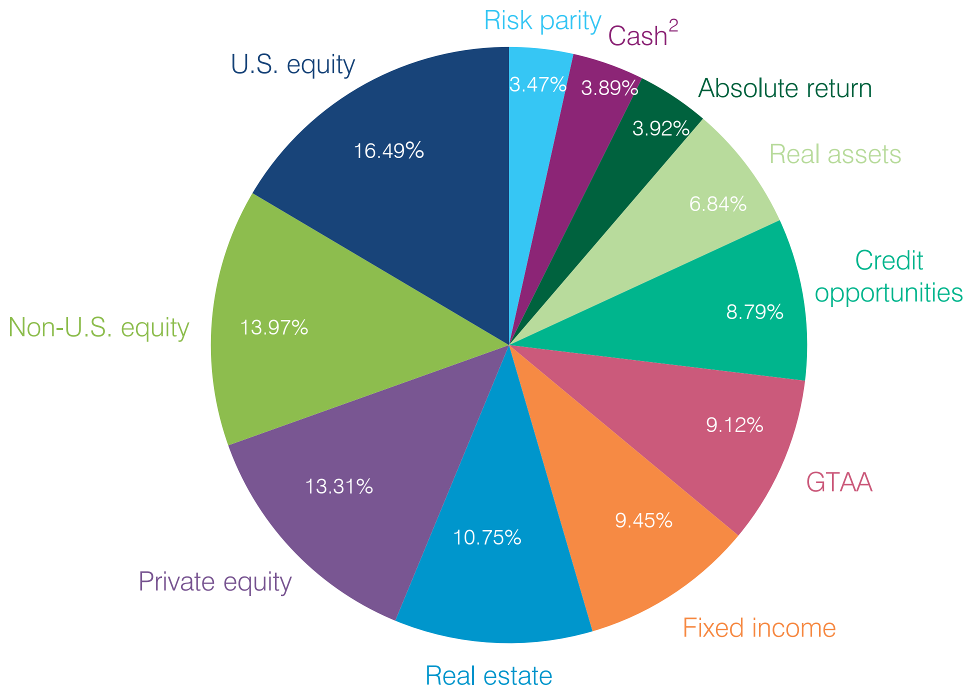
1 Aside from this annual appropriation, the System receives no other General Fund monies.

2 The net position restricted for benefits reflects the resources available to pay benefits to members at the end of the fiscal year and is the difference between the plans' assets and liabilities.

3 The System's investment policy is subject to some statutory investment limitations. For example, A.R.S. §38-848 includes limitations on how much of the portfolio value may consist of equities.

Figure 1: System's investment portfolio composition As of June 30, 2014[1] (Unaudited)



[1] June 30, 2014, represents the most recent fiscal year end information available.

[2] Cash is not an investment class. The System maintains cash accounts to pay expenses related to operating costs and investments.

Source: *Public Safety Personnel Retirement System 46th Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2014.*

- **Fixed income—**This investment class represents more than 9 percent of the System's portfolio and includes investments in bonds that governments and private businesses issue to borrow money from investors. These investments generally pay fixed, regular payments.

- **Credit opportunities—**This investment class represents about 9 percent of the System's portfolio and includes investments in bank loans and other forms of debt.

- **Global Tactical Asset Allocation (GTAA)—**This investment class also represents about 9 percent of the System's portfolio and includes investments in equities, fixed income, real assets, and other types of investments in domestic and foreign markets.

- **Real assets—**This investment class represents about 7 percent of the System's portfolio and includes investments in precious metals, commodities (agricultural products), agricultural land, and oil.

- **Absolute return—**This investment class represents about 4 percent of the System's portfolio and includes investments in assets that will return a small but positive rate of return each month.

- **Risk parity—**This investment class represents less than 4 percent of the System's portfolio. Risk parity is an investment approach that attempts to provide a lower-risk investment alternative to a portfolio of stocks and bonds by allocating funds to a wider range of investment categories such as stocks, government bonds, credit-related securities, and inflation hedges (including real assets, commodities, real estate, and inflation-protected bonds), while maximizing gains through financial leveraging (i.e., borrowing).

Consultant review of selected areas

As a part of its sunset review, the Office of the Auditor General retained Gallagher Fiduciary Advisors, LLC (Gallagher), a subsidiary of Arthur J. Gallagher & Co., to conduct an operational review of the following three areas:

- Determine the System's investment performance during the past 10 fiscal years (2005 through 2014), identify the causes for and impact of any underperformance, and make recommendations for improving the System's investment performance as appropriate;

- Determine if the System has adequate processes and other controls for selecting, monitoring, and terminating contracts with alternative investment managers and valuing these investments; and identify the reasons for and impact of any inadequate controls and make recommendations for improving controls, as appropriate; and

- Determine if the System has adequate processes and other controls over external investment manager fees, identify the reasons for and impact of any inadequate processes and controls, and make recommendations for improving processes and controls, as appropriate.

Gallagher's observations and recommendations in these areas are published separately from this report. See the *Independent Operational Review of the Public Safety Personnel Retirement System Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers* (Report No. 15-CR3).

FINDING 1

Based on the actuarial value of assets (see footnote 1), since June 30, 2005, the Public Safety Personnel Retirement System plan (PSPRS plan), the Corrections Officer Retirement Plan (CORP), and the Elected Officials' Retirement Plan (EORP) have experienced steady declines in their funded statuses. A pension plan's funded status is a general indicator of its financial health, reflecting the extent to which a plan's assets can cover its estimated pension obligations. Best practice organizations recommend that public pension plans should target a 100 percent funded status, but two of the three plans have a funded status less than half of this recommended level. In fact, some PSPRS plan employers did not have sufficient assets to pay members' pension benefits in fiscal year 2015. The funded statuses of all three plans have declined as a result of required permanent benefit increases that are added to retired members' pensions and unmet investment return assumptions. The Legislature and the Public Safety Personnel Retirement System (System), which administers these plans, have taken action to address these declines, but some of these actions were overturned as a result of legal challenges.

Plans' assets have not kept pace with estimated pension obligations

All three system plans' funded statuses have steadily declined

Based on the actuarial value of assets, the funded statuses for the PSPRS plan, CORP, and EORP have steadily declined from June 30, 2005 through June 30, 2014, and are considerably below the recommended 100 percent level.[1] Funded status, which measures the sufficiency of a pension plan's assets to meet its estimated pension obligations, is a general indicator of a pension plan's health at a specific point in time (see textbox for how to calculate funded status). Although funded status will vary over time, best practice organizations indicate that public pension plans should target a 100 percent funded status.[2] However, as of June 30, 2014, the funded statuses of the PSPRS plan (49 percent), CORP (57 percent), and EORP (39 percent) were well below this target. For the PSPRS plan and CORP, the System is required to present an aggregate funded status, which is useful for providing a general indication of each plan's overall financial health, and separate funded statuses for each participating employer, which

Calculating funded status

A typical method for determining funded status is to divide a pension plan's assets by its liabilities, or the amount needed to pay its estimated pension obligations for benefits that have been earned by all plan members (active, inactive, and retired), at a particular point in time. For example:

\$90 billion in assets ÷ \$100 billion in estimated pension obligations = 90 percent funded status

The deficit between a pension plan's assets and its estimated pension obligations is called an unfunded liability. In the example above, the pension plan has an unfunded liability of \$10 billion.

Source: Auditor General staff analysis of information from: Society of Actuaries. (2014). *Report of the blue ribbon panel on public pension plan funding;* and National Institute on Retirement Security. (2014). *2014 NIRS/NRTA pension education toolkit.*

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[1] The actuarial funded status for each of the System's plans is calculated using the PSPRS plan, CORP, and EORP's 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. The PSPRS plan's, CORP's, and EORP's actuarial value of assets and funded statuses are critical for the System's operations because they are used to determine contribution rates and are also important factors in making funding decisions and establishing funding goals and objectives, such as those outlined in the System's funding policy (see page 21). Therefore, throughout this report, any discussions regarding funded statuses are based on the actuarial value of assets. Funded status can also be calculated using the market value of assets, which represents the fair market value of assets at a point in time, such as at fiscal year-end. The market value of assets is a more volatile measure because it can shift at any point in time due to market conditions.

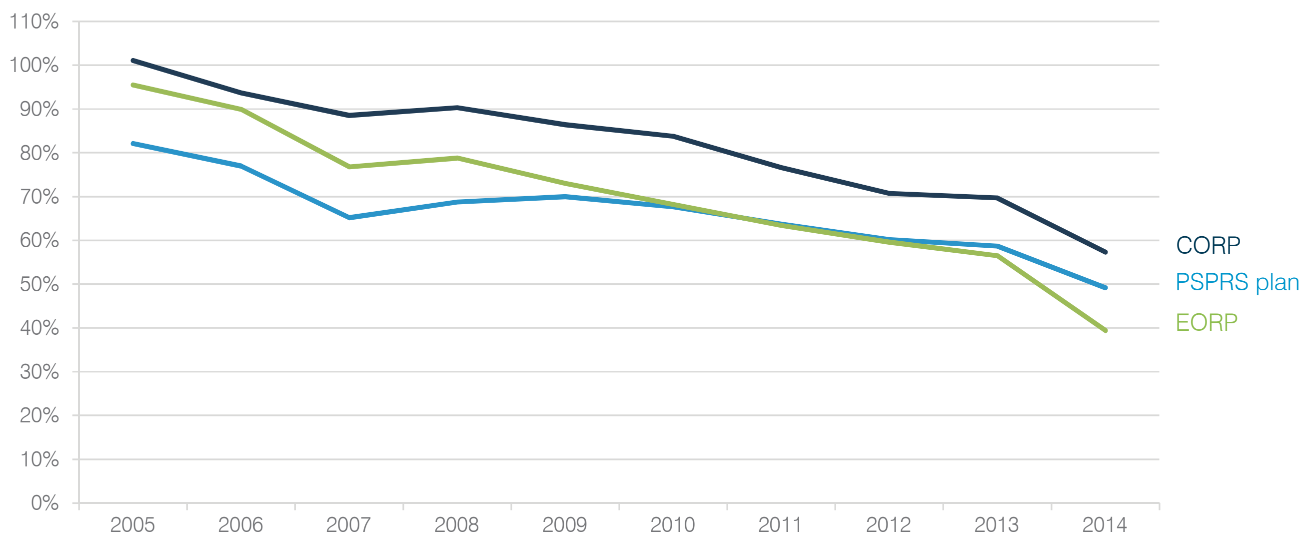
[2] Government Finance Officers Association. (2009). *Sustainable funding practices of defined benefit pension plans;* American Academy of Actuaries Issue Brief. (2012). *The 80% pension funding standard myth.*

is important for assessing the financial health of each participating employer.[1] These two plans are agent multiple-employer plans, which means that each participating employer is responsible for its own pension obligations. The individual funded statuses for participating employers in the PSPRS plan and CORP varied widely, with some employers having insufficient assets to pay pension obligations in fiscal year 2015. The PSPRS plan, which was the largest of the System's plans and therefore the most easily comparable to other states' pension plans, has declined more than the national average, and more than the three peer plans that auditors identified.

System plans' funded statuses have declined to well below recommended level—All three system plans have experienced steady declines in funded status from June 30, 2005 through June 30, 2014, that put them well below the recommended 100 percent level. Specifically, as shown in Figure 2, between June 30, 2005 and June 30, 2014:

- The PSPRS plan's funded status declined from 82.1 to 49.2 percent;
- CORP's funded status declined from 101.1 to 57.3 percent; and
- EORP's funded status declined from 95.5 to 39.4 percent.[2]

Figure 2: PSPRS plan, CORP, and EORP funded statuses[1]
As of June 30, 2005 through June 30, 2014



[1] The PSPRS plan and CORP are agent multiple-employer plans. This means that the funded statuses represented here for these two plans are aggregates of individual participating employers' funded statuses, which vary from employer to employer (see Tables 5 and 6 in Appendix A, pages a-2 through a-9, for individual PSPRS plan and CORP employer-funded statuses). EORP is a cost-sharing multiple-employer plan, which means that there is only one funded status for the entire plan.

Source: Auditor General staff analysis of the PSPRS plan, CORP, and EORP comprehensive annual financial reports for the fiscal year ended June 30, 2013; and actuarial valuation reports as of June 30, 2014.

[1] Arizona Revised Statutes (A.R.S.) §38-848(J) requires the System to present an aggregate funded status for both the PSPRS plan and CORP. A.R.S. §§38-843(B) and 38-891(A) require the System to obtain actuarial valuations for each PSPRS plan and CORP employer, respectively.

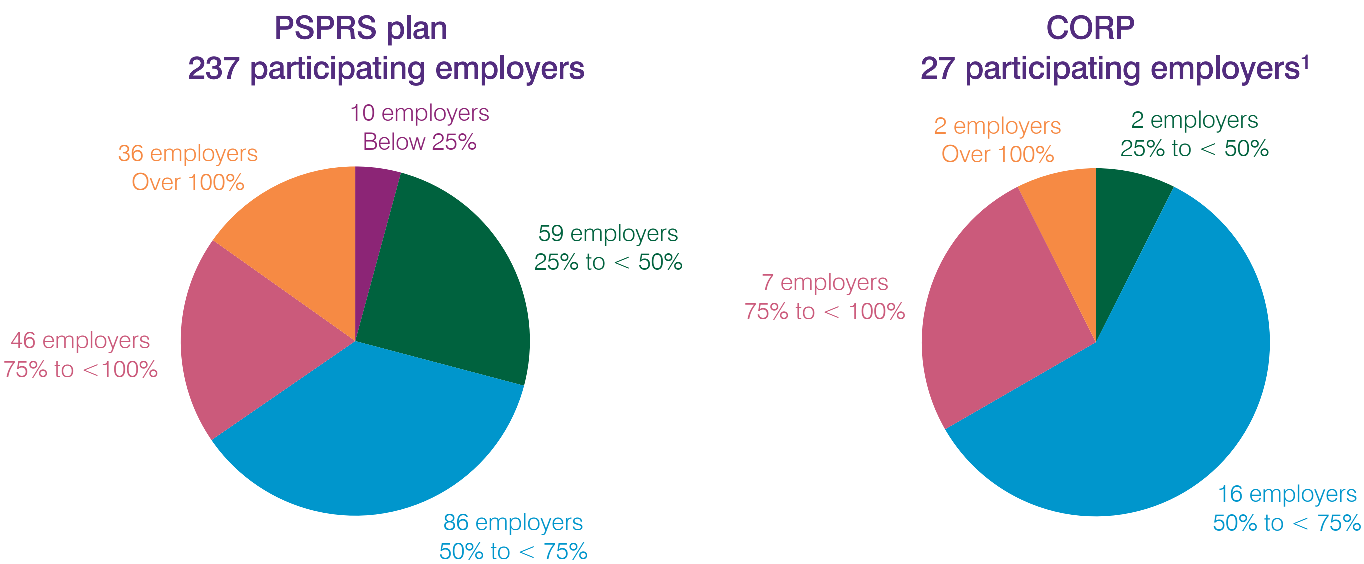
[2] Laws 2013, Ch. 217, closed EORP to new members as of January 1, 2014. The Legislature enacted a new defined contribution plan for eligible elected officials and judges employed by a participating employer on or after January 1, 2014, per A.R.S. §38-833(A).

These plans' declining funded statuses indicate that their assets have not kept pace with their estimated pension obligations. For example, as of June 30, 2014, the PSPRS plan had only about $6 billion in assets but more than $12 billion in estimated pension obligations, or, 49.2 percent of the assets needed to pay the estimated pension obligations to its approximately 32,100 members.

Several PSPRS plan and CORP employers have very low funded statuses, and these funded statuses also widely vary—The funded statuses shown in Figure 2, see page 14, for the PSPRS plan and CORP are referred to as aggregate funded statuses because they reflect the total of participating employers' assets and pension obligations for each plan. Because the PSPRS plan and CORP are agent multiple-employer plans, separate accounts are maintained for recording each participating employer's assets and estimated pension obligations. Therefore, each employer has an individual funded status that indicates the extent to which the employer's assets can cover its estimated pension obligations.

An analysis of each participating employer's funded status in these two plans shows that many employers are below the 50 percent level. Figure 3 illustrates the number of PSPRS plan and CORP employers by funded status as of June 30, 2014. Specifically, 69 PSPRS plan employers and 2 CORP employers, or about 27 percent of the total employers in these two plans combined, have a funded status below 50 percent. These employers include the Arizona Department of Public Safety (36.1 percent), the City of Phoenix Police Department (48.1 percent), the City of Flagstaff Police Department (38.0 percent), and Pima County Detention (48.6 percent). In all, 71 of the 264 participating PSPRS plan and CORP employers have less than half of the assets they need to pay the $7.5 billion in estimated pension obligations to nearly 18,700 members.

Figure 3: PSPRS plan and CORP participating employers' funded statuses As of June 30, 2014



[1] No CORP employers have a funded status below 25 percent.

Source: Auditor General staff analysis of the PSPRS plan and CORP actuarial valuation reports as of June 30, 2014.

In the two most dire cases, employers did not have sufficient plan assets to pay for retiree benefits in fiscal year 2015. As of June 30, 2014, the City of South Tucson Police Department had only $182,695 in assets to cover $571,435 in annual benefits to 15 retired members.[1] Further, the Yavapai County Attorney's Investigators does not have any assets to pay for $76,767 in annual benefits to two retired members.[2] The inability of a participating employer to pay its pension obligations may place it at financial risk. For example, employers in other states filed for bankruptcy when they were unable to pay their pension obligations. One of these employers, the City of Central Falls, Rhode Island, filed for bankruptcy in 2011 in part because its current and future pension benefit obligations had grown to be almost four times greater than the City's annual revenues. The City of Central Falls' members' pensions were cut by up to 55 percent as part of a bankruptcy agreement.[3]

As Figure 3 (see page 15) also shows, the funded statuses for the 264 participating PSPRS plan and CORP employers vary widely. As detailed in Appendix A, Tables 5 and 6 (see pages a-2 through a-9), the funded statuses for PSPRS plan employers ranged from -6.8 percent for the Yavapai County Attorney Investigators to 377 percent for the Town of Hayden Police Department, and CORP plan employers' funded statuses ranged from 43.7 percent for the City of Somerton–Dispatchers to 118.7 percent for the Graham County Dispatchers.

Decline in PSPRS plan's aggregate funded status is greater than the nation-wide trend and differs from peer plan experience

—Auditors compared the funded status of the PSPRS plan to the funded status of pension plans nation-wide and more specifically to three plans that can be considered as peers because they are similar to the PSPRS plan in a number of ways.[4] This comparison revealed that the decline in the PSPRS plan's funded status is greater than the decline that public pension plans nation-wide experienced. According to a 2015 report by the Public Fund Survey, the average funded status of 126 public pension plans throughout the nation declined by 13 percentage points, from 86.5 percent in fiscal year 2005 to 73.5 percent in fiscal year 2012.[5] In contrast, for the same time period, the PSPRS plan's funded status declined by approximately 21.9 percentage points, from 82.1 to 60.2 percent. As previously discussed, the PSPRS plan's funded status has continued to decline to 49.2 percent as of June 30, 2014.

The three peer plans identified by auditors also fared better than the PSPRS plan. As shown in Figure 4 (see page 17), after June 30, 2006, the PSPRS plan had a lower funded status when compared to these three plans. Additionally, none of these peer plans experienced the same long-term decline in funded status as the PSPRS plan. For example, Rhode Island's Municipal Employees' Retirement System's funded status decreased from 92.8 percent as of June 30, 2008, to 73.6 percent as of June 30, 2010. However, since that time, this plan's funded status

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1 According to the System, the City of South Tucson Police Department's contribution rate is more than 90 percent, allowing it to keep paying pension benefits for now.

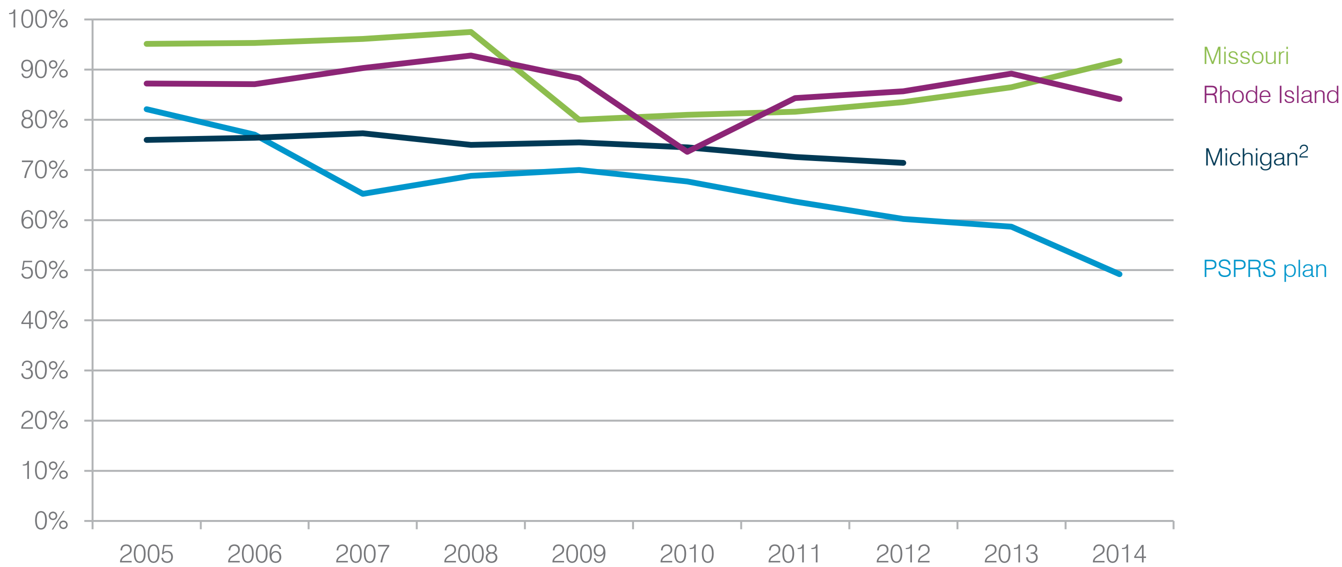
2 There are no active Yavapai County Attorney's Investigators members. According to the System, it invoices Yavapai County for the amounts needed annually to pay pension benefits as determined by the System's actuary.

3 As part of the statutory adoption of the settlement and release agreement for the City of Central Falls bankruptcy, the State of Rhode Island General Assembly provided supplemental appropriations to the city so that retired members would retain 75 percent of their pensions as of July 31, 2011.

4 The three peer plans are the Municipal Employees' Retirement System of Michigan, Missouri Local Government Employees Retirement System, and Rhode Island's Municipal Employees' Retirement System. These plans were selected based on similarities in areas such as the market value of assets and retired-to-active member ratio (see Appendix B, pages b-1 through b-2, for additional information).

5 Public Fund Survey. (2015). *Summary of findings for FY 2013.*

Figure 4: PSPRS plan and other state peer plans' aggregate funded statuses As of June 30, 2005 through June 30, 2014[1]



[1] The funded statuses for the PSPRS plan and Rhode Island's Municipal Employees' Retirement System are as of June 30. The funded status of the Municipal Employees' Retirement System of Michigan is as of December 31. The funded status for the Missouri Local Government Employees Retirement System is as of February 28, except for 2008 and 2012, which are as of February 29.

[2] The funded statuses for the Municipal Employees' Retirement System of Michigan as of December 31, 2013 and 2014, are not available.

Source: Auditor General staff analysis of the PSPRS plan comprehensive annual financial report for the fiscal year ended June 30, 2013, and actuarial valuation as of June 30, 2014; the actuarial valuations for the Municipal Employees' Retirement System of Michigan as of December 31, 2005 through December 31, 2012; the actuarial valuation for the Missouri Local Government Employees Retirement System as of February 28, 2014; and the actuarial valuations of Rhode Island's Municipal Employees' Retirement System as of June 30, 2005 through June 30, 2014.

had increased to 84.1 percent as of June 30, 2014.[1] Similarly, the Missouri Local Government Employees Retirement System declined in funded status from 97.5 percent as of February 28, 2009, to 80 percent as of February 28, 2010, but as of February 28, 2014, this plan's funded status had increased to 91.7 percent.

Two main factors have largely reduced the plans' funded statuses

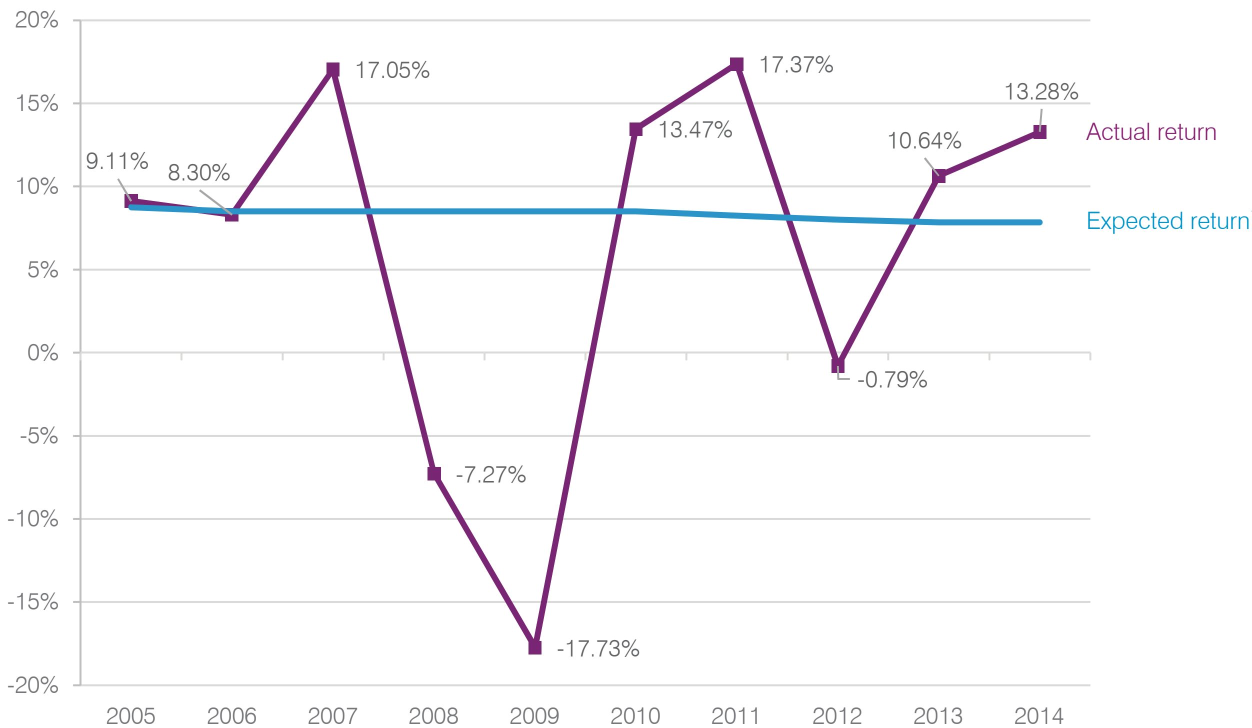
Auditors identified two principal factors that contributed to the decline in the system plans' funded statuses. First, required permanent benefit increases have raised the plans' pension obligations. Second, investment returns were lower than expected. Specifically:

- **Required permanent benefit increases**—Required increases to retirees' pension benefits have contributed to the decline in the plans' funded statuses. Statutes require that each qualified PSPRS plan, CORP, and EORP retired member will receive a permanent increase in his/her pension amount, called a permanent benefit increase, each year that the plan's separate

[1] In 2011, Rhode Island enacted several pension reforms, which became effective on July 1, 2012, that converted this plan to a hybrid plan and suspended annual cost-of-living adjustments until an employer's individual funded status exceeds 80 percent.

benefit increase accounts have sufficient funds available to provide a benefit increase. Monies are put into these separate benefit increase accounts each year that the System earns an investment return that is higher than 9 percent. Specifically, statute requires that when the System's investment return is higher that 9 percent, between 50 to 100 percent of the amount above 9 percent must be placed in these accounts. As Figure 5 shows, the System exceeded this rate of investment return in 6 of the 10 fiscal years ended from June 30, 2005 to June 30, 2014. Although the intent of providing benefit increases is to help retain the value of a retiree's benefit over time, these increases negatively impact the plans' sustainability because excess returns are used to fund benefit increases rather than improve funded statuses (see Finding 2, pages 25 through 35, for additional information on permanent benefit increase structures).

Figure 5: System's actual and expected rates of investment return As of June 30, 2005 through June 30, 2014 (Unaudited)



[1] The System maintained an expected rate of investment return of 8.75 percent as of June 30, 2005; 8.50 percent as of June 30, 2006 through June 30, 2010; 8.25 percent as of June 30, 2011; 8.00 percent as of June 30, 2012; and 7.85 percent as of June 30, 2013 through June 30, 2014.

Source: Auditor General staff analysis of investment results based on market value of assets as reported in the PSPRS plan's comprehensive annual financial reports for the fiscal years ended June 30, 2005 through June 30, 2014.

- **Unmet long-term investment returns**—Additionally, the plans have fewer assets than expected to pay estimated pension obligations in part because the System has not met its long-term expected rate of return on its investments. This rate reflects the investment return that the System expects to achieve on average over a period of time. If the System does not meet this rate, the funded statuses of its three plans may decline. To achieve this return, the System invests contributions it receives from the plans. As indicated in Figure 5, the System's annual rate of return varied greatly from June 30, 2005 through June 30, 2014, ranging from a low of -17.73 percent as of June 30, 2009, to a high of 17.37 percent as of June 30, 2011. Overall, however, the System's average investment return during this 10-year period was 5.74 percent, which was much lower than the average expected rate of return of 8.31 percent.[1] Since investment returns are a primary source of increasing the assets that the plans use to pay estimated pension obligations, this underperformance has negatively affected the plans' funded statuses. In addition, according to system management and information in PSPRS plan's, CORP's, and EORP's comprehensive annual financial reports, investment losses that occurred during fiscal years 2001 and 2002 also impacted the system plans' funded statuses during the time frame analyzed in this audit report because of the continued recognition of those losses.[2]

However, as previously mentioned, statute requires that when the System's investment return is higher than 9 percent, between 50 to 100 percent of the amount above 9 percent must be placed in separate accounts for permanent benefit increases. As a result, these monies cannot be used to improve plans' funded statuses (see Finding 2, pages 27 through 28, for more information on this requirement).

Gallagher Fiduciary Advisors, LLC (Gallagher) also analyzed the System's investment performance for fiscal years 2005 through 2014 and found that the large negative returns in fiscal years 2008 and 2009 have had a significant impact on its cumulative returns over 7 and 10 years, but that the System restructured the asset classes where the most significant underperformance was realized (see the Gallagher Report for more specific information on the System's investment performance).

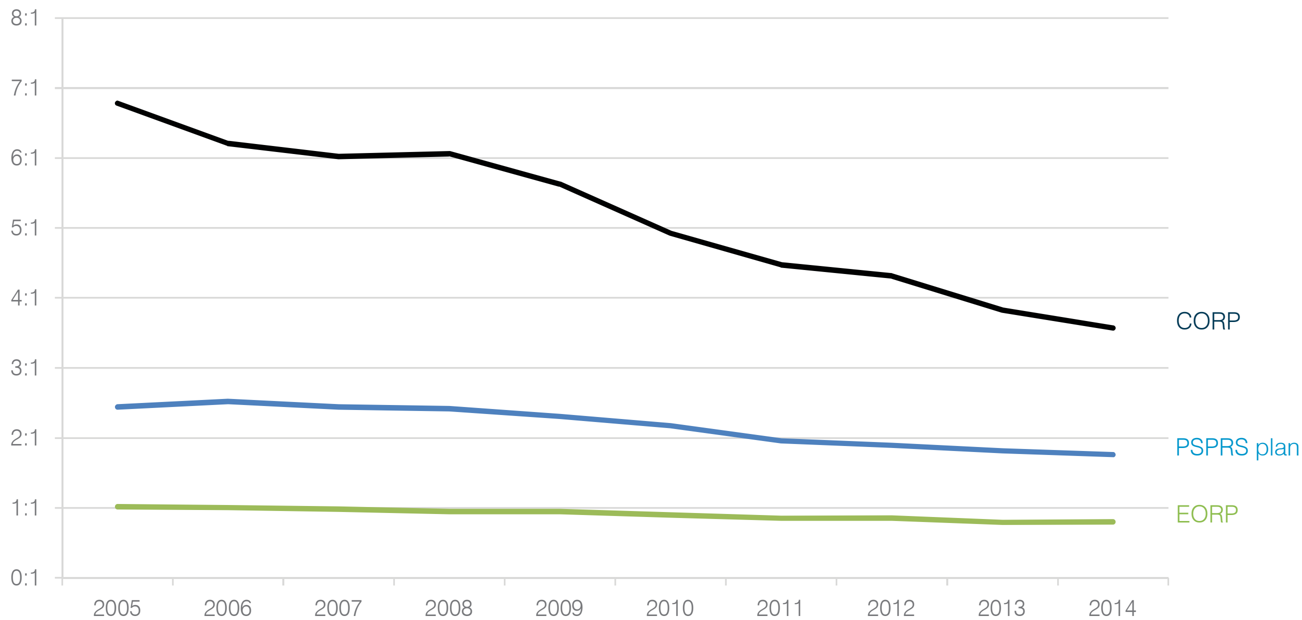
Although not a direct impact on the system plans' funded statuses, the plans' active-to-retired member ratios have also declined. Specifically, as illustrated in Figure 6 (see page 20), the active-to-retired member ratio has decreased for all three plans from June 30, 2005 to June 30, 2014. For example, the ratio of active-to-retired members in the PSPRS plan decreased from 2.44:1 as of June 30, 2005, to 1.76:1 as of June 30, 2014. This is because of a large increase in retired members, while active members have only increased slightly. For example, between fiscal years 2005 through 2014, the PSPRS plan's retired member population grew by approximately 3,800 members, or about 57 percent; whereas, the number of active members increased by only approximately 2,200, or about 14 percent. Although a declining active-to-retired member ratio by itself does not pose a direct problem to sustainability, it can result in relatively high contribution rates.[3]

1 The System uses a geometric mean to determine the average investment return over a period of time. This mean takes into account the effects of compounding. For example, negative investment returns in one year will affect investment returns in subsequent years.

2 As indicated on page 13 (see footnote 1), the System's actuary recognizes investment losses and/or gains over a rolling 7-year period.

3 Public Fund Survey. (2015). *Summary of findings for FY 2013*.

Figure 6: PSPRS plan, CORP, and EORP active-to-retired member ratios
As of June 30, 2005 through June 30, 2014



Source: Auditor General staff analysis of the PSPRS plan, CORP, and EORP actuarial valuation reports as of June 30, 2014.

System and Legislature have taken actions to improve plans' long-term sustainability, but plans' sustainability remains at risk because some actions were overturned

Although the System and the Legislature have taken several actions to improve its plans' funded statuses that are consistent with best practices, the long-term sustainability of the System's plans remains at risk. In line with best practices, the System and its Board of Trustees (Board) have adopted a funding policy and increased contribution rates. In addition, the Legislature enacted several statutory changes that are consistent with actions taken by other states to improve their pension plans' funded statuses, such as adjusting the pension benefit formula for new members and restructuring permanent benefit increases. However, some of these actions did not withstand legal challenges and were ruled unconstitutional. As a result, the long-term sustainability of the System's plans remains at risk.

Steps the System took are consistent with best practices—To address the declining funded statuses and promote the plans' sustainability, the System has taken a number of actions that are consistent with best practices. These include the following:

- **Changed investment strategies**—In its review of the System's investment strategies for fiscal years 2005 through 2014, Gallagher reported that the System has increased the number and complexity of asset classes by increasing the number of alternative investments in its portfolio. Alternative investments are investments other than equities, fixed income, and cash and may include private equity and real estate partnerships.

As Gallagher reported, this change in investment strategy is similar to changes made by the System's peer public retirement plans. Additionally, public retirement plans in general are responding to funding shortfalls by significantly increasing allocations to alternative investments (see the Gallagher Report for more specific information).

- **Adopted a pension funding policy—**Consistent with best practice, the System's Board adopted a pension funding policy in 2014 that explains its funding objectives and the elements that will be used to meet such objectives. Specifically, according to best practice literature, pension plans should have a documented strategy to attain or maintain a funded status of 100 percent or greater over a reasonable period of time and should adopt a pension funding policy as a strategy to help achieve these funding objectives.[1] According to the Pension Funding Task Force, a clear pension funding policy is important because it outlines a strategy to fund pensions, provides guidance in making annual budget decisions, demonstrates prudent financial management practices, and shows employees and the public how pensions will be funded.[2] For example, as recommended by the American Academy of Actuaries, the System's funding policy includes an objective to achieve a 100 percent funded status and indicates that through modification of contribution rates in combination with investment earnings, the system plans are expected to be fully funded by no later than 30 years. In addition, the System made this funding policy publicly available on its Web site.

- **Increased employer contribution rates—**Consistent with best practices, statute requires that the employer contribution rates be determined by an annual valuation by the Board's actuary, and the Board increases contribution rates when the actuary recommends to do so.[3] Based on a number of factors including the expected rate of investment return, the System's actuary annually determines the contribution rates for each system plan that will help pay for 100 percent of their estimated pension obligations over time. Therefore, when the System does not meet its expected rate of investment return, the actuary will recommend increasing contributions to ensure that each plan will have enough assets to pay for their estimated pension obligations. Because statutes establish member contribution rates for all three system plans, the Board adjusts the employers' contribution rates to address any difference between the member's contribution rate and the actuary's total recommended contribution rate. As illustrated in Figure 7 (see page 22), during fiscal years 2005 through 2014, the contribution rates for the PSPRS plan, CORP, and EORP employers have generally increased in an effort to improve these plans' funded statuses.

  However, EORP's contribution rates changed in fiscal year 2014 as a result of legislative actions. Effective January 1, 2014, when the Legislature closed EORP to new members, it also revised statute to establish a set amount for employer contributions.[4] As a result, the Board

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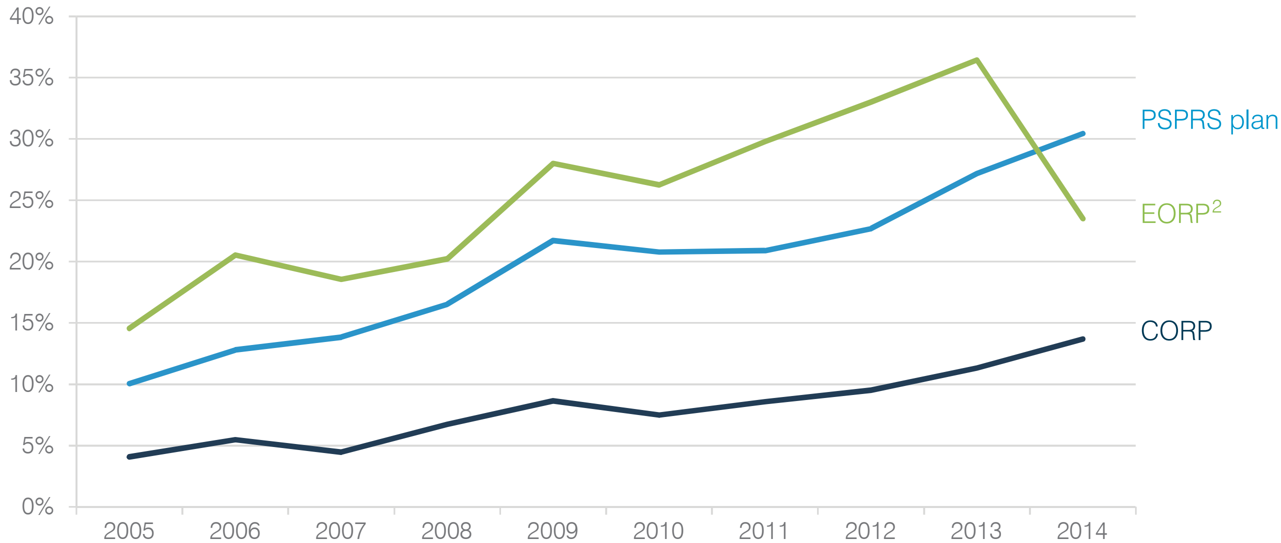
[1] American Academy of Actuaries Issue Brief. (2012). *The 80% pension funding standard myth*; Government Finance Officers Association. (2013). *GFOA best practice: Core elements of a funding policy.*

[2] Pension Funding Task Force. (2013). *Pension funding: A guide for elected officials.* The Pension Funding Task Force was established in 2012 by the National Governors Association, National Conference of State Legislatures, Council of State Governments, National Association of Counties, National League of Cities, U.S. Conference of Mayors, the International City/County Management Association, and the Government Finance Officers Association. The National Association of State Auditors, Comptrollers and Treasurers; the National Association of State Retirement Administrators; and the National Council on Teacher Retirement also serve on the Task Force. The Center for State and Local Government Excellence is the convening organization for the Task Force.

[3] Government Finance Officers Association. (2013). *GFOA best practice: The role of the actuarial valuation report in plan funding.*

[4] Laws 2013, Ch. 217, closed EORP to new members as of January 1, 2014. The Legislature enacted a new defined contribution plan for eligible elected officials and judges employed by a participating employer on or after January 1, 2014, in accordance with A.R.S. §38-833(A).

Figure 7: PSPRS plan, CORP, and EORP average employer contribution rates[1]
As of June 30, 2005 through June 30, 2014



1 Because the PSPRS plan and CORP are agent multiple-employer plans, each employer has an individual funded status and therefore an individual contribution rate (see textbox on page 2 for more information on agent multiple-employer plans and Appendix A, pages a-2 through a-9, for PSPRS plan and CORP employer contribution rates as of the end of fiscal year 2014). The contribution rates in Figure 7 reflect the average employer contribution rate for these two plans. However, EORP is a cost-sharing, multiple-employer plan where the funded status is determined by dividing the employers' shared assets by their shared estimated pension obligations (see textbox on page 2 for more information on cost-sharing, multiple-employer plans). Therefore, EORP features a single-employer contribution rate for all participating employers.

2 Laws 2013, Ch. 217, closed EORP to new members as of January 1, 2014. It also established that EORP employers will contribute 23.5 percent of payroll to EORP beginning on January 1, 2014, and continuing through June 30, 2044.

Source: Auditor General staff analysis of the PSPRS plan, CORP, and EORP comprehensive annual financial reports for the fiscal year ended June 30, 2014.

can no longer annually adjust EORP employer's contribution rates. If a higher contribution rate is needed than what is set in statute, the plan will continue to experience a decline in its funded status and its ability to pay its estimated pension obligations will be at risk (see Finding 3, pages 37 through 47, for more information).

- **Reviewed actuarial assumptions**—The System also contracts for two separate reviews of its actuarial assumptions that can help ensure their soundness. First, statute requires that at least once every 5 years, an actuary compares the plans' actual experience over a period of time, such as 5 years, with the assumptions used during that same time period.[1] These assumptions include expected rates of retirement among active members and the long-term rate of investment return (see textbox, page 23). Based on the results of this analysis, the actuary may recommend that the Board change certain assumptions. For instance, one of the actuary's recommendations to the Board, which it approved in 2012, was to decrease the assumptions regarding how many PSPRS plan and CORP active members will become disabled. The actuary projected that this change would decrease these plans' contribution rates.[2]

1 A.R.S. §38-848(Q).

2 Gabriel Roeder Smith & Company, Consultants & Actuaries. (2012). *Arizona Public Safety Personnel Retirement System analysis of actuarial assumptions, July 1, 2006 through June 30, 2011.*

Second, consistent with best practice, the System's Governance Manual requires it to conduct an actuarial audit at least every 7 years.[1] This audit involves retaining a separate actuarial firm to provide an independent review or audit of the analyses and methodologies used in the experience study and corresponding valuations. These audits may also include recommendations for the Board to reconsider certain assumptions. For example, one of the findings in a 2007 actuarial audit recommended lowering the System's investment return assumption from 8.5 percent to 7.5 percent.[2] The Board declined to implement this recommendation, which would have increased the plans' employer contribution rates.

Examples of actuarial assumptions

Withdrawal rates—Projects the number of active members who leave a plan before retiring and receiving a pension benefit.

Mortality rates—Projects the number of members who will die based on their age.

Disability rates—Projects the number of active members who will become disabled based on their age.

Wage inflation—Projects the long-term rates of growth of total payroll.

Source: Auditor General staff review of the PSPRS plan's 2012 actuarial experience study.

Legislature has also enacted changes to improve plans' funded statuses—Consistent with actions taken in other states, in 2011, the Legislature enacted several changes to the PSPRS plan, CORP, and EORP statutes to improve these plans' funded statuses and enhance sustainability. Specifically, Laws 2011, Ch. 357 (Senate Bill 1609), made the following changes:

- **Raised eligibility requirements—**This law amended the three plans' statutes to establish the minimum age at which an individual can retire and increase the number of years a member must work to be eligible for retirement. These changes apply to individuals who become members on or after January 1, 2012. Specifically, for individuals who became PSPRS plan and CORP members on or after this date, the minimum retirement age is 52.5 years of age. For individuals who became members of the PSPRS plan and CORP before January 1, 2012, statute did not previously establish a minimum retirement age.

- **Adjusted the pension benefit formula—**Laws 2011, Ch. 357, also changed the formulas for calculating the pension benefit amount for members of each of the three plans.[3] Similar to the eligibility requirement change, this change applies to individuals who become members on or after January 1, 2012. This legislative change increased the period of time used to calculate average monthly salary, which is used to determine retirement benefits, from the highest 36 months to the highest 60 months of compensation in the last 10 years (CORP and EORP) or 20 years (PSPRS plan) of a member's service. Expanding the time period used to calculate final average salaries generally reduces pension benefits by averaging in lower employee salaries.[4]

1 Government Finance Officers Association. (2013).

2 Milliman Consultants and Actuaries. (2007). *State of Arizona Public Safety Personnel Retirement System, Correction Officer Retirement Plan, Elected Officials' Retirement Plan actuarial audit report.*

3 A member's retirement benefit is calculated using a statutory formula that includes three main elements: years of credited service, a multiplier, and average monthly compensation. For an example of calculated benefits, see Introduction, page 5.

4 United States Government Accountability Office. (2012). *State and local government pension plans: Economic downturn spurs efforts to address costs and sustainability*. Washington, DC.

- **Restructured permanent benefit increases—**Finally, Laws 2011, Ch. 357, changed the requirements for providing permanent benefit increases, by establishing more stringent criteria before doing so. Specifically, Laws 2011, Ch. 357, eliminated the separate benefit increase accounts for each of the three plans. In addition, the System must attain a total return of more than 10.5 percent rather than the previous 9 percent and requires that the PSPRS plan, CORP, and EORP individually have a funded status of at least 60 percent before each individual plan can award permanent benefit increases. To help improve plans' sustainability, these changes were intended to apply to all plan members. However, the constitutionality of these changes was challenged, and in February 2014, the Arizona Supreme Court ruled that the changes made were unconstitutional for members who had retired on or before July 1, 2011 (see Finding 2, pages 25 through 35, for more information regarding permanent benefit increases, including changes made through Laws 2011, Ch. 357, and the resulting legal challenges).

According to a 2012 report by the National Conference of State Legislatures, from 2009 to 2011, 43 states including Arizona modified at least one state-sponsored defined benefit pension system to reduce member benefits and lower future pension obligations by either adjusting the pension benefit formula, raising eligibility requirements, and/or limiting post-retirement benefits.[1] However, according to a 2012 report by the U.S. Government Accountability Office (U.S. GAO), these types of benefit changes are generally limited to new plan participants because of legal provisions that protect pensions from being eliminated or diminished for current and retired members.[2] Further, this U.S. GAO report also noted that while these changes to pension plans for new employees do reduce plans' pension obligations, it can take a decade or more for any significant reduction because it takes time for new employees with these decreased benefits to represent a substantial portion of the workforce.

Long-term sustainability of all three plans remains at risk—Despite these actions, and because of the reversal of some change made through Laws 2011, Ch. 357, the long-term sustainability of the System's plans is at risk unless additional corrective measures are taken. As previously mentioned, for some of the employers participating in the plans, sustainability is more than a potential problem in the future: a few are already in danger of having insufficient plan assets to cover the immediate pension obligations to their respective members. The remaining findings of this audit discuss steps that could be taken to make the plans more sustainable. Finding 2 discusses changes and recommendations regarding the System's permanent benefit increase structures (see pages 25 through 35), and Finding 3 discusses additional actions that the System and Legislature should consider taking to help ensure the long-term sustainability of the System's three plans (see pages 37 through 47).

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1 Snell, R. (2012). *State pension reform, 2009-2011*. Washington, DC: National Conference of State Legislatures.

2 U.S. GAO, (2012).

FINDING 2

The Public Safety Personnel Retirement System (System) should collaborate with the Public Safety Personnel Retirement System plan (PSPRS plan) and Corrections Officer Retirement Plan (CORP) employers and local boards, members of the Elected Officials' Retirement Plan (EORP), and other stakeholders, to develop more sustainable approaches than currently exist for determining year-to-year benefit increases. In 2011, the Legislature attempted to address the system plans' sustainability by making statutory changes to the benefit increase structure, but these changes were ruled unconstitutional for retired members. The resulting outcome was the creation of two different benefit increase structures for each of the three plans: one for members retired on or before July 1, 2011, and one for members retired after that date. However, these two benefit increase structures warrant additional review because they include various features that affect the plans' sustainability. For example, one feature reserves an amount of excess investment earnings above 9 percent for future benefit increases thereby making these additional investment earnings unavailable to reduce plans' unfunded liabilities. In order to protect members' pension benefits over the long-term, the System will need to address how permanent benefit increases could be offered without impacting plans' sustainability. This finding discusses a variety of approaches—many requiring legislative changes—that could be adopted.

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

Recent efforts to address sustainability altered by legal challenges

Although the Legislature enacted changes to the system plans' permanent benefit increase structures in 2011, some changes did not withstand legal challenges. Permanent benefit increases are permanent increases provided to qualified PSPRS plan, CORP, and EORP retired members' pensions.[1] According to a 2014 report from the Center for Retirement Research at Boston College (Center), benefit increases are an important element in a pension plan to help maintain the value of retirees' benefits over time as the cost of living increases, especially for those employees who are not covered by Social Security.[2] However, benefit increases can be costly. For example, the EORP was required to give a 4 percent annual compounded benefit increase from fiscal year 2005 through fiscal year 2014.[3] As illustrated in the textbox on page 29, if a retired member with an annual pension benefit of $20,000 receives a 4 percent annual compounded benefit increase every year for 10 consecutive years, his/her annual pension benefit would increase to more than $29,000. In addition, as discussed in Finding 1 (see pages 13 through 24), each of the three plans' permanent benefit increases have been a factor in their respective reduced funded statuses.

To address the System's sustainability, Laws 2011, Ch. 357 (Senate Bill 1609), made changes to the permanent benefit increase requirements for the PSPRS plan, CORP, and EORP. Key changes to the benefit increase structure included eliminating the separate benefit increase accounts for each of the three plans, increasing the investment return threshold from 9 percent to more than 10.5 percent before granting a benefit increase, and requiring each plan to have a specific funded status before a benefit increase could be granted.

However, these statutory changes were challenged by various lawsuits. Specifically, in September 2011, *Fields v. Elected Officials' Retirement Plan (Fields)*, was the first case filed against the System challenging the legislative

[1] For some public pension plans, increases to members' pensions are sometimes referred to as cost-of-living adjustments or COLAs; however, unlike each of the System's three plans' permanent benefit increases, COLAs are often tied to the consumer-price index and designed to help ensure benefits keep pace with the cost-of-living increases.

[2] Munnell, A.H., Aubry, J.P. & Cafarelli, M. (2014). *COLA cuts in state/local pensions*. Boston, MA: Boston College, Center for Retirement Research.

[3] A compounded benefit increase includes past benefit increases in each new benefit increase calculation (see page 29).

changes to the permanent benefit increase structures.[1] This case challenged the 2011 law's changes for members who were retired as of July 1, 2011, on the basis that the changes violated the Arizona State Constitution's pension clause.[2] In February 2014, the Arizona Supreme Court ruled the legislative changes unconstitutional. In response to this ruling, the System took the following actions:

- **Retroactively reinstated increases—**The System retroactively reinstated benefit increases under the prior structure for all three plans' members who had retired on or before July 1, 2011. Although this ruling pertained only to EORP, the System followed advice from legal counsel that it had a fiduciary obligation to also make retroactive payments to the PSPRS plan and CORP members since they are similarly situated with respect to their retirement benefits rights.

- **Established different increase structures based on retirement date—**The System now has two different permanent benefit increase structures for all three system plans, one for members who retired on or before July 1, 2011, and another for members who retire after that date. According to the System, as of March 2015, there are approximately 13,400 retired members under the July, 1, 2011, structure and approximately 2,300 retired members under the structure for members who retired after July 1, 2011.

- **Increased contribution rates—**Because estimated pension obligations increased as a result of the reinstated benefit increases, the System increased contribution rates in fiscal year 2014.[3] For example, according to the System's actuary, because of the *Fields* decision, the PSPRS plan's estimated pension obligations increased by $1.35 billion. As a result employers' contribution rates increased by an average of 10 percent with the majority of this increase due to the reinstated benefit increases. In addition, the PSPRS plan's funded status decreased by almost 10 percent with the majority of the decrease resulting from the reinstated benefit increases.

Benefit increase structures still have issues that impact sustainability

Despite the changes made by Laws 2011, Ch. 357, and the *Fields* decision, the benefit increase structures for the System's three plans remain in need of attention because they include various features that affect the plans' sustainability. In order to protect members' pension benefits over the long-term, the System will need to address how permanent benefit increases could be offered without impacting plans' sustainability. Specifically, based on auditors' review of literature

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1 Three additional cases were filed with the Maricopa Superior Court challenging various changes made through Laws 2011, Ch. 357. These cases are (1) *Hall v. Elected Officials' Retirement Plan* filed in November 2011, which challenges the 2011 Law changes for active members; (2) *Rappleyea v. Public Safety Personnel Retirement System*, which challenges the 2011 Law changes for PSPRS plan retired members; and (3) *Parker v. Public Safety Personnel Retirement System*, which challenges the 2011 Law changes for PSPRS plan active members. Both of the PSPRS plan cases were filed in January 2012.

2 Article 29, Section 1(C), of the Arizona State Constitution includes a pension clause that states public retirement system benefits shall not be diminished or impaired.

3 The increase in contribution rates did not include EORP because this plan was closed to new members and statute established a specific contribution rate (see Finding 3, pages 43 through 44, for more information).

related to benefit increases and benefit increase structures in other states, there are seven issues that the System and stakeholders should consider when developing sustainable solutions, including whether an increase should be automatically given or only given under favorable conditions, whether each of the three plans' funded statuses should be higher than 60 percent before an increase is provided or whether increases should be linked to inflation. In developing solutions, the System will have to pursue legislative changes to implement them because each plan's benefit increase structure is specified in statute. Additionally, any changes to the benefit increase structures could potentially apply to all members. As a result, the System will need to determine if the solutions should apply to all members or to members hired or retired on or after a specific date, and consider whether a constitutional change might be warranted (see pages 33 through 34 for more information).

Issue 1: Increases are largely automatic, with limited consideration of plans' financial condition—The plans' benefit increase structures are fundamentally automatic, which makes them more costly and difficult to sustain than ad hoc increases granted only when conditions are favorable (see textbox for further explanation of "automatic" and "ad hoc"). This issue varies somewhat for the two groups into which retirees are divided—those retiring on or before July 1, 2011, and those retiring after that date. Specifically:

Automatic benefit increase—A retiree's pension benefit increases automatically every year by a certain percentage.

Ad hoc benefit increase—A benefit increase that is granted at the discretion of the plan sponsor, and usually when the plan is close to being fully funded and investment gains have exceeded expectations.

Source: Auditor General staff analysis of Peng, J., & Boivie, I. (2011). *Lessons from well-funded public pensions: An analysis of six plans that weathered the financial storm*. Washington, DC: National Institute on Retirement Security

- **Benefit increase structure for members who retired on or before July 1, 2011, is essentially automatic—** The plans' benefit increase structures for members who retired on or before July 1, 2011, are basically automatic. Specifically, these structures could be considered automatic because benefit increases have generally been provided every year. According to system documents, from fiscal years 2005 to 2014, retirees in the PSPRS plan, CORP, and EORP generally received a 4 percent increase annually, which is the statutory maximum increase.[1]

  A feature of the structure for these retirees that makes it generally automatic is the requirement that either 50 percent (PSPRS plan and CORP) or 100 percent (EORP) of investment earnings considered "excess" (that is, above 9 percent) must be accounted for separately and made available for future benefit increases (see textbox, page 28).[2] According to the System, this set-aside requirement has resulted in making monies available to pay for benefit increases even when investment performance was lower than 9 percent. For example, if the amount of excess investment earnings put into the separate benefit increase account were greater than what was needed to pay the maximum benefit increase in a given year, then the extra monies would remain in that account and could be used in the following year(s) to provide increases. However, this feature further undermines the plans' ability to reduce existing unfunded liabilities because these extra monies cannot be used to reduce any unfunded liabilities but instead must be made available for benefit increases.

[1] CORP provided a lower percentage increase in fiscal years 2012 through 2014; 1.94 percent, 0.55 percent, and 1.59 percent, respectively. The PSPRS plan provided a lower percentage increase in fiscal years 2013 and 2014; 2.94 percent and 1.58 percent, respectively.

[2] Arizona Revised Statutes (A.R.S.) §§38-818, 38-856, and 38-905 outlines the conditions that must be met to require the System to provide permanent benefit increases to the PSPRS plan, CORP, and EORP retired members and specifies how the increases are determined.

According to the National Institute on Retirement Security (Institute), if a system offers automatic benefit increases, it should ensure that they are fully funded prior to being provided.[1] Essentially, these benefit increases should be incorporated into the calculation of employer and employee contribution rates so they do not increase a plan's unfunded liabilities. However, the System's actuary had not been factoring in the cost of future benefit increases until recently. Specifically, according to the System, a 2007 audit of the System's actuary found that it had not incorporated benefit increases when determining contribution rates, which resulted in underestimated and thus unfunded liabilities.[2] Despite this 2007 audit finding, the System's actuary did not begin including the costs of expected future benefit increases when determining contribution rates until fiscal year 2014. The System indicated that it believed Laws 2011, Ch. 357, would address these issues and make benefit increases unlikely in the future. However, given the *Fields* decision, starting in fiscal year 2014, the plans' actuarial valuations reflect expected future benefit increases and has two different assumptions, one for members retired on or before July 1, 2011, and one for those retiring after that date.

Members who retired on or before July 1, 2011

PSPRS Plan and CORP—50 percent of investment earnings above 9 percent set aside for future benefit increases.

EORP—100 percent of investment earnings above 9 percent set aside for future benefit increases.

Members who retire after July 1, 2011

All plans—Excess investment earnings not used for current year benefit increases do not have to be set aside for future benefit increases.

Source: Auditor General staff analysis of A.R.S. §§38-818, 38-818.01, 38-856, 38-856.02, 38-905, 38-905.02, and agency documentation.

To ensure the System's actuary continues to include benefit increase assumptions when calculating expected benefit costs, the System should conduct an audit of its actuary as soon as possible. According to the Government Finance Officers Association, it is important to evaluate the appropriateness of actuarial methods, assumptions, and their application periodically, such as every 5 years.[3] The System last conducted an audit of its actuary in 2009 when it changed its actuary, but as of August 2015, had not conducted another audit of its actuary. According to the System, it plans to conduct the audit at the conclusion of fiscal year 2016. In addition, the System should adopt a procedure for ensuring the actuarial audits' recommendations are reviewed and appropriately implemented.

- **Benefit increase structure for members who retire after July 1, 2011 is less automatic, but additional changes may be needed—**The plans' benefit increase structures for members who retire after July 1, 2011, added features that make them less automatic, but additional changes may be warranted. The plans' structures for members who retire

1 National Institute on Retirement Security. (2014). *2014 NIRS/NRTA pension education toolkit*. Retrieved January 22, 2015, from http://www.nirsonline.org.

2 Milliman Consultants and Actuaries. (2007). *State of Arizona Public Safety Personnel Retirement System, Corrections Officer Retirement Plan, Elected Officials' Retirement Plan actuarial audit report*.

3 Government Finance Officers Association. (2013). *GFOA best practice: The role of the actuarial valuation report in plan funding.*

after July 1, 2011, tie benefit increases to a plan's funded status, requiring a minimum funded status of 60 percent before an increase can be offered (see textbox). To a degree, this new benefit increase structure takes funded status into account, but a higher minimum than 60 percent can make the structure more sustainable. For example, two of the three PSPRS plan peers require a higher funded status.[1] Specifically, according to a guide published by the Employees' Retirement System of Rhode Island, employers in the Rhode Island Municipal Employees' Retirement System must have an 80 percent funded status before offering an annual increase, and, according to an official from the Municipal Employees Retirement System of Michigan, employers are required to be at least 80 percent funded before adopting a recurring increase and must also pay 100 percent of the resulting increase in estimated pension obligations.[2]

Members who retired on or before July 1, 2011

All plans—No minimum funded status required

Members who retire after July 1, 2011

All plans—60 percent minimum funded status

Source: Auditor General staff analysis of A.R.S. §§38-818, 38-818.01, 38-856, 38-856.02, 38-905, 38-905.02, and agency documentation.

To ensure the plans' post-July 1, 2011, benefit increase structures are sustainable, the System should determine whether a higher funded status for each plan should be established before providing a benefit increase.

Issue 2: Benefit increase calculations include past increases provided to employees—Statutes specify that both the benefit increase structure for members who retired on or before July 1, 2011, and the structure for members who retire after that date are compounded increases, which tend to be more costly to maintain. Under a simple benefit increase structure, the annual adjustment is calculated based on the employee's original benefit at the time of retirement. Conversely, a compounded benefit increase includes past benefit increases in each new benefit increase calculation. As shown in the textbox, the compound approach results in a higher pension amount.

Example of a simple vs. compound benefit increase on a $20,000 pension

Suppose a member retired with an annual pension benefit of $20,000. If that member received a permanent benefit increase of 4 percent every year for 10 consecutive years on a **compounded** basis, the member's pension benefit would be approximately $29,605. However, if that same member had received a permanent benefit increase of 4 percent every year for 10 consecutive years on a **simple** basis, the member's pension benefit would be $28,000, which is approximately 5.4 percent less than the compounded basis.

Source: Auditor General staff calculation.

The System should consider following the lead of some other states in adopting a simple benefit increase structure to help reduce its future pension obligations. Specifically, for employees hired

1 Auditors selected the Rhode Island Municipal Employees' Retirement System, Municipal Employees' Retirement System of Michigan, and the Missouri Local Government Employees Retirement System as peer plans to the PSPRS plan. See Appendix B, pages b-1 through b-2, for how peer plans were selected and additional information on these peer plans.

2 According to an official from the Michigan system, once an employer in the Municipal Employees' Retirement System of Michigan adopts an automatic benefit increase, the benefit increase is distributed each year regardless of an employer's current funded level.

on or after January 1, 2011, the Illinois Municipal Retirement Fund has a simple 3 percent annual benefit increase or half of the Consumer Price Index, whichever is less.[1] Similarly, Ohio's three major plans rely on a simple cost of living adjustment, rather than a compounded one.[2] The System should determine whether a simple benefit increase structure may be more sustainable for its plans while still helping maintain the value of retirees' benefits over time.

Issue 3: Benefit increases are not tied to the Consumer Price Index—Both of the plans' benefit increase structures are based on investment performance and are not linked to the Consumer Price Index (CPI). According to the Center, the purpose of a post-retirement benefit increase is to reduce the effects of inflation on retirement income.[3] In other words, benefit increases are intended to retain the value of a member's pension benefit as prices for goods and services rise and the cost of living increases. Therefore, benefit increase structures that do not have a CPI element can create inconsistencies between the cost of living and the increases that are provided. For example, according to the Center's report, which was published in May 2014, the U.S. has been in a low inflation environment. However, for fiscal years 2005 through 2014, retirees in the System's three plans have generally been awarded 4 percent benefit increases annually, while the average inflation rate during that period was about 2 percent.

The System should consider adopting the approach of many public plans nation-wide in linking benefit increases to the CPI-linked inflation rate. According to the Center, about 41 percent of public pension plans provided increases linked to the CPI; however, providing full inflation protection can put state and local governments at risk because few states have sufficient resources to fund this type of commitment. As a result, some plans link benefit increases to providing part of the CPI inflation rate. New York is one such example.[4] Specifically, the New York State Teachers' Retirement System provides an automatic compound benefit increase that is half of the annual CPI-linked inflation rate and is only applied to the first $18,000 of a member's benefit. The inflation rate during 2005 through 2014 ranged from 1.5 percent to 3.8 percent per year, except in 2008 when it reached a low of -0.4 percent. Therefore, offering a benefit increase that is half of the CPI inflation rate during 2005 through 2014 would have resulted in increases up to 1.9 percent.[5] Similarly, the Missouri Local Government Employees Retirement System bases its benefit increases on the CPI-linked inflation rate, but limits the increases to no more than 4 percent. According to a Missouri official, it also assumes an annual 4 percent benefit increase when determining estimated pension obligations to ensure these increases are pre-funded. Similarly, the System should consider whether it should link its benefit increases to the CPI-linked inflation rate and, if so, whether it should provide full inflation protection.

[1] Peng & Boivie, 2011.

[2] Munnell, Aubry, & Cafarelli, 2014.

[3] Munnell, Aubry, & Cafarelli, 2014.

[4] Peng & Boivie, 2011.

[5] This calculation is based on auditors' analysis of inflation rate data from the United States Department of Labor, Bureau of Labor Statistics, Consumer Price Index, for U.S. cities.

Issue 4: Benefit increase structure approach can place stress on employers that are less financially sound and limit employers that have adequate financial strength—Each of the three plans' benefit increase structures for members who retire after July 1, 2011, require that the individual plan reach at least 60 percent funded status before a benefit increase can be offered, but this may result in sustainability issues for some PSPRS plan and CORP employers. As indicated in Finding 1 (see page 14), the PSPRS plan and CORP are agent multiple-employer plans, and each participating employer has its own funded status. Basing the benefit increase on an overall aggregate funded status creates two problems:

- Using the aggregate funded status of the PSPRS plan or CORP can cause sustainability issues for employers whose funded status falls below the aggregate. For example, if an individual PSPRS plan employer's funded status is 20 percent, but the aggregate funded status of the PSPRS plan is above 60 percent, then that employer must still provide and pay for the benefit increases of its retirees, which could reduce its funded status and impact its long-term sustainability.

- Conversely, when the aggregate funded status is less than the 60 percent threshold, employers whose individual funded status meets the threshold would not be able to give increases.

Two other PSPRS plan peers, the Rhode Island and the Michigan systems, also tie their increases to funded status, but base them on individual employer's funded status instead of the aggregate funded status. For example, in the Rhode Island system, each employer's funded status is calculated, and if the employer does not reach the specific level, then it does not give an increase. Similarly, the System should consider changing its benefit increase structure for the PSPRS plan and CORP to be based on each employer's funded status instead of the plan's overall aggregate funded status.

Issue 5: Increases in CORP and EORP are applied to a member's full pension benefit rather than a set amount—In CORP and EORP, benefit increases are applied to the full amount of a member's pension benefit, which results in higher benefit increases than would occur if the increase were applied only to a portion or set amount (see Issue 7, pages 32 through 33, for information on the PSPRS plan). Auditors identified other public pension systems that limit the amount of a member's pension to which the benefit increase is applied. Specifically, as part of its 2011 pension reform changes, Rhode Island enacted legislation revising its benefit increase structure. According to a document published by the Rhode Island Municipal Employees Retirement System, for members of employers that are under 80 percent funded, the Rhode Island system calculates interim benefit increases at 5-year intervals, and they are based on only the first $25,000 of a member's pension benefit. According to a report from the Rhode Island System's actuary, changes made as part of the 2011 pension reforms reduced the Rhode Island Municipal Employees Retirement System's unfunded liabilities by approximately $251 million, or approximately 58 percent.[1] Similarly, the New York State Teachers' Retirement System applies its increases to only the first $18,000 of a member's benefit. Therefore, to reduce the costs of benefit increases and make them more sustainable, the System should consider whether increases for all three plans should be applied to only a certain amount of a member's pension benefit.

[1] Gabriel Roeder Smith & Company. (2011). *Rhode Island Retirement Security Act of 2011: Plan details.*

Issue 6: Two aspects of EORP's benefit increase structures are inconsistent with other system plans' structures—Two features of EORP's benefit increase structures are inconsistent with the PSPRS plan and CORP structures. First, under the structure for members who retired on or before July 1, 2011, 100 percent of excess investment returns above 9 percent are transferred into a reserve account to fund future benefit increases for EORP members, whereas in the PSPRS plan and CORP, only 50 percent of the excess is put into a reserve account. This leaves no excess earnings to be used to reduce EORP's unfunded liabilities. Laws 2011, Ch. 357, addressed this issue for members who retire after July 1, 2011, but due to the *Fields* decision, this feature still impacts EORP's sustainability.

Second, although the PSPRS plan and CORP benefit increase formulas are based on the plans' assets, part of EORP's benefit increase formula uses the value of retired members' estimated future benefits instead. One step in all three plans' benefit increase formulas is to calculate the amount of monies available for benefit increases in a given year. To do this, the PSPRS plan and CORP multiply each plan's net asset amount times the excess earning rate. By contrast, EORP's statutory benefit increase formula is based on the value of retired members' estimated future benefits times the excess earning rate. According to a 2014 report from the System's actuary, when the present value of retired members' estimated future benefits is higher than the value of the plan's assets (which is the case now), there is the potential that the System must put more money in the reserve account than it actually earned on its investments in that year (see textbox for an example). This increases EORP's unfunded liabilities, thus further reducing its funded status. Therefore, the System should consider changing EORP benefit increase formula to be based on asset value similar to the PSPRS plan and CORP, instead of retired members' estimated future benefits.

Example of EORP's process for determining monies to set aside for future benefit increases

Suppose the value of EORP assets is $300 million while the present value of retired members' estimated future benefits is $700 million. If the System earned an 18 percent return on investments, under the benefit increase formula for members who retired on or before July 1, 2011, it would have an excess earnings rate of 9 percent. This 9 percent is then applied to the retired members' estimated future benefits of $700 million, which results in a $63 million transfer to the reserve account. The $63 million represents 21 percent of EORP's $300 million value of assets, which is 3 percent greater than the 18 percent return the plan actually earned on its assets.

Source: Auditor General Staff analysis of information presented by the System's actuary in its Arizona Elected Officials' Retirement Plan Defined Contribution Plan Study as of June 30, 2014.

Issue 7: In the PSPRS plan, all members receive the same dollar increase regardless of the size of their pension—Although not directly a sustainability issue, the benefit increase structure for the PSPRS plan is based on the previous year's average pension benefit, which results in disproportionate benefit increases. Specifically, the PSPRS plan's benefit increase is determined using the average pension benefit of retirees, and each member receives the same benefit increase amount. For example, as indicated in the Introduction (see page 4), the average pension for the PSPRS plan in fiscal year 2014 was approximately $53,000. Under the approach, if a full 4 percent increase is provided, each PSPRS plan member would receive a pension increase of $2,120, regardless of the member's actual pension. For a member with a $30,000 pension, this $2,120 benefit increase would represent an increase of 7.1 percent, compared to an increase of 2.7 percent for a member with an $80,000 pension.

In CORP and EORP, benefit increases are based on each individual member's pension benefit and not the average. The three peer states the auditors studied also base their increases on individual member's pension amount and not an average of all pensions. For example, the Rhode Island system's increases are based on each individual member's pension. To be consistent with other plans' structures, the System should consider modifying the PSPRS plan's benefit increase structure to be based on an individual member's pension benefit.

System should collaborate with stakeholders to develop sustainable benefit increase structures

As demonstrated earlier in this finding and in Finding 1 (see pages 13 through 24), the plans' benefit increase structures have impacted their funded statuses, putting these plans' long-term sustainability at risk. Given its fiduciary responsibility to protect the plans' assets, the System should take the lead in developing sustainability solutions. In developing solutions, the System should collaborate with the plan's employers and local boards and other interested stakeholders, such as professional associations for firefighters or police. The System should work with various stakeholders to review all of the issues and solutions outlined in this finding, such as using a simple versus compound benefit structure or linking benefit increases to the CPI. In developing solutions, the System and stakeholders may identify other necessary changes or may determine that benefit increases should be eliminated. For example, if the System decides to maintain benefit increases tied to investment performance, it may want to consider basing the increase on long-term investment performance instead of a 1-year result. The Arizona State Retirement System bases its benefit increase on investment performance over a rolling 10-year period. In addition, the Legislature eliminated benefit increases for Arizona State Retirement System members hired on or after September 13, 2013.

Once solutions are developed, the System should pursue the necessary legislation to implement them since most solutions, such as increasing the minimum funded status before providing an increase, will require statutory changes. Specifically, each plan's benefit increase structures are outlined in statutes. At a minimum, the System would need to pursue legislative changes for all three plans' benefit increase structures that apply to members who are hired or retire after a specific date, thus creating another structure. Specifically, as previously discussed (see pages 25 through 26), the *Fields* decision determined that changes to the benefit increase structure were unconstitutional for members who had retired before the 2011 law changes' effective date. Therefore, each of the System's plans has a benefit increase structure for those who retired on or before July 1, 2011, and one for those who retire after that date. Because of the *Fields* decision, the System and stakeholders may determine that any identified changes should apply only to members who are hired or retire after the legislation is enacted. In addition, the outcome of the *Hall v. Elected Officials' Retirement Plan (Hall)* lawsuit that challenges the 2011 legislative changes to the permanent benefit increase structures (see footnote 1, page 26) may impact the System's ability to make changes to the plans' benefit increase structures for active members who have not yet retired.

To effectively address its plans' sustainability, the System and stakeholders may also need to consider whether to pursue a ballot initiative to amend Arizona's Constitution and apply changes to all members. According to a 2014 Center report, most states protect pensions under a contracts-based approach, but Arizona is one of only seven states that has a State Constitution provision that prevents the State from changing retirement benefits.[1] Specifically, according to article 29, section 1, of Arizona's Constitution, "…public retirement system benefits shall not be diminished or impaired." Nevertheless, according to the Center's 2014 report, 17 states have made changes to their cost-of-living adjustments, including one state, Illinois, with constitutional protections similar to Arizona's. Of the changes that have been legally challenged, most have been upheld by the courts primarily because cost-of-living adjustments are not considered to be a contractual right. For example, the report indicated that in Minnesota, a judge ruled that the cost of living adjustment was not a protected core benefit, and changes were needed to prevent long-term fiscal problems. However, a lawsuit was filed in Illinois, and the Illinois Supreme Court ruled the changes unconstitutional in May 2015. Because Arizona's 2011 law changes to the System's plans were overturned by Arizona's Supreme Court for retired members, if the System and stakeholders determine that the best solution for addressing sustainability would be to change the benefit increase structures for all three plans' members, it should consider whether proposing a ballot initiative to amend Arizona's Constitution would be warranted. Depending on how an amendment is worded, it could supercede previous legal decisions. In addition, if considering an amendment, the System and stakeholders should ensure that this amendment is specific to the system plans' permanent benefit increases to ensure members' base pension benefits are not impacted.

Throughout this process, the System should ensure it provides the necessary training or informational materials to ensure stakeholders and the public understand the purpose and impact of the proposed changes.

Recommendations:

2.1. To ensure the plans' permanent benefit increase structures are sustainable, the System should take the lead and collaborate with stakeholders to identify changes that are needed and develop solutions. In developing solutions, the System will have to pursue legislative changes to implement them since each plan's benefit increase structure is specified in statute. The System will also need to determine if the solutions should apply to all members or members hired or retired on or after a specific date, and consider whether a constitutional change might be warranted (see Recommendations 2.2 and 2.3, page 35). In collaboration with stakeholders, the System should:

   a. Determine whether a higher funded status for each plan should be required before providing a benefit increase;

   b. Determine whether a simple instead of a compound structure may be more sustainable for its plans;

[1] Munnell, Aubry, & Cafarelli, 2014.

c. Consider whether it should link its permanent benefit increases to the Consumer Price Index, and if so, whether it should provide full inflation protection;

d. Consider changing its permanent benefit increase structure for the PSPRS plan and CORP to be based on the funded status of individual employers instead of each plan's overall aggregate funded status;

e. Consider whether increases for all three plans should be applied to a certain amount of a member's pension benefit, such as the first $18,000;

f. Consider changing the EORP benefit increase formula to be based on asset value similar to the PSPRS plan and CORP, instead of retired members' estimated pension obligations;

g. Consider modifying the PSPRS plan's permanent benefit increase structure to be based on an individual member's pension benefit; and

h. Identify other necessary changes, such as basing benefit increases on long-term investment performance instead of a 1-year result, or consider whether benefit increases should be eliminated.

2.2. Once solutions have been decided upon, the System and stakeholders should determine if the changes should apply only to members who are hired or retire after a specific date. If so, the System should pursue the necessary legislative changes to implement the solutions for all three plans' benefit increase structures. The outcome of the *Hall* lawsuit may impact the System's ability to make changes to the plans' benefit increase structures for active members.

2.3. The System should consider whether pursuing a ballot initiative to amend Arizona's Constitution would be warranted to make changes to the benefit increase structures for all three plans' members. Depending on how an amendment is worded, it could supersede previous legal decisions. If considering an amendment, the System and stakeholders should ensure that this amendment is specific to the System plans' permanent benefit increases to ensure members' base pension benefits are not impacted.

2.4. Throughout the process of developing solutions for the plans' benefit increase structures, the System should ensure it provides the necessary training or informational materials to ensure stakeholders and the public understand the purpose and impact of the proposed changes.

2.5. The System should ensure that its actuarial assumptions appropriately include the estimated costs for its permanent benefit increases when conducting the System plans' annual valuations by:

a. Conducting an audit of its actuary as soon as possible; and

b. Developing and implementing procedures for ensuring the actuarial audits' recommendations are reviewed and appropriately implemented.

FINDING 3

In addition to pursuing changes to the permanent benefit increase structures (see Finding 2), the Public Safety Personnel Retirement System (System) should take other actions to improve the financial condition and long-term sustainability of the Public Safety Personnel Retirement System plan (PSPRS plan), Corrections Officer Retirement Plan (CORP), and Elected Officials' Retirement Plan (EORP). These additional actions should include the following:

- Developing a funding improvement strategy. Such a strategy should establish the specific steps that the System or the plans' participating employers would need to take once their funded status falls below a certain threshold;
- Considering the feasibility of allowing PSPRS plan and CORP employers to provide different pension benefit options based on what they can afford;
- Developing materials for PSPRS plan employers on the potential impact of overtime pay and developing and implementing formal policies and procedures for verifying members' pension benefit calculations are correct;
- Considering increasing EORP's employer contributions and/or providing additional appropriations; and
- Continuing current training efforts for employers and local boards.

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

Funding improvement strategy needed to address plans' long-term sustainability

The System should develop and implement a funding improvement strategy to address the risks of any future declines in the plans' funded statuses and improve the prospects for these plans' long-term sustainability. As previously discussed in Finding 1, the funded statuses of the System's three plans have steadily declined between June 30, 2005 and June 30, 2014. In such circumstances, the experience of at least one other state retirement system shows that implementing a funding improvement strategy that identifies specific improvement actions can help ensure steps are taken to address a deteriorating retirement system.

Peer system established funding improvement strategy—

The Rhode Island Municipal Employees' Retirement System implemented a funding improvement strategy in 2011.[1] This funding improvement strategy was part of several legislative changes that the State of Rhode Island enacted. According to a report from the Rhode Island Office of the General Treasurer, these various pension reform changes immediately reduced the System's unfunded liabilities by an estimated $3.2 billion and improved its plans' funded statuses.[2] In addition, the changes are expected to save taxpayers approximately $4 billion over the next 24 years starting in July 1, 2012.

The Rhode Island funding improvement strategy that was adopted outlined steps and actions that member employers and others must take when an individual employer's funded status is considered to be endangered. The Rhode Island system's threshold for an endangered funded status, as certified by an actuary, is at or below 50 percent and which has declined for 5 consecutive years. In Arizona, several plans' employers are below a 50 percent funded status. Specifically, as discussed in Finding 1 (see pages 13 through 24), 69 of the 237 PSPRS plan employers and 2 of the 27 CORP

1 The Rhode Island Municipal Employees' Retirement System plan, one of the plans auditors identified as a PSPRS plan peer, was included within Rhode Island's pension reforms (see Appendix B, pages b-1 through b-2, for more information about peers).

2 State of Rhode Island, Office of the General Treasurer. (2011). *Rhode Island Retirement Security Act of 2011: A fair and comprehensive solution to our pension crisis.* Providence, RI.

employers had a funded status that was below 50 percent as of June 30, 2014.[1] In addition, EORP had a funded status of 39 percent as of June 30, 2014.[2]

System should develop and implement a funding improvement strategy—The System should develop and implement a funding improvement strategy to improve the long-term sustainability of the plans and their employers and review the actions taken by the Rhode Island system to help develop this strategy. This strategy should be applied at the employer level for the PSPRS plan and CORP and the plan level for EORP, and should be designed to help improve funded statuses for the PSPRS plan and CORP employers or EORP. In developing its funding improvement strategy, the System should consider:

- **Establishing a specific point at which a funding improvement strategy is needed—** The System should specify when a PSPRS plan or CORP employer or EORP is considered at-risk and must take certain actions. As indicated above, the Rhode Island system has determined that a plan's funded status is endangered when it is at or below 50 percent and has decreased for 5 consecutive years. However, if the PSPRS plan or CORP employers, or EORP experience a large percentage change in funded status in a shorter period of time, the System may want to establish a different threshold to initiate its funding improvement strategy. Therefore, the System should establish the funded status level at which a PSPRS plan or CORP employer and EORP should be considered at-risk, and could work with its actuary to determine what funded status level would be appropriate.

- **Requiring annual certification and specify notice requirements—**The System should require annual certification of the at-risk funded status of an employer/plan to prompt appropriate actions and steps. For example, Rhode Island's law requires an actuary to annually certify for its retirement system board and executive director whether or not an employer's plan is in endangered funded status. For those employers' plans that the actuary certifies as endangered, they are then required to initiate the funding improvement process. Arizona's System contracts with an actuary to complete statutorily required annual actuarial valuations for each PSPRS plan and CORP employer and EORP, so the certification of at-risk status could be done as a part of these annual valuations.

  The System should also specify who must be notified when a plan is certified to be at-risk and post a notice of the at-risk status on its Web site. For example, in Rhode Island, when any employer plan is certified as endangered, the Rhode Island system's executive director must notify various people or entities, including the plan members and beneficiaries, legislature, and governor. The notice also must be posted electronically on the System's Web site. Such notification would help ensure transparency and accountability, by informing the public and other stakeholders, and would prompt the funding improvement actions.

- **Developing specific funding improvement actions and time frames—**The System should include specific actions in its funding improvement strategy that it, member

[1] Auditors reviewed funded statuses as of June 30 for fiscal years 2010 through 2014 for five randomly selected PSPRS plan employers and both CORP employers with a funded status of less than 50 percent as of June 30, 2014. The review indicated that for all seven employers, funded statuses steadily declined over this time period by an average of about 21 percentage points.

[2] As a reminder, the PSPRS plan and CORP are agent multiple-employer plans, so each participating employer has its own funded status, and EORP is a cost-sharing plan, so the funded status is for the entire plan.

employers, or others can take to address an employer's or plan's at-risk funded status and set specific time frames for completing the actions. For example, Rhode Island's law requires that once an employer plan is certified as endangered, the actuary must develop and present funding improvement strategies to the System's Board, such as increasing contribution requirements and/or changing benefits. Rhode Island's law also specifies various expectations for improvement that should be achieved at the end of a 10 year period, such as increasing a plan's funded status by 1 percent annually until reaching an 80 percent funded status. Finally, Rhode Island's law provides various time frames for completing specific funding improvement strategy actions. Similarly, the funding improvement strategy the System develops and implements should consider establishing:

- The <u>specific actions</u> that can be taken to improve a plan's funded status when it is determined to be at-risk, including a requirement that the System review and approve the actions;

- <u>Who is responsible</u> for the various actions, including the employer, an actuary, or system administrator;

- The <u>amount of improvement</u> in funded status that should be achieved; and

- The <u>time frames</u> for completing the various actions, including an overall time frame for improvement in a plan's funded status.

Finally, the System should work with the Legislature to incorporate a requirement for a funding improvement strategy and its various components in statute. Doing so would help ensure that the System and the PSPRS plan and CORP employers take the actions necessary to improve the PSPRS plan's, CORP's and EORP's financial condition and long-term sustainability. All of the requirements related to Rhode Island's funding improvement strategy are outlined in statute, including the definition of endangered funded status, the funding improvement procedures, time frames, and notification requirement. Therefore, once the System has developed a funding improvement strategy, to provide greater leverage, the System should pursue legislation to incorporate the funding improvement strategy and its various components within its statutes.

System should collaborate with stakeholders to determine whether a variety of benefit options for employers would be beneficial

The System should collaborate with PSPRS plan and CORP employers and local boards, and other stakeholders, such as professional associations for firefighters or police, to research the feasibility of offering multiple benefit options. Although the PSPRS plan was established to move various public safety retirement programs to a uniform state-wide retirement program that provides the same benefits to all members, each employer is unique in its fiscal capacity and employee demographics, and thus may not be able to provide the same level of benefits for its employees. Multiple benefit options for employers, such as different service and age requirements and benefit increase structures, would allow more flexibility for plan employers and assist in important decision making, such as budgeting for pension costs that align with their fiscal capacity while being able to hire a sufficient number of employees to meet workforce needs.

Auditors identified two PSPRS plan peers, the Municipal Employees' Retirement System of Michigan and the Missouri Local Government Employees Retirement System, that provide employers a limited number of alternative pension benefit plan options to select for their employees. According to Michigan and Missouri system documents, these options include various service multipliers, age requirements, employee contribution requirements, and benefit increase structures.[1] In addition, in the Missouri system, the available options vary depending on whether an employer participates in Social Security. For example, as shown in Table 4, Missouri employers have the ability to select from seven different benefit structures, and the highest multiplier, 2.5 percent, is available only to employers that do not participate in Social Security. Missouri employers also have the ability to make adjustments to their benefit options once every 2 years such as changing the multiplier and employee contributions.[2] These various benefit options can be designed to align with the current fiscal condition of each employer and allow employers some flexibility to budget appropriately for the pension costs they are able to afford.

Table 4: Summary of Missouri Local Government Employees Retirement System's benefit structures As of July 2015

Structure	Multiplier	Final monthly salary	Years of service	Monthly pension benefit
L-1	1.00%	$3,000	25	$ 750
L-3	1.25	3,000	25	938
L-7	1.50	3,000	25	1,125
L-9	1.60	3,000	25	1,200
L-12	1.75	3,000	25	1,313
L-6	2.00	3,000	25	1,500
L-11[1]	2.50	3,000	25	1,875

1 This structure is only available for employers not participating in Social Security.

Source: Auditor General staff analysis of information obtained from the Missouri Local Government Employees Retirement System's Web site.

The System should work with stakeholders to explore the feasibility of offering a limited number of pension benefit options. If it is determined that pension benefit options would be beneficial, the System should collaborate with stakeholders as necessary and take the following actions:

- Determine the specific pension options that should be available and the specific times and conditions under which an employer can change its options;

1 A service multiplier is a percentage usually based on total years of service and is applied to the calculation of a member's pension benefit (see Introduction, pages 4 through 5, for more information on multipliers).

2 According to the Missouri Local Government Employees Retirement System's Web site, benefit changes apply only to members hired on or after the effective date of the change.

- Seek the necessary changes to the PSPRS plan and CORP laws to allow for employers to select options; and

- Develop and implement training materials on the various pension benefit options and their costs so that the PSPRS plan and CORP employers can make informed decisions about which benefit options would be the most appropriate for their members given the associated costs.

System should develop materials for PSPRS plan employers on overtime pay and implement formal policies and procedures to ensure benefit calculations are correct

The System should develop materials for PSPRS plan employers explaining how unusually large overtime pay increases the risk of pension spiking and also develop and implement formal policies and procedures for verifying that members' retirement benefit calculations are correct. Pension spiking refers to instances when a member's pension is higher than expected because the average salary during the benefit calculation period was larger than what would be expected from normal salary increases. Although PSPRS plan statutes provide some protections to limit pension spiking, overtime pay is allowed to be included in the pension benefit calculations, which could result in an individual's final average salary being higher than expected if there is unusually large overtime pay during the period that determines the members' pension benefits. Because this practice may generate unfunded liabilities for employers, the System should provide employers with materials explaining how their compensation practices, such as unusually large overtime pay, may affect their funded statuses. Additionally, the System should develop and implement additional procedures to ensure that the contribution data it uses to verify local boards' pension benefit calculations is correct.

Statutes provide some protections to limit pension spiking, but also allow for overtime pay that may increase the risk of pension spiking—Statutes establish a formula for determining PSPRS plan members' pension benefit (see Introduction, pages 4 through 5). This formula considers a member's years of service and average monthly compensation. According to a 2011 National Institute on Retirement Security report, pension spiking refers to the practice of substantially increasing a member's final average salary beyond what is expected from normal salary increases in order to receive a larger pension benefit. This substantial increase can happen when a member's final average salary includes unusually large payments for overtime, unused sick leave, or unused vacation, or a larger-than-normal salary increase in the final years of employment.[1]

Statutes do provide some controls against pension spiking. For example, PSPRS plan statutes use a member's highest three or five years' of compensation to determine that member's average monthly compensation. In addition, A.R.S. §38-842(12) excludes payments for unused sick leave and compensatory time, and payments in lieu of vacation as compensation for the purpose of calculating retirement benefits. However, A.R.S. §38-842(12) allows overtime pay to be included in PSPRS plan members' retirement benefit calculations (see textbox, page 42). By contrast, overtime

[1] Peng, J, & Boivie, I. (2011). *Lessons from well-funded public pensions: An analysis of six plans that weathered the financial storm*. Washington, DC: National Institute on Retirement Security.

Plans' statutory definitions of compensation factored into pension benefit calculations

PSPRS plan—Base salary, overtime pay, shift differential pay, military differential wage pay, compensatory time, and holiday pay.

CORP—Base salary, shift differential pay, military differential pay, and holiday pay.

EORP—A member's average yearly salary.

Source: Auditor General Staff analysis of A.R.S. §§38-842(12), 38-881(42), and 38-801(5).

pay is not included in the definition of compensation for CORP or EORP. Including overtime pay in the benefit calculation may increase the risk that the member's final average salary is higher than would be expected from normal salary increases, which may generate unfunded liabilities for employers. If a PSPRS plan member worked a large number of overtime hours during the period that determined that member's final average salary, these hours would increase the member's reported compensation and resulting pension benefit. Although the PSPRS plan would collect more contributions from the member's increased compensation, this increase could generate unfunded liabilities for the member's employer. Specifically, one of the assumptions that the System's actuary uses to estimate pension obligations forecasts the levels of compensation upon which members' pension benefits will be based. According to the System, overtime pay is reflected in this assumption; however, there is a risk that the overtime pay in the period used to determine a members' final average salary may surpass this assumption and generate unfunded liabilities for their employers. Further, according to the National Institute on Retirement Security, even though pension spiking is not common, a few isolated instances can create the impression of widespread abuse.[1]

System should develop materials on overtime pay for employers—Because unusually large overtime pay may result in pension spiking, the System should develop and provide some educational materials to PSPRS plan employers explaining how unusually large overtime pay increases the risk of generating unfunded liabilities. For example, the System could work with the PSPRS plan's actuary to create and include in communications to plan employers, such as newsletters and retirement manuals, an explanation and examples of how compensation practices like significant overtime pay can generate unfunded liabilities for participating employers.

System should develop and implement formal policies and procedures for verifying members' pension benefit calculations are correct—The System does not have written policies and procedures to guide staff on verifying the accuracy of a local board's pension benefit calculation, which may result in employers paying incorrect contributions and the System paying incorrect pension benefits. As indicated in the Introduction (see pages 1 through 2), for the PSPRS plan and CORP, statutes require that a local board be established for each employer and places certain administrative responsibilities with the local board, such as following applicable statutes to make eligibility determinations and calculating benefit amounts. The System will approve the local board's calculation of a member's pension benefit if the sum of the member's highest three years of compensation are within +/- $500 of the sum that the System generates from the contributions that it has received from that member. These contributions come from a percentage of PSPRS plan and CORP members' compensation and help cover the cost of their pension benefits. According to statute, only certain types of compensation can be factored into a member's pension benefit calculation (see textbox above for a description of these types of compensation), so the percentage of a member's pay that must be contributed applies only to the types of compensation included in

1 Peng & Boivie, 2011.

the calculation. However, system staff stated that they do not audit contributions. Instead, they rely on employers to comply with statutory definition of compensation when submitting contributions to the System. As a result, employers and members may be over- or under-paying their contributions, and the System may be paying out incorrect pension benefits to retired members.

The System should adopt practices similar to those in peer public pension plans to ensure that contributions are correct. For example, the data system that employers in the Municipal Employees' Retirement System of Michigan use to regularly upload members' wage and contribution information automatically flags a member's unusually high and low wages for staff review when calculating that member's retirement benefit. Additionally, the Rhode Island Municipal Employees' Retirement System contracts for regular audits of employers to ensure compliance with statutes related to reporting contributions and compensation. Therefore, the System should develop and implement policies and procedures for the following areas:

- **Identifying abnormal contributions—**Establish formal, written policies and procedures for system staff to flag and document any abnormal contributions that may indicate abnormal wage increases or contribution errors. These procedures should detail which staff will be responsible for completing these tasks;

- **Investigating abnormal contributions—**Establish formal, written policies and procedures for system staff to investigate flagged contributions. Investigations should focus on whether the underlying pay that generates an abnormal contribution satisfies the statutory criteria for compensation for the purpose of calculating retirement benefits. These procedures should detail the necessary steps and documentation for any investigation as well as which staff will be responsible for conducting these investigations; and

- **Conducting employer audits—**Develop and implement written policies and procedures for conducting regular audits of participating employers for compliance in reporting wages and contributions.

Legislature should consider increasing EORP employer contribution rate and/or appropriations

To ensure EORP's long-term sustainability, the Legislature should consider increasing EORP's employer contributions and/or providing additional appropriations. Laws 2013, Ch. 217, §8, closed EORP to new members as of January 1, 2014. At that time, EORP had estimated pension obligations of nearly $621 million, and A.R.S. §38-810 was amended to require EORP employers to contribute 23.5 percent of their members' salary to EORP starting on January 1, 2014. According to this statute, these contributions were intended to cover EORP's estimated pension obligations, the employer's contributions to the newly created Elected Officials' Defined Contribution Retirement System, and employer contributions for those EORP members who transferred to the Arizona State Retirement System.[1]

[1] A.R.S. §38-727(B) requires certain elected officials to participate in the Arizona State Retirement System.

However, it is unlikely that the contribution rate established in statute will be sufficient to sustain EORP. Specifically, the contribution rate that the System's actuary recommended for fiscal year 2016 was significantly higher than the statutory rate in part because of the *Fields v. Elected Officials' Retirement Plan* decision requiring the System to retroactively reinstate benefit increases for EORP members who had retired on or before July 1, 2011 (see Finding 2, pages 25 through 26, for more information on this case). For the fiscal year beginning July 1, 2015, the System's actuary determined that the employer contribution rate should be set at 86.54 percent and that if the 23.5 percent EORP employer contribution rate set in statute remained unchanged, EORP's assets would be depleted in the next 20 years.[1] As indicated in Finding 1 (see pages 21 through 22), annual actuarial valuations are completed as required by statute, and these valuations are used to recommend employer contribution rates to the System's Board of Trustees (Board) that will help ensure plans reach 100 percent funded status. However, since EORP's employer contribution rate is now established in statute, the Board is unable to adopt recommended contribution rates to help reduce EORP's unfunded liabilities. As a result, EORP's funded status will decline further.

In addition, although the Legislature appropriated $5 million to EORP in fiscal year 2014, the System reported that this appropriation was not sufficient to cover EORP's estimated pension obligations that year.[2] The System's actuary recommended that EORP receive $28.5 million in revenue each year in addition to the 23.5 percent employer contribution rate in order for the plan to reach a 100 percent funded status within 30 years.[3] Therefore, to help ensure that EORP remains solvent and can satisfy its pension obligations, the Legislature should consider revising A.R.S. §38-810 to allow the Board to annually establish contribution rates, or consider increasing its annual appropriations over time. Recommendations outlined in Finding 2 related to the System's permanent benefit increase structures and other parts of this finding are designed to help improve the three system plans' sustainability, including EORP, and thus may help reduce the amount of additional appropriations over time.

System should continue training employers and local boards

The System should continue its efforts to provide employers and local boards additional training on the administration and challenges of a defined benefit pension plan. As indicated in the Introduction (see pages 1 through 2), for the PSPRS plan and CORP, statutes require that a local board be established for each employer and places certain administrative responsibilities with the local board, such as following applicable statutes to make eligibility determinations and calculating benefit amounts. According to system management, not all employers and local board members have readily available resources and/or experience regarding defined benefit pension plans, and they would benefit from additional support and training to help ensure they understand their administrative responsibilities and the significance of their individual funded statuses. According to the System, it has consistently provided training to help local boards fulfill

1 The actuary determined the 86.54 percent contribution rate based on the goal of paying off the plan's unfunded liabilities within 22 years.

2 According to A.R.S. §38-810(I), in fiscal years 2014 through 2044, a sum of $5 million will be appropriated from the State General Fund to EORP in each fiscal year to help cover its pension obligations.

3 The recommended additional revenue assumes the verdict in the *Hall vs. EORP* case will not strike down changes that Laws 2011, Ch. 357, made to the permanent benefit increases for active members (see Finding 2, footnote 1, page 26, for a description of this case).

their duties, and in 2008, the Board formally adopted a local board training and outreach program. Further, according to the System, in 2014, it began to expand its outreach and training efforts to include employers' management and staff. For example, in February 2015, system staff presented information at four locations around the State to employers and local boards on key characteristics of the System's plans, including benefit calculation formulas, challenges the System is facing, and proposed solutions to the challenges. Auditors found that PSPRS plan peers also provide training. For example, according to an official of the Municipal Employees' Retirement System of Michigan, it provides training to employers on their actuarial valuation results and presents all the available options for the purpose of improving the employer's funded status, such as increasing contribution requirements and/or reducing benefits.[1]

To ensure that employer and local board decisions are well-informed, carefully considered, and accurate, the System should continue its efforts to provide employers and local boards with additional training. In conducting such training, the System should ensure that employers and local board members understand the associated costs and effects of certain benefit decisions, such as long-term disability approvals and benefit calculations, as well as the significance of their individual funded status. The training will be even more critical as the System works to help ensure the plans' long-term sustainability.

Recommendations:

3.1. The System should develop and implement a funding improvement strategy. This funding improvement strategy will need to be at the participating-employer level for the PSPRS plan and CORP, but at the plan level for EORP. In developing this strategy, the System should review and incorporate key elements from Rhode Island's funding improvement strategy that may reasonably help increase plans' funded statuses.

3.2. The funding improvement strategy the System develops should consider:

   a. Establishing the funded status level at which its plans should be considered at-risk, and work with its actuary to determine what would be appropriate;

   b. Requiring annual certification of the at-risk funded status. This could be done as a part of the annual actuarial valuations performed by the System's actuary;

   c. Specifying who must be notified when a plan is certified to be at-risk;

   d. Posting a notice of the at-risk status on its Web site;

   e. Establishing the specific actions that can be taken when a plan or plan employer is determined to be at-risk, including a requirement that the System review and approve the actions;

[1] Individual actuarial valuations for employers include estimated pension obligations, assets, funded status, and required contribution rates.

f. Identifying who is responsible for the various actions, including the employer, an actuary, or system administrator;

g. Establishing the amount of improvement in funded status that should be achieved; and

h. Determining time frames for completing the various actions, including an overall time frame for improvement in a plan's funded status.

3.3. Once the System has developed a funding improvement strategy, to provide greater leverage, the System should pursue legislation to incorporate the requirements related to the funding improvement strategy and its various components within its statutes.

3.4. The System should work with the PSPRS plan and CORP employers and local boards, and other stakeholders, such as professional associations for firefighters or police, to explore the feasibility of offering multiple benefit options.

3.5 If the System decides to offer a limited number of pension benefit options, it should take the following actions:

a. Determine the specific pension options that should be available;

b. Determine the specific times and conditions under which an employer can change its options;

c. Seek the necessary changes to the PSPRS plan and CORP laws to allow for employers to select options; and

d. Develop and implement training materials on the various pension benefit options and their costs so that PSPRS plan and CORP employers can make informed decisions about which benefit options would be the most appropriate.

3.6. The System should develop and provide educational materials to PSPRS plan employers explaining how unusually large overtime pay increases the risk of generating unfunded liabilities. The System could work with the PSPRS plan's actuary to create and include in communications to plan employers, such as newsletters and retirement manuals, an explanation and examples of how compensation practices like unusually large overtime usage can generate unfunded liabilities for participating employers.

3.7. The System should adopt practices similar to those in peer public pension plans to ensure that contributions are correct, including:

a. Establishing formal, written policies and procedures for system staff to flag and document any abnormal contributions that may indicate abnormal wage increases or contribution errors. These procedures should detail which staff will be responsible for completing these tasks;

b. Establishing formal, written policies and procedures for system staff to investigate flagged contributions. These procedures should detail the necessary steps and documentation for any investigation as well as which staff will be responsible for conducting these investigations; and

c. Developing and implementing written policies and procedures for conducting regular audits of participating employers for compliance in reporting wages and contributions.

3.8. To ensure that the EORP has sufficient assets to cover its estimated pension obligations, the Legislature should consider revising A.R.S. §38-810 to allow the Board to annually establish contribution rates or consider increasing its annual appropriations over time.

3.9. The System should continue its efforts to provide additional training to employers and local boards. In conducting such training, the System should ensure that employers and local board members understand the associated costs and effects of certain benefit decisions, such as long-term disability approvals and benefit calculations, as well as the significance of their individual funded status.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2954, the Legislature should consider the following factors included in this report in determining whether the Public Safety Personnel Retirement System (System) should be continued or terminated.

This analysis includes recommendations for the System to improve some of its information technology (IT) practices, take steps to enhance its internal audit function, and improve its processes for addressing members' issues (see Sunset Factor 2, pages 50 through 51, and Sunset Factor 6, page 54).

Sunset factor analysis

1. **The objective and purpose in establishing the System and the extent to which the objective and purpose are met by private enterprises in other states.**

   Established in 1968, the primary statutory purpose of the System is to manage and invest assets of the defined benefit retirement (pension) plans for members of the Public Safety Personnel Retirement System plan (PSPRS plan), the Corrections Officer Retirement Plan (CORP), and the Elected Officials' Retirement Plan (EORP). All 50 states sponsor at least one state-wide defined benefit retirement plan for their public safety employees. Auditors did not identify any state retirement plans that meet their objective and purpose entirely through private enterprise.[1] However, the System uses private contractors to help meet its mission (see Sunset Factor 12, pages 57 through 58, for more information on its use of private contractors).

2. **The extent to which the System has met its statutory objective and purpose and the efficiency with which it has operated.**

   The System has generally met its statutory objective and purpose of managing and investing system assets, but auditors also identified areas where improvement is needed. As indicated in Finding 1 (see pages 13 through 24), to improve the system plans' sustainability, the System has taken actions consistent with best practices, including changing its investment strategy, adopting a pension funding policy, increasing contribution rates, and reviewing its actuarial assumptions.

   In addition, the System has taken steps to improve its IT practices. Office of the Auditor General IT auditors reviewed the System's IT processes in March 2014 and determined that the System could improve its IT policies and procedures for change management, logging and monitoring, and disaster recovery.[2] IT auditors followed up on their initial recommendations in June 2015 and determined that system staff had created procedures that appropriately addressed many of these areas, including procedures for logging and monitoring and change management. Additionally, the System's disaster recovery plan was updated and included supplemental

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[1] Auditors reviewed statutes for peers to the PSPRS plan and determined that one peer, the Municipal Employees' Retirement System of Michigan (MERS), is a public corporation. Michigan statute states the corporation is an instrumentality, or a separate legal entity of the government entities creating it. According to MERS management, the Michigan legislature granted this status in 1997 after member municipalities requested independence from the state and Michigan acknowledged that MERS received no state budget money.

[2] Change management policies and procedures standardize how staff make changes to IT systems. Logging is a record of IT system activities. Monitoring is the analysis, assessment, and review of information to identify potential violations of IT system security. Disaster recovery plans are policies and procedures that guide an organization when it sustains a loss of IT capability or damage to its systems.

documentation that auditors found would be effective in restoring operations should a disaster occur.

However, there are some actions the System should take to further improve its IT practices. Specifically:

- Although the System developed a disaster recovery plan, it should develop training on the roles and responsibilities in the new plan;

- Many of the System's IT policies are still in draft form, and according to the System, there is no standard process to implement policies. The System should develop processes for reviewing, approving, and implementing its IT policies; and

- A hosted Web site that contains confidential system documents lacks appropriate security controls.[1] During auditors' follow-up work in June 2015, auditors found that the System was still actively using the hosted Web site, but had not added appropriate security controls. Therefore, the System should implement additional controls such as encryption technologies to prevent unauthorized access of confidential system information.

Auditors also determined that the System's internal audit function could be enhanced. This function is responsible for auditing and providing guidance on how to improve the performance of the System's governance, risk management, and control processes. The System's internal auditors are charged with these duties and report to the System's Board of Trustees (Board), but receive day-to-day supervision from the system administrator. Auditors' review indicated that the internal audit function could be improved by better conforming to the Institute for Internal Auditors' standards. Specifically, the System should enhance its internal audit function by:

- **Ensuring internal and external assessments are conducted—**Internal auditing standards recommend that internal audit functions undergo two forms of independent assessment to ensure that the function is operating in conformance with standards and best practices for efficiency and effectiveness.[2] The first involves a periodic self-assessment or assessment of the internal audit function by system staff with sufficient knowledge of internal audit practice. Best practice recommends that this assessment occur at least annually. Second, internal audit standards and the System's internal audit charter (Charter) state that the internal audit function should undergo an external assessment no less than once every 5 years. According to the standards, this external assessment may be performed by an independent team that demonstrates competence in internal auditing and the external assessment process or by self-assessment with an independent validation of findings. However, the System has not performed either an internal or external assessment at the required frequency. Therefore, the Board should amend the Charter to require the internal audit function to undergo a periodic self-assessment or assessments by other persons within the organization with sufficient knowledge of internal audit practices, and ensure that

1 Web hosts are companies that provide space on a server owned or leased for client use.

2 Institute for Internal Auditors. (2012). *International standards for the professional practice of internal auditing.*

these assessments occur. In addition, the internal auditors should work with the Board to schedule an external assessment of this function.

- **Disclosing and remedying conflicts of interest—**Internal audit standards require internal auditors to avoid conflicts of interest. Additionally, standards and the Charter require auditors to disclose any conflicts of interest to the Board's Operations, Governance Policy and Audit Committee. The System's internal auditors' responsibilities include conducting compliance activities, which creates the potential for conflicts of interests. Specifically, according to system staff, certain internal audit engagements involve reviewing compliance functions for which internal auditors are partially responsible. Therefore, the Board should ensure that internal auditors disclose any conflicts of interests and their appropriate mitigation to the Operations, Governance Policy and Audit Committee.

- **Enhancing reporting to the Board—**Internal audit standards state that internal auditors should periodically report to senior management and the Board on the internal audit function's purpose, authority, and responsibility, which are formally established in its Charter. Additionally, standards state that internal auditors should periodically review the Charter and present it to senior management and the board for approval. According to system staff, internal auditors conducted one such meeting for the Operations, Governance Policy and Audit Committee in March 2012. However, internal auditors have not conducted any subsequent meetings that would satisfy this standard. Because the Board and system administrator are responsible for administering and carrying out the System's operations, this reporting can help inform these parties on how internal auditing can fulfill its purpose of adding value and improving these operations. Internal auditors should therefore conform to standards by regularly briefing the Board on the purpose, authority, and responsibility of the audit function. The Board should similarly amend the Charter to require internal auditors to periodically review the Charter and present it to the system administrator and Board for approval.

- **Developing and implementing policies and procedures—**Internal audit standards state that internal auditors must establish policies and procedures to guide internal audit function. However, the internal auditors have not established these policies and procedures. Therefore, the Board and System should encourage internal auditors to develop and implement internal audit policies and procedures to help ensure all internal audits are undertaken in a systematic and disciplined manner.

This report also presents findings and recommendations regarding steps the System can take to ensure the long-term sustainability of its three plans. Specifically, the System should:

- **Collaborate with stakeholders on changes to permanent benefit increase structures—** The System should collaborate with the plan employers and local boards, as well as other stakeholders, such as professional associations for firefighters or police, to determine how permanent benefit increases could be offered without impacting the sustainability of its three plans. For example, the System should consider whether its benefit increases should be linked to the Consumer Price Index similar to many other public pension plans. Additionally, the System should consider changing its benefit increase structure for the PSPRS plan and CORP to be based on individual employers' funded statuses instead of the plans' aggregate funded status. Once solutions are developed, the System should pursue the necessary legislative changes to implement them. The System should also consider proposing a ballot initiative to amend Arizona's Constitution in order to make changes to these benefit increase structures for existing members of the three plans if determined appropriate (see Finding 2, pages 25 through 35, for more information).

- **Take additional actions to improve the system plans' financial condition and long-term sustainability—**The System should take additional actions to improve the financial condition and long-term sustainability of the PSPRS plan, CORP, and EORP, such as:

  - Developing a funding improvement strategy that identifies actions that the system, PSPRS plan and CORP employers, EORP, and the System's actuary should take if funded statuses fall below predetermined levels. This funding improvement strategy should also consider establishing who is responsible for these actions, the amount of improvement in funded status that should be achieved, and the time frames for completing various actions, including an overall time frame for improvement in a plan's funded status.

  - Collaborating with stakeholders to determine the feasibility of offering a limited number of pension benefit options and pursue statutory changes to allow these options so that each employer may choose between different pension benefit options for its employees based on its fiscal capacity and employee demographics. These benefits may include different service multipliers, service age requirements, contribution requirements, and benefit increase structures.

  - Developing and providing some educational materials to PSPRS plan employers explaining how unusually large overtime pay increases the risk of generating unfunded liabilities.

  - Establishing formal, written policies and procedures for ensuring that contributions are correctly calculated. Because the System uses these contributions to calculate a member's pension benefit, it should adopt procedures such as regular employer audits to ensure that employers are complying with statutes related to reporting contributions and compensation.

  - Continuing to train and educate employers and local boards, which are authorized by statute to determine a member's pension benefit, on the impacts of the pension-related decisions they make.

  Finally, the Legislature should consider increasing its annual appropriations to EORP or amending this plan's statute so that it can receive sufficient employer contributions to remain solvent. (See Finding 3, pages 37 through 47, for more information).

3. **The extent to which the System serves the entire State rather than specific interests.**

   The System serves the entire State by managing a pension trust on behalf of 302 participating employers of public safety personnel, correctional workers, judges, and elected officials.

These employers include the State, all 15 counties, and many local governments throughout the State. These benefits can help government employers recruit employees to serve the public. In addition, participating employers and members throughout the State may receive system services by phone, e-mail, and the Internet.

4. **The extent to which the rules adopted by the System are consistent with the legislative mandate.**

   This sunset factor does not apply as the System does not have rulemaking authority.

5. **The extent to which the System has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

   Although it does not have statutory authority to promulgate rules, the System informs the public about its actions and their expected impact on the public through its board meetings, Web site, and social media such as Facebook and YouTube.

   The Board also complies with open meeting law. From April to June 2014, auditors evaluated the Board's compliance with open meeting law requirements for nine public meetings, including meetings conducted by its two committees—the Investment Committee and the Operations, Governance Policy and Audit Committee. The evaluation included a review of public meeting information available on the System's Web site and provided by staff, observation of the Board's and its committees' meetings, and a review of board meeting minutes. Based on this evaluation, the Board complied with provisions of the State's open meeting law, including statutory requirements that meetings are open to the public, public meeting notices and agendas for such meetings are posted 24 hours in advance of the meeting on the System's Web site and at its office, and taking written minutes of its meetings and/or making recordings of its meetings available to the public within 3 working days. In addition, although not required by statute, the Board broadcasts its regular board meetings on the Internet.

6. **The extent to which the System has been able to investigate and resolve complaints that are within its jurisdiction.**

   Although the System is not a regulatory agency for the purposes of investigating and resolving complaints, it has established two processes for responding to member issues. Specifically:

   - **Local boards**—PSPRS plan and CORP members may forward issues or questions to their local board for resolution (see Introduction, pages 1 through 2, for a description of the local board system). As indicated in the Introduction, local boards are vested with the power to determine in accordance with statutory requirements all questions of eligibility for plan membership, service credits, and benefits, as well as determining the amount, manner, and time of payment of any benefits.[1] If a member disagrees with a local board's determination on one of these issues, statute allows members to request that the local board conduct a rehearing within 60 days.[2] Members may further appeal their local board's final decision

[1] For the PSPRS plan see A.R.S. §38-847(D)(1) and for CORP, see A.R.S. §38-893(D)(1).

[2] For the PSPRS plan see A.R.S. §38-847(H) and for CORP, see A.R.S. §38-893(H).

to the Superior Court of the State of Arizona.[1] Additionally, although the Board does not have a statutory duty to review the actions of local boards, it may request that a local board rehear its original determination. However, the Board is not required to implement or comply with a local board decision that violates the Internal Revenue Code or that threatens to impair the tax qualified status of the System or any plan administered by the Board.[2]

- **System administration—**Members of all three plans may contact the System's administration by phone, e-mail, or in person with questions or concerns. For member issues that require a response from the System's administration, system staff report that they do not have any formal policies and procedures to guide their research into member questions or concerns and preparation of a response. Instead, system staff rely on statutes, issue sheets that summarize system policy on particular issues, and the member's file to resolve member issues. Complex issues may require the involvement of legal counsel and system management. If a response to a member's issue is simple to explain, staff reported that they will contact a member by phone and/or e-mail and note this response in the member's file. For issues that are too complex to adequately explain in a phone call, the System will send a letter to the member and retain a copy of this letter in the member's file.

However, staff reported that the System does not maintain a central record of member issues that have been received and resolved. This absence of monitoring may limit the System's ability to more effectively and efficiently address member issues. To enhance its processes for addressing members' issues, the System should:

- Develop and implement formal, written policies and procedures for handling member communications to ensure that system staff provide uniform treatment to members. These policies and procedures should define which member communications staff should document and track;

- Develop and implement a central record that details when members' issues are received, the nature of the issue, the system staff members who handled the issue and when, and how the issue was resolved; and

- Develop and implement procedures for requiring a regular analysis of this centralized record to identify and address systemic causes of trends in member issues.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under the enabling legislation.

The System's enabling legislation does not provide authority for the Attorney General or any other applicable agency of state government to prosecute actions. However, the Attorney General is the System's legal advisor and renders legal services as needed according to A.R.S. §41-192(A). Specifically, an Assistant Attorney General provides legal advice, representation, and assistance in strategic planning, developing policies and procedures,

1 For the PSPRS plan, see A.R.S. §38-847(J), and for CORP, see A.R.S. §38-893(J).

2 See A.R.S. §38-848(H)(7).

and formulating proposed legislation through an Interagency Services Agreement. In addition, according to A.R.S. §38-848(P), the Attorney General or an attorney approved by the Attorney General and paid for by the System represents the Board in any legal proceeding that it deems appropriate.

The System is legally allowed to also make use of in-house and outside counsel. Specifically, pursuant to A.R.S. §38-848(O)(5), the Board has contracted with an individual to serve as in-house investment counsel. In addition, as of fiscal year 2014, the Board has contracted with four private firms for litigation services involving 28 different legal matters that required legal advice and representation. The Board also has contracted with one legal firm for services on tax-related issues. Further, the Board has contracted with an outside legal firm for independent investment counsel through the authority granted to it in A.R.S. §38-848(K)(3). Auditors determined that the three PSPRS peer plans used outside legal counsel as well (see Sunset Factor 12, page 58).

8. The extent to which the System has addressed deficiencies in its enabling statutes that prevent it from fulfilling its statutory mandate.

According to system administration, it has addressed deficiencies in its enabling statutes that have prevented it from fulfilling its statutory mandate of providing a uniform, consistent, and equitable state-wide program for public safety personnel that is sustainable for the System's members and beneficiaries. Since 2005, many legislative bills have been passed to clean up and clarify statutory language to ensure more efficient administration of the System and to stay compliant with Internal Revenue Code. Specifically, system administration indicated that two major changes since 2005 involved seeking legislative authorization to diversify its portfolio by expanding its asset classes and to invest globally as well as the changes to the systems plans' benefits (see Finding 1, pages 23 through 24, for a discussion of these benefit changes). The System also reported that although the legislative changes have been sufficient, the statutory changes made to the system plans' benefits are slowly being overturned by the courts to where certain deficiencies remain that have negatively impacted the system plans' sustainability.

In addition, some other changes have included:

- **New service purchase guidelines—**Laws 2012, Ch. 348, amended A.R.S. §§38-853.01, 38-909, and 38-816 and added A.R.S. §§38-853.02, 38-909.01, and 38-816.01 to specify service purchase payment guidelines for the PSPRS plan, CORP, and EORP members. Specifically, members who have been active in the System for at least 5 years may purchase up to 60 months of prior service or employment at qualified entities, such as prior employment at a government agency in another state. The statute explains which entities may qualify for service purchase and the methods for calculating how much this purchase will cost the member.

- **Expanding cancer insurance program coverage—**Laws 2014, Ch. 190, amended A.R.S. §§38-642 and 38-644 to expand the Firefighter and Peace Officer Cancer Insurance Program to include corrections officers. This program provides supplemental insurance coverage to reimburse costs that arise while undergoing cancer treatment. See Introduction, page 6, for additional information.

9. **The extent to which changes are necessary in the laws of the System to adequately comply with the factors listed in the sunset law.**

   This audit report recommends several changes to improve the sustainability of the System's three plans, and many of these recommendations would require statutory changes. Specifically, Finding 2 recommends that the System collaborate with stakeholders to determine how benefit increases could be offered without impacting plans' sustainability, and once solutions are developed, the System would need to pursue legislative changes to implement these solutions for all three of its plans since each of the plans' benefit increase structures are specified in statutes (see Finding 2, pages 25 through 35). However, to effectively address its plans' sustainability, the System and its stakeholders may also need to consider whether to pursue a ballot initiative to amend Arizona's Constitution so that changes would apply to all members instead of just those who start or retire on or after a specific date.

   Similarly, Finding 3 (see Finding 3, pages 37 through 47) recommends several statutory changes, some of which would require the System to pursue. These include the following:

   - Incorporate a funding improvement strategy in statute. This strategy would establish a specific point when a plan or employer is considered at-risk and must take certain actions, require annual certification of the plan or employer's at-risk status to prompt appropriate actions and steps, and include specific actions that the System, member employers, or others should take, and set specific time frames for completing the actions. Placing this strategy in statute will help ensure that the System and the PSPRS plan and CORP employers take the actions necessary to improve the PSPRS plan's, CORP's, and EORP's financial condition and long-term sustainability.

   - Consider amending statute to allow for different benefit options. After working with stakeholders to determine if offering a limited number of pension benefit options would be beneficial, the System should seek the necessary changes to the PSPRS plan and CORP laws to allow for employers to select options.

   Finally, to help ensure that EORP remains solvent and can satisfy its pension obligations, the Legislature should consider revising A.R.S. §38-810 to allow the Board to annually establish contribution rates, or consider increasing its annual appropriations over time. EORP's actuary has determined that if the 23.5 percent EORP employer contribution rate set in statute remains unchanged, the plan's assets will be depleted in the next 20 years. Although the Legislature appropriated $5 million to this plan in fiscal year 2014 and will continue to appropriate $5 million annually through fiscal year 2042 to help cover EORP's pension obligations, the System's actuary has recommended that EORP receive $28.5 million in revenue each year in addition to the 23.5 percent employer contribution rate in order for this plan to reach 100 percent funded status within 30 years.

10. **The extent to which the termination of the System would significantly affect the public health, safety, or welfare.**

    Terminating the System would significantly harm the public welfare. The System has obligations to and provided retirement benefits, disability benefits, and death benefits to more than 54,000 PSPRS plan, CORP, and EORP members as of June 30, 2014. Additionally, the System maintains an account for each of its three plans that provides health insurance premium subsidies to more than 9,700 PSPRS plan, CORP, and EORP retired members and another account to help pay for designated expenses in treating cancer for some active and retired PSPRS plan and CORP members.[1] The Arizona State Constitution specifies that membership in a public retirement system is a contractual relationship and that benefits cannot be "diminished or impaired." Therefore, if the System were terminated, another entity would need to assume the legal obligation for covering the more than $16 billion in total pension and other benefit obligations that the System reported for the PSPRS plan, CORP, and EORP as of June 30, 2014.

Finally, as indicated in Sunset Factor 1, see page 49, all 50 states sponsor at least one statewide defined benefit retirement plan for their public safety employees. According to literature cited by the National Institute on Retirement Security, employers with defined benefit pensions may experience lower rates of employee turnover than those that do not offer pensions.[2] Therefore, discontinuing the PSPRS plan, CORP, or EORP also may make it difficult for the 302 public employers throughout the State of Arizona that participate in these plans—including state, county, and municipal employers—to attract and retain a professional workforce to provide public services and safety.

11. **The extent to which the level of the regulation exercised by the System compares to other states and is appropriate and whether less or more stringent levels of regulation would be appropriate.**

    This factor does not apply because the System is not a regulatory agency.

12. **The extent to which the System has used private contractors in the performance of its duties as compared to other states and how more effective use of private contractors could be accomplished.**

    The System uses private contractors to a similar extent as its peer public pension plans. Auditors reviewed each peer's most recent comprehensive annual financial report available at the time the audit work was conducted for information regarding use of contractors and asked staff at those three public pension plans if they contracted for any other functions critical to their plan's missions.[3] Similar to the peer public pension plans identified by auditors, the System contracts for services in six common areas, including investment management and actuarial services. Specifically:

    - **Investment management—**The System contracts with external investment management organizations to invest assets in accordance with the System's investment strategies.

    - **Actuarial services—**The System contracts for actuarial services in several areas. For example, statutes require the System to conduct an annual actuarial valuation of assets

[1] As indicated in Sunset Factor 8 (see page 55), Laws 2014 Ch. 190, §§4 and 6, expanded this program to include corrections officers.

[2] National Institute on Retirement Security. (2010). *Public pension resource guide: Why do pensions matter?* Washington, DC.

[3] The three peer plans auditors selected are: (1) Municipal Employees' Retirement System of Michigan, (2) Missouri Local Government Employees Retirement System, and (3) Employees' Retirement System of Rhode Island. See Appendix B, pages b-1 through b-2, for more information on these peers and how they were selected.

and estimated pension obligations of the PSPRS plan, CORP, and EORP. Also, the System's actuary conducts experience studies, which compares assumptions used for annual actuarial valuations to the System's actual experience to determine if the assumptions (such as investment rate of return and length of service) should be changed. For examples of actuarial assumptions, see the textbox on page 23.

- **External audit services—**The System contracts with an accountant that provides external audit services, including a review of its comprehensive annual financial reports for the PSPRS plan, CORP, and EORP.

- **Custodial banking services—**The System contracts with a custodial bank to hold assets of the system trust, value assets, and provide reports on investment performance.

- **Legal services—**The System contracts with private attorneys for specialized legal assistance in tax and investment law.

- **Information technology services—**The System contracts for IT services, including for systems that provide customer service to its members.

Similar to the System, two of the three peer public pension plans also contract with investment consultants who provide investment advice.

The audit did not identify any other opportunities for the System to use private contractors.

Recommendations:

1. The System should (see Sunset Factor 2, page 50):

   a. Train IT staff on the roles and responsibilities of its updated disaster recovery plan;

   b. Develop processes for reviewing, approving, and implementing its IT policies; and

   c. Implement additional controls on its hosted Web site, such as encryption technologies, to prevent unauthorized access of confidential system information.

2. The Board and System should enhance its internal audit function by (see Sunset Factor 2, pages 50 through 51):

   a. Revising the System's internal audit charter to ensure internal and external assessments are conducted and scheduling an external assessment of the internal audit function;

   b. Requiring that the internal auditors disclose any conflicts of interest and their appropriate mitigation to the Operations, Governance Policy and Audit Committee;

   c. Periodically reviewing its internal audit charter, including requiring internal auditors to regularly brief the Board on the purpose, authority, and responsibility of the internal audit function according to the charter. In addition, the Board should also amend the internal audit charter to require these activities; and

d. Developing and implementing policies and procedures to guide internal audit function.

3. To enhance its processes for addressing members' issues, the System should (see Sunset Factor 6, page 54):

a. Develop and implement formal, written policies and procedures for handling member communications to ensure that system staff provide uniform treatment to members. These policies and procedures should define what member communications should be documented and tracked;

b. Develop and implement a central record that details when members' issues are received, the nature of the issue, the system staff members who handled the issue and when, and how the issue was resolved; and

c. Develop and implement procedures for requiring a regular analysis of the centralized record to identify and address systemic causes of trends in member issues.

APPENDIX A Information on participating employers

Table 5, pages a-2 through a-8, is a list of employers that participate in the Public Safety Personnel Retirement System plan (PSPRS plan), and Table 6, page a-9, is a list of employers that participate in the Corrections Officer Retirement Plan (CORP). Each entry includes information as of June 30, 2014, for the following categories:

- The total number of members for each participating employer. See Introduction, Table 1, page 3, for a description of PSPRS plan and CORP members;
- The funded status of each employer's account with the Public Safety Personnel Retirement System (System). See Finding 1, page 13, for a description of funded status;
- The employer contribution rate. The employer rate is the percentage of its employees' salaries an employer is required to contribute to cover its estimated pension obligations. See Finding 1, pages 21 through 22, for a description of how these percentages are determined; and
- The phase-in employer contribution rate. Employers can opt to pay this rate instead of the employer contribution rate. The System's Board of Trustees (Board) adopted a policy that allows participating employers to phase in their higher employer contribution rates, resulting from the 2014 *Fields v. Elected Officials' Retirement Plan* (*Fields*) decision, over a 3-year period. The *Fields* decision reversed changes that Laws 2011, Ch. 357 (SB 1609), made to the permanent benefit increase statutes for EORP retired members (see Finding 2, pages 25 through 26, for more information on this lawsuit). Although the *Fields* decision pertained only to EORP, the System retroactively reinstated benefit increases under the prior statutory requirements for all three plans' members who had retired on or before July 1, 2011. Consequently, the System's actuary proposed significantly higher contribution rates for fiscal year 2014 to make up for this increase in pension benefits.

Table 5: PSPRS plan participating employers' information As of June 30, 2014 (Unaudited)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Ak Chin Indian Community Fire Department	50	76.8%	15.76%	14.37%
Ak Chin Indian Community Police Department	26	90.5	14.38	13.30
Apache County Sheriff's Department	54	27.0	52.79	45.12
Apache Junction Fire District	96	75.5	20.00	17.66
Apache Junction Police Department	93	37.8	50.31	41.98
Arizona State University Campus Police	124	49.4	35.31	30.66
Attorney General Investigations	52	22.0	69.97	69.97
Avondale Fire Department	78	81.2	16.47	15.46
Avondale Police Department	158	65.4	20.02	17.69
Avra Valley Fire District	39	99.3	12.28	11.97
Arizona Department of Liquor and Licensing Control Investigations	30	37.0	66.82	54.22
Arizona State Parks Rangers	51	61.7	42.77	34.02
Benson Fire Department	1	84.3	21.93	20.56
Benson Police Department	19	51.6	26.33	22.92
Bisbee Fire Department	47	8.2	87.66	72.42
Bisbee Police Department	32	18.1	93.26	72.65
Black Canyon Fire District	11	120.0	10.40	9.94
Buckeye Fire Department	84	93.0	12.83	11.75
Buckeye Police Department	103	65.6	19.54	17.44
Buckeye Valley Fire Department	74	107.9	11.44	11.44
Buckskin Fire District	24	30.9	42.37	36.97
Bullhead City Fire Department	100	70.8	25.98	21.67
Bullhead City Police Department	111	54.1	36.16	29.66
Camp Verde Fire District	31	79.6	16.47	15.02
Camp Verde Marshals	27	62.3	24.92	22.11
Casa Grande Fire Department	77	55.2	27.18	23.87
Casa Grande Police Department	122	39.9	41.91	35.20
Cave Creek Marshals	1	83.5	15.25	14.32
Central Arizona College Police Department	7	64.6	20.03	18.47
Central Yavapai Fire District	121	53.5	35.42	30.61
Chandler Fire Department	248	66.9	26.48	22.33
Chandler Police Department	424	59.5	31.04	25.94
Chino Valley Fire Department	42	70.8	22.18	18.64
Chino Valley Police Department	31	63.7	26.43	21.56
Christopher-Kohl's Fire District	8	73.4	14.90	12.58

Table 5: (Continued)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
City of Maricopa Fire Department	64	102.4%	12.12%	11.69%
City of Maricopa Police Department	66	99.1	11.96	11.58
Clarkdale Fire District	11	97.2	11.93	11.83
Clarkdale Police Department	15	58.1	34.07	26.08
Clifton Fire Department	1	34.0	5.00	5.00
Clifton Police Department	8	136.4	10.34	10.34
Cochise County Sheriff’s Department	167	31.8	51.31	42.56
Coconino County Sheriff’s Department	116	25.3	75.15	62.46
Coolidge Fire Department	4	178.1	12.31	11.67
Coolidge Police Department	44	47.2	36.46	29.23
Corona de Tucson Fire District	20	75.8	17.02	15.97
Cottonwood Fire Department	30	75.0	17.77	16.04
Cottonwood Police Department	51	37.3	37.08	31.52
Daisy Mountain Fire District	91	96.5	12.73	12.46
Department of Emergency and Military Affairs	66	54.8	31.34	25.14
Department of Public Safety	2,361	36.1	76.00	62.20
Desert Hills Fire Department	26	68.7	15.95	15.04
Douglas Fire Department	52	26.2	66.00	51.27
Douglas Police Department	64	32.5	57.91	45.45
Drexel Heights Fire District	107	72.5	21.51	17.96
Eagar Police Department	15	49.9	44.32	33.69
El Mirage Fire Department	28	81.1	15.58	13.51
El Mirage Police Department	55	56.8	25.08	21.53
Eloy Fire District	32	77.7	15.82	14.93
Eloy Police Department	41	66.3	23.40	18.72
Flagstaff Fire Department	167	40.1	67.71	53.91
Flagstaff Police Department	208	38.0	43.26	36.99
Florence Fire Department	30	116.6	11.27	10.80
Florence Police Department	37	90.1	15.04	12.92
Fort McDowell Tribal Fire Department	15	98.8	12.54	12.09
Fort McDowell Tribal Police Department	20	97.5	13.46	12.79
Fort Mojave Mesa Fire District	43	59.0	29.55	25.02
Fort Mojave Tribal Police District	22	133.7	12.36	11.69
Fredonia Marshals	5	101.8	13.01	12.45
Fry Fire District	60	42.7	39.15	33.09
Game and Fish Department	284	27.2	88.12	71.89

Table 5: (Continued)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Gila County Sheriff's Department	74	38.4%	55.82%	40.28%
Gila River Fire Department	85	89.8	13.23	12.60
Gila River Police Department	137	106.7	12.08	11.43
Gilbert Fire Department	189	86.3	14.76	13.19
Gilbert Police Department	293	65.5	22.13	19.19
Glendale Fire Department	312	60.8	31.45	26.51
Glendale Police Department	591	47.9	35.90	31.43
Globe Fire Department	30	45.1	45.12	38.85
Globe Police Department	38	37.7	54.13	40.92
Golden Shores Fire Department	9	118.2	10.88	10.83
Golden Valley Fire District	35	67.9	18.74	16.75
Golder Ranch Fire District	147	73.6	18.29	16.64
Goodyear Fire Department	93	92.0	13.45	12.90
Goodyear Police Department	114	68.3	21.25	18.47
Graham County Investigations	0	0.0	5.00	5.00
Graham County Sheriff's Department	28	58.6	29.61	23.69
Green Valley Fire District	78	71.4	21.33	18.34
Greenlee County Investigations	0	0.0	5.00	5.00
Greenlee County Sheriff's Department	23	65.9	23.55	19.55
Groom Creek Fire District	8	124.4	10.04	9.99
Guadalupe Fire Department	5	56.8	26.33	23.12
Harquahala Fire District	21	134.2	11.35	11.04
Hayden Police Department	13	377.0	12.30	12.30
Heber-Overgaard Fire District	16	112.6	12.93	12.42
Hellsgate Fire District	9	80.1	18.07	16.53
Highlands Fire District	28	62.3	22.93	19.87
Holbrook Police Department	30	24.1	71.89	53.64
Huachuca City Police Department	6	58.5	18.45	18.45
Hualapai Indian Tribe Police Department	18	118.8	12.40	12.40
Jerome Police Department	5	150.2	12.65	11.54
Kearny Police Department	13	74.8	29.80	22.73
Kingman Fire Department	65	61.3	33.97	27.93
Kingman Police Department	85	52.1	35.94	29.47
La Paz County Investigations	1	67.8	8.00	8.00
La Paz County Sheriff's Department	55	39.1	48.24	40.10
Lake Havasu City Fire Department	129	45.9	41.98	34.42

Table 5: (Continued)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Lake Havasu City Police Department	129	46.4%	45.60%	37.21%
Lake Mohave Ranchos Fire District	15	72.9	26.55	23.53
Lakeside Fire District	25	85.0	15.30	13.53
Linden Fire District	9	114.4	11.99	11.37
Mammoth Police Department	14	56.2	21.36	16.15
Marana Police Department	112	61.3	24.80	21.19
Maricopa County Attorney's Office Investigations	34	38.7	50.95	50.95
Maricopa County Park Rangers	5	68.6	8.00	8.00
Maricopa County Sheriff's Office	1,108	44.5	48.83	41.46
Mayer Fire District	22	84.0	16.98	14.35
Mesa Fire Department	620	54.8	40.53	34.17
Mesa Police Department	1,271	51.4	41.22	34.58
Miami Fire Department	0	0.0	5.00	5.00
Miami Police Department	8	51.6	36.86	35.50
Mohave County Sheriff's Department	137	51.8	38.48	31.89
Mohave Valley Fire District	40	101.8	12.60	12.20
Montezuma Rimrock Fire District	14	67.2	20.58	18.75
Mount Lemmon Fire District	5	114.6	11.74	11.19
Northern Arizona University Campus Police	28	35.8	48.78	40.95
Navajo County Attorney Investigations	1	6.3	5.00	5.00
Navajo County Sheriff's Office	93	31.7	47.62	37.99
Nogales Fire Department	64	50.5	37.19	30.18
Nogales Police Department	81	54.0	32.48	26.38
Northern Arizona Consolidated Fire District	47	62.1	25.61	22.69
Northwest Fire District	226	73.1	20.20	18.39
Oracle Valley Fire District	9	117.8	12.24	11.75
Oro Valley Police Department	130	65.2	24.70	21.13
Page Fire Department	25	76.4	13.87	12.88
Page Police Department	27	55.2	33.75	24.62
Palominas Fire District	10	206.6	12.59	11.80
Paradise Valley Police Department	66	25.4	71.78	64.23
Parker Police Department	17	61.2	28.65	22.27
Pascua Yaqui Tribe Fire Department	26	64.2	21.33	20.16
Pascua Yaqui Tribe Police Department	37	62.4	20.83	18.88
Patagonia Marshals	7	49.5	53.47	47.17
Payson Fire Department	40	59.8	23.89	20.94

Table 5: (Continued)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Payson Police Department	57	32.6%	56.57%	45.68%
Peoria Fire Department	174	74.0	21.77	18.35
Peoria Police Department	262	55.5	31.49	26.42
Phoenix Fire Department	2,526	50.1	47.51	39.55
Phoenix Police Department	5,056	48.1	50.02	40.71
Picture Rocks Fire Department	33	69.8	26.77	19.52
Pima County Attorney Investigations	10	44.5	65.96	51.69
Pima County Community College Police Department	50	49.2	30.94	25.87
Pima County Sheriff's Department	942	43.7	49.76	40.89
Pima Police Department	4	344.9	14.47	12.66
Pinal County Sheriff's Department	317	56.1	30.19	25.39
Pine-Strawberry Fire District	24	62.6	26.68	23.22
Pinetop Fire District	37	58.3	24.30	21.32
Pinetop-Lakeside Police Department	25	30.7	53.98	44.35
Pinewood Fire District	20	55.9	22.14	20.27
Ponderosa Fire District	4	149.3	10.17	10.17
Prescott Fire Department	123	31.9	74.49	63.44
Prescott Police Department	139	25.7	66.16	54.31
Prescott Valley Police Department	85	67.1	23.13	19.21
Quartzsite Fire Department	11	93.9	11.87	11.64
Quartzsite Police District	14	103.2	12.59	12.58
Queen Creek Fire Department	32	65.4	15.36	13.91
Queen Valley Fire District	3	92.0	14.77	14.35
Rincon Valley Fire District	43	99.3	12.02	12.02
Rio Rico Fire District	37	115.1	11.31	11.05
Rio Verde Fire District	17	83.0	16.83	16.52
Safford Police Department	33	33.8	54.81	46.88
Sahuarita Police Department	43	98.6	12.55	11.71
Salt River Pima-Maricopa Fire	89	79.5	17.67	15.96
Salt River Pima-Maricopa Police	120	72.1	18.63	16.28
San Carlos Tribal Police Department	28	80.9	14.56	14.15
San Luis Fire Department	34	96.9	12.77	12.40
San Luis Police Department	42	70.2	19.66	16.97
Santa Cruz County Sheriff's Department	61	41.2	44.50	33.83
Scottsdale Fire Department	259	111.1	12.06	11.51

Table 5: (Continued)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Scottsdale Police Department	667	56.1%	35.36%	29.81%
Sedona Fire District	94	62.2	23.55	21.02
Sedona Police Department	39	59.3	25.02	23.19
Show Low Fire District	36	98.5	12.53	11.98
Show Low Police Department	43	51.7	30.44	26.05
Sierra Vista Fire Department	74	56.4	37.22	30.17
Sierra Vista Police Department	105	42.8	42.24	34.27
Snowflake Police Department	22	47.0	32.82	27.36
Somerton Fire Department	23	70.2	20.33	17.81
Somerton Police Department	25	69.9	22.17	19.34
Sonoita Elgin Fire Department	15	89.8	12.76	12.33
South Tucson Fire Department	10	41.3	92.22	66.47
South Tucson Police Department	31	2.2	90.09	76.57
Springerville Police Department	10	68.0	27.81	21.47
St. John's Police Department	10	76.6	21.02	15.21
Summit Fire District	50	81.1	16.91	15.67
Sun City Fire District	73	50.7	45.50	38.15
Sun City West Fire District	71	60.4	26.48	24.03
Sun Lakes Fire District	53	74.9	19.28	17.40
Sun Sites Pearce Fire District	8	94.9	12.17	11.69
Superior Police Department	12	80.7	18.68	18.44
Surprise Fire District	117	82.6	15.58	14.25
Surprise Police Department	158	70.3	20.26	17.46
Tempe Fire Department	279	49.3	49.67	41.30
Tempe Police Department	585	41.9	44.03	37.12
Thatcher Police Department	19	42.0	40.48	33.95
Three Points Fire District	20	72.3	19.15	17.30
Tohono O’Odham Nation Fire Department	57	102.4	11.27	11.27
Tohono O’Odham Nation Police Department	87	79.5	18.07	15.92
Tolleson Fire Department	35	76.5	18.72	17.03
Tolleson Police Department	39	54.3	26.06	22.72
Tombstone Marshals	8	256.8	7.22	7.22
Tonopah Fire District	16	154.4	11.54	11.34
Town of Superior Fire Department	6	118.6	11.17	10.81
Tri-City Fire District	26	94.4	12.52	11.68
Tubac Fire District	33	86.2	15.23	14.12
Tucson Airport Authority Fire Department	35	32.3	73.55	56.92

Table 5: (Concluded)

PSPRS plan employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Tucson Airport Authority Police Department	40	27.9%	65.77%	52.48%
Tucson Fire	1106	37.7	66.23	54.55
Tucson Police	1839	39.3	64.13	52.14
University of Arizona Campus Police	101	50.9	33.04	28.46
Verde Valley Fire District	35	79.9	17.29	15.98
Wellton Police Department	8	42.6	30.82	22.91
Whetstone Fire District	6	147.5	10.05	10.05
Wickenburg Fire Department	13	112.4	10.79	10.63
Wickenburg Police Department	28	47.8	28.81	24.07
Willcox Police Department	16	39.2	56.12	42.98
Williams Police Department	19	58.9	27.16	20.09
Williamson Valley Fire District	20	122.3	10.64	10.43
Winslow Fire Department	9	192.6	10.76	10.17
Winslow Police Department	32	61.2	35.77	27.76
Wittman Fire District	11	106.1	11.76	11.48
Yavapai County Attorney Investigations	2	-6.8	5.00	5.00
Yavapai County Sheriff's Office	207	42.9	39.54	33.25
Yavapai Prescott Tribal Police	9	191.3	13.51	12.59
Youngtown Police Department	7	44.3	122.09	82.29
Yuma County Sheriff's Department	128	50.5	32.60	28.47
Yuma Fire Department	185	41.9	48.55	40.75
Yuma Police Department	299	47.4	42.05	34.18

1 The Board adopted a policy that allows participating employers to phase in their higher employer contribution rates, resulting from the 2014 *Fields v. Elected Officials' Retirement Plan (Fields)* decision, over a 3-year period. Employers can opt to pay the phase-in rate instead of the employer contribution rate. The *Fields* decision reversed changes that Laws 2011, Ch. 357 (SB 1609), made to the permanent benefit increase statutes for EORP retired members (see Finding 2, pages 25 through 26, for more information on this lawsuit). Although the *Fields* decision pertained only to EORP, the System retroactively reinstated benefit increases under the prior statutory requirements for all three plans' members who had retired on or before July 1, 2011. Consequently, the System's actuary proposed significantly higher contribution rates for fiscal year 2014 to make up for this increase in pension benefits.

Source: Auditor General staff analysis of information contained in the *Arizona Public Safety Personnel Retirement System Consolidated Report as of June 30, 2014.*

Table 6: CORP participating employers' information As of June 30, 2014 (Unaudited)

CORP employer name	Total number of members	Funded status	Employer contribution rate	Phase-in employer contribution rate[1]
Administrative Office of the Courts	2,814	59.10%	19.10%	16.29%
Apache County—Detention	31	66.00	13.72	10.79
City of Avondale—Detention	12	75.20	11.27	9.96
City of Somerton—Dispatchers	7	43.70	27.63	23.74
Cochise County—Detention	106	58.50	17.51	14.30
Coconino County—Detention	142	75.70	10.20	8.71
Department of Corrections—Detention	11,490	56.10	18.45	14.92
Department of Juvenile Corrections—Detention	899	54.00	22.95	17.89
Department of Public Safety—Dispatchers	62	68.60	16.55	14.04
Department of Public Safety—Detention	4	60.60	6.85	6.76
Gila County—Detention	91	86.90	9.35	8.54
Gila County—Dispatchers	13	74.70	18.52	14.17
Graham County—Detention	51	81.30	8.15	7.85
Graham County—Dispatchers	9	118.70	6.11	5.92
Maricopa County—Detention	2,733	57.30	16.24	13.73
Mohave County—Detention	179	110.30	7.03	6.85
Navajo County—Detention	78	85.80	8.84	7.97
Pima County—Detention	722	48.60	22.79	18.62
Pinal County—Detention	313	78.10	10.26	9.49
Pinal County—Dispatchers	26	63.70	14.38	12.37
Santa Cruz County—Detention	56	91.70	7.86	7.23
Town of Marana—Dispatchers	12	68.80	11.87	11.19
Town of Oro Valley—Dispatchers	13	54.10	22.05	18.57
Town of Wickenburg—Dispatchers	7	50.60	27.46	19.47
Yavapai County—Detention	270	54.80	14.16	12.51
Yavapai County—Dispatchers	9	66.30	15.42	12.07
Yuma County—Detention	223	67.10	12.91	10.44

1 The Board adopted a policy that allows participating employers to phase in their higher employer contribution rates, resulting from the 2014 *Fields v. Elected Officials' Retirement Plan (Fields)* decision, over a 3-year period. Employers can opt to pay the phase-in rate instead of the employer contribution rate. The *Fields* decision reversed changes that Laws 2011, Ch. 357 (SB 1609), made to the permanent benefit increase statutes for EORP retired members (see Finding 2, pages 25 through 26, for more information on this lawsuit). Although the *Fields* decision pertained only to EORP, the System retroactively reinstated benefit increases under the prior statutory requirements for all three plans' members who had retired on or before July 1, 2011. Consequently, the System's actuary proposed significantly higher contribution rates for fiscal year 2014 to make up for this increase in pension benefits.

Source: Auditor General staff analysis of information contained in the *Arizona Corrections Officer Retirement Plan Consolidated Report as of June 30, 2014*.

APPENDIX B Peer plan selection

This appendix provides information on the methods auditors used to select peer public retirement plans for the Public Safety Personnel Retirement System plan (PSPRS plan). Auditors selected peer plans using data from the 2012 Public Fund Survey (PFS), which is an online compendium of data from 126 public pension plans in the United States.[1] After reducing the pool of plans to those that were agent multiple-employer plans that included public safety personnel, auditors also considered the following characteristics: market value of assets, the retired-to-active member ratio, the actuarial cost method, and the investment return assumption. Through this analysis, auditors identified three peer plans: the Municipal Employees' Retirement System of Michigan (Michigan), Missouri Local Government Employees Retirement System (Missouri), and Rhode Island Municipal Employees' Retirement System (Rhode Island). In addition to some of the characteristics used in selecting the peer plans, Tables 7 and 8 contain additional comparative information, including the number of members, aggregate funded status, and average contribution rates for employers and members.

Table 7: PSPRS plan and peer plan asset and demographic information As of June 30, 2014[1] (Unaudited)

State plan	Aggregate funded status	Actuarial value of assets (in millions)	Retired members	Active members	Retired/active member ratio
Michigan[2]	71.4%	$7,861	32,460	34,809	0.933:1
Missouri	91.7%	5,388	18,502	33,205	0.557:1
PSPRS plan	49.2%	6,019	10,524	18,526	0.568:1
Rhode Island	84.1%	1,341	5,129	7,263	0.706:1

1 Each plan's reporting period varied (see source).

2 The Michigan plan's funded status is as of December 31, 2012, and its actuarial value of assets, and retired and active member information are as of December 31, 2013.

Source: Auditor General staff analysis of Municipal Employees' Retirement System of Michigan's actuarial valuation as of December 31, 2012 and 2013; Missouri Local Government Employees Retirement System's actuarial valuation as of February 28, 2014, and comprehensive annual financial report for the fiscal year ended June 30, 2014; the PSPRS plan's actuarial valuation as of June 30, 2014, and comprehensive annual financial report for the fiscal year ended June 30, 2014; and Rhode Island Municipal Employees' Retirement System actuarial valuation as of June 30, 2014.

1 Auditors reviewed the validity and reliability of the PFS' data by contacting the survey's administrator and verifying its data reliability process. In addition, auditors conducted a data accuracy and reliability test by reviewing data elements reported by the PFS and comparing them to PSPRS plan financial reports for fiscal year 2012, such as its comprehensive annual financial report for the fiscal year ended June 30, 2012. Auditors did not find any significant differences in the data elements tested and concluded that the data obtained from the PFS was sufficiently accurate and reliable for purposes of selecting peer systems.

Table 8: PSPRS plan and peer plan actuarial information As of June 30, 2014[1] (Unaudited)

State plan	Actuarial cost method[2]	Investment return assumption	Average employer contribution rate	Average member contribution rate
Michigan	Entry Age Normal	8.00%	14.50/14.49%[3]	5.65%
Missouri	Entry Age Normal	7.25%	N/A[4]	N/A[4]
PSPRS plan	Entry Age Normal	7.85%	30.44%	10.35%
Rhode Island	Entry Age Normal	7.50%	13.23%	3.61%

1 Each plan's reporting period varied (see source).

2 Actuarial cost methods estimate an employee's salary and years of service at retirement and then spread the cost of the estimated pension obligation over the employee's career. The Entry Age Normal cost method allocates costs evenly, as a level percentage of pay, throughout an employee's projected career.

3 For contributory groups, in which members and employers make contributions, the average employer contribution rate is 14.5 percent. For noncontributory groups, in which only employers make contributions, the average employer contribution rate is 14.49 percent. The average contribution rates for the Municipal Employees' Retirement System of Michigan are for defined benefit plans and the defined benefit portions of hybrid plans.

4 Missouri Local Government Employees Retirement System actuarial valuation did not provide data on contribution rates for its members and 654 participating employers.

Source: Auditor General staff analysis of Municipal Employees' Retirement System of Michigan's actuarial valuation as of December 31, 2013; Missouri Local Government Employees Retirement System actuarial valuation as of February 28, 2014; PSPRS plan actuarial valuation as of June 30, 2014, and comprehensive annual financial report for the fiscal year ended June 30, 2014; and Rhode Island's Municipal Employees' Retirement System actuarial valuation as of June 30, 2014.

APPENDIX C

This appendix provides information on the methods auditors used to meet the audit objectives.

This audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Auditor General and staff express appreciation to the Public Safety Personnel Retirement System (System) Board of Trustees (Board), Administrator, and staff for their cooperation and assistance throughout the audit.

Methodology

Auditors used various methods to study the issues addressed in this report. Auditors interviewed board members, the administrator, interim administrator, and staff; attended several board meetings from April 2014 to June 2014; and reviewed and analyzed information in various documents, including the Board's Governance Manual, board policies, and prior audit reports. Auditors also reviewed state statutes applicable to the System and its Board.

In addition, auditors used the following specific methods to address the audit's objectives:

- To determine the funded statuses of the System's three defined benefit plans from June 30, 2005 through June 30, 2014, and assess the actions the System and/or the Legislature have taken to improve the plans' long-term sustainability, auditors analyzed information from the Public Safety Personnel Retirement System plan's (PSPRS plan), the Corrections Officer Retirement Plan's (CORP), and the Elected Officials' Retirement Plan's (EORP) annual actuarial valuation reports as of June 30, 2005 through June 30, 2014. In addition, auditors compared changes the System and Legislature had taken to ensure plan sustainability to recommended practices or actions taken in other states as outlined in various reports, including those published by the American Academy of Actuaries, the Government Finance Officers Association, and the National Conference of State Legislatures.

- To identify potential solutions for the System's permanent benefit increase structures, auditors compared the System's structures to other states' structures as outlined in reports including those published by Center for Retirement Research at Boston College and the National Institute on Retirement Security. In addition, auditors obtained information from three PSPRS plan peers' Web sites and their statutes, and conducted interviews with these plans' representatives (see Appendix B, page b-1 through b-2, for information on these peer plans).

- To develop other recommendations for improving system plans' sustainability, auditors also obtained information from the three PSPRS plan peer retirement systems' Web sites and two peer retirement systems' statutes. In addition, auditors conducted interviews with PSPRS plan peer retirement system representatives and compared that information to system statutes and other documents. To determine how the System defines, identifies, investigates, resolves, and tracks instances of pension spiking, auditors interviewed system management and staff, reviewed statutes related to calculating member benefits, and reviewed system documents and local board benefit calculations.

- To obtain information for the Introduction and Sunset Factors, auditors reviewed and compiled information from the PSPRS plan, CORP, and EORP statutes, the *State of Arizona—The Master List of State Government Programs and State Agencies' Five Year Strategic Plans* (2014), and system documents, such as its member benefits handbook, and its comprehensive annual financial reports as of June 30, 2005 through June 30, 2014. Auditors also reviewed comprehensive annual financial reports for fiscal years 2012 through 2014 and conducted interviews with officials at the three peer defined benefit retirement plans to the PSPRS plan to determine the extent of the System's use of private contractors. Finally, auditors analyzed PSPRS plan, CORP, and EORP fiscal years 2013 and 2014 financial statements audited by an independent certified public accounting firm and system-prepared estimates for fiscal year 2015 to prepare the system plans' financial tables.

- Auditors' work on internal controls focused on the steps the System has taken to improve the long-term sustainability of the PSPRS plan, CORP, and EORP, the proper management of its information technology systems, and its processes for responding to member issues. Auditors' conclusions on internal controls are reported in Findings 1 through 3 and Sunset Factors 2 and 6 of the report. In addition, the Office of the Auditor General contracted with Gallagher Fiduciary Advisors to assess internal controls over investments, and conclusions on these controls are found in Gallagher's report—*Independent Operational Review of the Public Safety Personnel Retirement System's Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers* (Report No. 15-CR3).

AGENCY RESPONSE

PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
CORRECTIONS OFFICER RETIREMENT PLAN
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Administration
Jared A. Smout
Administrator
Ryan Parham
Assistant Administrator-CIO

14 September 2015

Debra K. Davenport, Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

We are both excited and sad to have this sunset review and performance audit come to an end. Working with your staff over the past year and a half has been very enjoyable and I hope the same for them. We have been able to work together to help the Auditor General better understand the uniqueness of the Public Safety Personnel Retirement System (System), the challenges we have been facing and the efforts we have made to overcome those challenges. We, in turn, through your staff's exhaustive efforts, have been able to see some things in a different light to help us improve the service we provide, both in terms of efficiency and sustainability. Below you will find our formal response and any comments on the recommendations given for the individual findings.

Finding 1: The Public Safety Personnel Retirement System plan's (PSPRS plan), the Corrections Officer Retirement Plan's (CORP), and the Elected Officials' Retirement Plan's (EORP) assets have not kept pace with estimated pension obligations.

No recommendations given.

Finding 2: Changes in calculating and awarding annual benefit increases would help the system plans' sustainability.

Recommendations

2.1 To ensure the plans' permanent benefit increase structures are sustainable, the System should take the lead and collaborate with stakeholders to identify changes that are needed and develop solutions. In developing solutions, the System will have to pursue legislative changes to implement them since each plan's benefit increase structure is specified in statute. The System will also need to determine if the solutions should apply to all members or members hired or retired on or after a specific date, and consider whether a constitutional change might be warranted (see Recommendations 2.2 and 2.3). In collaboration with stakeholders, the System should:

a. Determine whether a higher funded status for each plan should be required before providing a benefit increase;

   Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

b. Determine whether a simple instead of a compound structure may be more sustainable for its plans;

   Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

c. Consider whether it should link its permanent benefit increases to the Consumer Price Index, and if so, whether it should provide full inflation protection;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

d. Consider changing its permanent benefit increase structure for the PSPRS plan and CORP to be based on the funded status of individual employers instead of each plan's overall aggregate funded status;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. There are a number of practices based on aggregate numbers. Changing the PBI structure to be based on individual employer funded levels will be considered along with those other practices.*

e. Consider whether increases for all three plans should be applied to a certain amount of a member's pension benefit, such as the first $18,000;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

f. Consider changing EORP benefit increase formula to be based on asset value similar to the PSPRS plan and CORP, instead of retired members' estimated pension obligations;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

g. Consider modifying the PSPRS plan's permanent benefit increase structure to be based on an individual member's pension benefit; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

h. Identify other necessary changes, such as basing benefit increases on long-term investment performance instead of a 1-year result, or consider whether benefit increases should be eliminated.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We will consider basing benefit increases on long-term investment performance instead of a 1-year result, but do not think eliminating benefit increases altogether is appropriate.*

2.2 Once solutions have been decided upon, the System and stakeholders should determine if the changes should apply only to members who are hired or retire after a specific date. If so, the System should pursue the necessary legislative changes to implement the solutions for all three plans' benefit increase structures. The outcome of the *Hall* lawsuit may impact the System's ability to make changes to the plans' permanent benefit increase structures for active members.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.3 The System should consider whether pursuing a ballot initiative to amend Arizona's Constitution would be warranted to make changes to the benefit increase structures for all three plans' members. Depending on how an amendment is worded it could supersede previous legal decisions. If considering an amendment, the System and stakeholders should ensure that this amendment is specific to the System plans' permanent benefit increases to ensure members' base pension benefits are not impacted.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.4 Throughout the process of developing solutions for the plans' benefit increase structures, the System should ensure it provides the necessary training or informational materials to ensure stakeholders and the public understand the purpose and impact of the proposed changes.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.5 The System should ensure that its actuarial assumptions appropriately include the estimated costs for its permanent benefit increases when conducting the System plans' annual valuations by:

a. Conducting an audit of its actuary as soon as possible; and

   Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Our internal governance policies state that "an actuarial audit or equivalent is conducted at least every seven (7) years." Three actuarial audits or equivalents were performed between 2005 and 2009, the last being performed by our current actuaries as part of their new engagement that year. In consultation with those actuaries, and accepted by the Board of Trustees' Operations, Governance Policy and Audit Committee, we agreed it would be best to wait until the* Hall *case is determined before conducting the next actuarial audit. It is our understanding and hope that the* Hall *case will be determined early enough to incorporate any necessary retro payments and return of contributions in this fiscal year if the Superior Court ruling is upheld. If so, performing the next actuarial audit as of June 30, 2016 will still be in compliance with our internal policies.*

b. Developing and implementing procedures for ensuring the actuarial audits' recommendations are reviewed and appropriately implemented.

   Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

Finding 3: Additional actions are necessary to improve the system plans' financial condition and long-term sustainability.

Recommendations

3.1 The System should develop and implement a funding improvement strategy. This funding improvement strategy will need to be at the participating employer level for the PSPRS plan and CORP, but at the plan level for EORP. In developing this strategy, the System should review and incorporate key elements from Rhode Island's funding improvement strategy that may reasonably help increase plans' funded statuses.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We have already discussed the need for a funding improvement strategy with employer stakeholders and will be working with them to develop it. We will review Rhode Island's funding improvement strategy and incorporate those key elements that may reasonably help increase an individual plan's funded status.*

3.2 The funding improvement strategy the System develops should consider:

a. Establishing the funded status level at which its plans should be considered at-risk, and work with its actuary to determine what would be appropriate;

   Response: *The finding of the Auditor General is agreed to and the audit recommendation will be* *implemented.*

b. Requiring annual certification of the at-risk funded status. This could be done as part of the annual actuarial valuations performed by the System's actuary;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

c. Specifying who must be notified when a plan is certified to be at-risk;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

d. Posting a notice of the at-risk status on its Website;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

e. Establishing the specific actions that can be taken when a plan or plan employer is determined to be at-risk, including a requirement that the actions be reviewed and approved by the System;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

f. Identifying who is responsible for the various actions, including the employer, an actuary, or system administrator;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

g. Establishing the amount of improvement in funded status that should be achieved; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

h. Determining time frames for completing the various actions, including an overall time frame for improvement in a plan's funded status.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.3 Once the System has developed a funding improvement strategy, to provide greater leverage, the System should pursue legislation to incorporate the funding improvement strategy and its various components within its statutes.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We will compare and contrast which elements are most appropriate for statute as some elements may need some flexibility to where a policy is more appropriate. We will seek legislation, coupled with policy, to ensure the most effective strategy is followed.*

3.4 The System should work with the PSPRS plan and CORP employers and local boards, and other stakeholders, such as professional associates for firefighters or police, to explore the feasibility of offering multiple benefit options.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.5 If the System decides to offer a limited number of pension benefit options, it should take the following actions:

a. Determine the specific pension options that should be available;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

b. Determine the specific times and conditions under which an employer can change its options;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

c. Seek the necessary changes to the PSPRS plan and CORP laws to allow for employers to select options; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

d. Develop and implement training materials on the various pension benefit options and their costs so that PSPRS plan and CORP employers can make informed decisions about which benefit options would be the most appropriate.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.6 The System should develop and provide educational materials to PSPRS plan employers explaining how unusually large overtime pay increases the risk of generating unfunded liabilities. The System could work with the PSPRS plan's actuary to create and include in communications to plan employers, such as newsletters and retirement manuals, an explanation and examples of how compensation practices like unusually large overtime usage can generate unfunded liabilities for participating employers.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We are already doing this to some degree in our Local Board training program formally adopted by the Board of Trustees in 2008. We will review that material and expand as appropriate.*

3.7 The System should adopt practices similar to those in peer public pension plans to ensure that contributions are correct, including:

a. Establishing formal, written policies and procedures for system staff to flag and document any abnormal contributions that may indicate abnormal wage increases or contribution errors. These procedures should detail which staff will be responsible for completing these tasks;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Informal, unwritten procedures are already in place so we will make sure they are formally written and reviewed in accordance with our annual policies and procedures process.*

b. Establishing formal, written policies and procedures for system staff to investigate flagged contributions. These procedures should detail the necessary steps and documentation for any investigation as well as which staff will be responsible for conducting these investigations; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Informal, unwritten procedures are already in place so we will make sure they are formally written and reviewed in accordance with our annual policies and procedures process.*

c. Developing and implementing written policies and procedures for conducting regular audits of participating employers for compliance in reporting wages and contributions.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.8 To ensure that EORP has sufficient assets to cover its estimated pension obligations, the Legislature should consider revising A.R.S §38-810 to allow the Board to annually establish contribution rates or consider increasing its annual appropriations over time.

3.9 The System should continue its efforts to provide additional training to employers and local boards. In conducting such training, the System should ensure that employers and local board members understand the associated costs and effects of certain benefit decisions, such as long-term disability approvals and benefit calculations, as well as the significance of their individual funded status.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We are already doing this to some degree in our Local Board Training program formally adopted by the Board of Trustees in 2008. We will review that material and expand as appropriate.*

Sunset factor analysis

Recommendations

1. The System should:

   a. Train IT staff on the roles and responsibilities of its updated disaster recovery plan;

      Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This has already been completed.*

   b. Develop processes for reviewing, approving, and implementing its IT policies; and

      Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This has already been completed.*

   c. Implement additional controls on its hosted website, such as encryption technologies, to prevent unauthorized access of confidential system information.

      Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Just to clarify for the public, the hosted website referred to is for Board of Trustee meeting material only. All personally identifiable and other confidential membership information and material is hosted internally and very secure. We have received assurance from the third-party host that this website will be made secure before the end of October.*

2. The Board and System should enhance its internal audit function by:

   a. Revising the System's internal audit charter to ensure internal and external assessments are conducted and work with the Board to schedule an external assessment of the internal audit function;

      Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. The Internal Audit and Compliance Officer prepared an internal review of the IIA standards and how they are addressed at PSPRS for the Auditor General as part of this review. We will incorporate this review into a self-assessment review and expand as needed. We will also schedule an external review for this fiscal year.*

   b. Requiring that internal auditors disclose any conflicts of interest and their appropriate mitigation to the Operations, Governance Policy and Audit Committee;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

c. Periodically reviewing its internal audit charter, including requiring internal auditors to regularly brief the Board on the purpose, authority, and responsibility of the internal audit function according to the charter. In addition, the Board should also amend the internal audit charter to require these activities; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. In March of 2012 the Internal Audit Officer, in conjunction with audit partner from our external audit firm, made a presentation of the roles of Internal Audit, External Audit and the Audit Committee. This has not been updated since then; however, there has been no turnover on the Board, but we will expand upon this presentation to more frequently and fully comply with this recommendation.*

d. Developing and implementing policies and procedures to guide internal audit functions.

Response: *The finding of the Auditor General is not agreed to, but the recommendation will be implemented. We have established policies and procedures, but agree they are not sufficiently documented. We will include this documentation as part of the Internal Audit and Compliance plan for the current Fiscal Year.*

3. To enhance its processes for addressing members' issues, the System should:

a. Develop and implement formal, written policies and procedures for handling member communications to ensure that system staff provide uniform treatment to members. These policies and procedures should define what member communications should be documented and tracked;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

b. Develop and implement a central record that details when members' issues are received, the nature of the issue, the system staff members who handled the issue, and when, and how the issue was resolved; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

c. Develop and implement procedures for requiring a regular analysis of the centralized record to identify and address systemic causes of trends in member issues.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

Again, we thank you for the enormous amount of time and effort you and your staff have put into this report and look forward to it again ten years from now.

Respectfully,

Jared A. Smout
Administrator

Performance Audit Division reports issued within the last 18 months

14-102	Gila County Transportation Excise Tax
14-103	Arizona State Board of Dental Examiners
14-104	Arizona Office of Administrative Hearings
14-105	Arizona Board of Executive Clemency
14-106	State of Arizona Naturopathic Physicians Medical Board
14-107	Arizona Department of Child Safety—Children Support Services—Emergency and Residential Placements
14-108	Arizona Department of Administration—Arizona State Purchasing Cooperative Program
15-101	Arizona Department of Child Safety—Child Abuse or Neglect Reports, Substantiation Rate, and Office of Child Welfare Investigations
15-102	Arizona Department of Administration—State-wide Procurement
15-103	Arizona Medical Board—Licensing and Registration Processes
15-104	Arizona Department of Transportation—Motor Vehicle Division
15-105	Arizona Department of Revenue—Use of Information Technology
15-CR1	Independent Review—Arizona's Child Safety System and the Arizona Department of Child Safety
15-CR1SUPP	Supplemental Report to the Independent Review—Arizona's Child Safety System and the Arizona Department of Child Safety
15-106	Arizona State Retirement System
15-CR2	Independent Operational Review of the Arizona State Retirement System's Investment Strategies, Alternative Asset Investment Procedures, and Fees Paid to External Investment Managers
15-107	Arizona Sports and Tourism Authority
15-108	Arizona Department of Administration—Personnel Reform Implementation
15-109	Arizona Department of Administration—Sunset Factors
15-110	Arizona Foster Care Review Board

Future Performance Audit Division reports

Arizona Commerce Authority