

SDCTA Backgrounder: Review of California Public Employees' Pension Reform Act of 2013

Current State of Public Pension Plans in California

As of June 30, 2011 the California Public Employees' Retirement System's (CalPERS) state employee plan had an unfunded pension liability of approximately \$90 billion. The total unfunded pension liability for cities enrolled in CalPERS within San Diego County as of the same date totaled approximately \$643 million. For the fiscal year ending June 30, 2012 CalPERS reported an investment return of 1 percent, well below the 7.5% expected rate of return needed to pay for employee pension benefits. These lower than expected investment returns coupled with the high costs of paying for employee pension benefits outline the need for pension reform at a statewide level.

In San Diego County, many cities have implemented pension reforms to the maximum extent allowed by state law. This includes adopting lower second tier retirement benefits for new employees as well as having employees pay for a portion of their pension benefits to the maximum amount allowed by law. Despite these reforms, many cities continue to see increases in their unfunded pension liabilities and thus an increase in annual pension costs that eat into their annual budgets.

Governor Brown's Pension Reform Package

In October 2011, Governor Brown released his *Twelve Point Pension Reform Plan* that would, "apply to all California state, local, school and other public employers, new public employees, and current employees as legally permissible." The plan included:

- Requiring employees to pay 50 percent of the normal cost of the benefits;
- Hybrid pension plan with both a defined benefit and defined contribution element;
- Increasing retirement ages for new employees; and
- Eliminating pension spiking

In addition, the Governor's proposal included reforms to the CalPERS Board of Directors. The Governor

intended to reform the composition of the Board to encourage independence and "financial sophistication."

In February 2012, Assembly and Senate Republicans introduced Governor Brown's pension reform legislation. Assembly Republican Leader Connie Conway stated, "Governor Brown's pension reform plan represents the first step of the changes that must be enacted to get our runaway pension system under control." Senate Republican Leader Bob Huff further stated, "The Governor should have an up-or-down vote on his pension reform plan." The legislation never received a hearing or vote in a committee or on the floor of either chamber prior to the end of the legislative session.

Pension Reform Negotiations

Prior to the end of the 2012 legislative session, Governor Brown met with Democratic leaders in the legislature to come up with a series of reforms to the current pension system. Many of the reforms outlined within the negotiated deal do not match with the Governor's initial reforms that were released in October 2011. Despite these exclusions, Assembly Bill (AB) 340, otherwise known as the California Public Employees' Pension Reform Act of 2013, was passed by the California legislature on August 31, 2012, and signed by the Governor on September 12, 2012. The law will become effective on January 1, 2013.

Elements of AB 340

Reforms within AB 340 fall into various categories that also incorporate various reforms initially proposed by Governor Brown. The reform elements within the legislation are highlighted below. A majority of the elements within the legislation are specifically for new employees hired after January 1, 2013. As well, the reforms within the legislation apply to not only employees enrolled within CalPERS, but employees under a county retirement plan (otherwise known as a '37 Act county) or a State Teachers' Retirement System plan (STRS) are also affected. For the purposes of this report, only the impacts for CalPERS employees will be discussed.

Pensionable Compensation

Under the legislation, pensionable compensation only includes the base pay of each employee. Pensionable compensation DOES NOT include:

- Any one-time or ad hoc payments
- Any employer provided allowances, reimbursement, or payment, e.g. housing, vehicle, uniforms
- Any bonus paid in addition to normal base pay
- Compensation for overtime

In addition, AB 340 places a cap on the amount of pensionable compensation for employees. For those employees that are enrolled in Social Security, the cap will be 100 percent of the Social Security base (\$110,100). For employees not within Social Security, the cap will be 120 percent of the Social Security base (\$132,120). This cap will be adjusted annually for inflation.

This new definition of pensionable compensation as well as the cap will apply to new employees hired after January 1, 2013.

Required Normal Cost Sharing for New Employees

For new employees hired after January 1, 2013, employees must pay at least 50 percent of normal cost. Normal cost is defined as the annual actuarially determined cost for the defined benefit plan expressed as a percentage of payroll. Employers will also be prohibited from paying a portion of the employee share of pension costs, otherwise known as Employer Paid Member Contribution (EPMC).

Between January 1, 2013 and December 31, 2017, the employers may collectively bargain for both current and future employees to share the employer’s contribution costs over and above the normal contribution required by employees. Any change to the contribution rate in excess of 50 percent of normal cost is subject to good faith meet and confer process and cannot be imposed upon the employees.

Beginning on January 1, 2018, if current and new employees within a bargaining unit under CalPERS

are not paying for at least 50 percent of their normal pension costs, then the employer may unilaterally require employees to pay 50 percent of the total annual normal cost up to an 8 percent contribution rate for miscellaneous employees and 12 percent contribution rate for local police officers, firefighters and county peace officers (11 percent for all other local safety members).

New Lower Defined Benefit Pension Formulas/Higher Retirement Age/Final Compensation

Both new public safety and miscellaneous employees hired after January 1, 2013 will receive a new lower cost pension benefit that reduces the pension formula and increases retirement age.

For a new miscellaneous employee, they will receive a 2 percent at 62 pension benefit formula, increasing to 2.5 percent at 67. The minimum retirement age under this formula is 52.

For new public safety employees, one of three pension benefits is available to be offered by employers:

Figure 1: New Retirement Formulas

	Normal Retirement Age	Maximum Benefit
Basic Formula	1.426% at 50	2% at 57
Option Plan 1	2% at 50	2.5% at 57
Option Plan 2	2% at 50	2.7% at 57

The formula that is offered after January 1, 2013 must be the one that is closest to the formula presently offered to the same classification and that provides a lower benefits at 55 years of age. Furthermore, the decision about this benefit must be negotiated with the represented employees and cannot be unilaterally imposed upon them.

New employees enrolled within either of these benefit formulas will also have their final pensionable compensation based off the highest consecutive 36-month work period. This is instead of allowing pensionable compensation to be based off a high 12-

month period which has currently been in place for some jurisdictions.

Prohibition of Retroactive Pension Benefit Enhancements

In 2002, the California legislature passed Senate Bill (SB) 400, which was the impetus for the retroactive pension benefit increases that were adopted by state and local governments throughout the state. The legislation allowed for a higher, more expensive pension benefit level that would be granted to employees for the time already worked but not paid for by either the employee or employer. This retroactive increase, coupled with sluggish pension system investment returns, have lead to billions of dollars in unfunded pension debt.

Under this legislation, state and local governments would now be prohibited from adopting any retirement formula or benefit enhancement for prior service.

Estimated Savings from AB 340

CalPERS conducted an actuarial cost analysis of the California Public Employees’ Pension Reform Act of 2013 and concluded the legislation will result in savings of between \$42 and \$55 billion for all state, schools and local agency plans.

Figure 2: Estimated Savings of AB 340

Plan	Estimated 30 Year Savings	
	Low	High
State Plans	\$10.3 Billion	\$12.6 Billion
Schools Plan	\$8.6 Billion	\$10.8 Billion
Local Agency Plans	\$24.4 Billion	\$32.4 Billion
Total	\$43.3 Billion	\$55.8 Billion

Savings from this measure will take some time to accumulate. This is due to reforms mostly impacting new employees as opposed to current employees. Savings will not be achieved unless employers are able to hire new employees that enroll within the newly reformed pension plans.

CalPERS chief actuary Alan W. Miligan has stated publicly that the reform legislation will “have no material effect” on the system’s unfunded liability.

Figure 3: Estimated Savings by Time Period

Plan	Time Period	Estimated Savings	
		Low	High
State Plans	10-Year	\$1.8 Billion	\$1.9 Billion
	20-Year	\$5.1 Billion	\$5.9 Billion
	30-Year	\$10.3 Billion	\$12.6 Billion
Schools Plan	10-Year	\$941 Million	\$1.1 Billion
	20-Year	\$3.8 Billion	\$4.6 Billion
	30-Year	\$8.6 Billion	\$10.8 Billion
Local Agency Plans	10-Year	\$2.6 Billion	\$3.2 Billion
	20-Year	\$10.5 Billion	\$13.4 Billion
	30-Year	\$24.4 Billion	\$32.4 Billion

Next Steps in Pension Reform

Governor Brown has stated that this is the best deal that he could get out of the legislature, but due to the delayed savings under the reform legislation, more needs to be done to reduce growing pension benefit costs. An important reform component that was not included within AB 340 but was recommended by Governor Brown was moving new employees into a hybrid pension plan with a defined contribution component. Adoption of this reform could potentially further reduce future costs of retirement plans for employers.

Additionally, reforms to current employee pension benefit plans could result in greater savings in the short-term. This includes freezing and guaranteeing the benefits employees have earned to date, which was recommended by The Little Hoover Commission in February 2011.

Pension Reform Element	Current Pension System	Initial Governor Brown Pension Reform Package		California Public Employees' Pension Reform Act of 2013	
	Current/New Employees	Current Employees	New Employees	Current Employees	New Employees
Pensionable Compensation	Includes salaries, specialty pay, bonus pay, etc. used for calculating final retirement benefit.	Current Pension System definition.	Base pay only. Excludes other forms of reimbursements, bonuses, deferred compensation, etc.	Current Pension System definition.	Base pay only. Excludes other forms of reimbursements, bonuses, deferred compensation, etc. Pensionable compensation capped at \$110,100 (if in Social Security) or \$132,120 (if not in Social Security). Cap annually adjusted for inflation.
Pension Cost Sharing	Employee contribution capped at 8% of pay for public safety members and 9% for non-public safety members.	Phase-in increase of employee paying at least 50% of normal cost	Phase-in increase of employee paying at least 50% of normal cost	Current Pension System definition.	New employees pay at least 50% of normal costs. Cannot impose employee payment of more than 50%, must be negotiated. Prohibits employer from paying employee contribution (EPMC).
Employee Retirement Formulas	Employers can choose from following menu of retirement formula options outlined by CalPERS: Misc Employees: 1.5%@65 (if Social Security offered) 2%@50; 2.5%@55; 2.7%@55; 2%@60; 3%@60 Safety Employees: 2%@50; 2%@55; 3%@50; 3%@55	Current employees have option to enroll in new hybrid pension plan.	Hybrid retirement plan that is mandatory for new hires and optional for current employees: <ul style="list-style-type: none"> • Targets 75% of final compensation; • 30 years of service and retirement age of 57 for safety members; • 35 years of service and age 67 for all other public employees; • With an annual benefit cap of 120% of Social Security wage base (cap would be \$132,120 in 2012) if not receiving Social Security 	Current Pension System definition.	Requires implementation of new retirement formula for new employees. Misc Employees: 2%@62; maximum benefit of 2.5%@67. Minimum retirement age of 52. Safety Employees: May use 1 or more of following 3 tiers: <ul style="list-style-type: none"> • Basic Safety Formula: 1.836%@55 or 2%@57 • Option 1 Formula: 2.357%@55 or 2.5\$@57 • Option 2 Formula: 2.5%@55 or 2.7%@57 Minimum retirement age of 50.
Final Average Compensation	Choice between highest 12-month compensation or 3-year highest average.	Current Pension System definition.	Final compensation based solely on 3-year highest average.	Current Pension System definition.	Final compensation based solely on 3-year highest average.
Retroactive Pension Benefit Increases	Can be negotiated and implemented for current employees.	Prohibit retroactive pension increases, starting January 1, 2013.	Prohibit retroactive pension increases, starting January 1, 2013.	Employer cannot implement retroactive pension benefit enhancements.	Employer cannot implement retroactive pension benefit enhancements.