***STATE OF CALIFORNIA***

***California Actuarial Advisory Panel***



May 28, 2025

The Honorable Tina McKinnor
Chair, Assembly Committee on Public Employment and Retirement
1021 O Street, Suite 5520
Sacramento, CA 95814

**SUBJECT: Assembly Bill 1383 (McKinnor) – Request for Technical Clarification and Summary of Potential Actuarial Impacts**

Dear Assemblymember McKinnor:

The California Actuarial Advisory Panel (CAAP) appreciates the opportunity to comment on Assembly Bill 1383, as amended April 11, 2025. CAAP, established under Government Code §7507.2, provides independent actuarial advice on California's public retirement systems. We believe several provisions in AB 1383 would benefit from technical clarification. We also offer comments regarding potential actuarial and administrative impacts.

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## 1. Clarifications Needed

### A. Compensation Limits for Pre-2026 Service

AB 1383 would raise the pensionable compensation limit, prospectively, to align with the federal IRC §415(b)(1)(A) benefit cap. However, it is unclear whether this revised cap would apply exclusively to benefits for service performed on or after January 1, 2026, or retroactively to all accrued benefits. We recommend that the bill be clarified to specify whether the current compensation limit (with continued indexing as described below) continues to apply to benefits for service earned prior to January 1, 2026.

We note that this approach would appear to be more consistent with the existing statutory prohibition on retroactive benefit enhancements under Government Code §7522.44, and Section 7 of the proposed legislation,


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which states that “It is the intent of the Legislature that this act shall not be construed to affect any retirement benefits or pension rights accrued before its effective date." However, the modifications to Section 7522.10 included in the text of AB 1383 (as of the date of this letter) do not clearly describe this approach.

**B. Application to Disability and Death Benefits Based on Final Compensation**

Even if distinct compensation limits are used for pre- and post-2026 service, further statutory clarity is needed to guide the application of these limits to benefits that are not based on particular periods of service — particularly for benefits such as service-connected disability or death benefits that are expressed as a percentage of final pay.

For example, a member with final average pay exceeding the new compensation limit who becomes entitled to a 50% of pay service-connected disability pension after 10 years of service—5 years before 2026 and 5 years after—could have their benefit calculated in multiple ways:

- **Method 1: Use of New Higher Cap Throughout**
  Compensation used = $280,000
  50% of pay = $140,000

- **Method 2: Prorated Compensation Based on Years of Service**
  5 years at $186,096 and 5 years at $280,000
  Average compensation = ($186,096 × 5 + $280,000 × 5) / 10 = $233,048
  50% of pay = $116,524

This difference of over $23,000 in annual benefit underscores the potential fiscal significance. Systems should have clear legislative guidance for how to administer these benefits under the new compensation limits.

**C. Indexing Methodology for Multiple Compensation Limits**

It is also unclear from the current language if the new limit would continue to be tied to the Section 415(b)(1)(A) of Title 26 of the United States Code as adjusted annually or be adjusted as per the rules set in §7522.10(d). We recommend clarifying how the new compensation limit will change annually after 2026.

If two compensation limits remain in use, we recommend confirming that the compensation limit set in §7522.10(c)(1) would continue to be indexed annually using the change in September CPI-U, rounded to the nearest thousandth, as specified in §7522.10(d).

### D. Safety Formula Transition Language

Section 7522.26(g)(2) would require employers to transition safety members hired after January 1, 2013, into a new formula "closest to" the one previously offered under §7522.25. This wording could be considered ambiguous.

For example, the existing 2.7% at 57 formula provides a 2.5% multiplier at age 55—equal to the new 2.5% at 55 formula. This could create confusion about whether the correct transition is to the new 2.5% @ 55 formula (Safety Option 1) or the new 2.7% @ 55 formula (Safety Option 2), which appears to reflect legislative intent. We recommend replacing "closest to" with unambiguous language identifying the intended successor formula.

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## 2. Summary of Potential Impacts

### A. Actuarial Accrued Liability and Normal Cost Increases

The bill states that benefit enhancements apply prospectively. This is consistent with Government Code §7522.44, which prohibits retroactive benefit enhancements. Nonetheless, due to how the Entry Age Normal (EAN) actuarial cost method operates (the method used by all public systems in California for calculating actuarially determined contributions and required under GASB 67/68 for disclosure purposes), the actuarial accrued liabilities (AAL) and unfunded actuarial accrued liabilities (UAAL) will increase even when the changes are applied only to future service.

This is particularly evident when benefits are based on compensation figures that reflect the new higher limit. For example, in the case of service-connected disability or death benefits tied to final pay, a portion of the benefit is implicitly associated with past service. When that benefit is calculated using higher future compensation, liabilities assigned to past service years (i.e., the AAL) increase accordingly.

Even if the benefits associated with past service are not changed, the EAN method will generally allocate higher costs across both the normal cost and AAL. The technical nuances of these calculations are beyond the scope of this letter; for additional information we refer you to pages 12-13 in the Conference of Consulting Actuaries' paper on actuarial funding policies for public pension plans, available from the CAAP's website here.

### B. Member and Employer Contribution Rates

For PEPRA members, current statutes require that members pay at least half of the normal cost (subject to rounding provisions for some groups). As discussed above, the overall normal cost is expected to increase for all groups if they include members with benefits that are expected to be affected by the current PEPRA compensation limits, including non-Safety groups. If this occurs, PEPRA member contribution rates will increase for all members of the group, unless the employer negotiates to pay more than half the normal cost, which would now be allowed under AB 1383. In other words, it is likely that all PEPRA members would be required to contribute more, even though only the more highly compensated individuals will experience any benefit improvement, at least for the non-Safety groups.

In our work as actuaries for our appointing systems and other clients, we are aware that some systems have already begun preparing cost estimates to be shared with stakeholders indicating how the member contribution rate for existing PEPRA members is expected to be impacted by the proposed changes.

For example, CalSTRS expects its PEPRA member contribution rate for its 2% at 62 members will increase by 0.5% of creditable compensation. Also, CalPERS expects an increase in the total normal cost rate of 0.0% - 2.0% (with a median of 0.3%) of pensionable payroll for public agency miscellaneous plans and an increase in the total normal cost rate of 0.5% - 6.0% (with a median of 3.0%) of pensionable payroll for public agency safety plans. Notwithstanding any other negotiated changes to the member rates, the impact to the CalPERS member contribution rates would be an increase equal to 50% of the associated total normal cost changes.

**C. Impact on Risk**

In addition to increasing liabilities and normal cost rates, the changes to the benefit formulas and compensation limits can be expected to increase the future *volatility* of costs. Higher benefits must eventually result in higher liabilities and assets. With more assets invested in the market, investment risk will go up. With higher liabilities, changes in behavior or assumptions that affect those liabilities - such as a potential future reduction in the discount rate - will have a greater impact on the required contributions.

The changes in the benefits may also result in modifications in member behavior that could result in other unexpected downstream effects. For example, improvements in the benefit multiplier for public safety members at earlier ages could result in changes in the retirement patterns for these members. These changes may not only affect plan costs, but also other compensation and personnel-related costs, such as post-retirement medical benefits and training or recruitment expenses.

**D. Administrative Considerations and Implementation Timing**

Implementing the revised compensation limits, especially if they are applied separately to pre-2026 and post-2026 service, presents significant administrative complexity. Retirement systems will need to accurately track and apply multiple limits based on the period of service, revise payroll reporting processes, update benefit calculation software, retrain staff, and educate stakeholders.

These changes may result in substantial administrative costs, including system reprogramming, testing, communication efforts, and ongoing support. In addition, the current proposed implementation date of January 1, 2026, is likely to provide administrative challenges for an effective rollout.

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**3. Summary of Recommendations**

1. Amend AB 1383 to explicitly state how different compensation limits will be determined and applied, and how each limit applies to benefits that are not directly related to specific periods of service, such as disability, death, and other projected service benefits.
2. Clarify indexing methodology for all compensation caps.
3. Clarify §7522.26 transition language to ensure that safety members are transitioned to the benefit formula that is consistent with legislative intent.
4. Ensure all stakeholders understand both the anticipated cost impact and the increased risk for all plans involved.
5. Consider administrative impacts and potential delay in proposed implementation date.

CAAP stands ready to assist with additional feedback or qualitative analysis. Thank you for considering our comments and for your ongoing commitment to sound retirement policy.

Respectfully submitted,

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Chair, California Actuarial Advisory Panel

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