BILL NUMBER: AB 1469 (Bonta) as amended June 12, 2014

SUMMARY

This bill increases state, employer and member contributions to the Teachers' Retirement Fund in order to eliminate the unfunded actuarial obligation (UAO) of the Defined Benefit (DB) Program by June 30, 2046.

REASON FOR THE BILL

As of June 30, 2013, the CalSTRS DB Program had an unfunded liability of $73.7 billion, primarily as a result of poor investment returns for several years during the first decade of this century. Absent any changes in contribution rates or liabilities, current calculations show the program will deplete its assets by as early as 2046.

ANALYSIS

Existing Law:

<u>DB Program Benefits.</u> The DB Program provides retirement, disability and survivor benefits for eligible educators. As a result of the Public Employees' Pension Reform Act of 2013 (PEPRA), the DB Program provides reduced retirement benefits for members first hired on or after January 1, 2013, to perform service that could be creditable to CalSTRS.

For members who are not subject to PEPRA (2% at 60 members), 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. Furthermore, 2% at 60 members retiring with 30 or more years of service receive an increase in their retirement benefit of 0.2 percent of final compensation per year of service, up to the 2.4 percent maximum.

For members who are subject to PEPRA (2% at 62 members), the retirement benefit is equal to 2 percent of final compensation per year of service for those retiring at the normal retirement age of 62, increasing to 2.4 percent at age 65. Final compensation is based on the highest 12 consecutive months of average annual compensation earnable for 2% at 60 members with 25 years or more of service. Final compensation for all other members, including all 2% at 62 members, is based on the highest three consecutive years of average annual compensation earnable. In addition, 2% at 62 members are prohibited from accruing retirement benefits as a result of earning certain types of compensation that are creditable for 2% at 60 members.

Under the DB Program, all members and beneficiaries receive an annual increase in monthly allowances for retirement, disability and survivor benefits that is equal to 2 percent of the base allowance. This adjustment is known as the "improvement factor." Although all members and beneficiaries have received the improvement factor since it was enacted in 1972, the law specifically reserves the right for the Legislature to adjust or even eliminate it as economic conditions dictate. As a result, unlike the rest of the benefits provided by CalSTRS, the improvement factor is not vested, and the state is not contractually required to provide it.

<u>DB Program Contributions.</u> All contribution rates applicable to the DB 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 it funds approximately 43 percent of the normal cost of the benefit for 2% at 60 members. As a result of PEPRA, 2% at 62 members are required to pay one-half of the normal cost of their benefits rounded to the nearest quarter percent. Based on the most current actuarial analysis, the board has determined that, based on the normal cost of the 2% at 62 benefits, the 2% at 62 member contribution rate is also 8 percent.

Long-standing California case law prohibits the impairment of vested pension benefits, including increases in member contribution rates that are fixed by statute, without an offsetting comparative advantage. CalSTRS' outside counsel has confirmed that the CalSTRS member contribution rate is vested and cannot be increased without providing a comparative new advantage in exchange for such an increase. CalSTRS' counsel has further advised that establishing the improvement factor as a vested benefit would provide a sufficient comparable new advantage in order to increase the member contribution rate up to the normal cost of the improvement factor.

The employer contribution rate has been set at 8.25 percent since 1986. However, the state's contribution rate has declined, through a series of legislation, from 4.607 percent in 1998 to the current 3.041 percent. The state rate currently includes a 2.017 percent base rate with additional increases dependent upon whether a UAO exists as a result of the benefits in effect in 1990. Under current law, the state's contribution would increase by a quarter percent per year until the final state's contribution rate to the DB Program reaches a maximum of 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 the benefits, the amount contributed to the DB Program has been less than the amount necessary to fully amortize the UAO in the DB Program since 2002.

This Bill:

<u>Member Contributions and Vesting the Improvement Factor.</u> This bill increases member contributions on compensation that is creditable to the DB Program over three years beginning in the 2014–15 fiscal year as follows:

Effective Date	Prior Rate		AB 1469	
	2% at 60 Members	2% at 62 Members*	2% at 60 Members	2% at 62 Members*
July 1, 2014	8%	8%	8.15%	8.15%
July 1, 2015	8%	8%*	9.20%	8.56%*
July 1, 2016	8%	8%*	10.25%	9.205%*

* As a result of PEPRA, the rate imposed on CalSTRS 2% at 62 members is one-half of the normal cost of benefits. The contribution rates for future years assume no change in normal cost of benefits.

For 2% at 60 members, the final increase of 2.25 percent covers the majority of the 2.83 percent normal cost of the improvement factor, as determined by the CalSTRS actuary. For 2% at 62 members, the final increase covers exactly half of the 2.41 percent normal cost of the improvement factor, as determined by the CalSTRS actuary. As a result, 2%

at 62 members, who already pay one half of the cost of their total benefit, will now be paying the full cost of their improvement factor.

In return for this increased contribution by members, the bill removes the Legislature's right to adjust the improvement factor and declares the improvement factor vested as a contractually enforceable promise for any member who is an active member on or after January 1, 2014. As a result, although current members will be required to pay more, by vesting the improvement factor, the Legislature provides a comparable new advantage in order to comply with California's long-standing constitutional provisions prohibiting the impairment of pension benefits.

This bill retains the Legislature's right to adjust the improvement factor for members who retire prior to January 1, 2014. It is possible that a member could retire prior to January 1, 2014, and reinstate from retirement, thus returning to active member status after January 1, 2014. According to the language in the bill, the improvement factor would vest for these individuals because they would be active members in a year in which the increased contributions were paid. It is also reasonable to assume that, regardless of whether the member had previously received a retirement benefit, the provision reserving the right of the Legislature to reduce or eliminate the improvement factor would not apply to them because they would eventually be retiring after January 1, 2014. This ambiguity is likely to motivate certain retirees to reinstate in order to vest their improvement factor.

<u>Employer Contributions.</u> This bill increases employer contributions on compensation that is creditable to the DB Program above the current 8.25 percent contribution rate over seven years in order to pay the UAO for service credit earned prior to July 1, 2014, as follows:

		AB 1469	
Effective Date	**Prior Rate**	**Increase**	**Total**
July 1, 2014	8.25%	0.63%	8.88%
July 1, 2015	8.25%	2.48%	10.73%
July 1, 2016	8.25%	4.33%	12.58%
July 1, 2017	8.25%	6.18%	14.43%
July 1, 2018	8.25%	8.03%	16.28%
July 1, 2019	8.25%	9.88%	18.13%
July 1, 2020	8.25%	10.85%	19.1%
2021–22 through 2045–46	8.25%	1% adjustments, if necessary, up to 20.25% maximum	
July 1, 2046	8.25%	Increase from prior rate ceases in 2046–47	

This bill requires the Teachers' Retirement Board to adjust the employer contribution rate beginning in 2021–22 to reflect the contribution rate required to eliminate the UAO for service credited to members prior to July 1, 2014, by June 30, 2046. The board would have the authority to adjust the contribution rate by no more than 1 percent per year up to a maximum of 20.25 percent. The total increased contribution rate and the board's authority to adjust the rate would be eliminated as of July 1, 2046.

<u>State Contributions.</u> This bill increases the continuous appropriation from the state above the current base contribution rate of 2.017 percent of creditable compensation

that is credited to the DB Program. The increase will occur incrementally over three years in order to pay the UAO attributable to the benefits in effect in 1990 as follows:

		Prior Rate		AB 1469		
Effective Date	Base Rate	1990 Benefit Rate	Total	1990 Benefit Rate	Total	Increase from Prior Rate
July 1, 2014	2.017%	1.024%	3.041%	1.437%	3.454%	0.413%
July 1, 2015	2.017%	1.274%	3.291%	2.874%	4.891%	1.600%
July 1, 2016	2.017%	1.505%	3.522%	4.311%	6.328%	2.806%
2017–18 through 2045–46	2.017%	• 0.25% increases, if necessary, up to 3.522% • Reduction to 0% if no UAO or normal cost deficit		• 0.5% increases, if necessary • No maximum rate • Reduction to 0% if no UAO		
July 1, 2046	2.017%	Prior rate is reinstated in 2046–47, if necessary, to address 1990 UAO				

This bill requires the board to adjust the state contribution beginning in 2017–18 to reflect the contribution required to eliminate the UAO attributable to benefits in effect as of July 1, 1990. If an increase is required, the board is allowed to adjust the rate by no more than 0.5 percent per year. If a decrease is required, the board shall reduce the rate to the level required to eliminate the UAO accordingly. If there is no UAO, the board is required to eliminate the increase in the contribution rate. The total increased contribution rate would be eliminated as of July 1, 2046, at which point the prior provisions concerning the state's contribution rate would be reinstated.

<u>2019 Funding Assessment and Adjustment Authority.</u> This bill requires CalSTRS to report to the Legislature on the fiscal health of the DB Program every five years beginning on or before July 1, 2019. The reports would provide the projected UAO for service credited to members prior to July 1, 2014, as of June 30, 2046, and identify any contribution rate adjustments required to eliminate that UAO by 2046.

LEGISLATIVE HISTORY

<u>AB 340 (Furutani, Chapter 296, Statutes of 2012)</u> made various changes to the CalSTRS benefit structure that affect 2% at 62 members, including reducing the age factor, increasing minimum and normal retirement age, eliminating the career factor, requiring final compensation be calculated based on the highest average annual compensation earnable over three consecutive school years, reducing the limit on compensation that counts toward retirement benefits, limiting the type of compensation that counts toward retirement benefits, eliminating the Replacement Benefits Program, and requiring the contribution rate to equal 50 percent of the normal, ongoing cost of benefits. Also made other changes that apply to all CalSTRS members, including prohibiting the purchase of nonqualified service, requiring that a conviction for a work-related felony result in the forfeiture of benefits, expanding the separation from service requirement to all members, adding a narrow exemption to the separation from service requirement, extending the narrow exemption to the annual postretirement earnings limit to June 30, 2014, and prohibiting retroactive benefit enhancements.

SCR 105 (Negrete McLeod, Resolution Chapter 123, Statutes of 2012) encouraged CalSTRS to develop at least three options to address the long-term funding needs of the DB Program and submit those options to the Legislature by February 15, 2013, and declared the intent of the Legislature to enact legislation to address the long-term funding needs of the DB Program during the 2013–14 legislative session.

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.

SB 1370 (C. Green, Chapter 460, Statutes of 1990), the Elder Full Funding Act, revised the annual General Fund contributions to CalSTRS to a level that provided full funding of the normal cost and provided for the amortization of the CalSTRS' unfunded obligation.

AB 75 (Hughes, Chapter 1597, Statutes of 1985) increased the employer contribution from 8 percent to 8.25 percent of teacher payroll to pay for service credit granted for unused sick leave and, for the 1985–86 fiscal year only, directed the State Controller to transfer the equivalent of the 0.25 percent increase directly from the General Fund to the Teachers' Retirement Fund.

AB 8 (Greene, Chapter 282, Statutes of 1979) adjusted the flat state contribution rate annually by the rate of the California Consumer Price Index (CCPI) and provided an additional state appropriation schedule that increased from $10 million in 1980–81 to $280 million in 1994–95, at which point that amount is also adjusted by the CCPI.

AB 543 (Barnes, Chapter 1305, Statutes of 1971) enacted the E. Richard Barnes Act, changed the funding of CalSTRS to long range reserved funding, fixed the state's General Fund contribution at $135 million for 30 years to amortize the cost of benefits in place as of June 30, 1972, and set contributions from members and employers at 8 percent.

PROGRAM BACKGROUND

DB Program Funding. CalSTRS' current shortfall of approximately $73.7 billion is based on an actuarial valuation of the fund's assets and liabilities as of June 30, 2013, which shows the CalSTRS DB Program is 66.9 percent funded. CalSTRS' financial holdings sustained significant losses in the 2001 dot com bust and 2008 world economic turmoil. Since CalSTRS does not have authority to correct the situation by adjusting its contribution rates like other public pension funds, the long-term health of the fund has continued to weaken. Absent any changes in contribution rates or liabilities, current calculations show the program will deplete its assets by as early as 2046.

Last year, CalSTRS submitted a report to the Legislature pursuant to Senate Concurrent Resolution 105 (Negrete McLeod, Resolution Chapter 123, Statutes of 2012) that provided a range of sustainable funding strategies built upon gradual, incremental contribution increases that could be adopted to close the funding gap and secure the long-term stability of the fund. Within the report, CalSTRS asserted that the definitive approach to addressing the long-term funding needs of the DB Program is to fully fund the program within 30 years. For every day that goes by without a funding strategy in place, the costs rise by $15 million.

This bill significantly reduces these costs by putting in place an incremental funding plan over approximately 30 years. The contribution increases would significantly increase the likelihood of eliminating the current unfunded liability of the DB Program by July 1, 2046. Although the adjustments to the contribution rates required under the bill also provide additional protection, the 20.25 percent cap that is placed on the employer contribution rate significantly reduces any advantage that is provided by establishing this authority. Nevertheless, barring consecutive significant market losses, this bill provides the needed financial stability to secure and sustain the retirement benefits of California's educator's into the foreseeable future.

<u>DBS Program Impacts.</u> Beginning in 2001, compensation that members earned for performing more than one year of service (usually for summer school) or receiving a one-time bonus became creditable to the DBS Program, a cash balance type of defined benefit program in which each member receives a benefit based on the balance of a nominal account that earns a board-determined annual interest rate. At the same time, contributions on compensation that was determined to be paid for the purpose of enhancing the DB Program benefit were no longer creditable to the DB Program, and CalSTRS was required to deposit them into the nominal DBS accounts, significantly easing administrative complexities that would be required to return the contributions without affecting the funding of either program.

For these three types of DBS compensation, CalSTRS currently deposits the full amount of the member contributions and the 8 percent employer contribution that is not attributable to unused sick leave into the nominal accounts. The 0.25 percent employer contribution that is attributable to unused sick leave is remitted for DBS compensation but deposited into the Teachers' Retirement Fund to pay for DB Program service credit for unused sick leave. Because CalSTRS does not know until the end of the school year which compensation should be creditable to the DBS Program based on the lowest pay rate earned, allowing CalSTRS to retain all of the contributions and make the necessary transfers at that time significantly reduces the complexities of administering the programs.

The bill preserves the status quo with regards to the DBS Program by specifically requiring the increased member and employer contributions only on compensation that is creditable to the DB Program. As a result, the bill will substantially change the way CalSTRS allocates contributions between the two programs, which will increase the administrative complexity of the plan. Specifically, when CalSTRS has determined that compensation is creditable to the DBS Program, any contributions for that compensation that are the result of the increases provided for within the bill will be returned to the employer who will return the excess member contributions to the member. Such member contributions will be deemed excess contributions, which will allow them to be considered income for tax purposes in the year they are received by the employee, significantly reducing any adverse tax considerations. Nevertheless, this return of excess contributions adds a certain level of difficulty to the plan that will necessarily increase under special circumstances when, for example, members have worked in multiple school districts or have changed employers or even careers, and the districts are required to find them in order to reimburse excess contributions.

FISCAL IMPACT

Program Cost – For fiscal year 2014–15, increased costs of approximately $59 million for the state, $175 million for employers and $42 million for members. The total increased costs to members, employers and the state is $237.7 billion over 32 years.

There are savings of approximately $15 million per day, resulting from prefunding the benefits that are due to members by setting forth a plan to eliminate the $73.7 billion unfunded obligation for which the state, as plan sponsor for the DB Program, is ultimately responsible.

Administrative Costs/Savings – Administrative costs are estimated at approximately $500,000 to $1 million for changing the corporate database to allow for the appropriate accounting for the increased contributions and additional unknown absorbable costs to communicate changes to members and employers.

SUPPORT

None known.

OPPOSITION

None known.

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