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[Fitch: Calif. Court Decision Maintains Pension Protections]

Fitch Ratings-New York-05 August 2020: In a much-anticipated ruling last week, the California Supreme Court upheld a 2012 state pension reform provision that prevents pension “spiking” while simultaneously choosing not opining on, and therefore leaving in place, the “California rule,” a legal doctrine that sets a high bar for rolling back the pension benefit provisions of existing workers. The ruling has no impact on Fitch’s ratings on California state and local governments, as the 2012 reforms and limitations on changing benefits are already assumed in Fitch’s analysis.

Fitch views the court’s affirmation of the anti-spiking provision as a positive step toward eventually achieving the savings envisioned by the state’s comprehensive 2012 reform package. However, most of these savings will be limited and take decades to emerge. In the meantime, retaining the California rule leaves governments in California with little discretion to manage their pensions, and underscores that near-term funding trends will be driven by more immediate factors, including asset performance, actuarial and economic assumptions and the ability of participating governments to continue making rising contributions. Other cases challenging the California rule have been on hold awaiting last week’s decision. Since the court did not opine on the rule itself, the new ruling fails to offer a precedent for these other cases.

In Alameda County Deputy Sheriff’s Association v. Alameda County Employees’ Retirement Association, employees had sought to overturn the restriction on spiking, a practice that allowed excess compensation to be earned by employees nearing retirement in order to inflate future benefits. The restriction was adopted in 2012 as part of the Public Employees’ Pension Reform Act (PEPRA), the comprehensive pension reform law that broadly rolled back benefits for workers hired beginning on Jan. 1, 2013.

At the time of passage, PEPRA was anticipated to save $42 billion to $55 billion over 30 years just in the plans administered by the California Public Employees Retirement System (CalPERS); additional savings could be expected in the California State Teachers’ Retirement System, county systems operating under the County Employees’ Retirement Law (CERL) and the University of California Retirement System.

Most benefit changes in PEPRA pertained to new hires, although a handful of provisions affected existing workers, including the anti-spiking provision. Benefits for existing workers are protected under the California Rule, a legal interpretation of contract protections dating to a 1955 state Supreme Court case that limits the ability to modify pension benefit provisions of current workers, unless offset by other benefits of equal value. The impact is that governments subject to it can change benefits only for new hires, and therefore any savings from reform only accrue gradually over decades, as employee turnover shifts the workforce into the newer, lower benefits structure. Many other states have modeled their own contract protection of pensions on the California rule, although other states have adhered to somewhat less restrictive contract protections, including those that permit changes to benefits prior to vesting or changes to noncore benefits, such as cost-of-living adjustments.

PEPRA is undoubtedly improving the sustainability of California’s public pensions, as more of the workforce is covered under PEPRA benefit provisions and as the court affirms some of the minor reform provisions applicable to workers hired before 2013. The ruling last week held that closing the spiking loophole among county systems subject to CERL was within the powers of the legislature, without having to grant an offsetting benefit. It marks the top court's second decision in two years affirming specific PEPRA reforms while leaving the California Rule untouched. In March 2019, the ruling in Cal Fire Local 4881 v. California Public Employees' Retirement System preserved PEPRA's prohibition on "airtime", a practice whereby employees could buy additional years of retirement service credit.

Contact:

Douglas Offerman
Senior Director
+1 212-908-0889
Fitch Ratings Inc.
Hearst Tower, 300 West 57th Street
New York, NY 10019

Amy Laskey
Managing Director
+1 212-908-0568

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com