

**California Public Employees' Pension Reform Act of 2013
CalPERS Agency Issues**

Background

On September 12, 2012 the Governor signed pension reform AB 340, which the California State Legislature approved on August 31. Within AB 340 is the California Public Employees' Pension Reform Act of 2013 (PEPRA), which affects most California retirement systems, including CalPERS, effective January 1, 2013. PEPRA generally restricts current pension provisions while increasing flexibility for employee/employer cost sharing. It includes 1 new retirement formula for Miscellaneous members and 3 for Safety members.

This paper focuses on PEPRA's implications for agencies participating in CalPERS.

PEPRA is unclear and difficult to interpret in a number of areas. We look forward to clarification, which could change our understanding summarized in this preliminary analysis. Our interpretation of PEPRA is not legal advice; agencies should consult with counsel for a legal interpretation of the statute.

New Member Provisions

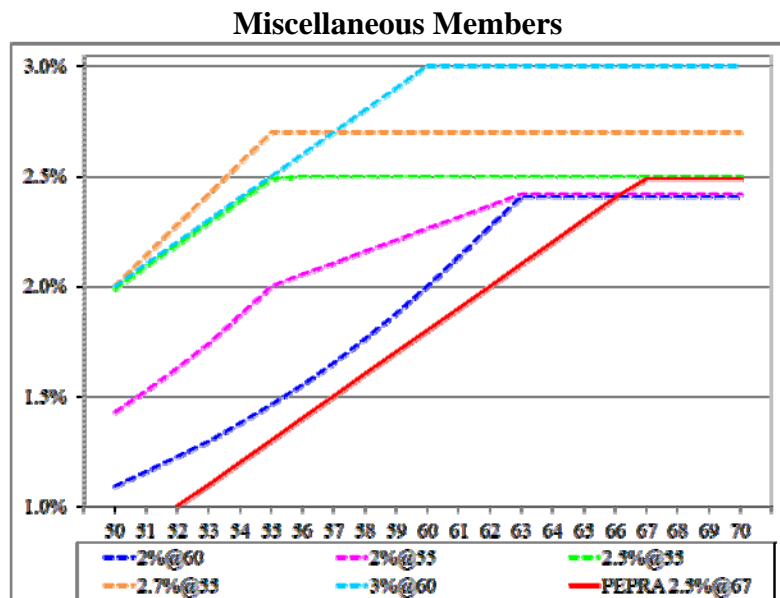
"New members" are individuals who join any public retirement system on or after January 1, 2013 and individuals who were last in CalPERS or a reciprocal system more than 6 months before their hire. PEPRA cost savings are for requirements imposed on new members hired on or after January 1, 2013.

Since savings will be realized only as new members are hired in the future, savings will be very minimal short term. Attached are sample projections.

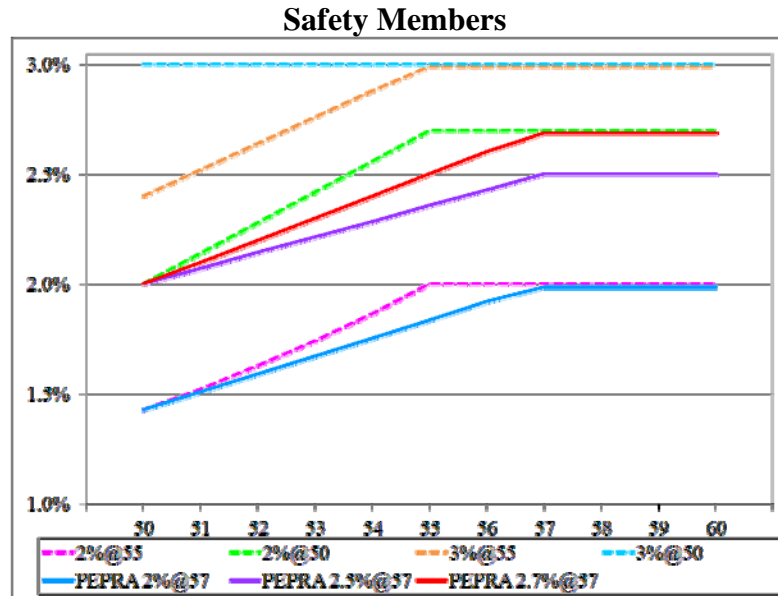
■ *Benefit Formulas*

Benefit formulas cannot be greater than the new PEPRA formulas:

- 2.5% @67 for Miscellaneous members. The earliest service retirement age under the new PEPRA formula increases to 52 for Miscellaneous members. The following graph compares new and current formulas:



- PEPRA creates 3 new Safety member formulas (2% @57, 2.5% @57, and 2.7% @57). The new member formula is the one with the closest lower benefit factor at age 55 to the applicable formula for members hired before 2013 (if agency already has a second tier, the applicable formula is the benefit for employees hired on December 31, 2012). This means 2.7% @57 applies to 99% of Safety groups, with 2% @57 applying to the remainder (those that currently have 2% @55). Agencies may bargain with employee groups for any of the lower formulas. The following graph compares new and current formulas:



Additional issues:

- If a group not in CalPERS has a pension plan with a lower factor at age 55 and a lower Total Normal Cost rate¹ than the applicable benefit above, that plan can continue for current and new members.
- PEPRA does not appear to limit optional benefits.

Agencies may still determine new member COLAs, Post Retirement Survivor Allowance (PRSA), and industrial disability benefits.
- Note that the new formulas do not apply to employees hired after December 31, 2012 directly from another CalPERS or reciprocal agency because they're not considered new members. We believe old members will be eligible for the same formula as those hired on December 31, 2012 with apparently no ability to change to a lower formula after that date.

Agencies with no second tier may want to consider implementing one before January 1, 2013 (subject to bargaining requirements).
- PEPRA is similar to but significantly varies from Governor Brown's proposed pension reform bill released in February 2012. One significant difference is the original proposal included recognition that Social Security provides a substantial retirement benefit for those enrolled, while new PEPRA formulas do not.

¹ Total Normal Cost is the sum of the employer normal cost rate and the employee contribution rate.

■ *Employee Contributions (new hires including new members)*

The following provisions apply to new hires and new members effective January 1, 2013. If they impair a contract in force at that time they won't apply until the contract expires or is renewed, amended, or extended.

- Employees must contribute at least ½ of the Total Normal Cost rate, initially set for 2013 (rounded to the nearest 0.25%), then adjusted in future years if the Total Normal Cost rate changes by more than 1% of payroll.
- If higher, the new hire rate must be the current contribution rate of similarly situated employees (“similarly situated” is not specified in the law, although we believe it means, for example, those in the same bargaining group).
- The agency may not pay this amount, which essentially will eliminate Employer Paid Member Contributions (EPMC) over time; we believe it is still allowed for current employees and, if in a contract, for new hires who are old members.
- Additional amounts may be paid by employees if agreed in collective bargaining and if this doesn't result in the employer paying a higher rate for nonrepresented, managerial, or supervisory employees in related retirement membership classifications.

CalPERS provided the following sample Total Normal Cost rates under the new formulas (CalPERS estimates are based on a large public agency). We've added a column showing the associated employee contribution rate (based on 2% COLA with PRSA and basic industrial disability benefits).

Benefit Formula	Total Normal Cost Rate²	Employee Contribution Rate³
Miscellaneous Members • 2.5% @67	11.9%	6.0%
Safety Members • 2% @57	16.8%	8.5%
• 2.5% @57	n/a	n/a
• 2.7% @57	21.0%	10.5%

Because new members will not pay less than current members, actual employee contribution rates will vary across agencies based on current MOUs. Ultimately each agency's savings will be a function of current formulas and the new member employee contribution rate.

New members will pay at least as much as current members for significantly lower benefits, with most new Safety members paying more than current members.

² CalPERS estimates based on June 30, 2011 valuation assumptions.

³ 50% of Total Normal Cost rounded to nearest 0.25%



Pensionable Compensation (new members)

Final compensation must be the highest average annual compensation over 36 consecutive months. Annual pensionable compensation for this purpose is described below:

- Compensation in 2013 is limited to \$113,700 (2013 Social Security Wage Base) if the new member participates in Social Security, and \$136,440 (120% of the 2013 Social Security Wage Base) if the new member does not participate in Social Security⁴.
- The 2013 limit increases in future years by CPI.
- PEPRA states that the Legislature may change this limit if the change doesn't decrease accrued benefits. Presumably, this language is intended to avoid vested rights issues should the Legislature want to reduce future limits.
- Pensionable compensation for new members is generally defined as base pay (paid in cash on a full-time basis for normal hours worked, based on a publicly available schedule). Deferred compensation is treated as pensionable when earned. PEPRA lists compensation that is not pensionable - overtime, severance, unused vacation, and allowances, as well as any compensation "determined by the board to have been paid to increase a member's retirement benefit."

This limit has a significant impact on new member benefits for agencies currently including EPMC in pensionable compensation. However, this change will have very little impact on agency contributions.

■ *Other Retirement Plans (new hires)*

Additional plans provided by an agency are restricted as follows:

- No additional defined benefit plan (supplemental or otherwise).⁵
- Generally, there are no PEPRA restrictions on defined contribution plans. However, PEPRA limits the amount an employer can contribute to a defined contribution plan if the contribution is applied to pay in excess of the compensation limit.

⁴ The IRC Section 401(a)(17) compensation limit (\$255,000 in 2013) also applies, but is currently much higher than the Wage Base, and CalPERS already applies this limit to employees hired after July 1, 1996.

⁵ Exception: If a Safety group contracts with CalPERS for a lower PEPRA formula than required (for example, a 3% @50 group adopts 2% @57 benefit for new members), then presumably an additional Safety defined benefit plan could be provided if the combined plans did not exceed the highest allowable PEPRA benefit (2.7% @55 in this example).

Current and New Member Provisions

The following provisions apply to current employees, and unless indicated otherwise, also to new members:

■ *Employer Contributions*

The annual employer plus employee contribution cannot be less than Total Normal Cost. This requirement may be suspended for an employer, but applicability is not likely to occur in the near future and may never apply⁶. Note that for plans with no active participants, there is no Total Normal Cost and therefore no minimum contribution required under PEPRA.

CalPERS will need to address how to fund their risk pools; unless current policy changes, risk pools will be virtually closed to new participants.

■ *Employee Contributions (does not apply to new members)*

- PEPRA states equal cost sharing of Total Normal Cost “shall be the standard,” but does not appear to require this “standard” or that current employees contribute any portion of Total Normal Cost⁷. Instead, the legislation allows agencies to impose, beginning January 1, 2018 (subject to good faith collective bargaining) a minimum employee contribution, for employees hired before January 1, 2013: at least ½ of Total Normal Cost, but not greater than the maximum below. Current CalPERS employee contribution rates are shown for comparison.

Since current PERL generally allows agencies to impose full employee contribution rates, this PEPRA provision is a modification of current law.

The maximum amounts are less than ½ of the Total Normal Cost for roughly 50% of the current Miscellaneous plans, and 99% of Safety plans. This means most plans will not have the ability to impose a ½ member paid normal cost.

Group	Maximum Employee Contribution That Can Be Imposed	Current CalPERS Employee Contribution Rates ⁸
Miscellaneous Members	8%	7% - 8%
Safety Members		
- Police, Fire and County Peace Officers	12%	9%
- Other Safety	11%	9%

- Employee contributions may exceed these amounts if agreed through collective bargaining and subject to additional criteria if made through a CalPERS contract amendment. PEPRA

⁶ Plan must be 120% funded and, among other criteria, contributions must result in the possible disqualification of plan’s tax-exempt status due to “excess earnings.”

⁷ PEPRA doesn’t require the “standard” 50% Total Normal Cost employee contribution for current employees - we do not consider this a cost savings.

⁸ Dependent on benefit formula. Miscellaneous 1.5% at 65 and Safety ½ at 55, 2% @55, and 2.5% @55 formula employee contribution rates omitted.



does not appear to limit employee contributions. Current Public Employee Retirement Law (PERL) limits employee contribution contract amendments to the specified employee rate (such as 7% for Miscellaneous 2% @55), with additional employee contributions permitted only to share the cost of certain benefit improvements.

■ *Benefit Improvements*

Benefit improvements adopted after 2012 are permitted, subject to the following:

- Improvements can apply only to future service. This is a clear change from current PERL that benefit improvements *must* apply to past service. In addition, when a job classification change gives the employee an enhanced benefit or agency plan, the enhanced plan can provide service credit only after the job classification change.
- Cost-of-living increases are almost certainly not considered retroactive benefit enhancements, but PEPRA is not entirely clear on this point.
- New member retirement formulas are limited to the formulas described above.

It is unclear whether accrual rates are restricted. For example, benefits for an employee age 50 with 10 years of service and \$100,000 compensation could not be increased to provide an additional 1% of pay benefit for all service. However, could the benefit be increased by a flat \$10,000 (1% x \$100,000 x 10 years service)?

■ *Disability Benefits*

In what appears to be the only PEPRA pension enhancement, Safety member industrial disability retirements before age 50 must receive at least the actuarial equivalent of their service retirement benefit. Before age 50, these members currently receive 50% (75% if an enhanced disability option elected by agency) of compensation.

PEPRA also includes a sunset on this provision; it remains in effect only until January 1, 2018 (unless extended by another statute).

■ *Airtime Purchase*

PEPRA prohibits any member from purchasing nonqualified service after 2012.

■ *Other Retirement Plans*

Other than retroactive benefit increase provisions, PEPRA has no limits on current defined benefit plans in existence before 2013, including supplemental pension plans with benefits in excess of the compensation limit and IRC Section 415 benefit limits not provided by the pension plan.

The legislation has no restrictions on new defined contribution plans.

New defined benefit plans for current members are restricted as follows:

- Existing supplemental plans cannot be expanded to cover additional members.
- Agencies cannot adopt a supplemental pension plan after 2012.

Since supplemental plans cannot be added nor coverage expanded after 2012, agencies without supplemental plans may want to consider implementing one before January 1, 2013 with minimal benefits. Such plans only would apply to current members, but would allow an agency to increase benefits in the future for current members.

■ *Other Provisions*

- Impose restrictions on agencies hiring retirees.
- Broaden felon benefit reductions to include all employees and expand felony acts that trigger the reductions.
- Require CalPERS to monitor excessive reciprocal compensation and protect early employers if necessary.

■ *OPEB*

A somewhat unexpected PEPRA provision concerning retiree health benefits appears to apply to current as well as future employees. The law states that no public employees who are elected, appointed, exempt from civil service, not represented, or managers can have a better vesting schedule than other employees in related retirement member classifications. Pending clarification of the law, it is unclear whether:

- This section applies to:
 - Future hires only?
 - Future and current employees?
 - All current retirees?
- The vesting schedule:
 - Applies only to individual vested rights?
 - Means just the percentages applied to the benefit?
 - Is intended to include all provided benefits?

This provision could result in an agency needing to increase OPEB benefits for all nonmanagement or reduce them for management. It may be prudent for agencies exposed to this risk to implement a management supplemental pension plan before 2013. In the event management OPEB benefits are reduced, supplemental pension benefits could be provided to compensate.

* * *

Bartel Associates looks forward to clarifying your responsibilities under this new pension legislation.

Contact us at: PEPRA@bartel-associates.com

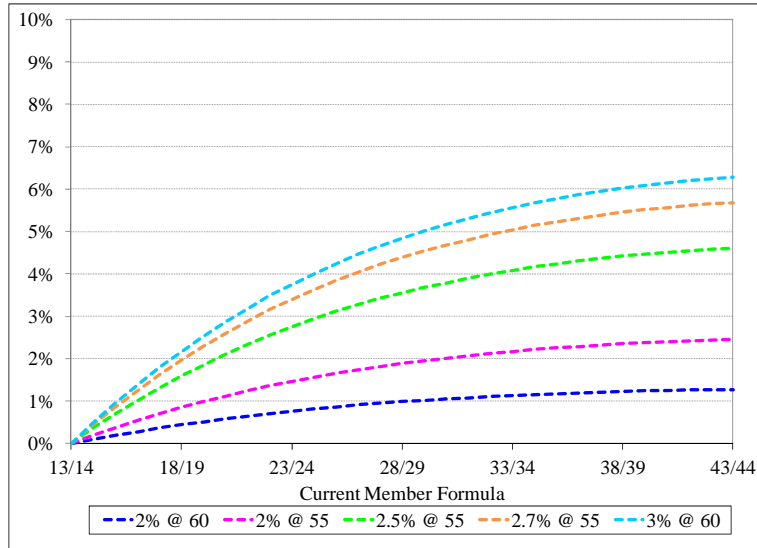
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Sample Projections

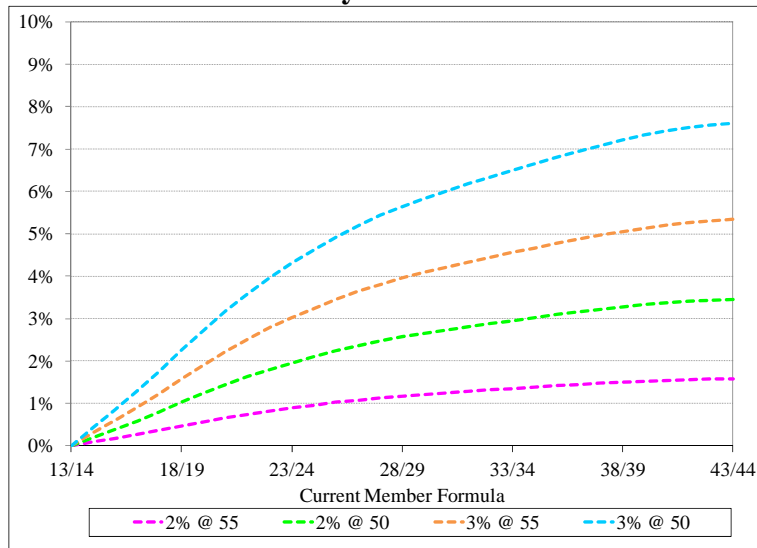
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PEPRA cost savings depend primarily⁹ on current member formulas and EPMC. For example, an agency with Miscellaneous 2.7% @55 and full EPMC will see much larger savings than an agency providing 2% @60 with members paying the full member rate. Any savings will be realized only as new members are hired, and will be very minimal short term. Following are sample 30-year cost savings projections for the employer contribution rates only. Savings are expressed as a percentage of total (current and new members) compensation and assume no PRSA, final average 36 month compensation, a 2% COLA, and basic industrial disability benefit.

Miscellaneous Members



Safety Members



⁹ Other factors that affect savings include current member PRSA, COLA, industrial disability, and final average compensation (12 or 36 months).



Sample Projections

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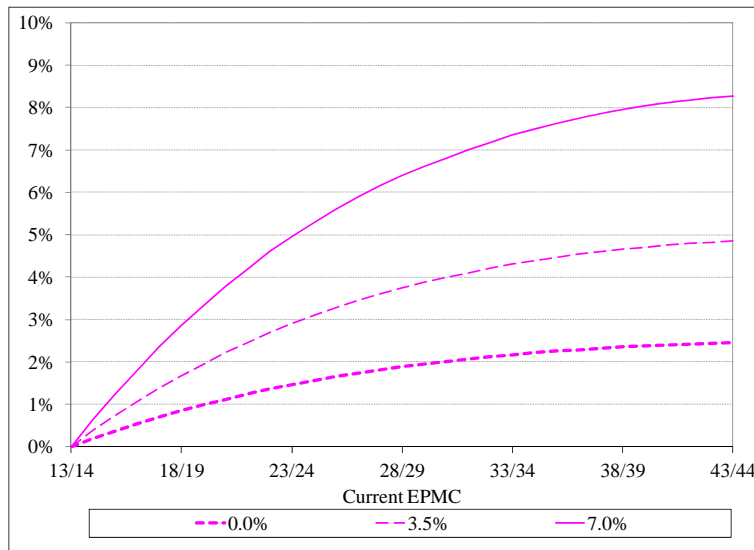
Savings above include only the impact on employer rates; this is equivalent to assuming there is no EPMC for current members. Agencies currently paying EPMC will see additional reductions in employer contributions due to:

- PEPRAs eliminates EPMC for new hires.
- PEPRAs requires new hires pay the same member rates as "similarly situated" employees.

Note that if long-term agency contribution rates decrease, member contributions may as well. The projections below assume current member contribution rates (minimum amounts under PEPRAs) remain in effect.

Following are sample 30-year cost savings projections for the most popular Miscellaneous (2% @55) and Safety (3% @50) formulas, each projected with full, 1/2, and no EPMC (full EPMC is 7% for 2% @55 and 9% for 3% @50). Again, savings are expressed as a percentage of total (current and new members) compensation.

Miscellaneous Members 2% @55



Safety Members 3% @50

