BILL NUMBER: Assembly Bill 654 (Mendoza) as amended April 23, 2009

SUMMARY

This bill, as of July 1, 2010, defines "regular interest" as interest that is equal to the actuarially assumed rate of return on investments on assets of the Defined Benefit (DB) Program. This bill also clarifies the application of regular interest to the installments that employers make when paying for retirement enhancements for their employees. Finally, this bill establishes a basis for the consistent assessment of interest and penalties for late payment of contributions and submission of reports instead of applying assessments on a case-by-case basis.

BOARD POSITION

Sponsor. This measure is consistent with the Teachers' Retirement Board's policy to preserve the assets and minimize the liabilities of the funds administered by CalSTRS.

PURPOSE OF THE BILL

This bill changes the definition of regular interest to the actuarially assumed rate of return on investments in order to more accurately reflect the cost to the DB Program when the funds are not available for investment. These funds can come to CalSTRS via member redeposits of previously withdrawn contributions, as well as through installment payments for those redeposits, member purchases of service credit, or employer paid retirement incentives. In addition, current law authorizes CalSTRS to assess interest on late payment of contributions and penalties for late contribution reports, but the basis for making those assessments is not defined in law. This bill addresses how those assessments are to be made. Beginning next fiscal year, the state proposes to not pay contributions on compensation reported after the fiscal year in which the compensation was earned, and there is currently no recourse to recover lost contributions. This bill establishes mechanisms to recover those forgone contributions.

SUMMARY OF AMENDMENTS

The April 23, 2009, amendments include an appeals process for an entity reporting directly to CalSTRS that is assessed penalties or interest. The amendments also require an entity that reports directly to CalSTRS to be assessed penalties only for creditable compensation reported more than one fiscal year after the fiscal year in which it was earned. Finally, the amendments require creditable compensation reported for the immediately preceding fiscal year to be subject to the state contribution rates.

LEGISLATIVE HISTORY

<u>Chapter 939, Statutes of 1999 (SB 1074 – PE&R Committee)</u> among other things, provided that if a county superintendent of schools or employing agency or school district or community college district that reports directly to the system fails to make payment of contributions as provided in Section 23002, the Board may assess penalties.

<u>Chapter 655, Statutes of 2006 (SB 1466 – PE&R Committee)</u> among other things, required employers to report contributions paid on behalf of each participant in each pay period, along with all other information required by the system no later than 10 working days following the

last day of the pay period in which the salary was earned. Allowed the Board to assess a penalty against the employer for a report submitted late or in an unacceptable form.

PROGRAM BACKGROUND

Regular Interest

The interest rate used by CalSTRS when members redeposit previously withdrawn contributions to the Defined Benefit Program or make installment payments either for those redeposits or to purchase service credit is comparable to what CalSTRS earns from corporate debt, consistent with the concept that the installment purchase is a debt to CalSTRS. (This interest rate is equal to 5.25 percent for the 2008-09 fiscal year.)

Changing the method used to calculate regular interest for redeposits, installment payments, and penalties to equal the actuarially assumed rate of return on investments would reflect the total opportunity cost that redeposits, installment payments, and late reports and remittances have on the overall program. The actuarially assumed rate of return on investments for CalSTRS in the 2008-09 fiscal year is 8 percent. Applying this higher rate of interest specifically to installment payments for service credit purchases or redeposits would generate about $10 million over a 30 year period.

Employer Penalty and Interest Assessments

Currently, CalSTRS is authorized to assess interest on late remittances of contributions and penalties for late contribution reports. Contribution payments are due from the employers five working days following the pay period in which the compensation was earned under the DB Program, and ten working days following the last day of the pay period in which the compensation was earned under the Cash Balance (CB) Benefit Program. After those deadlines, contributions are considered delinquent.

Contribution reports under the DB Program are considered delinquent if they are not submitted 45 calendar days immediately following the month in which the compensation was earned. Contribution reports under the CB Benefit Program are considered delinquent if they are not submitted ten days following last day of the pay period when the compensation was earned. The minimum penalty for late reports is $500.

Beginning next fiscal year, the state proposes to not pay contributions on compensation reported after the fiscal year in which the compensation is earned, and there is currently no recourse to recover these lost contributions.

ANALYSIS:

Existing Law:

Regular Interest

Existing law defines regular interest as interest that is compounded annually based on the annual equivalent of the prior year’s average yield to maturity on the investment-grade fixed income securities attributable to the DB Program. The law also requires the rate to be adopted annually by the Board as a plan amendment with respect to the DB Program. The regular interest rate for fiscal year 2008-09 is 5.25 percent.

Current law does not specify that regular interest is to be charged when employers pay for retirement enhancements for their employees through installments.

Employer Penalty and Interest Assessments

Existing law authorizes CalSTRS to assess interest on late remittances of contributions and penalties for late contribution reports; however, the law does not set a clear basis for when interest or penalties should be assessed. Penalties and interest are monitored for all employers, but they are assessed on a case-by-case basis.

This bill:

Regular Interest

As of July 1, 2010, this bill would change the definition of "regular interest." Regular interest would be defined as interest that is equal to the actuarially assumed rate of return on investments on assets of the Defined Benefit Program. As with current law, the regular interest rate would be adopted on an annual basis as a plan amendment by the Board. The actuarially assumed rate of return on investments is 8 percent for fiscal year 2008-09. The change would apply to redeposits of previously withdrawn contributions and installment purchases initiated on or after July 1, 2010.

This bill also would clarify the application of regular interest to the installments that employers make when paying for retirement enhancements for their employees. Overall, this bill would affect the regular interest rate applied to installment payments for employer paid retirement incentives, member redeposits of previously withdrawn contributions, installment payments for member purchases or redeposits of service credit, and penalty interest.

Employer Penalty and Interest Assessments

This bill would require CalSTRS to assess interest on late remittances of contributions, for both the DB Program and the CB Benefit Program, in accordance with regulations to be established by the Teachers' Retirement Board. Regular interest would be charged on any delinquent contributions.

This bill also would require CalSTRS to assess penalties on late contribution reports, in accordance with regulations to be established by the Teachers' Retirement Board. Penalties would be assessed based on the total employer and employee contributions at the regular interest rate from the time the report was due to when the report is received by CalSTRS, with a minimum fee of $500.

CalSTRS would be required to assess penalties on employers reporting directly to CalSTRS who include creditable compensation earned during any prior fiscal year, except for the immediately preceding fiscal year, in their monthly reports. Those penalties would be equal to the contribution rates from the General Fund to fund DB Program and related purchasing power benefits. In addition, the penalties would include regular interest charged on the amount of creditable compensation earned in relevant prior fiscal years, until the penalty is received in full by CalSTRS. This authorization would provide a recourse for CalSTRS to recover, from the employers, contributions that were not paid by the state for creditable compensation reported more than one fiscal year after the fiscal year in which it was earned.

Any creditable compensation reported for the immediately preceding fiscal year would be paid by the General Fund at the state contribution rates specified in current law, consistent with past practice.

OTHER STATES' INFORMATION

CalSTRS' existing interest rate policy for member service credit purchases and redeposits through installments is unlike most other public pension systems responding to a CalSTRS survey. An interest rate that is equal to the actuarially assumed rate of return on investments is charged by 71 percent of those public pension systems responding to a CalSTRS survey.

FISCAL IMPACT

Benefit Program Cost – Charging an interest rate equal to the actuarially assumed rate of return on investments specifically for installment payments for member service credit purchases or redeposits is estimated to generate approximately $10 million over a 30 year period.

In addition, assessments of penalties and interest for late contributions and contribution reports would generate additional funds. For fiscal year 2007-08, the total penalties and interest assessed would have been $2.9 million for the DB Program and $250,000 for the CB Benefit Program.

Also for fiscal year 2007-08, the state contribution based on late reported creditable compensation was approximately $14.7 million of which the state has only budgeted $3 million for payment in fiscal year 2009-10. Of the $14.7 million, approximately $13 million was based on creditable compensation earned in 2006-07, or the immediately preceding fiscal year. The other approximately $1.7 million was generated by creditable compensation earned more than one fiscal year before the fiscal year in which it was reported.

Administrative Costs/Savings – The cost of automating the penalties and interest calculation processes, instead of manually monitoring the calculation, is estimated at approximately $1 million.

SUPPORT

CalSTRS (sponsor).

OPPOSITION

None known.

SUPPORTING ARGUMENTS

Reflects the total opportunity cost that redeposits and installment payments have on the overall program.

Offsets the cost of the increased benefit that will be paid to the member or the cost of forfeiting the state contribution due to late reports or remittances.

Creates consistency with the other public pension systems.

Members would benefit from the timely reporting of creditable earnings to their account.

Employers would prioritize the reporting and remitting of monies more timely and accurately.

CalSTRS would benefit from timely reporting of creditable earnings so that it could receive state contributions.

CalSTRS would also benefit from timely remittances for investment purposes.

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