California Public Employees' Pension Reform Act of 2013
1937 Act System Issues

Background

On September 12, 2012 the Governor signed pension reform bill AB 340, which the California State Legislature approved on August 31. Within AB 340[1] is the California Public Employees' Pension Reform Act of 2013 (PEPRA), which affects most California public retirement systems, including CalPERS and the '37 Act County Plans effective January 1, 2013. PEPRA generally restricts current pension provisions while increasing flexibility for employee/employer cost sharing. It includes 1 new retirement formula for General members and 3 for Safety members.

This paper focuses on PEPRA's implications for Plans formed under the County Employees Retirement Law of 1937 ('37 Act or CERL).

PEPRA is unclear and difficult to interpret in a number of areas. We look forward to clarification, which could change our understanding summarized in this analysis. Our interpretation of PEPRA is not legal advice; agencies should consult with counsel for a legal interpretation of the statute.

New Member Provisions

PEPRA cost savings are from requirements for new members hired on or after January 1, 2013.

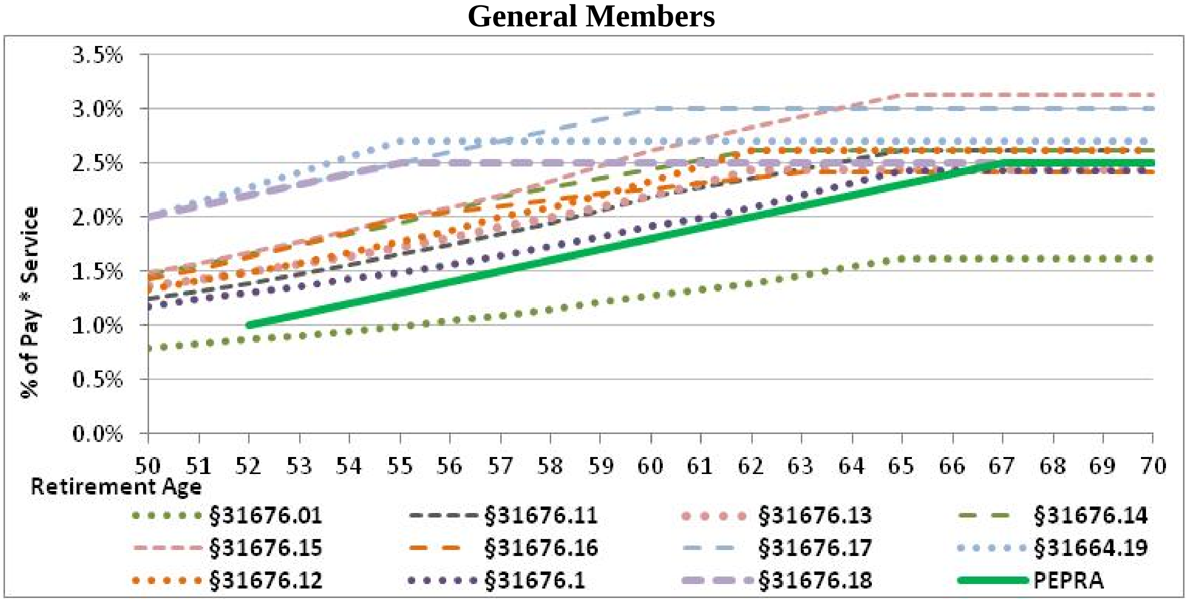
> Since savings will be realized only as new members are hired in the future, cost reductions will be very minimal in the short term.

"New members" are individuals who join any public retirement system on or after January 1, 2013 and individuals who were last in CalPERS, a '37 Act System or a reciprocal system more than 6 months before their hire.

- *Benefit Formulas*

  Benefit formulas cannot be greater than the new PEPRA formulas:
  - 2.5%@67 (also known as 2%@62) for General members. The earliest service retirement age increases to 52 for General members. The following graph compares the formulas:

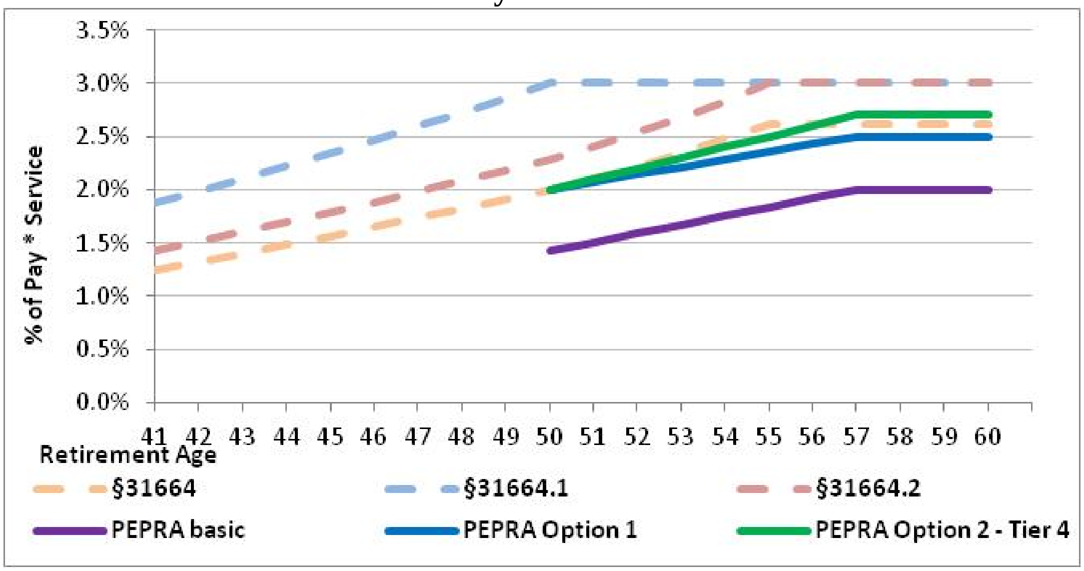
General Members



[1] Subsequent legislation, notably AB197 (2012) and AB 1380 (2013) amended PEPRA, and further legislative changes and clarifications are in progress.

- PEPRA creates 3 new Safety member formulas (2%@57, 2.5%@57, and 2.7%@57). The new member formula is the one with the closest lower benefit factor at age 55 to the applicable formula for members hired before 2013 (if the agency already has a second or later tier, the applicable formula is the benefit for employees hired on December 31, 2012). This means 2.7%@57 applies to 99% of Safety groups across the State. Agencies may bargain with employee groups for any of the lower formulas. The following graph compares formulas:

Safety Members



Additional issues:

- Many '37 Act Systems "integrated" their benefit formula with Social Security, as permitted under the CERL, by providing reduced benefits on pay up to $350 per month. Most '37 Act Systems are not integrating the PEPRA formulas.
- PEPRA does not appear to limit optional or ancillary benefits.

> Agencies may still determine new member COLAs, death, retiree medical, and industrial disability benefits.

- Note that the new formulas do not apply to employees hired after December 31, 2012 directly from a reciprocal agency because they're not considered "new members." "Classic" members will be eligible for the same formula as those hired on December 31, 2012 with apparently no ability to change to a lower formula after that date.

■ *Employee Contributions (New Members)*

The following provisions apply to new members effective January 1, 2013. If they impair a contract in force at that time they won't apply until the contract expires or is renewed, amended, or extended.

- Employees must contribute at least ½ of the Total Normal Cost rate, initially set for 2013 (rounded to the nearest 0.25%), then adjusted in future years if the Total Normal Cost rate changes by more than 1% of payroll. AB 1380 allows '37 Act Systems to disregard the rounding rules.

- If higher, the new member rate must be the current contribution rate of similarly situated employees ("similarly situated" has been defined as those employees with the same retirement benefit formula).
- PEPRA does not specify whether the employee contribution rates should be uniform or based on entry age, as was usual for '37 Act Systems pre-PEPRA. Most of these Systems adopted uniform PEPRA contribution rates as being consistent with the intent of the law.
- The agency may not pay this amount for the member; it is still allowed for current employees and, if in a contract, for lateral Classic members.
- Additional amounts may be paid by employees if agreed in collective bargaining and if this doesn't result in the employer paying a higher rate for nonrepresented, managerial, or supervisory employees in related retirement membership classifications.

Actual employee contribution rates will vary across agencies based on current MOUs. Ultimately each agency's savings will be a function of current formulas and the new member employee contribution rate.

New members will pay at least as much as current members for significantly lower benefits, with most new Safety members paying more than current members.

- *Pensionable Compensation (New Members)*

Final compensation must be the highest average annual compensation over 36 consecutive months. Annual pensionable compensation for this purpose is described below:

- Compensation in 2013 is limited to $113,700 (2013 Social Security Wage Base) if the new member participates in Social Security, and $136,440 (120% of the 2013 Social Security Wage Base) if the new member does not participate in Social Security[2].
- The limits increase in future years by CPI. For 2014 they are $115,064 and $138,077, as calculated by the California Actuarial Advisory Panel.
- PEPRA states that the Legislature may change this limit if the change doesn't decrease accrued benefits. Presumably, this language is intended to avoid vested rights issues should the Legislature want to reduce future limits.
- Pensionable compensation for new members is generally defined as base pay (paid in cash on a full-time basis for normal hours worked, to similarly situated members in the same grade or class, based on a publicly available schedule). Deferred compensation is treated as pensionable when earned. PEPRA lists compensation that is not pensionable – overtime,

We believe the limits on pensionable pay, if not modified, will eventually have an adverse impact on agencies' ability to hire and retain employees.

Pay types considered pensionable can differ for Classic and new members, complicating administration.

[2] The IRC Section 401(a)(17) compensation limit ($255,000 in 2013) also applies, but is currently much higher than the Wage Base.

severance, unused vacation, and allowances, as well as any compensation "determined by the board to have been paid to increase a member's retirement benefit."

- AB 197 limits compensation to what is "earnable and payable" meaning, for accrued leave, amounts that could actually be cashed out or sold in the period.

■ *Other Retirement Plans (new hires)*

Additional plans provided by an agency are restricted as follows:

- No additional defined benefit plan (supplemental or otherwise).[3]
- Generally, there are no PEPRA restrictions on defined contribution plans. However, PEPRA limits the amount an employer can contribute to a defined contribution plan if the contribution is applied to pay in excess of the compensation limit.

Current and New Member Provisions

The following provisions apply to current employees, and unless indicated otherwise, also to new members:

■ *Employer Contributions*

The annual employer plus employee contribution cannot be less than Total Normal Cost. This requirement may be suspended for an employer, but applicability is not likely to occur in the near future and may never apply[4]. Note that for plans with no active participants, there is no Total Normal Cost and therefore no minimum contribution required under PEPRA.

■ *Employee Contributions (does not apply to new members)*

- PEPRA states equal cost sharing of Total Normal Cost "shall be the standard," but does not appear to require this "standard" or that current employees contribute any portion of Total Normal Cost[5]. Instead, the legislation allows agencies to impose, beginning January 1, 2018 (subject to good faith collective bargaining) a minimum employee contribution for employees hired before January 1, 2013: at least ½ of Total Normal Cost, but not greater than the maximum below.

Group	Maximum Employee Contribution That Can Be Imposed
General Members	14% above the normal rate
Safety Members - Police and Fire and - Other Safety	 33% above the normal rate 37% above the normal rate

- Employee contributions may exceed these amounts if agreed through collective bargaining. PEPRA does not appear to limit employee contributions.

The maximum amounts are less than ½ of the Total Normal Cost for roughly 50% of the current General plans, and 99% of Safety plans. This means most plans will <u>not</u> have the ability to impose a ½ member paid normal cost.

[3] Exception: If a Safety group adopts a lower PEPRA formula than required (for example, a 3%@50 group adopts 2%@57 benefit for new members), then presumably an additional Safety defined benefit plan could be provided if the combined plans did not exceed the highest allowable PEPRA benefit (2.7%@55 in this example).

[4] Plan must be 120% funded and, among other criteria, contributions must result in the possible disqualification of plan's tax-exempt status due to "excess earnings."

[5] PEPRA doesn't require the "standard" 50% Total Normal Cost employee contribution for current employees − we do not consider this a cost savings.

- *Pensionable Compensation*
  - AB 197 limits compensation for all members to what is "earnable and payable" meaning, for accrued leave, amounts that could actually be cashed out or sold in the period. The issue of whether and how this limit can apply to Classic members is currently being litigated.
- *Benefit Improvements*

  Benefit improvements adopted after 2012 are permitted, subject to the following:
  - Improvements can apply only to future service. In addition, when a job classification change gives the employee an enhanced benefit or agency plan, the enhanced plan can provide service credit only after the job classification change.
  - Cost-of-living increases are not considered retroactive benefit enhancements.
  - New member retirement formulas are limited to the formulas described above.

> It is unclear whether accrual rates are restricted. For example, benefits for an employee age 50 with 10 years of service and $100,000 compensation could not be increased to provide an additional 1% of pay benefit for all service. However, could the benefit be increased by a flat $10,000 (1% x $100,000 x 10 years service)?

- *Disability Benefits*

  In what appears to be the only PEPRA pension enhancement, Safety member industrial disability retirements before age 50 must receive at least the actuarial equivalent of their service retirement benefit. Before age 50, these members currently receive 50% of compensation.

  PEPRA also includes a sunset on this provision; it remains in effect only until January 1, 2018 (unless extended by another statute).
- *Airtime Purchase*

  PEPRA prohibits any member from purchasing nonqualified service after 2012.
- *Other Retirement Plans*

  Other than retroactive benefit increase provisions, PEPRA has no limits on current defined benefit plans in existence before 2013, including supplemental pension plans with benefits in excess of the compensation limit and IRC Section 415 benefit limits not provided by the pension plan.

  The legislation has no restrictions on new defined contribution plans for Classic members, since defined contributions do not create unfunded liabilities or commit an employer to future costs that could escalate.

  New defined benefit plans for current members are restricted as follows:
  - Existing supplemental plans cannot be expanded to cover additional members.
  - Agencies cannot adopt a supplemental pension plan after 2012.
- *Other Provisions*
  - Impose restrictions on agencies hiring retirees.
  - Broaden felon benefit reductions to include all employees and expand felony acts that trigger the reductions.

- *OPEB*

  A somewhat unexpected PEPRA provision concerning retiree health benefits appears to apply to current as well as future employees. The law states that no public employees who are elected, appointed, exempt from civil service, not represented, or managers can have a better vesting schedule than other employees in related retirement member classifications. Pending clarification of the law, it is unclear whether:

  - This section applies to:
    - Future hires only?
    - Future and current employees?
    - All current retirees?
  - The vesting schedule:
    - Applies only to individual vested rights?
    - Means just the percentages applied to the benefit?
    - Is intended to include all provided benefits?

> This provision could result in an agency needing to increase OPEB benefits for all nonmanagement or reduce them for management. It would have been prudent for agencies exposed to this risk to implement a management supplemental pension plan before 2013. In the event management OPEB benefits are reduced, supplemental pension benefits could be provided to compensate.

* * *

Bartel Associates looks forward to clarifying your responsibilities under this new pension legislation.
Contact us at: PEPRA@bartel-associates.com

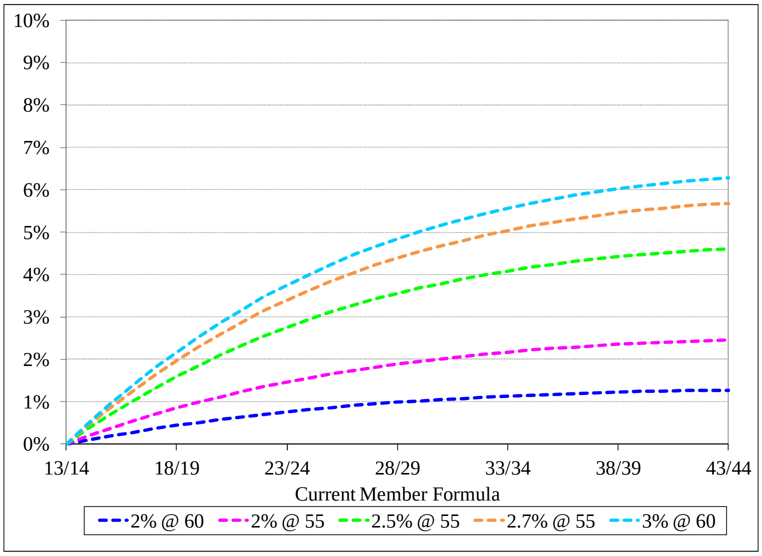
o:\technical\1937 act\ba pepra brief summary '37 act counties.docx

Sample Projections

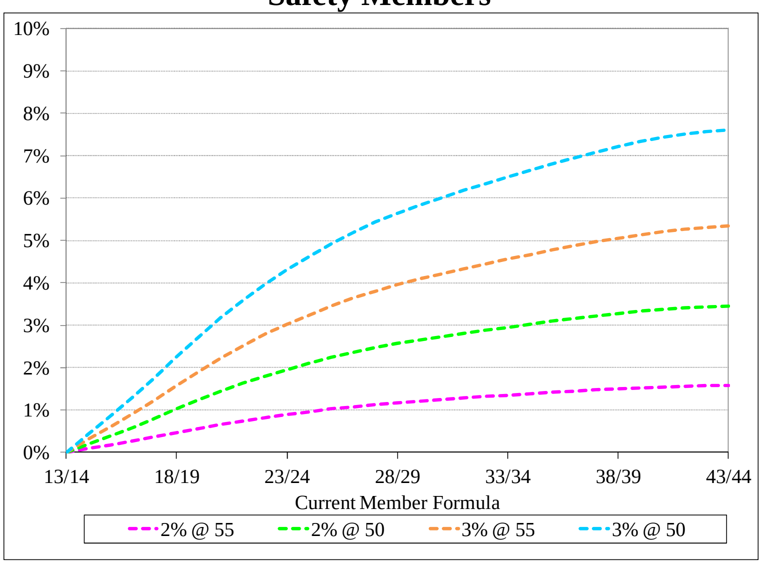
California Public Employees' Pension Reform Act of 2013

PEPRA cost savings depend primarily[6] on current member formulas and EPMC. For example, an agency with Miscellaneous 2.7%@55 and full EPMC will see much larger savings than an agency providing 2%@60 with members paying the full member rate. Any savings will be realized only as new members are hired, and will be very minimal short term. Following are sample 30-year cost savings projections for the employer contribution rates only. Savings are expressed as a percentage of total (current and new members) compensation and assume no PRSA, final average 36 month compensation, a 2% COLA, and basic industrial disability benefit.

Miscellaneous Members



Safety Members



6 Other factors that affect savings include current member PRSA, COLA, industrial disability, and final average compensation (12 or 36 months).

Sample Projections

California Public Employees' Pension Reform Act of 2013

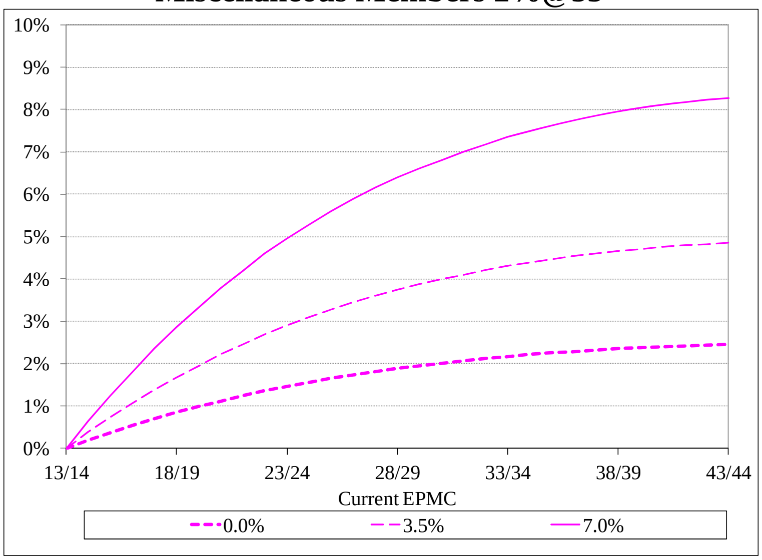
Savings above include only the impact on employer rates; this is equivalent to assuming there is no EPMC for current members. Agencies currently paying EPMC will see additional reductions in employer contributions due to:

- PEPRA eliminates EPMC for new hires.
- PEPRA requires new hires pay the same member rates as "similarly situated" employees.

Note that if long-term agency contribution rates decrease, member contributions may as well. The projections below assume current member contribution rates (minimum amounts under PEPRA) remain in effect.

Following are sample 30-year cost savings projections for the most popular Miscellaneous (2%@55) and Safety (3%@50) formulas, each projected with full, ½, and no EPMC (full EPMC is 7% for 2%@55 and 9% for 3%@50). Again, savings are expressed as a percentage of total (current and new members) compensation.

Miscellaneous Members 2%@55



Safety Members 3%@50