



Board of Administration

Agenda Item 8b

November 19, 2025

Item Name: State Legislative Proposal: Discontinuation of Actuarial Equivalent Reduction for Service Credit Elections and Other Technical Amendments

Program: Legislation

Item Type: Action

Recommendation

Sponsor legislation to discontinue the Actuarial Equivalent Reduction (AER) option for any new elections for service credit purchases, tier conversions, and redeposits of withdrawn contributions that occur on or after January 1, 2027, and make other technical changes as needed.

Executive Summary

The Public Employees' Retirement Law (PERL) provides a variety of service credit options for eligible California Public Employees' Retirement System (CalPERS) members. At the time of purchase, active members can pay for the service credit through a lump sum payment (e.g., personal check, money order), plan-to-plan transfer or rollover from an eligible retirement plan, or elect installment payments up to 180 monthly payroll periods. For purchases made on or after January 1, 2020, when a member retires and has a remaining balance due, the member must pay the remaining balance in full or elect an AER. The AER allows the member to receive a retirement benefit including the total years of service credit purchased by paying the remaining balance through a permanent benefit reduction in the monthly retirement allowance using annuity factors based on member's age at retirement, assumed interest rate, and mortality assumptions. The AER payment option is intended to be cost neutral by calculating the remaining service credit purchase balance and the lifetime monthly payments, so they are equivalent in value. While the underlying goal of AER remains the same, implementation has revealed situations where the AER option has had some unintended results and additional calculation complexities. To address these matters and align CalPERS' business practices with other pension systems, effective January 1, 2027, CalPERS is proposing to discontinue the AER option for any new service credit purchases, tier conversions, and redeposits of withdrawn contributions.

Instead:

- Require members to pay service credit purchase balances in full within 60 days of the member's retirement date. If unable to pay, prorate the service credit based on the amount paid.
- For tier conversions, require members to pay balances in full or through installment payments. If unable to pay balance in full within 60 days of the member's retirement date, prorate Tier 1 service credit based on the amount paid and revert the remainder to Tier 2.
- In cases of service credit purchases impacted by pre-retirement death, require beneficiaries to pay balances in full within 60 days of the member's preretirement death or prorate the service credit based on the amount paid.

Discontinuing the option to elect AER ensures that the member's retirement benefit is based on the elected service credit the member has paid for in full and reduces the unintended administrative complexities resulting from implementing AER.

This proposal also makes other technical changes to ensure the proper application of laws administered by CalPERS.

Strategic Plan

This proposal supports the CalPERS 2022-27 Pension Sustainability Strategic Plan goal to strengthen the long-term sustainability of the pension fund, and to reduce complexity across the enterprise.

Background

Service credit represents the earned and purchased amount of employee service time for a CalPERS-covered employer or employers and is accumulated on a fiscal year basis. Service credit is one of three factors used to calculate an employee's retirement benefit, along with their retirement formula and final compensation. The PERL provides over 50 types of service credit that eligible members may purchase before they retire.

CalPERS team members determine eligibility by reviewing submitted service credit purchase requests, business partner contracts, and the PERL. If the member is eligible to purchase service credit, there are four payment method options: a lump sum payment (e.g., personal check, money order), plan-to-plan transfer or rollover from an eligible retirement plan (e.g., 457, 401(k) or individual retirement account), an installment payment plan, or an initial partial payment with an installment payment plan for the remaining balance. For tier conversions, state members may also elect AER at the time of election to defer their payments for past contributions until retirement.

If a member elects to purchase service credit with installment payments, they may choose the duration of the payment period, not to exceed 180 monthly payroll periods or the equivalent. For purchases made on or after January 1, 2020, if the member retires while still making installment payments on a service credit election, they must pay the remaining balance in full or elect to have their monthly allowance reduced by the actuarial equivalent of the unpaid balance (i.e., AER).

Service Credit Purchase Costing Methods

The cost to purchase service credit is determined using methods established by the PERL. These methods can differ depending on an individual's membership category (i.e., state, school, or public agency) and the type of service credit they elect. The methods used to calculate costs include the present value method, the pay and contribution rate method, the redeposit method, and the tier conversion method.

CalPERS calculates the cost to purchase Alternate Retirement Program, Comprehensive Employment & Training Act, Fellowship, Leave of Absence, Peace Corps, AmeriCorps VISTA, AmeriCorps, and Military service credit using the present value cost method. This method estimates the increase to the member's future retirement benefits based on their highest monthly full-time pay rate and average of any special compensation, using a number of actuarial assumptions, including projected age at retirement, life expectancy, salary inflation, and the assumed rate of return on investments.

The cost to purchase Base Realignment and Closure Firefighter, Prior Service, Service Prior to Membership, Temporary Disability Leave of Absence (TDA), Layoff, and Optional Member service is based on the member's pay rate and retirement contribution rate on a specified date. For TDA and Layoff, the date is when the member returned to work. For all others, the date is when the employee became a CalPERS member (after service is rendered). Interest will be calculated through the date provided on the election document.

In addition, the cost to purchase Service Prior to Membership for a member employed by a local agency that contracts with CalPERS for retirement benefits depends on the specific terms of the contract, which may allow the member to be credited at no member cost with some or all the service credit the member would have earned, or given the option to purchase the service credit the member would have earned.

CalPERS calculates the cost for an active member to redeposit contributions they had previously withdrawn from the System upon separating from CalPERS-covered service by identifying the amount and date of the refund, and applying interest from that date through the date of the election to redeposit was received. A state member subject to a Second Tier retirement formula may also elect to convert that service to a First Tier retirement formula. The cost for converting state Second Tier service credit is based on a number of factors, including the retirement contributions the member would have paid as a state First Tier member plus interest, offset by any Second Tier contributions paid since July 2013.

Actuarial Equivalent Reduction (AER)

The actuarial equivalent is defined in the PERL as *"...a benefit of equal value when computed upon the basis of the mortality tables adopted and the actuarial interest rate fixed by the board."* Application of the actuarial equivalent helps to ensure that the benefit paid to a member or beneficiary has the same value as the payments made for that benefit.

When a benefit is reduced by the actuarial equivalent, the balance due at retirement is converted into a benefit reduction in the monthly allowance from the date of the member's retirement to the date of the member's death. The reduction is based on annuity factors calculated using the member's age, the assumed interest rate, and the member's mortality assumption. While the calculation of the service credit cost under an AER is equal in actuarial expectation, the actual outcome for each individual may vary. For example, if a member retires

at the age of 62 with a hypothetical mortality assumption of 85, the reduction in the monthly allowance will amortize any remaining unpaid balance at retirement over 23 years. If the member dies before their assumed life expectancy, the value of the expected increased service credit will not be fully paid for. On the other hand, if a member lives beyond their assumed life expectancy, they will continue to have their monthly allowance reduced by the actuarial equivalent.

From the 2017 industry scan, all the pension systems reviewed required and continue to require members to pay their service credit purchases in full prior to retirement.

Analysis

Proposed Amendments

CalPERS recommends amending the PERL to require CalPERS members who elect to purchase service credit either to pay the service credit purchase balance in full within 60 days of their retirement date or receive prorated service credit based on the amount paid. The proposed amendments would also apply to survivors and beneficiaries of members who pass away with a service credit purchase balance remaining. In addition, they would require state Second Tier members to either elect to pay for their tier conversions in full or by installment payments and would remove the option to elect AER at the time of tier conversion election. These proposed amendments would apply prospectively to service credit purchases elected on or after January 1, 2027, and would not impact members who have already elected an AER.

Reduces Complexities and Strengthens CalPERS' Financial Policies

Prior to January 1, 2020, members were allowed to continue their service credit purchase installment payments into retirement, resulting in unpaid account receivables if the member passed away prior to the last installment payment. In 2018, CalPERS sponsored legislation to discontinue allowing members to continue their installment payments into retirement for new service credit purchases and instead required them to either pay the remaining balance in full or to elect an AER. This change was meant to reduce the complexity of having to track installment payments into retirement, as well as support ongoing efforts to strengthen CalPERS' financial policies. Even though this amendment reduced the administrative complexity associated with installment payments into retirement, CalPERS' experience administering this new AER option has created other administrative complexities and unintended results.

First, this AER option created new complexities in maintaining a member's account. When a member passes away, the AER will follow the benefit to the beneficiary and will need to be applied to the beneficiary's allowance. There are additional complexities if the member has more than one lifetime beneficiary as the AER will need to be applied to each beneficiary's allowance.

Second, the AER option appears to have resulted in members electing to purchase eligible service credit closer to their retirement. For elections between January 1, 2014, and December 31, 2019, on average, members retired over two years after the election. For elections after January 1, 2020, on average, members retired within a year of election.

Discontinuing the option to elect AER will reduce these administrative complexities and address these unintended results, as well as align CalPERS' service credit payment options and

requirements with other pension systems by requiring members to fund these purchases in full at retirement.

Budget and Fiscal Impacts

Benefit Program Costs/Savings:

The member will receive the benefit that they paid for at retirement. The benefits that CalPERS pays out to members will be fully funded and CalPERS will not experience a loss if a member dies before their service credit purchase obligations have been paid in full.

Administrative Costs/Savings:

Initial administrative costs related to member communications and changes to forms and publications.

Benefits and Risks

Benefits:

- Reduces system complexity
- Service credit will be fully funded at retirement or at the time of a member's pre-retirement death
- Retirement and survivor benefits are not actuarially reduced
- CalPERS service credit payment options and requirements will align with other pension systems

Risks:

- Some members may not have the resources at the time of retirement to pay their balance in full or obtain a loan. However, the member will be credited with the service credit based on the amount paid.

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