Agenda Item 6d

February 20, 2013

ITEM NAME: Proposed Regulations to Implement PEPRA

PROGRAM: Customer Account Services, Benefit Services

ITEM TYPE: Action

RECOMMENDATION

Approve the proposed regulations and the initiation of the rulemaking process to rename Article 6 to "2013 Public Employees' Pension Reform Implementation" and add sections 579 through 579.25 to Chapter 2 of Division 1 of Title 2 of the California Code of Regulations (CCR). This Article and these regulations establish the California Public Employees' Retirement System's (CalPERS) implementation and interpretation of certain provisions within Assembly Bills (AB) 340 and 197, known as the California Public Employees' Pension Reform Act (PEPRA) of 2013, and related pension reform changes to the Public Employees' Retirement Law (PERL) and law governing the Legislators' Retirement System (LRS).

EXECUTIVE SUMMARY

Staff recommends the proposed regulations be additions to the CCR. The proposed regulations are intended to assist with the implementation and administration of the new pension reform statutes by clarifying CalPERS interpretation of certain PEPRA provisions and by outlining certain procedures now necessary as a result of pension reform. Some of the PEPRA statutes do not fully define certain terms and phrases and accordingly require retirement systems to interpret how those phrases will be defined. It is necessary for CalPERS to interpret these words and phrases so it can properly implement pension reform and administer the System. These regulations will also assist CalPERS staff, employers, members and other stakeholders to gain uniform compliance with the new statutory provisions by providing clarity for terms and phrases that might have more than one meaning. The proposed regulations are consistent with the PEPRA provisions described below and are reasonably necessary to effectuate the purpose of these statutes.

STRATEGIC PLAN

This item is presented in support of CalPERS implementation of PEPRA and related pension reform changes to the PERL and LRS law and in accordance with two of CalPERS Strategic Plan Goals. First, within Goal A which is to improve the long-term pension and health benefit sustainability, the proposed regulations support the Strategic Goal by implementing the new pension reform changes and by educating employers and other stakeholders of the new provisions and CalPERS interpretations so they can make informed decisions about retirement security and understand how pension reform changes may impact retirement benefits. Second, within Goal C which is to engage in State and national policy development to enhance the long-term sustainability and effectiveness of our programs, this item supports the Strategic Goal by clarifying and communicating CalPERS interpretation of certain pension reform provisions, and providing education and outreach to members, employers, and stakeholders to promote the uniform application of certain pension reform provisions.

BACKGROUND

On September 12, 2012, Governor Brown signed into law AB 340 and AB 197, which included the PEPRA and related pension reform changes to the PERL and LRS law. These statutory provisions became effective on January 1, 2013. This legislation adds, amends, and repeals numerous sections of the Government Code (GC) relating to public employees' retirement benefits. This agenda item is intended to be the first in a series of agenda items that will bring forth proposed regulations that are necessary to implement and administer the System as a result of the changes mandated by the new pension reform laws. Staff anticipates bringing additional proposed regulations to the Board over the next several months.

Staff has developed the seven proposed regulations attached hereto as Attachment One for the Board's approval. These proposed regulations serve to provide formal notice to employers, members, and stakeholders of CalPERS interpretation on these issues, to ensure consistency in the application and implementation of the new statutory provisions for all employers and members, and to minimize the risk of potential litigation over the meaning of certain undefined statutory terms. It is anticipated that these proposed regulations will also help avoid confusion associated with the new statutory language and should assist CalPERS-covered employers and other stakeholders in complying with the new laws.

ANALYSIS

Many of the new pension reform provisions apply to "new members" (a term defined by GC section 7522.04(f)) and not to existing or "classic members" (those members who entered into membership with a retirement system on or before December 31, 2012, who do not meet the definition of a "new member" in Section 7522.04(f)). The distinction between the two types of members is very important when it comes to determining the member's appropriate retirement formula, final compensation periods, caps on compensation, and other rights to and limitations on retirement benefits. It is therefore important that CalPERS have a well-defined implementation plan to establish the clear meaning of key terms that will be required to make such determinations.

By way of background, the term “new member” (as defined in GC section 7522.04(f)) includes three groups:

- An individual (with no prior membership in any public retirement system) who becomes a member of any public retirement system for the first time on or after January 1, 2013.
- An individual (with prior membership in a public retirement system) who becomes a member of any public retirement system for the first time on or after January 1, 2013, provided the person is not subject to reciprocity (under 7522.02(c)).
- An individual who was an active member in a public retirement system and who, after a break in service greater than six months, returns to active membership in that system with a new employer. However, a person who moves between State agencies or departments within the State, or from one school employer to another is not considered to be a “new member” regardless of the length of the break in service.

The proposed regulations interpret and clarify various terms used to: 1) categorize members as new members or classic members; 2) identify the required contribution rates and compensation limits; and, 3) determine the required level of retirement benefits and benefit limitations.

CalPERS staff held a series of educational sessions relating to pension reform for CalPERS employers in December of 2012. Over 1,500 people attended these sessions and CalPERS received over 250 questions relating to pension reform. Most of these questions have been answered through a series of Circular Letters issued in December. However, the volume of questions received highlighted the need to provide clarity on the key terms used and the necessary processes needed to implement the new pension reform statutes.

Staff has developed a comprehensive communication plan to ensure that all affected members, employers, and stakeholders are kept informed of the regulatory process and will have the opportunity to understand and comment on the proposed regulations. This plan includes holding several “town hall” meetings in different areas of the State to provide a forum for stakeholders to interact with staff, ask questions, and receive an overview of the content of the proposed regulations. These meetings will be scheduled early in the public comment period to ensure stakeholders have sufficient time to formally submit any comments.

As noted above, staff has determined that many regulations will be required to implement the new pension reform requirements. The proposed regulations discussed below are the first set of such regulations and staff anticipates returning to the Board in the coming months with additional proposed regulations.

PROPOSED REGULATIONS

The first set of seven proposed regulations necessary to implement and administer the pension reform statutes are discussed individually below.

Amendment of Article 6. 2013 Public Employees' Pension Reform Implementation

The proposed amendment to rename Article 6 will enable CalPERS to promulgate a set of regulations that are specific to the implementation of pension reform. By placing all proposed pension reform regulations together within this Article, it will make it easier for members, employers, stakeholders, and CalPERS staff to locate all of the regulations promulgated on pension reform issues.

Addition of Proposed Section 579 Scope and Authority

The proposed addition of section 579 to the CCR provides the scope of the authority for the proposed regulations added to this Article. This proposed regulation establishes that these regulations (and those additional regulations to be proposed later in this Article) interpret and implement the PEPRA (GC sections 7522 through GC 7522.74) and related pension reform statutes in GC sections 9355.4 through GC 9355.45 (LRS provisions), and GC sections 20281.5, 20516, 20516.5, 20677.96, 20683.2, 20791, 21076, 21076.5, and 21400 (PERL provisions).

This regulation is necessary to provide clarity and to define the scope of the regulations to be housed in Article 6.

Addition of Proposed Section 579.1 New Members and Classic Members Defined

The proposed addition of section 579.1 to the CCR clarifies the terms "new member" and "classic member" as those terms will be used by CalPERS to implement pension reform and to administer the System. CalPERS use of the term "new member" is synonymous with the definition of "new member" in GC section 7522.04(f). In order to distinguish between a new member and a member not subject to the provisions of PEPRA, CalPERS will use the term "classic member." This regulation makes clear that a "classic member" is a member who does not meet the definition of a "new member." The distinction between the two types of members is critical to identifying the appropriate contribution rates and compensation limits, and determining the appropriate level of retirement benefits and benefit limitations mandated the new statutory provisions.

This regulation also makes clear that the proposed regulations contained in Article 6 apply exclusively to new members unless expressly stated otherwise. This proposed regulation is necessary to make clear each of these terms so that all employers, members, stakeholders and CalPERS staff can utilize the same definitions when implementing the new pension reform laws.

Addition of Proposed Section 579.2 Additional Definitions

The proposed addition of section 579.2 to the CCR seeks to define the phrase "active member" as used in GC section 7522.04(f). This regulation will likely be amended in the future to include other necessary definitions.

The term "active member" as used in GC section 7522.04(f)(3) shall mean a member, as defined by GC section 20370, and who is employed by a CalPERS-covered employer. The term "active member" is used within the PERL in GC sections 20840 and 21073.5, and it is also defined in CCR Section 554.5, an existing regulation. In all of these instances, the definition of the term "active member" is limited in scope only to the statute or regulation where it resides. The definition used in this proposed regulation is consistent with the use of the term in the existing Government Code sections and regulations.

This regulation is necessary to properly determine whether an individual will be classified as a new or classic member.

Addition of Proposed Section 579.3 Subject to Reciprocity Defined

The proposed addition of section 579.3 to the CCR seeks to implement CalPERS interpretation regarding when a member is "subject to reciprocity" as that phrase is used in GC sections 7522.02(c) and 7522.04. Reciprocity is an agreement, either written or pursuant to statute, between retirement systems to allow members to move from one public employer to another public employer within a specific time limit without losing certain retirement and related benefit rights. For the purposes of determining whether an individual is "subject to reciprocity," CalPERS will look to whether an individual has established membership in a reciprocal retirement system and whether he or she has met the requirements stated in the regulation which include: 1) leaving service credit and contributions, if any, on deposit with the reciprocal retirement system; 2) entering employment that results in CalPERS membership within six months of permanently separating from the employer at the most recent reciprocal retirement system; and, 3) permanently separating from the employer at the most recent reciprocal retirement system before entering into membership at CalPERS.

A clear definition of the phrase "subject to reciprocity" is necessary to correctly determine whether a member will be classified as a "new member" or a "classic member." Correctly classifying members is critical to ensuring that members receive the correct benefit formula, final compensation period, and other statutory rights or limitations used to determine retirement benefits and contributions to the retirement system. The contributions a member will pay into the retirement system and the benefits a member may receive at retirement may be substantially different if he or she is determined to be "subject to reciprocity" and therefore a "classic member," from those benefits that would be received if he or she is classified as a "new member." Therefore, it is crucial for employers to consistently apply the same definition of the phrase “subject to reciprocity” when employers enroll members with CalPERS.

In addition to clarifying the definition of the phrase “subject to reciprocity,” this proposed regulation also provides the minimum information CalPERS will require from employers to confirm a member is “subject to reciprocity.” The proposed regulation also confirms that employers must maintain information used to determine reciprocity and provide it to CalPERS at the time of enrollment, or later upon request during investigations and audits.

Addition of Proposed Section 579.4 Break in Service Defined
The proposed addition of section 579.4 to the CCR seeks to implement CalPERS definition of the phrase “break in service” as that phrase is used in GC section 7522.04(f). GC section 7522.02 establishes to whom PEPRA applies and specifically provides that the newly described benefit plan shall apply to public employees who are new members. GC section 7522.04(f) defines “new members” and includes a reference to a “break in service” as a part of that definition. The proposed regulation defines “break in service” to mean a permanent separation from service and clarifies that separations that are temporary in nature and result in absences from employment, such as leaves of absence or maternity/paternity leave as provided in GC sections 20990 through 21013, do not constitute a “break in service.

The interpretation of this phrase makes clear whether a “break in service” has occurred. Clearly defining “break in service” is essential to correctly identifying those individuals who will be new members since the PEPRA definition of a “new member” includes an individual who after a break in service greater than 6 months, returns to active membership in the same retirement system with a new employer. Classifying members correctly as “new” or “classic” is important because it will ultimately impact the amount of retirement benefits received and the amount of required member retirement contributions that must be paid. This regulation is necessary to ensure that members are correctly enrolled, receive the correct benefit formula, and contribute the correct required member contributions from the start of their service.

Addition of Proposed Section 579.5 Similarly Situated Defined
The proposed addition of section 579.5 to the CCR seeks to implement CalPERS interpretation of the meaning of the phrase “similarly situated” (as used in GC section 7522.30(c)) for the purposes of determining the member contribution rate for “new members.” GC section 7522.30 sets the contribution rates for certain new members (those employed by public agencies, school employers, California State University (CSU), and the judicial branch) as the greater of either 50 percent of normal cost rate or the contribution rate established for similarly situated employees.

Because the phrase “similarly situated” could be interpreted in more than one way, it is necessary to promulgate the proposed regulation to make clear the interpretation

CalPERS will utilize. The phrase “similarly situated” could be interpreted as broadly as all members in the same membership classification (e.g. miscellaneous members or safety members) or all members employed by the same employer type (e.g. School member, Public Agency member). The phrase “similarly situated” could also be interpreted more narrowly like the phrase is interpreted in the proposed regulation. The proposed regulation defines the phrase “similarly situated” to mean members with the same retirement benefit formula who also share similarities in job duties, work location, collective bargaining unit, or other logical work-related characteristics. This phrase should be interpreted in this manner because it is the most reasonable interpretation for the members at issue. Clarifying the meaning of this phrase will help ensure member contribution rates are correctly established for “new members” from the start of their service.

Addition of Proposed Section 579.24 Final Compensation Calculations for Service Accrued under PEPRA and the PERL

The proposed addition of section 579.24 to the CCR seeks to clarify the process that will be used by CalPERS where a member has accrued service credit both as a new member and as a classic member. In such a situation, the calculated final compensation amount for each period of service may differ. Pensionable compensation for a new member may be limited and may not include all of the compensation amounts allowed for a classic member for several reasons. These reasons may include: 1) special compensation items earned during service as a classic member may not constitute pensionable compensation for a new member; 2) payrates established during service as a classic member may exceed the pensionable compensation limits for new members; and, 3) final compensation periods of less than 36 months may be used to calculate final compensation for service accrued as a classic member that would not apply to service earned as a new member.

In those instances where members have earned service as both a classic member and a new member, CalPERS will determine two final compensation amounts. The first final compensation amount will be determined for the service earned as a classic member, using the rules applicable to classic members, and the second final compensation amount will be determined for the service earned as a new member using the PEPRA rules. Those two final compensation amounts will then be used to calculate the member’s retirement benefit allowance.

This regulation is necessary to avoid confusion about how these situations will be handled and to avoid potential legal challenges over such determinations. This regulation should assist members, employers, stakeholders and CalPERS staff by clearly articulating the process that will be followed under these circumstances.

BENEFITS/RISKS

The proposed regulations are designed to implement the new pension reform provisions. By interpreting key phrases and outlining key processes, the proposed regulations will provide clarity and uniformity for CalPERS, its members, employers and stakeholders and should help avoid protracted litigation over disputes relating to how the new pension reform provisions should be interpreted. The proposed regulations will also ensure that individuals are properly enrolled into membership from the start so that proper contributions are collected on their behalf, and the proposed regulations will help ensure the correct level of benefits will be provided to these individuals at the time they retire. Additionally, the proposed regulations make clear various processes that will be used by CalPERS to implement the pension reform laws which should make administration of these new statutes more efficient.

Without the adoption of the proposed regulations, there are significant risks. Some of these risks include the fact that not all CalPERS-covered employers may interpret the new legislation consistent with CalPERS interpretation, and that could lead to inconsistent application of these new laws. Moreover, without the proposed regulations, employers might interpret certain phrases in a manner that could be potentially detrimental to CalPERS members. Further, should the proposed regulations not be promulgated, there could be confusion amongst CalPERS-covered employers when enrolling members, which could lead to members being improperly enrolled as new members when they should have been enrolled as classic members, or vice versa. Proper enrollment is critical to ensuring that members receive the correct benefit formula, final compensation period, and applicable cap on pensionable compensation, as well as ensuring that members pay the statutorily required amount of member contributions amounts. Finally, without the proposed regulations, legal challenges may be undertaken to resolve disputes over the meaning of various key phrases used in the pension reform statutes.

NEXT STEPS

If the Board approves the proposed regulations and the initiation of the regulatory process, CalPERS staff will request the publication of the Notice of Proposed Regulatory Action in the California Regulatory Notice Register. A minimum 45-day written comment period will be followed by a public hearing, which is anticipated to be scheduled for the May or June 2013, Pension and Health Benefits Committee Meeting. If any public comments require revisions to the proposed regulations, the revised proposed regulations may require an additional 15-day or 45-day comment period and may require additional Board approval. If no additional comment period is required, or after final Board approval, the final proposed regulations may be transmitted to the Office of Administrative Law (OAL) for review, approval and filing with the Secretary of State and publication in the CCR. The proposed regulations will then become effective in accordance with the OAL calendar, which as of January 1, 2013, now uses a quarterly effective date schedule; because the regulations apply to the PEPRA laws already in effect, staff intends to request an earlier effective date from OAL so that the proposed regulations will become effective immediately upon transmittal to the Secretary of State. If no additional comment periods are necessary, the earliest effective date for the proposed regulations could be in this summer, however, should additional comment periods become necessary due to modifications to the regulatory text or should the request for an earlier effective date not be approved by OAL, the effective date would be pushed back accordingly.

CalPERS will incur some costs in order to comply with the PEPRA legislation. Notwithstanding this fact, staff has attempted to identify the fiscal impact associated with implementing the proposed regulations. In general, certain administrative costs will be attributable to the proposed regulations, including education outreach and training, programming costs to the my|CalPERS system, publication costs, and postage. In some instances, CalPERS-covered employers may also incur certain administrative costs for training or enhancements to their own systems, and costs associated with complying with the proposed regulations; however, staff may be unable to quantify all of these costs incurred by CalPERS-covered employers. As this information must be provided to OAL and the Department of Finance as part of the regulatory process, staff continues to work on quantifying the above costs, and determining whether there may be additional costs to CalPERS and CalPERS-covered employers associated with individual proposed regulations, including evaluating whether there may be a need to hire additional staff to complete the necessary processes associated with PEPRA as outlined in the regulations.

ATTACHMENTS
Attachment 1 – Proposed Regulatory Action by CalPERS

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