BILL NUMBER: AB 2998 (Kiley) as amended May 4, 2020

SUMMARY

AB 2998, the Rising Academic Instructor Salaries in Education (RAISE) Act, permits school districts to offer a defined contribution (DC) plan to certificated employees in lieu of the CalSTRS Defined Benefit (DB) Program. To incentivize participation in a DC plan, the bill allows school districts to offer higher salaries or lower contribution rates for those who opt into the plan and allows certificated employees to individually negotiate salaries and plan contribution rates outside of the salary schedule set forth in a collective bargaining agreement.

BOARD POSITION

Oppose. It is the board's policy to oppose legislation that conflicts with CalSTRS' strategic directions or policies established by the board, and this bill conflicts with the 2019-22 CalSTRS Strategic Plan Goal 1, Objective A, which is to achieve full funding of the DB Program by June 30, 2046, by potentially reducing the number of active members contributing to the DB Program. The board's policy is also to oppose legislation that adversely affects the actuarial balance of the funds administered by CalSTRS or results in adverse selection against a retirement plan, and this bill incentivizes certificated employee participation in less secure DC plans instead of the DB Program, thereby hindering CalSTRS' long-term sustainability and ability to carry out the fiduciary duty owed to members.

ANALYSIS

Existing Law:

CalSTRS administers a hybrid retirement system consisting of traditional defined benefit (DB Program), cash balance (Defined Benefit Supplement (DBS) Program and Cash Balance Benefit Program) and voluntary defined contribution (Pension2) plans. CalSTRS also provides disability and survivor benefits.

<u>Defined Benefit Program</u>
The DB Program was established in 1913 to provide for the payment of retirement salaries to California public school teachers. All public school teachers automatically became members of the retirement system when it was established and were eligible for an annual retirement salary upon completion of 30 years of service.

With more than 964,000 members and beneficiaries, CalSTRS is the nation's largest public educator pension fund. Membership in the DB Program is mandatory for all certificated and academic employees performing creditable service for 50% or more of the time required for the full-time position and optional for those employed part time in school districts, community college districts, participating charter schools and county offices of education.

The DB Program pays a guaranteed monthly lifetime retirement benefit to eligible members based on years of service, age at retirement and final compensation, which replaces approximately 50% of a career educator's compensation. The DB Program also pays disability, death and survivor benefits, which provide a safety net for California's educators and their families. DB members also contribute to the DBS Program, a supplemental cash balance plan, for summer school or other assignments that result in more than one year of service credit in a school year. The DBS Program provides members with a nominal account that is credited with member and employer contributions, a guaranteed interest rate and additional earnings credits when the funding levels meet certain thresholds. Members do not contribute to or receive Social Security for their CalSTRS service, so they rely on their defined benefit pension as their primary source of income in retirement.

Pension2 provides all employees of participating employers with a low-cost means to supplement their DB plans by investing through tax-advantaged payroll deductions in 403(b) and 457(b) plans. The DC plans offered through Pension2 are not intended as standalone retirement savings, but rather as a way for members to further build upon their guaranteed defined benefit retirement income to create a solid financial foundation for retirement in the absence of Social Security benefits.

Defined Benefit Plan Funding

The CalSTRS Funding Plan enacted by Chapter 47, Statutes of 2014 (AB 1469–Bonta), relies on future contributions to put CalSTRS on a trajectory toward eliminating the unfunded liability by 2046. Achievement of this funding goal is essential to ensuring the long-term sustainability of the pension fund and CalSTRS' ability to meet its fiduciary duty to continue paying secure retirement benefits to California's educators. The funding plan provides a schedule of contribution increases for members, employers and the state that balances the need for higher contributions with the budgetary needs of employers. It also provides limited rate-setting authority to the Teachers' Retirement Board to adjust employer and state contributions in order to help the system remain on track to reach full funding. For 2019-20, member contributions to the DB Program are 10.25% for 2% at 60 members and 10.205% for 2% at 62 members; employer contributions are 17.10%; and state contributions are a total of 10.328%. The board cannot adjust employer contributions by more than 1% of payroll annually with a cap of 20.25% starting on July 1, 2021, and cannot increase state contributions more than 0.5% of payroll annually. Because the funding plan is based on contribution rates as a percentage of payroll, one of the key actuarial assumptions of funding the system is assumed growth of payroll, which is currently set at 3.5% annually.

This Bill:

Specifically, AB 2998:

- Allows school districts to offer a DC plan and for certificated employees to opt into the plan in lieu of the DB Program.
- Excludes a person who opts into the DC plan from DB Program membership.
- Prohibits decisions on employing, terminating or granting permanent status to a certificated employee from being based on their participation in the DC plan.
- Allows districts to offer higher salaries or lower DC contribution rates to incentivize participation in the plan and permits employees to individually negotiate a salary or contribution rate outside of the salary schedule for the school district.
- States the changes made by this bill do not apply to collective bargaining agreements entered into before January 1, 2021, until they expire or are renewed, and new bargaining agreements entered into on or after January 1, 2021, may not prohibit employers from offering higher pay or lower contribution rates or employees from individually negotiating pay or contribution rates outside of the salary schedule.

PROGRAM BACKGROUND

Funding Impact

AB 2998 would seriously jeopardize the CalSTRS Funding Plan and could increase contribution rates as well as long-term costs if any unfunded liability remains in 2046. By incentivizing participation in a DC plan and excluding those participants from the DB Program, AB 2998 could reduce the number of active members in the DB Program. Though the overall number of certificated employees would remain the same, active DB membership and, therefore, overall payroll reported to CalSTRS would decrease by the number of certificated employees opting into a DC plan.

It is important to note that while AB 2998 would have no impact on the size of the unfunded liability for the DB Program, it would impede CalSTRS' ability to reach full funding. The funding plan was designed assuming the contributions needed to eliminate the unfunded liability by 2046 would be collected based on a percentage of DB member payroll. Since AB 2998 could reduce the number of active DB members, the total statewide payroll of DB members on which contributions are received could be reduced. This would make the current scheduled contribution rates inadequate to fund the DB Program.

When the payroll of active DB members either increases slower than anticipated or declines, increased contribution rates are required to collect the same amount and ensure full funding, even if the unfunded actuarial obligation remains constant. If AB 2998 is enacted and enough teachers opt into a DC plan, under the funding plan, CalSTRS would be forced to raise the employer contribution rate from 17.10% to the maximum rate of 20.25%, and the state contribution rate of 10.328% would increase each year by 0.5% through 2046. Even with these increases, a decline in the number of DB members would likely result in contributions that would not be sufficient to eliminate the unfunded liability because CalSTRS would be collecting less from employers than it does currently.

As an example, in Fiscal Year 2022-23, CalSTRS would be required to collect about $6.8 billion in contributions from employers to meet the goals of the funding plan. If the DB membership were reduced to half of what it is today, the contribution rate would have to be set at the maximum of 20.25%. Even with a higher rate, CalSTRS would only be able to collect about $3.9 billion in contributions from employers, or about $3 billion less than needed. Under this scenario, funding levels would once again be expected to decline, leading to the future insolvency of the entire plan and a need for a new funding plan.

Additionally, the ratio of active members to retired members could also be shifted by individuals electing into a DC plan, negatively impacting the balance of contributions received to liabilities being paid out from the fund. As a result, CalSTRS would likely have to start using invested assets sooner to pay benefits. The need for increased liquidity to pay benefits, as a percentage of the fund, would decrease assets available for diversified, long-term investment and reduce the return that CalSTRS could expect to earn from its funds, further increasing the cost of the benefit plans.

Moreover, any necessary increase in DB contribution rates could further incentivize school districts with limited budgets to encourage alternative DC plans, further increasing contribution rates and funding risks for the DB Program. These rate increases are also likely going to lead to a shifting of pension costs between school districts, with districts that do not offer a DC plan paying an unfair share of the unfunded liability costs.

Impacts to School Districts

If the funding plan were unable to eliminate the unfunded liability, it could also impact the interest costs for debt issued by school districts to, for example, construct or improve infrastructure. This is because the Governmental Accounting Standards Board requires public agencies that are responsible for funding pension liabilities to disclose those liabilities within their financial statements. One component of that disclosure is how the liability is calculated if projected assets are insufficient to pay projected benefit payments. For those payments for which projected assets are sufficient, the liabilities are determined based on the assumed investment return, or 7% in the case of the DB Program. If the assets are insufficient to pay all projected benefits, then the liabilities for which there are no projected assets are calculated based on the 20-year general obligation municipal bond index rate, which is currently approximately 3%. As a result, if the funding plan is insufficient to reach full funding, it would significantly increase the net pension liability that school districts are required to disclose on their financial statements, which could negatively affect their bond ratings as well as other aspects of their financial plans.

This bill seeks to increase teacher pay and decrease employer contributions now at the expense of a secure retirement in the future. This may be attractive to districts and teachers in the short term, but in the long term, it may put a strain on retirees and employers. Employers would have the additional responsibilities and costs associated with offering a DC plan and tracking which certificated employees are members of that plan versus the DB Program. Additional costs may also be felt in terms of workforce planning and taxes.

The DB Program presents advantages over DC plans for workforce planning in school districts. Because DB pensions are more advantageous for those who remain in their careers for the long term, they create an incentive that helps employers retain teachers and reduce hiring and training costs.[1] DB plans also help school districts encourage older employees, whose pay and benefits often cost more, to retire in their early 60s. Educators in the DB Program reach full retirement at age 60 or 62, depending on their retirement formula, and because their benefits are guaranteed, they can retire without concern for market impacts on their pension benefits. Conversely, DC plans increase the incentive for younger teachers to leave because they offer more flexibility to rollover and distribute funds. Older teachers in DC plans must consider whether their total contributions and investment returns adequately cover retirement expenses. This may lead them to stay in a position longer to contribute enough to cover retirement costs, especially during periods of market decline.

The role of employers in providing retirement benefits also will change. Currently, CalSTRS has fiduciary responsibility for actions associated with the administration of the retirement system. Under a typical tax-qualified public DC plan, however, the employer is responsible for the provision of the retirement plan for its employees. Even if the employer elects to contract with another party to provide plan administration, the employer will have the fiduciary duty to make a prudent selection of the plan administrator and investment options.

Retirement Security

A study titled "Are California Teachers Better off with a Pension or a 401(k)?" from 2016 found that the DB Program is a better fit for California teachers than a 401(k) and switching to a DC plan

[1]Rhee, Nari and William B. Fornia. "Are California Teachers Better off with a Pension or a 401(k)?" *UC Berkeley Center for Labor Research and Education*, February 2016, pp. 13, https://www.calstrs.com/sites/main/files/fileattachments/are_california_teachers_better_off_with_a_pension_or_a_401k.pdf?1464728737.

would reduce retirement security for most teachers.[2] While there are many factors that determine the suitability of retirement plans for different individuals, the study highlighted two key factors in its findings.

First, the DB Program provides a predictable stream of income for life, allowing members to plan for financial security in retirement. Investment and longevity risks for DB plans are pooled over a larger number of people and a longer period of time, reducing those risks for plan members. In contrast, DC plans place more risk on individuals, who are responsible for selecting their investments and determining how much to contribute to cover retirement expenses without outliving their savings. Though DC plan participants have the potential to achieve higher market gains, they also bear the risk of losses from market downturns or poor investment decisions.

Second, most California teachers enter the profession after their twenties and remain in their careers for the long term, and the DB Program provides a better way to deliver income replacement for the average career trajectory. The mean age of new hires is 33, and the average age of members retired for service is 62. The benefit formula offers a more advantageous benefit for those with more service later in their careers. Conversely, DC plans provide the greatest benefit for contributions made early in a career, and the benefit for the same contribution level declines throughout a career as a participant gets closer to retirement. For example, when comparing income replacement at age 60 for retirement across age groups in an idealized DC plan with contribution rates and investment returns similar to the DB Program, it was found that replacement rates for employees with active employment from ages 25 to 45 were 6% higher for DC participants, but replacement rates for employment from ages 40 to 60 were 16% higher for DB members.[3]

In addition to providing less of a retirement benefit for career educators, DC plans also do not provide any additional protection in the event of disability or death. In DC plans, individuals on disability do not receive a benefit and may need to tap into their retirement savings early. Survivors receive whatever remains in the account after the participant's death but do not have the opportunity to receive a guaranteed income. These issues are further exacerbated by the fact that AB 2998 incentivizes a DC plan option with lower contribution rates and, therefore, less retirement savings, increasing risk to those participating employees.

FISCAL IMPACT

Program Costs/Savings – Increased long-term costs to the system due to a potential decline in the active DB member population, which would seriously jeopardize the system's ability to reach full funding through the funding plan. Without any changes, as of the June 30, 2019, actuarial valuation, the employer rate was not projected to increase beyond 18.4%, and the state contribution rate was expected to only require three more years of 0.5% increases beginning July 1, 2020. In contrast, if AB 2998 is enacted and the plan experiences significant decline in membership, employers would contribute the maximum rate allowed for under the funding plan of 20.25%, and the state rate would increase by the maximum 0.5% allowed annually through 2046. Even with these increases, the funding plan would likely not be able to achieve full funding because the overall amount received from districts would be less. Additionally, while those districts that move to offer DC plans may experience some cost savings, those districts that do not offer an alternative

[2] Rhee and Fornia.
[3] Rhee and Fornia pp. 31-32.

DC plan would contribute more than they otherwise would have and be subject to an unfair share of the unfunded liability costs.

Administrative Costs/Savings – Increased upfront cost due to extensive revisions to training and member education materials.

ARGUMENTS

Pro: None identified.

Con: May significantly impact CalSTRS' ability to achieve full funding.

Could increase costs for districts that do not provide the alternative DC plan and require those districts to cover an unfair share of the unfunded liability.

Could increase the fiduciary liability for school districts that administer alternative DC plans.

Could negatively affect school districts bond ratings.

Could contribute to higher teacher turnover and delayed retirements.

Threatens the security provided by the DB Program's retirement, disability and survivor benefits for California's educators and their families.

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