BILL NUMBER: Assembly Bill 1425 (Simitian) as amended May 4, 2010

SUMMARY

This bill is aimed at eliminating abuses in the benefits paid out by public pension funds in California. This bill seeks to curtail compensation practices that have been undertaken by some public employees in order to increase their final compensation, thereby inflating their retirement benefit (known popularly as "spiking"). By precluding certain types of compensation from the calculation of a member's retirement benefit, this bill would increase the extent to which retirement benefits paid to public employees reflect the annual compensation they earned while employed. In addition, this bill aims to reduce the incidence of retirees returning to work immediately after retirement by requiring a 180-day separation from service after retirement.

BOARD POSITION

Sponsor, if amended to limit, without a rebuttal process, salary increases for all members during their final compensation period and the two years prior to 10 percent annually and delay the effective date to facilitate implementation.

PURPOSE OF THE BILL

This bill seeks to restrict the abuse and manipulation of public pension funds and retirement benefits through spiking and the unrestricted ability to return to work immediately after retirement.

SUMMARY OF AMENDMENTS

The May 4, 2010, amendments were minor and technical in nature.

LEGISLATIVE HISTORY

SB 1094 – Soto (2005) specified that, for members of CalSTRS, housing stipends and car allowances are fringe benefits that are excluded from the definition of creditable compensation. This bill was held in the Senate Public Employment and Retirement Committee.

Chapter 1028, Statutes of 2000 (AB 821 – PER&SS) changed the definition of "final compensation" for those members of CalSTRS with 25 years of creditable service from the highest average annual compensation earnable during any period of three consecutive school years to any period of 12 consecutive months.

Chapter 482, Statutes of 1997 (SB 471 – Burton) made minor, technical changes to the definition of "creditable compensation," and related technical changes to other sections of the Teachers' Retirement Law.

Chapter 1165, Statutes of 1996 (AB 3032 – Burton), among other provisions, repealed the definitions of "compensation" and "salary" and added the definition of "creditable compensation," making clarifying amendments as appropriate.

Chapter 468, Statutes of 1993 (AB 631 – Cannella) clarified the definitions of “compensation” and “salary” for the purposes of calculating a CalSTRS retirement benefit in order to make it more difficult to “spike” a member’s final compensation or otherwise to improperly inflate benefit amounts. Prohibited the making of ad hoc adjustments to compensation when the purpose is to enhance a member’s retirement benefit.

Chapter 860, Statutes of 1993 (SB 698 – Torres) allowed a member’s retirement benefit to be based on the highest earnable compensation during any three non-consecutive years if the member’s salary was reduced because of budget cuts and authorized employers to elect to preserve a member’s retirement benefit when salary reductions due to budget cuts have occurred.

Chapter 1184, Statutes of 1989 (AB 123 – Elder) authorized a benefit based on one-year final compensation for teachers who spent 60 percent or more of the last ten years of their careers as classroom teachers, required employers to pay the actuarial difference between the one-year and three-year final compensation and made one-year final compensation subject to collective bargaining.

AB 2882 – Elder (1988) defined the term “final compensation” as the highest annual compensation earnable by a classroom teacher during any 12 consecutive months. This bill was vetoed.

PROGRAM BACKGROUND

Potential Impairment of Contract

This bill applies to all current and future active members of CalSTRS. Applying such provisions to existing members could constitute an impairment of contract if it reduced the benefit paid to current members without an offsetting increase. The potential reduction in the Defined Benefit (DB) Program benefit resulting from the limitation in final compensation, however, could be offset by the increase in benefits paid from the Defined Benefit Supplement (DBS) Program as a result of the additional compensation that would be credited to that program, particularly for those members who earned the recharacterized compensation earlier in their career.

Changes in Final Compensation

Under the bill, increases in compensation during the final compensation period would be limited. There are two aspects of this limitation that are administratively complex as the bill is currently drafted. First, although the allowable percentage increase in final compensation generally would be ten percent annually, in years in which the average salary rate paid to DB members increased by more than five percent, the limitation would increase to twice the average increase. The average annual increase in compensation paid in any fiscal year is not determined until CalSTRS completes its annual reconciliation of contributions and account information, which takes place in October. The bulk of retirements, however, take place in May and June, four or five months before staff can determine whether the increase in compensation would be credited toward final compensation. To the extent that the salary rate paid to a retiring member increased by more than ten percent, any final determinations of the benefit being paid would have to wait until October to determine if the higher allowable increase in compensation would apply.

Second, although any increase in compensation paid in excess of the allowable percentage is presumed to have been paid for the purposes of enhancing the retirement benefit, and therefore credited to the DBS Program, that presumption is rebuttable by the member or the employer through the submission of evidence that the increase was appropriate. This rebuttable presumption currently exists in the law, but is generally used only in response to audit findings. Under this bill, the rebuttable presumption would apply in each case in which the salary rate increase exceeded the allowable percentage. Over the past ten years, that limitation would have been applied to an average of about 1,500 retiring members each year.

These two aspects of the limitation are intended to allow for the fact that (1) in some years, particularly after the existing budget problems facing schools are behind them, average compensation could increase significantly, and (2) members, even at the end of their career, sometimes do change jobs that result in higher than normal increases in compensation. By making it possible that increases in compensation could be credited toward the DB Program benefit, however, there would be a potentially significant increase in workload associated with (1) evaluating the information submitted by the member and/or employer to rebut the presumption that the increase was paid to enhance the retirement benefit and (2) participating in any appeals that might result from a determination by CalSTRS with which the member disagreed. Moreover, regulations would likely need to be promulgated to provide clear definition of the circumstances in which increases in compensation in excess of the allowable percentage could still be credited toward final compensation.

These two issues would be mitigated if (1) the ten percent allowable increase in the salary rate was the sole threshold and (2) the limitation was applied in every case, without a rebuttal process, even if, in fact, the extraordinary increase was appropriate given changes in employment. Amending this proposal would reduce the technology costs by $1 million, and reduce the implementation costs to up to six positions, with two additional ongoing audit staff, plus potentially additional staff for increased member communication. However, applying this limitation to all members could exacerbate the impairment of contract issue.

Finally, a July 1, 2011, implementation deadline is aggressive, particularly given the bill's current provisions regarding the limitation in final compensation and the change of crediting some additional types of compensation to the DBS Program.

<u>Return to Work Restrictions</u>

In addition, imposing a limitation on earnings for all members who retire could have an impact on school employers. Under current law, effective July 1, 2010, retired members under age 60 will have their benefit reduced by the amount of compensation earned in CalSTRS-covered service during the first six months of retirement. This change was enacted to conform to federal restrictions imposed on pensions plans paying benefits to members retiring before normal retirement age, which is age 60 for CalSTRS. No such federal limit exists for those over age 60, but this bill would impose such a restriction on all retired members during the first six months after retirement. No exemptions to this limitation are allowed. This restriction is intended to reduce the incidence of members, regardless of age, retiring and returning to work within the retirement plan, a not uncommon occurrence in many retirement plans, and the subject of much media scrutiny. This change would, however, limit the pool of available staff to replace other employees who leave employment, making it potentially difficult for employers to fill critical vacancies. In addition, as under current law, the member bears the entire financial impact of returning to work before the six month period has ended, even though the employer was the one who instigated the premature return to work.

ANALYSIS:

Existing Law:

Under current law, benefits are paid to retiring members of the DB Program based on the age, service credit and final compensation at retirement. Final compensation is based on the average annual full-time salary rate (or "compensation earnable") over one or three years, depending on the number of years of service. Generally, any compensation, including salary and remuneration in addition to salary, earned by a person for performing creditable service is included in the determination of final compensation, unless the compensation is:

- Paid for service in excess of 1.000 years of service credit in any school year,
- Paid for a limited number of times, or
- Determined by CalSTRS to have been paid for principal purpose of enhancing the retirement benefit. (This determination is subject to rebuttal by the member or employer.)

Under those circumstances, the contributions paid by the member and employer are credited to the DBS Program and, therefore, not included in final compensation. Some compensation paid to members, however, is not credited to any CalSTRS retirement program. Excluded compensation includes lump-sum payments of accrued vacation, severance pay and reimbursements for substantiated job-related expenses.

Other retirement systems, such as those administered pursuant to the County Employees Retirement Law of 1937, include lump-sum vacation payouts and overtime pay in final compensation. SB 1425 compels public retirement systems to abide by certain minimum standards. Although CalSTRS and CalPERS already include most of such safeguards, the intention of SB 1425 is to improve the existing protections afforded by the Teachers' Retirement Law and Public Employees' Retirement Law, respectively.

This bill:

SB 1425 specifies which types of compensation are included in a member's final compensation for the purpose of determining retirement benefits. Salary will continue to be credited to the DB Program. However, salary is further defined as being compensation paid for performing service or using employer approved leave over the course of a specific time period. In addition, "remuneration that is paid in addition to salary" would now be credited to the DBS Program and would, therefore, not be included in final compensation. "Remuneration that is paid in addition to salary" is defined to include:

- Reimbursements or allowances for unsubstantiated expenses (such as car allowances or housing allowances).
- Cash in lieu of health or other benefits.
- Lump-sum payments or bonus payments made for meeting career, educational, age, or performance-related criteria.
- Any other payments the Board determines to be "remuneration that is paid in addition to salary."

This bill also requires all payments that increase a member's salary rate from one year to the next in excess of the greater of (1) ten percent or (2) twice the percentage increase in the average salary rate of active members to be presumed to have been paid to enhance the member's benefits. This limitation would be applied to the final compensation period and the two years prior to the final compensation period. CalSTRS would reverse this presumption upon receipt of sufficient evidence that the increase was not paid to enhance the member's benefits. If a rebuttal is rejected, compensation that is determined to have been paid to enhance a benefit would be credited to DBS.

In addition, members who have unique responsibilities (such as a superintendent) would be subject to a different limitation on final compensation. All payments to such members that increase their salary rate in excess of the average percentage increase in the salary rate of the closest related class of employees during the same period would be credited to DBS, unless the increase was paid as a result of a legitimate change in a member's duties and responsibilities. This requirement would only be applied to the final compensation period and the two years prior to the final compensation period.

Finally, all retired members who retire on or after January 1, 2011, and who return to CalSTRS-covered service within 180 days of retirement would have their DB benefit reduced by the amount of compensation earned during the 180 day period. Currently, this provision only applies to retired members who are under age 60. Similar restrictions would apply to retired Cash Balance Benefit Program participants.

Except as provided, the provisions this bill would be effective July 1, 2011. SB 1425 would apply to all current and future active members.

Similar provisions in this bill are applicable to CalPERS. In addition, AB 1987 (Ma) makes parallel changes applicable to local retirement systems, including county retirement systems. However, no other system besides CalSTRS has provisions that require an automatic review for all members who receive a salary increase above a certain percentage. SB 1425 would take effect only if AB 1987 is enacted.

OTHER STATES' INFORMATION

In May 2010, the National Conference of State Legislatures provided a preliminary version of their annual report of state pensions and retirement legislation. Drawing from that report, the following summarizes some of the legislation that is being pursued or has been enacted in other states.

In Vermont, the Teachers Retirement System would cap compensation growth for the purposes of calculating final compensation at 10 percent per year for the final compensation period. In Colorado, the increase in compensation that counts towards final compensation is limited to 8 percent annually. Colorado also requires retired members who go back to work for a Public Employees' Retirement Association-covered employer to make member contributions that will not be credited to their accounts.

In Maryland, a member who retired based on a $25,000 final compensation would be exempt from the earnings limitation, an increase from the current limit of $10,000. Mississippi subjects retirees to a 90-day separation from state service. After the 90 days, those retirees may return to work while employers are required to make contributions. Illinois provides for the suspension of annuities for members who enter most of the statewide retirement plans on or after January 1, 2011, and who return to covered service after retirement. New Mexico has extended the separation from service period for retirees covered by the Public Employees Retirement Act from 90 days to 12 months. In Utah, the benefit paid to retired members is cancelled if they return to work with a Utah Retirement System-covered employer within one year after retirement, and they can earn additional service credit. Two years of service must be completed in order to receive the additional service credit.

FISCAL IMPACT

Benefit Program Cost – It is anticipated that there would be an immediate savings to the fund due to a decrease in annual benefit costs; however, these savings would be offset by a decrease in annual contributions. Therefore, there would be an anticipated net savings to the fund in excess of $10 million annually.

Administrative Costs/Savings – One-time technology costs are estimated at up to $6 million. One-time employer training costs for changes to how creditable compensation is reported to the DB and DBS programs are estimated at approximately $100,000. In addition, it is estimated that up to 17 positions would be needed to implement and administer SB 1425 and that the implementation timeline would extend beyond the July 1, 2011.

SUPPORT

Glendale City Employees Association
Organization of SMUD Employees
San Bernardino Public Employees Association
San Luis Obispo County Employees Association
Santa Rosa City Employees Association
Service Employees International Union, Local 1000
California School Boards Association, if amended

OPPOSITION

California State Association of Counties, unless amended
Judicial Council of California, Administrative Office of the Courts, unless amended

SUPPORTING ARGUMENTS

Provides additional means for preventing spiking and returning to work immediately after retirement.

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