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October 22, 2010

Rep. Bette Grande, Chairman
Employee Benefits Programs Committee
c/o Jeff Nelson
ND Legislative Council
State Capitol
600 East Boulevard
Bismarck, ND 58505-0360

Re: **Bill 217 (Special Final Average Salary Provisions for certain retiring Administrators)**

Dear Rep. Grande:

As requested, we have reviewed Bill 217 (Bill 10217.0100). This bill would limit the Final Average Salary (FAS) of any member who retired as an administrator before completing eight years of service as an administrator. The FAS of such a member would be based on his or her salaries earned while a teacher before becoming an administrator. This change is applied prospectively, as discussed below.

Provisions of Bill

Under present law, a member's FAS is calculated by averaging the member's highest three (Tier 1) or five (Tier 2) plan year salaries. All compensation increases resulting from promotions or performing additional responsibilities are included in the earnings for calculating retirement benefits.

This bill makes an exception in the case of a member who was employed as a teacher for some period of time and then becomes an administrator. If the administrator has not completed eight years of service as an administrator, he or she would not be permitted to use his or her salaries as an administrator in the calculation of the FAS.

To illustrate this, here is some salary data on Betty Brown, a hypothetical Tier 1 member hired as a high school teacher in 1986 and promoted to principal for the 2015-16 school year:

Plan Year	Position	Salary		Year	Profession	Salary
2012-13	Teacher	$52,000		2017-18	Principal	$72,000
2013-14	Teacher	54,000		2018-19	Principal	75,000
2014-15	Teacher	56,000		2019-20	Principal	78,000
2015-16	Principal	66,000		2020-21	Principal	81,000
2016-17	Principal	69,000		2021-22	Principal	84,000

If she decides to retire at the end of 2022, her compensation earned as an administrator would not be included in calculating her FAS because she only has seven years of service as an administrator. Therefore, her FAS would be $54,000/year, or $4,500/month, which is the average of her pays in FY 2013 – FY 2015, when she was a teacher. Under current law, her FAS would be the average of her salaries in FY 2020 – FY 2022, or $81,000 or $6,750/month. Therefore, under the bill, her retirement benefit would be one-third smaller than under current law.

The bill applies only to someone who is classified as an "administrator" but was previously employed in the "profession of teaching." Section 1 of the bill defines both terms. To be an "administrator", the member must hold an administrator's credential and must be employed primarily in providing administrative services. The definition identifies a number of positions by title as administrators, including superintendents, principals, assistant and associate principals, and certain other directors. Profession of teaching is defined by job description, applying to services as a teacher, counselor, school librarian, speech therapist, etc.

Under the bill's definition of an "administrator", the member would have to be employed by a school district, special education unit, of career and technology unit. It would apparently not apply to a member employed by a state agency or state institution, such as the School for the Deaf, School for the Blind, Youth Correctional Center, or Division of Independent Study. The bill may need to be amended if the intent is to apply the FAS restrictions to all members promoted into administration.

It is also worth observing that the bill would not apply to someone hired as an administrator if they were not previously a teacher in North Dakota public schools. For example, this would not apply to someone hired as a principal after having taught in Minnesota or after having taught in a Catholic school.

Sections 2 and 3 amend the calculation of a member's final average monthly salary as previously described. Section 4 described the effective date of this bill as applying to salaries earned after June 30, 2011.

In discussing the bill, there was some initial confusion/disagreement about the meaning of the effective date. We ultimately concluded that the eight-year requirement is applied to all members retiring after June 30, 2011 with service as an administrator, but salaries earned prior to June 30, 2011 would be included in the FAS calculation regardless how many years the member worked as an administrator.

Consider John Jenkins, a hypothetical assistant principal. He is a Tier 1 member who was promoted to this position at the beginning of the 2007-08 school year, after working as a counselor. He intends to retire at the end of June 2012. His last ten years pays are shown below.

Plan Year	**Position**	**Salary**		**Year**	**Profession**	**Salary**
2002-03	Counselor	$42,000		2007-08	Asst. Principal	$54,000
2003-04	Counselor	44,000		2008-09	Asst. Principal	57,000
2004-05	Counselor	46,000		2009-10	Asst. Principal	60,000
2005-06	Counselor	48,000		2010-11	Asst. Principal	63,000
2006-07	Counselor	50,000		2011-12	Asst. Principal	66,000

Under current law, his FAS would be $63,000/year or $5,250/month, the average of his last three salaries. Since he has only five years as an administrator, his FAS would be limited under the bill. We believe his FAS would be $60,000/year, or $5,000/month, which is the average of his pays in FY 2009 – FY 2011. Only his last year would be excluded from the calculation under our interpretation of Section 4.

Assuming we have correctly interpreted how the effective date provision is intended to work, we recommend that the Section 4 be clarified to confirm this understanding.

Methodology

We faced a significant handicap in determining the actuarial savings due to this bill: we do not receive any data that identifies the member's occupation or job title. The employers do not report this information directly to the Retirement and Investment Office either. However, the Department of Public Instruction (DPI) does receive job title information from the school districts, and DPI provides this information to the RIO. The file from DPI includes most but not all of the participating employers/members. The Retirement and Investment Office does not retain historical information on job titles in their records; they only keep on file the last title reported. (Under TFFR's current statutes, there is no reason to acquire or retain this information, since the benefits are the same regardless of position.) Further, it would not have been possible, given the Committee's schedule, to get this information directly from the districts.

In discussions with the Retirement and Investment (RIO) staff, we finally decided on the following procedures.

1. We first asked the RIO staff to supply a list of the retirees who had retired in the last five years and whose last job title reported indicated the retiree was an administrator. This list contained 122 members. In addition, the RIO supplied the last ten salaries prior to retirement for these members.

2. Next we developed a set of screening conditions to help identify members who had been promoted into an administration position within the last eight years. We reasoned that a promotion into administration would have produced a significant increase in salary. After discussing this with the RIO staff, we settled on a 10% increase for this test. We also concluded that someone already making a large salary when the increase occurred was probably already in administration at the time of the increase, and that a 12% increase from $62,000 to $70,000, for example, was most probably a promotion from one position in administration to another, for example, from assistant principal to principal, or from principal to superintendent.

3. Therefore, we screened the 122 members looking for those who, during the last eight years before retirement, had received an increase in salary of at least 10%. We eliminated those who did not pass this test.

4. Next we screened for those whose pays were always above a certain minimum threshold, concluding that anyone earning over $50,000 in FY 2000 or $60,000 in FY 2010 was in administration all along. (The $60,000 threshold was used for FY 2010; for earlier years we

reduced this by $1,000 per year.) We then eliminated anyone whose salaries had been above the threshold in each of the last eight years before retirement.

5. Steps 3 and 4 winnowed the group to 24 possible retirees from FY 2006 – FY 2010 who might have been affected had Bill 217 been in place when they retired. We sent this list back to the RIO, which asked the individual school districts from which the members retired for additional information about the positions the member had held. The RIO received responses on all but two of these retirees. (In one of these two cases, the school that the member had retired from was now closed.)

6. Of these 22 retired members for whom responses were received, 1 was misclassified and had not been an administrator, 16 had been in an administrative position for at least the last eight years of service, and four others were part-time principal/part-time teacher. Only one of the 22 had clearly been promoted into an administrative position in the last eight years of service.

We should note that we had to make a judgment call in a handful of cases, because the member had a long service break in his/her last ten years of service. Some cases appeared to be members who taught or were an administrator in North Dakota, then either left the profession or worked elsewhere—in a private or parochial school or out of state—for many years, and then returned to an administrative position.

Therefore, we concluded that it would be reasonable to project that only one retiree every other year would be affected by Bill 217. In examining the one real case in the past five years, and in considering some other hypothetical cases, we estimated that the bill would generally reduce the member's FAS and benefit less than 40%, depending on the number of years the administrator worked before retirement and the raise received when promoted. This translated to a decrease in the value of the member's benefit of $160,000 or less per affected member.

Actuarial Analysis

Based on the above, we determined the bill would reduce the liability of the average affected member by $160,000 or less at the time of retirement. Over the last five years, the liability for newly retired members has averaged about $99 million per year. Since we assume there will be one such case every other year, we concluded that the bill would reduce future retirement liabilities by no more than 0.08% [($160,000 x 0.5) ÷ $99,000,000].

We calculate that the GASB 25 Annual Required Contribution (ARC) would be reduced by about 0.02%. That is, the ARC would change from 12.79% to 12.77%. The impact on the funded ratio and funding period would be immaterial.

While the bill could save as much as indicated above (0.08% in liability, 0.02% on the ARC), actual savings could be much smaller. We believe that rather than forfeit the use of their highest salaries, many administrators will choose to continue in service until they have eight years of service as an administrator. This is especially likely for members who have been administrators for six or seven years when they want to retire. There would still be some savings, because they would have to delay their retirement date, but the savings would be much smaller than indicated above.

Technical Comments

We have not identified any legal, regulatory or compliance issues raised by the bill. We are not aware of any conflicts between federal pension law and the bill.

One consequence of this bill is that a member, by accepting a position in administration, would end up with a smaller retirement benefit than if he/she had remained a classroom teacher. For example, if a teacher is promoted to principal of an elementary school at the beginning of the 2013-14 school year, and then retires at the end of the 2016-17 school year, the member's FAS would be based on pays from FY 2011 – FY 2013, which will presumably be smaller than the salaries that he/she would have received in FY 2015 – FY 2017 as a teacher. This fact could have the inadvertent result of making it difficult to fill positions in administration.

Additionally, Bill 217, as it is currently drafted, would provide reduced death and disability benefits to administrators with less than eight years of service, i.e. these benefits would also be calculated using the restricted FAS. Consideration should be given whether to amend Bill 217 such that the FAS used to calculate these ancillary benefits are based on the member's highest FAS, regardless of their service-period working as administrator.

The bill may also create difficulties in the case of an administrator who wishes to purchase service before completing eight years of service in administration. The member could receive a windfall, if the purchase price was determined based on the FAS based on teacher salaries, or could pay too much if the price was based on actual salaries as an administrator, but he/she terminated before earning eight years of administrative service.

For similar reasons, the bill would also create problems if an administrator is divorced during this eight-year period and the ex-spouse seeks a QDRO (qualified domestic relations order). Should the QDRO award the ex-spouse a share of the member's benefit based on the FAS as though the administrator terminated immediately and received a benefit based on old teacher salaries, possibly short-changing the ex-spouse, or should the ex-spouse's share be based on the FAS using actual current salaries, possibly over-rewarding the ex-spouse?

We believe some consideration should be given to amending the bill to deal with the case of members who have a break in service. If a member taught in ND public schools for five years in the late 1980s, left to teach in Minnesota for twenty years, and is recruited back to North Dakota to serve as Superintendent of a district, her benefits would be based on those salaries from the 1980s unless she remained in North Dakota administration for eight years.

We have treated members as in an administrative position if they were classified as part-time principal/part-time teacher. There were a number of such positions in the data we received.

This bill would require changes to a number of administrative procedures, since historical data on job position is not tracked. This would require changes for the RIO and the employers. Significant programming changes would be required, and the RIO would need to make a number of changes to its policies and procedures. Communication materials would also have to be revised.

Members who have less than eight years of service in administration will likely feel they are being treated unfairly because they will be required to make contributions to the system based on their current salary, while their FAS might be based on older and smaller salaries.

We assume the intent of the legislation is to address what are seen as cases of salary spiking, in which a teacher may take an administrative position a few years prior to retirement in order to increase his/her retirement benefit. It is worth noting that the bill leaves unaddressed many similar cases. For example, the bill has no impact on the assistant principal who becomes a principal a few years before retirement, or the principal who becomes superintendent of the district for three years at the end of his/her career. Teachers can also increase their salaries in later career by adding extra duties, teaching summer school, or perhaps changing schools.

Basis of Calculations

Our analysis was based on the member and financial data, and the actuarial assumptions and methods, used for preparing the July 1, 2010 actuarial valuation.

General Comments

Our calculations are based upon assumptions regarding future events, which may or may not materialize. Please bear in mind that actual results could deviate significantly from our projections, depending on actual plan experience.

In the event that more than one plan change is being considered, it is very important to remember that the results of separate actuarial valuations cannot generally be added together to produce a correct estimate of the combined effect of all of the changes. The total can be considerably greater than the sum of the parts due to the interaction of various plan provisions with each other, and with the assumptions that must be used.

Nothing in this letter should be construed as providing legal, investment or tax advice. We certify that the undersigned are members of the American Academy of Actuaries and that we meet all of the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein. No statement in this letter is intended to be interpreted as a recommendation in favor of the change or in opposition to it.

If you have any questions, or require any additional or clarifying information, please do not hesitate to contact either one of the undersigned.

Sincerely,

Daniel J. White

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Senior Consultant

J. Christian Conradi

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cc: Ms. Fay Kopp, Deputy Executive Director, ND Retirement and Investment Office

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