

**Government Finance Officers Association
Awards for Excellence in Government Finance
2013 Application**

Local Significance and Value (Background)

1. Please give a brief general description of the project or program being submitted.

Many public pension systems offer defined benefit pension plans that provide retirement benefits using a formula that is based on the member's final average salary and years of service. Final average salary (FAS) is typically defined as the average of some number of the member's highest salary years (typically 3 or 5). Accordingly, the member's pension benefit has no direct correlation to their lifetime / career contributions paid to the pension system that fund the benefit. Given the design of public pension plans, this is typically not a problem when a member has normal salary increases and promotions throughout their career.

However it is possible for a member to dramatically increase their retirement benefit by assuming a position that has a much higher salary than they have earned over their career for a brief number of years to establish a high FAS for their retirement benefit formula. This practice is referred to as "pension spiking", which represents an increase in a pension benefit by substantially increasing the final average salary beyond what is expected from normal salary increases.

For example, spiking can occur when a member is employed in the private sector but also serves as a township trustee earning service credit in this role with a nominal salary. The member assumes a full time position in public employment for the three years necessary to establish a final average salary and receives a pension benefit based on the salary earned during these three years. These higher than normal pension benefits are not funded by the member and employer contributions received over the member's career and the investment income earned on these contributions. As a result, they represent a drain on the pension fund and can create funding issues for the plan as a whole. Pension spiking has been an issue for public pension systems for decades with no clear solution that does not also penalize members who experienced legitimate salary and position advancements throughout their career.

OPERS has developed an innovative approach to solving this problem by instituting a contribution based benefit cap or "CBBC". The CBBC concept limits the pension benefits of members who have not contributed a reasonable amount to fund their pension. Under the CBBC concept, a member's benefit is calculated in accordance with the statutory benefit formula, and in accordance with the CBBC calculation. A member with a pattern of salary spiking receives the lesser of the two benefit calculations. The CBBC benefit is calculated by multiplying the member's career accumulated contributions by an annuity factor that converts the contributions to an annuity value payable over the member's expected remaining life in retirement status. This value is then multiplied by a CBBC factor approved by the Board of Trustees. The CBBC factor may be any integer greater than zero, and is designed to impact only the most egregious "spikers". For example, the factor may be set to impact proximately 2% of the population or 5% depending on the demographics and funding goals of the retirement system.

2. Describe the local events and/or problems that led to the undertaking of this project / program.

The investment market downturn of 2008 had a significant impact on the funding status of public pensions and the ability of state and local government employers to meet their expense obligations. To address these funding concerns, OPERS began a comprehensive review of the pension benefit structure to identify and eliminate areas where subsidization of benefits was occurring so that pension benefits could be sustained for the majority of the members. Pension spiking is an example of a subsidized benefit because the pension benefits paid to these members under the defined benefit formula are out of proportion to the career contributions paid on the member's behalf to fund these benefits. Implementation of the "Contribution Based Benefit Cap" limits these benefits, reducing their funding requirements.

3. Describe the role the finance office / finance officer played in this project / program.

The "Contribution Based Benefit Cap" concept was developed by personnel within the Finance division and vetted with a cross functional project team of approximately 10 members. All projections and estimates were created by the Finance Division personnel. The concept was presented to the Board and advocated for by the Finance division and was also advocated for at the legislative by the Finance division. The finance division also developed a self-help calculator for members to use to determine if their benefit would be subject to the cap and the Finance staff also helped develop the communication materials for members.

4. How much time did each participant devote to this program / project? Were outside consultants engaged?

The cross functional project team responsible for the comprehensive review of the pension benefit structure was comprised of approximately 10 members who met twice a week on a variety of plan design issues. The CBBC concept was conceived in January 2012 and approved by the Board of Trustees in February 2012. The concept was included in a pension reform bill approved by the Ohio Senate in May 2012 and by both the House and Senate in September 2012. No outside consultants were engaged in the development of the concept.

Technical Significance

What financial concepts, standards, or techniques are displayed or advanced by this entry? Why is this important to the public finance profession?

As noted in the background information above, pension spiking has been a funding and member equity issue for public retirement systems for decades. Whenever a group of employees receives a benefit that is out of proportion with their contributions to the pension system, the excess benefit must be funded from assets of the pension system as a whole. This reduces the value of assets available to sustain the retirement benefits of the member population as a whole, and potentially can result in higher employer contribution rates. The development of a solution to this problem reduces the liabilities of the public pension systems and the contribution pressure on public employers. Reducing the public pension liability will become more important to employers as the effective dates of the pension reporting

requirements of GASB 67 and 68 approach and pension liabilities must then be shown on the face of the employers' financial statements.

Transferability

How can this project / program be adapted for use by other organizations? Who else might benefit by its adoption? Would significant modifications be required for implementation?

The contribution based benefit cap concept can be adapted for use by any retirement system that provides pensions under a defined benefit formula. It can be used by single employer, agent or multiple-employer cost-sharing plans. The CBBC factor used in the formula can be selected by each system based on the member demographics and funding needs of each system / retirement plan.

Documentation

What documentation describes the entry (e.g. reports, forms, memoranda, software, audio-visual materials, etc.) All materials must be provided in electronic format.

Attached is a copy of the PowerPoint presentation (attachment 1) presented to the OPERS Board of Trustees at the February 15, 2012 monthly meeting that describes the concept and provides examples of how members would be affected based on their employment behavior during their career. Also attached is a copy of the legislation passed by the Ohio House and Senate as approved by the Governor, authorizing the use of this concept in the calculation of OPERS retirement benefits (attachment 2 - Revised code 145.333).

Cost / Benefit

Quantify the total resources (money and time) devoted to this project / program and identify the value added (tangible and/or intangible) as a result of undertaking it.

The CBBC concept was developed and vetted using approximately 100 hours of staff time at a cost of less than \$6,000. The pension bill authorizing the use of this benefit cap is not effective until January 7, 2013, and the OPERS Information Technology division is currently in the process of adding the necessary programming code to our pension system. The cost of this programming effort is not yet available but is expected to be in the range of \$5000 - \$7500.

By contrast, implementation of the CBBC concept is expected to save the retirement system over \$4 million a year in annual benefit payments. Using the retiree population from 2006 through 2010, OPERS calculated what the annual benefits would have been for affected retirees under the CBBC concept compared to the actual benefits paid. The annual savings for this group alone is \$3.5 million before the application of the 3% annual COLA. With the approaching wave of baby-boomer retirees, these savings should be well in excess of \$4 million per year.

Complexity

Describe the complexity of the project / program. How much training and technical skill is required for employees to make use of this solution?

The CBBC concept is a solution that can be automated within the information technology systems used to calculate pension benefits. It is a fairly simple formula but is dependent on annuity factors typically obtained from the retirement system's actuary. At OPERS, these factors are supplied by the actuary at the beginning of each year as a normal component of the pension system's annual update.

Originality, Creativity, and Innovation

To your knowledge, is this the first time this type of project / program has been implemented by a government entity? If not, identify previous work in this area and explain the uniqueness of your approach.

Historically, solutions proposed to address pension spiking have focused on limiting a member's final average salary (FAS) rather than limiting the benefit itself. For example, proposed solutions have included increasing the number of years on which the final average salary is based, limiting the allowable percentage of salary growth over a member's career or during their FAS period, capping FAS at a defined dollar amount, or limiting the types of wages that can be included in the earnable salary used to compute FAS. Each of these approaches bears the inherent risk of penalizing members whose salaries have grown based on promotions through development of enhanced skills, or through salary enhancements such as overtime that reflect actual services provided to the public. If the benefit structure is too restrictive, talented personnel will leave the public employment in pursuit of more lucrative salaries in the private sector.

To the best of our knowledge, OPERS is the first to propose a benefit cap tied to actual contribution history as a way to limit the excessive benefits that occur with pension spiking. The majority of members are protected from the benefit cap by the careful selection of a CBBC factor. This solution has been heralded by independent actuaries as a "revolutionary idea".

Other Distinguishing Features (Optional)

Highlight any other noteworthy features about your project / program.

The contribution based benefit cap was lauded by the OPERS Board of Trustees, representatives from the Ohio House and Senate, external consultants, and peers as a creative approach to the solution of a long standing problem.