STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

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DEPUTY AUDITOR GENERAL

October 16, 2015

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. Paul Matson, Director
Arizona State Retirement System

Mr. Jared Smout, Administrator
Public Safety Personnel Retirement System

Transmitted herewith are two reports of the Auditor General, *Information Brief—A Comparison of Arizona's Two State Retirement Systems* and *Information Brief—Alternatives to Traditional Defined Benefit Plans*. These information briefs were developed in conjunction with the performance audits and sunset reviews of the Arizona State Retirement System (see Report No. 15-106) and the Public Safety Personnel Retirement System (see Report No. 15-111), which were conducted in response to an October 3, 2013, resolution of the Joint Legislative Audit Committee and as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq.

These information briefs provide additional information pertaining to the two state retirement systems and alternative types of retirement plans. The briefs do not include recommendations.

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

Sincerely,

Debbie Davenport
Auditor General

Attachments

cc: Arizona State Retirement System Board of Trustees
Public Safety Personnel Retirement System Board of Trustees

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STATE OF ARIZONA
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A Comparison of Arizona's Two State Retirement Systems

INFORMATION BRIEF

The State sponsors two retirement systems for government employees—the Arizona State Retirement System (ASRS) and the Public Safety Personnel Retirement System (System). Although these retirement systems are independent of each other and differ in terms of structure, membership, size, and benefits, they are sometimes perceived as the same. This information brief provides a comparison of the two retirement systems, highlighting some of the similarities and differences between the ASRS and the System as discussed in-depth in their 2015 performance audits and sunset reviews (see ASRS Report No. 15-106 and System Report No. 15-111). In addition, Table 1 (see page 2) provides fiscal year 2014 information for both retirement systems.

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Benefits and members

The ASRS and the System were established in 1953 and 1968, respectively, to provide defined benefit (pension) plans to state and local government employees. In addition, both the ASRS and the System offer disability benefits, health insurance premium subsidies, and survivor benefits. However, there are key differences between the members of and defined benefit plans offered by the ASRS and the System (see ASRS Report No. 15-106, pages 1 through 5, and System Report No. 15-111, pages 1 through 6, for more information regarding each retirement system's members and benefits).

Both the ASRS and the System provide defined benefit retirement plans—The ASRS administers the ASRS defined benefit plan (ASRS plan) and the System administers three defined benefit plans: the Public Safety Personnel Retirement System plan (PSPRS plan), the Corrections Officer Retirement Plan (CORP), and the Elected Officials' Retirement Plan (EORP) (see textbox). These defined benefit plans provide guaranteed lifetime pension benefits.

> **Defined benefit plan**—An employee retirement plan that provides a guaranteed lifetime retirement benefit of an amount calculated by a predetermined formula. The ASRS and the System direct how contributions are invested.

ASRS benefits cover general public employees—The ASRS plan is available to employees of participating employers, including the State and the State's counties, universities, community colleges, school districts, and municipalities. As of June 30, 2014, the ASRS had 690 participating employers and over 550,000 active, inactive, retired, and disabled members and other beneficiaries. In addition to the ASRS plan, the ASRS also provides long-term disability and survivor benefits as well as optional retiree health insurance and a health insurance premium benefit to offset the cost of health insurance premiums to its members.

System benefits cover public safety personnel, correctional workers, and elected officials—The System administers three retirement plans, each of which provides benefits to different types of government employees:

- The PSPRS plan covers public safety personnel such as police and firefighters;
- CORP covers correctional workers such as state and local corrections officers, detention officers, parole and probation officers, corrections administrators, and dispatchers; and
- EORP covers elected officials and judges of certain state, county, and local governments.[1]

As of June 30, 2014, the three plans combined served 302 participating employers and nearly 55,000 members. Similar to the ASRS, the System plans provide disability and survivor benefits as well as health insurance premium subsidies to its members.[2]

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1 Laws 2013, Ch. 217, 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, pursuant to A.R.S. §38-831 et seq.

2 The System does not contract with a health insurance plan, but it provides retired members and their survivors who choose health insurance through the Arizona Department of Administration (ADOA), ASRS, or their former employer with monies to defray the costs of their medical and dental insurance premiums.

Table 1: Comparative information for Arizona's two state retirement systems As of and for the year ended June 30, 2014 (Unaudited)

Retirement System information	Arizona State Retirement System (ASRS)	Public Safety Personnel Retirement System (System)		
Defined benefit plans administered	ASRS plan	PSPRS plan, CORP, and EORP		
Number of retirement system employees[1]	226.4	46.25		
Number of board members	9	7		
Expected annual rate of investment return	8.00%	7.85%		
Actual rate of investment return	18.60%	13.47%		
Individual plan information	**ASRS plan**	**PSPRS plan**	**CORP**	**EORP**
Number of members	551,296	32,172	20,372	2,045
Types of employees covered by plan	Employees of the State and local governments, including counties, municipalities, and educational institutions	Public safety personnel, such as police officers and firefighters	Includes detention, corrections, parole, and probation officers	Elected officials and judges of certain state, county, and local governments
Number of participating employers	690	237	27	38
Average age of active members	45.7 years	39.7 years	39.6 years	55.6 years
Average salary of active members	$43,841	$75,048	$42,841	$81,069
Average age of retired members	70.1 years[2]	63.8 years	63.8 years	71.5 years
Average annual normal retirement pension benefit	$19,668[2]	$54,761	$27,908	$52,608
Average age at normal retirement	60.3 years[2]	51.4 years	56.7 years	61.1 years
Member contribution rates (as percent of compensation)	11.30%[3]	10.35%	8.41%	13.00%
Employer contribution rates (as percent of compensation)	10.70%[3]	30.44% (average)[4]	13.68% (average)[4]	23.50%
Net position restricted for benefits[5]	$35.5 billion	$6.2 billion	$1.6 billion	$337 million
Pension, survivor, and disability benefits paid	$2.7 billion	$527.1 million	$105.3 million	$54.0 million
Funded status[6]	76.30%	49.20%	57.30%	39.40%
Cost to administer retirement system (percent of net position restricted for benefits)[5]	$29,786,000 (0.095%)	$5,826,300 (0.094%)	$1,437,700 (0.090%)	$315,900 (0.094%)

1 The number of ASRS employees is as of June 2015 and the number of system employees is as of May 2015. Both numbers represent filled full-time equivalent positions.

2 The ASRS includes beneficiaries when calculating the average age of retired members, average annual normal retirement pension benefit, and average age at normal retirement.

3 The ASRS employee and employer contribution rate is not equal because of how the ASRS must record the health insurance premium contribution (see footnote 2, page 4, for more information).

4 This percent is an aggregate of all employers' variable contribution rates. See page 4 for more information.

5 Net position restricted for benefits reflects the net resources available to pay benefits to members at the end of the fiscal year.

6 Funded status is the ratio of assets to estimated pension obligations and represents the percentage of obligations to active, inactive, and retired members at a point in time that could be paid with assets on hand. For the PSPRS plan and CORP, each participating employer has an individual funded status and for each of these plans, this total funded status is an aggregate of each employer's funded status. For more information, see pages 5 through 6.

Sources: Auditor General staff review of statutes, agency-prepared documents, and information from the ASRS, PSPRS plan, CORP, and EORP comprehensive annual financial reports and actuarial valuations as of June 30, 2014.

Board and agency structure

Both the ASRS and the System are administered by their respective agencies with each of their board's oversight. However, each agency and board is structured differently and therefore administers benefits differently (see ASRS Report No. 15-106, pages 4 through 6, and System Report No. 15-111, pages 6 through 8, for more information regarding agency and board composition and responsibilities at each retirement system).

ASRS is centrally administered—The ASRS plan and other benefits are centrally administered by an agency of approximately 226 employees with oversight from a 9-member Board of Trustees (ASRS board). The ASRS board is responsible for setting investment policy goals and objectives, allocating assets to meet investment goals and objectives, and reviewing the performance of investment managers to ensure their attainment of and adherence to the board-approved investment policy's goals and objectives. The ASRS plan is a cost-sharing, multiple employer plan where participating employers' and their members' contributions are pooled. All ASRS plan assets are equally shared and are used to pay the pension benefits of any participating employer's retirees as well as the costs of administering the ASRS plan, including asset management.

System both centrally and locally administered—Like the ASRS, the System is also composed of an agency with board of trustee oversight. Similar to the ASRS board, the System's Board of Trustees (system board) is responsible for 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. However, key differences include that the system board has 7 members and fewer agency employees (approximately 46), and the System's structure is driven by its varying degrees of statutory responsibility for its three defined benefit retirement plans. Specifically:

- **PSPRS plan**—The structure of this plan is decentralized as each employer that participates in the PSPRS plan has a local board that is responsible for following applicable statutes to make eligibility determinations and calculating benefit amounts. The cost of administering the PSPRS plan is paid through an agent-multiple employer arrangement where each employer has an individual account for only its assets from which the costs of only its employees' benefits and a fractional share of administering the System are paid.
- **CORP**—Like the PSPRS plan, CORP has a local board structure and is an agent-multiple employer arrangement.
- **EORP**— Unlike the PSPRS plan and CORP, EORP is a cost-sharing multiple-employer plan in which the System does not account for pension plan assets or estimated pension obligations for each employer. Instead, EORP assets may be used to pay the pensions for members from any participating employer. In addition, statute does not designate a local board structure. Rather, the System is responsible for performing functions such as making eligibility determinations and calculating benefit amounts according to statutory requirements.[1]

Finally, the System is somewhat centrally administered as it is also responsible for managing the three plans' assets, which are combined for investment purposes.

Budget and investments

Retirement benefits at both the ASRS and the System are funded by employer and member contributions and investment income. However, there are key differences in the amount of contributions collected and the size and composition of the ASRS' and the System's investment portfolios. See ASRS Report No. 15-106, pages 6 through 9, and System Report No. 15-111, pages 8 through 12, for more information

[1] Laws 2013, Ch. 217, closed EORP to new members as of January 1, 2014.

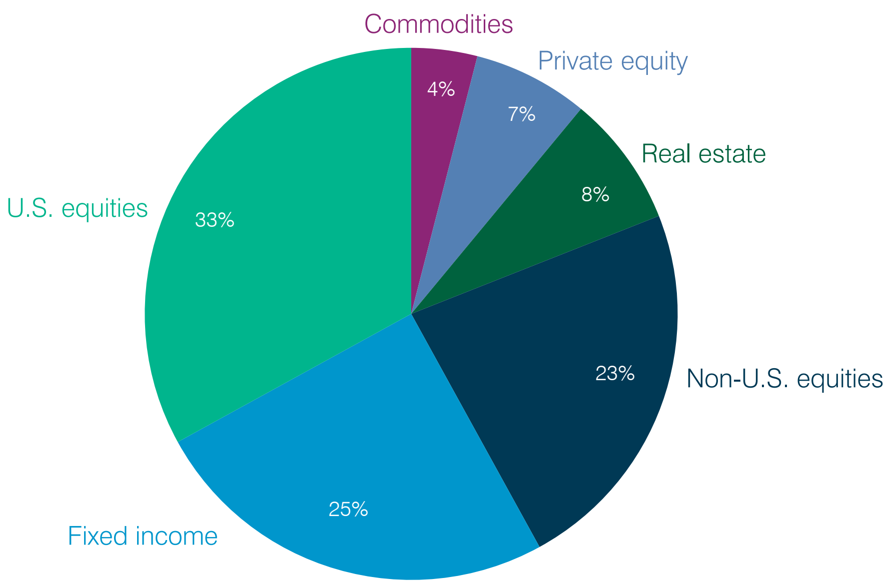
regarding the budgets and investments at each retirement system.[1]

ASRS invests equal contributions—In fiscal year 2014, employers and members each paid 11.54 percent of the members' compensation for a 23.08 percent total contribution rate with the majority of this amount, 22 percent, covering the retirement benefit.[2] The remaining 1.08 percent covers the cost of the long-term disability and health insurance premium benefits.

Investment income generally has been the ASRS' largest source of revenue and is used along with contributions to cover the ASRS plan's benefits and other costs. The ASRS does not receive any State General Fund appropriations, but its administrative expenses are appropriated by the Legislature. As of June 30, 2014, the ASRS held investments with a value of about $35.5 billion and paid about $2.7 billion in pension and disability benefits in fiscal year 2014.

The ASRS invests money according to a board-approved investment policy, which is required to be consistent with statutory requirements. The ASRS investment portfolio is composed of six types of assets that fall within three broad asset classes: equities, fixed income, and commodities and real estate. In fiscal year 2014, the ASRS' asset allocation policy targeted a majority of the ASRS' portfolio to be invested in equities (63 percent) and fixed income (25 percent) (see Figure 1).

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



[1] Percentages represent ASRS' asset allocation policy targets.

Source: The ASRS *Popular Annual Financial Report For Fiscal Year Ended June 30, 2014.*

System invests variable contributions on behalf of three plans—In fiscal year 2014, contributions for each of the three plans the System administered varied greatly in terms of amount and the percentages paid by the employer and members (see Table 1, page 2, for employee contribution rates, and the System Report No. 15-111, pages a-1 through a-9, for individual PSPRS plan and CORP employer contribution rates). This is because employee contribution rates for each of the three system plans are set in statute, but employers must pay a higher contribution rate as determined by an actuary each year to ensure the plans are able to meet their pension obligations if the employee rate is not sufficient.

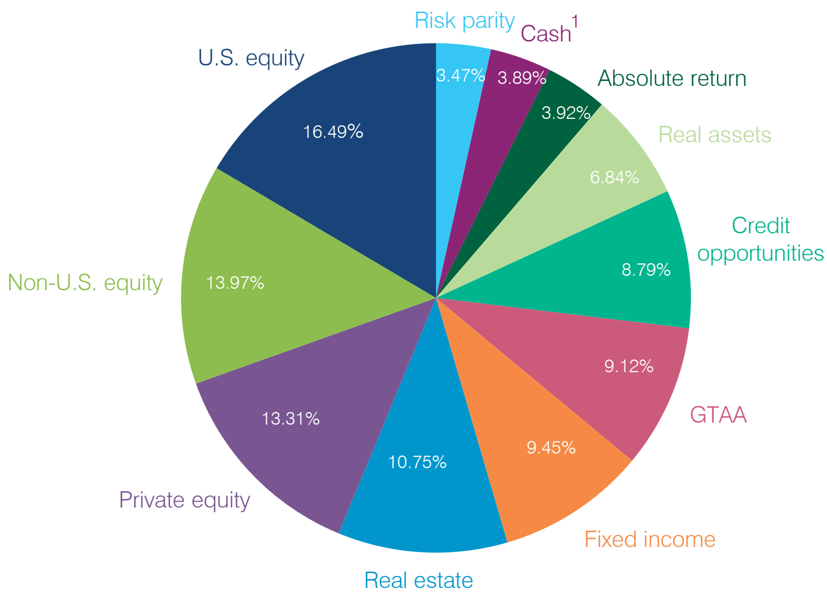
[1] In addition, as a part of the ASRS and System sunset reviews, the Office of the Auditor General retained Gallagher Fiduciary Advisors, LLC (Gallagher) to conduct operational reviews of the ASRS' and System's investment strategies, alternative asset investment procedures, and fees paid to external investment managers. To review Gallagher's observations and recommendations in these areas, see ASRS Report No. 15-CR2 and System Report No. 15-CR3.

[2] The 23.08 percent total contribution rate funds retirement benefits, long-term disability benefits, and the health insurance premium (see ASRS Report No. 15-106, page 3, for more information). According to the ASRS, 100 percent of the health insurance premium contribution (0.60 percent) is reflected in the employer rate to comply with U.S. Internal Revenue Code requirements. As a result, Table 1 on page 2 reports that for the retirement benefit, the employee contribution rate is 11.30 percent and the employer contribution rate is 10.70 percent. However, the overall total contribution for both employer and employee is 11.54 percent.

Similar to the ASRS, the System's largest source of revenue generally is investment income, which is used along with contributions to cover the three retirement plans' benefits and other costs. 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 them. Aside from an annual $5 million appropriation from the State General Fund for EORP, the System's monies are not subject to legislative appropriations.[1]

As of June 30, 2014, the System's three plans had a combined asset value of about $8.1 billion and paid about $836 million in benefits in fiscal year 2014. The System invests money according to the System's board-approved investment policy, which is required to be consistent with statutory requirements. This policy includes an asset allocation strategy that establishes ten investment classes: equities (domestic, foreign, and private), real estate, fixed income, credit opportunities, global tactical asset allocation, real assets, absolute return, and risk parity (see Figure 2). In fiscal year 2014, more than half of the System's portfolio consisted of investments in equities and real estate.

Figure 2: System's investment portfolio composition As of June 30, 2014 (Unaudited)



1 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.*

Funded status

The funded status for the ASRS plan and the System's three plans varies (see ASRS Report No. 15-106, pages 11 through 13, and System Report No. 15-111, pages 13 through 17, for more information regarding the funded status of each retirement plan). Funded status, which measures the sufficiency of a pension plan's assets to meet its estimated pension obligations for benefits that have been earned by all plan members (active, inactive, and retired), is a general indicator of a pension plan's health at a specific point in time. Although funded status will vary over time, best practice organizations indicate that public pension plans should target a 100 percent funded status.

1 This appropriation for EORP started in fiscal year 2014, and was the first of 31 annual payments to the System required by the legislation that closed EORP to new members in 2014 (see System Report No. 15-111, pages 43 through 44, for more information).

ASRS plan's funded status was 76.3 percent as of June 30, 2014—As of June 30, 2014, the ASRS plan's funded status was 76.3 percent, which means that on that date, the ASRS had assets to cover 76.3 percent of its estimated pension obligations. However, as of June 30, 2005, the ASRS plan's funded status was 86.1 percent. Unmet investment return expectations between June 30, 2005 and June 30, 2014, were in part responsible for this decline in the ASRS plan's funded status. Although the ASRS plan's funded status is below 100 percent, the ASRS has processes in place to improve the ASRS plan's funded status, such as increasing the percentage of an employee's salary that is contributed to pay for the ASRS plan's costs. In addition, it has recommended, and the Legislature has enacted, statutory changes that will help improve the ASRS plan's long-term sustainability over time, such as requiring employees who are hired on or after July 1, 2011, to be older or work longer to be eligible for pension benefits.

The System's three plans' funded statuses varied from 39.4 percent to 57.3 percent as of June 30, 2014—As of June 30, 2014, the funded status for the System's three plans was 49.2 percent for the PSPRS plan, 57.3 percent for CORP, and 39.4 percent for EORP.[1] Two principal factors that contributed to the system plans' low funded statuses are required permanent benefit increases and unmet long-term investment returns. Actions that the System and Legislature have taken, which have been consistent with best practice, have not reversed this trend. Specifically, although the System has made changes such as increasing contribution rates and adopting a funding policy and the Legislature has adjusted the pension benefit formula for new members and restructured permanent benefit increases, the system plans' funded statuses have continued to decline. Additionally, changes to permanent benefit increases for members who had retired on or before July 1, 2011, were ruled unconstitutional.

Board independence

Auditors' research identified some support for allowing public retirement systems to establish their own budgets, procurement rules, and personnel rules. Arizona's Constitution requires that the ASRS' and System's assets be held in independent trusts and invested, administered, and distributed solely in the interests of their members and beneficiaries. The ASRS and the System's Boards of Trustees are also statutorily responsible for making decisions that are in the best interests of members of the retirement plans they administer. In addition to approving investment policies, this responsibility includes making operational decisions related to budgeting, procuring goods and services, and managing personnel. According to section 5 of the Uniform Management of Public Employee Retirement Systems Act (UMPERSA), trustees should be able to establish a budget, procure and dispose of goods and services as needed, and employ or contract for services necessary to perform the trustees' duties independently of the plan sponsor.[2,3] For the ASRS and the System, the plan sponsor is the State. However, the ASRS and the System's Boards of Trustees do not have independence in all of these areas. In addition to research, auditors also reviewed statutes pertinent to board independence in these areas for seven peer retirement plans.[4] Of the seven peer plans auditors selected in total for the ASRS and the System, not all have authority in these areas.

Authority to establish budget—UMPERSA §5 indicates that public pension trustees should have authority to establish a budget. According to the model law's commentary, independence is important in this area to ensure the trustees may fulfill their fiduciary obligations free from pressures from others who are not subject to those obligations.

To be equivalent to UMPERSA, a public pension must be able to develop its budget and have the authority to withdraw from the fund whatever is needed for its budget. The Legislature has ultimate control over the ASRS' administrative expenditures, but if the ASRS and Legislature agree in practice on budgets, then the budget process could be effectively equivalent to the model law. However, the Legislature modifies the budgets the

[1] 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. See System Report No. 15-111, pages 15 through 16, and Appendix A, pages a-1 through a-9, for more information.

[2] UMPERSA is a model law developed in 1997 by the Uniform Law Commission. As of September 2015, Maryland and Wyoming have enacted it.

[3] Uniform Management of Public Employee Retirement Systems Act, §5, *Powers of Trustee*.

[4] Auditors selected peer retirement plans for the ASRS and the System to conduct some audit work for their performance audits and sunset reviews. For more information regarding auditors' selection methodology used to find comparable retirement plans and the peers selected, see the ASRS Report No. 15-106, pages a-1 through a-2, and the System Report No. 15-111, pages b-1 through b-2.

ASRS proposes on a regular basis. Similar to the model law, the System's monies are not subject to legislative appropriations.

Authority to procure and dispose of goods and services—UMPERSA §5 states that a public pension's trustees should have the authority to procure and dispose of goods and services as necessary to exercise the trustees' powers and duties, including actuarial, custodial, investment, and legal services.

The ASRS has some statutory authority to independently procure services. Specifically, the ASRS has the authority to obtain investment management services, but for all other procurements is subject to the state procurement code. Similar to the model law, the System is exempt from the state procurement code.

Authority to employ or contract for personnel—UMPERSA §5 states that a public pension's trustees should have the authority to employ personnel or contract for the services necessary to perform the trustees' duties.

Neither the ASRS' nor the System's statutes provide the personnel authority recommended by the model law. Specifically:

- **Salary—**Statute gives the Arizona Department of Administration (ADOA), rather than the ASRS' or the System's Board of Trustees, the authority to set salaries for their staff;
- **Terms of employment—**Both the ASRS and the System are part of the State's personnel system and subject to its requirements; and
- **Incentive compensation—**Statutes require that the ASRS and the System consult with ADOA when developing incentive compensation plans for investment-related personnel.

Trustee authority at ASRS' and System's peer retirement systems—In addition to UMPERSA, auditors also reviewed statutes for the seven peer public pension plans auditors selected for comparison to the ASRS and the System.[1] Auditors determined that about half of the ASRS' and the System's peers have budget and procurement authority and one-third of the peers have the authority to set their own personnel policies. Specifically, of the seven peers:

- **Budget—**Four peers' trustees have the authority to set a budget (Nevada, Michigan, Missouri, and Rhode Island); three do not (Mississippi, South Carolina, and Tennessee);
- **Procurement—**Three peers' trustees do not have to follow the plan sponsor's procurement code (Michigan, Missouri, and Rhode Island), two do (South Carolina and Tennessee), and two must follow procurement code except when procuring services related to investment services and trust administration (Mississippi and Nevada); and
- **Personnel—**Two peers' trustees do not have to follow the plan sponsor's personnel rules (Michigan and Missouri), three do (Rhode Island, South Carolina, and Tennessee), and two must follow personnel rules but may set their own policies for executive staff (Mississippi and Nevada).

1 The four peers auditors selected for the ASRS are the Public Employees' Retirement System of Mississippi (Mississippi); the Public Employees' Retirement System of Nevada—Regular Employees (Nevada), the South Carolina Retirement System (South Carolina); and the Tennessee State Employees, Teachers and Higher Education Employees Pension Plan (Tennessee). The three peers auditors selected for the System are the Municipal Employees' Retirement System of Michigan (Michigan); Missouri Local Government Employees Retirement System (Missouri); and the Rhode Island Municipal Employees' Retirement System (Rhode Island).

A Comparison of Arizona's Two State Retirement Systems

A copy of the full report is available at:

www.azauditor.gov

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