INITIAL STATEMENT OF REASONS

Problem Statement

The CalSTRS Defined Benefit Program is funded through contributions from members, employers and the state, supplemented by investment income. Pursuant to section 22955.5 of the Education Code, each October, on or before October 25, the Teachers' Retirement Board calculates the total amount of creditable compensation for the fiscal year that ended on the preceding June 30 using information provided by employers. CalSTRS submits a report that includes this calculation to the Director of Finance, the Chairperson of the Joint Legislative Budget Committee and the Legislative Analyst. On or before April 15 (generally in early April), CalSTRS notifies the same parties of any revisions to the total amount of creditable compensation since the October calculation. This number forms the basis for the final amount of the next year's state appropriation pursuant to sections 22954, 22955 and 22955.1, and there is no provision for subsequent correction. Therefore, CalSTRS does not receive any state appropriation funds for creditable compensation that is not included in the April revised report.

In order to determine the correct amount of the state appropriation, CalSTRS relies on the timely and correct remittance of information and contributions from county offices of education and district employers that are authorized to report directly to CalSTRS. Late and inaccurate reporting of data can result in inaccurate benefit payments to members and lost state contributions; late contributions result in lost investment opportunities.

Chapter 17 of the Education Code requires that penalties and interest be assessed on employers for late or inaccurate reporting of retirement data and payment of contributions. Effective July 1, 2012, the Penalties and Interest Regulations (Article 15.5, California Code of Regulations) were adopted by the Teachers' Retirement Board to ensure consistent and transparent assessment of penalties and interest in accordance with current laws.

Section 23003 of the Education Code provides that the board shall assess penalties if an employer fails to make payment of contributions as provided in section 23002. Using this authority, current regulations levy a 5 percent penalty for extra-late contributions received from employers after March 1 of the year following the fiscal year in which the contributions were due. The penalty on extra-late contributions is intended to both recoup the amount of lost state appropriation funds that CalSTRS would have received had the reporting been timely and to incentivize employers to report timely.

The penalty does not perfectly mirror or recoup the resulting missed state appropriation funds; however, within the constraints provided by law, the extra-late contributions penalty has served to both approximate the loss sustained by the fund and motivate employers to report and remit contributions more timely. For example, in both 2010–11 and 2011–12, prior to the implementation of the Penalties and Interest Regulations, employers submitted approximately three times the volume of contributions via extra-late reporting as they did in the first year the penalty was assessed, March 2014 through February 2015.

The problem these amendments seek to address is that the current penalty rate falls short in recovering lost state appropriation funds. At the time the Penalties and Interest Regulations were written, the state appropriation rate was lower than it is today. The state appropriation rate increased effective July 1, 2014, and will be subject to adjustment by the Teachers' Retirement Board under Chapter 47, Statutes of 2014 (AB 1469–Bonta), beginning July 1, 2017. The state appropriation rate may be increased by no more than 0.5 percent per year or may be adjusted down as low as 4.517 percent (2.017 percent for the state contribution to the Defined Benefit Program, plus 2.5 percent for the Supplemental Benefits Maintenance Account), in accordance with the funding needs of the plan pursuant to the actuarial valuation.

Benefits Anticipated

Setting the penalty rate to reasonably recoup lost state appropriation funds ensures that the Defined Benefit Program is appropriately funded and not shortchanged by late reporting, which benefits taxpayers, the state and employers who remit contributions according to the law.

Purpose

This amendment is expected to result in (1) recouping from employers an amount that will more closely relate to the actual state rate and (2) retaining the existing incentive for employers to remit contributions and report in a timely fashion by establishing the existing 5 percent penalty rate as the minimum penalty rate.

Rationale

Paragraph (1) of Subdivision (a)

These amendments clarify that "creditable compensation" refers to creditable compensation for which member contributions are credited under the Defined Benefit Program. This is necessary because there are two definitions of creditable compensation in the Teachers' Retirement Law and related regulations. The alternative definition of creditable compensation is creditable to the Defined Benefit Supplement (DBS) Program, a cash balance plan. It is possible without this clarification that "creditable compensation" could be misconstrued to include DBS-creditable compensation.

Paragraph (2) of Subdivision (a)

Paragraph 2 sets the penalty rate as the greater of the state appropriation rate that is in effect on March 1 of the year following the fiscal year in which the contributions were due, or 5 percent.

By proposing a penalty rate that is the same as the state rate that is in place each March 1 immediately preceding the date the extra-late contribution is received, the amendments to the regulations effectively set the penalty rate to lag the state rate by eight months. This is necessary because the penalty assessment year begins on March 1, while the next year's state rate will not be adopted by the board until the valuation is heard in April.

Below is an example illustrating how the penalty rate would be determined for contributions due in 2014–15 but received after March 1, 2016.

<table>
<tr><td colspan="8"></td><td colspan="12">Penalty rate year 2016–17 uses 2015–16 state rate</td></tr>
<tr><td colspan="12">Fiscal year 2015–16: State rate 7.391%</td><td colspan="8"></td></tr>
<tr><td>July</td><td>August</td><td>September</td><td>October</td><td>November</td><td>December</td><td>January</td><td>February</td><td>March</td><td>April</td><td>May</td><td>June</td><td>July</td><td>August</td><td>September</td><td>October</td><td>November</td><td>December</td><td>January</td><td>February</td></tr>
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Contributions are due within five working days following the pay period in which the compensation was earned. The monthly reports that contain the reporting data associated with contributions are due 30 calendar days after the compensation was earned. Thus, contributions for fiscal year 2014–15 that were timely reported should be transmitted to CalSTRS no later than July 5, 2015. Reporting of compensation that is associated with those contributions may occur later. Between October 2015 and April 2016, CalSTRS must finalize the total creditable compensation for the 2014–15 fiscal year and report that number to the Director of Finance, the Chairperson of the Joint Legislative Budget Committee and the Legislative Analyst. This number is then multiplied by the state appropriation rate for 2016–17 and forms the basis for the state appropriation funds received by CalSTRS for fiscal year 2016–17. Therefore, when these regulations were first adopted, March 1 was identified as the most appropriate start date for penalizing contributions, since the reporting associated with those contributions may be received later and therefore be reasonably likely to not be included in the calculation sent to the state.

The state appropriation rate for fiscal year 2016–17 is adopted by the board in April 2016 and becomes effective July 1, 2016. CalSTRS will not receive the 2016–17 state appropriation for any creditable compensation that was earned in 2014–15, but not reported in time to be included in the report to the state.

In theory, to recoup the lost state funds for the 2016–17 fiscal year, any creditable compensation earned in fiscal year 2014–15 that is reported between March 1, 2016, and February 28, 2017, should be assessed a penalty in the amount equal to the 2016–17 state appropriation rate. However, as the penalty rate year runs from March 1 through February 28, on March 1, 2016, there is no way for CalSTRS to know what the state rate will be for the upcoming fiscal year. Therefore, the regulations set the penalty rate to lag the state rate by eight months. Thus, any creditable compensation earned in fiscal year 2014–15 that is reported between March 1, 2016 and February 28, 2017 will be assessed a penalty equal to the state appropriation rate in effect for the 2015–16 fiscal year.

The state rate can only be increased in increments of 0.5 percent, with no maximum annual decrease. Because of the lag in the penalty rate, the potential for underrecovery as opposed to overrecovery of actual lost state contributions is a risk. To mitigate this risk, these amendments establish a minimum penalty rate equal to the current 5 percent, which has historically adequately served its primary function as an incentive to employers to report timely.

Studies, Reports or Other Documents Relied Upon

None.

Economic Impact Analysis

CalSTRS has considered the proposal's impact on business, with consideration of industries affected and information supplied by interested parties, including the ability of California businesses to compete with businesses in other states.

These amendments are expected to result in costs to school employers (including school districts, community college districts and county offices of education) that remit contributions late. CalSTRS has determined that the regulations proposed do not constitute a major regulation as the total economic output in the first 12 months is not expected to exceed $50 million. The total economic output during that period has an initial negative impact of $633,000 statewide. Over the long term, CalSTRS expects that encouraging employers to report timely via collection of penalties will result in a modest benefit to the state and school employers as a whole and, thus, to taxpayers and the economy.

These regulations are not anticipated to have any effect on California businesses. Specifically:

- The action will have a negligible induced effect on the creation or elimination of jobs within the state.
- The action will not affect the creation of new businesses or the elimination of existing businesses within the state.
- The action will not affect the expansion of businesses currently doing business within the state.
- The action will have no effect on the health and welfare of California residents, except as described above, and no effect on worker safety and the state's environment.

Economic Effect on Business

CalSTRS concludes that there will be no economic impact on business, including no effect on the ability of California businesses to compete with businesses in other states. These regulations do not place any economic burden on business as they do not place any additional licensing, record keeping or compliance requirements on businesses. These regulations primarily affect school districts, community college districts, county offices of education and other employing agencies, and no direct or indirect effect on businesses is anticipated. Induced effects in the economy were modeled, revealing negligible impact statewide of -1.8 jobs and -$290,800 on the economy statewide. These impacts do not place disproportionate burden on any particular business activity or sector.

Conferring with Interested Persons

Pursuant to Government Code section 11346.45, CalSTRS staff provided information and solicited input regarding this proposed action with stakeholder groups, including representatives of the California Teachers Association, the Faculty Association of California Community Colleges, the California Federation of Teachers, the Small School Districts' Association, the Association of California School Administrators and other representative groups, and the CalSTRS Employer Advisory Committee.

CalSTRS staff has provided information to the Department of Finance regarding the proposed amendments and their economic and fiscal impact.

Alternatives Considered

Alternatives considered, and the reasons each were rejected, are discussed below.

> Alternative 1: Hold billings or bill employers at a tentative rate beginning March 1, finalizing the rate after the state rate is adopted by the board at the actuarial valuation each April. This alternative would allow CalSTRS to collect an amount that most closely approximates the actual loss to the fund–because it **would be at the actual state appropriation rate** and **based on the actual lost state appropriation funds.**
>
> However, staff determined this approach would impose an unacceptable burden of uncertainty on employers that might be subject to later corrections or re-billings under such a policy. This option also would be subject to administrative complexity as a result of tentative billing, rebilling, returning excess collections and managing competing rates in the administering software.
>
> Alternative 2: Shift the effective date of the penalty. This would allow CalSTRS to assess a penalty that is the same as the state rate adopted by the board for the year relating to the service period being penalized. This would work if the penalty was assessed on a May to April cycle, rather than a March to February cycle. This would allow CalSTRS to collect at **the actual state appropriation rate**, but the amount collected **would not be based on actual lost state appropriation funds.**
>
> This alternative would discard the key purpose of the regulations to capture late contributions that relate to creditable compensation that is not included in the last report to the state, generally produced at the beginning of April, because the yearly penalty cycle would no longer begin on the date extra late contributions are most likely to result in missed state appropriations. In addition, this alternative introduces new complexity and resulting procedural and training needs that would be unduly burdensome relative to the advantages they would introduce.
>
> Alternative 3: Increase the penalty rate, consistent with anticipated future state appropriation rates, to a flat rate higher than the one currently in place. This alternative

would allow CalSTRS to collect at a rate that is **unlikely to be the actual state appropriation rate** but **would be based on actual lost state appropriation funds**.

To most adequately fulfill the purpose of the regulation, imposing a rate that could fluctuate up or down was identified as a more desirable alternative that would provide the ability to more closely recoup the actual loss sustained as a result of late reporting and would be less likely to result in under or overrecovery of penalties from employers relative to actual losses.

Alternative 4: Do nothing. Under this alternative, a portion of the cost of unrecouped lost state contributions would not be borne by employers who remit extra late contributions; it would instead be covered initially by the state beginning in 2017 and by employers as a whole beginning in 2020. This alternative has no cost or benefit as it does not change the regulations currently in place. The cost to the state and employers is the result of Chapter 47, Statutes of 2014 (AB 1469–Bonta).

The standards contained in these regulations were determined to strike an appropriate balance between making late-reporting employers responsible for making the fund whole when late reporting threatens CalSTRS' ability to accurately calculate the amount of creditable compensation on which the state appropriation is based and avoiding the imposition of new complex processes or unpredictable penalty rates on school districts, community college districts, county offices of education or CalSTRS.

CalSTRS has not identified any alternative that would lessen any adverse impact on small businesses. No alternative has been proposed that would be less burdensome and equally effective in achieving the purposes of the regulation in a manner that accomplishes the purposes of the statute being implemented.