BILL NUMBER: SB 27 (Simitian) as amended July 7, 2011

SUMMARY

SB 27 changes the types of compensation that are credited to CalSTRS and CalPERS defined benefit programs in order to curtail the inappropriate inflation in retirement benefits (known popularly as “spiking”). In addition, this bill aims to reduce the incidence of retirees returning to work immediately after retirement (known as “double-dipping”) by requiring a 180-day separation from service after retirement.

BOARD POSITION

Support, if amended to apply certain provisions of the bill only to future members, to replace the percentage increase limitation in the bill with a flat limitation on compensation earnable, and to make other clarifying and conforming changes.

SUMMARY OF AMENDMENTS

The July 7, 2011, amendments:

- Make technical corrections, including changes to ensure that members under the normal retirement age who retire prior to January 1, 2013, are subject to the correct zero dollar earnings limit.

PURPOSE OF THE BILL

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

ANALYSIS:

Existing Law:

Under current law, benefits are paid to retiring members of the Defined Benefit (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.

<u>Determining Final Compensation</u>
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. However, the contributions paid by the member and employer are credited to the Defined Benefit Supplement (DBS) Program and, therefore, not included in final compensation, if 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 the principal purpose of enhancing the retirement benefit (this determination is subject to rebuttal by the member or employer).

Some compensation paid to members, moreover, 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.

CalSTRS has safeguards in place to stop compensation practices that some members may undertake to increase their final compensation, thereby inflating their retirement benefit. At the direction of the board, CalSTRS is evaluating those existing practices to prevent spiking and determining how they could be enhanced, either by making administrative changes or modifying existing law. SB 27 provides an opportunity to further those efforts. However, the bill, as currently drafted, creates contract impairment issues and increases administrative complexity for the plan.

Post-Retirement Employment

Existing law limits the compensation that a retired member can earn if he or she performs creditable service as an employee or a contractor. Any compensation earned in excess of that limit reduces the DB benefit dollar-for-dollar. In 2011-12, the limit is $31,020. There are specified exceptions to that limitation. If the member is under age 60, any compensation earned during the first six months of retirement results in an equivalent reduction in benefits. There are no exemptions from the latter restriction.

This Bill:

SB 27 is very similar to SB 1425 (Simitian) from 2010, which ultimately was vetoed by the Governor. SB 27 contains provisions that apply to CalSTRS and CalPERS. However, it is not tied to a separate bill making parallel changes applicable to local retirement systems, including county retirement systems, as SB 1425 was last year.

In regards to CalSTRS, SB 27 prohibits members from being in a class of one. As a result, some members would not be considered as a class of employees.

SB 27 also specifies which types of compensation would be included in a member's final compensation for the purpose of determining retirement benefits. Salary would 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 or wages" 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 or wages" is defined to include:

- Reimbursements or allowances for unsubstantiated expenses (such as car allowances or housing allowances), which currently are credited to the DB Program.
- Cash in lieu of health or other benefits, which currently may be credited to the DB Program.
- Payments made for a limited number of times (current law also requires that these payments be transferred to DBS).
- Compensation that is payable for meeting specified criteria if it is not paid in proportion to service performed or leave used.
- Compensation that is payable for attaining a specific age threshold.

- Compensation that is payable for meeting performance-related criteria if it is not used as the basis for subsequent increases in salary or wages, which currently may be credited to the DB Program.
- Compensation for an agreement to terminate employment, unless it is otherwise excluded from the definition of “creditable compensation.”
- Any other payments the board determines, pursuant to regulations, to be “remuneration that is paid in addition to salary or wages.”

The bill also includes a new creditable compensation principle to strengthen CalSTRS ability to review a member’s creditable compensation for consistency with other members who have previously or subsequently held the same position.

In addition, SB 27 requires contributions on a member’s salary increase to be credited to DBS if the member is not or could not be under a bargaining agreement and if the increase is more than 25 percent during a five-year period of service that ends in the last year in which the member’s final compensation is determined. A salary increase received when a member moves from one employer to another is exempt from this cap. The cap can be raised by the board if the 10 largest CalSTRS employers have an average salary increase that exceeded 5 percent in any year during the five-year period.

SB 27 also requires all retired members who retire on or after January 1, 2013, and who return to CalSTRS-covered service within 180 days of retirement to have their DB benefit reduced by the amount of compensation earned during the 180 day period. Currently, this provision only applies to retired CalSTRS members who are under age 60. There is one specific exemption to this limitation. Members over age 60 working as substitutes in grades nine through 12 in small school districts would be able to earn up to $2,500 during the 180-day period. The school district must submit documentation to CalSTRS to substantiate the member’s eligibility for the exemption. The bill also requires the maximum exemption to be adjusted as specified and imposes a sunset date on the exemption. In addition, the bill delays the disbursement of DBS lump-sum payments until 180 days have elapsed. Similar restrictions would apply to retired Cash Balance (CB) Benefit Program participants.

The bill delineates employer responsibilities when hiring a retired CB participant, including informing the participant of employment limitations after retirement, maintaining accurate records of earnings, and reporting those earnings to CalSTRS, which reflects current law for the DB Program. Language exempting employers from liability for any amount paid to a retiree in excess of earnings limitations in the similar DB statute is deleted by the bill.

The bill also adds a penalty under the CB Benefit Program for late or improper adjustments to employer reporting received more than 60 days after discovery or notification by the system that parallels an existing penalty for the DB Program.

Except as provided, the provisions of this bill would be effective July 1, 2012. SB 27 would apply to all current and future active members.

LEGISLATIVE HISTORY

SB 1425 (Simitian, Vetoed, 2010) limited the types of compensation included in a member's final compensation for the purpose of determining retirement benefits and effectively required all members to have a separation from service of 180 days after retirement. This bill was vetoed.

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.

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.

AB 821 (PER&SS, Chapter 1028, Statutes of 2000) 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.

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

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

AB 631 (Cannella, Chapter 468, Statutes of 1993) 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.

PROGRAM BACKGROUND

Impairment of Contract

SB 27 applies to all current and future active members of CalSTRS. Applying some of these provisions to existing members constitutes an impairment of contract if it reduces the benefit paid to current members without an offsetting increase. A CalSTRS member's contractual right to a pension benefit vests when he or she accepts employment to perform creditable service for an employer. (*Betts v. Board of Administration* (1978) 21 Cal.3d 859, 863; *California Teachers' Association v. Cory* (1984) 155 Cal.App.3d 494, 506-508.) The nature of this right is defined by the benefits provided for in the Teachers' Retirement Law at the time the member accepts employment, as well as any additional benefits or enhancements conferred during the member's employment. (*Betts*, at p. 866.) The alteration or elimination of this right constitutes an impairment of the contractual obligation the state owes to the member. (*Betts*, at p. 863; *Cory*, at p. 506.) The Legislature's ability to modify these benefits is permitted only in situations where the modification is reasonable and bears some material relation to the theory of a pension system and its successful operation. (*Betts*, at p. 864; *Miller v. State of California* (1977) 18 Cal.3d 808, 816.) Reasonable modifications that result in disadvantages to the member must be accompanied by comparable new advantages. (*Betts*, at pp. 864-865; *Allen v. Board of Administration* (1983) 34 Cal.3d 114, 120; *Claypool v. Wilson* (1992) 4 Cal.App.4th 646, 666.)

In order to mitigate impairment of contract issues, it is recommended that the salary limitation in this legislation, which would reduce benefits for some members, only be applied to individuals who first perform creditable service on or after July 1, 2012, as well as to individuals who first performed creditable service prior to July 1, 2012, received a refund of their contributions, and become members again on or after July 1, 2012. In order to avoid changing the rules for existing members who have already made employment decisions based on existing retirement rules, the same amendments are recommended for the redefinition of creditable compensation.

<u>Salary Limitation</u>
The provisions regarding the 125 percent limitation on compensation earnable increases would require several technological changes and manual processes to implement the necessary data collection and account transfers. These issues could be alleviated, and the legislation could be more effective in combating spiking, if the limitation on compensation earnable increases was amended to a uniform limitation on annual compensation earnable, applicable to all members regardless of collective bargaining status and without exemptions for a change in employer. A limit equal to 60 percent of the Internal Revenue Code 401(a)(17) limit is recommended. For 2011-12, this recommended limit would equal $147,000. Contributions on compensation earnable in excess of the limit would be credited to the member's DBS account.

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 was 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 toward 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

Program Cost – As currently drafted, it is anticipated that there would be an immediate savings to the fund due to a decrease in annual benefit costs; however, those savings would be offset by a decrease in annual contributions. Therefore, there would be an anticipated net savings to the fund of approximately $10 million annually.

Administrative Costs/Savings – As currently drafted, one-time technology costs are estimated at up to $5 million for changes to the pension system, as well as additional costs for modifying the system to levy penalties and interest for late reporting to incorporate the provisions related to an adjustment penalty for the CB Benefit Program. In addition, the Secure Employer Website (SEW) and all final compensation calculators would need to be updated. 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. Furthermore, it is estimated that up to 12 positions would be needed to implement and administer SB 27, including six positions for implementation efforts and six ongoing positions for customer service issues, communication, manual interaction with accounts and data, and maintenance once the process is fully automated.

SUPPORT

California Association of Highway Patrolmen
California Public Employees' Retirement System
California School Boards Association (if amended)
California State Employees Association
Glendale City Employees Association
League of California Cities
Organization of SMUD Employees
Retired Public Employees Association
San Bernardino Public Employees Association
San Luis Obispo County Employees Association
Santa Rosa City Employees Association
Service Employees International Union, Local 1000
State Controller John Chiang
State Treasurer Bill Lockyer

OPPOSITION

Association of California School Administrators
California Association of Joint Powers Authorities
California Association of School Business Officials
California District Attorneys Association
California Faculty Association

California Police Chiefs Association
California State Association of Counties
California State Sheriffs' Association
California Teachers Association (unless amended)
City of Benicia
City of Santa Rosa
Community College League of California
Humboldt County Superintendent of Schools
Orange County Superintendents' Association
Orange County Superintendent of Schools
Regional Council of Rural Counties
Riverside County School Superintendents' Association
Small School Districts' Association
Numerous Educators

ARGUMENTS

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

Con: Calls for broad technology system changes, internal and external training sessions and member education.

As currently drafted, impairs contractual rights of existing members.

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