BILL NUMBER: AB 1997 (McKinnor) as amended April 1, 2024

SUMMARY

AB 1997 addresses compensation reporting challenges and other concerns encountered by employers, members and CalSTRS staff by simplifying sections of the Teachers' Retirement Law relating to creditable compensation and creditable service, effective upon a date determined by the CalSTRS board and no later than July 1, 2027.

BOARD POSITION

Sponsor. The board's policy is to support or sponsor legislation that improves the delivery of benefits and services and provides more effective and efficient administration of the retirement plan.

REASON FOR THE BILL

Beginning in 2022, CalSTRS staff met with various member and employer groups to identify the biggest challenges associated with creditable compensation and creditable service laws and regulations and to discuss possible solutions. As an outcome of those meetings, this bill is a consensus-based approach to address the issues relating to complex compensation and service requirements and achieve more consistent reporting, fewer errors and a reduction in benefit overpayments and underpayments.

SUMMARY OF AMENDMENTS

The March 11, 2024, and April 1, 2024, amendments:

- Move the backstop operative date from July 1, 2028, to July 1, 2027.
- Make minor, technical changes to correct drafting errors.

PROGRAM BACKGROUND

Current practice requires employers and CalSTRS staff to go through many steps to determine whether each compensation item earned by a member meets the requirements for creditable compensation and creditable service. Employers regularly express frustration over the complexity of reporting compensation and service to CalSTRS, and misinterpretations of the requirements lead to reporting errors that can have significant consequences for member benefits. CalSTRS staff also find it challenging to provide consistent guidance on employer reporting because of ambiguities and undefined terminology in the statute and regulations.

This challenge is represented in the 2022 Independent Financial Statement Auditor's Management Letter presented to the board's Audits and Risk Management Committee in March 2023, which noted that despite significant efforts by CalSTRS, there was an ongoing audit deficiency relating to the accuracy of reported member data. CalSTRS staff have invested considerable time and resources to improve guidance and controls for reporting. However, CalSTRS is ultimately reliant upon employers to provide accurate member data based on complex compensation and service requirements, so fully addressing member data without simplifying statutory and regulatory requirements will continue to remain a challenge.

The passage of AB 1667 (Cortese, Chapter 754, Statutes of 2022) sought to provide relief to benefit recipients affected by overpayments due to misreported compensation and service and required CalSTRS to provide formal resources to help interpret and clarify the law, but it did not address the underlying cause of reporting errors and overpayments—the complexity of creditable compensation and creditable service requirements.

ANALYSIS

Existing Law:
CalSTRS' Defined Benefit (DB) Program provides monthly lifetime retirement benefits to eligible educators based on a formula that uses age at retirement, final compensation and years of service credit. Final compensation is based on the highest average annual compensation earnable over a one- or three-year consecutive period, depending on the number of years of service provided and a member's benefit formula. Compensation earnable is determined using a member's average full-time pay rate plus any remuneration in addition to salary earned during the same school year, while service credit is equal to the ratio of the salary actually paid to a member to the full-time pay rate for that assignment.

The Teachers' Retirement Law delineates what is, and is not, creditable compensation and whether such compensation should be reported to the to the DB Program or the Defined Benefit Supplement (DBS) Program, a supplemental cash balance plan. The unique nature of employment for educators, shifts in how they are compensated for their work and continual changes to the California Education Code require CalSTRS to frequently update the Teachers' Retirement Law. These piecemeal changes, in combination with CalSTRS' unique hybrid plan design as well as broad application of the Public Employees' Pension Reform Act (PEPRA), have made requirements for creditable compensation and creditable service highly complex.

For compensation to be creditable, it must be paid for the performance of creditable service activities and meet numerous other requirements, some of which depend upon a member's benefit formula. Compensation for regular salary and ongoing remuneration in addition to salary are reported to the DB Program and included in a member's final compensation. Compensation for creditable service that exceeds one year in a school year, or that is paid a limited number of times for CalSTRS 2% at 60 members, is credited to the DBS Program and is not included in final compensation. Other types of compensation, such as compensation for unused accumulated leave, fringe benefits or, for CalSTRS 2% at 62 members, compensation that is paid a limited number of times or that is not paid in each pay period service is performed, are not creditable to CalSTRS.

Existing law requires employers to report all creditable compensation for a member's creditable service to CalSTRS and to specify the compensation type and annualized pay rate so that it may be appropriately credited. Accurate reporting of compensation is critical to determining correct benefits and ensuring contributions are predictable and sufficient to pay those benefits. To help employers accurately report, CalSTRS developed regulations to clarify the statutes regarding creditable compensation, though the existing regulations only apply to members under the CalSTRS 2% at 60 benefit formula, and ambiguities in reporting requirements still exist.

This Bill:
This bill includes the following components that change existing statute, effective upon authorization by the board based on when the system has the capacity to implement the changes and no later than July 1, 2027:

- Amend the definition of "creditable service" to be "service in a position subject to membership," as defined, eliminating the list of creditable service activities.
- Consolidate "creditable compensation" definitions for CalSTRS 2% at 60 and 2% at 62 members, while retaining separate compensation limits and benefit formulas to comply with existing law, including PEPRA.
- Provide that "creditable compensation" is comprised exclusively of three pay types:
    - Two types of "base pay" to be used for determining compensation earnable and generally limited to ongoing compensation for full-time employment in a position subject to membership:
        - "Salary."
        - "Special pay," which may include ongoing pay for holding an advanced degree or for reaching years of experience.
    - "Supplemental pay," to include any other compensation that is provided to a member and is not explicitly prohibited under the statute, such as stipends for additional duty assignments, limited-term payments or overtime.
- Clarify that annualized pay rates must be established according to a "publicly available pay schedule," as specified, and exclusively determined as the salary for performing creditable service on a full-time basis in a position subject to membership.
- Provide that "supplemental pay" must not affect compensation earnable but can be used to provide additional service credit for members with less than one year in a school year, credited at the ratio of the supplemental pay earned to the compensation earnable for that year. For those with a year of service in one school year, any additional supplemental pay is credited to the DBS Program.
- Eliminate the requirement to return excess member contributions from the DBS Program, thereby keeping members' contributions in their accounts.

<u>Discussion:</u>
Currently, employers and CalSTRS staff must consider specific work activities being performed when they determine whether compensation earned by a member is creditable. This can lead to judgement calls about the creditability of various duties that could later be determined by someone else to be non-creditable. Removing the requirement that all creditable compensation be for performing creditable service and deleting the list of activities from the definition of creditable service would significantly reduce the administrative burden of reviewing those individual activities.

The bill also simplifies administration of creditable compensation requirements by creating one definition and a set of standards that applies to all members as well as consolidating several existing pay types into one, "supplemental pay," for all creditable compensation that does not affect compensation earnable and final compensation. Examples of existing pay that would be "supplemental pay" under the bill include compensation for additional assignments, overtime, bonuses and other limited-term payments.

Employers would no longer need to create annualized pay rates for supplemental pay, which would protect against unintentionally inflating benefits. Employers are also expected to experience savings from reduced workload associated with reporting corrections and returning excess DBS member contributions.

Overall, members would experience increased contributions to their DBS account from the expansion of the types of compensation that are creditable and the elimination of the return of excess member contributions. Part-time members would benefit from limited-term payments creating additional service credit under the DB Program. In addition, compensation that is not “paid in each pay period” would no longer be excluded for CalSTRS 2% at 62 members; it would instead be creditable as either “special pay” or “supplemental pay” going forward. There may also be a small number of members who experience a lower or higher compensation earnable due to the annualized pay rate requirements, though the change would not affect final compensation for those members unless they are within their final three years before retirement.

LEGISLATIVE HISTORY

AB 644 (PE&R, Chapter 96, Statutes of 2019), among other changes, defined the term “annualized pay rate” as the salary or wages a person could earn during a school term for service performed in an assignment on a full-time basis to distinguish it from the definition of “compensation earnable” and clarified creditable compensation is salary and wages or remuneration in addition to salary for CalSTRS 2% at 62 members.

AB 963 (Bonilla, Chapter 782, Statutes of 2015) clarified the definition of “creditable service” and remedied membership issues for individuals in classified positions who were erroneously reported to CalSTRS.

AB 1381 (PER&SS, Chapter 559, Statutes of 2013) made various technical and conforming changes that align the Teachers’ Retirement Law with the provisions of the PEPRA, including creating a separate definition of “creditable compensation” for CalSTRS 2% at 62 members.

AB 340 (Furutani, Chapter 296, Statutes of 2012), PEPRA, made various changes to the CalSTRS benefit structure that affect those first hired on or after January 1, 2013, including requiring final compensation be calculated based on the highest average annual salary rate over three consecutive school years and reducing the limit on compensation and limiting the type of compensation that counts toward retirement benefits.

AB 2700 (Lempert, Chapter 1021, Statutes of 2000), among other provisions, made most compensation for creditable service creditable to CalSTRS, credited member and employer contributions for service in excess of 1.000 year of service per school year to the DBS Program, and made several other changes to the definitions of “class of employees,” “creditable compensation” and “creditable service.”

AB 1509 (Machado, Chapter 74, Statutes of 2000) established the DBS Program, a cash balance plan, which was credited with 25% of a member’s contributions from 2001 through 2010.

AB 3032 (Burton, Chapter 1165, Statutes of 1996) repealed the former definition of “compensation” and “salary” and added new definitions for “creditable compensation” and “final compensation” for purposes of determining benefits and contributions for the DB Program.

AB 948 (Gallegos, Chapter 394, Statutes of 1995) established a definition of various employment activities that are considered “creditable service” that can be reported to CalSTRS.

FISCAL IMPACT

Given the timing of the rollout of CalSTRS’ new pension administration system and the necessary updates to employer reporting file formats, the anticipated effective date for the bill is July 1, 2027.

As a result, fiscal impacts are expected to be delayed until 2027-28 for members and employers and until the 2029-30 for the state.

Program Costs/Savings – The bill is not anticipated to affect CalSTRS' ability to reach full funding by 2046 or the overall contribution rates. It would increase contributions to the DB and DBS programs as additional compensation for CalSTRS 2% at 62 members would be creditable, with the additional contributions largely going to the DBS Program (no state contributions). In some circumstances, members working less than full time may receive a small amount of additional service credit in the DB Program for limited-term or other payments reported as supplemental pay, which would be funded with contributions. Compensation for certain special pay items that are currently paid regularly once or twice a year, but are not "paid in each pay period," would become creditable and included in compensation earnable for CalSTRS 2% at 62 members. Such a change protects the plan from funding shortfalls that could occur when employers simply change the frequency of payments to make them creditable.

State Impact – It is estimated that additional ongoing state contributions of approximately $2 million annually would be expected for members with less than one year of service credit if they receive supplemental pay that would increase their service credit balance, as well as for CalSTRS 2% at 62 members who would be credited with ongoing periodic payments. Previous estimates assumed the bill would take effect with the current state contribution rate, 10.828%. However, the state contribution likely would not be affected until remittances beginning in 2029-30. As of today, the unfunded liabilities assigned to the state under the CalSTRS Funding Plan are expected to be eliminated by 2029-30. As a result, the state contribution is expected to be reduced from about $4.8 billion to about $2.1 billion during the same year that state costs would be anticipated to increase due to this bill.

Employer Impact – On the high end, it is estimated that additional ongoing employer contributions of approximately $15 million annually, or 0.03% of the total compensation of approximately $45.6 billion projected to be creditable to the DB Program in 2027-28, would be expected for members with less than one year of service credit if they receive supplemental pay that would increase their service credit balance, as well as for CalSTRS 2% at 62 members who would be credited with what are currently known as limited-term payments. At the same time, employers are expected to experience savings resulting from fewer instances of creating annualized pay rates, no longer returning DBS contributions to members and less time spent determining how to report creditable compensation and creditable service. This simplification is also expected to reduce reporting errors, which would decrease administrative work and resources associated with reporting corrections and audit findings and lower employer costs for penalties and interest and overpayments related to employer information.

Administrative Costs/Savings – The one-time technology costs for updates to CalSTRS' pension administration and financial systems are estimated to be between $1.03 million and $2.26 million, assuming the bill would be effective after the completion of the Pension Solution Project. One-time implementation costs to update training and internal processes are also anticipated for Employer Services, Audit Services and Financial Services. Employers will be updating their reporting systems and processes to accommodate CalSTRS' new pension administration system file specifications. By delaying implementation to no later than July 1, 2027, CalSTRS will be able to incorporate the provisions of AB 1997 within the new specifications, which would mitigate additional implementation costs due to the bill. Over time, the bill is expected to reduce workload and costs for both employers and CalSTRS related to reporting errors, adjustments and recovery of overpayments.

SUPPORT

CalSTRS (sponsor)
Association of California School Administrators
California Association of School Business Officials
California County Superintendents
California Federation of Teachers AFL-CIO
California Retired Teachers Association
California Teachers Association
Delta Kappa Gamma California
Elderly Care Everywhere
Faculty Association of California Community Colleges
Los Angeles County Office of Education
Office of the Riverside County Superintendent of Schools

OPPOSITION

None known.

ARGUMENTS

Pro: Simplifies and provides clarity on how to administer requirements for creditable compensation, annualized pay rates and creditable service, promoting consistent guidance, accurate reporting and potentially fewer audit findings.

Increases the compensation that is creditable to the system, while ensuring inconsistent pay types are credited as “supplemental pay” and excluded from compensation earnable and final compensation, consistent with PEPRA.

Provides clear direction on how annualized pay rates are documented or derived.

Reduces the administrative burden on employers and CalSTRS staff of reviewing the list of specific creditable service activities.

Minimizes confusion over whether pay for various additional duty assignments is creditable and eliminates the need to determine and report annualized pay rates for such assignments.

Provides a small increase to many members’ DBS account balances and benefits.

Eases the burden employers incur to process returns of excess DBS contributions to members for relatively small amounts.

Con: Requires significant technology changes in CalSTRS’ pension administration and financial systems.

May raise sensitivity regarding PEPRA when consolidating creditable compensation definitions and requirements.

May raise sensitivity regarding shifting limited-term payments from being credited directly to the DBS Program to creating service credit in the DB Program for members working less than full time.

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