Brief: The Anti-Pension Spiking Contribution-Based Benefits Cap (CBBC) at Two Years Old, an Evaluation

Executive Summary

The Fiscal Integrity/Pension-Spiking Prevention Act, Session Law (S.L.) 2014-88 was enacted by the North Carolina General Assembly in 2014 and contained the benefit cap which serves to control the practice of "pension spiking," by preventing all employing public agencies participating in the Teachers' and State Employees' Retirement System (TSERS) and the Local Governmental Employee's Retirement System (LGERS) from absorbing certain unforeseen liabilities caused by compensation decisions made by other employing agencies in the systems. The Law also applies to liabilities caused by non-pension spiking factors such as significant late career promotions. Further, the law allows government entities to maintain the flexibility to set compensation and only applies to retirements of employees with an average final compensation (AFC) of $100,000 or more, adjusted annually for inflation, and is limited to no more than 0.75% of expected retirements in a given year.

Finding

The Department of State Treasurer believes the new law is functioning as designed and does not require major modification. It is reducing the monetary impact on the TSERS and the LGERS of unexpected liabilities caused by employer compensation decisions on highly compensated public employees and significant late career promotions. There is also anecdotal evidence that the law is impacting employer behavior by discouraging compensation decisions that shift liability from local budgets to the retirement systems. While the new law is functioning as designed, there are some minor, largely technical, improvements that could be made by the General Assembly that are discussed at the end of this brief.

Analysis of Total Cases by Average Final Compensation Category

As of November 2016, there have been 64 retirements that have triggered CBBC liabilities, with invoices to employers totaling $6.8 million. This $6.8 million represents the amount of negative monetary impact that employer compensation decisions regarding highly compensated employees would have had on the retirement systems if the law had not been in place.

Table 1: TSERS & LGERS CBBC Liabilities by Average Final Compensation of Retirees

	< $125,000	***$125,000-149,999***	***$150,000-174,999***	***> $175,000***	***TOTAL***
LGERS	$ 231,376	$ 174,673	$ 572,164	$ 274,146	$ 1,252,360
TSERS	$ 358,724	$ 440,107	$ 1,422,602	$ 3,283,250	$ 5,504,683
TOTAL	$ 590,100	$ 614,780	$ 1,994,766	$ 3,557,396	$ 6,757,043
% of $	9%	9%	30%	53%	100%
# of Cases	18	15	16	15	64
Average	$32,783	$40,985	$124,672	$237,159	$105,578

Table 1 illustrates that of the $6.8 million in CBBC liabilities incurred thus far, 53% of the liabilities have been incurred in the 15 cases involving retirees with an average final compensation exceeding $175,000. The average amount owed to the retirement systems for cases in the highest AFC category was $237,000 and the average owed for cases in the lowest category was $33,000.

Analysis by Type of Agency

Table 2 shows that school systems have incurred $2.8 million, or 41% of all CBBC liabilities, the largest share among agencies affected by the legislation. The smallest share, 1%, of CBBC liabilities has been incurred by state agencies, which have only yielded three cases.

Table 2: TSERS & LGERS Liabilities by Type of Employing Agency

	# Cases	*Amount of CBBC Liability*	*% of CBBC Liabilities*
School Systems	21	$ 2,782,792	41%
UNC System	15	$ 1,420,647	21%
Local Governments	18	$ 1,252,360	19%
Community Colleges	7	$ 1,200,685	18%
State Agencies	3	$ 100,560	1%
TOTAL	64	$ 6,757,043	100%

Pending Litigation

The 64 CBBC liabilities have been incurred by 54 different public agencies. Of the 64 liabilities, 59 have been paid or payment arrangements are in place. Four local school boards have engaged in multiple legal actions designed to avoid paying the CBBC liabilities that have been incurred for five retirements from their school systems. These agencies have received invoices from the state totaling $1.8 million.

Table 3: CBBC Liabilities Incurred by the Four School Systems Engaging in Legal Action Against the State to Avoid Paying the Funds to TSERS

Cabarrus County Schools	$ 208,405.81
Johnston County Schools	$ 435,913.54
Union County Schools	$ 548,034.26
Wilkes County Schools	$ 590,694.32
TOTAL	$ 1,783,047.93

The Cap Factor and Its Practical Impact

The law requires the TSERS and LGERS Boards of Trustees (Boards) to set the actuarial factors used for the calculation such that no more than 0.75% of retirements are impacted. Since the law has been in effect, there have been approximately 31,456 retirements processed for TSERS and LGERS. The 64 retirements impacted by the law represent 0.2% of the retirements processed. This figure is well within the 0.75% limit set by the General Assembly.

The "cap factor" is one of the two primary actuarial factors set by the Boards to determine the cost of a CBBC liability. The cap factor is a mechanism for assigning a percentage of the value of the benefit that will be a required contribution from the member to pay for his or her pension benefit. Consequentially, S.L. 2014-88 requires that highly compensated members first hired after January 1, 2015, must contribute "x%" of the cost of the pension benefit. The law then envisions the "x%" as a figure that represents a threshold at which the benefit-to-contributions ratio is considered an outlier. The Boards are authorized in the statute to identify this threshold at least quinquennially in conjunction with the approval of the Actuarial Experience Investigation. For example, if one of the Boards selects 5.1 as the cap factor, then the employee contributions must pay for 19.6% of the value of the benefit (1 divided by 5.1). Similarly, if a Board selects 4.1 as the cap factor, it requires that the employee contributions pay for 24.4% (1 divided by 4.1) of the value of the benefit. Currently, the cap factor selected by the TSERS Board is 4.5 (22.22% of the value of the benefit) and the LGERS Board's factor is 4.7 (21.28% of the value of the benefit).

The contribution deficit represents the percentage difference between the contribution required under the anti-pension spiking law and the amount actually contributed by the member and is an indicator of the degree to which the case is an outlier. Two examples of this concept are provided below in Table 5. The ranges of the deficit percentages by type of agency are illustrated in Table 4. E.g., deficit percentages for School Systems ranged from 9% to 0.11%. A 9% deficit in TSERS means that the member's contributions made up 13.2% of the value of the benefit.

Table 4: Ranges of Percentage Deficit in Required Contributions by Agency Type

	Maximum Deficit Percentage	***Minimum Deficit Percentage***
School Systems	9.00%	0.11%
UNC System	4.25%	0.55%
Local Governments	3.64%	0.19%
Community Colleges	6.85%	0.37%
State Agencies	1.38%	0.07%
All Types of Agencies	9.00%	0.07%

Table 5 shows details regarding the development of the CBBC liability for a case with a large contribution deficit and a case with a large value of the benefit ("Benefit Value").

Table 5: Calculation of CBBC Liabilities and Contribution Deficit for Two Example Cases		
Calculation of Hypothetical Maximum Benefit	***CBBC Case with a Large Contribution Deficit***	***CBBC Case with a Large Benefit Value***
(1) Average Final Compensation	$ 222,578	$ 326,428
(2) Benefit Accrual Rate	0.0182	0.0182
(3) Years of Membership Service	29.67	31.50
(4) Hypothetical Max Benefit ((1)*(2))*(3)	$ 120,177	$ 187,141
(5) Value of Benefit (4)* (8)	$ 1,458,591	$ 2,081,755
(6) Monthly Benefit Amount (4)/"12"	$ 10,015	$ 15,595
Calculation of Contribution-Based Benefit Cap		
(7) Accumulated Member Contributions Derived from Membership Service	$ 192,866	$ 395,584
(8) Actuarial Annuity Factor for Member's Age *(see explanation below)*	12.137	11.124
(9) Actuarial CBBC Cap Factor	4.5	4.5
(10) Contribution-Based Benefit Cap ((7)/(8))*(9)	$ 71,508	$ 160,026
Calculation of Amount Owed to Retirement System		
(11) Maximum Benefit - Benefit Cap (4)-(10)	$ 48,669	$ 27,115
(12) Actuarial Annuity Factor *(see explanation below)*	12.137	11.124
(13) Amount Owed to Retirement System (11)*(12)	$ 590,694	$ 301,629
Calculation of Contribution Deficit		
(14) Accumulated Contributions % (7)/(5)	13.22%	19.00%
(15) Accumulated Contributions % Required "1"/(9)	22.22%	22.22%
(16) Contribution Deficit % (15)-(14)	(9.00%)	(3.22%)

Employer Pays for Currently Vested Employees

For members first hired before January 1, 2015, the final employer of the member before his or her retirement must make up the deficit to the retirement system. For members first hired after that date, the final employer or the retiring member must make up the deficit or the retiree's benefit is actuarially reduced to make up the difference.

The Annuity Factor and Its Practical Impact

In addition to the cap factor discussed above, the other primary actuarial factor set by the Boards to determine the cost of a CBBC liability is the "annuity factor." The annuity factor is an age-dependent factor that encapsulates the total annuity value for service retirements. The factors are based on an annual interest rate of 7.25% and the mortality assumption used for the payment option factors in the retirement systems.

As a result of the Actuarial Experience Reviews (Experience Reviews) approved by the Boards in January 2016, the retirement system will begin using new annuity factors for retirements where

benefits commence on or after January 1, 2017. One key finding of the Experience Reviews was that TSERS and LGERS retirees are living longer. Consequently, the new annuity factors will result in higher costs to agencies required to pay for contribution deficits under the CBBC law.

If the 63 CBBC liabilities assessed using the "old" annuity factors used the "new" factors, the total of the liabilities incurred would be $9.9 million, which is $3.1 million higher than the $6.8 million actually incurred. This represents a 46% increase in the cost. Since the Experience Review process inherently has a five-year lag time, it could be correctly argued that the amount charged for the pension spikes in the first two years of the policy have actually been 45% lower than the actual impact to the system.

Analysis of the Cap Factors at Different Average Final Compensation (AFC) Thresholds

AFC in TSERS and LGERS is an average of a member's highest four years of pensionable compensation and is a component of the formula that defines the amount of a retiree's benefit. The CBBC law only applies to retirements where the member's AFC is equal to or higher than $100,000. Pursuant to a request from a member of the General Assembly, the Department has prepared the following analysis of increasing that AFC threshold from $100,000 to $125,000, $150,000, or $175,000.

As discussed above, the Boards select a cap factor required under the CBBC law. The statutory requirement that the Boards select a number not expected to impact more than 0.75% of retirements in a given year imposes limits on the authority of the Boards in that the Boards may not adopt a factor that would be expected to exceed this bound. For example, if a Board were to select 3.1 as a cap factor, then the employee contributions would pay for 32.3% of value of the benefit (100 divided by 3.1). However, many more pension benefits would be affected by such a low cap factor, and the General Assembly was simply trying to bring the outliers (i.e. those retirement benefits paid for by the lowest percentage of member contributions) back into a normal range of the expected proportion of contributions for a given benefit amount.

However, the existence of the CBBC law itself indicates the General Assembly's intent that the cap factor impacts at least some benefits. On this basis, the Boards asked the consulting actuary to provide data on the "maximum allowable cap factor" and the "minimum allowable cap factor" and then selected the midpoint between the two extremes. Given that the Boards have generally taken the approach of selecting a cap factor in the middle of the range of possible factors, then any law change that affects the midrange of the cap factor could cause the Boards to revisit the decision. Thus, under the proposed change(s), the Boards would likely have to reset the cap factors to both impact more retirees at a higher threshold and increase the cost of each CBBC liability.

For example, if the AFC were raised to $150,000, then in order for the same number of retirements to be affected, the Boards would have to adjust the cap factor. If the combination of statute and Board policy determined that 64 retirees were the correct number to be identified over the period from January 2015 to November 2016, but the AFC threshold were

raised to $150,000, then 18 + 15 = 33 (see Table 1, above) previously identified cases would be excluded and the factors would need to be adjusted so that 33 other cases among those with AFC over $150,000 would now incur an additional contribution. Our analysis below shows that this would actually result in agencies paying a greater amount in additional contributions, even just considering the cases identified under the current lower threshold.

Table 6 provides an estimate of what the total cost to all employing agencies would have been if the Board had selected the mid-range cap factor using the new annuity factors for the 62 of the 64 CBBC cases that actually occurred between January 1, 2015 and November 30, 2016 which had effective dates earlier than January 1, 2017 and further provides a snapshot of what that would have been under different AFC thresholds. The $9.9 million cost on the first row represents selecting the mid-range cap factors using the current $100,000 AFC and the higher costs that would have realized under the annuity factors in effect after January 1, 2017. Similarly, the next three rows indicate what the total cost would have been for the cases that actually occurred if the higher AFC thresholds would have been in effect alongside the new annuity factors. This should be considered a minimum estimate of increase in costs because more cases would have been identified if the lower cap factors had been in effect.

Due to data limitations, we are unable to provide a reliable estimate of the increased number of cases that would have been identified under the lower cap factor. But simply increasing the cost of each CBBC case to the mid-range cap under the $125,000 threshold would have been a 60% increase in costs to employing agencies. Additionally, while a higher threshold would mean that agencies do not need to be concerned about legitimate raises that bring salaries up to an amount below $125,000, it also would allow agencies to intentionally spike pensions below this pay level without fear of consequences.

Table 6: Analysis of the Mid-Range Cap Factors at Different AFC Thresholds

	TSERS Mid-Range Cap Factor	LGERS Mid-Range Cap Factor	Total Cost to Agencies of Selecting Mid-Range Cap Factor and Using Annuity Factors Effective 1/1/2017
Using Current $100K AFC Threshold	4.5	4.7	$9.9M
Using Hypothetical $125K AFC Threshold	3.8	4.0	$16.7M
Using Hypothetical $150K AFC Threshold	3.0	3.4	$18.9M
Using Hypothetical $175K AFC Threshold	2.8	3.0	$11.9M

Four Law Changes that Would Facilitate Administration

Staff of the Retirement Systems Division (RSD) identified two law changes that would facilitate administration of the Contribution-Based Benefits Cap that were introduced in legislation during the 2016 short session, but did not pass.

1) Anti-Pension Spiking Contribution-Based Benefits Cap Payment Plans

Extends the length of current interest-free payment plans for monies owed to the Retirement System under the anti-pension spiking contribution-based benefit cap from 12 months to up to 15 months to allow agencies more time to correct records and to provide that payment plans may always cross a fiscal year. Optionally offers a payment plan of up to 27 months in length that charges interest at rate equal to the investment return assumption of the Retirement System.

2) Anti-Pension Spiking Contribution-Based Benefits Cap Inflation Adjustment

Changes the time period from calendar year to fiscal year for setting the inflation adjustment to the threshold of average final compensation used to determine the anti-pension spiking contribution-based benefits cap. The initial threshold was set at $100,000 for calendar year 2015 and was adjusted to $100,750 for calendar year 2016. It would next be adjusted in July 2017 for inflation covering January 2016-June 2017, and thereafter on a fiscal year basis. This change is requested by the Department to increase the ease of providing advance notice to agencies regarding pension-spiking invoices.

Additionally, during the legislative session, two other provisions were drafted at the request of members of the General Assembly and supported by the Department that would have impacted the anti-pension spiking law.

3) Require Pension-Spiking Reports be Transmitted to Governing Boards

Requires that a public school system chief financial officer transmit a copy of the pension spiking watch report to the local board of education. The school financial officer must also notify the board of county commissioners of the county in which the local administrative unit is located that the report was received and the total number of employees listed in the report.

4) Prohibit Benefit Conversions

Prohibits conversion for retirement purposes of additional benefits to salary, such as health, life, or disability plans, so long as the benefits are other than mandated by State law or regulation. Applies only to employees first hired January 1, 2017 or later.