October 8, 2015

TO: Boards of Trustees
FM: Sam Watts
RE: Briefing on Agency Participation Procedures Act (Entry and Exit Procedures for Employing Agencies)

Brief Summary – Major Provisions of New State Law (Session Law 2015-168)

- Removes the 30-day window for all charter schools that elect to participate in the Retirement System and provides that the State System Board of Trustees will require financial and actuarial reviews before agencies are allowed to become participating employers.
  - *This provision is a new responsibility for the State System Board of Trustees*
  - *Allowing the Board of Trustees to choose to admit agencies protects the tax status and fiscal integrity of the Retirement System and is consistent with the Board's fiduciary responsibility*

- Requires any agency exiting the Retirement Systems that has participated in the Retirement System for more than one year to pay a withdrawal liability before exiting.
  - *The State System Board can allow charter schools to exit the system, the legislature retains the authority to allow any other agency out of the Systems*
  - *Allowing charter schools to disaffiliate from the System upon payment of a withdrawal liability is consistent with charter schools' need for flexibility without creating more unfunded liabilities*
  - *The Boards will adopt the interest rate to use for this part of the law on 10/22/2015*

- Requires the Fiscal Research Division to obtain an estimate of the cost of the applicable withdrawal liability for any legislation that would remove an agency from the System.
  - *This requirement increases the transparency of the unforeseen costs imposed on the state when an agency withdraws from the Retirement System*

- Provides that in the event of a voluntary or involuntary dissolution of a charter school, certain funds reserved for closure proceedings shall be used to pay wages owed to charter school employees, funds owed to the Retirement System, and funds owed to the State Health Plan, in that order.

- Disallows the granting of retirement service credits for years that employees worked at a local government agency before the agency joined the Local Governmental Employees Retirement System. This prohibition applies to agencies that join the system after August 1, 2015 and does not impact agencies that have already applied to join.
  - *This change affects the LGERS Board procedures for admitting new agencies*
  - *Allows technical change to the actuarial and accounting procedures recommended by the Systems' Actuary. To be detailed in the experience review presentation on 10/22/2015.*

Why was the Charter School participation procedure changed?

I. THE LAW THAT WAS CHANGED:

- Under the old law, charter schools had 30 days after obtaining a charter from the State Board of Education to notify the Retirement System that they wished to participate in the State System
  - Admission was automatic – no votes were required by Legislature or Board of Trustees
  - No legal, financial, or actuarial reviews were required
  - NC was only state that imposed a 30-day deadline for admission after the 30-day window closed.
  - Schools had to seek permission from the legislature to enter the retirement system and even then, no financial or actuarial reviews were conducted by the Retirement System.
  - States where charter schools' participation in the retirement systems is optional typically require schools to apply for admission
- Admission to the Retirement System was irrevocable
- Legislature could remove agencies from the System, and this would create an unfunded mandate on all other agencies in the system to pay for cost of liabilities left behind, since no withdrawal liability existed.

II. ADMINISTRATIVE PROBLEMS WITH SCHOOLS ADMITTED UNDER THE OLD LAW:

- Forty percent (40%) of charter schools in the Retirement System (27 out of 69 schools) have received penalties for submitting late payments of retirement contributions. For comparison, only about 15 to 20% of all other agencies participating in the Retirement System have submitted late payments. This represents a significantly worse payment history compared to all other agencies
    - On-time payment of retirement contributions is essential for maintaining predictability of the State's cash flow, which minimizes the need for unplanned liquidation of investments
    - If an agency fails to forward withholdings from employee paychecks, it can trigger criminal investigation *(This happened in a state audit of Kinston Charter Academy)*
- Three of the 69 schools have received between 5 and 10 penalties each
- Three schools have incurred more than 20 late payment penalties each
- Nineteen out of 69 schools (28%) have had difficulty accurately reporting employees' creditable membership service rendered (i.e., service creditable to employees' retirement benefit)
    - Ten instances of improper reporting from these 19 schools span multiple years or represent several distinct occurrences of improper reporting. Seven of these 19 instances of improper reporting, some of which date back more than 4 years, remained unresolved as of April 2015,
    - An agency's late submission of service credit can delay retirement processing and lead to inaccurate calculations of retirement benefits and overpayments
- A review of the budget and financial information submitted as a part of applications to obtain charters from the State Board of Education for the previous two years revealed the following information:
    - That for 11 schools being allowed to open this fall, 4 indicated they wish to join the Retirement System, but 3 of those 4 failed to factor the full costs of participation in the budgets submitted to the Dept. of Public Instruction. Another indicated a desire to join the Retirement System when they have been operating for three years.
    - For schools allowed to open last fall, 5 originally indicated they wish to join the Retirement System, 2 of those 5 failed to factor budget costs properly.

CASE STUDIES OF SOME CHARTER SCHOOLS WITH DIFFICULTIES:

Kinston Charter Academy: Kinston Charter surrendered its charter in September 2013; State Auditor issued a report in January 2015 detailing a number of violations and referring certain findings to the local District Attorney and the State Bureau of Investigation

- Prior to the school's closing, the Retirement System penalized Kinston Charter Academy 20 times in four years for late payment of retirement contributions, amounting to a total of $4,900 in penalties on $379,000 in late contributions. Of those late contributions, $120,000 were funds withheld from employees' paychecks.
- The school provided signed statements to the Retirement System from employees purportedly waiving rights to timely transfer of funds to the retirement system. Those signed statements were inconsistent with the school's statutory duty to transfer those funds to the retirement system. *[N.C.G.S. 135-8(f)]*
- The agency was in arrears with the retirement system for 23 months in four years.
- The school still had multiple outstanding late payment penalty invoices when it closed.
- When the agency closed in September, it had failed to submit contributions and complete service records for July, August, and September 2013. The agency owes $10,717 in employer contributions for the month of July 2013 and approximately $4,500 in employee contributions. Additionally, a $147 penalty for late payment remains unpaid. There may be additional funds owed for August and September 2013 when the school officially closed, but no service records were ever submitted.

SEGS Academy: State Board of Education voted to revoke charter and school closed effective April 1, 2015, leaving unfunded liabilities on the Retirement System.

***Downtown Middle School/STEAM Academy*:** State charter revoked in April 2013. Ceased reporting contributions without notifying Retirement System of status change

Wilmington Prep Academy: Has received 38 late payment penalties

CHARTER SCHOOLS UNDER H-276 (S.L. 2015-168)

New Charter School
(in operation for less than one school year)

NOTIFICATION OF ELECTION TO JOIN RETIREMENT SYSTEM

- No 30-day window
- **Automatic provisional affiliation for one year upon notification of election to join**
- May be removed for late payment or failure to submit contributions
- May choose to leave the Retirement Systems at any time prior to full affiliation

[AFTER ONE YEAR]

Financial & Actuarial Review to evaluate stability and risk to the Retirement Systems

- Determination of withdrawal liability
- Acknowledgement and acceptance of withdrawal liability

Vote by Board of Trustees to grant or deny **full affiliation** with the Retirement Systems

Existing Charter School
(in operation for more than one school year)

NOTIFICATION OF ELECTION TO JOIN RETIREMENT SYSTEM

- Charter school notifies Board of Trustees of intent to join Retirement System
- Financial & Actuarial review to evaluate stability and risk to the Retirement Systems
- Determination of withdrawal liability
- Acknowledgement and acceptance of withdrawal liability

Vote by Board of Trustees to grant or deny **full affiliation** with Retirement System

North Carolina Retirement Systems Division

Withdrawal Liability Under Agency Participation Procedures Act of 2015

October 22, 2015

buckconsultants

xerox

Agency Participation Procedures Act of 2015 (House Bill 276/SL-2015-168)

Under the Agency Participation Procedures Act of 2015, any employing unit that is allowed to cease participation in the Retirement System by the Board of Trustees will pay a withdrawal liability as paraphrased below:

On the date of complete withdrawal, the withdrawal liability of an employer is the greater of one thousand dollars ($1,000) or the amount determined by a., multiplied by the ratio of b. to c., as follows:

a. The excess of the actuarial present value of the vested accrued benefits of the System's members over the market value of its assets, based on the plan provisions and actuarial assumptions used in the last actuarial valuation, <u>***except the interest rate assumption shall be reduced by an amount determined by the consulting actuary***</u> to reflect the increased investment, mortality, and other actuarial risk for the exiting agency's participants.

b. The total present value of accrued benefits of all active members of the withdrawing employer.

c. The total present value of accrued benefits of all active members of the System.

Illustrative Example of Withdrawal Liability

Here is an illustrative example of a withdrawal liability calculation based on December 31, 2014 valuation for a small employer of TSERS allowed to cease participation in the Retirement System.

Withdrawal Interest Rate	2.75%
1. Actuarial Present Value of vested accrued benefits of TSERS	$91.3B
2. Market Value of Assets (TSERS)	$64.6B
A. Excess of (1) over (2)	$26.7B
B. Total Present Value of accrued benefits of active members of withdrawing employer	$50,000
C. Total Present Value of accrued benefits of active members of TSERS	$18.0B
Withdrawal Liability [(A) times (B)/(C)]	$74,167

Please note that Item (1) is calculated based on the Withdrawal Interest Rate, while Item (B) and Item (C) are based on the valuation interest rate of 7.25%.

Interest Rate Alternatives

The Actuarial Present Value of vested accrued benefits illustrated on the prior slide was shown based on 30-year Treasury rate of 2.75% as of 12/31/2014

- 30-year Treasury is about 2.87% around 9/30/2015
- 30-year Treasury is a risk-free rate.

One alternative would be the 20-year Municipal Bond Index

- 20-year Municipal Bond Index is a tax-free rate
- Indexed at 3.34% as of 12/31/2014
- Indexed at 3.48% around 9/30/2015

Another alternative would be the Moody's AAA Corporate Bond Index

- Indexed at 3.72% as of 12/31/2014
- Indexed at 4.00% around 9/30/2015

The 30-year Treasury rate and both alternatives have the advantage of being published and publicly available rates

Both alternatives would produce lower withdrawal liabilities based on current rates

Interest Rate Alternatives

	30-Year Treasury	20-Year Municipal Bond Index	Moody's AAA Corporate Bond Index
Withdrawal Interest Rate as of December 31, 2014	2.75%	3.34%	3.72%
1. Actuarial Present Value of vested accrued benefits of TSERS	$91.3B	$84.5B	$80.6B
2. Market Value of Assets (TSERS)	$64.6B	$64.6B	$64.6B
A. Excess of (1) over (2)	$26.7B	$19.9B	$16.0B
B. Total Present Value of accrued benefits of active members of withdrawing employer	$50,000	$50,000	$50,000
C. Total Present Value of accrued benefits of active members of TSERS	$18.0B	$18.0B	$18.0B
Withdrawal Liability [(A) times (B)/(C)]	$74,167	$55,278	$44,444

Please note that Item (1) is calculated based on the Withdrawal Interest Rate, while Item (B) and Item (C) are based on the valuation interest rate of 7.25%.

Recommendations By The Consulting Actuary

For purposes of this calculation, the consulting actuary selects an interest rate to reflect the actuarial risk for the exiting agency's participants.

Buck suggests selecting an objective standard for the interest rate. Having an objective standard avoids issues of stakeholders contesting the subjectively chosen basis that might otherwise occur.

Specifically, Buck suggests selecting a rate based on the 30-year Treasury Rate as of the date of the most recent actuarial valuation adopted by the Board of Trustees, based on the following criteria:

- The 30-year treasury rate represents a risk free rate that is consistent with the long term nature of the benefits for the exiting agency's participants
- The 30 year-year treasury rate is a publicly available rate

Alternatively, a different rate such as the Municipal Bond Rate or a corporate bond rate may be selected.

We considered the other elements of possible actuarial risk for the exiting agency, such as mortality, and recommend using the valuation assumptions for purposes of these calculations as an individual assessment of each possible exiting agency seems to create monumental issues that might lead to contentious arguments.

Questions?

THANK YOU