



## Agenda Item 5

April 16, 2014

**ITEM NAME:** Initiate Public Comment Period on Draft Regulations for Reportable Compensation under PEPRA

**PROGRAM:** Customer Account Services

**ITEM TYPE:** Action

### **RECOMMENDATION**

Staff recommends approval of the draft regulation defining pensionable compensation for publication and the initiation of the rulemaking process of Chapter 2 of Division 1 of Title 2 of the California Code of Regulations (CCR), Section 571.1.

### **EXECUTIVE SUMMARY**

Since the passage of AB340, the California Public Employees' Retirement System (CalPERS) has introduced a series of regulations to aide in the interpretation and administration of the Public Employees' Pension Reform Act (PEPRA) of 2013. This regulation, when finalized, is intended to clarify CalPERS interpretation of what is considered pensionable compensation and should be reported to CalPERS for a "new" member, gaining uniform compliance amongst all participating employers. Staff have engaged in extensive outreach with stakeholders but have been unable to reach consensus on the interpretation of the statute. As a result, we expect a robust comment period, likely followed by a public hearing.

### **STRATEGIC PLAN**

This item is presented in support of CalPERS implementation of PEPRA and related pension reform changes to the Public Employees' Retirement Law (PERL) and in accordance with one of CalPERS Strategic Plan Goals. Goal A is to improve the long-term pension and health benefit sustainability. This item supports both goals by clarifying and communicating CalPERS interpretation of certain pension reform provisions, in addition to providing education and outreach to members, employers, and stakeholders to make informed decisions about retirement security and understand how pension reform changes may impact retirement benefits.

### **BACKGROUND**

CalPERS has demonstrated a long-term commitment to provide protection against the unsound treatment of compensation for the purpose of enhancing retirement allowances. CalPERS sponsored legislation, (SB 53, Russell) in 1993, which enacted many of the same principles found in AB 340 & SB 13. Among other things, SB 53:

- Provided a definition of compensation
- Provided for full funding of member benefits
- Reduced the ability to manipulate compensation
- Prohibited the use of cash conversions, final settlement pay and termination pay for purposes of calculating members' retirement benefits
- Provided the CalPERS Board of Administration (Board) with clear oversight of benefits

SB 53 also provided the Board with the ability to promulgate regulations to delineate more specifically exclusively what constitutes special compensation. As a result, CCR 571 was developed to clearly and succinctly define reportable compensation for local, public agencies and schools. Special compensation for state members was governed by section 20636.

Until January 1, 2013, employers continued to submit reportable compensation on behalf of all their "classic" employees that are CalPERS members. On September 12, 2012, when Governor Brown signed into law AB 340, reporting to CalPERS for "new" members changed. PEPRA now defines "Pensionable Compensation" for new members (generally those brought into membership after January 1, 2013) and limits payments and compensation that may be used to calculate a defined benefit for "new" members. PEPRA also excludes specified payments from being reportable compensation. Classic members remain unchanged under the original statutes and regulations.

In addition, on October 4, 2013, Governor Brown signed into law Senate Bill 13, PEPRA clean-up legislation. While it included several items of technical corrections, it did not make specific changes to the definition of pensionable compensation. However, it did include a provision that would allow a pay item to be excluded from pensionable compensation if agreed upon through collective bargaining with represented state employees or imposed on non-represented state employees.

### **ANALYSIS**

Similar to what occurred with SB 53, this draft regulation is necessary to implement and administer the pension reform statutes. It also provides a requirement for exclusions from pensionable compensation for those items that are collectively bargained with represented state employees or imposed on non-represented state employees.

For new members, pensionable compensation must meet the following four criteria:

- Pay is part of the normal monthly rate of pay or base pay.
- Pay is paid in cash to similarly situated members of the same group or class of employment.
- Pay is for services rendered during normal working hours.

- Pay is paid pursuant to publicly available pay schedules.

PEPRA also expressly states what cannot be included in pensionable compensation for new members. For example, pensionable compensation does not include monies paid to new members for bonuses, uniform allowance, overtime allowance or reimbursement for housing and vehicles, or any ad hoc or one-time payments.

In December 2012, CalPERS issued Circular Letter 200-062-12, listing the types of compensation that may be reportable as “pensionable compensation” based on our initial interpretations and understanding of PEPRA. The list removed six items from the original CCR 571, based on that initial interpretation:

- Bonus
- Value of Employer Paid Member Contributions
- Management Incentive Pay
- Off-Salary Schedule Pay
- Uniform Allowance
- Temporary Upgrade Pay

Since the passage of AB 340, the project team has been working with our internal staff and external stakeholders to gather input and feedback on the development of Pensionable Compensation regulations. We have engaged with many of our key stakeholders on this topic, including the State administration, labor and employer groups, and other pension systems. These stakeholder meetings have occurred in different venues, both formally and informally. Most recently staff has met with several employer and employee stakeholder groups to discuss our approach on the initial draft regulation. In most cases our stakeholders were agreeable and understood the rationale for moving forward with the initial draft regulations to begin the formal public comment period.

In reaching this stage with the draft regulation, there were a few issues that needed a staff decision. In evaluating the language of the statute, the clarifying language in SB 13, and stakeholder feedback, the draft regulation reflects staff’s decisions on the following three issues:

- Normal Monthly Rate of Pay vs. Base Pay: There has been much discussion on whether PEPRA limited pensionable compensation to base pay only. The definition of “pensionable compensation” uses both terms. Some pension systems have decided to interpret “pensionable compensation” to mean base pay only while others are using normal monthly rate of pay. In discussions with our stakeholder there are those that believe base pay is the appropriate interpretation and consistent with the cost cutting goals of PEPRA. Others have stated that pensionable compensation was meant to control pension

spiking by eliminating those pay items expressly excluded or paid discriminately to manipulate the system, not pay items that an employee receives on a normal monthly basis. In the passage of SB13, language was included to allow the State to collectively bargain with labor organizations (or impose on non-represented) to exclude certain special pay items. By passing legislation allowing the ability to exclude, it would seem to infer that items other than base pay are included. As such this draft regulation includes items that are considered part of an employee's normal monthly rate of pay.

- State Inclusion : For classic members, public agency and school employers submit reportable compensation under the guidance of the Government Code and associated CCR's, whereas the State relies on the relevant Government Code Section that apply solely to State employees. However, AB340 defines pensionable compensation uniformly for all members, including State, public agencies, and schools. Therefore, staff recommends the draft regulation apply to all "new" members.
- Temporary Upgrade Pay compensation: At the time of the December 2012 Circular Letter staff characterized this pay item as "Ad Hoc" because it is typically paid on a limited duration. Since PEPRA expressly prohibits "Ad-Hoc" pay items, temporary upgrade pay was one of the items initially removed from pensionable compensation. Since the release of the circular letter, staff has reconsidered its position on temporary upgrade pay. Based on additional review, staff believes that the best interpretation is that it aligns with normal monthly rate of pay for services rendered and included as pensionable compensation.

With the release of the draft regulation we will continue our process of engaging with our stakeholders and gathering feedback as part of the regulatory process. At the completion of this process, approval of this regulation will:

- Ensure compliance with applicable laws governing pensionable compensation
- Describe with precision what is and isn't pensionable compensation
- Promote transparency by informing all stakeholders of the types of compensation that can be used to calculate retirement allowances for new members
- Enable the organization to provide an effective platform to clearly communicate the definition of pensionable compensation

CalPERS is continuing to engage in outreach to educate our members, employers and stakeholders on changes related to pension reform and the regulatory development process. The outreach includes training classes, materials posted on

the CalPERS website, meetings with stakeholders, and presentations. We will continue outreach throughout the regulatory process.

## **BUDGET AND FISCAL IMPACTS**

### Administrative Costs

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 draft regulation. In general, certain administrative costs will be attributable to the draft regulation, 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 draft regulation; however, staff may be unable to quantify all of the costs incurred by CalPERS-covered employers. As this information must be provided to the Office of Administrative Law (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 the draft regulation.

### Benefit Costs

This regulation could result in savings to the employer to the extent it reduces the final compensation used to calculate benefits for “new” members. Any savings will vary by employer and depend on how many pay items are eventually excluded in the final regulation package and whether the excluded pay items are items the employer currently pays.

## **BENEFITS/RISKS**

Without the adoption of a regulation, there are significant risks. 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. CalPERS may achieve cost savings as a result of decreased litigation and administrative appeals related to the definition of pensionable compensation as employers and members become more aware of what compensation is or isn't reportable to CalPERS.

## **NEXT STEPS**

If the Board approves the draft regulation 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 optionally followed by a public hearing, which, if requested, is anticipated to be scheduled for the August 2014 Pension and Health Benefits Committee meeting. If any public comments require revisions to the draft regulation, the revised draft regulation 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 regulation may be transmitted to OAL for review, approval and filing with the Secretary of State and publication in the CCR. The proposed regulation 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 regulation applies to the PEPRA laws already in effect, staff intends to request an earlier effective date from OAL so that the final, proposed regulation will become effective immediately upon transmittal to the Secretary of State. Assuming an initial 45-day comment period and an additional 15-day comment period, we anticipate this regulation could be completed in late 2014/early 2015.

**ATTACHMENTS**

Attachment A – Proposed Regulatory Action by CalPERS

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