LEGISLATIVE PROPOSAL: Creditable Compensation Simplification

SUMMARY

This proposal addresses compensation reporting challenges and other concerns encountered by CalSTRS staff, employers and members by simplifying sections of the Teachers' Retirement Law (TRL) relating to creditable compensation and creditable service.

RECOMMENDATION

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. In addition, this proposal aligns with the CalSTRS Strategic Plan Goal 2: Leading innovation and managing change—Innovate to grow resiliency and efficiency in service of our members. This proposal reduces ambiguities and facilitates consistent reporting of compensation and service, both critical components of benefit determination, without adversely affecting benefits or system funding.

REASON FOR THE PROPOSAL

Over the last year, 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 proposal 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.

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 Audits and Risk Management Committee in March 2023, which noted that despite significant efforts by CalSTRS, there continues to be 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 resolving the member data audit deficiency 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 TRL 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 TRL. 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 Proposal:
This proposal 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:

- 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."
    - "Remuneration in addition to salary," sometimes called "special pay." Examples of this pay type 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 that employers return excess member contributions submitted to CalSTRS and later credited to the DBS Program.

<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 proposal 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 proposal 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 may also experience savings from reduced workload associated with reporting corrections and returning excess DBS member contributions. While an increase in employer contributions would be expected for part-time members receiving limited-term payments (which would create service credit) as well as compensation that is not “paid in each pay period” for CalSTRS 2% at 62 members (which is currently not creditable), the proposal would not affect the overall contribution rate.

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 “remuneration in addition to salary” 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.

FISCAL IMPACT

Program Cost – The proposal is not anticipated to affect CalSTRS’ ability to reach full funding by 2046. It would increase contributions to the DB and DBS programs as additional compensation for CalSTRS 2% at 62 members would be creditable. The additional contributions would largely go to the DBS Program. In some circumstances, members working less than full time may receive a small amount of additional service credit in the DB Program, which would be funded with contributions. Compensation for certain special pay items that are currently paid regularly once or twice a year would become creditable and included in compensation earnable for CalSTRS 2% at 62 members, which would increase liabilities; however, such a change protects the plan from funding shortfalls that could occur when employers simply change the frequency of payments to make them creditable. It is estimated that additional state contributions of approximately $5 million 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.

Administrative Costs/Savings – The one-time technology costs for updates to CalSTRS’ benefit administration and financial systems are estimated to be between $1.03 million and $2.26 million, assuming the proposal would be effective after the completion of the Pension Solution Project. Cost and schedule impacts to the Pension Solution Project may be mitigated by implementing the proposal after the project is completed. One-time implementation costs to update training and internal processes are also anticipated for Employer Services, Audit Services and Financial Services. Over time, the proposal is expected to reduce workload and costs related to reporting errors, adjustments and recovery of overpayments.

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’ benefit 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.