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**PUBLIC SAFETY PERSONNEL RETIREMENT SYSTEM
CORRECTIONS OFFICER RETIREMENT PLAN
ELECTED OFFICIALS' RETIREMENT PLAN**

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14 September 2015

Debra K. Davenport, Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Dear Ms. Davenport:

We are both excited and sad to have this sunset review and performance audit come to an end. Working with your staff over the past year and a half has been very enjoyable and I hope the same for them. We have been able to work together to help the Auditor General better understand the uniqueness of the Public Safety Personnel Retirement System (System), the challenges we have been facing and the efforts we have made to overcome those challenges. We, in turn, through your staff's exhaustive efforts, have been able to see some things in a different light to help us improve the service we provide, both in terms of efficiency and sustainability. Below you will find our formal response and any comments on the recommendations given for the individual findings.

Finding 1: The Public Safety Personnel Retirement System plan's (PSPRS plan), the Corrections Officer Retirement Plan's (CORP), and the Elected Officials' Retirement Plan's (EORP) assets have not kept pace with estimated pension obligations.

No recommendations given.

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

Recommendations

2.1 To ensure the plans' permanent benefit increase structures are sustainable, the System should take the lead and collaborate with stakeholders to identify changes that are needed and develop solutions. In developing solutions, the System will have to pursue legislative changes to implement them since each plan's benefit increase structure is specified in statute. The System will also need to determine if the solutions should apply to all members or members hired or retired on or after a specific date, and consider whether a constitutional change might be warranted (see Recommendations 2.2 and 2.3). In collaboration with stakeholders, the System should:

- a. Determine whether a higher funded status for each plan should be required before providing a benefit increase;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- b. Determine whether a simple instead of a compound structure may be more sustainable for its plans;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- c. Consider whether it should link its permanent benefit increases to the Consumer Price Index, and if so, whether it should provide full inflation protection;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- d. Consider changing its permanent benefit increase structure for the PSPRS plan and CORP to be based on the funded status of individual employers instead of each plan's overall aggregate funded status;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. There are a number of practices based on aggregate numbers. Changing the PBI structure to be based on individual employer funded levels will be considered along with those other practices.*

- e. Consider whether increases for all three plans should be applied to a certain amount of a member's pension benefit, such as the first \$18,000;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- f. Consider changing EORP benefit increase formula to be based on asset value similar to the PSPRS plan and CORP, instead of retired members' estimated pension obligations;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- g. Consider modifying the PSPRS plan's permanent benefit increase structure to be based on an individual member's pension benefit; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- h. Identify other necessary changes, such as basing benefit increases on long-term investment performance instead of a 1-year result, or consider whether benefit increases should be eliminated.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We will consider basing benefit increases on long-term investment performance instead of a 1-year result, but do not think eliminating benefit increases altogether is appropriate.*

2.2 Once solutions have been decided upon, the System and stakeholders should determine if the changes should apply only to members who are hired or retire after a specific date. If so, the System should pursue the necessary legislative changes to implement the solutions for all three plans' benefit increase structures. The outcome of the *Hall* lawsuit may impact the System's ability to make changes to the plans' permanent benefit increase structures for active members.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.3 The System should consider whether pursuing a ballot initiative to amend Arizona's Constitution would be warranted to make changes to the benefit increase structures for all three plans' members. Depending on how an amendment is worded it could supersede previous legal decisions. If considering an amendment, the System and stakeholders should ensure that this amendment is specific to the System plans' permanent benefit increases to ensure members' base pension benefits are not impacted.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.4 Throughout the process of developing solutions for the plans' benefit increase structures, the System should ensure it provides the necessary training or informational materials to ensure stakeholders and the public understand the purpose and impact of the proposed changes.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

2.5 The System should ensure that its actuarial assumptions appropriately include the estimated costs for its permanent benefit increases when conducting the System plans' annual valuations by:

- a. Conducting an audit of its actuary as soon as possible; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Our internal governance policies state that "an actuarial audit or equivalent is conducted at least every seven (7) years." Three actuarial audits or equivalents were performed between 2005 and 2009, the last being performed by our current actuaries as part of their new engagement that year. In consultation with those actuaries, and accepted by the Board of Trustees' Operations, Governance Policy and Audit Committee, we agreed it would be best to wait until the Hall case is determined before conducting the next actuarial audit. It is our understanding and hope that the Hall case will be determined early enough to incorporate any necessary retro payments and return of contributions in this fiscal year if the Superior Court ruling is upheld. If so, performing the next actuarial audit as of June 30, 2016 will still be in compliance with our internal policies.*

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

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

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

Recommendations

3.1 The System should develop and implement a funding improvement strategy. This funding improvement strategy will need to be at the participating employer level for the PSPRS plan and CORP, but at the plan level for EORP. In developing this strategy, the System should review and incorporate key elements from Rhode Island's funding improvement strategy that may reasonably help increase plans' funded statuses.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We have already discussed the need for a funding improvement strategy with employer stakeholders and will be working with them to develop it. We will review Rhode Island's funding improvement strategy and incorporate those key elements that may reasonably help increase an individual plan's funded status.*

3.2 The funding improvement strategy the System develops should consider:

- a. Establishing the funded status level at which its plans should be considered at-risk, and work with its actuary to determine what would be appropriate;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be*

implemented.

- b. Requiring annual certification of the at-risk funded status. This could be done as part of the annual actuarial valuations performed by the System's actuary;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- c. Specifying who must be notified when a plan is certified to be at-risk;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- d. Posting a notice of the at-risk status on its Website;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- e. Establishing the specific actions that can be taken when a plan or plan employer is determined to be at-risk, including a requirement that the actions be reviewed and approved by the System;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- f. Identifying who is responsible for the various actions, including the employer, an actuary, or system administrator;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- g. Establishing the amount of improvement in funded status that should be achieved; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- h. Determining time frames for completing the various actions, including an overall time frame for improvement in a plan's funded status.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.3 Once the System has developed a funding improvement strategy, to provide greater leverage, the System should pursue legislation to incorporate the funding improvement strategy and its various components within its statutes.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We will compare and contrast which elements are most appropriate for statute as some elements may need some flexibility to where a policy is more appropriate. We will seek legislation, coupled with policy, to ensure the most effective strategy is followed.*

3.4 The System should work with the PSPRS plan and CORP employers and local boards, and other stakeholders, such as professional associates for firefighters or police, to explore the feasibility of offering multiple benefit options.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.5 If the System decides to offer a limited number of pension benefit options, it should take the following actions:

- a. Determine the specific pension options that should be available;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- b. Determine the specific times and conditions under which an employer can change its options;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- c. Seek the necessary changes to the PSPRS plan and CORP laws to allow for employers to select options; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- d. Develop and implement training materials on the various pension benefit options and their costs so that PSPRS plan and CORP employers can make informed decisions about which benefit options would be the most appropriate.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.6 The System should develop and provide educational materials to PSPRS plan employers explaining how unusually large overtime pay increases the risk of generating unfunded liabilities. The System could work with the PSPRS plan's actuary to create and include in communications to plan employers, such as newsletters and retirement manuals, an explanation and examples of how compensation practices like unusually large overtime usage can generate unfunded liabilities for participating employers.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We are already doing this to some degree in our Local Board training program formally adopted by the Board of Trustees in 2008. We will review that material and expand as appropriate.*

3.7 The System should adopt practices similar to those in peer public pension plans to ensure that contributions are correct, including:

- a. Establishing formal, written policies and procedures for system staff to flag and document any abnormal contributions that may indicate abnormal wage increases or contribution errors. These procedures should detail which staff will be responsible for completing these tasks;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Informal, unwritten procedures are already in place so we will make sure they are formally written and reviewed in accordance with our annual policies and procedures process.*

- b. Establishing formal, written policies and procedures for system staff to investigate flagged contributions. These procedures should detail the necessary steps and documentation for any investigation as well as which staff will be responsible for conducting these investigations; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Informal, unwritten procedures are already in place so we will make sure they are formally written and reviewed in accordance with our annual policies and procedures process.*

- c. Developing and implementing written policies and procedures for conducting regular audits of

participating employers for compliance in reporting wages and contributions.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

3.8 To ensure that EORP has sufficient assets to cover its estimated pension obligations, the Legislature should consider revising A.R.S §38-810 to allow the Board to annually establish contribution rates or consider increasing its annual appropriations over time.

3.9 The System should continue its efforts to provide additional training to employers and local boards. In conducting such training, the System should ensure that employers and local board members understand the associated costs and effects of certain benefit decisions, such as long-term disability approvals and benefit calculations, as well as the significance of their individual funded status.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. We are already doing this to some degree in our Local Board Training program formally adopted by the Board of Trustees in 2008. We will review that material and expand as appropriate.*

Sunset factor analysis

Recommendations

1. The System should:

a. Train IT staff on the roles and responsibilities of its updated disaster recovery plan;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This has already been completed.*

b. Develop processes for reviewing, approving, and implementing its IT policies; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. This has already been completed.*

c. Implement additional controls on its hosted website, such as encryption technologies, to prevent unauthorized access of confidential system information.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. Just to clarify for the public, the hosted website referred to is for Board of Trustee meeting material only. All personally identifiable and other confidential membership information and material is hosted internally and very secure. We have received assurance from the third-party host that this website will be made secure before the end of October.*

2. The Board and System should enhance its internal audit function by:

a. Revising the System's internal audit charter to ensure internal and external assessments are conducted and work with the Board to schedule an external assessment of the internal audit function;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. The Internal Audit and Compliance Officer prepared an internal review of the IIA standards and how they are addressed at PSPRS for the Auditor General as part of this review. We will incorporate this review into a self-assessment review and expand as needed. We will also schedule an external review for this fiscal year.*

b. Requiring that internal auditors disclose any conflicts of interest and their appropriate mitigation

to the Operations, Governance Policy and Audit Committee;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- c. Periodically reviewing its internal audit charter, including requiring internal auditors to regularly brief the Board on the purpose, authority, and responsibility of the internal audit function according to the charter. In addition, the Board should also amend the internal audit charter to require these activities; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented. In March of 2012 the Internal Audit Officer, in conjunction with audit partner from our external audit firm, made a presentation of the roles of Internal Audit, External Audit and the Audit Committee. This has not been updated since then; however, there has been no turnover on the Board, but we will expand upon this presentation to more frequently and fully comply with this recommendation.*

- d. Developing and implementing policies and procedures to guide internal audit functions.

Response: *The finding of the Auditor General is not agreed to, but the recommendation will be implemented. We have established policies and procedures, but agree they are not sufficiently documented. We will include this documentation as part of the Internal Audit and Compliance plan for the current Fiscal Year.*

3. To enhance its processes for addressing members' issues, the System should:

- a. Develop and implement formal, written policies and procedures for handling member communications to ensure that system staff provide uniform treatment to members. These policies and procedures should define what member communications should be documented and tracked;

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- b. Develop and implement a central record that details when members' issues are received, the nature of the issue, the system staff members who handled the issue, and when, and how the issue was resolved; and

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- c. Develop and implement procedures for requiring a regular analysis of the centralized record to identify and address systemic causes of trends in member issues.

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

Again, we thank you for the enormous amount of time and effort you and your staff have put into this report and look forward to it again ten years from now.

Respectfully,

Jared A. Smout
Administrator