California Actuarial Advisory Panel

November 5, 2012

Public Employment & Retirement Committee
California State Senate
1020 N Street, Room 568
Sacramento, CA 95814

Public Employees, Retirement & Social Security Committee
California State Assembly
1020 N Street, Room 153
Sacramento, CA 95814

RE: Request for Legislation to Address Certain Aspects of Pension Reform (Assembly Bill 340)

Members of the Senate Public Employment & Retirement Committee and Assembly Public Employees, Retirement & Social Security Committee:

The California Actuarial Advisory Panel is established pursuant to Government Code section 7507.2 to provide impartial and independent information on pensions, other postemployment benefits, and best practices to public agencies.

The Panel supports the work of the two committees. Pension reform was a monumental and difficult undertaking. Given the complexity of the issues, it was inevitable that there would be a need for clarifications and amendments to the legislation; that does not detract from your accomplishment.

We have attached a list of issues that we have identified with respect to the bill. We have included our recommendations for addressing each one with specific language that could be included in a clean-up bill. In preparing our recommendations, we have attempted to be consistent with the intent of the Legislature. To the extent that we have misinterpreted that intent, our solutions may not be acceptable or may need to be modified. We would be pleased to work with the committees to address any issues where that has occurred. Please let us know how we can help.

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In closing, we would like to reiterate our support for the work of the committees and congratulate you on your accomplishment.

Sincerely,

Alan Milligan, FSA, FCA, MAAA
Chair, California Actuarial Advisory Panel

cc: Panel members:
Paul Angelo, Vice Chair
John E. Bartel
Leslie P. Finertie
Harold A. Loeb
Lynn C. Miller
Nick Collier
Graham Schmidt
Jerry Brown, California Governor
John Perez, Speaker of the Assembly
Darrell Steinberg, Senate President Pro Tempore
Anne Stausboll, Chief Executive Officer, CalPERS
Jack Ehnes, Chief Executive Officer, CalSTRS
Mark Yudof, President, University of California
Douglas Rose, President, State Association of County Retirement Systems
Ana Matosantos, Director, Department of Finance

Enclosure

California Actuarial Advisory Panel
Request for Legislation to Address Certain Aspects of Pension Reform (Assembly Bill 340)

Issue #1 – Member contributions on earnings in excess of the compensation cap

Discussion – Section 7522.10 limits the amount of pensionable compensation that can be used in the calculation of a benefit. However, neither this section nor any other section of the Government Code imposes a comparable limit on the amount of pensionable compensation that can be used for the purpose of calculating a member's contributions to the system.

Recommendation – Permit retirement systems to limit the pensionable compensation on which contributions are made to the same amount as the pensionable compensation used in the calculation of benefits.

Proposed Wording – Section 7522.10 is modified by adding a new subdivision (h) as follows:

> *(h) Notwithstanding any other provision of law, the retirement system may limit the pensionable compensation used to calculate the contributions required of a new member to the amount of compensation that would be used for calculating the defined benefit as set forth in subsections (c) and (d).*

Issue #2 – Integration of benefits and member contributions under the CERL

Discussion – CERL, Article 13 (31800-31817)
Article 13 of the CERL (31800-31817) addresses the integration of retirement benefits and member contributions provided under the CERL with those provided under the Federal Old Age and Survivor's Insurance programs (Social Security). The language defining the application of integration makes specific references to the benefit formula sections of the CERL: Section 31676 for General members and 31664 for Safety members. PEPRA does not modify Article 13 of the CERL to include references to the new benefit formulas provided under 7522.20 and 7522.25; therefore it is unclear whether the benefits and related contributions can be integrated with Social Security.

Recommendation – We recommend that Article 13 be amended to specify that the integration of the benefits and member contributions does not apply to members covered by the new formulas.

Proposed Wording – Section 31808 is modified by adding subdivision (c) as follows:

> *(c) The retirement allowance of persons who become members of a County retirement system under a benefit plan established pursuant to Section 7522.20 or 7522.25 of the Government Code, shall be determined without regard to this section.*

Section 31812 is modified by adding subdivision (c) as follows:

> *(c) Persons who become members of a County retirement system under a benefit plan established pursuant to Section 7522.20 or 7522.25 of the Government Code shall contribute as provided for in Section 7522.30 of the Government Code, without regard to this section.*

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Issue #3a – Contribution rate for new members – Definition of "Plan"

Discussion – Subdivision 7522.30(c) of AB340 states that "New employees employed on and after January 1, 2013… shall have an initial contribution rate of at least 50 percent of the normal cost rate for that ***defined benefit plan***, rounded to the nearest quarter of 1 percent, or the current contribution rate of similarly situated employees, whichever is greater." Subdivision 7522.30(b) states that "The normal cost rate" shall mean the annual actuarially determined normal cost for the ***defined benefit plan of an employer*** expressed as a percentage of payroll."

All plan administrators we have spoken to have assumed that the "normal cost rate" for any new PEPRA members shall be based on the normal cost for the benefits provided to these members, including the PEPRA-defined benefit formula, eligibility criteria, and any applicable COLA provisions provided to the new members. However, several attorneys have commented that the most literal interpretation of the language "defined benefit plan of an employer" would be the average normal cost of all members of the retirement plan for a given employer.

This latter interpretation would lead to many illogical and seemingly unfair conclusions. For instance, if the "normal cost rate" for the defined benefit plan of the employer were to be based on the average normal cost of an employer, then for those employers who provide benefits to both Safety and Miscellaneous members as part of the same defined benefit plan (such as is the case for many CERL systems), the higher relative cost of the Safety benefits will not be borne by the Safety members, but rather will be substantially shifted to the Miscellaneous members.

Similarly, if the normal cost rate were to be computed based on the average normal cost of all members of an employer, and the current benefit structure provides a richer benefit (such as one based on a higher multiplier, less stringent eligibility criteria and/or more generous post-retirement COLA) to the pre-PEPRA members, then the new PEPRA members would end paying an amount greater than 50 percent of the cost of the benefits that they will be expected to receive.

Recommendation – We recommend that the legislature amend PEPRA to specify that the "normal cost rate" shall be calculated based on the "plan of benefits" provided to the specific member's to whom the rate will apply. The plan of benefits should be defined to include elements which would impact the calculation of the normal cost, including the benefit multiplier, eligibility criteria, ancillary benefit provisions and actuarial assumptions necessary to determine the normal cost. For those plans which provide benefits to multiple groups of employees with distinct benefit structures, multiple normal cost rates shall be developed.

Proposed Wording – Subdivision 7522.30(b) is amended as follows:

> (b) The "normal cost rate" shall mean the annual actuarially determined *total* normal cost for the ~~defined benefit plan of an employer expressed as a percentage of payroll~~ *"plan of retirement benefits" provided to the new member. The "plan of retirement benefits" may include any elements which would impact the actuarial determination of the normal cost, including but not limited to the benefit formula, eligibility and vesting criteria, ancillary*

benefit provision, and any automatic cost of living adjustments as determined by the public retirement system. The "normal cost rate" for the new members should be determined based on the actuarial assumptions used to determine the liabilities and costs as part of the annual actuarial valuation.

Issue #3b – Contribution rate for new members – Definition of "Similarly Situated"

Discussion – Subdivision 7522.30(c) of AB340 states that "New employees employed on and after January 1, 2013… shall have an initial contribution rate of at least 50 percent of the normal cost rate for that defined benefit plan, rounded to the nearest quarter of 1 percent, or the current contribution rate of similarly situated employees, whichever is greater."

Many administrators have assumed that newly hired members would not be "similarly situated" to the pre-PEPRA members, due to the fact that they will be receiving a substantially different (and lower) set of retirement benefits. However, in its cost analysis, CalPERS interpreted "similarly situated" employees to be members of the same bargaining unit or employment group, regardless of any differences in the retirement benefits. The difference between these two interpretations is significant. In its cost analysis, CalPERS indicated that "If the intent of the legislation is to have new members only pay half the plan total normal cost, it would result in lower member contributions than we have assumed in our estimate and the savings would be reduced by $13 to $17 billion."

If the latter interpretation is correct, and the current contribution rate for pre-PEPRA members in the same employment group is greater than 50 percent of the normal cost rate for the new PEPRA employees, this could result in potential anomalies. For example, some current Safety bargaining groups have previously negotiated a higher benefit formula (such as 3% @ 50) by agreeing to pay a substantially higher level of member contributions; we are aware of at least one CERL system in which the Safety member contributions can exceed 20% of payroll, depending on the member's age at entry to the system.

In this case, the contribution rate for the new PEPRA employees would vastly exceed 50 percent of the normal cost for the PEPRA benefits, and could potentially exceed 100 percent of the normal cost. This would seem to violate the spirit of 7522.30(a), which states that "Equal sharing of normal costs between public employers and public employees shall be the standard".

Recommendation – We encourage immediate legislative clarification as to whether new employees employed on and after January 1, 2013 should or should not be considered "similarly situated" to pre-PEPRA members in the same bargaining group, regardless of any differences in retirement benefits. Such clarification is necessary, as the alternative interpretations of this provision will have a substantial impact on the contribution rates for new employees of many systems effective January 1st. Due to the equity considerations identified above we have included proposed wording below assuming that members of the same bargaining group are not similarly situated if they have substantively different retirement provisions. We note that this would not prevent employers from negotiating contributions higher than 50 percent of normal cost, due to the language in subdivision (e).

Proposed Wording – Subdivision 7522(c) is amended as follows:

(c) New employees employed on and after January 1, 2013, by those public employers defined in paragraphs (2) and (3) of subdivision (i) of Section 7522.04, the California State University, and the judicial branch who participate in a defined benefit plan shall have an initial contribution rate of at least 50 percent of the normal cost rate for that defined benefit plan, rounded to the nearest quarter of 1 percent, or the current contribution rate of similarly situated employees *with the same plan of retirement benefits*, whichever is greater. This contribution shall not be paid by the employer on the employee's behalf.

Issue #4a – It appears that the wording of G.C. Sections 7522.66 and 21400 may result in an increase in industrial or duty disability benefits greater than was intended.

Discussion – We believe the Legislature intended to provide the greater of current duty disability or a benefit that was actuarially equivalent to the service retirement benefit that the member would have been eligible for if the member had terminated employment on the date of the disability. However, the wording may result in an increased benefit above and beyond what was intended as a result of the wording in both 7522.66(a)(1) and 21400.(a)(1). Both include the wording "plus an annuity purchased with his or her accumulated contributions" which could imply a significantly greater benefit than is currently provided.

Recommendation – Amend both 7522.66 and 21400 to make it clear that the only enhancement of benefits will occur if an actuarially reduced service retirement benefit is greater than the benefit that would otherwise be provided.

Proposed Wording – See proposed wording under issue #4b below:

Issue #4b – Sunsetting of the Industrial Disability change.

Discussion – Subsections 7522.66(b) and 21400(b) are unclear as to the application to employees hired before January 1, 2018 who become disabled on or after January 1, 2018.

Recommendation – Include wording to make it clear that the benefit only relates to industrial disability retirement in the period between January 1, 2013 and December 31, 2017 inclusive but keep the existing wording about repealing the section on January 1, 2018.

Proposed Wording – Section 7522.66 is amended as follows:

7522.66. (a) A safety member of a public retirement system who retires for industrial disability *between January 1, 2013 and December 31, 2017 inclusive* shall receive an industrial disability retirement benefit equal to the greater of the following:

(1) Fifty percent of his or her final compensation attributable to the defined benefit plan, plus an annuity purchased with his or her accumulated contributions *to defined contribution plans*, if any.

(2) A service retirement allowance, if he or she is qualified for service retirement.

(3) An actuarially reduced factor, as determined by the actuary, for each quarter year that his or her service age is less than 50 years of age, multiplied by the number of years of safety service subject to the applicable formula, if he or she is not qualified for service retirement.

(b) This section shall remain in effect only until January 1, 2018, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2018, deletes or extends that date.

Section 21400 is amended as follows:

21400. (a) A safety member who retires ~~on or after January 1, 2013,~~ for industrial disability *between January 1, 2013 and December 31, 2017 inclusive* shall receive a disability retirement benefit equal to the greater of the following:

(1) Fifty percent of his or her final compensation, plus an annuity purchased with his or her accumulated *additional* contributions, if any.

(2) A service retirement allowance, if he or she is qualified for service retirement.

(3) An actuarially reduced factor, as determined by the actuary, for each quarter year that his or her service age is less than 50 years, multiplied by the number of years of safety service subject to the applicable formula, if he or she is not qualified for service retirement.

(4) Nothing in this section shall require a member to receive a lower benefit than he or she would have received prior to January 1, 2013, as the law provided prior to that date.

(b) This section shall remain in effect only until January 1, 2018, and as of that date is repealed, unless a later enacted statute, that is enacted before January 1, 2018, deletes or extends that date.

Issue #5 – Employer required contributions for employers currently contributing less than the normal cost.

Discussion – Some employers are currently in surplus and are contributing less than the normal cost. As a result of 7522.52 these employers will have to increase their contributions to the retirement systems. This will be a great hardship for many employers if implemented in the current fiscal year. These employers have been making contributions in accordance with the law and will have contributed less than the normal cost for the fiscal year to date. If this section is effective on January 1, 2013, it will result in the employer having to make greater contributions than were contemplated in their budgets, not just for the contributions after the effective date but for periods prior to the effective date that are still in the current fiscal year. This is an undue burden for those employers who are sufficiently well funded to have a required contribution less than the normal cost. These employers are effectively being penalized for being well funded.

Recommendation – G.C. Section 7522.52 should be effective for any fiscal year beginning on or after the effective date of the legislation.

Proposed Wording – Subsection 7522.52(a) is amended as follows:

> 7522.52. (a) In any fiscal year *beginning on or after January 1, 2013*, a public employer's contribution to a defined benefit plan, in combination with employee contributions to that defined benefit plan, shall not be less than the normal cost rate, as defined in Section 7522.30, for that defined benefit plan for that fiscal year.

Issue #6 – Clarification is required regarding the operation of G.C. Section 7522.40 regarding health benefit vesting.

Discussion – Some people believe current language of 7522.40 is not clear and could be broadly interpreted. We understand the intent of this section was to apply only to new members hired on or after January 1, 2013. In addition we understand it is intended to only limit vesting schedules, not benefits those schedules are applied to.

Recommendation – Section 7522.40 should be modified to make clear the intent, adding language as to who it applies to and that it is not intended to limit benefits, only vesting schedules.

Proposed Wording – Section 7522.40 is amended as follows:

> 7522.40. *For new members hired on or after January 1, 2013,* ~~A~~ *a* public employer shall not provide to a public employee who is elected or appointed, a trustee, excluded from collective bargaining, exempt from civil service, or a manager any *retiree* health benefit vesting schedule that is more advantageous than that provided generally to other public employees, including represented employees, of the same public employer who are in related retirement membership classifications.