South Dakota Retirement System

MANAGING SDRS BENEFITS: CONSIDERED COMPENSATION AND FINAL AVERAGE COMPENSATION

BOARD OF TRUSTEES
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INTRODUCTION

Unlike most public sector retirement systems, SDRS is managed within fixed, statutory contributions and does not subject its employers to the risk of higher future contributions. Managing the System within the available resources is the key objective of the SDRS Board of Trustees and has been achieved as a result of a number of SDRS initiatives—including active management of the Plan's benefits.

Eliminating or preventing subsidies has been a primary focus of the Board and has resulted in numerous past changes to the SDRS benefit structure. A subsidy is a benefit that is available to some SDRS members, but not all, and results in higher SDRS costs. Because SDRS is managed within fixed resources, subsidies ultimately restrict or reduce the benefits payable to all members.

Eliminating or preventing subsidies enhances equity among all members and increases the likelihood that SDRS can meet its benefit goals for all members.

This paper discusses the role of Compensation and Final Average Compensation in the calculation of SDRS benefits, the subsidies that have occurred, and the initiatives the Board has taken, and is currently considering, to reduce them. Throughout this document, terms such as Compensation, Final Average Compensation and certain other terms defined in South Dakota Codified Law related to SDRS will be capitalized for emphasis.

SDRS RETIREMENT BENEFIT OBJECTIVES

SDRS provides lifetime retirement benefits to help members maintain their standard of living after retirement. To accomplish this objective, SDRS retirement benefits are designed to replace a portion of the member's Compensation paid during employment. The member's Compensation reflects the value of the member's job duties and responsibilities. It also is the primary resource that supports the member's standard of living while employed and typically increases throughout the member's career.

SDRS benefits are based on Final Average Compensation. This is the member's average Compensation close to retirement and most accurately measures the member's purchasing power and standard of living immediately before retirement.

SDRS COMPENSATION

Both SDRS benefits and contributions are based on Compensation as defined in South Dakota Codified Law.

Compensation is gross wages paid to a member by the employer for personal services rendered during the member's credited service. This is the W-2 compensation for many members plus:

- SDRS member contributions, and
- Tax deferred employee contributions to IRS qualified retirement or medical plans

However, Compensation specifically excludes the following items even if reported on the member's W-2:

- Expense reimbursement by the member's employer for business related expenses
- Lump-sum payments at termination of employment for sick leave or annual leave
- Payments for insurance coverage of any kind, or any other employee benefit, by the member's employer on behalf of the member or the member's dependents
- Payments attributable to retirement or an incentive to retire in the future
- Severance benefits or payments contingent upon a member terminating employment at a specified time in the future
- Worker's compensation payments

In 2004, lump-sum payments at termination of employment for sick leave or annual leave were excluded from Compensation because they were not payment for personal services rendered during the member's credited service. The Special Pay Plan was adopted to permit payment on a tax-deferred basis of these amounts to that plan for the benefit of the member.

The definition of Compensation for SDRS purposes is limited to pay received for services rendered and excludes additional or extraordinary pay as noted above. If this additional pay were included in Compensation, SDRS benefits and both employer and member contributions would be based on a level of pay that is in excess of normal Compensation for the member's job and responsibilities. This is contrary to SDRS's benefit goals since the resulting retirement income would support a standard of living in retirement greater than the member's standard of living during employment.

FINAL AVERAGE COMPENSATION

As noted above, SDRS benefits are based on Final Average Compensation. This is also defined in South Dakota Codified Law and is the highest average annual Compensation earned by a member during any period of 12 consecutive quarters during the member's last 40 calendar quarters of membership. This definition applies to Foundation Members.

For Generational Members, Final Average Compensation is based on the highest 20 consecutive calendars quarters during the last 40 quarters.

For most SDRS members, Final Average Compensation will be based on their last period of employment, since Compensation is typically highest then.

Example 1

A Foundation Member retires June 30, 2017, with the following Compensation history:

Four Quarters Ending June 30	Compensation	
2017	$44,000 ←	
2016	42,700 ←	Final Average Compensation
2015	41,500 ←	
2014	40,000	
2013	39,000	
2012	38,000	
2011	37,000	
2010	36,000	
2009	34,800	
2008	33,700	

The Final Average Compensation will be based on the last three years of employment. In this example, the Final Average Compensation is ($44,000 + $42,700 + $41,500) ÷ 3 = $42,733.

However, some members may not have a Compensation history that was so steady because of specific job requirements, overtime, or other causes.

Example 2

A Foundation Member retires June 30, 2017, with the following Compensation history:

Four Quarters Ending June 30	Compensation	
2017	$43,000	
2016	42,700	
2015	41,500	
2014	40,000	
2013	39,000	
2012	45,000 ←	
2011	44,000 ←	Final Average Compensation
2010	40,000 ←	
2009	34,800	
2008	33,700	

The Final Average Compensation in this example is based on an earlier period of employment and is ($40,000 + $44,000 + $45,000) ÷ 3 = $43,000.

This example illustrates that a member whose Compensation declined during the last 10 years will still have a Final Average Compensation based on the member's highest average Compensation during that period.

LATE-CAREER PAY INCREASES

Basing SDRS benefits on Final Average Compensation is important to assure adequate income replacement to maintain the member's standard of living in retirement. However, it is potentially a costly practice because it provides benefits at retirement based on the member's total service and Compensation close to retirement, and is funded by employer and member contributions based on a member's Compensation earned each year over the member's career.

Member and employer contributions and investment earnings on those contributions provide the funding for SDRS benefits. The adequacy of the funding depends upon predictable Compensation increases throughout a member's career so the investment earnings on contributions based on Compensation increases have sufficient time to pay the cost of higher benefits resulting from higher Compensation.

Many members receive significant Compensation increases early in their careers as they progress in their job. Promotions and job changes may also significantly increase their Compensation at mid-career and before. However, in late career, most members have progressed in their job and receive smaller and more predictable Compensation increases as they approach retirement.

SDRS anticipates that some members will receive significantly larger than expected Compensation increases late in their career and plans for that eventuality. These Compensation increases can be due to job changes, promotions, or across the board pay increases. While these late-career Compensation increases will increase the SDRS benefits they typically result in manageable experience variations.

However, when late-career Compensation increases result from intentional restructuring of pay (or the attempt to include pay not previously considered in Compensation) solely to enhance the benefits from SDRS whether done by members, or by employers and members, the resulting subsidies can become excessive and affect the benefits for all SDRS members.

The practice of intentionally restructuring pay, resulting in unintended and excessive benefits to some members, is referred to as "spiking." It is frequently and rightfully criticized by observers of public retirement plans and reflects poorly on all public plans, including SDRS. Spiking increases the incidence and severity of late-career Compensation increases, and creates subsidies, inequities, and higher costs for SDRS. In addition, these practices occur more frequently with higher-paid members, which increases the amount of subsidies and the costs to SDRS even more.

The spiking issue is not unique to SDRS. Some recent national spiking headlines follow:

California Appeals Court Denies Pension Spiking as Legal Right-California
Pension Boost Tactic Sidesteps Laws to Cost Taxpayers Millions-Illinois
Governor Signs into Law Measure to Curb Pension Spiking-North Carolina
Pension Spiking Adds to Burden on Taxpayers-Florida
Possible Pension-Spike Shows Unfair System, Entitlement Mentality-Idaho
Another School District-Teachers Union Pension Spiking Deal-Michigan

An example of the effect of late-career Compensation increase on SDRS follows.

Example 3

A Foundation Member retires June 30, 2017, with the following Compensation history:

Four Quarters Ending June 30	**Compensation**	
2017	\$65,000 ←	Final Average Compensation
2016	60,000 ←	
2015	55,000 ←	
2014	50,000	
2013	39,000	
2012	38,000	
2011	37,000	
2010	36,000	
2009	34,800	
2008	33,700	

This member's Compensation increased 28 percent in 2014 and moderate increases continued in the next three years resulting in a Final Average Compensation of (\$65,000 + \$60,000 + \$55,000) ÷ 3 = \$60,000.

This member retired with 30 years of service at age 62 with the following SDRS benefits:

SDRS Benefit with Late-Career Compensation Increases

1.7% X \$60,000 X 21 years	= \$21,420
+	
1.55% X \$60,000 X 9 years	= <u>8,370</u>
Total	= \$29,790

If the Member's Compensation had increased by 5 percent per year from 2013, the member's Final Average Compensation would have been \$45,183. Without the extraordinary, late-career Compensation increases, the member would have received an annual lifetime benefit from SDRS of:

SDRS Benefit without Late-Career Compensation Increases

1.7% X $45,183 X 21 years	=	$16,130
+		
1.55% X $45,183 X 9 years	=	6,303
Total	=	$22,433

This one example results in a 33 percent increase in the member's Final Average Compensation and benefit. The unanticipated costs to SDRS are offset by additional contributions made, but the net increase in costs is 31 percent, or approximately $100,000 in this example because of extraordinary late-career Compensation increases.

SDRS COSTS DUE TO LATE-CAREER COMPENSATION INCREASES

The late-career Compensation increases have resulted in higher costs for SDRS of between $5-10 million per year and these costs are growing. Even more importantly, a very high percent of those costs are a result of a very few members. For example, in 2015 the late-career Compensation increases for only 1 percent of the retirees resulted in 44 percent of the unanticipated costs to SDRS.

Without changes, the SDRS actuarial assumptions with regard to Compensation increases in late career will likely require modification to reflect these additional costs.

SDRS COMPENSATION CAPS

Late-career Compensation increases have been a concern of SDRS throughout its history. Currently, caps on Compensation considered in Final Average Compensation are applied as follows:

- Compensation received in the last calendar quarter considered in Final Average Compensation cannot exceed 105 percent of the Compensation in any prior calendar quarter, and
- Average Compensation received in the last four quarters considered cannot exceed 105 percent of the Compensation received in any quarter prior to the last four quarters considered

Prior to 2005, higher caps applied. They were reduced based on the Board's recommendations to deal with late-career Compensation increases at the time.

While these caps have been successful in limiting the costs for typical late-career Compensation increases, they have not eliminated intentional restructuring of Compensation.

SDRS has also monitored the Compensation submitted by participating employers to remind employers of their responsibility to comply with South Dakota Codified Law.

FUTURE SDRS INITIATIVES

The Board is currently evaluating solutions to the late-career Compensation issues as part of its responsibilities to manage SDRS within its resources. Initiatives under consideration include enhanced SDRS practices and new legislation that would:

- Add more emphasis on communicating and enforcing the provisions of South Dakota Codified Law and auditing of employer practices
- Extend the Compensation caps currently in place to provide a cap on each four calendar quarter period considered
- Continue to monitor Final Average Compensation experience and propose additional changes as needed

While extending caps is advisable to avoid the late-career Compensation increases, it also may be equitable to refund the employer and member contributions made on Compensation excluded from Final Average Compensation since the Compensation above the caps is not considered in the SDRS benefit calculations. In addition, consideration should be given to applying extended Compensation caps prospectively, to avoid incenting members to retire just prior to the effective date of any change.

Future considerations include extending the averaging period for determining Final Average Compensation from the current 12 quarters (three years) to 20 quarters (five years) as currently in place for Generational Members, or even longer periods.

CONCLUSIONS

Late-career Compensation increases result in significant unanticipated benefit increases that are in excess of SDRS goals and increasingly substantial cost issues for SDRS, exacerbated by deliberate actions to inflate SDRS benefits. The result is a very large subsidy to a few members of SDRS at the expense of all other members.

SDRS will continue to monitor the experience with regard to Compensation and Final Average Compensation and propose initiatives as needed to avoid continuing subsidies.