

1 MR. EHNES: Great. Thank you, Mr. Chair. And
2 thank you for inviting us back for a second discussion,
3 this time with a little more focus on the pension side
4 than the health-care side. But we'll still have some
5 comments today for you on health care as well. And I
6 think we're hoping to speak with you for about -- I guess
7 we're told for about 20, 25 minutes, and then engage in a
8 dialogue with you.

9 Let me first start just by -- I assume you have
10 our handout? Because you obviously can't see the screen.
11 But I do want to walk through that with you and kind of
12 amplify some of the comments that are on our slides as we
13 go through today.

14 But let me first introduce, on my direct right
15 here is Jerilyn Harris. And we really brought the
16 leadership team here to be with you so it isn't just
17 staff. And Jerilyn is our vice chair of our board, a
18 retired teacher, but also has been a leader in education.
19 So she's got a lot of vantage points to this issue to
20 talk with you today.

21 On Jerilyn's right is Mark Johnson. And
22 although he carries that label and baggage of being an
23 actuary, I would tell you that Mark's been a very special
24 resource for the CalSTRS board. And we've gone through
25 many competitive bids over many years. And we choose

1 Milliman not because of Milliman, but because of Mark.
2 He's been able to make the public translation of
3 technical work to public. And I hope you'll judge that
4 today for us, because I think Mark is very eloquent on
5 the issues that we are facing. And Mark serves actually
6 on the board of directors of Milliman, so he is a leader
7 in the actuarial field as well.

8 And Ed -- a lot of you know Ed -- Ed is our
9 deputy CEO, and really oversees a number of the parts of
10 the organization, but particularly the actuarial part
11 that we're so focused on today.

12 It sounds, Mr. Chairman, from your comments
13 that you're in the last furlong before the homestretch.
14 And I'm hoping we're not just talking at you --

15 CHAIR PARSKY: With the Del Mar racetrack at
16 our back, that's a very appropriate comment.

17 MR. EHNES: Well, I am a racetrack person.

18 But I would say, I'm hoping we're not just
19 talking at you, but leaving you some of the nuggets of
20 information that does, in fact, leverage some
21 conclusions.

22 I'm sure you're not surprised that when you
23 started this in February, we're nervous. We're all
24 nervous. We're not sure of the composition, how that
25 works, the balance, the agenda, the conclusions, what it

1 all means.

2 You've benefited from having some excellent
3 staff that we know well. But I would say you've been
4 very fair, as we listen to the speakers that come before
5 you, many of which have difficult stories, you've done
6 that with independence and objectivity. And we have a
7 lot of confidence that the homestretch is meaningful and
8 not just another commission report on a shelf.

9 This really does need to be an important point
10 for California to define this area and what we are doing.

11 Let me start out here -- and not that, but kind
12 of -- those are things you've seen before. Of course,
13 they're kind of metrics around our system that were
14 large -- large in the country, we're large in the world.
15 But let me make a stronger point. I'm not sure I've
16 heard this one said to you before. Our investment return
17 is spectacular that we just issued our press release this
18 week. It's 21 percent. It's not just one of the highest
19 in the country, it's unusually large for such a large
20 investor to have a return that size. Our real estate
21 portfolio returned 32 percent and our private equity
22 portfolio, 27 percent.

23 Not only have we become a major global player,
24 but when we looked at interesting surveys of other
25 investors that we're a partner with, we're viewed as a

1 good business partner. That's critical to get in the top
2 tier of funds and be successful at what we do.

3 The \$25 billion that we gained over the last
4 year is larger than most public pension plans in the
5 entire country. Just that net change. In five years, we
6 have doubled in size as a pension plan.

7 So even though that vision is out there 30,
8 40 years -- and Mark is going to share that vision -- you
9 know being in a political environment and you have
10 numbers like this, it's very difficult for people to
11 maintain context.

12 I'm concerned that we don't get back into some
13 dot-com period euphoria, and there's not the recognition
14 of the way these markets work. And thankfully,
15 yesterday, maybe it was a little sobering in checking
16 behavior around this. But I do think possibly that's
17 something you might consider and think about, is how you
18 add context to the long-term financial portrayal of our
19 pension plans as you think about that. How do
20 policymakers working in a political environment come back
21 when we have to be making sound economic decisions in
22 what we do here every day?

23 We are transitioning from being bureaucratic
24 old-time state agencies into modern, progressive
25 financial services organizations.

1 And I challenge you to think about, have we
2 laid the right organizational of the governance context
3 in government for what we will be in ten years from now
4 and twenty years from now? Step back from this
5 short-term thinking about these returns. And these are
6 large, complicated financial services, asset-management
7 companies. Are we really ready, prepared to give us the
8 tools to do that? And that's part of the dialogue that
9 needs to go on, because we are definitely changing in
10 culture and focus with our global strategies.

11 So with that start, let me just do a few more
12 slides with you and then we'll go -- just, again, about
13 CalSTRS. On the one hand, a lot of this must be mooshing
14 together for you because we're talking one day about a
15 city plan, a county plan, a CalPERS plan, a CalSTRS plan.
16 So one of the things we do want to leave with you today
17 is some of the unique attributes of this system being so
18 large, and the fact that solutions could be different for
19 different systems.

20 This Commission has served us well, and we have
21 been issuing short policy reports as you've gone along.
22 We issued one on health care and again today. We issued
23 a report called "Teachers Count on Promised Pension
24 Benefits" to look at the financing of our plan. But the
25 one thing that's so critical for all of you again is that

1 this plan has been tilted toward long service, given the
2 nature of this profession, the longevity as you see is
3 nearly 30 years of service. And the rewards that come
4 from this benefit formula come through long service.

5 We do have a supplemental benefit plan as well
6 that provides some additional security for our teachers,
7 for that service that is in excess of a normal teaching
8 year. So that does provide some added benefit.

9 But in a minute, as you see, the replacement
10 ratios that teachers have, they're still, under any
11 standard, modest.

12 The other thing to mention is, we are thinking
13 differently about our business as well. I hope we are
14 all leaving you with that impression, that we're not just
15 here to defend the status quo. Even though we've been
16 here since 1913 and the core benefit is solid, we are
17 also thinking about other services and products.

18 Last week, we announced a new partnership with
19 TIAA-CREF -- kind of unusual, frankly, for the public
20 sector -- where together we'll be introducing financial
21 services products throughout California because we do
22 believe teachers have been abused by high-cost products
23 over the years. And if we are going to talk about
24 savings beyond the defined benefit plan, we want them in
25 fair, good, low-cost products. And we don't think this

1 market has served them well. So we are going to work
2 very hard with TIAA-CREF to change this marketplace in
3 the coming year.

4 Just on the benefit itself, you know, these
5 two bullets fit together very tightly that we have on
6 this slide. As any good financial planner will tell
7 you -- and, boy, that wild card is retiree health care --
8 we think of numbers of 80 percent, 85 percent, some say
9 even 90, I see in the literature, depending upon where
10 that health-care benefit is.

11 That average replacement benefit for our
12 members for new -- and you need to double-underline the
13 word "new" there -- is 63 percent of income. So there's
14 certainly a gap there so any concept that everyone's
15 living on a cruise ship in retirement is quickly deflated
16 by those kinds of statistics.

17 The side statistic to that, though, is really
18 that's for new retirees. If we took a look at all of our
19 retirees and kind of readjust that number, that drops
20 down to about 53 percent replacement income. So that's
21 really what a hard-working teacher expects out of our
22 system.

23 So when you get letters or commentary or
24 testimony here at the microphone about that
25 purchasing-power program, that is absolutely critical to

1 maintaining the stability of that replacement income.
2 And I think rightfully so, teachers would like to see
3 that number increase over time. That is probably the
4 highest priority for our membership, is the maintenance
5 of that purchasing power program. And with a 53 percent
6 replacement ratio for the bulk of the membership, that
7 80 percent is very crucial.

8 What makes us different as a system? Well, you
9 know, we do not get Social Security credit for while
10 you're teaching with our system. So the safety-net issue
11 is very vulnerable, it's porous for this membership. And
12 that's a standout finding. And the implications of that,
13 for as we think about improving the system, that guides a
14 lot in what we do.

15 But the next bullet on there is really the one
16 I'll come back to when I close that I guess we have
17 reached a conclusion with our board, we need to think
18 about and talk about differently.

19 I think over the years, the fact that the
20 Legislature has determined the contribution rates has
21 served us reasonably well in the charts that we have in
22 that policy paper that we gave you, you see actually the
23 employer rates have not changed since the eighties for
24 us. But the markets have been more volatile. And we
25 have to figure out, how do we make economic decisions in

1 a political context to this system? And the fact is, if
2 we're going to rely on a legislative body to have that
3 financial tool on a close to -- soon a \$200-billion
4 operation, you are guaranteed that you are going to make
5 decisions too late in the game, and they would become
6 more expensive.

7 And again, a distinguishing characteristic
8 about CalSTRS -- not uniquely but certainly many other
9 systems rely on the governing body to make those
10 adjustments. And I think our board expects that those
11 have to be done within prudent parameters, certainly.

12 But the fact that the system is not more
13 elastic around this issue is a stand-out issue for us for
14 our success in the future. So I hope, again, you'll
15 highlight that bullet. And the fact, again, that our
16 system is based on local employers determining the health
17 benefit as well.

18 And just finally for my comments, you know, I
19 don't know that we've done a good job as a pension
20 system. We spend our time educating our members, doing
21 actually a spectacular job with the investment portfolio.
22 And I'm not sure the public understands our connection to
23 the rest of California.

24 We issued, again, a policy paper on this, along
25 with CalPERS, by commissioning a study with Sac State.

1 These numbers are huge. If you relate them to other
2 sectors of the California economy, the spin-off economic
3 benefit of those \$6 billion of annual benefits rivals
4 other significant economic sectors in the California
5 economy.

6 Now, that's a common ripple, economic model
7 that you see universities do; but I think it is, as you
8 can certainly look at methodology here and debate the
9 numbers a bit; but it says big things, not just about the
10 impact to our membership, but the impact to jobs in the
11 state, to the tax revenues to the State, and particularly
12 in some of the non-urban areas that we often forget in
13 that economic dialogue.

14 So I'm hoping, again, that we tell that message
15 a little stronger than we have in the past about this
16 plan.

17 So let me turn now to Mark Johnson, as I said,
18 our consulting actuary for CalSTRS.

19 Mark, I'll give you this.

20 MR. JOHNSON: Thank you very much. And I
21 appreciate the opportunity to come and glaze your eyes.

22 CHAIR PARSKY: We'll try to stay alert
23 throughout your presentation.

24 MR. PRINGLE: I move for a recess.

25 MR. JOHNSON: Let's quickly get into some

1 numbers. You're used to actuaries talking about numbers.
2 The slide you have in front of you is a pie chart. And a
3 couple things I wanted to point out. As was mentioned by
4 one of the public commentators, investments are, by and
5 large, the vast majority of the funding of a system like
6 CalSTRS. And you'll see over the last 20-plus years,
7 investments have produced about 63 percent of the
8 revenue. Members and employers, about 15 percent each,
9 and the State has put in about 8 percent of the total
10 over that period.

11 Now, this kind of pie chart would be changing
12 depending upon the time frame you look at it. If you
13 looked at it, you know, in 2000, right before the
14 market's decline, that investment percentage might have
15 been closer to 70 percent, and so forth. So it is
16 something that changes.

17 As Jack pointed out, the employer contribution
18 and the State contribution are set in statute.

19 Now, just to give you a little bit of
20 perspective, in 1913 teachers were asked to contribute
21 \$12 a year to this plan. And they received all their
22 past service credit. So all the credit they've had as
23 teaching before 1913 was trying to be financed by \$12 a
24 year. The schools didn't put in anything, and the State
25 offered 5 percent of the inheritance tax.

1 I submit to you that starting in 1913, this
2 plan was in the hole, okay. And it used those types of
3 contributions until 1930s, 1940s. Then the State started
4 to pay. But it was called pay-as-you-go. They would
5 contribute just what was required to make the benefit
6 payments at that time.

7 It wasn't until 1972, almost 60 years after the
8 program started, when the Legislature put in a program to
9 fund in advance. And by "fund in advance," what I mean
10 is the contributions going in this year should be paying
11 for the benefits being earned by the teachers this year,
12 not last year.

13 Social Security, for example, is more or less
14 pay-as-you-go. So money that's coming out of my check
15 for Social Security is paying for my relative's benefit
16 next month, okay.

17 What we want to try to do here is to even
18 things out. The taxpayers of the state of California,
19 in their current taxes, ought to be paying for the
20 benefits earned by the teachers this year. And that's the
21 goal of advanced funding. That was put into place for
22 CalSTRS in 1972.

23 In 1998, the program became what I call fully
24 funded. In other words, the contributions going in were
25 paying all for just the benefits that were being earned

1 in that year. That was 1998.

2 The other thing I want to point out here is
3 that unlike most other retirement systems -- and Jack
4 alluded to this -- all of the contributions are defined
5 by the statute. The most customary role of the actuary
6 to a retirement board is to make a recommendation on what
7 the employers ought to contribute next year. That's not
8 the case here. And I'll talk a little bit more about
9 that as I get a few slides later.

10 The State contributes 2.017 percent of
11 salaries. That's declined. In 1998 it would drop to
12 that level. So if you do a calculation, you say, well,
13 since 1998 the State has saved \$3 billion -- in other
14 words, \$3 billion less has gone in during this time
15 period because the contribution went down. The
16 contribution went down in 1998, that was a key point.
17 That was when a benefit improvement went into place, and
18 at the same time, contributions were reduced. This is
19 because this was the first year in which, since 1913, we
20 had a surplus -- an actuarial surplus, not meaning that
21 there was money to say is a dividend. But we were, now,
22 past the point of just paying for benefits that were
23 currently being earned. We had more than enough to pay
24 for just the benefits currently being earned.

25 Employer contributions, 8¼ percent of pay,

1 unchanged since 1990.

2 Member contributions, 8 percent of pay,
3 unchanged since 1972.

4 And then there's an additional 2½ percent of
5 state contributions that goes into a reserve fund to pay
6 for the 80 percent purchasing power.

7 By the way, the basic CalSTRS program does have
8 an automatic cost-of-living adjustment. It's somewhat
9 antiquated in that it's called a simple, 2 percent
10 simple. Instead of being compounded, it's 2 percent of
11 your original benefit. So over time, you're not
12 really -- you can't keep up with 2 percent inflation, let
13 me put it that way, all right. You're going to fall
14 behind on 2 percent inflation.

15 This, as Jack mentioned, is a key element for
16 the security. The benefits are not rich. And if we
17 can't keep the purchasing power level for teachers on
18 this modest benefit, I think we're really doing a
19 disservice. So this is a key element of the benefit
20 structure.

21 Let me talk a little bit about the 2006
22 valuation. Anytime somebody says \$20 billion unfunded,
23 it raises your level of alertness, so to speak. I would
24 point out several things. All of the methods,
25 assumptions, calculations that we've performed in these

1 valuations have been reviewed by competitors from time
2 to time. And that's a point I wanted to make that didn't
3 get in the slide. But on a defined benefit program, it's
4 my belief that from time to time, retirement systems
5 ought to hire my competitor to come in and look over my
6 shoulder. And we support that wholeheartedly. And when
7 CalSTRS did it several years ago, and you totally
8 cooperate -- and this has become more common. Actuaries
9 are used to doing it because nobody likes to have
10 somebody look over your shoulder, obviously. But for the
11 benefit of, I think, the taxpayers, you ought to be very
12 supportive of this.

13 Some actuary can have just a small glitch in
14 their computer program that can compound over decades,
15 and then all of a sudden somebody can look at it and say,
16 "Wow, they said we were in good shape and we're not." So
17 that's one of the things I wanted to mention.

18 Now, for CalSTRS, our role is not to recommend
19 a contribution rate. On the other hand, it's to say:
20 Can the contributions in the statute work out? Is that
21 enough money to finance all of these benefits, to pay for
22 the benefits that are being earned this year, and if
23 we're behind, to pay for the benefits that have been
24 earned in previous years?

25 The unfunded obligation as of the last

1 valuation that was performed was \$19.6 billion. That's
2 87 percent funded. That sounds pretty good. And it's
3 not bad. In fact, there was a gain this last year from
4 investments, from salaries being not quite as high of
5 increases as they were in the past. And we expected the
6 unfunded obligations to be \$22 billion, and it turned out
7 to be 19.6. So, again, you've got to recognize, in a
8 system like this, there are gains and losses that go each
9 time you do a valuation.

10 Even though the contributions that are coming
11 in exceed the cost of benefits being earned this year,
12 there's not enough difference between the total revenue
13 and what it cost for the benefits being earned this year
14 to amortize that unfunded obligation. It doesn't work.

15 Somebody asked me earlier this morning: Well,
16 okay, the board's policy is to try to have that amortized
17 over 30 years. Well, how long is it? Well, it's
18 infinite. It just doesn't work.

19 And, again, the Board's policy is, again, not
20 to set a contribution but to just see if it works. And
21 30 years is kind of a standard time frame. It's the
22 length of a career, for example. So it's just to see if
23 the contributions coming in can finance the benefits.
24 And they cannot.

25 The primary reason is lower returns, and to a

1 certain extent, some -- I'm going to tell you how it got
2 so high -- to a certain extent, there's some salary
3 losses as well. But for the most part, these are the
4 returns for three years in a row and, obviously,
5 represented huge losses.

6 And when an actuary is talking about a loss,
7 it's anything less than the assumed rate of return.

8 In this case, we're assuming that over a long
9 period of time, a portfolio such as CalSTRS will earn
10 8 percent per year. If you earn 7.9, it sounds all
11 right, that's a loss to the actuary.

12 So here, in 2000-2001, you're 17 percent behind
13 what we thought it would be. In 2001-2002, you know,
14 you're 14 percent behind what we thought it would be.

15 Well, 2002-2003, you finally get up above zero?

16 Well, no, you're still 4½ percent behind what we
17 expected to be.

18 So all of that is compounding these losses.
19 It was just unprecedented. And that's what put CalSTRS
20 in the hole that it's in.

21 To a lesser extent, during this same time
22 frame, towards the end of it, we had experienced losses
23 due to salaries. In other words, the salaries of the
24 average teacher increased higher than we expected.

25 Those types of demographic gains and losses go

1 both ways. It just so happened that during this time
2 frame there were losses. And what happens is that you'll
3 get, due to the collective bargaining and so forth, you
4 don't always get the same increase every year. Sometimes
5 the district may say, "Well, we can't have any salary
6 increase for the next couple years, but then later you
7 catch up." So those types of things vary by district.

8 But it's kind of a double whammy here. At the
9 same time we had these investment losses, we had losses
10 due to salaries.

11 I'd like to point out that the benefit
12 enhancements in the late 1990s did not cause this
13 shortfall. As I mentioned before, it was the first
14 really substantial benefit enhancement in decades.

15 And after the benefits were enhanced, the
16 system still had a surplus, okay. And we've done some
17 calculations to just put a perspective on this. During
18 those three poor investment years, if the market had
19 returned about 6.7 percent, we still would have been
20 100 percent funded.

21 And if we factor out those salary increases
22 right at the end, the unusual salary increases, if the
23 market had just returned under 3 percent, we still would
24 have been, you know, 100 percent funded.

25 And to put it even lower, to say, "Well, we

1 don't need to be 100 percent funded. We just need to
2 finance this over 30 years." All you would have needed
3 was a market return of 5.4 average for those three years.
4 And, obviously, we were way negative.

5 So can it happen? Yes.

6 And we looked at, several years ago, right at
7 the end we got in this big deep hole, and the question
8 was, when we got here from investments, can we invest our
9 way out of it? And, of course, everybody would like to
10 think we could. This is just down, and we're at the
11 bottom of the wave, and we're going to go back up and do
12 it. Well, we did a stochastic analysis to determine the
13 chance of investing your way out of this with a
14 reasonable portfolio; it was less than 6 percent.

15 So it can happen, you can invest your way out
16 of it. But the chance of doing it is very, very small.
17 And we've recommended, as Jack has mentioned to the
18 board, to try to deal with a different way to finance
19 this, so that we're not just stuck in a hole that gets
20 deeper and deeper, because this is a perfect situation of
21 pay-me-now or pay-me-later.

22 If the actuary is right, and the assumptions
23 turn out to deliver experience year by year that's
24 reasonable, if you're in the hole now and you're not
25 contributing enough to get yourself out of the hole, the

1 hole gets deeper and deeper.

2 So with that, I'm going to turn it back to
3 Jerilyn.

4 MR. PRINGLE: Mr. Chairman, I have a couple
5 question's.

6 CHAIR PARSKY: Sure.

7 MR. PRINGLE: Could I ask them now or would it
8 be better to do it later?

9 CHAIR PARSKY: Well, I thought we would finish
10 the panel.

11 MR. PRINGLE: Okay.

12 CHAIR PARSKY: If you think it's really ripe,
13 you can do it, but I thought maybe we'll finish the panel
14 and come back around. So let's keep the thoughts.

15 By the way, that was not a glazed-over
16 presentation. That was very astute.

17 MR. JOHNSON: Thank you.

18 MR. PRINGLE: For some of us.

19 Because I -- really, part of my glazed-over
20 presentation is how to make sure charts on pages 4 and 5
21 are the same, since I don't understand where those dollars
22 are coming from and the level of contribution from both
23 the employer, the employee, the State, and such. So if I
24 can reserve that question then.

25 CHAIR PARSKY: Yes, if you can hold that and

1 reserve it.

2 MR. PRINGLE: I can reserve it until later, but
3 that's what I want to ask.

4 CHAIR PARSKY: Okay, so you'll be ready?

5 MR. JOHNSON: Yes.

6 CHAIR PARSKY: Okay, Mark.

7 Who will be next, Jack?

8 MR. EHNES: Jerilyn Harris, our vice-chair.

9 MS. HARRIS: Thank you, Commissions, staff, our
10 wonderful Anne Sheehan who is in service with us so
11 beautifully on the CalSTRS board, and members of the
12 audience.

13 I'm currently vice-chair of the Teachers
14 Retirement Board, chair of the leg. committee and the
15 appeals committee and vice-chair of benefits and
16 services, former chair of the Commission on Teacher
17 Credentialing, and from three governors I've had seven
18 total appointments, governors' appointments. But the
19 thing I'm proud of is I'm a classroom teacher. I've
20 spent my life teaching. I want you to know, there are
21 800,000 of us out here between retirees and those who
22 are actively teaching. And we're real people. And
23 everything you say and do affects us.

24 I've spent 27 years teaching, five years in
25 Beverly Hills, 22 in Ukiah. Interesting, when I left

1 teaching in Beverly Hills, very pregnant, I knew that I
2 was going to be a housewife the rest of my life. And we
3 moved up to wine country and got a house we loved. And
4 the next thing I knew, well, I was just going to sub, and
5 then, gee, we could use a little extra money, and now I'm
6 looking back on a career. I've been retired since 2002.
7 And I'm very grateful to CalSTRS for making that
8 possible.

9 Just to put a personal at the start, when I was
10 at UCLA -- I'm a UCLA graduate -- I was recruited by
11 Beverly Hills -- with a degree in biology. And I
12 remember saying to my dad, "Gee, I wonder what I ought to
13 do with my life?" Because I wanted to go into medicine.

14 My father said, "Jerilyn Anne, you get yourself a
15 teaching credential, because then if your husband ever
16 leaves you, then you can keep a roof over your head."
17 And I hated him for it.

18 32 years later, when my husband left, I could
19 keep a roof over my head. So I thank my dad.

20 I want you to know a little bit about what
21 these numbers and what these statistics mean in the life
22 of real teachers, because we are not living a rich life
23 out here. 64 percent of our retirees are women. Our
24 average age is 72. I'm not there yet, but it's coming a
25 lot faster than I would like to accept it.

1 Our median monthly income is \$2,400 a month.
2 And when you think of what it is like for someone to live
3 on that in the state of California, it's certainly not
4 rich.

5 60 percent of us are unmarried. We may not
6 have started out that way, but 60 percent of us are
7 currently unmarried.

8 And we are expected to live approximately
9 27 years after we retire.

10 Our CalSTRS retirees, the educators in
11 California have fewer safety nets than most other
12 retirees. We depend on our defined benefit from CalSTRS
13 heavily. It's our primary source of retirement. Most of
14 us do not have any Social Security coming. Some who do
15 have been encouraged to go into teaching mid-career. And
16 I did serve as chair of the CTC for a long time as we
17 tried to recruit. Those teachers who are being
18 encouraged to enter teaching mid-career often find that
19 they will lose much of their Social Security that they
20 garnered elsewhere because they've chosen to go into
21 teaching.

22 I have some friends that are very angry with me
23 who went into teaching with my encouragement then found
24 out recently about the kind of penalties that they
25 incurred for doing it.

1 Teachers' retiree health-care benefits are
2 determined by each school district, not by CalSTRS, not
3 by CalPERS.

4 We are unlikely to have employer-subsidized or
5 paid health care after we reach age 65. 62 percent of us
6 receive no financial assistance for health care from our
7 employers. That number is growing.

8 We do a survey every three years because we
9 have predicated our actuarial comfort zone on providing
10 a somewhat adequate retirement on whether or not we have
11 health care. And most of us don't have it. So we're
12 basing this whole premise for retirees on a falsehood.

13 Only 1 percent of employers offer retired
14 employees the same level of health benefit as their
15 working employees.

16 I'm still working for my school district, even
17 though I retired five years ago to pay for my health
18 care. But other personal, I blew out a knee two years
19 ago that I was told should be operated on right away.
20 I have a few more months until I'm eligible for Medicare,
21 at which time I'm going to get the knee fixed.

22 86 percent of our employers who employ
23 62 percent of the school employees provide no retiree
24 payment for health benefits once we reach 65. That's an
25 increase from 78 percent in 2003. So you can see the

1 direction that health care is going for the educators of
2 the state.

3 Many of these people were your teachers. So
4 we're going to take a look at a couple of teachers, and
5 they are not atypical.

6 The first is Jay Klopenstein, who lives in
7 Carlsbad, not far from here. He's 68 years old. He has
8 39 years in teaching, mostly at the high school level.
9 Since he retired in 2000, he has worked two jobs. He
10 buys his insurance for his son. Just to pay the medical
11 bills for his family he works at two jobs. Even while he
12 was teaching he faced financial challenges due to
13 health-care costs. He not only has high expenses for a
14 son that is only covered to a small degree, but he had a
15 daughter who was hospitalized with meningitis, and his
16 health plan only paid 20 percent of the cost of that
17 hospitalization.

18 He had to work extra jobs in addition to
19 teaching to avoid bankruptcy. Now, he continues to work
20 to pay the \$10,000-a-year insurance coverage that his
21 school district is allowing him to purchase. And that
22 district is actually being generous because many of them
23 say: Sorry about that. You might have put in 30,
24 40 years with us, but you're no longer working for us.

25 Jay's health plan has a cap of \$30,000 for his

1 son's hospitalization. But the cost just for his son
2 runs from \$60,000 to \$90,000 a year. So he doesn't see
3 an end to his working in his, quote, "golden years,"
4 unquote.

5 Anne Anderson has worked for 35 years as an
6 elementary teacher. She lives in -- excuse me, it's
7 Anne H., excuse me, she lives in Anderson in Shasta
8 County.

9 I'm nervous. I've talked in front of people my
10 whole life, but this means an awful lot to me.

11 She retired in 1998 after 35 years of teaching
12 in the Cascade Union Elementary School District. She is
13 69 years old. She receives a \$2,500-a-month CalSTRS
14 pension. She pays for her health insurance. Her school
15 district dropped financial contributions for health
16 coverage when she turned 65. She pays another \$280 every
17 three months for Medicare Part A.

18 She has serious medical conditions, peripheral
19 neuropathy, high cholesterol, and diabetes. Without
20 insurance, medication would cost Anne more than \$725 a
21 month.

22 Anne's husband retired from teaching in 1989.
23 He was dropped from her insurance when she turned 65. He
24 has a Medicare Part D prescription plan that helps to
25 cover the cost of his medication for non-Hodgkin's

1 lymphoma.

2 He needs serious dental work, but they can't
3 afford it. After two of his crowns fell off, he went to
4 Mexico to get cheap replacements, but they didn't work.
5 So he resigned himself to a smile with two big gaps.

6 Lack of employer-paid insurance has placed a
7 financial burden on Anne and her husband. They took out
8 a second mortgage and used their credit cards to meet
9 their payments from month to month.

10 The Teachers Retirement Board is well aware
11 that the health-care problems face retired educators, and
12 they are drastically important. We now pay Medicare
13 hospital Part A premiums for retirees who don't qualify
14 based on their own work.

15 Last summer, CalSTRS established the Public
16 Education Benefits Task Force to help determine how
17 CalSTRS can assist our members and employers with
18 health-care problems. I serve on that task force with
19 representatives from the State Treasurer's office, the
20 Department of Finance, the insurance industry, the
21 teacher unions, state employee unions, school districts,
22 community college, CalPERS, and CalSTRS. The task force
23 is developing recommendations on how CalSTRS can address
24 this critical shortage.

25 We expect some sort of final recommendations

1 early in the fall. We are still meeting. And we ask you
2 to understand we are real, we are hurting, and we need
3 your help.

4 CHAIR PARSKY: Thank you.

5 MS. HARRIS: Ed Derman will take the next
6 section.

7 MR. DERMAN: Thanks, Jerilyn.

8 I just want to spend a few minutes talking a
9 little bit about where we stand in terms of the future,
10 both as far as the pension program is concerned and
11 health care.

12 Speaking on the pension side, you know, Jack
13 made references to our 21 percent investment return this
14 past year. And you know, we've had similar -- we've had
15 very high returns the last four years. And I guess it's
16 sort of indicative of the impact that those three bad
17 years that Mark talked about, that even with those really
18 high returns -- and 21 percent is the highest return
19 we've had in over 20 years -- that even with that, it's
20 still not enough to retire the \$20 billion unfunded
21 liability that we have over any time period. I mean, it
22 had that big of an impact on us.

23 So, you know, that sort of reflects the notion
24 of whether or not we can invest our way out of it. It
25 seems unlikely. So it is something that the Board

1 continues to address.

2 And in looking at this for the last year, they
3 sort of -- in the course of a number of meetings, the
4 board came down and adopted a number of principles that
5 they've asked the staff to utilize in terms of developing
6 a specific strategy. And it involves sort of three major
7 principles. One is, the information that we've given you
8 sort of identifies the fact that the benefits that are
9 provided by CalSTRS, while they are good benefits -- I
10 mean, they're certainly not terrible benefits -- they are
11 not rich benefits. And as we've said, this is really the
12 only source of ongoing income that our members receive
13 because they don't get Social Security benefits. So it
14 was very important to the board to sustain the existing
15 benefit structure and not reduce those benefits further.

16 Secondly, you know, in response to what we've
17 seen over the last several years about the impact on
18 health care for retirees and the reduced support from
19 employers for retiree health care, they wanted to see
20 what possibilities existed for CalSTRS to assist members,
21 retired members, in improving the affordability of health
22 care in their retirement. We do it now in terms of for
23 those people who didn't qualify for Medicare
24 hospitalization. But the board wanted to see what more
25 could be done with that. And that's a big part of what

1 the task force, that Jerilyn just referred to, is looking
2 at. So they wanted to see how we could help that out.

3 And then the third critical piece is something
4 that Jack and Mark both talked about, in terms of having
5 some limited flexibility for the board to set
6 contribution rates.

7 As Mark said, that when you rely upon a fixed
8 contribution rate, you have to go back to the Legislature
9 to adjust, you know, you're always going to be a little
10 bit behind just because of the timing of these events.
11 And if you don't make those changes, then you just get
12 deeper and deeper in the hole. So the Board felt that it
13 was important to have some flexibility.

14 It recognizes that having that flexibility will
15 have an impact on school budgets and on employees. And
16 so we are spending the time working with our stakeholders
17 and the Legislature to get them to understand what the
18 issue is with our funding of our pension and what the
19 implications are of having some adjustments that -- some
20 limited authority of the board to adjust it. But the
21 important thing that what we're looking at, in terms of
22 what the board is looking at is having that limited
23 authority.

24 Unlike other pension systems where the board
25 can set it at anything from zero to whatever in order to

1 fund the benefit, I think the board recognizes that there
2 has to be some limits to that. For a couple of -- and
3 limits in two ways. One is that there's an absolute
4 limit, that the contribution rate doesn't drop below a
5 certain amount, it doesn't go above a certain amount
6 without having some further legislative action.

7 But the other consideration is that whatever
8 those increases or decreases are, they occur gradually,
9 so that the employers have some opportunity to adjust
10 their budgets to reflect that; and that there be enough
11 warning and enough notice so that they can make the
12 necessary changes they're budgeting.

13 And even with that, you know, with that kind of
14 authority, we can address and fully -- and appropriately
15 manage the pension issues that we're dealing with as far
16 as the funding is concerned. But that's a key issue for
17 them.

18 As far as the health-care strategies, you know,
19 it's important we do provide the Part A coverage for
20 those people who don't qualify on their own. We have a
21 very well-funded program to do that. And while from a
22 GASB perspective it may not come across this way, in
23 reality we've actually got more than enough assets sort
24 of identified for this program to fund those liabilities.

25 So unlike many other health-care programs, this

1 one actually is very well funded. And there are
2 opportunities perhaps to extend the benefit to some other
3 people who don't currently qualify under the program, but
4 still are not going to get Medicare coverage when they
5 ultimately retire.

6 So this one is something that the Board is very
7 supportive of, of continuing that very important program
8 because it saves those affected employees, you know,
9 \$300 or more a month in not having to pay that premium
10 themselves.

11 And then the final issue, in terms of their
12 strategy, is evaluating the recommendations that the task
13 force ultimately gives the Board in terms of how to
14 address the health-care issues that the retirees in
15 particular are facing. And after the task force makes
16 that recommendation to the board, the board will have an
17 opportunity to evaluate that and see how it wants to go
18 from there.

19 So the board is very much involved in both the
20 pension and the health-care side because based on the
21 mission of the system to secure the financial future,
22 both of those are very critical pieces of a secure
23 financial future for our teachers.

24 Finally, before turning it back to Jack to wrap
25 up, I just sort of want to talk a little bit just to sort

1 of summarize the promises that CalSTRS has made and the
2 promises that it has been able to keep.

3 Number one, to provide a benefit to members
4 that is fair, that is appropriate for the level and the
5 type and the length of the service that they provide. It
6 is biased more towards longevity, which is reflective of
7 the kind of occupations that teachers have where they
8 tend to work a very long time. But they're also very
9 committed to a well-managed fund. And even though we do
10 have a shortfall at the current time, it is in much
11 better shape than it had been historically. And the
12 board is very committed to trying to address those
13 situations, and not funding benefits that they can't
14 support. Even though they would like to be able to
15 increase benefits, they recognize that they have the
16 responsibility of managing the fund well.

17 And related to that is adopting a plan that's
18 responsible, that is sensitive to the impacts on members
19 and employers and the State, to try to meet the projected
20 shortfall that currently exists because they recognize
21 that even though we have been wildly successful in our
22 investments, that it wouldn't be prudent to assume that
23 that kind of investment returns will continue
24 indefinitely.

25 So let me turn it over to Jack to sort of give

1 you a little wrap-up before we turn it over for some
2 questions.

3 MR. EHNES: Thank you. A few quick points.

4 One, to circle back, if I could, to the
5 contribution issue, if you have that little policy
6 brochure we provided along with your slides on page 3, it
7 graphically shows, quite starkly, the 17-year history of
8 these contribution trends, and just how they've never
9 changed, obviously, for the employer and the employee;
10 and it shows the decreasing contribution from the State
11 side that Mark went through. So that kind of shows you
12 what's been funding this plan over these 17 years.

13 Just a final comment, I guess, is just around
14 expectations a little bit and where we can help and where
15 you might go with your findings in the end. I think I'm
16 on pretty good ground here assuming you don't have a
17 \$10 billion pot of money that you've been keeping here
18 that you're going to put on the table at the end of your
19 period and fund retiree health care, but that you have
20 to look otherwise for -- and I'm assuming that we
21 have that -- the wonderful word -- an alignment of
22 interests here that you're trying to make us more
23 successful.

24 And I guess if I could respectfully challenge
25 the chairman here to picture running that private equity

1 fund under the public sector environment that we work
2 under and the decision structures and compensation
3 structures, and the purchasing structures; and, you
4 know, that should give you some sense to produce a
5 21 percent return under the burden we carry. If you add
6 up the assets of the top three pension plans here in
7 California, we're getting dangerously close to a half
8 trillion. So I'm hoping you're going to -- you need to
9 provide the vision here.

10 Gosh, if it's close to a half trillion dollars
11 in 2007 and we're trying to make some guidance here for
12 the State and think through 20 years of how are we going
13 to position an asset-management environment like this
14 going forward? How would we create that phrase that we
15 always like to use, a business-friendly climate for us to
16 make our decisions on? Because we are running big
17 financial services operations every day. And the
18 pressure is on because the sunshine is much tougher on us
19 than the private-equity world in terms of our
20 decision-making. So we've got to do that in a business
21 climate to manage close to a half trillion dollars in
22 aggregate already going forward.

23 So please do consider looking at those tools
24 that would make us more successful, such as we've said
25 several times today purposely to you around looking at

1 the financial tools that can keep the system elastic,
2 responsive to economic changes in the environment, and
3 take us away from being in a political football
4 environment for a financial services world.

5 So that's our comments for you. And we'll be
6 here as long as you need us.

7 CHAIR PARSKY: Thank you very much.

8 Let me just start off and then we'll turn it to
9 Commission Members.

10 First of all, I really appreciate, as I'm sure
11 do all Commission members, this kind of presentation.

12 I hope that your fear has been alleviated a
13 little in terms of what our objective is, and that is,
14 although we can't make decisions, we've been asked by the
15 leadership -- political leadership in this state -- the
16 Governor and the legislative leaders -- to come forward
17 with some recommendations to give comfort to public
18 employees -- in this case, public teachers -- that
19 benefits that have been promised to them will be met, and
20 create an environment where we can continue to attract
21 quality people to public employment.

22 When you start with that, then the proposition,
23 then the first step, as we said, was to try to understand
24 some of the facts that are important. In that
25 connection, you're certainly to be congratulated about

1 the performance in this year, and perhaps the performance
2 over the last three or four years. But I think your
3 presentation highlighted the problems that can be created
4 by one or two or three years where, perhaps out of your
5 control, you have the most professionally well-run
6 investment program, but the markets don't allow you, if
7 you will, to meet the kinds of returns that you have
8 currently achieved.

9 Therefore, I think you've indicated that
10 these high returns have not resulted in your changing
11 your estimate or what you guide to, which is still an
12 8 percent return.

13 Is that correct?

14 MR. EHNES: Correct.

15 MR. JOHNSON: Correct.

16 CHAIR PARSKY: That would suggest that, along
17 with your comment about not believing you can invest your
18 way out of this, you're not proposing to change the
19 8 percent.

20 Is that right?

21 MR. EHNES: That's correct, that's correct.

22 CHAIR PARSKY: And that's, in part, inherent in
23 that is a belief that over time, that's an appropriate
24 level of return to be anticipating; right?

25 MR. JOHNSON: That's correct.

1 CHAIR PARSKY: And, therefore, let's put a
2 little bit more meat on -- assuming for the moment -- and
3 I think it's important for the public to understand that
4 these returns, many people have come to us as individuals
5 and said, "Why are you worrying about an issue that
6 should just go away? Because these returns have been so
7 high. And even if you assume 12 or 13 percent returns,
8 you don't have an issue," at least a number of people are
9 saying.

10 From what you all are saying, is that's not a
11 prudent way to go about looking at this problem.

12 Is that right?

13 MR. EHNES: Correct.

14 MR. JOHNSON: I'd like to respond to that.

15 The actuaries' assumption isn't going to
16 produce revenue, okay. I mean, we could assume
17 12 percent, and there would be no unfunded obligation in
18 the valuation. But that means that you have to earn --
19 average 12 percent a year from here on out. And that's
20 not going to -- no prudent investor would be able to tell
21 you that that's really likely to happen.

22 I've got to tell you that in the nineties,
23 boards would come to me and say, "Johnson, what are you
24 thinking? Only 8 percent? I mean, we were earning
25 double-digit for the last eight years. What are you

1 thinking?"

2 And I said, "Well, wait, hang on."

3 And now recently, until just the last year or
4 two, people said, "Johnson, what are you thinking?
5 8 percent, there's no way you're going to earn
6 8 percent."

7 So it is a long-term horizon. And we make
8 projections for a teacher that's hired, that's going to
9 go out 75 years or more.

10 Obviously, the liability is more weighted to
11 those who are already retired or close to it. But when
12 you look at a long time frame, I think you've got to be
13 more prudent, and consider the implications of being too
14 aggressive on your assumption just to make it look like
15 you're in sync.

16 CHAIR PARSKY: Thank you.

17 MR. EHNES: The other thing is I think we need
18 to get out of this black-and-white drama around the
19 funding of these plans, because we are talking with you
20 about some reasonable modulation of what that revenue
21 would look like. And all of our graphs and charts have
22 long history spans to them that we present them. But
23 we're often combated with, frankly, opportunistic
24 presentations that begin in the year 2000. And we all
25 know sound business judgment can't be made around that

1 kind of data in this presentation.

2 So it's one thing to say, "Yes, there needs to
3 be a revenue adjustment." But how much and the context
4 of it is often lost in this public debate.

5 And again, I guess I encourage you to give that
6 kind of sound, reasonable interpretation to all these
7 stories you've heard today, so that people get in the
8 right level of concern. Whether it's cautiously guarded
9 or whether people reach other draconian conclusions is
10 greatly determined by this context that we've set in
11 place here; and the dialogue hasn't been reasonably
12 defined.

13 CHAIR PARSKY: One final question before I turn
14 it over, and that is, I took out of the comments about
15 the decline in the State contribution level, and your
16 comment about this is not a problem that has been created
17 by increased benefits. I just want to make sure you
18 clarify that.

19 What is your point of view on the movement down
20 in the State contribution?

21 MR. JOHNSON: I think the graph showed that if
22 the State contribution had not declined from 1998, there
23 would be \$3 billion more in the fund, plus earnings on
24 that \$3 billion. So let's say there's four or
25 five billion extra. The unfunded obligation would be

1 \$15 billion instead of almost 20.

2 I think Ed can talk more specifically to it,
3 but there was a bit of a trade-off in 1998, when we were
4 faced with a system that was well-funded. And a
5 combination of lessening the obligation of the State with
6 improving the long-term benefit for the teachers was
7 doable, taking a snapshot at that point in time. And the
8 Legislature saw fit to make these changes at that point
9 in time. But this is not a snapshot. This is a movie.
10 And things change.

11 And my point was that had we had even just,
12 call it a poor three years, we still would have been
13 100 percent funded. We had a disastrous three years.

14 And fortunately, I think, for the teachers in
15 the state of California, this is a safety net. This
16 wasn't a defined contribution plan where teachers about
17 ready to retire in 2003 would have saw a third of their
18 money disappear; okay. So that's the safety-net issue
19 here.

20 And it is a tough issue. I mean, when you're
21 faced with providing a guarantee and you're trying to
22 invest the money as best you can, if you have a bad year,
23 things don't look as good as they did the year before.
24 On the other hand, there are systems, plans that are
25 contributing much less than they did 20 years ago

1 because of the investment return. And you may get some
2 testimony on that as well, where the actuary is making
3 a recommendation on contributions. Sometimes those
4 contributions go down.

5 CHAIR PARSKY: Ed?

6 MR. DERMAN: Just to follow up on what Mark
7 said, just to give you some sense.

8 When the decisions are being made from the
9 board about supporting these changes, I mean, just to
10 give you a sense of the concern the Board had about the
11 prudence of those benefit enhancements, we went through a
12 lot of the analysis with the board about looking at
13 different scenarios of investment returns in the future
14 and what impact those reduced returns might have if we
15 didn't improve these benefits and then the investment
16 returns went down, where would we be? And quite
17 honestly, we never contemplated -- I don't think anybody
18 contemplated a market like this.

19 And so, you know, based on the analysis that we
20 had done, we had said we think this is a prudent thing to
21 do. It's okay to increase the benefits. Even if the
22 markets go down to some degree, we can still maintain a
23 well-funded, adequately funded, fully funded system.
24 And, unfortunately, the returns were much worse.

25 CHAIR PARSKY: Curt?

1 MR. PRINGLE: If I could just ask a couple of
2 these questions.

3 I'm trying to -- again, the chart on page 3,
4 when you talk about the financing of the benefits. So
5 I see the contribution level really from the members and
6 the employers, and then this 4.3 now to 2 percent State
7 contribution reflects the 8 percent overall funding to
8 the plan.

9 Is that correct?

10 MR. JOHNSON: Are you talking about this pie
11 chart?

12 MR. PRINGLE: I'm talking about that chart, not
13 what Jack is showing you.

14 MR. JOHNSON: Okay, yes, let me explain the
15 difference.

16 The percentages that we show on the following
17 pages are a percentage of salaries.

18 MR. PRINGLE: Right, I get it.

19 MR. JOHNSON: So the members are putting in
20 8 percent of their salary.

21 What I'm saying on the pie chart is that
22 represents 15 percent of the revenue we expect for that
23 year. In fact, this is historical.

24 MR. PRINGLE: So with the growth in there, the
25 individual wage, because it matches a percentage,

1 basically, that has remained relatively constant and to
2 the level of contribution --

3 MR. JOHNSON: This is an average over
4 twenty-some years.

5 Just to give you a context, the total salaries
6 of the teachers in the state of California is about
7 \$25 billion. 8 percent above that is about \$2 billion.
8 What we're saying is that \$2 billion represents about
9 15 percent of the total revenue we expect in one year.
10 So that's why we are saying, the members are contributing
11 15 percent of the total. It's 8 percent of their pay,
12 but it's 15 percent of the total.

13 MR. PRINGLE: And with that then, that is set
14 by statute?

15 MR. JOHNSON: Yes, sir.

16 MR. PRINGLE: The employer's contribution
17 level, the employee's contribution level, as well as the
18 State contribution; right?

19 MR. JOHNSON: Yes, sir.

20 MR. PRINGLE: So when this State contribution
21 went down 2 percent, or went down by 50 percent, there
22 was a trade-off as a part of that, is that --

23 MR. JOHNSON: Well, I won't speak for the
24 Legislature.

25 What I'm saying is that at the same time that

1 that happened, there was a benefit enhancement. And the
2 net result of the increased cost of the benefit
3 enhancement and the decrease in the State contribution
4 was the system was still in a positive funding position.

5 MR. PRINGLE: Right, just because of the years
6 of positive investment growth?

7 MR. JOHNSON: That's correct.

8 MR. PRINGLE: I see.

9 CHAIR PARSKY: Just pause on that for one
10 second, because coming out of that occurrence, what
11 recommendation would you give to our legislative leaders
12 as a result of that experience?

13 MR. JOHNSON: That's a good question.

14 I think looking back, clearly, there were a lot
15 of reasons -- and I'm not a policy maker, but there were
16 a lot of reasons --

17 CHAIR PARSKY: You can go ahead and pretend for
18 a while.

19 MR. JOHNSON: There were a lot of reasons to
20 make the benefit changes that were made.

21 One of the things that would happen is we were
22 trying to provide an incentive for the teachers to stay
23 in the classroom longer.

24 Now, that has other benefits that you don't see
25 by the cost of the retirement system. That may save the

1 district from training and so on and so forth.

2 So the Legislature, for probably a number of
3 reasons, went ahead and thought that these benefit
4 enhancements were prudent. So I'm not saying anything to
5 dissuade you from that.

6 One of the things, from looking in hindsight,
7 is that after the benefit enhancement was made and after
8 the contribution from the State was decreased, there was
9 a very small amount of the contribution that was left
10 over beyond what the cost for the benefits were in that
11 particular year. In other words, with 20/20 hindsight,
12 you say, well, there wasn't enough left over to pay for
13 an unfunded liability that might come in, in the future.
14 And that's with 20/20 hindsight.

15 But even today, of a total contribution coming
16 in of about 8 -- revenue from members, employers in the
17 state of about 18 or so percent of pay, over 16 percent
18 of that is used to pay for the benefits of the current
19 year. So what's left over was not enough to finance the
20 unfunded liability.

21 And one of the things you see is, well, we're
22 87 percent funded. But even though that's fairly-well
23 funded, there's not enough revenue above what the annual
24 cost is for contributions to amortize that.

25 MR. PRINGLE: And if I could ask then, in '98,

1 when that legislative action took place, would it have
2 been defined that the system was fully funded at that
3 time?

4 MR. JOHNSON: Yes.

5 MR. PRINGLE: So the concept that it was fully
6 funded, and that I believe that when the State
7 contribution was originally established to establish the
8 CalSTRS program, it was a State contribution until the
9 plan was fully funded.

10 MR. JOHNSON: Yes.

11 MR. PRINGLE: So you're making a State
12 contribution, therefore, legitimately without adding
13 additional program -- I mean, the State had the ability
14 because of their prior or early-on established position
15 on making a State contribution, that that could have gone
16 down to zero at that time?

17 MR. DERMAN: Yes, although under the way it had
18 been structured, it would have gone down over a very long
19 period of time. And, instead, the Legislature enacted a
20 bill that brought it down right way. So that was part of
21 the trade-off.

22 And that a gradual reduction is reflected in
23 that \$3 billion savings. It's \$3 billion on top of what
24 they have gotten, anyway.

25 MR. PRINGLE: And if I could, Ed, ask you a

1 question. How many of the 734,000 members, be they
2 retirees or active, are state employees?

3 MR. DERMAN: Oh, very few.

4 MR. PRINGLE: And so that is kind of the weird
5 relationship to me here, too, in terms of what is the
6 statutory benefit presently in place for STRS?

7 MR. DERMAN: It's equal to 2 percent of
8 per-year service of final compensation at age 60. So --

9 MR. PRINGLE: So 2 percent at 60, and that is
10 established by the State?

11 MR. DERMAN: By the statute.

12 MR. PRINGLE: The contribution limits are
13 established by the State.

14 MR. DERMAN: Correct.

15 MR. PRINGLE: And is it also established by the
16 State that local districts cannot participate in Social
17 Security if they wish?

18 MR. DERMAN: That was actually a decision --
19 well, it's sort of established by federal law that
20 allowed the state or occupation groups to decide whether
21 to participate. It was actually the teachers who decided
22 in the fifties not to join Social Security.

23 MR. PRINGLE: So to change that, individual
24 districts could not, even though they are not the
25 employer, they could not allow for that --

1 MR. DERMAN: Correct.

2 MR. PRINGLE: -- individually within their
3 district?

4 MR. DERMAN: It would have to be a statewide
5 change.

6 MR. PRINGLE: It would have to be a state
7 change?

8 MR. DERMAN: Yes.

9 MR. PRINGLE: Thank you.

10 CHAIR PARSKY: John?

11 MR. COGAN: Jack, you made me real nervous when
12 you started out. The CEO of a very well-run and very
13 successful pension fund says -- I think I've got the
14 quote here right -- "Yeah, I'm a racetrack guy."

15 MR. EHNES: Well said.

16 MR. COGAN: You may have a tough time living
17 that one down.

18 MR. EHNES: That's a good point.

19 MR. COGAN: In any event, I have a question for
20 you, I guess, Jack and Mark and Ed and Jerilyn -- anybody
21 who wants to. It follows on Gerry's question. And it
22 gets to this issue of governance. It seems to me that
23 when I think of a defined benefit plan and a defined
24 contribution plan, I can see the benefits of the DB
25 plans.

1 They have one failing, it seems like, in the
2 public sector especially, and that is there's a
3 systematic tendency for underfunding. And the story that
4 is told about CalPERS and the story that you told about
5 STRS, is maybe a good story about how we end up with
6 systematically underfunded pension plans in the public
7 sector. When the returns are high, the fund becomes a
8 little bit overfunded. 110 percent of the liabilities
9 are covered by the assets. The Legislature steps in,
10 cuts the contribution rate, and maybe raises the benefit
11 rates. And then as night follows day and the returns
12 fall as they have in 2001, 2002, 2003, we find the
13 pension fund underfunded and in trouble. Okay, and it's
14 a very, very common occurrence across all legislative
15 bodies.

16 So when I think of our job down the road to
17 recommend how we handle especially the health-care
18 problem, but pensions as well, I wonder how we can
19 develop governance procedures that would help protect the
20 long run of these funds, the long-run solvency of these
21 funds from the short-run tendencies of our political
22 system?

23 One way, obviously, to do that is to separate
24 the decision-making with respect to the fund from the
25 legislative body. I want you to get your thoughts, if I

1 could, on that. But even short of that kind of global
2 recommendation, are there accounting devices, are there
3 institutional rules that have worked in the past that
4 would better protect the pension funds and health-care
5 benefit funds, should we set them up, from this tendency
6 to grant benefits, not necessarily because the benefit
7 levels are inadequate or recruitment is inadequate, but
8 because the money is there, and to cut contribution rates
9 simply because that money is perceived at the moment not
10 to be needed?

11 So, maybe, Jack, you can --

12 MR. EHNES: I can start, and Mark, if you
13 would -- we didn't rehearse this, of course. But Mark
14 has some experience outside California in his consulting
15 practice, where I think key decision-makers were
16 reluctant to embrace sound economic judgment, and so he
17 might reflect on that.

18 But your caricature of the clash of the
19 short-term versus our long-term vision and needs is very
20 real for sure. And this chart -- you were right there
21 when you said this, well, maybe there was a need to set a
22 different glide path for that contribution rate. But
23 instead of an incremental light path, people jumped for
24 the ring immediately and say, "It's precipitous
25 decision-making." And we do need to have those financial

1 tools in place to allow us to be more elastic but in a
2 continuous fashion, and not in these abrupt changes that
3 go on in what we're doing.

4 Having said that, I don't want to paint the
5 picture too bleakly. I worry a little -- I think we're
6 in a reasonable situation, but there's definitely room
7 for improvement. The governance of the system itself,
8 especially -- you know, I'm very proud of our governance
9 because it does reflect a blend of policymakers that come
10 from governor's appointment of public representatives,
11 teachers that are elected by the teachers -- we need
12 those on the board -- retired teachers, and then
13 constitutionally elected officers. It creates an
14 interesting blend of perspectives. Where elsewhere in
15 the country, as we speak right now, people are debating
16 other public pension governance structures that might
17 have sole-trustee governance structures over
18 hundred-billion-dollar-asset plans. And people also
19 wonder is that also a sound model, even though that can
20 lead to very nimble decision-making to your point, much
21 more CEO-like structure, that also has terrible
22 weaknesses, I think, given the fact, ultimately -- we
23 can't be so divorced from that political structure
24 because ultimately, the State is the plan sponsor. Or
25 they're the settlor of the trust, going back to the legal

1 start of this whole thing. So in the end, they pay the
2 bill if something goes wrong.

3 Mark, you've got so much good experience around
4 that conflict, around economics versus other tainting
5 decision factors that get in.

6 MR. JOHNSON: Well, I think the governance of
7 CalSTRS is set up in a very good manner. Let me give you
8 an example of one that was a total disaster, and that was
9 the state of Oregon. And there were 12 members on the
10 board, nine of which were -- 12 board members, nine of
11 which were in the plan. And certain aspects of the
12 program were such that they are decisions that could be
13 made by the board that would affect the benefits.

14 So as you had a good return, for example, they
15 could credit some extra money to members' accounts. And
16 it totally got out of hand. They received advice from
17 the Attorney General's office. They were also in the
18 plan. There were lawsuits filed -- the judges were in
19 the plan.

20 I'm not saying everything was corrupt, but what
21 I'm saying is there was a system set up that was
22 designed, in my opinion, to fail. And we helped the
23 Legislature several years ago totally revamp that plan,
24 where the trustees are set up so they're not making those
25 types of decisions, there is private participation on the

1 retirement board, and so on and so forth. They have
2 outside legal counsel, which they were never allowed to
3 have before. That's kind of the extreme case.

4 I think for CalSTRS, there are very few
5 instances, if any, where the board itself has an effect
6 on the benefit level of a member. That's good from your
7 standpoint, and that should stay that way.

8 I think what Jack was alluding to in terms of
9 the contribution is it would be helpful for the Board to
10 be able to assist in smoothing out these really, I'd say
11 outlying events, such as the returns of 2000 to 2003.

12 CHAIR PARSKY: Just to follow that for one
13 second in terms of given the fact that you wouldn't
14 recommend allowing a board to impact benefits that they
15 might benefit from. How would you address the concerns
16 about the Legislature making the kind of decision that
17 they did, which was to reduce their contributions at a
18 point in time? How would you deal with that?

19 MR. JOHNSON: Well, the amount of information
20 that the Legislature receives on a bill is enormous, as
21 I'm sure you're aware.

22 I think that there ought to be -- and there is
23 now -- a requirement for an actuarial impact statement.
24 And we do those. I mean, any -- some of the smaller
25 ones, we don't. The actuary and the staff at CalSTRS

1 does. But the larger ones, we take a look at. And we
2 think that's important as well.

3 But I think if you had gone back to 1998 -- and
4 even if I had done a study that said, "You know what?
5 I'm just going to throw out a number here, there's a
6 5 percent chance that this whole thing is all going to
7 blow up," what would the Legislature have done? I mean,
8 would they have said, "Okay, there's a 5 percent chance
9 we're not going to pass this benefit," or "There's a
10 5 percent chance, we'll take it"?

11 CHAIR PARSKY: Focus on the contributions side.
12 What, for instance, would you say about changing the
13 ability of the Legislature to reduce contributions at a
14 different level? Instead of 100 percent, maybe it was --

15 MR. JOHNSON: Well, in my opinion, there ought
16 to be a trigger in the Act which says that if we do get
17 into a situation like we're in now, that temporarily
18 we're going to increase the contribution.

19 If it's an automatic trigger, or whether the
20 board pulls the trigger, so to speak, there ought to be
21 some way to gradually reverse course. And that's not
22 possible now without walking down, you know, to the
23 Capitol and lobbying to try to get -- you know, that's --

24 MR. COGAN: Would it be symmetric, Mark? Would
25 you have a trigger that's symmetric?

1 MR. JOHNSON: Absolutely, yes. Because that
2 addresses your issue of becoming overfunded, and then
3 wanting to spend it.

4 MR. COGAN: Right, right. That makes it fair.

5 MR. EHNES: Yes, absolutely.

6 MR. JOHNSON: And the nomenclature is leapfrog
7 and ratchet. Okay, ratchet is: Once you go up in a
8 benefit, you're not going down.

9 MR. COGAN: Right.

10 MR. JOHNSON: And leapfrog is: They've got it,
11 we want it. And when you've got different systems in one
12 state, that's what's going to happen. So in order to
13 prevent that, I think you're absolutely right --

14 MR. PRINGLE: But isn't one of the issues here
15 really that the State Legislature is controlling the
16 contribution limit, and the employer is actually that
17 local school district? So that local school district may
18 wish to address some of the fiscal stability issues, and
19 others may have other priorities, therefore, I think part
20 of your whole challenge is making sure you set a floor,
21 if there is a legislative floor of contribution, but then
22 allow for that floor to be increased, be it by that local
23 school board of the employer contribution, because there
24 are, believe it or not, school districts at times that
25 may wish to put a higher priority in moving some of

1 those dollars in that year forward into a higher
2 contribution. And if they were given that ability to,
3 they would be able to contemplate that, as opposed to
4 they don't have to contemplate that today. They put in
5 X-percent established by the Legislature, even if there
6 may be some within that school board that says, "You
7 know, that 5 percent risk that was presented, I'm going
8 to make sure we protect ourselves from that."

9 MR. JOHNSON: Well, let me tell you where
10 you're going to end up if you do that. You're going to
11 have, what, 1,100 school districts in the program.
12 Eventually, we're going to have to do it -- instead of
13 doing an valuation on one system, we're going to have to
14 do an evaluation on 1,100 employers. It's going to be
15 like CalPERS, different employer contribution rates for
16 all the districts.

17 And then what happens when some districts don't
18 put in the extra monies, others do, investments go up,
19 and one district now is 140 percent funded, the other is
20 80 percent funded. They're going to want a different
21 benefit. I think it falls apart in a system like this if
22 you start to cut up the pie into 1,100 pieces.

23 MR. PRINGLE: So CalPERS demonstrates where
24 it's falling apart?

25 MR. JOHNSON: No. What I'm saying is that --

1 MR. PRINGLE: Let me get it clarified. Because
2 there's multiple benefit schemes under the CalPERS deal,
3 and I just want to see if that is a definition of where
4 it's gone bad. I'd really like to hear that a little
5 more clearly.

6 MR. JOHNSON: I'm not saying that the CalPERS
7 system for municipalities, and so on and so forth, in the
8 state -- I'm not saying that's bad. It's complicated,
9 yes, but it's not, per se, bad.

10 What I'm saying is that for the teachers in the
11 system to have their benefits determined on how the
12 funding did because of the decision that was made, most
13 likely through collective bargaining, to make an extra
14 contribution, is going to eventually turn into some
15 inequities across the state for the teachers.

16 CHAIR PARSKY: Teresa?

17 DR. GHILARDUCCI: I have three short questions,
18 and I think a rather longer one.

19 But now I just want to be clear, because I
20 thought I was, in your presentation, but it's gotten
21 unclear.

22 Are you recommending that this Commission
23 recommend that the CalSTRS Board has the authority to set
24 contributions?

25 MR. EHNES: Yes.

1 MR. JOHNSON: Yes.

2 DR. GHILARDUCCI: But you've qualified that.
3 You've said "limited authority."

4 MR. JOHNSON: Yes.

5 DR. GHILARDUCCI: Could somebody spell that out
6 and the rationale for it?

7 MR. DERMAN: Sure.

8 MR. EHNES: And this is, of course, the balance
9 between what would give us total flexibility and what
10 needs to be realistic in an environment where the plan
11 sponsor is a settlor of the trust.

12 Ed, would you --

13 DR. GHILARDUCCI: If you could separate that.
14 What is really ideal for a good financial system, which a
15 pension fund ultimately is? And then nuance it by what
16 you think the political reality is. I just want to know
17 what the ideal is.

18 MR. DERMAN: I would think that the ideal is
19 that the board can set the contribution rate at whatever
20 level is necessary to amortize the cost of the plan over
21 whatever period of time is appropriate.

22 DR. GHILARDUCCI: Okay, so why not just stop
23 there?

24 MR. DERMAN: Well, because we do recognize that
25 we need the approval -- it's not a board decision to make

1 that. And I think we're trying to be sensitive to the
2 impacts of that proposal.

3 DR. GHILARDUCCI: Okay.

4 MR. DERMAN: So what we have proposed to the
5 board is that there be a floor, the contributions can't
6 drop below a certain amount of money.

7 DR. GHILARDUCCI: What? Normal cost or --

8 MR. DERMAN: Actually, it's below the rates
9 that they currently are, to be honest with you. But that
10 is essentially the normal cost.

11 DR. GHILARDUCCI: Okay.

12 MR. DERMAN: So I think it's fair that at the
13 very least -- I think Mark would agree, at the very
14 least, you ought to contribute what the normal cost of
15 the plan is. You shouldn't go below that.

16 And then put a cap -- and there's no specific
17 number on the cap - but there should be some limit, so it
18 doesn't go above that.

19 DR. GHILARDUCCI: What would be the rationale
20 for a cap? To decide that it's not too high or --

21 MR. DERMAN: Just so I think -- it's one of
22 those things -- you know, if for no other reason, that
23 there's some governor on so that if things got bad enough
24 that it ended up having to go above that cap, the
25 Legislature ought to be involved in the decision of how

1 it wants to address that.

2 DR. GHILARDUCCI: No, but if you're that really
3 underfunded and if you have to fund over a period of
4 time --

5 MR. DERMAN: Again, it's a reflection of the
6 realities of the world we live in.

7 DR. GHILARDUCCI: Okay, well, what cap would
8 you put then?

9 MR. DERMAN: We looked at a cap, and we looked
10 at for the board a year ago, there was a cap of
11 13 percent for the employer. That may not be the number
12 that would be necessary now, but that's a reasonable
13 number. And I think it was 3¼ percent, I believe it was,
14 or 3½ percent for the State, and 8½ percent for the
15 employee.

16 DR. GHILARDUCCI: Okay, okay.

17 MR. DERMAN: Then the other key piece of
18 limiting it is that it go up, in terms of what we
19 identified for the board a year ago, is that it go up a
20 half a percent a year, so we don't have these large
21 whip-saws that a lot of other pension plans have gone
22 through, so that there's a gradual amount.

23 DR. GHILARDUCCI: So you amortize the
24 contributions in some ways?

25 MR. DERMAN: Right. And also, so it's more

1 sensitive to the budgetary implications to the employer.

2 DR. GHILARDUCCI: Sure, sure.

3 MR. DERMAN: But, again, it's a reflection
4 of -- it's a balance between the needs of the fund versus
5 the needs of the people involved.

6 DR. GHILARDUCCI: Well, as I said before, a
7 pension fund has to be legitimate to the workers who are
8 paying in to it, to the employers that has serviced a lot
9 of taxpayers, and to the State, who is also contributing
10 as well, and to the voters.

11 The second question is, let's get clear about
12 why the teachers are not in Social Security, just to
13 clear that up. The federal government allowed some
14 states to exempt their employees -- not all states -- and
15 the State allowed the teachers to decide at one point.
16 So ultimately, I just want to be clear, it is the State
17 Legislature that decides whether or not their state
18 employees are in or out; right?

19 MR. DERMAN: Well, the way historically -- the
20 way it was, when Social Security was created, all the
21 public employees were out.

22 DR. GHILARDUCCI: Right.

23 MR. DERMAN: And the Congress allowed the
24 states to let them in. And it was a vote made by the
25 teachers. And it may have been pursuant to state law, I

1 honestly don't know. But it was a vote made by the
2 teachers that they said, "We've got a plan that's well in
3 advance of Social Security."

4 DR. GHILARDUCCI: Okay, but you don't have to
5 have a vote of the teachers to put them into Social
6 Security?

7 MR. DERMAN: That may well be the case. That
8 may well be the case, yes.

9 DR. GHILARDUCCI: That's actually just too
10 technical.

11 The bigger question is, should teachers and
12 school employees be in Social Security? And that would
13 seem to be reasonable.

14 MR. DERMAN: Well, yes, we've looked at that
15 because there's been proposals in the past for Congress
16 to mandate everybody in Social Security. And what we've
17 found was -- and Mark has done this analysis for us -- is
18 the cost to the employer and the employee would be so
19 enormous, having them pay 6.2 percent, that -- that, you
20 know, that would have been hugely costly to the school
21 districts for the kind of benefit they would get out of
22 that.

23 So, yes, they could. And even if we reduced
24 our benefit to compensate for what they would have gotten
25 under Social Security, it would have still cost

1 substantially more than what they're paying, anyway.

2 DR. GHILARDUCCI: And when was that study done?

3 MR. JOHNSON: We've done it several times.

4 We'll certainly get a copy of that for you.

5 DR. GHILARDUCCI: Yes, great.

6 MR. JOHNSON: In 25 words or less, the reason

7 that that's true is you go back to this pie chart, and

8 Social Security doesn't have two-thirds --

9 DR. GHILARDUCCI: Right, coming from
10 investment.

11 MR. JOHNSON: -- coming from investments.

12 DR. GHILARDUCCI: Right, right.

13 MR. JOHNSON: So once you're going to say,
14 "Okay, where are we going to put this 6-plus percent from
15 the employee and 6-plus percent from the employer" --

16 DR. GHILARDUCCI: Sure.

17 MR. JOHNSON: -- are you going to have it in
18 Social Security or are you going to earn 8 percent
19 interest?

20 MR. EHNES: And the portfolio clearly creates
21 restrictions in their ability to -- I mean, if someone
22 had the financial willingness to fund us there with those
23 extra dollars, we, of course, would amplify that much
24 more than a Social Security benefit would ever do with a
25 32 percent --

1 CHAIR PARSKY: The Social Security IOU's didn't
2 earn quite 25 percent.

3 MR. EHNES: So that's a hurdle they just could
4 never overcome in the cost of money.

5 DR. GHILARDUCCI: Okay, the third question is,
6 maybe to anticipate your task force recommendations or
7 just if somebody would just talk about this, you were
8 talking -- because I'm not clear, either -- you know, you
9 were talking about the inequities in retiree health
10 coverage by these many 1,100 school districts.

11 Are you going to propose a state law that all
12 school districts provide retiree health?

13 MS. HARRIS: I could try to answer that, but I
14 don't know just what the group is going to propose yet.

15 However, one thing that I want was extremely
16 interesting -- and had I known it at the time I decided
17 to go into teaching, it might well have had an impact on
18 where I chose to teach.

19 DR. GHILARDUCCI: Yes.

20 MS. HARRIS: All districts -- and Ed, correct
21 me if this is an incorrect statistic -- with 500 teachers
22 or less, have no health benefit, no lifetime health
23 benefit. It is only the larger districts that -- or the
24 very, very wealthy districts that are offering that
25 lifetime health.

1 But the number of teachers who are in those
2 large districts -- i.e., LAUSD, whatever -- really, it is
3 the cornerstone of what a lot of policy has been over
4 many years. So here, we're looking at a future teacher
5 shortage -- we already have one in many areas,
6 particularly rural areas. I come from a rural, and
7 certainly our chair, Dana, from Weed is from a rural,
8 rural area.

9 What's going to happen to the state of
10 California in those rural areas as it becomes known that
11 this very, very important component of a public-service
12 career is going to be missing in small areas?

13 DR. GHILARDUCCI: One more question. I know
14 that the public is going to want to know the answer to
15 this question, and I would suppose it's the Commission's
16 responsibility to answer it, which is, what does
17 "86 percent funded" mean? What does something less than
18 underfunded mean in this way? We know it was a Social
19 Security debate, that what it meant is that by 2042 the
20 system would only have enough money coming in to pay
21 three-fourths of benefits.

22 So that, of course, it was lost that that was
23 only under a certain set of assumptions, the intermediate
24 scenario. But if CalSTRS went along 86 percent funded,
25 at what point would the system not have enough money to

1 pay 100 percent benefits? And under what circumstances?

2 MR. JOHNSON: That's really generations out
3 there. It's not an issue of CalSTRS running out of
4 money.

5 DR. GHILARDUCCI: Right.

6 MR. JOHNSON: It's a situation of pay-me-now or
7 pay-me-later.

8 I mean, at some point -- I have not calculated
9 when that is, but it would be very, very long in the
10 future.

11 But if I look at Table 14 -- you don't have it
12 in front of you -- of the actuarial valuation, just to
13 cite that, if no changes are made to the contribution
14 levels, and all future experience emerges just like we're
15 assuming, including 8 percent return, that \$19.6 billion
16 unfunded obligation will grow in 30 years to
17 \$158 billion.

18 DR. GHILARDUCCI: Okay.

19 MR. JOHNSON: So in order to fix the problem
20 now, assuming that we earn 8 percent, all the other
21 demographic assumptions turn out to be true, it costs
22 several percentage of salary.

23 DR. GHILARDUCCI: That's it?

24 MR. JOHNSON: Yes.

25 DR. GHILARDUCCI: Like 2? What is it?

1 MR. JOHNSON: No, it was 3.3.

2 DR. GHILARDUCCI: 3.3 percent of salary?

3 MR. JOHNSON: Correct.

4 MR. EHNES: But, Mark, I think we want to make
5 that point that you often tell that board, which is you
6 could be 91 percent unfunded and still unable to amortize
7 your obligation.

8 MR. JOHNSON: Right.

9 DR. GHILARDUCCI: Without any boost, right.

10 MR. EHNES: And those numbers could sound great
11 but you need that extra detail from anyone, is can we
12 amortize?

13 DR. GHILARDUCCI: Got it.

14 MR. EHNES: If not, there is a point of problem
15 out there.

16 DR. GHILARDUCCI: Okay.

17 CHAIR PARSKY: What year -- how many years for
18 the 158 to have --

19 MR. JOHNSON: 30 years.

20 CHAIR PARSKY: 30 years? But that doesn't mean
21 in 30 years you will be 158 billion short?

22 DR. GHILARDUCCI: It does.

23 MR. JOHNSON: It does if there are no changes
24 in the contribution, and all the future experience
25 emerges as we're assuming, that's where you're going to

1 be.

2 DR. GHILARDUCCI: So you need to increase
3 contributions?

4 MR. EHNES: Somewhat. Soon.

5 MR. COGAN: And it is true, the sooner you do
6 it, the less the taxpayer is on the hook for and the less
7 the employee has to contribute towards maintaining that
8 retirement.

9 MR. EHNES: And that's a cost-of-money issue
10 that we're consumed with. But it's hard to get a
11 short-term environment to appreciate that.

12 MR. COGAN: Right.

13 MR. PRINGLE: Unless the taxpayer is on the
14 hook for it. I saw that there was a contribution made
15 from the State. So those state taxpayer dollars that is
16 presently a part of this system; right? And that is
17 unique to CalSTRS, we're going back to that 2 percent and
18 4 percent -- there is not a similar type of contribution
19 from the State for non-state employees, from the State's
20 General Fund to CalPERS; is that correct?

21 MR. DERMAN: Well, the amount of money that the
22 State provides under the revenue limits for the school
23 districts that are under Prop. 98 is adjusted as the
24 CalPERS contribution changes. But it's all under the
25 amount of money that the State has to pay the schools,

1 anyway. So the color of that money might be different,
2 but...

3 MR. PRINGLE: So you're saying because this is
4 Prop. 98 money --

5 MR. DERMAN: Well, the State contribution is
6 not. But I was talking about -- we were talking about
7 CalPERS, when there's a change in the State's -- in the
8 employer's contribution to CalPERS, the State's -- the
9 revenue limit that any individual district gets also
10 changes.

11 But CalSTRS is a different world.

12 MR. PRINGLE: So for the employees of CalPERS,
13 there's not a state equivalent contribution --

14 MR. DERMAN: No, not a direct contribution.

15 MR. PRINGLE: -- unless they are the employer?
16 Unless the State is the employer?

17 MR. DERMAN: No. What I'm saying is for a
18 given school district, like San Diego Unified, for
19 example, that has a revenue limit, their revenue limit
20 will change in response to a change in the CalPERS
21 contribution rate.

22 MR. PRINGLE: You're making it way too
23 complicated. I was making a simple point. The employees
24 of the city, my -- as the mayor of Anaheim, I don't get a
25 benefit --

1 MR. DERMAN: You are correct.

2 MR. PRINGLE: -- from the State General Fund
3 to pay 2 percent of my CalPERS costs.

4 MR. DERMAN: You're correct.

5 MR. PRINGLE: I was trying to make it nice
6 without being mean.

7 CHAIR PARSKY: Stay nice. It's very important.

8 MR. PRINGLE: That's what I work on.

9 CHAIR PARSKY: Lee?

10 MR. LIPPS: I'm practicing my patience.

11 CHAIR PARSKY: That's good.

12 MS. CONWAY: You're the one that's getting
13 married? Is that why you said that?

14 CHAIR PARSKY: We're not supposed to reveal
15 that.

16 MR. LIPPS: That is precisely what I meant.

17 MS. CONWAY: That's what I was alluding to,
18 Mr. Chairman. I apologize.

19 MR. PARSKY: It's okay.

20 MR. LIPPS: Actually, I have several questions.
21 But, again, I don't want to keep people from lunch.

22 First of all, Teresa, with respect to your
23 question on Social Security, let me offer the model that
24 happened in 1985 when it became required for teachers
25 hired after April 1st, 1986, to have to pay a

1 contribution into Medicare of about a percent and a half.

2 That only applied to teachers, towards new hires in a
3 district after April 1st, 1986; and the school district
4 had to make a matching contribution.

5 For those teachers that were already hired in
6 that district, two things had to happen for them to be
7 able to qualify for Medicare at age 65. The first is
8 that that there had to be a districtwide election, a
9 Medicare election, where the teachers as a group voted
10 whether or not their individuals could opt in.

11 If there was no election held -- and, Dom,
12 correct me if I'm wrong -- as I recall, it had to be a
13 joint decision between the school district management and
14 the teachers in the district because they were both going
15 to have to contribute for this earlier group of retirees.

16 If the district did not hold an election, then none of
17 the teachers who worked in that district prior to
18 April 1st, 1986, were allowed to contribute to Medicare
19 and thus wouldn't qualify for it.

20 If you held the election, then it was an
21 individual opt-in -- you know, it was an opt-in by
22 individual teachers. You could decide that you wanted to
23 be able to qualify for Medicare at age 65, and a lot of
24 that would be determined by the level of benefit that the
25 district you were working in offered, whether it was

1 lifetime or not, whether or not you thought you were
2 going to stay in the district, or if you were going to
3 qualify for Medicare by virtue of being, you know,
4 through your spouse, by virtue of being married, as I
5 recall, for ten years or more.

6 So the astounding thing is that there were any
7 number of districts where the election was never held. I
8 don't recall the exact number of districts -- I'm sorry,
9 Dom?

10 MR. SUMMA: I have that for my testimony.

11 MR. LIPPS: Dom has that for his testimony
12 later today.

13 But my guess is that should some sort of
14 legislation change and teachers be able to go into Social
15 Security, a similar model, it might be followed -- or at
16 least contemplated. I just wanted to clarify that part.

17 The original question, Chairman Parsky, that
18 you asked about, the actuarial assumptions, I would like
19 to revisit that with Mark.

20 Mark, over about the last 20 years -- and I
21 know that CalSTRS has used an 8 percent assumption rate
22 on investment return.

23 Over the last 20 years, how many years has
24 that, Mark, not been met? Just sort of ballpark.

25 MR. JOHNSON: You know, I don't have that. If

1 I had to make a wild guess, I'd say probably a third.

2 MR. LIPPS: Three?

3 MR. JOHNSON: A third.

4 MR. LIPPS: About a third? Okay.

5 We've heard testimony at our last meeting of
6 the actuarial assumption by CalPERS of 7¾ percent. But
7 there's no quibbling between that and 8 percent, that
8 there was only a 50-50 chance, probably chance of hitting
9 that mark.

10 Is it the practice of actuaries to set an
11 assumption, Mark, that its client, or an assumption
12 recommendation to its client that only has a 50 percent
13 chance of being met?

14 MR. JOHNSON: 15?

15 MR. LIPPS: 50.

16 MR. JOHNSON: 50?

17 Yes, in the public sector, there's a difference
18 between -- the private sector and who makes the decision
19 on the assumption.

20 In the public sector, the onus is on the board
21 to make an assumption. And it's normally based on a
22 recommendation of the actuary.

23 We have recommended to CalSTRS' board that they
24 select an assumption of 8 percent, and they have. And
25 the last time we did an experience study, there was just

1 slightly greater than a 50 percent chance that they would
2 enjoy an 8 percent return over a long period of time.

3 MR. LIPPS: Over a long period of time. But in
4 a given year --

5 MR. JOHNSON: Oh, who knows? That could be
6 anything. It could be -- and we're not dealing with that
7 particular year. This is a long-term prospect. So I'm
8 not able, nor is it necessary for me to predict what the
9 return will be for one year or one month or tomorrow.

10 MR. LIPPS: Okay.

11 Jack, I think this question is for you. There
12 was some mention that there's no intent to reduce
13 retirement benefits through CalSTRS. There is one
14 provision that's sunsetting, I believe, in 2010, relating
15 to longevity and the \$100, \$200, \$300 bonuses.

16 Is that up to reauthorization by the
17 Legislature or is that something that the Board has any
18 control over?

19 MR. EHNE: It requires additional funding, and
20 it would be a legislative decision for sure. And I think
21 what gives us heartburn, of course, is going back to that
22 replacement percentage that I showed you on the board,
23 the fact that it's between 55 and 65 percent, depending
24 upon your date of retirement. So that is negatively
25 impacted to the extent that benefit sunsets.

1 MR. LIPPS: Because I was going to ask about
2 that retirement, the replacement factor in that. So that
3 leads into my last question, Mr. Chairman.

4 The slide on page 2, where it says for new
5 retirees, based on an average benefit there is about a
6 63 percent replacement factor --

7 MR. EHNES: I know what you're going to say
8 yes.

9 MR. LIPPS: In the brochure, it doesn't refer
10 to new retirees.

11 MR. EHNES: It's the entire retiree base.

12 MR. LIPPS: It says "median" as opposed to
13 "average," but the 10 percent spread seems statistically
14 a little large.

15 MR. EHNES: Well, we've been looking at those
16 numbers. And one is, we do think given the extremities,
17 that the median is a better statistic. So we were going
18 to start moving those over to a median calculation.

19 Because as you as well said, we also -- it is a
20 different scope, that fifty-three, four number is
21 reflecting our entire retiree base. So it is those two
22 differences that cause that difference, the change from
23 an arithmetic mean to a median value, plus the entire
24 retiree base, which there is definitely perceived
25 accurately inequities from that retiree base of what the

1 early retirees have versus our most recent group.

2 MR. LIPPS: Okay, thank you.

3 CHAIR PARSKY: Ron?

4 MR. COTTINGHAM: Getting back to the -- I want
5 to ask a question about the shortfall, because you had
6 indicated that the benefit enhancements that were created
7 after they were implemented, there was still overfunding,
8 you were over 100 percent funded in CalSTRS.

9 MR. EHNES: That's correct.

10 MR. COTTINGHAM: Had there been no benefit
11 enhancements and the market would have done what it did,
12 would you still have then experienced a shortfall in
13 funding?

14 MR. JOHNSON: I haven't tested that particular
15 question, but there is a portion of the statute which
16 requires us to test the benefit that was in place in
17 1990. And if the benefit structure and the funding
18 mechanism that was in place in 1990 had been in place for
19 the last 16 years, up through 2006, there would still be
20 a surplus, even with the poor returns in 2000-2003.

21 MR. COTTINGHAM: Okay, you still would have
22 been able to have a surplus?

23 MR. JOHNSON: Again, that's 1990 -- and, again,
24 there were not significant benefit changes between 1990,
25 1998.

1 So I guess what I would --

2 CHAIR PARSKY: The logic would be that the
3 contribution reduction contributed the most to the
4 situation you described then? If the benefits were not
5 increased that dramatically, but the contribution levels
6 were -- or not during this period, 1990, forward?

7 MR. JOHNSON: No, you're right. But we would
8 have paid out fewer benefits during this period, since
9 1998. We would have had higher contributions, okay,
10 working in the same direction. And even though if we had
11 poor returns in 2000-2003, given those --

12 CHAIR PARSKY: Those dynamics.

13 MR. JOHNSON: -- those dynamics, we would have
14 still had a surplus.

15 CHAIR PARSKY: Okay, I'm sorry, go ahead.

16 MR. COTTINGHAM: As Lee indicated in the last
17 presentation, they talked about some of the contribution
18 levels, or the projections, earning projections. And one
19 of the things that was brought up and recommended is, I
20 guess, twofold: Is if you're having volatility in the
21 market, and this affects rates and contribution levels,
22 should you invest in things that were, like, treasuries
23 and bonds that are steady in their return, and should you
24 lower your projections to -- and I think what was
25 recommended at that meeting was around 5 or .5 percent --

1 would that help the system?

2 MR. JOHNSON: I'll let Jack or Ed weigh in on
3 this as well.

4 CHAIR PARSKY: It's clearly not an actuarial
5 question, but that's all right.

6 MR. JOHNSON: You know, I'm not an investment
7 expert. But let's say you had a portfolio that the
8 actuary expected to return 5 percent. This chart would
9 look different. You would not expect the 63, or
10 two-thirds, as the gentleman said earlier, 70 percent of
11 the funding to come from investments. A smaller portion
12 of the total funding would come from investment.

13 Yes, they'd be safer, but over a long period of
14 time, you're giving up return. You're trading some risk
15 for a higher return. And CalSTRS does an excellent job.
16 They have excellent investment staff, they have excellent
17 consultants to help them get the best portfolio they can
18 with just the appropriate amount of risk. And to say
19 that we could be safer with a return that's -- let's say
20 it's going to average 5 percent, that's true, but then
21 the taxpayers have to put in that much more money.

22 MR. EHNES: We really had just two states left
23 in the country, until relatively recently, Indiana and
24 South Carolina, if I remember right, that had those types
25 of restrictions. And they've certainly let them out --

1 it was actually South Carolina is just going now into
2 global equities. They finally made it to equities, and
3 now they're taking the last step. And their benefit
4 structures reflect the penalties of all that period of no
5 growth, but certainly safer.

6 MR. COTTINGHAM: And when you're talking about
7 having CalSTRS or the retirement systems being able to,
8 within parameters, raise or lower contribution levels,
9 I'm assuming that's -- it wasn't stated, but that would
10 be employer and employee contributions? Because what I
11 am wondering there is, obviously, most of the
12 employer-employee contribution levels are set through
13 memorandums of understanding. And how would you deal
14 with that issue if you were in a current MOU? Because if
15 you have to wait -- if you're put behind the curve
16 because the Legislature cannot act quickly enough to
17 change things for you, then I guess you're put behind the
18 curve if the MOU currently in place prevents the same
19 action.

20 MR. DERMAN: Well, the actions, the memorandums
21 of understanding don't address the contribution rates
22 paid by the employee because it's set in statute. So
23 it's not a bargaining issue. So the more significant
24 issue in terms of the employee contribution is that
25 there's a constitutional limitation in terms of you can't

1 increase the contribution rate that an employee pays
2 without giving them something in return for that.

3 So, yes, there would be in terms of what we
4 were suggesting to the board an increase in the
5 contribution rate paid by the employee, but there would
6 have to be some offsetting increase in the benefit to
7 offset that.

8 We happened to identify one that, in fact,
9 wouldn't cost the plan any money to sort of provide that
10 economic justification. But there would be an increase
11 in terms of what we were suggesting in the employee and
12 the employer contribution.

13 But that's one of the reasons why we were
14 suggesting, because of the bargaining implications in
15 terms of having the employer and the employee paying more
16 money, is that what we would propose would be deferred in
17 terms of the board sets the rates, say, in July of -- or
18 in April of 2008. It wouldn't take effect for another
19 two years. So that people would have an opportunity to
20 have their bargaining process adjust to whatever the
21 increased contribution rates are.

22 CHAIR PARSKY: The last question, Dave?

23 MR. LOW: I just have a contextual question.

24 As far as I know, you're the only system that
25 have come up here and said, "Our rates are all fixed,"

1 and all the other defined benefit systems have the
2 ability to adjust their rates.

3 So what is the context? How many other systems
4 are there out there that run like yours?

5 MR. EHNES: Ed can address that.

6 MR. DERMAN: Yes, we've been looking around.
7 And we found a couple other state systems that have it.
8 In terms of in California local plans, from the counties,
9 the information we've got is there may be a handful in
10 which the governing body, like the county board might set
11 the rate or participate in setting the rate. But this is
12 by far the outlier. I mean, I can't think of one that is
13 as rigid as this one is.

14 CHAIR PARSKY: Thank you all very much for a
15 very interesting discussion.

16 And we'll now take a break for lunch and be
17 back in about 30 or so minutes.

18 Thank you all very much.

19 *(Midday recess taken from 12:34 p.m.*
20 *to 1:20 p.m.)*

21 CHAIR PARSKY: Let's see if we can't resume our
22 agenda.

23 And we have our next panel.

24 School Funding and Retired Classified and
25 Certificated Health Care.