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May 13, 2016

The Honorable John Allen, Chair
Joint Legislative Audit Committee

The Honorable Judy Burges, Vice Chair
Joint Legislative Audit Committee

Dear Representative Allen and Senator Burges:

Our Office has recently completed an initial followup of the *Public Safety Personnel Retirement System* (the System) regarding the implementation status of the 44 audit recommendations (including sub-parts of the recommendations) presented in the performance audit report released in September 2015 (Auditor General Report No. 15-111). As the attached grid indicates:

- 5 have been implemented;
- 24 are in the process of being implemented;
- 1 legislative recommendation has not been implemented; and
- 14 are not yet applicable.

Our Office will conduct an 18-month followup with the System on the status of the recommendations that have not yet been fully implemented.

Sincerely,

Dale Chapman, Director
Performance Audit Division

DC:ka
Attachment

cc: Jared Smout, Administrator
Public Safety Personnel Retirement System

Public Safety Personnel Retirement System Board of Trustees

Public Safety Personnel Retirement System

Auditor General Report No. 15-111

Initial Follow-Up Report

Recommendation

Status/Additional Explanation

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

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;

The System collaborated with stakeholders to provide input for Laws 2016, Ch. 2, which was passed in the 2016 legislative session. For Public Safety Personnel Retirement System plan (PSPRS plan) members hired on or before June 30, 2017, this legislation repeals the statutes relating to permanent benefit increases and replaces them with a cost-of-living adjustment. However, these changes are contingent on approval of a constitutional amendment the Legislature referred to voters in a special election that will be held on May 17, 2016. Laws 2016, Ch. 2, also establishes cost-of-living adjustments for PSPRS plan members who are hired on or after July 1, 2017, and this change is not contingent on approval of the constitutional amendment. However, the changes made through Laws 2016, Ch. 2, do not apply to the System's two other defined benefit plans—the Corrections Officer Retirement Plan (CORP) and the Elected Officials' Retirement Plan (EORP). Changes to permanent benefit increases have yet to be made for CORP and EORP members.

Implementation in process

Laws 2016, Ch. 2, requires a higher funded status before providing a cost-of-living adjustment for PSPRS plan members hired on or after July 1, 2017, but there is no funded status requirement for PSPRS plan members hired before that date. Specifically, for members hired on or after July 1, 2017, the PSPRS plan must be at least 70 percent funded before a cost-of-living adjustment can be provided, and members cannot receive the maximum 2 percent cost-of-living adjustment unless the PSPRS plan has a funded status of 90 percent or higher. These changes do not apply to CORP or EORP.

Implementation in process

The changes made through Laws 2016, Ch. 2, establish a compounding cost-of-living adjustment to the PSPRS plan member's base benefit. For members hired on or before June 30, 2017, the changes are contingent on voter approval of a constitutional amendment. These changes do not apply to CORP or EORP.

Recommendation

Status/Additional Explanation

- 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;

Implementation in process

Laws 2016, Ch. 2, repeals the statutes relating to permanent benefit increases and replaces them with a cost-of-living adjustment that is linked to the Consumer Price Index, not to exceed 2 percent annually. However, for members hired on or before June 30, 2017, these changes are contingent on voter approval of a constitutional amendment. These changes do not apply to CORP or EORP.

Implementation in process

According to the System, it has had discussions about this recommendation, but it has not yet determined whether the funded status requirement should be at the individual employer or the aggregate plan level. Specifically, although Laws 2016, Ch. 2, requires a funded status of at least 70 percent before providing a cost-of-living adjustment for PSPRS plan members hired on or after July 1, 2017, the System has not yet determined if this new tier of members will be part of a cost-sharing plan or part of an agent multiple-employer plan. The PSPRS plan for members hired on or before June 30, 2017, is an agent multiple-employer plan where pension assets are pooled for investment purposes, but each participating employer is responsible for its own pension obligations and has its own funded status. Under a cost-sharing plan, participating employers' and members' contributions are pooled and the plan assets are equally shared and used to pay the pension benefits of any participating employer's retirees. Under a cost-sharing plan, the funded status is for the entire plan. In addition, there is no funded status requirement for members hired on or before June 30, 2017, but changes for these members are contingent on voter approval of a constitutional amendment. Finally, the changes made through Laws 2016, Ch. 2, do not apply to CORP.

Implementation in process

According to the System, this recommendation was discussed and considered; however, Laws 2016, Ch. 2, requires that cost-of-living adjustments for the PSPRS plan be based on a retired member's base benefit, and does not limit the increase to a certain amount of a member's pension benefit. For members hired on or before June 30, 2017, changes are contingent on voter approval of a constitutional amendment. However, the changes made through Laws 2016, Ch. 2, represent a change in how benefit increases are calculated for PSPRS plan members (see explanation for Recommendation 2.1g for more information). These changes do not apply to CORP or EORP.

Recommendation

Status/Additional Explanation

- 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.

Implementation in process

According to the System, changes for EORP were discussed with legislative members and stakeholders, but the Legislature decided to focus on changes to the PSPRS plan.

Implementation in process

Laws 2016, Ch. 2, establishes cost-of-living adjustments that will be based on individual PSPRS plan member's pension benefit. Prior to this change the benefit increase was determined using the average pension benefit of retirees, and each member received the same benefit increase amount regardless of the size of their pension, which resulted in disproportionate benefit increases. However, for members hired on or before July 30, 2017, these changes are contingent on voter approval of a constitutional amendment.

Implementation in process

According to the System, it was determined that benefit increases were important and should not be eliminated. Laws 2016, Ch. 2, maintained benefit increases in the PSPRS plan by replacing them with cost-of-living adjustments. In addition, the cost-of-living adjustments are not tied to investment performance, but rather to the Consumer Price Index (see Recommendation 2.1c, for more information). However, for members hired on or before June 30, 2017, these changes are contingent on voter approval of a constitutional amendment. These changes do not apply to CORP or EORP.

- 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.

Implementation in process

See explanation for Recommendation 2.1.

- 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.

Implementation in process

See explanation for Recommendation 2.1.

Recommendation

Status/Additional Explanation

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.

Implementation in process

The System has informed its members regarding the impact of some of the changes made through Laws 2016, Ch. 2, to the PSPRS plan. According to the System, it plans to develop an information and training program by June 30, 2017, to communicate changes made to the System's plans.

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

Implementation in process

The System has developed a document proposing additional contract expenses for its Board to consider for fiscal year 2017, which includes an actuary audit. The System will be requesting approval of these additional contract expenses from the Board during an upcoming board meeting. The System indicated that it plans to conduct this audit by June 30, 2017.

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

Not yet applicable

The System plans to develop procedures after the next actuarial audit is conducted. See explanation for Recommendation 2.5a.

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

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.

Implementation in process

According to the System, it has discussed the need for a funding improvement strategy with some stakeholders and plans to work more with employers in the coming year. In addition, the System believes that the advisory committee established by Laws 2016, Ch. 2 may also provide guidance to the System's Board on the funding improvement strategy.¹ The System estimates that a funding improvement strategy would be completed by June 30, 2017.

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;

Not yet applicable

See explanation for recommendation 3.1.

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;

Not yet applicable

See explanation for Recommendation 3.1.

¹ Laws 2016, Ch. 2, requires the System to establish an advisory committee on January 1, 2017. The committee will consist of ten members who are participating employers or members of the PSPRS plan, CORP, and EORP. The advisory committee will serve as a liaison between the System's Board and the System's members and employers.

Recommendation	Status/Additional Explanation
<ul style="list-style-type: none"> 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; 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. 	<p>Not yet applicable See explanation for Recommendation 3.1.</p>
<p>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.</p>	<p>Not yet applicable See explanation for Recommendation 3.1.</p>
<p>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.</p>	<p>Implementation in process The System sent an e-mail on November 5, 2015, to stakeholders, such as the Arizona Law Enforcement Association and the Professional Fire Fighters of Arizona, informing them of the need to discuss the feasibility of offering multiple benefit options during a meeting scheduled for November 13, 2015. The System indicated that it was the consensus of the stakeholders that offering multiple benefit options was not something they wanted to pursue. However, the System did not provide documentation of its discussion with stakeholders. In addition, the System did not provide information about whether the feasibility of offering multiple benefit options was discussed with employers and local boards.</p>
<p>3.5 If the System decides to offer a limited number of pension benefit options, it should take the following actions:</p> <ul style="list-style-type: none"> 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 	<p>Not yet applicable See explanation for Recommendation 3.4.</p> <p>Not yet applicable See explanation for Recommendation 3.4.</p> <p>Not yet applicable See explanation for Recommendation 3.4.</p>

Recommendation

Status/Additional Explanation

- 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.

Not yet applicable

See explanation for Recommendation 3.4.

- 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.

Implementation in process

The System developed materials explaining how unusually large overtime pay increases the risk of generating unfunded liabilities and reported that it is in the process of scheduling meetings with PSPRS plan local boards to discuss these materials.

- 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.

Implemented at 6 months

Implemented at 6 months

Implementation in process

According to the System, it is considering whether to use a private firm to conduct regular audits of participating employers or expand its staff to do so. Once it makes this decision, the System reported that it will develop policies and procedures for conducting such audits. The System estimates its policies and procedures will be completed by June 2017.

- 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.

Not implemented

The Legislature did not introduce any bills in the 2016 legislative session that would revise A.R.S. §38-810 to allow the Board to annually establish EORP contribution rates or to increase its annual appropriation to the System over time.

Recommendation

Status/Additional Explanation

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.

Implementation in process

The System provided one training in February 2016 to CORP local board members that discussed the cost and effects of certain benefit decisions, such as long-term disability approvals and benefit calculations, as well as the significance of each employer's individual funded status.

Sunset Factor #2: The extent to which the Department has met its statutory objective and purpose and the efficiency with which it has operated.

1. The System should:

- 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.

Implemented at 6 months

Implemented at 6 months

Implemented at 6 months

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 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.

Implementation in process

The System reported that the Board began a governance manual review in March 2016. The review will include adding internal and external assessments to its internal audit charter. Arizona State Retirement System internal audit staff has agreed to conduct a review of the System's internal assessment, and the System reported that it is working to identify an organization to provide an external assessment.

Implementation in process

The System reported that it is developing a process for mitigating and disclosing conflicts of interest to the Board and that this process will be incorporated into its internal audit charter.

Implementation in process

The System reported that the Board began a governance manual review in March 2016. The review will include incorporating requirements for the Board to periodically review its internal audit charter and for internal auditors to regularly brief the Board on the purpose, authority, and responsibility of the internal audit function.

Implementation in process

The System reported that it is in the process of creating an audit manual and written procedures to guide the internal audit function.

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

1. 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;
- 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.

Implementation in process

The System is developing a central record to log member issues and track how its staff handle them. System staff have created five categories to classify member complaints and these complaints will be documented and tracked through this central record. The System reported that it is currently testing this central record, and once this testing is complete, the System will develop procedures for handling member issues and conducting a regular analysis of the central record.

Implementation in process

See explanation for Recommendation for Sunset Factor 6, 1a.

Implementation in process

See explanation for Recommendation for Sunset Factor 6, 1a.
