CALSTRS

Regular Meeting

Item Number 8 – Open Session

Subject: Discussion Regarding the Second Report to the Legislature on the Progress of the CalSTRS Funding Plan

Presenter(s): Rick Reed / David Lamoureux

Item Type: Information

Date & Time: March 7, 2024 – 30 minutes

Attachment(s): None

PowerPoint(s): Review of CalSTRS Funding Plan

Item Purpose

The purpose of this item is to discuss the second report to the Legislature on the progress of the CalSTRS Funding Plan. This report is required by statute to be completed every five years. The second report is due to the Legislature by July 1, 2024.

Recommendation

This is an information item only.

Executive Summary

The CalSTRS Funding Plan, enacted in June 2014 by Assembly Bill 1469, was developed through a joint commitment by members, employers and the state to contribute more to CalSTRS to fully fund the Defined Benefit Program by 2046 and to ensure the long-term sustainability of CalSTRS.

When passed, the funding plan established increased contribution rates that were phased in over a three-year period for members and the state and a seven-year period for employers with the goal to fully fund the Defined Benefit Program by 2046. One of the key features of the funding plan is the limited ability it provides to the board to adjust the employer and state contribution rates. This flexibility has made CalSTRS more resilient, allowing it to react to market volatility and changes in long-term expectations, keeping the funding plan on track to achieve its goal. Since the passage of the funding plan, the board has exercised its authority to increase the state contribution rate by 0.5% of payroll on four occasions. The board also elected to keep the employer rate at the level set by the funding plan for each of the last three years, providing rate stability to employers while keeping the funding plan on track. Today, the Defined Benefit Program is slightly ahead of schedule to reach full funding by 2046. In short, the funding plan is working.

The funding plan contains a provision requiring CalSTRS to provide a report to the Legislature every five years on the fiscal health of the Defined Benefit Program and the progress of the funding plan. The statute requires the report to compare the funding levels and projected contribution rates at the time the funding plan was enacted to those based on the most recent actuarial valuation, and the report must indicate whether adjustments to contribution rates are necessary to eliminate the unfunded actuarial obligation by 2046.

The first report was provided to the Legislature in June 2019. That report went beyond the statutory requirements and provided an in-depth history of the Defined Benefit Program funding before the funding plan, a description of how the funding plan operates, and a discussion of how the funding plan had impacted contribution rates and funding levels since 2014, and highlighted risks that could impact the ability of the Defined Benefit Program to reach full funding by 2046.

For the second report to the Legislature, staff will build on what was included in the first report, updating information based on the latest actuarial valuation, reflecting recent events that impact funding and highlighting how CalSTRS investment performance since the passage of the funding plan, combined with the additional contributions made by members, employers and the state, have put the Defined Benefit Program slightly ahead of the anticipated schedule when the funding plan was enacted.

The report will once again highlight the risks that could impact the ability of the funding plan to reach full funding while also discussing how these risks could be reduced by further strengthening the funding plan.

Once the progress report has been completed, a copy will be provided to the board and posted on the CalSTRS website.

At the meeting, staff will be seeking direction from the board on continuing to engage with CalSTRS stakeholders about plan funding, the strengths of the funding plan and potential opportunities for furthering the long-term sustainability of the fund on behalf of California's public educators.

Background

CalSTRS regularly monitors the progress of the funding plan. The annual actuarial valuations, which are completed in May each year, provide a point in time measurement of the funding levels, determine the sufficiency of contributions and recommend any necessary changes to contributions within the parameters of the funding plan. Each year in November, CalSTRS also presents the annual review of funding levels and risks report, which provides a forward-looking and holistic view of risks that could threaten the ability of the plan to reach full funding by 2046.

The most recent review of funding levels and risks report showed that CalSTRS is slightly ahead of the initial schedule set out in the funding plan to reach full funding. The limited rate-setting authority provided to CalSTRS is currently expected to allow the Defined Benefit Program to reach full funding by 2046. The report to the Legislature will highlight this fact and fulfill the statutory requirement by providing updated projections of contribution rates and funded levels through 2046.

The report to the Legislature provides CalSTRS with an opportunity to increase the understanding of the funding plan and to engage the Legislature and stakeholders in discussions regarding the funding of the system. To facilitate these discussions, the report will again provide a comprehensive discussion of both the funding of the Defined Benefit Program and the operation of the funding plan. The following topics will be included as part of the second report to the Legislature:

- A history of the Defined Benefit Program, its funding structure and the development of the funding plan.
- Details regarding what changes were made as part of the funding plan and a discussion of the complexities and intricacies of how the plan operates.
- A reconciliation of why funding levels and contribution rates have changed since the adoption of the funding plan and a discussion of some of the significant events that have impacted funding levels.
- A discussion of risks that could prevent CalSTRS from reaching full funding and how these risks could be reduced by further strengthening the funding plan.

Mitigating risks and strengthening the funding plan

The funding plan as structured is working. The Defined Benefit Program is slightly ahead of the original funding schedule and is projected to reach full funding by 2046 under the current actuarial assumptions. Furthermore, as detailed in the review of funding levels and risks report, CalSTRS is in a favorable position to withstand significant recession scenarios and make meaningful progress to improve funding levels.

However, there remain significant risks to funding the system. The largest risk facing CalSTRS ability to reach full funding is investment risk. This risk is further exacerbated by the maturing of the Defined Benefit Program, which will increase the system’s sensitivity to investment experience. As the funding plan end date of 2046 gets closer, investment volatility will be more challenging to react to as there will be less time remaining to pay down any new unfunded actuarial obligations that may arise later in the funding plan.

As per existing statute, on June 30, 2046, the funding plan will sunset along with the limited rate-setting authority provided to the board. Even if everything goes according to the funding plan and the Defined Benefit Program is 100% funded on June 30, 2046, the fund would again be at significant risk of seeing declining funding levels following a recession or a period of low investment returns. The previous structure did not provide sufficient flexibility in the contribution rates to withstand even minor investment losses.

It is also important to point out the funding plan does not provide the board with authority to address the entire unfunded actuarial obligation. The funding plan established a complex structure for paying down the unfunded actuarial obligation with rules that determine how much of the unfunded actuarial obligation is allocated to the state and employers. The state is responsible for any unfunded actuarial obligation that is related to CalSTRS benefits that were in effect on July 1, 1990, and this responsibility applies to all service performed by CalSTRS members. The employers are responsible for any unfunded actuarial obligation that is related to benefit changes that occurred after July 1, 1990, but only for service that was accrued by members before July 1, 2014. This allocation structure leaves out a portion of the unfunded actuarial obligation that is related to benefit changes that occurred after July 1, 1990, associated with service that was accrued on and after July 1, 2014. This is referred to as the unallocated unfunded actuarial obligation. The funding plan does not provide any source of funding for this portion. The unallocated unfunded actuarial obligation is currently in a surplus position but could quickly become unfunded if CalSTRS were to experience investment returns below 7%.

For several years now, CalSTRS has highlighted the fact that the state's contribution rate is most sensitive to volatility in investment returns and to changes in demographic trends. As such, flexibility in relation to the state's contribution rate is essential in maintaining the long-term sustainability of the fund.

There is a provision within the funding plan that requires the state supplemental contribution rate be reduced immediately to zero if the state's share of the unfunded actuarial obligation is ever eliminated. At that point, the state would only contribute at the base contribution rate of 2.017%. As reported last November, the state is currently expected to eliminate its share of the unfunded actuarial obligation in five years. In fiscal year 2023-24, the state currently pays 8.328% to the Defined Benefit Program[1]. The state supplemental rate is expected to be eliminated in fiscal year 2029-30, which would reduce the state contribution rate to the Defined Benefit Program to 2.017%.

If a new unfunded actuarial obligation were to develop after the state contribution rate has been reduced to 2.017%, for example due to lower-than-expected investment returns, the board would only be able to increase the state supplemental rate by 0.5% per year starting from the base rate of 2.017%, limiting CalSTRS' ability to eliminate any possible future unfunded actuarial obligation.

[1] The state contributes an additional 2.5% of payroll to fund the Supplemental Benefit Maintenance Account (SBMA) that is used to provide inflation protection to CalSTRS retirees and their beneficiaries. Pursuant to Education Code section 22954, the state contribution to the SBMA is reduced by $72 million each fiscal year.

For the report to the Legislature, staff intends to include a section that will discuss these risks and how they could be reduced by strengthening features of the funding plan, which include:

- The funding plan's end date of 2046.
- No funding source to address the unallocated portion of the unfunded actuarial obligation, if needed.
- Flexibility in setting the state contribution rate.

At the meeting, staff will be seeking direction from the board on continuing to engage with CalSTRS stakeholders about plan funding, the strengths of the funding plans and potential opportunities for furthering the long-term sustainability of the fund on behalf of California's public educators.

Note that in March 2021, the Legislative Analyst's Office released a report titled, "Strengthening the CalSTRS Funding Plan." The report stated that, while the funding plan is working, it is a complex structure, and certain aspects of the plan may impede its success. The report also detailed some changes that the Legislature could consider addressing some of the risks to the funding plan.

Strategic Plan Linkage: Goal 1: Ensure a well-governed, financially sound trust fund.

Optional Reference Material:

2019 Report to the Legislature on the Progress of the Funding Plan

2023 Review of Funding Levels and Risks

Legislative Analyst's Office Report on Strengthening the CalSTRS Funding Plan