BILL NUMBER: AB 340 (Furutani) as amended August 28, 2012

SUMMARY

AB 340 makes various changes to California public employee pension systems through the enactment of the California Public Employees' Pension Reform Act of 2013.

REASON FOR THE BILL

In September 2011, the creation of a legislative conference committee on pension reform was announced, and in October 2011, the Governor announced his 12-point pension reform proposal. AB 340 encompasses the work of the conference committee and includes 10 of the 12 points included in the Governor's plan.

ANALYSIS

Existing Law:

Defined Benefit (DB) Program. The DB Program pays monthly retirement benefits to eligible educators based on years of service, age at retirement and final compensation. (The DB Program also pays disability benefits and survivor benefits, which are largely unaffected by AB 340.) The retirement benefit is equal to 2 percent of final compensation per year of service for those retiring at the normal retirement age of 60, increasing to 2.4 percent at age 63. The percentage of final compensation paid per year of service is referred to as the age factor. Members retiring with 30 or more years of service may receive an increase of up to 0.2 percent in their age factor, up to a maximum age factor of 2.4 percent. This increase in the age factor is known as the career factor. About 29 percent of members who retired in 2010-11 received a benefit based in part on the career factor. Members can retire at age 55, with at least five years of service, or as early as age 50 with at least 30 years of service, but the percentage of final compensation paid at earlier ages of retirement is decreased. The average retirement age is 62, and the average retiring member has performed 26 years of service. The average benefit paid to a member retiring in 2010-11 was approximately 56 percent of the member's final salary.

Under current law, final compensation is based on the average annual full-time salary rate (or "compensation earnable") over a one- or three-year consecutive period, depending on the number of years of service provided while an active member. Generally, for members that have at least 25 years of service credit, final compensation is based on the highest compensation earnable over a period of 12 consecutive months, and for those members that have less than 25 years of service credit, final compensation is based on the average compensation earnable over a consecutive three-year period. Classroom teachers with less than 25 years of service credit can retire with highest single year final compensation, if the teacher meets statutory requirements and their employer elects to offer that benefit. Of the members who retired in 2010-11, 52 percent had 25 or more years of service credit, earning one-year final compensation. Additionally, CalSTRS can use a member's highest three nonconsecutive years of average compensation earnable when the member's salary was reduced due to a reduction in school funds. For a member who works less than full time or is receiving a disability benefit, CalSTRS uses the member's earnings rather than earnable as final compensation. If a CalSTRS member is also a member of certain other California public retirement systems, CalSTRS can base the member's final compensation on the highest one- or three-year consecutive earnable salary in either system.

The Teachers' Retirement Law delineates what is, and is not, creditable compensation. Final compensation is based on different forms of compensation, including salary, auto and housing allowances, performance bonuses and the payment of cash in-lieu of receiving fringe benefits. Existing law requires that compensation for creditable service that exceeds one year in a school year (overtime) or is paid a limited number of times be credited to the Defined Benefit Supplement (DBS) Program and not counted toward final compensation. Other types of compensation, such as compensation for unused accumulated leave, are not creditable compensation under the existing framework and do not count toward any CalSTRS retirement benefit.

Internal Revenue Code section 415 generally limits the amount of benefits that can be paid by a qualified defined benefit plan. In 2012, the limit applicable to a 65 year old CalSTRS member is $171,202. That limit is increased based on the cost-of-living. The Internal Revenue Code, however, also allows public pension systems, such as CalSTRS, to pay benefits above that limit under a separate program, up to the amount payable under the pension plan's benefit formula. In 2012, 317 CalSTRS members are receiving benefits under the Replacement Benefits Program.

Internal Revenue Code section 401(a)(17) limits the compensation that counts toward the pension of a public employee first hired on or after July 1, 1996. In 2012, that limit is $250,000. That limit is increased based on the cost-of-living. No contributions are paid by the member, employer or the state on compensation in excess of the limit, and any excess compensation is excluded from determining final compensation.

Retired DB Program members are subject to limitations on postretirement earnings for compensation earned from CalSTRS-covered service. These limitations apply regardless of whether the retired member is an employee of a CalSTRS employer, an employee of a third party performing service for a California public school or an independent contractor performing service for a California public school. A limit of zero dollars applies for the first six months of retirement if the member is under age 60, and the annual earnings limit is currently $40,011, pursuant to the recently enacted Chapter 135, Statutes of 2012 (AB 178 – Gorell). The annual earnings limit will be adjusted each year to equal 50 percent of the median final compensation for recently retired members. Neither employers nor members pay contributions on postretirement earnings for the compensation earned from creditable service after retirement. Retired members who exceed the earnings limitations have their monthly benefits reduced for each dollar of compensation earned in excess of the limit.

Chapter 135 also established a very limited exemption to the $40,011 earnings limit, for 2012-13 only, for retired members appointed by a county superintendent of schools, the California Community Colleges Board of Governors, the State Board of Education or the State Superintendent of Public Instruction to perform specific duties with respect to schools that are experiencing specific academic or fiscal distress. Documentation substantiating the member's eligibility must be received by CalSTRS before the service begins. Finally, Chapter 135 excluded certain employees of a third party from the earnings limit, if the member was, for a limited number of time, performing service not normally performed by a school employee.

Existing law requires that any elected public officer who takes public office or is reelected to public office on or after January 1, 2006, who is convicted of any specified felony arising directly out of his or her official duties, forfeit all rights and benefits in any public retirement system in which he or she is a member. It also enumerates which felony convictions would trigger forfeiture and provides a safe harbor provision that would void the forfeiture if the governing body of the public officer's employer authorized the officer to receive his retirement benefits. Under this current law, only a small number of CalSTRS members are affected, including 52 county superintendents of schools elected to office by the county voters and a small number of elected school board trustees whose districts offer the Cash Balance Benefit Program. To date, there have been no CalSTRS members who have had to forfeit their retirement benefits pursuant to this law.

In the past, when CalSTRS pension benefits were improved, the improvement applied to service that was performed in the past, as well as future service. These improvements included:

- One-year final compensation for those with 25 years or more of credited service.
- Increased age factor for those who work past age 60.
- Career factor for those with 30 years or more of credited service.
- Longevity bonus for those with 30 years or more of credited service by December 31, 2010.

Vested CalSTRS members are permitted to purchase up to five years of nonqualified service, defined as any credit for which a member did not perform creditable service subject to coverage by the plan. Purchases of nonqualified service credit do not count toward qualifying for any benefit enhancements, such as the 25-year threshold for one-year final compensation or the career factor. However, it can be used to qualify for the 30 year service credit requirement for retirement between ages 50 and 55. Generally, CalSTRS initiates approximately 700 to 800 purchases of non-qualified service credit annually. In addition, a member may purchase additional service credit for time spent on approved leave or for prior service in another state. The member pays the entire cost, based on the actuarial assumptions adopted by the board and an analysis of actual prior purchases. Finally, members who terminated their employment in the public schools and withdrew their CalSTRS contributions and interest can redeposit their DB contributions, with additional interest, and restore their service credit.

All contribution rates applicable to the DB Program and the DBS Program are fixed in statute. As a result, only the Legislature and the Governor can increase or reduce contribution rates, through the enactment of legislation. The member contribution rate has been set at 8 percent since 1972, and funds 44 percent of the normal cost of the DB Program as of June 30, 2011. The employer can pay the member contribution if it is paid on behalf of everyone in the same class of employees. The employer contribution rate has been set at 8.25 percent since 1990. However, the state's contribution rate has declined, through a series of legislation, from 4.607 percent in 1998 to the current 2.541 percent. The state's contribution will increase by ¼ percent per year until the final state's contribution rate to the DB Program is 3.522 percent in 2015-16. (In addition, the state contributes about 2.5 percent to fund a separate program that maintains the purchasing power of DB Program benefits.) Although total contributions are sufficient to fully fund the ongoing, or normal cost of benefits, the amount contributed to the DB Program has been less than the amount necessary to fully amortize the unfunded liability in the DB Program since 2002.

Defined Benefit Supplement (DBS) Program. The DBS Program supplements the benefits paid under the DB Program at the time that DB benefits are paid. The DBS benefit is equal to the account balance at the time of retirement, disability or death. Contributions that are credited to DBS are paid by the member and employer on compensation for service in excess of the full-time assignment, such as summer school or after-school activities; compensation paid for a limited period of time, such as compensation paid to those who agree to retire at the end of the school year; or certain compensation that CalSTRS determines is not creditable to the DB Program. In 2010-11, 57 percent of members were credited with additional contributions to the DBS Program from additional service, and less than 1 percent of the active members were credited contributions to DBS from other compensation.

Contributions are credited with a minimum amount of interest, based on 30-year Treasury bond rates, but additional interest can be credited by the board if there are sufficient excess funds after meeting long-term program liabilities. Benefits can be paid either as a lump sum, a monthly annuity or a combination of both.

(CalSTRS administers a second cash balance program, called the Cash Balance (CB) Benefit Program. It is a retirement program for eligible part-time employees who perform creditable service on a part-time basis and elect not to participate in the DB Program. It has an identical plan design as DBS, but with different employee and employer contribution rate. It is optional for employers to offer the CB Benefit Program.)

Pension2. Pension2 is a CalSTRS program that offers school employees an opportunity to further supplement their retirement with additional investments on a pre-tax basis, pursuant to either section 403(b) or 457 of the Internal Revenue Code. Pension2 offers 22 different investment options in low-cost mutual funds or variable annuities, and sets up portfolios of these core selections that reflect different target retirement dates and risk profiles. Individual employers elect whether to offer Pension2 to their employees. Pension2 is not directly affected by AB 340.

This Bill:

AB 340 makes a variety of changes to CalSTRS benefit programs that primarily affect those who first become CalSTRS members on or after January 1, 2013. These members are known as CalSTRS 2% at 62 members. This would exclude those who were CalSTRS members before 2013, had terminated their membership, and returned to active membership on or after January 1, 2013. These latter members still will be subject to the current benefit program and are known as CalSTRS 2% at 60 members. The changes made in AB 340 include:

- Reducing the age factor for any specific age, and increasing both the normal retirement age and the minimum retirement age, regardless of years of service.
- Eliminating the career factor.
- Requiring that final compensation be calculated based on the highest average annual salary rate over three consecutive school years, regardless of years of service.
- Reducing the limit on compensation that counts toward the retirement benefit paid by CalSTRS.
- Limiting the type of compensation that counts toward a CalSTRS retirement benefit.
- Prohibiting the payment of benefits in excess of the limitation imposed by the Internal Revenue Code.

Other provisions of the bill apply to both 2% at 60 and 2% at 62 members. These include:

- Prohibiting the purchase of nonqualified service, or airtime, after December 31, 2012.
- Requiring that a conviction for a felony that is related to the member's official duties result in the forfeiture of CalSTRS benefits beginning from the date the felony was committed.
- Requiring that a DB member's benefit be reduced dollar for dollar, regardless of age, for the first 180 days after retirement if the member performs activities in the public schools that are creditable to CalSTRS, unless the governing body of the school district takes specified actions with respect to a member who is above normal retirement age.
- Extending a very limited exemption from the postretirement earnings limit through 2013-14, and prohibiting the granting of the exemption if the member received an incentive to retire in the previous six months.
- Prohibiting any enhancement to the DB benefit from applying to service performed prior to the effective date of the enhancement.
- Prohibiting the suspension of employer and/or employee contributions necessary to fund annual pension costs, unless the plan is at least 120 percent funded and the system actuary determines that continuing to accrue excess earnings could jeopardize the plan's federal tax qualification.

Finally, AB 340 requires the contribution rate for 2% at 62 members to equal 50 percent of the normal, ongoing cost of benefits.

Each of these provisions is analyzed in more detail below.

<u>Retirement Age and Age Factor.</u> AB 340 prohibits 2% at 62 members from retiring for service any earlier than age 55, regardless of the number of years of service. In addition, the bill increases the normal retirement age from age 60 to age 62. Moreover, AB 340 reduces the percentage of final compensation per year of service that a 2% at 62 member will receive at retirement and eliminates the career factor for 2% at 62 members. Below is a comparison of the current age factors and the age factors that will

be applicable to those who become a CalSTRS member on or after January 1, 2013. Generally, the age factors applicable to 2% at 60 members will apply two years later in age for 2% at 62 members.

Retirement Age	**2% at 60 Members**	**2% at 62 Members**
55	1.40%	1.16%
56	1.52%	1.28%
57	1.64%	1.40%
58	1.76%	1.52%
59	1.88%	1.64%
60	2.00%	1.76%
61	2.13%	1.88%
62	2.27%	2.00%
63	2.40%	2.13%
64	2.40%	2.27%
65	2.40%	2.40%
66	2.40%	2.40%
67	2.40%	2.40%

<u>Final Compensation.</u> Under AB 340, all 2% at 62 members, regardless of the number of years of service, will have their final compensation based on their highest three school years, and districts will not be able to offer highest single year final compensation to their classroom teachers, unless no 2% at 62 member qualifies.

<u>Limitation on Creditable Compensation.</u> AB 340 reduces the limit on creditable compensation for 2% at 62 members, currently set by federal law and equal to $250,000 in 2012, to 120 percent of the 2013 limit upon which Social Security benefits are determined and Social Security payroll taxes are paid. In 2012, that limit is $132,120. Although this limitation only applies to 2% at 62 members, in 2010-11, only about 4,500 DB Program members earned creditable compensation in excess of $132,120 per year.

In future years, the compensation limit will be adjusted for changes in the Consumer Price Index. As with the existing federal limit, any excess compensation will be excluded from determining final compensation, and no contributions will be paid by the member, employer or the state on compensation in excess of the limit.

Employers will not be permitted to offer a defined benefit plan for the compensation in excess of the limit, but can make contributions for such compensation to a defined contribution (DC) plan, as long as the contribution rate to such a DC plan does not exceed the employer contribution rate to the DB Program.

<u>Changes in Creditable Compensation.</u> AB 340 limits compensation paid to 2% at 62 members that is creditable to CalSTRS benefit programs to compensation that is regularly payable in cash pursuant to a publicly available pay schedule. Any such compensation for service in excess of one year in a school year will continue to be credited to the DBS Program, but other compensation, such as allowances, bonuses, cash in-lieu of fringe benefits, limited-period compensation or compensation determined

to have been paid for the purposes of enhancing a benefit, will not be creditable to any CalSTRS benefit program.

Elimination of the Replacement Benefits Program. Under AB 340, 2% at 62 members will not receive any benefits from CalSTRS in excess of the Internal Revenue Code section 415 limit. Given the limitation on compensation that counts toward the final compensation of 2% at 62 members, as well as the reduction in the age factor for such members, however, it is unlikely that anyone would accrue a benefit in excess of the section 415 limit.

Elimination of Airtime. AB 340 prohibits purchases of airtime after 2012 by 2% at 60 and 2% at 62 members. In order to purchase airtime, CalSTRS will have to receive the appropriate CalSTRS form prior to January 1, 2013. No other service credit purchases, including the ability to redeposit previously withdrawn contributions, are affected by the bill.

Forfeiture of Benefits Upon Felony Conviction. AB 340 requires that benefits be forfeited by any CalSTRS member who is convicted of committing a felony in the course of his or her official duties, including specifically if the felony involved a child with whom the member had contact as part of the member's official duties. Any benefits accrued after the commission of the felony will be forfeited, but not benefits accrued prior to the commission of the felony. Any contributions made by the member to CalSTRS after that date will be returned by CalSTRS, without interest, to an account of the member that conforms to Internal Revenue Code requirements. The convicted member and the prosecuting agency are required to notify the member's employer within 60 days of the conviction, and the member and the public employer are required to notify CalSTRS within 90 days of the conviction. If the conviction is overturned, the member can either receive the forfeited benefits or redeposit the returned contributions, with interest.

Postretirement Earnings Restrictions. AB 340 extends the limited exemption for retired members appointed by a county superintendent of schools, the California Community Colleges Board of Governors, the State Board of Education or the State Superintendent of Public Instruction for another year, through 2013-14, but the exemption now does not apply if the member received a financial inducement to retire within the previous six months. It also extends the zero-dollar earnings limit to all retired members, regardless of age, for the first 180 days of the member's most recent retirement. For 2% at 60 members who are at least age 60, and 2% at 62 members who are at least age 62, that 180-day period in which no compensation could be earned may not apply if the appointment is necessary to fill a critically needed position, the governing body of the employer approves the appointment in a specified manner, the member did not receive any financial inducement to retire, and the member's termination of service was not the cause of the need to acquire the services of the member. Documentation substantiating the member's eligibility for this exemption must be received by CalSTRS before the service begins.

Prohibition on Retroactive Benefits. Under AB 340, future benefit enhancements will only apply to service performed on or after the operative date of the enhancement. For example, when legislation was passed in 1998 that created the career factor, increasing the percentage of final compensation paid upon retirement for each year of service if the member retired with at least 30 years of service, not only did the service credit that was earned before 1998 count toward meeting the 30 year eligibility requirement, the increased percentage of final compensation resulting from the legislation was applied to that earlier service credit. If this new provision had been in effect at that time, any increase in the percentage of final compensation resulting from the creation of the career factor in 1998 would only have applied to service credited after 1998.

Prohibition on Pension Holidays. AB 340 prohibits all employers from suspending employer and/or employee contributions necessary to fund annual pension costs. Contributions may not be less than the normal cost. Given that CalSTRS contributions are set in statute, the system has already been in compliance with this provision.

Member Contributions. AB 340 requires 2% at 62 members to pay 50 percent of the normal cost of their benefit structure, rounded to the nearest one-quarter percent. Based on a preliminary analysis of AB 340, which estimates that the normal cost of the benefit structure for 2% at 62 members will be 15.9 percent, the contribution rate paid by those members will be 8 percent, the rate currently paid by 2% at 60 members. The contribution rate required to be paid by 2% at 62 members will be adjusted if the actuarial valuation of the DB Program indicates that the normal cost of the benefit structure for 2% at 62 members has changed by at least one percent since the last adjustment in member contributions. The employer is not permitted to pay the member’s contribution.

LEGISLATIVE HISTORY

AB 178 (Gorell, Chapter 135, Statutes of 2012) changed the postretirement earnings limit to one-half of the median final compensation of all recently retired members; excluded specified employees of a third party from the postretirement employment limitations; extended a very narrowly applied exemption for limited-term appointments for one year, and included another very narrow exemption related to failing community college districts, with additional requirements for substantiating eligibility; and allowed service retired members to re-retire within a year of reinstating and required those members to keep the same option and beneficiary or beneficiaries that were in effect before reinstatement, or to retain their unmodified benefit, for one year after reinstatement.

AB 1044 (Aghazarian, Chapter 322, Statutes of 2005) required a public officer who takes public office or is re-elected after January 1, 2006, and is convicted of a felony involving a bribe, embezzlement, extortion or theft of public money, perjury, or conspiracy to commit any of these crimes, to forfeit all rights and benefits under any public retirement system earned during the period in which he or she was in elective office, unless the governing body of the public officer's employer authorize the benefits. Provided that any employee contributions made by the elected public officer during his or her term of office shall be returned without interest; required the public officer's employer to notify the retirement system of the officer's conviction, as specified; and applied the provisions to any person appointed to service for the period of an elected public officers' unexpired term of office.

AB 2700 (Lempert, Chapter 1021, Statutes of 2000) made all compensation for creditable service creditable to CalSTRS and credited member and employer contributions for service in excess of 1.000 year of service per school year to the DBS Program.

PROGRAM BACKGROUND

Currently, CalSTRS administers a hybrid retirement system consisting of the DB Program (a traditional defined benefit plan), the DBS Program (a cash balance plan) and Pension2 (a defined contribution 403(b)/457 program funded through voluntary employee contributions). CalSTRS members do not participate in Social Security for their public education service. As a result, the benefits paid by CalSTRS are the only ongoing source of retirement income that members receive for their public education service. In addition, CalSTRS has a very limited retiree health benefit focused on members who did not qualify for premium-free Medicare Part A coverage. The provision of health benefits is negotiated at the local level, and 62 percent of members retiring now do not receive financial support from their employer for their health benefits after they reach age 65.

Impact of AB 340 on Benefits of 2% at 62 Members. The most significant change enacted in AB 340 will be the reduction in the age factor for 2% at 62 members. Any 2% at 62 member who retires before age 65 will receive a benefit based on a lower age factor than would that same member retiring under the 2% at 60 benefit formula. About 80 percent of those who retired in 2010-11 were under age 65. Based on those retiring in 2010-11, the reduction in benefits will average about 12 percent. Put another way, the average replacement ratio, the percentage of salary replaced by a benefit, will decline by about 6 percentage points, and the DB Program will end up replacing about 50 percent of the final salary for the average member. Alternatively, a member will have to work two years longer to receive the same benefit provided under the 2% at 60 benefit structure.

In addition, 52 percent of those retiring in 2010-11 had sufficient service credit to retire with final compensation based on a single year of salary. Members under the 2% at 62 benefit structure with at least 25 years of service will realize an additional reduction in their DB benefit if they received salary increases in their final working years because final compensation will be based on the highest three consecutive years. Substantially fewer members will realize additional reductions either in their DB or DBS benefits from the new limitation on creditable compensation and the expanded limitations on the type of compensation that will be creditable.

FISCAL IMPACT

Program Cost – A preliminary analysis of the actuarial impact of AB 340 indicates that the normal cost of the 2% at 62 benefit structure will be 15.9 percent. This represents a 2.61 percent reduction from the 18.51 percent normal cost of the 2% at 60 benefit structure if it would have applied to 2% at 62 members. This reduction in benefit costs is projected to save a total of $22.7 billion over 30 years, equivalent to $12.0 billion in 2013 dollars. This reduction in benefits will reduce the amount of additional contributions required to fully fund the existing DB Program over 30 years by $4.9 billion, assuming the DB Program earns 7.5 percent over that time period. This is equivalent to a 0.754 percentage point reduction in the required increase in contributions to fully fund the benefit program.

There will also be savings for 2% at 62 members, employers of 2% at 62 members and the state based on reduced contributions. The chart below shows cumulative savings over 30 years (in millions).

	Cumulative Savings (in millions)
2% at 62 members	$530
Employers of 2% at 62 members	$550
State	$190
Total	$1,270

Administrative Costs/Savings – Administrative costs due to system changes are unknown. Required changes in the procedures would be incorporated into the training of affected staff and CalSTRS communications materials.

SUPPORT

League of California Cities
Urban Counties Caucus

OPPOSITION

California Association of Professional Scientists
CDF Firefighters
Laborers' International Union, Locals 777 and 792
Local Government Employees
Professional Engineers in California Government
Service Employees International Union

ARGUMENTS

Pro: Provides valuable anti-spiking tools that will allow CalSTRS to better define and prevent pension spiking.

Validates the strength and appropriateness of CalSTRS current plan design.

Con: Does not address CalSTRS $64.5 billion funding gap.

Requires 2% at 62 CalSTRS members to work longer or receive a reduced benefit.

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