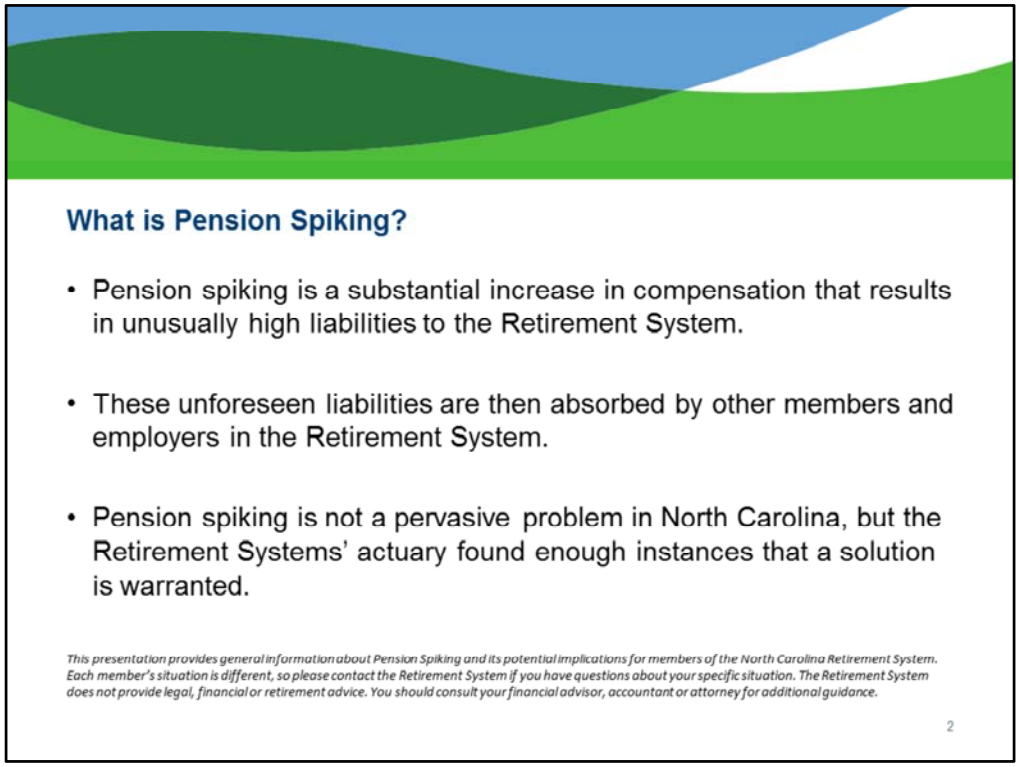


LGERS Anti-Pension Spiking Contribution-Based Benefit Cap

North Carolina
Total Retirement Plans

Dale R. Folwell, CPA
State Treasurer of North Carolina

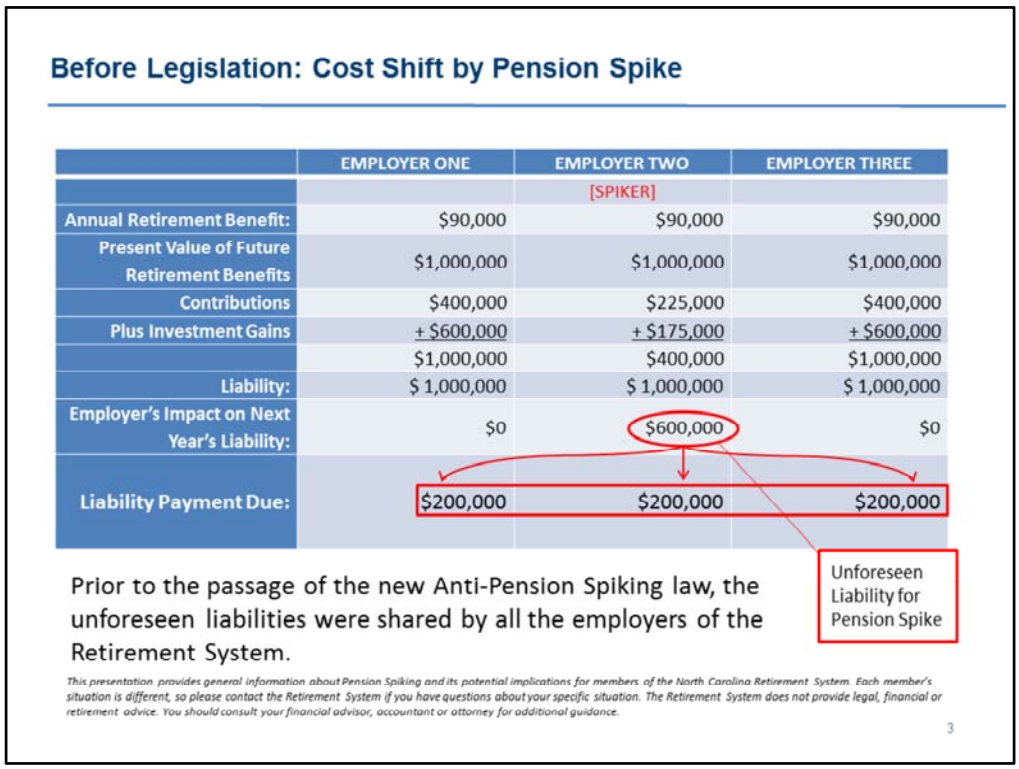
August 2018



For the purpose of this legislation, pension spiking is defined as a substantial increase in compensation that results in unusually high liabilities to the Retirement System, which would have to be absorbed by other members and employers in the Retirement Systems.

- A number of factors can cause a substantial increase in compensation, including significant late-career promotions, conversion of benefits into compensation and leave payouts at retirement.
- Some states have had major issues with pension spiking, but the problem is less pervasive in North Carolina.
- However, the Systems' actuary conducted a review and determined that it was costly enough to warrant a solution.
- So, it was necessary to address pension spiking

because it erodes public confidence in the Retirement Systems and it results in increased costs across the board. For example…



Let's see how pension spiking results in increased costs…
In the NC Retirement Systems, all employers pay a set percentage of payroll to the system, and one employer engaging in pension spiking impacts the amount that all employers must pay.

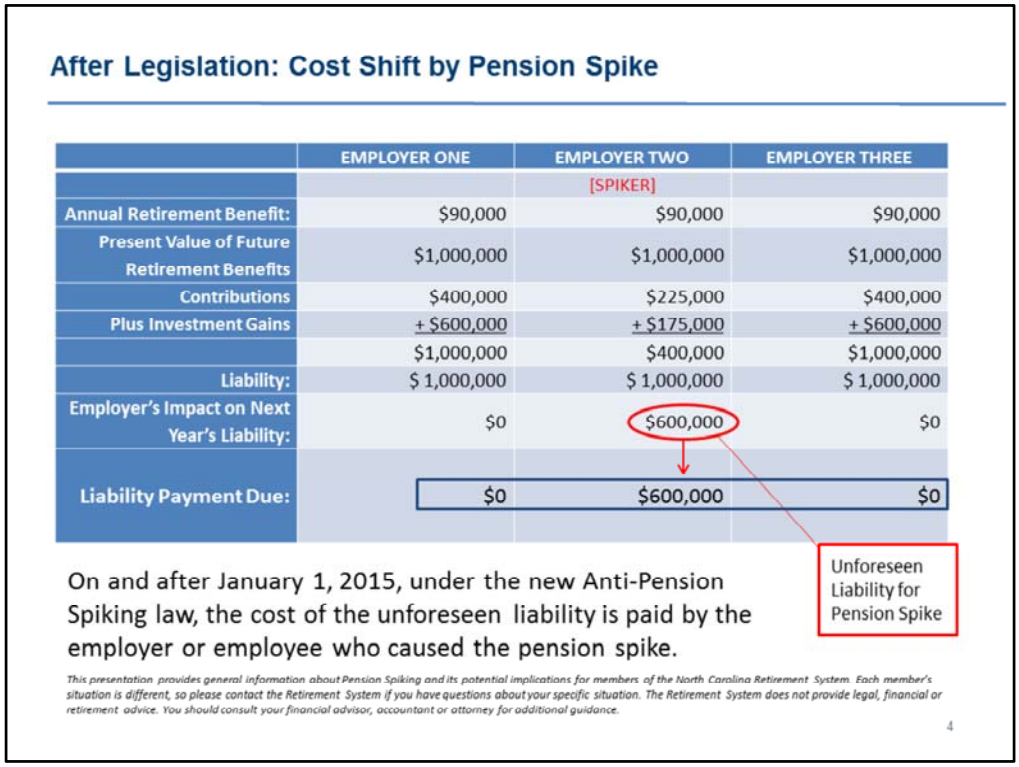
<u>Employers 1 & 3:</u>

- Gave raises and promotions that are, on average, similar to the raises and promotions provided by other employers.
- Paid in exactly the right amount to cover 100% of the liabilities they incurred.

<u>Employer 2:</u>

- Gave large salary increases during the last few years of employment to boost retirement benefits.
- Since Employer 2 only paid contributions on the higher salary for a few years, they paid in less money overall than Employers 1 & 3.
- And since Employer 2 contributions were only in the system for a comparatively short period of time, the investment gains are much lower than the investment gains on Employer 1 & 3's contributions.

Employer 2 has accumulated contributions that are $600,000 below what is necessary to fully fund the system. Consequently, that extra $600,000 liability will be split equally among all three employers in the following year, resulting in an across-the-board increase in employer contribution rates.



After Legislation: Cost Shift by Pension Spike

	EMPLOYER ONE	EMPLOYER TWO	EMPLOYER THREE
		[SPIKER]	
Annual Retirement Benefit:	$90,000	$90,000	$90,000
Present Value of Future Retirement Benefits	$1,000,000	$1,000,000	$1,000,000
Contributions	$400,000	$225,000	$400,000
Plus Investment Gains	+ $600,000	+ $175,000	+ $600,000
	$1,000,000	$400,000	$1,000,000
Liability:	$ 1,000,000	$ 1,000,000	$ 1,000,000
Employer's Impact on Next Year's Liability:	$0	$600,000	$0
Liability Payment Due:	$0	$600,000	$0

Unforeseen Liability for Pension Spike

On and after January 1, 2015, under the new Anti-Pension Spiking law, the cost of the unforeseen liability is paid by the employer or employee who caused the pension spike.

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- This law shifts the burden of paying for pension spiking to the employer or employee whose compensation decisions caused the benefit to exceed the cap..
- So Employer 2, the spiker, will pay the unforeseen liability and the other employers will not be impacted.

- The Department of State Treasurer endorsed this proposal because it affects only people who spike pensions in a manner that creates a significant liability on the Retirement System.
- Other proposals to address pension spiking include:
  - Not allowing salary increases over 10% per year to be considered for Retirement purposes
  - Increasing the AFC period to 10 years (lower benefits for all)



So, to explain this law, I'm going to use a baseball analogy.

How does the new game work?

Example		Meaning
	Baseball	Retirement Application Form (Form 6)
	Pitcher	Members
	Batter	The Retirement System
	Umpire	The Anti-Pension Spiking Law

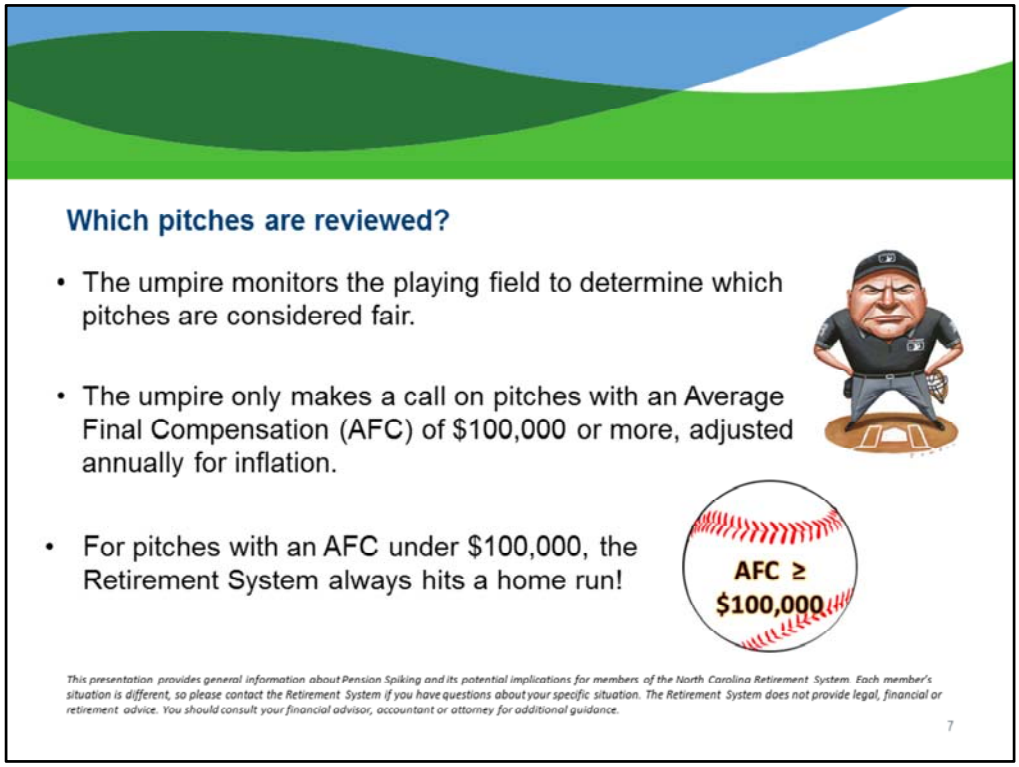
- Before the Anti-Pension Spiking law, the Retirement System had to swing at every pitch.
- The Anti-Pension Spiking law introduces an umpire to ensure more quality pitches.

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- To explain pension spiking, we're going to use a baseball analogy.

(see slide)



- It's important to remember not every retirement application (or ball) is subject to review for pension spiking.
- The Retirement System (or umpire) has a threshold to decide which pitches are reviewed.

(see slide)

A pitch the umpire does not review



If the pitcher throws a ball with an AFC under $100,000, the batter swings and hits the ball out of the park. It's a home run!

But how did the batter know to swing?



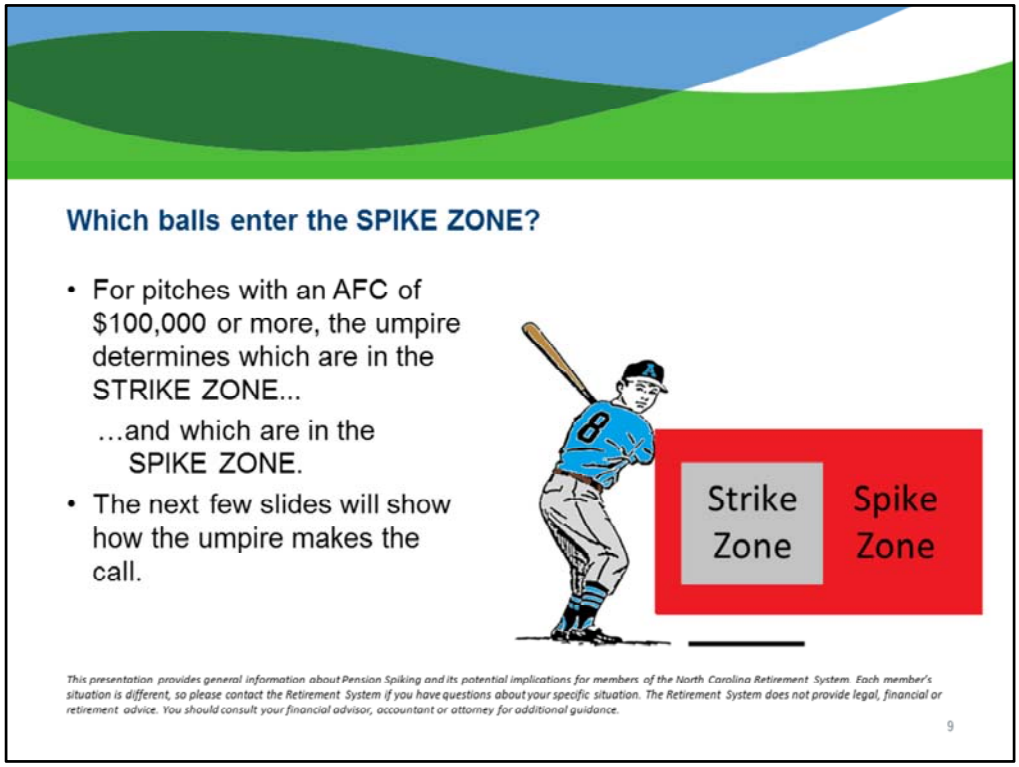
Since the pitcher's AFC was under $100,000, the umpire does not review the pitch.

The member's retirement benefit is processed and paid.

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(see slide)



- Some members will retire with an AFC over $100,000—this is where the umpire comes in to determine which are in the STRIKE ZONE…and which are in the SPIKE ZONE.

- The next few slides show how the umpire makes the call.

A pitch in the STRIKE ZONE

Example of a pitch over the plate:



Name	Prudence Parker
System	Local Governmental
Retirement System Entry Date	1/1/1985
Retirement Date	1/1/2015
Age at Retirement	57
Years of Service	30
AFC	$175,000
Pension Benefit	$97,125 per year

- Prudence Parker received annual raises of 6% per year and did not receive a pension spike during the AFC period.
- The umpire reviews the pitch and determines that it is in the STRIKE ZONE.

Amount Employer Owes Retirement System = $0

This example uses a Pension Spiking factor of 4.7. The Board of Trustees selected a factor of 4.5 for TSERS and 4.7 for LGERS during the October 2015 Board Meeting.

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Pitch over the plate, in the STRIKE ZONE: Prudence Parker

- Local Governmental System
- Retirement System Entry Date: "This is the first time you paid a 6% contribution to the plan from which you retire."
- Since she entered the system before January 2015, her benefit cannot be reduced by the new law—so the umpire is just trying to determine if Prudence's employer owes the system any money.
- She retires next year at age 57 with 30 years of service.
- AFC=$175,000, which results in a $97,125 annual benefit.
- She received annual 6% raises, and the umpire reviews the pitch and determines that her employer doesn't owe any additional money.

A ball in the SPIKE ZONE

Example of a ball that enters the SPIKE ZONE:



Name	Steven Spiker
System	Local Governmental
Retirement System Entry Date	1/1/1985
Retirement Date	1/1/2015
Age at Retirement	57
Years of Service	30
AFC	$175,000
Pension Benefit	$97,125 per year

- Steven Spiker received annual raises of 6% per year and receives $40,000 in additional compensation as a result of benefit conversion during the AFC period.
- The umpire reviews the pitch and determines that it is in the SPIKE ZONE.

Amount Employer Owes Retirement System ≈ $107,000

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Ball in the STRIKE ZONE: Steven Spiker

Steven Spiker is also…(LGERS, same entry date, etc.)

But, in addition to his annual 6% raises, his employer agrees to convert a non-salary benefit, say a housing allowance, into salary during the AFC period to boost the salary used in the retirement calculation.

In this case, the pitch is in the SPIKE ZONE—and the employer owes about $107,000

Prudence Parker vs. Steven Spiker

- Both Prudence Parker and Steven Spiker retired on the same day from the same system with the same pension benefit.
- The big difference is that Prudence Parker and her employer paid more into the Retirement System than Steven Spiker and his employer.
- When Steven Spiker retires, his employer owes an additional ~$107,000 to make up for this difference.
- This charge to the employer is the increased cost that the Retirement System would have borne in the absence of the new anti-spiking statute to pay the same benefit to Steven Spiker as Prudence Parker.





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To reiterate…

(see slide)

The future of the SPIKE ZONE

Example of a ball that enters the SPIKE ZONE after 2020:



Name	Steven Spiker, Jr.
System	Local Governmental
Retirement System Entry Date	***1/1/2015***
Retirement Date	1/1/2045
Age at Retirement	57
Years of Service	30
AFC	$175,000
Pension Benefit	$97,125 per year

- Just like his dad, Steven Spiker, Jr. received annual raises of 6% per year and an additional $40,000 as a result of benefit conversion during the AFC period.
- The umpire reviews the pitch and determines that it is in the SPIKE ZONE.
- Since Steven Spiker Jr. first entered the Retirement System in 2015, he has options….

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Now, let's look at how this law impacts someone hired on or after January 1, 2015.

Steven Spiker, Jr. is just like his dad, except he enters the Retirement System on January 1, 2015

(see slide)

Options for members first hired in 2015 or later

- When Steven Spiker, Jr. retires he has three options:
  1. He can accept a reduced pension benefit, or
  2. He can pay the ~$107,000 himself, or
  3. His employer can choose to pay the ~$107,000 owed to the Retirement System.



- If Steven Spiker, Jr. chooses option #1, his annual pension benefit would decrease by $9,372 – from $97,125 to $87,753

This example uses a Pension Spiking factor of 4.7. The Board of Trustees selected a factor of 4.5 for TSERS and 4.7 for LGERS during the October 2015 Board Meeting.

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(see slide)

Calculation details for Prudence Parker

Average Final Compensation		$175,000.00
Local Governmental Multiplier	×	0.0185
Years of Service	×	30
Maximum Benefit Amount*		**$97,125.00**



Accumulated Employee Contributions		$263,805.07
Annuity Factor (for age 57)	÷	11.4455
Contribution Based Benefit Cap Factor*	×	4.7
Contribution Based Benefit Cap		**$108,329.37**

Amount Owed to Retirement System	**$0**

The cap <u>does not</u> have an impact because the maximum benefit of $97,125.00 is less than the cap of $108,329.37.

*Choice of an alternative retirement benefit payment option, such as a joint and survivor payment option, does not alter the calculation.
*This example uses a Pension Spiking factor of 4.7. The Board of Trustees selected a factor of 4.5 for TSERS and 4.7 for LGERS during the October 2015 Board meeting.

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(go through calculation)

Calculation details for Steven Spiker



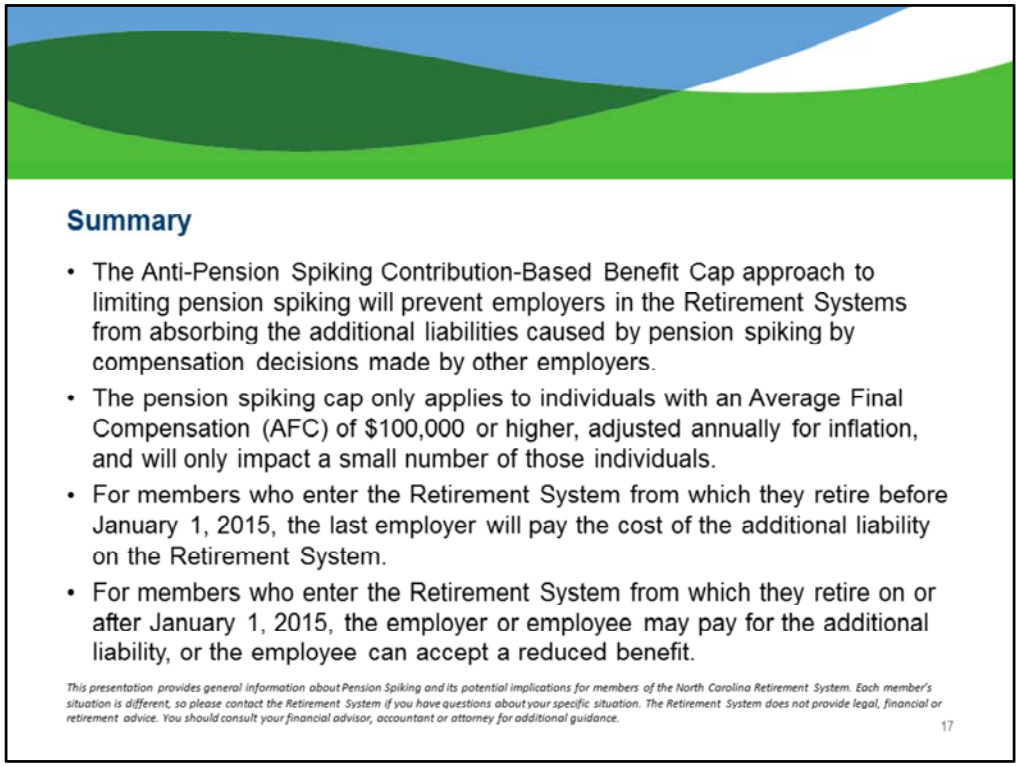
Average Final Compensation		$175,000.00
Local Governmental Multiplier	×	0.0185
Years of Service	×	30
Maximum Benefit Amount*		**$97,125.00**
Accumulated Employee Contributions		$213,698.27
Annuity Factor (for age 57)	÷	11.4455
Contribution Based Benefit Cap Factor*	×	4.7
Contribution Based Benefit Cap		**$87,753.43**
Maximum Benefit – Benefit Cap		$9,371.57
Annuity Factor (for age 57)	×	11.4455
Amount Owed to Retirement System		**$107,262.32**

The cap <u>does</u> have an impact because the maximum benefit of $97,125.00 is greater than the cap of $87,753.43.

*Choice of an alternative retirement benefit payment option, such as a joint and survivor payment option, does not alter the calculation.
*This example uses a Pension Spiking factor of 4.7. The Board of Trustees selected a factor of 4.5 for TSERS and 4.7 for LGERS during the October 2015 Board meeting.

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(go through calculation)
But…there is hope…if Steven Spiker decided to work for another year, the value of his contributions would have caught up with him and he would no longer be caught by the cap.



The Retirement System will provide a monthly report to each employer listing those employees who would be most likely to require an additional employer payment, if they were to retire in the next year.


North Carolina
Total Retirement Plans
Dale R. Folwell, CPA
State Treasurer of North Carolina
Dale R. Folwell, CPA
Thank you
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