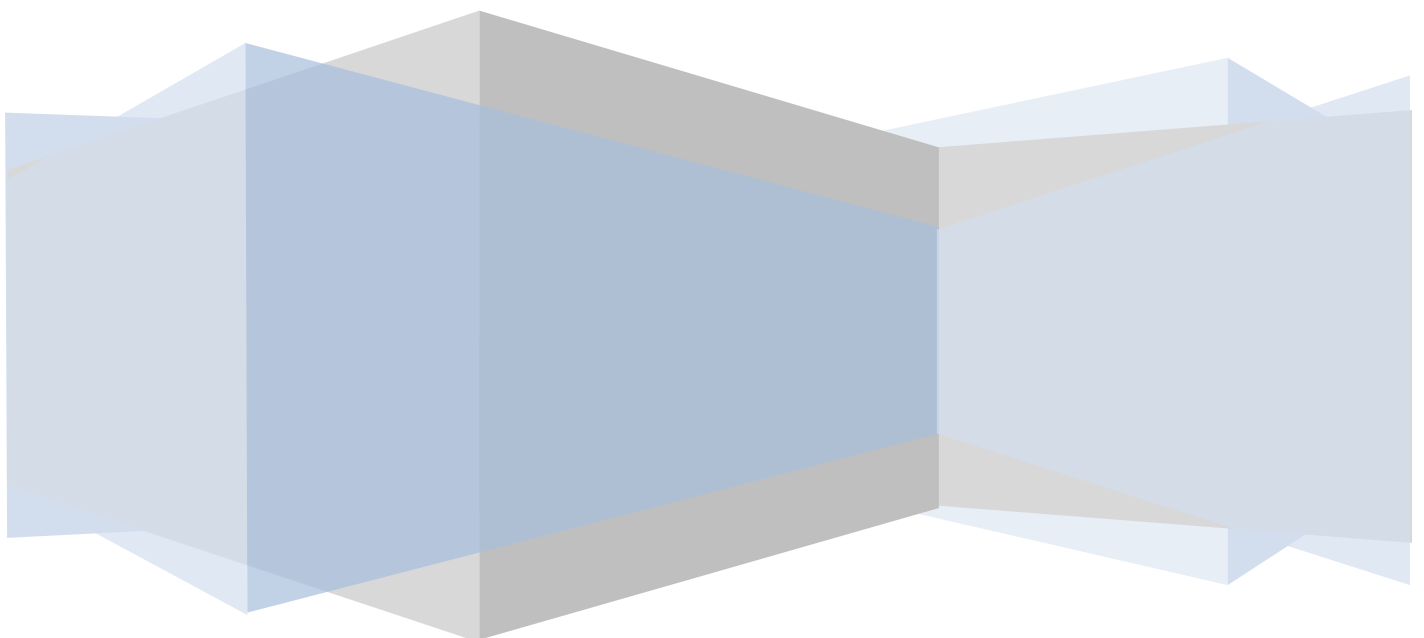


The Yardstick: A Tool to Evaluate Proposed Reforms of Arizona's Public Safety Personnel Retirement System (PSPRS)

Final Report

August 19, 2015

Prepared by the League of Arizona Cities and Towns'
Pension Task Force



Presented to and Approved by the
League of Arizona Cities and Towns Executive Committee on August 19, 2015

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August 19, 2015

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RE: Public Safety Pension Reform Recommendations from the Pension Reform Task Force

President Mitchell and Members of the Executive Committee,

The Task Force believes reforming PSPRS is one of the most important financial issues facing the taxpayers in the State of Arizona, as the current system is not sustainable. To provide perspective on the magnitude of this issue, the system's total unfunded liability at June 30, 2014 was \$6.2 billion; 72% of this amount (\$4.5 billion) relates to Arizona's cities and towns for their police departments (\$3.0 billion) and fire departments (\$1.5 billion). Arizona cities and towns have 120 plans within PSPRS (74 for police and 46 for fire), which include about 22,000 employee and retiree members.

Arizona's cities and towns are the system's largest participant and our involvement in reform is critical. The Task Force began its work in June, 2014 and has provided updates to the Executive Committee on three occasions over this period of time, sharing our observations and thoughts. Over the course of our work, we have completed a tremendous amount of education, communication and outreach having met with all stakeholders including:

- Staff from the Governor's Office;
- Staff from the Treasurer's Office;
- State Legislators and staff;
- The State Legislative Pension Group led by Senator Lesko and Representative Olson;
- Labor associations;
- PSPRS Board and staff;
- PSPRS' Actuaries;
- Arizona State Retirement System (ASRS) staff;
- Elected officials of cities, towns, counties, and fire districts;
- The Arizona Tax Research Association (ATRA);
- The Reason Foundation;
- Public Pension Associations and National Subject Matter Experts;
- The County Supervisor Association;
- The Arizona City and County Management Association (ACMA); and
- The Government Finance Officers Association of Arizona (GFOAz).

This extensive process has been invaluable by providing education to the Task Force and to the others that were involved. For example, the Yardstick recommends creating the “third leg” of the retirement stool for those members not in the Social Security system by creating a replacement-like program. This recommendation resulted directly from the feedback provided by the labor associations.

Additionally, we developed ‘Employer Recommended Practices’, which are ideas for employers to implement immediately, to improve the financial condition of their pension plans. These ideas have been very well received and have, in fact, already improved the final condition of those who have taken action. Specifically, the Task Force has relentlessly described a plan’s unfunded liability as “debt” and challenged employers to develop ways to eliminate and reduce it.

I also mention these specific ideas because it shows the depth and level of understanding the Task Force has developed about the system. Prior reform efforts have not resulted in these ideas, and when combined with the Yardstick, we expect will result in the necessary reform. The Task Force strongly believes the Yardstick can play an important role in the reform discussions and decisions, but it is not intended as a reform proposal. Rather, the Yardstick identifies the key elements that need to be addressed through reform. As designed, it is a tool that we can use to assist in the evaluation of pension reform proposals and by communicating your position on important reform issues.

On behalf of all members of the Task Force, I want to thank the Executive Committee for the opportunity to participate in this process – it has been our privilege. We feel we have provided a professional assessment and thorough analysis that serves both the taxpayers and pension participants.

Respectfully submitted,

A handwritten signature in black ink that reads "Scott McCarty, CPA". The signature is written in a cursive, flowing style.

Scott McCarty
Chair
Finance Director
Town of Queen Creek

Executive Summary

Currently, the Arizona Public Safety Personnel Retirement System (PSPRS) is comprised of 256 employer (individual) plans with roughly 32,000 active members and retirees. Of the 256 plans, the financial condition and employer contribution (ER) rate varies amongst each; however, the employee contribution (EE) rate is set uniformly by state law and presently fixed at 11.65%. The growing unfunded liability and anticipated demand on the system has generated multiple reform efforts over the years. As of June 30, 2014 the total underfunded liability was \$6.2 billion, with the funded status varying greatly across the 256 plans; 216 plans are less than 100% funded.

The current system is unsustainable and reform is necessary. The declining financial condition of PSPRS has accelerated the call for action and spurred the creation of the Task Force by the League of Arizona Cities and Towns Executive Committee, to assess the current system and identify the next steps to provide the necessary relief.

The PSPRS Task Force was formed in June, 2014, through the leadership of the Executive Committee of the League of Arizona Cities and Towns in partnership with the Arizona City/County Managers Association (ACMA) and the Government Finance Officers Association of Arizona (GFOAz). Fifteen members comprise the Task Force, with all members currently or formerly holding executive positions in Arizona government.

The Task Force was formulated to undertake a comprehensive review of PSPRS, but rather than develop a specific reform proposal, the Task Force created the Yardstick. The Yardstick identifies the goals, characteristics, and elements of a viable and sustainable, well-designed public safety pension system. As the name suggests, it is an evaluation tool for the current system and for potential reform proposals for Arizona's public safety pension system. This report explains the approach of the Task Force, discusses the elements of the Yardstick, and how creating an approach consistent with the Yardstick will create a more sustainable and affordable system, while still attracting the highest quality employees.

The conclusions of this report are as follows:

1. The current system is unsustainable and comprehensive reform is necessary.
2. Achieving successful reform is a shared responsibility of system members, elected officials, employers, and taxpayers.
3. The Yardstick reflects characteristics of a well-designed public safety pension plan.
4. The Yardstick is a tool to evaluate reform (not a specific proposal) and to aid in communicating the reform elements important to employers.

How Did We Get Here?

PSPRS is a multi-agent employer, defined benefit pension plan. Meaning, once vested, an employee/beneficiary is guaranteed a monthly benefit based on years of service and salary. The plan is funded by a combination of contributions from employees, employers (taxpayers), and investment gains. Within the system, there are 256 individual plans, with each maintaining their own provisions and requirements. For example, the City of Phoenix has two plans within the system, one for fire and a second plan for police.

There are two components that determine the pension amount: normal cost and unfunded liability. The ratio of a plan's assets to liabilities reflects its funded status and measures the value of current assets to pay for the future pension benefits employees have earned. A funded ratio of 100% means the plan has a net present value equal to the present value all of its obligations. Again, because there are 256 individual plans, each plan has its own unique funded status and unique employer contribution requirements. As of the June 30, 2014, 216 of the 256 plans were less than 100% funded, with the total unfunded liability equaling \$6.2 billion.

Over the past few years, funded status has been declining for most plans. This growing unfunded liability results in increased annual pension costs for employers (because the employee contribution is capped); meaning a larger share of an employer's budget is spent on pension costs, with fewer resources are available for public safety and other essential services. This impact is best measured by calculating the percent of pension costs expressed as a percent of an entity's operating budget. This measurement also allows for comparability across employers, to assess their relative position. There are some cities in which the pension contributions for both police and fire represent about 20% to 25% of operating revenues, with no immediate relief in sight.

A combination of many issues have caused this declining financial condition, including investment losses, benefit increases, the permanent benefit increase calculation, governance, and inadequate reform in 2011. If we do not evaluate past reform efforts, we are likely to repeat the same mistakes, making it critical to develop an understanding of these issues and the appropriate approach to reform. The issues discussed in the following paragraphs summarize some of the challenges PSPRS has faced.

Investment Losses

One of the most obvious impacts has been the stock market downturn in 2000 and the Great Recession in 2007-2009. These severe economic conditions have caused investment return to be lower than actuary assumptions. Since employee contribution rates are capped, increased

employer contributions have been needed to cover the shortfall. Historically, the PSPRS Board has been reluctant to reduce the interest rate assumptions to more accurately reflect this.

Benefit Increases

The creation of the Deferred Retirement Option Plan (DROP) was a cost to the system when it was first implemented. This program was intended to allow employers to retain highly-experienced personnel who intended to retire after their minimum years of service. Under DROP, the retirement benefits are allocated to a separate account and bear interest at a specified rate, which is problematic for employers when those returns are not produced by the market.

Permanent Benefit Increase (PBI)

The current system provides for an annual Permanent Benefit Increases (PBI), which functions like a dividend. One half of annual investment earnings in excess of 9% are separated out, placed into a separate fund, and paid to retirees as a PBI by dividing this amount by the number of retirees. As a result, each retiree receives the same dollar amount increase.

This method is problematic because years of high investment returns are not available to offset years of low returns. Dollars that could have been used to increase a plan's assets (and reduce its unfunded liability) are paid out to retirees, leaving the system without a safety net to cover years with low returns. The PBI is paid out regardless of the financial condition and funded status of a plan and it is done system wide. As an example, retirees in the Town of Bisbee fire plan receive these increases even though the plan is 8.0% funded.

It is also important to point that prior to FY 2015-16, the cost of the PBI was not included in the employer contribution rate. Excluding the PBI from the calculation effectively underestimated the normal cost of the pension plan, causing it to manifest itself in the unfunded liability. This issue was identified by PSPRS actuaries several years ago, but the PSRPS Board did not take action to address it.

Governance

The PSPRS Board of Trustees functions as the plan administrator responsible for fiduciary responsibilities, such as investment management, setting actuarial assumptions, and benefits administration. Additionally, unique to this system, is the fact that each plan has a local board. The local board makes decisions regarding eligibility, such as accepting members into the plan and determining disability retirements.

In practical terms, it means each local entity is responsible for managing a public safety pension plan, or plans. For example, the City of Phoenix has to manage two pension plans: police and fire. Self-management has proven to be an issue. Other than the largest member employers in the system, most entities do not have the resources and professional staff to manage a pension

system. As such, they rely on the PSPRS Board and administration to provide oversight and management of their plans.

Unfortunately, self-management and the PSPRS Board have not resulted in the type of active management needed to prevent unfunded liabilities. For example, only a handful of employers have completed a detailed study of how their actual performance has compared to the actuarial assumptions. To this point, the Task Force created “Employer Recommended Practices” to assist employers with evaluating and improving the financial condition of their plan. These are included in this report as Appendix A and we encourage all employers to implement these practices.

Finally, given the fact that the employee contribution is capped at 11.65% of salary, any differences between actuary assumptions and actual performance manifests in unfunded liability, which is the sole responsibility of the employer.

2011 Failed Reform Efforts

Recent legal challenges have also had adverse financial impacts on the system. The rulings from the Fields Case and the Hall Case (still-pending) have left employers grappling with the impending fiscal impacts. The Fields Case restored the PBI for retirees and is estimated to have a financial impact in the vicinity of \$375 million. Assuming the Hall Case is ruled upon similarly, it will restore the PBI formula for current employees and return the employee contribution rate to the previously established fixed amount of 7.65% (from the current amount of 11.65%), resulting in retroactive reimbursements to employees, creating increased unfunded liabilities to many employers. Court decisions from across the country have produced similar results; pension promises to current employees and retirees are difficult to change and, if enacted, are sure to be litigated.

Reform Principles

It is important to note that the Task Force undertook a concerted effort to catalog all of the various interests present in pension reform. Collectively, the group sought to identify interests held by each group and develop alternatives that would generate reform, without undermining or violating other strong interests. This was done through a process that included educational presentations to the Task Force and subsequent discussions with subject matter experts from across the county. These presentations are identified in Appendix A and reference articles are identified as References at the end of this report. At the highest level, the Task Force set out to answer the following key questions:

- What should the Employee, Retiree, Employer, and Taxpayer get out of the pension system?
- How is this best accomplished?

These questions are answered using guiding principles and elements, called the Yardstick. The remainder of the report discusses these guiding principles and then identifies and explains each element of the Yardstick.

The guiding principles represent the common interests of employees/retirees and taxpayers/employers. The guiding principles are:

- Adequate and Affordable
- Financial Solvency
- Transparency and Accountability

Guiding Principle: Adequate and Affordable

Pension plans should provide adequate benefits yet be affordable to both the employee and employer. Some elements of a plan that impact its adequacy and affordability levels include: minimum age of retirement; minimum years of service; actuarial assumptions; social security participation by members; available health insurance benefits; and other key elements.

Income Adequacy

In a defined benefit plan, retirement benefits are determined by two factors (years of service and average income) and use a formula to determine the full applicable retirement benefit for recipients. The Task Force acknowledges that public safety positions are more physically/mentally demanding than most other governmental positions and that each retirement plan should be designed with this difference in mind. To this point, the Task Force spent a tremendous amount of time discussing the pros and cons of a Defined Contribution

plan and a hybrid plan. We believe a defined benefit plan best answers the Task Force’s key questions, meets the guiding principles and is ultimately the most cost-effective approach to managing plan adequacy.

System Affordability

The overall intent of the new reform efforts is to have a plan that provides a sustainable cost structure for the employee and the employer. Both the normal cost and unfunded liability must be aggressively managed to provide transparent and understandable contribution amounts. Targeting a funded status of 100% is the best way to ensure each generation pays their fair share. From the employer perspective, affordability is best measured by determining the percent of pension costs as a percent of an entity’s operating budget. Also, this provides comparability across employers, while comparing contribution rates does not. Lastly, if benefits are increased, they must be funded by contribution increases as there is no other funding source if all actuary assumptions are believed to be correct.

Guiding Principle: Financial Solvency

The primary financial objective of any pension system is to ensure it will be able to make its promised future benefit payments. Both the funded status and its trend (whether increasing or decreasing) are important metrics that measure solvency. Ideally, action should be taken to prevent wide swings in a plan’s funded status. For example, if a plan’s funded status is decreasing and not addressed, future taxpayers will be forced to pay more.

In this regard, understanding trends leads to identifying management and policy issues. A routine, critical evaluation of actuary assumptions is of the highest importance. As an example, if a plan has a higher than expected number of disability retirements, the evaluation may suggest enhancements to the employer’s worker compensation program as appropriate.

Financial performance is also greatly impacted by investment strategies, which can be very complicated and difficult to understand, especially in changing economic markets.

Guiding Principle: Transparency and Accountability

The governance structure is especially critical to the success of a pension plan. A healthy and well-run system will be evident through its structure and design. The structure must be simple enough for users to understand, without being confused by terminology, complex formulas, lengthy descriptions, or excessive options.

To be transparent and ensure accountability, a healthy system will rely on simplicity to meet the core needs (benefits) of its members. By focusing on core needs, a plan will enhance its ability to be healthy, accountable, and transparent.

A transparent plan will clearly identify systems, structures, and responsibilities. Experts should be utilized to provide advice, guidance, direction, and functionality for the system. Expert advice should be accepted unless there is a logical and defensible reason not to. In either case, the advice and any contrary determinations should be publicized in order to provide opportunities for public comment.

Customer Service

A sign of a healthy and well-run system is the level of service that it provides to its users. Users include, but are not limited to: employees and employers enrolled in the system; government and financial institutions; the media; and citizens. Good service includes timely and consistent responses to inquiries, knowledgeable and easily understandable communication that is easily accessible, and a commitment of resources to ensure that the information is delivered timely to those who need it. A system that achieves these objectives will often have a simplistic workflow, process, and forms; it will utilize an approach that is less complicated in structure, making it easier to convey how the system works to others.

A dedicated resource to address the questions and needs of those who utilize the system, such as a liaison, can often create a buffer between the more technical operations of the system and the end users. A liaison can often coordinate multiple requests and make sure that the system provides transparent and accountable service.

Outreach and Education

Providing the necessary and adequate levels of education to keep members informed and involved is vital for transparency between plan administrators and plan members. Users must receive regular training in both a structured group setting and in a one-on-one setting (as long as the training is consistent from one user to the next). Computerized training, on-line tutorials, and other easily accessible electronic visuals can provide alternate ways of providing consistent data and information that is often relegated to legal documents and manuals.

A system that achieves these objectives will often provide regular trainings, user meetings, tutorials, and a breakdown of complex legal and legislative language into a more simplified and user-friendly product. The most transparent and accountable forms of education start with a source document (the enabling legislation) and build from that. Appropriate documentation requires that any source be cited, which ensures transparency with what is “cast in stone” and what is based on operational needs and efficiency. This allows the users to understand what is open for interpretation and what is not.

Documents that are not proprietary should be readily available and accessible to everyone. Users should be able to view all aspects of how the system operates, not just their particular area. From start to finish, a solid understanding of system operations helps reduce questions and confusion, which is why access to documents and training materials should not be restricted, unless necessary.

Information and Data

Another sign of a healthy and well-run system is the level of data that it provides to its users. Users must receive regular data and communication that is clear, concise, useful, relevant, accurate, verified, timely, and compliant. To ensure transparency, all official reports, minutes, legislation, directives, guidance, interpretations, disbursements, budgets, revenues, audits, findings, and decision-making documents should be readily available, searchable, and accessible. To be useful, data must be presented in a timely manner.

A system that achieves these objectives will ensure that the data has been reviewed and certified, preferably by an independent third party or responsible administrative personnel. Every attempt should be made to ensure that a common user can understand and interpret the data. If the data is too complex, it should be accompanied by documents or documentation that explains the complexities. A system that is accountable should follow the same reporting requirements as the entity responsible for its existence or operation. This would include all financial operations from annual budgeting, to auditing, to daily functions such as purchasing, payroll, accounts payable/receivable, and so forth. The responsible entity should receive reports detailing all relevant financial activity, with all data and decisions being made public to the maximum extent permitted by law.

A transparent and accountable system will detail and break down data into base elements that aid informed decision making; however combining too much data actually restricts decision making. If data is combined, its source information should be available to aid in decision making and data interpretation. When operating as a government agency, or quasi government agency, laws and statutes that govern the responsible entity/government should be adhered to, including those related to bidding, advertising, publishing, and public notice.

Consistency

A sign of a healthy and well-run system is easily identifiable by the consistency of the information and communication provided. Users should come to expect consistent treatment in all matters; if precedence is established it should become the rule. Individual employers and employees should be able to apply past determinations to current decisions. This can best be achieved when there is one deciding entity/board for actions.

The Yardstick

After completing the educational process, which included testimony from subject matter experts, and identifying the guiding principles, the Task Force was poised to develop its reform recommendations. To this point, the Yardstick identifies the goals, characteristics, and elements of a viable and sustainable public safety pension system for the State of Arizona; it is not a proposal. Rather, as the name suggests, it is an evaluation tool for the current system and reform proposals. The balance of this report explains and discusses the elements of the Yardstick, and how creating an approach consistent with the Yardstick will create a sustainable system, which will serve to attract the highest quality employees while maintaining affordability for taxpayers. The Yardstick is shown on the following pages:

The Yardstick

1. DEFINED BENEFIT PLAN

- The pension benefit is predetermined by a formula based on employee compensation, age, and tenure of service

2. FREE FROM LEGAL CHALLENGE

- All current employees and all current retirees remain in the existing tiers

3. NEW STATEWIDE TIER

- For employees hired after July 1, 2016

4. PLAN ELEMENTS OF THE NEW STATEWIDE TIER

- **Pooled Assets and Liabilities.** Shares risk across the broadest base
- **Fully Funded.** Assets at least equal liabilities (at least 100%) over an economic cycle
- **Equal Cost Sharing.** There will be only one equal employer / employee contribution rate in the new tier
- **Funding New Benefits or Benefit Increases.** Funded as a tier component and only if the tier is determined to be fully funded before and after the change
 - **Pension Increases.** To maintain purchasing power
- **In-Lieu of Social Security Program.** Mandatory participation in an employer-matched Defined Contribution plan for those members not in Social Security to replicate a Social Security like benefit

5. GOVERNANCE STRUCTURE

- **System Design.** Structure that requires sustainable outcomes
- **Funding Policy.** Identifies financial objectives to ensure equity and sustainability
- **Investment Policy.** Identifies beliefs and objectives regarding asset allocation
- **Board of Trustees.** Independent, qualified professionals with fiduciary responsibility of ensuring compliance with Plan Elements
- **Administration.** Consolidated and one independent disability committee of qualified experts

The Yardstick's elements are further defined and discussed in the following section.

1. DEFINED BENEFIT PLAN

- The pension benefit is predetermined by a formula based on employee compensation, age, and tenure of service

As discussed in the 'Guiding Principles' section of the this report, the Task Force believes a defined benefit plan is the most cost effective way to provide pension benefits to public safety employees. Fewer years on the job and longer years in retirement are characteristics unique to public safety employees, so the predictability of retirement income is paramount; however, a structure should exist that prevents an employee from inflating (spiking) their pension.

2. FREE FROM LEGAL CHALLENGE

- All current employees and all current retirees remain in the existing tiers

The Task Force believes that changing benefits for existing employees and retirees will be legally challenged both at the state and federal level and ultimately reversed. Court cases from across the country and Arizona have reversed attempts to change benefits to existing members and retirees. Most recently in Arizona, in the Fields Case, the Arizona Supreme Court reversed changes to the retiree PBI, which forced PSPRS to revert back to the way it was originally administered.

This also raises concerns about the length of time legal challenge and corresponding litigation can take. Essentially, the system is in a holding pattern while litigation is pending, as is the situation with the Hall case. It is highly probable that this case, which was filed in response to the 2011 reform, will not be decided until 2016, or later. For these reasons, any proposed reform should avoid legal challenges to the maximum extent possible.

3. NEW STATEWIDE TIER

- For employees hired after July 1, 2016

It is legal to create a tier for new employees on a prospective basis. Doing so means the current tiers will close naturally, avoiding potential legal challenges; however, putting new hires in a different tier does not terminate them. Under this application, the 256 existing plans would be closed to new enrollment as of June 30, 2016, but the plan would not dissolve completely until the last member (or beneficiary) of the plan passes away.

Opponents of this recommendation typically react by saying it will greatly increase costs. Costs that are incurred in this case are ones in which the plan is underfunded, meaning it was priced incorrectly. Closing the plan to new employees will not impact any of the current obligations or liabilities of the plan. Using basic pension funding principles, assets should equal liabilities based on current membership at any time. If a plan is underfunded, the solution is not adding more members to the plan, it is contributing more for the members currently in the plan.

4. PLAN ELEMENTS OF THE NEW STATEWIDE TIER

- **Pooled Assets and Liabilities.** Shares risk across the broadest base

The primary purpose of pooling is to achieve economies of scale that are gained when risk and volatility are spread across the broadest base. It is recommended that new members entering into PSPRS be pooled into one tier. The 256 plans would not be replicated in the new tier and pooling would help disperse the risk and volatility in the new tier. Also, each jurisdiction would still be responsible for their unfunded liabilities of the current plan. A new plan would address the exchange of resources when an employee transfers from one tier to another, under the current system. Every time this occurs in the current system, there is a winner and loser because each employer plan has a different funded status and contribution rate.

Additionally, the current system puts individual plans at extreme financial risk. For example, if an instance occurs that is an extreme anomaly as compared to the actuary assumptions (such as a high amount of disability retirements to regular retirements), employer costs will immediately spike.

Finally, public safety services are provided throughout the State of Arizona and without regard to jurisdictional boundaries. If public safety functions as one large system protecting the public, it seems appropriate that the pension system serves as one large system as well.

- **Fully Funded.** Assets equal liabilities (at least 100%) or greater over an economic cycle

Taxpayer and member equity is achieved only when funding equals 100%. If a plan is less than 100% funded, it means taxpayers and members have not paid their fair share up to that point and future taxpayers and members will be forced to make up the difference. Measuring funding over an economic cycle is also recommend, to account for natural changes in asset values that do not necessitate contribution increases. For example, in a down market with decreased asset values, a funded level of about 80% is acceptable. Similarly, in a strong

financial market, a funded level of about 125% is understandable. In both cases, the difference from 100% is attributable to market conditions, not the underlying financial structure of the plan.

- **Equal Cost Sharing.** There will be only one equal employer / employee contribution rate in the new tier

Equal cost sharing is a critical issue and the source of much debate. It is recommended that the costs of the new tier be shared equally by the employee and employer, since both parties would have the same position (neutral position) regarding decisions. Whether it's investment strategies, actuarial assumption, or benefit increases, both sides experience the same financial impacts of decisions when costs are shared equally; however, under the current system, the employee contribution is capped at 11.65% and the employee is insulated from bearing any additional costs. When the system achieves its expected financial goals, that responsibility is borne entirely by the employer.

Under this element, there would be only one employer / employee contribution rate; not 256.

- **Funding New Benefits or Benefit Increases.** Funded as a tier component and only if the tier is determined to be fully funded before and after the change

- **Pension Increases.** To maintain purchasing power

If you rely on all of your actuarial assumptions, benefit increases can only be paid for with contribution increases - there is no other source. Benefits should never be enhanced because the plan is well funded. Funding new benefits is a plan element that ties together several other Yardstick elements. Specifically, it emphasizes the importance of the recommended cost sharing element. If benefit increases are made, both parties should pay equally, but that is not the case under the current system. Presently, if benefit increases are made, the employer pays the full cost because the employee contribution is capped.

Additionally, the Task Force believes the new tier should include cost-of-living-adjustments (COLAs) to maintain the purchasing power of a retiree's pension. The financial impact of COLAs should be included in the normal cost, not isolated in a separate fund and funded from investment performance. As discussed earlier, the current system's separate fund and dividend structure has had an adverse financial impact on the system's financial condition.

- **In-Lieu of Social Security Program.** Mandatory participation in an employer-matched Defined Contribution plan for those members not in Social Security to replicate a Social Security like benefit

Retirement is often described as a three-legged stool, with one leg as the public pension, the second leg as personal savings, and the third leg as Social Security. Not all members of PSPRS participate in Social Security, which creates different retirement realities for each member. Many cities in Arizona employ a sworn police force that participates in Social Security; however, the same cannot be said about sworn fire fighters, who are typically exempt from participation.

Mandatory participation in Social Security would be a challenging feat. If PSPRS were to mandate that all members participate in Social Security, it would require a 100% vote by the current membership. Although this route would be ideal by offering another leg of the stool to members, it would be challenging to achieve.

The Deferred Retirement Option Plan (DROP) was conceived as a necessary mechanism to deal with the “baby boomer retirement tsunami” and has been subsequently defended as a necessary mechanism to allow retirees to pay for health insurance benefits between retirement and Medicare eligibility. The Task Force believes the metrics used to determine retirement eligibility should be adhered to and not extended via DROP. Given the demanding physical and mental elements of public safety jobs, the benefit should be funded based on the eligibility criteria, not automatically extended. We see DROP as a costly method to extend retirement and a significant cost to employers during that period; therefore, it is recommended that the Deferred Retirement Option Plan not be included in any future system design.

Nonetheless, the issue of accumulating resources to pay for healthcare from retirement to Medicare eligibility, as well as other reasons for portable retirement savings, is valid. To address this, the Task Force developed the idea of creating a Social Security-like replacement program for those not eligible for Social Security. Essentially, the replacement program would function as a defined contribution plan where both the employer and employee contribute equally.

5. GOVERNANCE STRUCTURE

- **System Design.** Structure that requires sustainable outcomes
- **Funding Policy.** Identifies financial objectives to ensure equity and sustainability

- **Investment Policy.** Identifies beliefs and objectives regarding asset allocation
- **Board of Trustees.** Independent, qualified professionals with fiduciary responsibility of ensuring compliance with Plan Elements
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Successful reform is not possible in Arizona unless the current governance structure is addressed. For example, since Arizona has such a unique system with 256 financially distinct plans, not addressing its shortcomings will dilute plan design and financial reform outcomes. The importance of change in this area cannot be overestimated.

The very structure of PSPRS itself contributes to the problems of fiscal sustainability. It is highly inefficient to maintain 256 separate entities, creating an administrative cost burden and in most cases, a lack of expertise and oversight. Creating one system will result in one pension funding policy, one investment policy, one set of financial information, one funded status, one actuarial report, one disability board, and one set of performance measures. This will eliminate the role of the employer, making management the responsibility of the PSPRS Board and administration. Currently, that responsibility is shared and has not proven successful.

There is a woeful lack of clear understanding on the part of participating employers on the fundamental actuarial and accounting aspects of the current system that directly contribute to calculating the employer contribution and the plan's unfunded liability.

The system should develop ongoing training and communication avenues to educate member employer elected officials and administrators on how contribution rates are determined and most specifically, the impact of individual unfunded liabilities, and potential ways to address that liability. New GASB rules related to reporting pension liability in 2015 should foster a new awareness on the part of system employers.

Further vigilance in establishing initial eligibility under the disability provisions of the system as well as the ongoing affirmation of such disability may be compromised by the lack of expertise in a given local board. Thus, it is our position that the necessary changes be made in law and policy to provide for a centralized processing and adjudication of all disability claims (both service-related and ordinary). The new system being created would not maintain local boards, instead it would utilize the system's administration to manage new hires, transfers, withdrawals, disability claims, and so forth.

The system's board should be comprised of independent, qualified professionals who are not impacted in any way by the policies and decisions made by the board or by the administrative

staff. Creating these requirements ensures impartial decision-making and the discharge of the board's fiduciary duty.

Finally, consolidating PSPRS and Arizona State Retirement System (ASRS, Arizona's other public pension system) administration is anticipated to result in a cost savings to taxpayers. At its core, both PSPRS and ASRS perform the same functions of administering pensions and investment monies. In fact, ASRS already manages the retiree healthcare plan used by PSPRS. In regards to the size of the investment portfolio, number of members, and other aspects, PSPRS is about 10 percent the size of ASRS.

Under such a scenario, there would be two divisions of the state's public pension system: one for public safety and one for non-public safety (ASRS). There are nuances that result from these two different plans, but at the macro level, they both perform the same functions, and if consolidated, would likely result in decreased costs.

The Yardstick: Its Effects

Now that we have explained the Yardstick, this section identifies the effects of the Yardstick. The effects are discussed from two perspectives: (i) employees/retirees and (ii) employers/taxpayers.

Employees/Retirees

The Yardstick identifies best practices that are fiscally sustainable as well as new resources that can be redirected by the employer to the current system, in order to reduce or eliminate its unfunded liability. How this can be accomplished is discussed later.

Also, since it identifies the option of a third leg of the retirement stool, while maintaining a defined benefit plan, it can still attract quality employees.

Employers/Taxpayers

The Yardstick identifies best practices that are less expensive to employers and taxpayers as well as being more transparent. The best practices can be less expensive and identify ways that current plans can be more affordable for the following reasons:

1. **Lowers the Cost for New Employees.** The unfunded liability is a significant cost component of the current plan. As an example, the current employer contribution rate for the City of Phoenix's police plan is 50%, or \$50K for a police officer earning \$100K. Of this \$50K, \$13K represents normal cost and \$37K relates to the unfunded liability. This cost of \$37K is eliminated in the new system because it does not have an unfunded liability.

2. **Allows an Employer to Reallocate Savings to Reduce or Eliminate Costs of the Current System.** Savings from the employees enrolled in the new plan can be redirected to pay down the liability of the current plan because the cost for new employees is less expensive. Again, using the City of Phoenix example above, \$37K could be used per new employee to reduce costs of the current system.
3. **Equalizes Contributions for Employees and Employers.** The current employee contribution is capped at 11.65%, so anytime the system needs to increase contributions, they are made by the employer. In the new system, costs that would otherwise be fully paid by employer are now split equally.
4. **Reduces Employer Contribution Volatility.** Pooling the assets and liabilities absorbs entity specific shocks.
5. **Creates Affordable Retiree Pension Increases.** Creates a COLA and eliminates the dividend model, which does not allow earnings from a good year to offset earnings from a bad year.
6. **Reduces Administrative Costs.** Operating one plan (not 256) in conjunction with ASRS will cost less money at the statewide level as well as for the individual employers (i.e. disability boards eliminated). Changing the governance to be more strategic will ensure the success of other reform efforts. Creating a pension funding policy that targets 100% funded status can be effectively achieved under one system; with 256, it is difficult. Having only one plan will be easier to evaluate, communicate, and administer.

Conclusions

As we begin to project the future of the Arizona Public Safety Personnel Retirement System (PSPRS), in its current form, it will not be able to provide the security and support needed by its 32,000 active members and retirees. Maintaining 256 employer (individual) plans has resulted in a fragmented and inconsistent approach to retirement planning. Many factors have led to the dire conditions of this system, from poor investment returns to the structure of permanent benefits and the overall governance of the system; PSPRS is suffering death by a thousand paper cuts. The growing unfunded liability and anticipated demand on the system has spurred multiple attempts at reform, with negligible success. To date, judicial rulings on previous attempts to modify the system, the Fields Case and Hall Case (still-pending), have failed to reduce employer liability, forcing the retroactive payment of benefits to the tune of \$375 million. As of June 30, 2014, the total underfunded liability was \$6.2 billion, with 216 of the 256 plans being funded at less than 100%.

Meager investment returns and the Deferred Retirement Option Plan (DROP) strained the system when the market failed to yield its projected returns. Permanent Benefit Increases (PBI) only compounded the negative impact to employers by increasing future liabilities on investment earnings exceeding 9%, which offered no insulation when the market suffered shocks and underperformed. The dismal financial conditions of PSPRS have heightened the call for action, spurring the creation of the Task Force by the League of Arizona Cities and Towns Executive Committee. The fifteen-member Task Force assessed the current system and identified a tool to evaluate various reform proposals, provided throughout this document.

During the comprehensive review of PSPRS, the Task Force developed a specific reform assessment tool: The Yardstick. The Yardstick identifies the goals, characteristics, and elements of a viable and sustainable, well-designed public safety pension system. As the name suggests, the Yardstick functions as an evaluation tool for the current system and any potential reform proposals for PSPRS. This report was intended to provide clarity around the approach of the Task Force, the elements of the Yardstick, and how creating an approach consistent with the Yardstick will create a more sustainable system that attracts talented employees at a more affordable rate.

The conclusions of this report are as follows:

1. The current system is unsustainable and comprehensive reform is necessary.
2. Achieving successful reform is a shared responsibility of system members, elected officials, employers, taxpayers.
3. The Yardstick reflects characteristics of a well-designed public safety pension plan.
4. The Yardstick is a tool to evaluate reform (not a specific proposal) and to aid in communicating the reform elements important to employers.

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Appendix A: Presentations Made to the Task Force

August 15, 2014 Presentations:

1. PSPRS. League of Arizona Cities and Towns' PSPRS Pension Task Force.
2. PSPRS. Investment Update Arizona PSPRS Trust.

September 12, 2014 Presentations:

1. Gabriel Roeder Smith & Company. Arizona PSPRS Pension Task Force "Actuary 101"
2. Arizona State Retirement System. A Requested Presentation on Pension Plan Concepts, Data, and Information.

October 3, 2014 Presentations:

1. National Institute on Retirement Security. Critical Issues for Key Public Pension Stakeholders.
2. Laura and John Arnold Foundation. Protecting Workers and Taxpayers: Responsible Public Pension Reform.
3. Kutak Rock LLP. Pension Task Force: Options for Governments to Obtain Relief from Pension Liabilities Post *Fields*

October 10, 2014 Presentations:

1. National Conference on Public Employee Retirement Systems. Presentation to the Arizona's Public Safety Pension Task Force.
2. NEPC, LLC. Pension Investment Strategies (In a Low Return World).
3. Grand Canyon Institute. PSPRS: On Track to Financial Sustainability with Retirement Security with One Exception.
4. National Conference of State Legislatures. State Retirement Reform Legislation.

October 24, 2014 Presentations:

1. National Association of State Retirement Administrators. Overview of Public Pension Issues and Plan Designs.
2. The PFM Group. Arizona Public Safety Pension Task Force Presentation.
3. Professional Fire Fighters of Arizona. Fixing the PSPRS Pension Fund.
4. Gabriel Roeder Smith & Company. Arizona PSPRS Pension Task Force.

Appendix B: Employer Recommended Practices



AZ PSPRS Pension Task Force

2015 EMPLOYER WORKSHOPS



You are one of 256 individual employers participating in the Arizona Public Safety Personnel Retirement System (PSPRS). While there are many plan aspects that are universal, your employer contribution rate is unique to you...and so is your funded status and unfunded liability. New GASB rules will bring sharp focus on your unfunded liability in 2015 and we need to prepare our organizations and our elected officials for this revelation.

It has been said that Arizona's public pension programs are "unsustainable". A ballot measure was considered by Phoenix voters in 2014 (but failed) which would have replaced their defined benefit plan with a defined contribution retirement plan for all non-public safety employees. In response to these items and similar issues being debated around the country, the League of Arizona Cities and Towns, in partnership with the Arizona City/County Management Association and the Government Finance Officer's Association of Arizona, assembled a Task Force to take a comprehensive look at PSPRS, identify areas of improvement and develop reform recommendations. A group of 15 representatives from Arizona's cities, towns and counties, reflecting the diversity of PSPRS plan members, began meeting in July, 2014. The Task Force's final report will identify three essential elements of a well-designed pension program and is intended to be the "yardstick" against which reform proposals can be evaluated. The three elements are: 1) adequate and affordable, 2) financially solvent, and 3) transparent and accountable. The Employer Workshops are an important part of the Task Force's work in developing this yardstick.

- Constants for Every AZ PSPRS Plan:**
- Employee contribution percentage
 - Benefit formula
 - Plan economic assumptions:
 - Net investment return
 - Price/Wage growth rate
 - Population growth rate
 - Retirement/turnover/mortality/disability rates

- Variables for Each AZ PSPRS Plan:**
- Number/age/service of active employees
 - Number/age of retired/disabled employees
 - Number/age of employees in DROP
 - Interest earned on Plan balance



Have you ever read your annual PSPRS Actuarial Valuation Report? If you've never studied your report, it contains all of the calculations used in arriving at your contribution rate and unfunded liability. The report shows your normal cost calculation and provides your *minimum* contribution requirement...which is the number we typically use in our budgets. And, in all fairness, that's what is required of us. If you are one of the 84 employers who currently have a funded percentage of 80% or more (considered by many to be the measure of a "healthy plan"), congratulations. But don't get too comfortable. Your employee demographics will change for a variety of reasons and, therefore, your funded status will likely decrease.

In cannot be emphasized enough, you are managing a pension plan and have a fiduciary responsibility to ensure your plan has sufficient financial resources to provide the benefits earned by the retirees. Understanding your financial condition is complicated and requires that you ask the right questions and get the right answers.

February, 2015

Appendix B: Employer Recommended Practices

Every employer should be asking these questions:

1. What is the financial condition of *my* plan?
2. How can I improve the financial condition of *my* plan *now*?

The Task Force has developed Employer Recommended Practices to help address these questions. These are steps employers can take now to improve their financial condition by increasing your assets and decreasing your liabilities.

Employer Recommended Practices

1. Budget contributions for DROP members.

·DROP has a cost even though employer contributions are not required. Keep the amount in your budget to avoid the increase when the replacement employee is hired.

2. Prepay your budgeted contribution.

·The sooner you pay PSPRS, the more interest your account earns. Full payment July 1 is best and a model exists to calculate the additional interest you can earn. The actuary amount is only an estimate of the minimum requirement...every little extra bit helps.

3. Do not defer the impact of the Fields case.

·The option to defer this cost increase is available over a 3-year period. However, doing so will cost more in the long-term. A model is available to calculate the cost of deferral.

4. Review Local Board practices.

·These practices serve to improve the management of your plan in areas such as member eligibility, pre-existing conditions, and disability claims.

5. Prepare a comprehensive study.

·Your annual valuation report is only a “picture”; you need to see the “movie” of your 22-year financial projection of your plan.

·A study helps you understand the financial realities (i.e. cost of DROP) and shows where you are in the pension lifecycle. A study will identify how specific factors (active/retiree ratio, turnover rates, etc.) will impact your future.

6. Pay off unfunded liability (debt) earlier.

·The reduction of the liability is “smoothed” over 22 years. It may have a large impact on your annual contribution amount. Treat and manage as debt.

7. Create a pension funding policy.

·A comprehensive document intended to ensure financial resources will exist to fund your plan. It provides guidance related to your plan’s major elements such as contribution amounts and funded status.

Please visit www.azleague.org for additional resources.

Appendix C: PSPRS Consolidated Report

ARIZONA PUBLIC SAFETY PERSONNEL RETIREMENT
SYSTEM CONSOLIDATED REPORT
JUNE 30, 2014

http://www.psprs.com/Admin_Investments_and_Finance/2014_actuarial_reports_by_system/2014-06-30_PSPRS_Annual_Valuation.pdf