A Report
to the
Montana
Legislature

Performance Audit

Analysis of Retirement Benefit Inflation in Montana's State Pension Systems

Montana Public Employee Retirement Administration Teachers' Retirement System

December 2010

Legislative Audit
Division

10P-10

Performance Audits

Performance audits conducted by the Legislative Audit Division are designed to assess state government operations. From the audit work, a determination is made as to whether agencies and programs are accomplishing their purposes, and whether they can do so with greater efficiency and economy.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Members of the performance audit staff hold degrees in disciplines appropriate to the audit process. Areas of expertise include business and public administration, journalism, accounting, economics, sociology, finance, political science, english, anthropology, computer science, education, international relations/security, and chemistry.

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December 2010

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of retirement benefit calculations by the Montana Public Employee Retirement Administration and the Teachers' Retirement System. Both agencies are administratively attached to the Department of Administration.

This report provides the Legislature information about the potential for retirement benefit amounts to exceed the expected level based on a system member's normal service history and compensation. This report includes recommendations for addressing potential controls for retirement benefit inflation and improving the efficiency of retirement benefit calculations by strengthening data collection and retention practices.

We wish to express our appreciation to the staff members of the Montana Public Employee Retirement Administration and the Teachers' Retirement System for their cooperation and assistance during the audit.

Respectfully submitted,

/s/ Tori Hunthausen

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Legislative Auditor

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Appointed and Administrative Officials

			Term Expires
Public Employees' Retirement Board	John Nielsen, President	Glendive	March 2012
	Terrence Smith, Vice President	Bozeman	March 2014
	Darcy Halpin	Belgrade	March 2013
	Patrick McKittrick	Great Falls	March 2014
	Scott Moore	Miles City	March 2015
	Dianna Porter	Butte	March 2013
	Timm Twardoski	Helena	March 2011

Administrative Official Roxanne Minnehan, Executive Director, Montana Public Employee Retirement Administration

			Term Expires
Teachers' Retirement Board	Kari Peiffer, Chair	Kalispell	July 2012
	Darrell Layman, Vice Chair	Glendive	July 2011
	Scott Dubbs	Lewistown	July 2013
	Jeff Greenfield	Shepherd	July 2011
	Robert Pancich	Great Falls	July 2014
	James Turcotte	Helena	July 2015

Administrative Official David L. Senn, Executive Director, Teachers' Retirement System

MONTANA LEGISLATIVE AUDIT DIVISION

PERFORMANCE AUDIT

Analysis of Retirement Benefit Inflation in Montana's State Pension Systems

Montana Public Employee Retirement Administration
Teachers' Retirement System

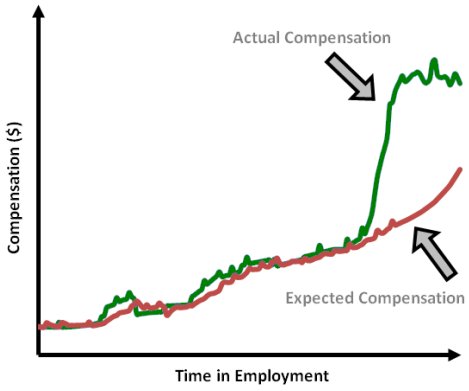
DECEMBER 2010 10P-10 REPORT SUMMARY

Limited examples of benefit inflation can occur within Montana's state-administered pension systems; if the legislature wishes to address benefit inflation, statutory changes are necessary.

Context

Public sector pensions have been attracting significant attention across the United States in recent years. Due to economic factors such as investment volatility, many states, including Montana, have struggled to adequately fund retirement benefits.

One of the risks associated with defined benefit plans is benefit inflation. Benefits in these plans are generally set as a percentage of the employee's highest average compensation. When increases in compensation occur late in a member's career, they inflate the member's retirement benefit without a corresponding increase in contributions to the system.



Example of benefit inflation - actual compensation increases at a fast rate in final years of employment as compared with expected compensation

Our analysis indicates that benefit inflation is a relatively rare practice. It can represent a significant financial benefit to an individual member but unlikely impacts the solvency of Montana's retirement systems. When it occurs, it creates a negative public perception of system operations.

Results

This audit determined that benefit inflation can and does occur within Montana. Retirees have been legally able to increase pension benefits by engaging in several types of actions that coincide with the period used to calculate pension benefits:

- Working significant amounts of overtime
- Receiving bonuses or other discretionary payments
- Accruing legislative service time prior to other full time public service
- Earning compensation from dual employment
- Obtaining other significant, late-career compensation increases
- Seeking exemptions to existing compensation growth limits

Because defined benefit systems guarantee a pension benefit for life, even small increases to a pension benefit can create a significant financial impact. For example, this report discusses eight examples of the practices listed above. We estimate that in those eight cases the retirees cumulatively increased their lifetime pension payments by approximately $1.75 million.

Despite the work of both agencies which administer pension benefits in the state, we determined that retirement benefits are not always equitable or based on normal compensation and service history. Agency controls to detect retirement benefit inflation could be strengthened, but other aspects of the retirement benefit calculation process can only be addressed through changes in statute.

This report includes four recommendations. Two recommendations address legislative consideration of the conditions which may allow retirement benefit

the conditions which may allow retirement benefit inflation to occur. Two are addressed to the administrative agencies and concern improvements related to the efficient collection and retention of member data.

Recommendation Concurrence	
Concur	3
Partially Concur	0
Do Not Concur	0
Source: Agency audit responses included in final report.	

For a complete copy of the report or for further information, contact the
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Chapter I – Introduction and Background

Introduction

Defined benefit retirement systems have been a common source of retirement income for many American retirees for over a century. These types of systems guarantee a stream of income for an employee's entire retirement. The benefit amount earned by an individual employee is not directly based on contributions made by that member; instead the benefit amount is typically calculated as a percentage of the employee's compensation over a predetermined period of time. Therefore, the retirement benefit replaces a set portion of the retiree's former income.

Defined benefit plans are especially prevalent within the public sector, with over 90 percent of public employers participating in some type of defined benefit system. Defined benefit plans are useful in attracting and retaining employees. This audit report deals with some risks associated with defined benefit retirement systems; including the possibility that benefits paid to retired members can exceed the benefit amount expected based on a member's normal service history and compensation.

Defined Benefit Retirement Plans in Montana

There are eight unique defined benefit retirement systems administered at a state-wide level in Montana. These systems award benefits based on the average compensation during a 3-year period of a member's career. Another plan provides a benefit to volunteer firefighters and is based only upon the number of years of trained service. A summary of each system including who may be a member and the sources of contributions is shown in Table 1.

Table 1
The Defined Benefit Retirement Systems of Montana

System	Retirees as of FY10	Annual Benefits FY10	Membership	Contribution Sources
Public Employees Retirement System (PERS)	17,512	$212 million	State, local governments and some university system and school district employees	Employer, employee, state
Judges Retirement System (JRS)	55	$2.1 million	Supreme, district court, and water court judges	Employer, employee
Highway Patrol Officers Retirement System (HPORS)	295	$7.6 million	Members of the Montana Highway Patrol	Employer, employee, state
Sheriffs Retirement System (SRS)	415	$8.3 million	Sheriffs, Department of Justice criminal investigators, detention officers	Employer, employee
Game Warden and Peace Officers Retirement System (GWPORS)	136	$2.6 million	Game wardens, state peace officers	Employer, employee
Municipal Police Officers Retirement System (MPORS)	670	$15.7 million	Municipal police officers	Employer, employee, state
Firefighters Unified Retirement System (FURS)	546	$14.6 million	Municipal and rural firefighters and some Montana Air National Guard firefighters	Employer, employee, state
Volunteer Firefighters Compensation Act (VFCA)	1,149	$1.9 million	Members of qualified volunteer fire companies	General fund via fire insurance premium taxes
Teachers' Retirement System (TRS)	12,440	$234 million	Teachers, principals, or superintendents, other education professionals	Employer, employee, state

Source: Complied by Legislative Audit Division from Agency Records.

Each of the systems is governed by the Public Employees' Retirement Board and administered by the Montana Public Employee Retirement Administration (MPERA) with the exception of the Teachers' Retirement System (TRS) which is governed by its own board and staffed by its own agency, also known as the Teachers' Retirement System. Both TRS and MPERA are administratively attached to the Department of Administration.

How do Defined Benefit Retirement Plans Work?

Sources of income to defined benefit retirement systems include contributions and investment income. Contributions are usually set as a total percentage of member payroll, with an employer and employee component and, for some systems, an

additional state contribution. Contributions are invested in order to earn interest for the system. These sources of income are used to pay system expenses, primarily retirement and death and disability benefits along with administrative expenses. In Montana, an individual member's benefit is calculated as a percentage of his or her average compensation over a three year period. For most of the systems it is the three-year period during which the member's compensation was highest. For one system, it is the final three years of a member's service. In the majority of cases, the final three years are the period of highest average compensation.

Due to economic factors such as investment volatility, many public retirement systems have struggled to obtain adequate funding to pay for benefit obligations. Montana is among the many states that have recently experienced shortfalls in retirement system funding, which has caused the state legislature to add funds to the Teachers' Retirement System and the Public Employees' Retirement System and to consider plan design alternatives aimed at reducing future liabilities.

Studies of defined benefit plans indicate that one risk associated with defined benefit plans is the possibility that employees or employers may engage in practices that increase the rate of compensation for some members only during the late stages of their careers. This adversely impacts the financial health of retirement systems because it drives up the amount of retirement benefits that are paid out, but only includes contributions based on high compensation rates for a short period of time. The outflows from the system are increased at a greater rate than the inflows.

Scope, Objectives and Methodologies

We developed our audit scope to focus on the defined benefit retirement systems administered by MPERA and TRS and sought to determine:

1. If retirement benefits are equitable and based on normal service history and compensation.
2. If there are controls in place to effectively deter and detect inflation of retirement benefits.

We did not evaluate the operations of volunteer fire departments that participate in the VFCA pension or the municipal fire and police pensions funded through the State Auditor's office. Each of these areas may be a viable area for future study, and is discussed in more detail later in this chapter.

To address our objectives, we developed the following audit methodologies:

- Reviewed statutes and administrative rules relating to calculation of retirement benefits for each of the defined benefit systems.

- Obtained and reviewed actuarial experience studies for each of the retirement systems.
- Obtained and reviewed internal policies and procedures related to the calculation of benefits at both agencies.
- Reviewed financial-compliance evaluation of controls in place at both agencies.
- Obtained compensation and service history data for new retiree populations. For TRS, we obtained data for members who retired in fiscal years 2004-2009.
- For MPERA, the population was members who retired in fiscal years 2003-2009. These time periods match with actuarial experience studies recently completed for the systems.
- Identified normal trends in compensation data for the population of members and identified individual anomalies or outliers in the data obtained.
- Re-calculated the expected retirement benefit amounts for the population of outliers.
- Interviewed staff members at both agencies to determine how analysts ensure that only statutorily-approved compensation is reported by member employers.
- Evaluated controls in place in other states for defined benefit retirement systems.
- Obtained criteria regarding best management practices for controls over public employee defined benefit retirement systems.

Areas for Further Study

During the audit we identified three areas we believe warrant consideration for future performance audit work.

Volunteer Firefighters Compensation Act

The VFCA provides a retirement benefit to retired members of qualified volunteer fire departments. Collectively, VFCA retirees annually receive over $1.9 million in retirement allowances. To qualify for a benefit a member must receive 30 hours of firefighting training during each year of service. In order to track years of service, MPERA requires volunteer fire departments to submit a roster of members who met the criteria to obtain a service year. MPERA is statutorily required to accept a timely and properly completed certificate as proof of service. A performance audit of this area could seek to identify if controls over the disbursement of VFCA benefits effectively ensure that only qualified volunteers receive benefits.

Municipal Fire and Police Pension Plans

In addition to the statewide systems for municipal police officers (MPORS) and firefighters (FURS) there are locally-governed fire and police retirement plans. These plans are funded through the general fund via fire insurance premium taxes collected by the State Auditor's Office. The use of these funds is statutorily limited to retirement benefits for members of fire and police departments and some disability or death benefits. In fiscal year 2010, individual payments of up to $225,000 were distributed to participating municipalities. A potential performance audit could seek to determine if existing State Auditor's Office controls are sufficient to ensure these funds are applied only to statutorily-approved uses.

Working Retirees

Retirement benefit inflation is one type of risk that can increase costs to retirement systems, another is the potential increased expenses related to working retirees. When a retired member of a defined benefit system begins receiving retirement benefits but continues to be employed or work as an independent contractor in a position covered by the same retirement system as before filing for retirement, costs increase because the benefit is paid for an increased length of time and contributions may no longer be made to the system. Montana statutes seek to reduce the risk from this practice by placing restrictions on retirees returning to work. For example, a PERS retiree may only work up to 960 hours in a PERS-covered position without sacrificing retirement benefits. Similarly, a TRS retiree may earn only one-third or less of his or her former compensation or be deemed ineligible for retirement benefits. A performance audit could seek to determine if the controls in place effectively deter working retirees from exceeding statutory limits.

Report Organization

The remainder of this report details our analysis of the audit objectives and includes four recommendations. It is organized in three additional chapters:

- Chapter II–Assessment of Retirement Benefits Calculations. Includes information related to our methodologies and conclusions to our audit objectives.
- Chapter III–Legislative Consideration of Retirement Benefit Calculations. Addresses the existing operations of the systems studied and presents options for increasing the equity and normality of retirement benefits.
- Chapter IV–Improving Efficiency of Retirement Benefit Calculations. Introduces recommendations related to data retention and information collection that could improve efficiency in benefit calculation and analysis of aggregate trends in retirement benefits.

Chapter II – Assessment Of Retirement Benefits Calculations

Introduction

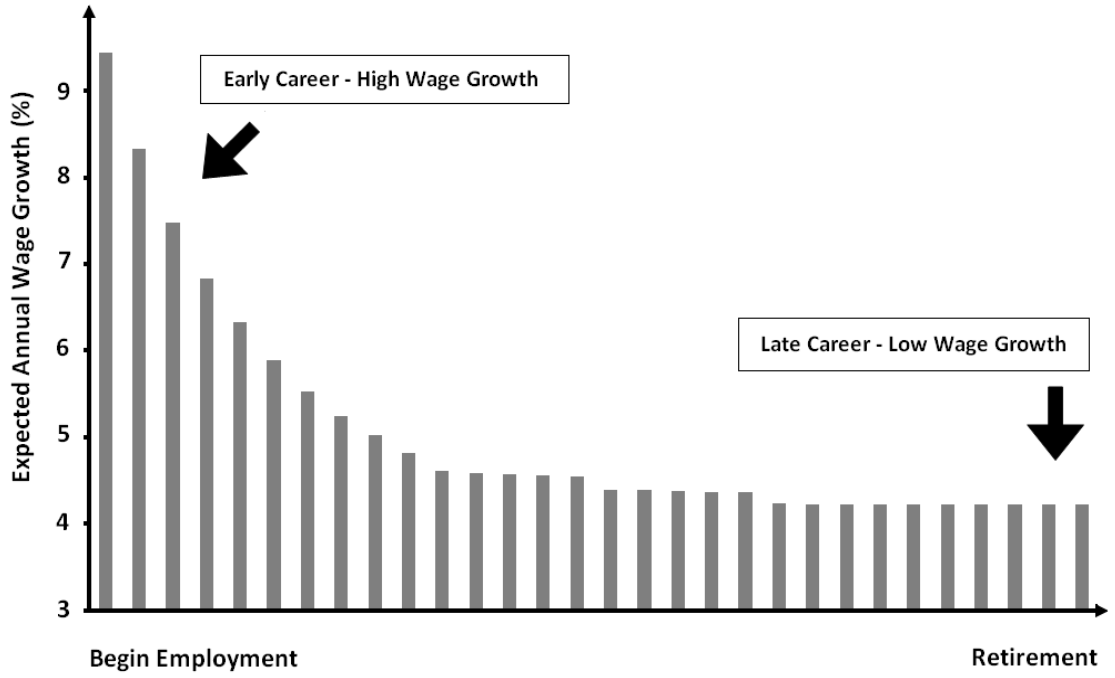
When a member of a defined benefit system receives an increase in compensation during or just before the period of time used to calculate his or her retirement benefit amount it runs contrary to the assumptions used to manage the system and results in an increase to a member's retirement benefit without a corresponding contribution history to support it.

Defined benefit retirement systems in Montana and elsewhere rely on valuations performed by actuaries in order to gauge their financial condition. To perform actuarial studies, it is necessary to make a set of assumptions regarding the future conditions affecting the system. These assumptions are grounded in the actual experience of the system. Important assumptions in each valuation include:

- The general rate of inflation.
- The rate of return for system investment assets.
- The rate of merit promotions and longevity adjustments for system members.
- Life expectancy of members.
- Retirement and disability rates.
- Other economic and demographic assumptions.

All of these assumptions are important when estimating the expected income and liabilities for a retirement system but two are of interest for the purposes of this audit: the rate of inflation and the rate of merit and longevity promotions. We are interested in these assumptions because they provide a gauge for what may be considered to be normal wage growth. Overall wage growth is expected to be the sum of inflation and promotions. Inflation assumptions remain constant over time for all system members but promotion increases are assumed to be larger early in a member's career and decline over time. A composite value for expected wage growth as a member's career progresses is expressed graphically in the following figure.

Figure 1
Composite Expected Wage Growth for Defined Benefit Systems



Note: Wage growth includes inflation and promotions.

Source: Compiled by the Legislative Audit Division from actuarial valuations of systems.

Are Retirement Benefits Equitable and Based on Normal Compensation?

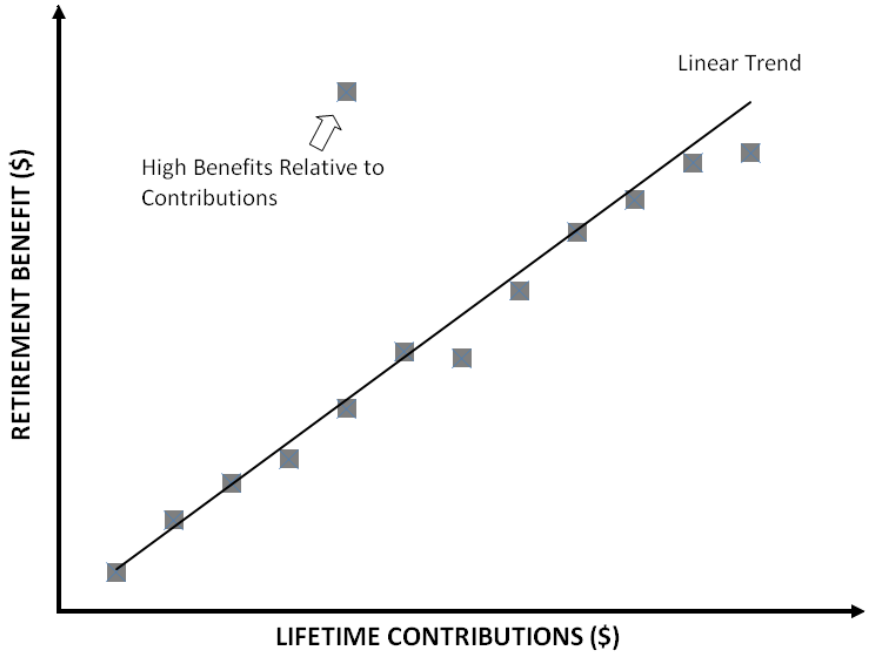
Our first audit objective was to determine if retirement benefits are equitable and based on normal service history and compensation. Essentially, to look at the systems within Montana and determine if the salary during the period of time used to calculate the retirement benefit is predictable based upon the remainder of a member's career.

To accomplish this objective, we collected historical compensation information for system members. We initially wanted to obtain data for an entire segment of the retiree population but the availability of electronic data was limited. Given the absence of electronic data, we opted to use risk-based sample selection. While this approach limits our ability to project results to the population as a whole, it minimized the risk that the existence of benefit inflation would be missed due only to sample selection.

Though in a defined benefit system a member's individual retirement benefit is not solely based on his or her own contributions, our methodological approach involved identifying individuals with high retirement benefit amounts relative to their total contributions to the system. Individuals whose compensation increased sharply at the end of their career are likely to exhibit a relatively high ratio of gross benefit amount to total contributions.

A sample of individual lifetime contributions and retirement benefit amounts is shown in the following figure. Most members follow a normal relationship between contributions and benefits. As contributions increase, benefits increase a corresponding amount. We sought to analyze those members who received an abnormally large benefit relative to their contributions. Individuals exhibiting such qualities distinguished themselves from the majority of members as shown in Figure 2.

Figure 2
Relationship of Lifetime Contributions to Retirement Benefits



Source: Compiled by the Legislative Audit Division.

We sorted individual members by system and by retirement option and stratified them by benefit to contribution ratio. We then developed potential pools of individuals by system and selected individual members at random from within these pools. Resources allowed for analysis of 252 members from Montana Public Employee Retirement Administration (MPERA) systems and 150 from Teachers' Retirement System (TRS).

We included members from each of the defined benefit systems in rough proportion to their incidence in the overall population. We obtained monthly compensation and service data beginning at a point 15 years prior to a member's retirement through the retirement date. The distribution of members included in our sample is shown in Table 2.

Table 2
Retirees Sampled by System

System	New retirees during time period analyzed	Number included in sample
FURS	105	15
GWPORS	53	8
HPORS	36	5
JRS	11	2
MPORS	104	16
PERS	5,140	191
SRS	106	15
TRS	2,929	150
TOTALS	**8,464**	**402**

Note: time period for MPERA systems is FY 2003-09. Time Period for TRS is FY 2004-09.

Source: Compiled by the Legislative Audit Division from Agency Records.

Once we obtained the compensation and service data, we used time series forecast modeling to determine if any individuals within the sample exhibited a level of highest average compensation that deviated from what was expected based upon the normal trend. The level of highest average compensation is important because it forms the basis for calculating a member's retirement benefit amount. It is by increasing the level of compensation that a member is able to increase his or her retirement benefit. We found that in 67 of the 402 (16.7 percent) files reviewed the actual highest average compensation exceeded the expected value by more than 10 percent. Because we used a risk-based sampling approach, it is not possible to determine whether this rate of occurrence is representative of the population as a whole. However, the results of our analysis do indicate that for a minority of retirees, compensation in the final years of employment deviated enough from a normal trend to affect the calculation of their retirement benefit. Although we do not believe these circumstances are widespread in Montana's retirement systems, they can and do occur.

Conclusion

Retirement benefits are usually but not always equitable and based on normal service history and compensation.

Are There Effective Controls to Deter and Detect Inflated Retirement Benefits?

As part of the biennial financial-compliance audits of the Teachers' Retirement Board and the Public Employees' Retirement Board, the accuracy of the retirement benefit calculations performed by TRS and MPERA are regularly reviewed. These audits have not reported any findings related to inaccurate benefit calculations. It was also apparent from our review of files that the staff members at both agencies are assessing the accuracy and completeness of retirement applications.

MPERA employs a system which helps benefit analysts identify monthly compensation that may be anomalous. We noted benefit analysts use this tool along with their own observation of data to identify compensation trends that appear to be abnormal when performing a benefit estimate or processing a retirement application. This process helps MPERA benefit analysts properly assign earnings when they are paid on a retroactive basis and to identify things such as leave payouts made without termination. During our file review, we noted benefit analysts seeking information about retroactive payments also discovered large payments that resulted from bonuses, large amounts of overtime, or significant promotions. MPERA staff rightfully included these types of compensation in the retirement benefit calculations and did not question their inclusion because they are not prohibited under state law.

TRS staff members have procedures for assuring only reportable types of compensation were included in retirement benefit calculations. When TRS members exceeded the allowable compensation growth limits, benefit analysts compiled information from employment contracts to ensure that the member received the maximum allowable retirement benefit—but no more. Statutes limit compensation growth for pension purposes to no more than 10 percent per year, with some exceptions.

Statute Allows Inflation of Retirement Benefits to Occur

Despite the work of both agencies as discussed above, we determined that retirement benefits are not always equitable or based on normal compensation and service history because statutes allow benefit inflation to occur. Controls to deter and detect retirement benefit inflation within both agencies could be improved in some areas.

Improving data collection and retention practices could, for example, help the agencies or internal auditors to more efficiently assess trends in or the magnitude of benefit inflation. However, the statutes governing the retirement systems create conditions in which benefit inflation can occur and the only way to address these conditions is through consideration of changes in state law.

CONCLUSION

Agency controls to detect retirement benefit inflation could be strengthened, but other aspects of the retirement benefit calculation process can only be addressed through changes in statute.

Chapter III– Legislative Consideration Of Retirement Benefit Calculations

Introduction

When an individual member receives a retirement benefit that is higher than expected when compared to normal compensation growth, another member must either receive a correspondingly lower benefit or the system will be left with a net negative outflow. If benefit inflation is allowed to become more prevalent the boards may be forced to revise wage growth assumptions in the future. Increasing the expected wage growth rate would have a negative effect on the financial condition of a retirement system.

Because retirement benefits are typically guaranteed for life, if a few individuals engage in practices which increase the actual retirement benefit above what is expected they can significantly increase their personal retirement income without impairing the overall soundness of the system. However, if even a few individuals are able to increase retirement benefits above what is expected negative consequences occur including:

- greater than expected financial outflows from the system
- a negative perception of system operations by taxpayers
- a negative perception by system members who are unable to achieve similar results

The members who are able to leverage unique situations in order to increase their retirement benefits create inequality within the system and cause financial uncertainty for the agencies which administer the systems.

How Does Benefit Inflation Affect Montana Public Employee Retirement Administration (MPERA) Systems?

We reviewed a total of 252 retiree compensation histories within MPERA-administered systems and identified 45 cases in which the actual retirement benefit amount exceeded the expected amount by 10 percent or more. We selected 36 of these cases for further analysis, plus an additional 11 cases where the statistical time-series modeling used did not appear to form a valid estimate but the compensation history exhibited a large, late-career compensation increase. Information in the files indicated that 13 of the 47 cases fit at least one of the conditions described below. For the remaining 34 cases, we found no documentation detailing the cause of the unexpected increase. This does not imply that MPERA failed in identification, only that the cause of the increase was due to something other than what MPERA is currently directed to identify.

We obtained compensation data for the sampled employees for 15 years prior to retirement. We then used statistical time-series forecasting to estimate the expected value of the highest average annual compensation and compared the expected value to the actual value attained by the member in question. To calculate the difference in total lifetime benefits received, we took the annual difference and calculated a cumulative total including guaranteed annual benefit adjustments and assuming life expectancy of 15 years. We cannot use these results to calculate how frequently such practices may occur overall. Because it was necessary to pare down the size of the pool using risk-based procedures the sample is not representative of the population as a whole.

The following table summarizes the monthly and cumulative additional benefits received by the MPERA system members discussed later in this chapter. As shown, if even a small minority of members can augment their final average compensation and therefore their retirement benefit, the financial impact can be significant. The lifetime expected additional benefit for the five examples discussed is approximately $1.16 million.

Table 3
Summary of Additional Lifetime Benefits for MPERA Examples*

Example	Expected Benefit	Actual Benefit	Monthly Difference	Cumulative Difference
Overtime	$2,850	$4,219	$1,369	$305,469
Bonuses	$2,719	$3,163	$445	99,244
Legislative Service	$453	$2,073	$1,620	361,581
Promotion	$3,658	$4,445	$787	175,667
Dual Employment	$1,730	$2,725	$995	222,015
Total				**$1,163,976**

*Note: Not actuarial estimates, projected additional cumulative benefits to member over a 15 year period.

Source: Compiled by the Legislative Audit Division from Agency Records.

Identification and Analysis of Retirement Benefits Calculations for MPERA

We identified instances in which members were able to increase their retirement benefits above what would be expected based on normal service history and compensation through the following means:

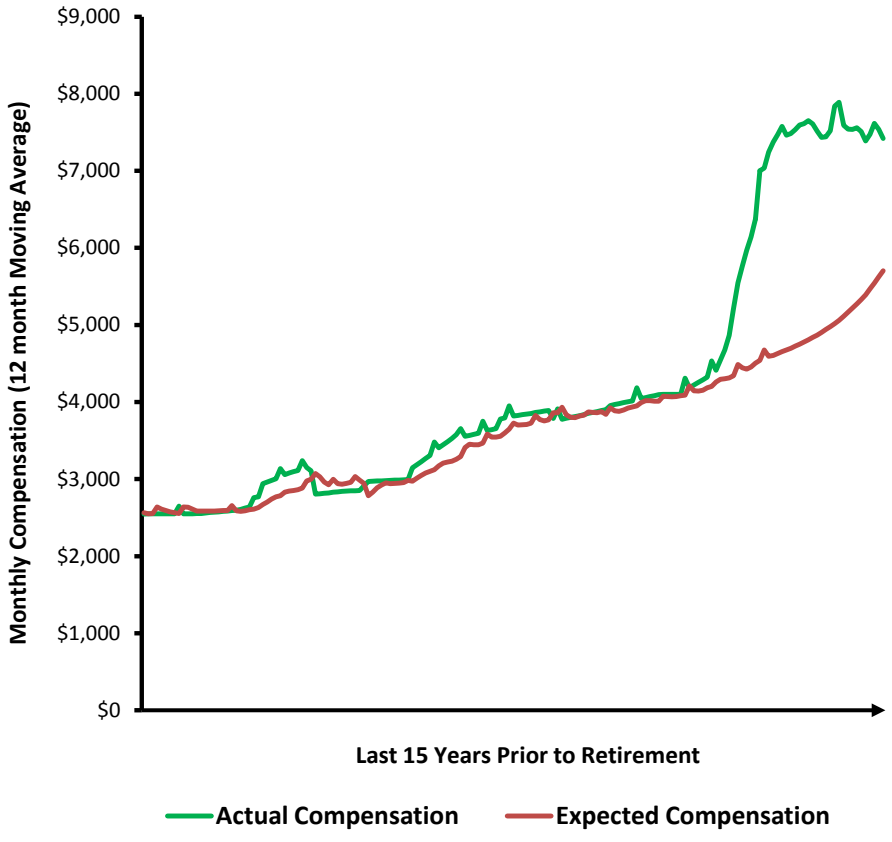
- Inclusion of significant increases in overtime pay.
- Inclusion of bonuses or other discretionary payments.

- Inclusion of other public sector service following a period of legislative service.
- Inclusion of late-career promotions or salary adjustments.
- Inclusion of compensation earned from dual employment.

Inclusion of Overtime Compensation

Overtime compensation is excluded from pension calculations within two of the retirement systems (MPORS and FURS) but is allowable in others. Our review indicated the inclusion of overtime pay only late in a member's career was a factor in augmenting the retirement benefit for some members of the systems where it is allowed. By increasing the amount of overtime worked during the period of highest average compensation, one member was able to raise the monthly benefit amount from an expected $2,850 per month to an actual $4,219 per month. The following figure depicts one member's monthly compensation.

Figure 3
Compensation Trend Including Overtime Earnings



Note: Example of one member's compensation history.

Source: Compiled by the Legislative Audit Division from Agency Records.

In reviewing the member's file, we discovered the member in question had very stable monthly service hours reported during the first 12 years of the time period we analyzed but had regularly reported excess hours during the final 3 years.

Inclusion of Bonuses or Other Discretionary Payments

Bonuses or other forms of discretionary payments are not generally considered to be staples of public sector compensation plans; however, public employers are increasingly adopting alternative pay plans which may include discretionary payments or rewards for time-specific performance.

Incentive and bonus payments that are not part of a series of annual payments are explicitly excluded from the calculation of a member's pension amount within TRS but are not addressed in MPERA-administered plans. The statutes for PERS do exclude lump sum payments of leave balances without termination but do not address other types of lump sum payments.

Our file review identified several members whose retirement benefits were augmented through the inclusion of a bonus. In one example, the member's monthly benefit was increased from an expected $2,719 to $3,163 due to the inclusion of bonuses or other performance payments.

Inclusion of Other Public Sector Service Following Legislative Service

Retirement system membership participation for state legislators is governed by unique sections of state law and rule. Legislators may (ARM 2.43.3402):

- Elect to become members of PERS.
- Continue active membership in another public retirement system if nonlegislative employment allows.
- Decline membership in any public system.

Legislators who participate in retirement systems earn full-time service credit during the period in which they serve and make contributions. Legislators who decline membership while actively serving may later retroactively purchase the service (subject to purchase regulations). Retired legislators may attain employment as a local elected official, be appointed to service in the executive or judicial branches, or obtain another public sector position. This can be problematic for a retirement system because regular contributions for legislative service are low, due to the low rate of compensation for legislative service, while post-legislative earnings can be higher by comparison. When this is the case, it can result in a larger retirement benefit than expected. For example,

an individual who served in the legislature for a series of sessions followed by a period of full time system-covered employment received actual retirement benefits of $2,073 per month from an expected $453 per month if the member had continued legislative service.

Inclusion of Late-Career Promotions or Salary Adjustments

Some employees follow career paths that feature slow but steady compensation growth for many years followed by a sharp increase as retirement nears. This path may reflect an employee who happens to be promoted to a significantly more responsible position or may be due to some other type of salary adjustment, such as a market adjustment or longevity pay. Regardless of the reason for such late-career increases, the practice can be problematic for retirement systems because such increases are not expected based on actuarial assumptions. As with the other conditions described above, a member's retirement benefit grows without a corresponding contribution history to support it.

For example, one of the files we reviewed exhibited a large late-career compensation increase. According to SABHRS records, this member received a 22 percent pay increase due to a reclassification approximately 3 years prior to retirement. The reclassification provided an actual retirement benefit amount of $4,445 per month, up from an expected $3,658 per month based on the expected trend.

According to a report by the Center for Retirement Research, a worker who receives a 20 percent pay raise near retirement increases his lifetime salary by only 2 percent but his initial pension benefit is 15.5 percent larger. According to the report, "The total value of a late promotion or sudden salary increase is roughly three times as valuable as the pay raise itself."

Inclusion of Compensation Earned from Dual Employment

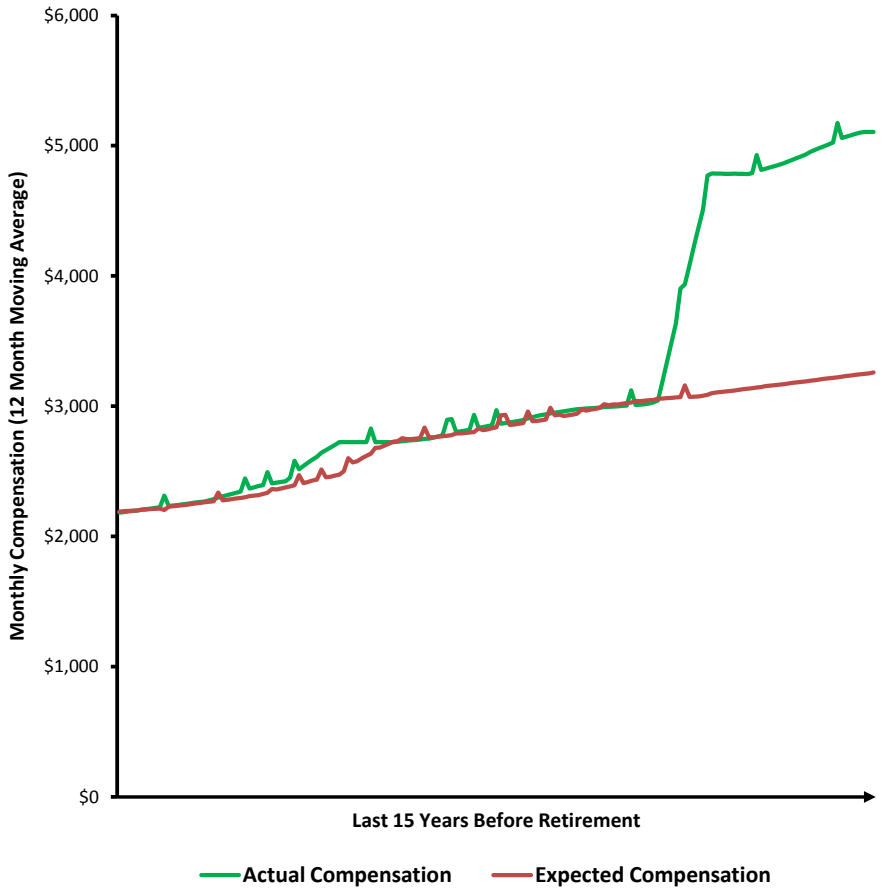
State law prevents members of the defined benefit retirement systems from earning duplicative service credit when serving in more than one covered position. However, the compensation earned from multiple positions is additive.

When an employee works multiple positions during the early period of his or her career this can be beneficial to retirement systems because contributions are made for each position but the compensation earned at that time may not be included in the period of highest average compensation. But when dual employment occurs primarily or only during the period of time used to calculate a member's highest average compensation it can result in an increase to a member's retirement benefit without a corresponding contribution history to support it.

For example, one of the files we reviewed was that of member who was a full time employee who obtained a second, part-time job during the period of highest average compensation. The increased income was sufficient to increase the actual monthly retirement benefit to $2,725 from an expected value of $1,730. The monthly compensation data for this member is shown in the following figure.

Figure 4

Compensation Trend Including Dual Employment Earnings



Note: Example of one member's compensation history.

Source: Compiled by the Legislative Audit Division from Agency Records.

Retirement Benefits Should Be Distributed Equitably and Normally

Numerous studies by nationally-recognized organizations indicate that increases in pension benefits due to late career compensation increases should be avoided. These organizations include the Center for Retirement Research, The National Association of Retirement Administrators and the Government Finance Officers Association.

> A Center for Retirement Research study indicates, "about 40 percent of state and local plans in our sample have introduced "anti-spiking" provisions, limiting the amount of a pay raise that counts for pension calculations, to prevent this type of pay boost immediately before retirement. Without such a provision…the incentive to inflate late-career pay is very strong in final pay plans."
>
> The National Association of Retirement Administrators "supports adequate funding of promised benefits and efforts to ensure the financial integrity of public employee retirement systems including safeguarding against abusive benefit enhancements or manipulation."
>
> The Government Finance Officers Association considers it a best practice to limit retirement benefit inflation, stating, "headline grabbing abuses of retirement benefit enhancements such as salary spiking can create negative public perceptions that are harmful to all retirement systems and can adversely affect the sustainability of the system. Policies to safeguard against these abuses or undesired outcomes should be considered." In October 2010, the same organization issued an advisory stating, "A pension formula that allows extraordinary income to be included in the base salary on which pensions are based may result in inequitable distribution of benefits and hidden costs, and potentially cause a public perception of impropriety."

The Legislature has taken action to exclude some types of compensation from the retirement benefit calculations within MPERA-administered systems. Maintenance, allowances, and expenses are excluded within FURS and statutes exclude overtime, holiday and shift differential payments from compensation within MPORS.

Options for Increasing the Equity and Normality of Retirement Benefits

Numerous other states have also enacted legislation which has the effect of limiting late career compensation increases on their retirement systems. Table 4 describes a sample of laws that have been enacted by various state legislatures in recent years.

Table 4
Sample of Legislation

Year	State	Legislation Enacted
2010	Colorado	Limit pensionable compensation growth to 8%
2010	Arizona	Extend benefit calculation period
2010	Illinois	Extend benefit calculation period and placed a cap on the maximum average compensation used
2010	Iowa	Extend benefit calculation period
2010	New Jersey	Extend benefit calculation period
2010	Virginia	Extend benefit calculation period
2009	Arkansas	Limit pensionable compensation growth to 120% of the next highest salary
2009	Nevada	Limit pensionable compensation growth to 10%
2009	Rhode Island	Extend benefit calculation period
2009	New York	Restrict the amount of overtime to no more than 15% of regular compensation.
2009	Georgia	Limit pensionable compensation growth to 5%
2008	New Hampshire	Cap annual benefits at $120,000.
2006	Louisiana	Extend benefit calculation period and limit pensionable compensation growth to 10%
2006	Illinois	Limit pensionable compensation growth to 6%
2005	Nebraska	Limit pensionable compensation growth to 7% and limit exceptions to cap

Source: Compiled by the Legislative Audit Division.

Several legislative changes are possible to help ensure that retirement benefit amounts are based upon normal service history and compensation. The list below is nonexhaustive but summarizes the types of legislation which could increase the equity and normality of retirement benefits:

- Extending the period of time used to calculate a member's highest average compensation. This would reduce the impact of one-time payments and reduce the impact of late-career compensation increases stemming from overtime, promotions, or dual employment income.
- Excluding from benefit calculations the types of compensation that can cause deviations from normal trends, such as bonuses, overtime, and dual employment.
- Placing limits on the growth rate for compensation used in the calculation of retirement benefits.

- Restricting pensionable compensation growth to a specific rate but allowing compensation above that rate to be included if the actuarial cost of inclusion is contributed.
- Enacting a cap on the total gross amount an individual may earn as a pension benefit.
- Requiring legislators to buy back legislative service time at a cost equivalent to the actuarial cost of their retirement benefit amount.

RECOMMENDATION #1

We recommend the Legislature consider whether the elements of compensation used in calculating retirement benefits within Montana Public Employee Retirement Administration-administered systems should be revised.

How Does Benefit Inflation Affect the Teachers' Retirement System?

We reviewed a total of 150 retiree compensation histories within Teachers' Retirement System and identified 22 cases in which the actual retirement benefit amount exceeded the expected amount by 10 percent or more. We selected 17 of these files for further analysis, plus an additional eight cases where the statistical time-series modeling did not appear to form a valid estimate but the compensation history exhibited a large, late-career compensation increase. Information in the files indicated 15 of the 25 cases fit at least one of the conditions described below. In the other 10 cases, the member achieved unexpected compensation growth through other means, such as by changing employers or the rate of growth did not exceed the 10 percent cap.

Table 5
Summary of Additional Lifetime Benefits for TRS Examples*

Example	Expected Benefit	Actual Benefit	Monthly Difference	Cumulative Difference
Summer	$4,541	$5,989	$1,448	$289,919
Pay Scales	$2,302	$3,069	$767	$153,470
Extra Duties	$3,172	$3,999	$827	$165,487
Total				**$608,876**

*Note: Not actuarial estimates, projected cumulative additional benefit to member over a 15 year period.

Source: Compiled by the Legislative Audit Division from Agency Records.

Table 5 summarizes the monthly and cumulative additional benefits received by the TRS members discussed as examples below. As shown, if even a small minority of members can augment their final average compensation and therefore their retirement benefit, the financial impact can be significant. The lifetime expected additional benefit for the three examples discussed is approximately $609,000.

For individual members, benefit inflation can represent a significant financial advantage, though our analysis indicates the practice is limited and would not likely affect the actuarial soundness of the retirement system as a whole. However, when individuals engage in practices which result in benefit inflation it can create a negative perception of the retirement system by members who are unable to achieve similar results and by the taxpaying public.

Identification and Analysis of Retirement Benefits Calculations for TRS

We identified instances in which members were able to increase their retirement benefits above what would be expected by seeking exceptions to the statutorily-imposed cap on compensation growth, including:

- Accumulating significant amounts of summer earnings.
- Increasing compensation through late-career movements on school district pay scales.
- Earning compensation through duties other than base teaching pay.

Much like the conditions described for the MPERA-administered retirement systems, when compensation from these practices is distributed over the course of an employee's career it is not problematic for pension systems assuming contributions are made for these types of compensation. When they occur primarily or only during the period of time used to calculate a member's highest average compensation it can result in an increase to a member's retirement benefit without a corresponding contribution history to support it.

Inclusion of Summer Earnings

Compensation received for summer employment is currently exempt from the 10 percent maximum growth rate, provided that it does not exceed "one-ninth of the academic year contract for each full month or prorated for each portion of a month employed during the summer." (ARM 2.44.518(1)(c)) For an employee who works under a 9-month academic year contract, it may be possible to increase overall pensionable compensation by approximately 33 percent by maximizing allowable summer earnings. TRS staff also report that it is difficult to ensure that compensation that is reported as summer earnings is in fact earned during the summer.

Through the accumulation of significant summer earnings, one member was able to raise the monthly benefit amount from an expected $4,541 per month to an actual $5,989 per month. The member informed TRS via letter of his intention to increase his compensation above the 10 percent growth limit by taking advantage of the

exemptions. TRS staff indicate other individual members and employers within the system have also come to understand the exemptions and work to ensure that increases in compensation fall within one of the exempt areas.

Inclusion of Late-career Movements on Pay Scales

The compensation rate for many teachers within Montana and elsewhere is governed by a pay scale or salary matrix approved by a local school board. The scales typically feature increases due to longevity or qualifications. Some teachers follow career paths that feature slow but steady compensation growth for many years followed by a sharp increase as retirement nears. This path may reflect an employee who happens to be promoted to a significantly more responsible position or may be due to some other type of salary adjustment. Regardless of the reason for such late-career increases, the practice can cause funding problems for retirement systems because a member's retirement benefit grows without a corresponding contribution history to support it. For example, one member's monthly benefit was increased from an expected $2,302 to $3,069 due to movement on the school district's salary matrix during the period of highest annual compensation.

Inclusion of Duties Other Than Base Teaching Pay

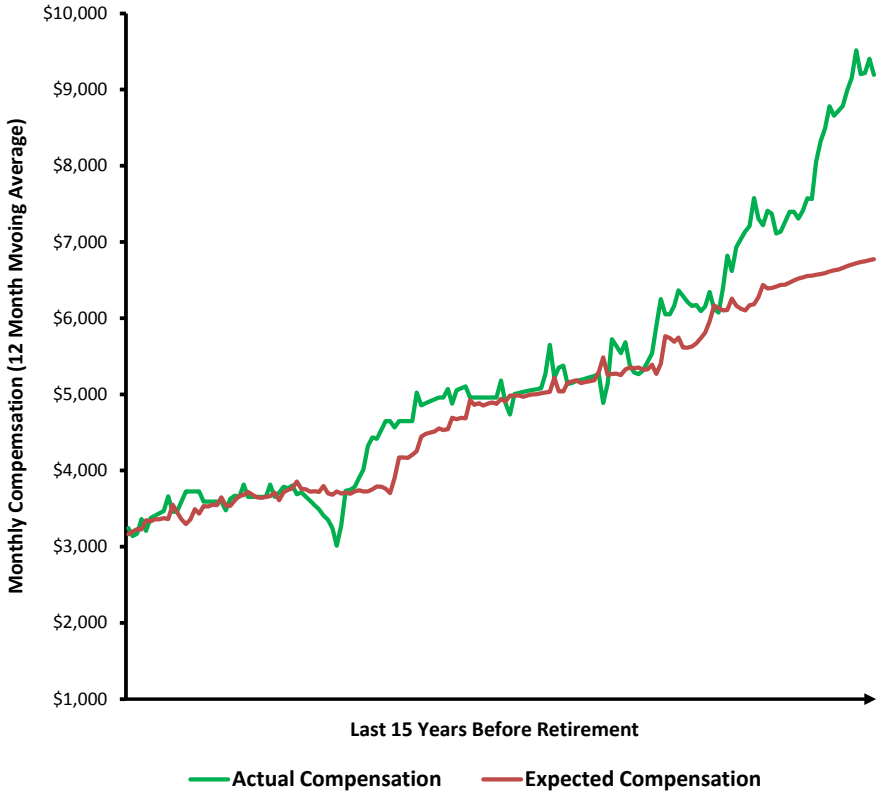
Many school districts feature part-time or seasonal positions that may be filled by employees who are also full-time teachers. Examples may include coaching, drivers education instruction, or teaching online courses.

Employers are required to report extra duty compensation paid to a member and to make contributions to the retirement system for such compensation. Extra duty compensation is required by administrative rule (ARM 2.44.528(1)) to:

- be published in an extra duty schedule that is approved and adopted by the governing body
- be included in the member's employment contract
- be included in the official job description

During our file review, we noted one member performed a variety of extra duties and subsequently was able to increase the actual retirement benefit amount to $3,999 per month from an expected $3,172 per month. The monthly compensation trend for this member is shown if the following figure.

Figure 5
Compensation Trend Including Extra Duty Earnings



Note: Example of one member's compensation history.

Source: Compiled by the Legislative Audit Division from Agency Records.

Exemptions to Compensation Growth Limits Create Inequity

The Montana Legislature has taken steps to limit the inclusion of certain types of compensation or cap compensation growth within TRS. Statutes restrict the compensation growth rate to 10 percent, but give the Teachers' Retirement Board discretion to grant certain exceptions to the limit. The statutes also exclude nonannual incentive or bonus payments from retirement benefit calculation. Finally, the statutes §19-20-102(2)(a) and §19-20-102(2)(b)contain the following statement:

"It is the policy of the state to:

a. provide equitable retirement benefits to members of the teachers' retirement system based on each member's normal service retirement and salary;

b. limit the effect on the retirement system of isolated salary increases received by a member, including but not limited to end-of-career promotions or one-time salary enhancements during the member's last years of employment."

TRS has recognized exceptions to the compensation growth limit create opportunities for individual members to earn retirement benefits that are not equitable nor based upon normal service history and compensation. TRS has indicated plans to address this by seeking legislation which limits the allowable exceptions to the cap. Such clarification will reduce the conflict between the policy statement that pensions should be equitable and based upon normal service history and compensation and the statute allowing for exceptions which create opportunities for inequality and abnormality to exist.

RECOMMENDATION #2

We recommend the Teachers' Retirement System clarify the exceptions to the compensation growth limit.

Chapter IV – Improving Efficiency Of Retirement Benefit Calculations

Introduction

Both the Montana Public Employee Retirement Administration (MPERA) and the Teachers' Retirement System (TRS) collect service and compensation data from employers via web-based reporting systems. Each agency is charged with collecting the information from hundreds of employers at least monthly. The data collected forms the basis for each agency's calculation of a member's retirement benefit amount. When an individual member applies for retirement, benefit analysts at the respective agency access the service and compensation data to estimate and then confirm the member's length of service and period and amount of highest average compensation.

While we found both agencies review retirement applications and service history and compensation data used in calculating benefits, we also identified process improvements that could strengthen process controls. Specifically, this chapter discusses findings in the following areas:

- MPERA data retention practices
- Employer data collection practices for both MPERA and TRS

Electronic Data Retention Could Improve Data Access for MPERA

When an active member retires from service within an MPERA-administered defined benefit retirement system, the agency removes the electronic monthly compensation and service data that has been submitted over the course of that member's career. The agency does retain the information by printing a paper copy of the member's data, which is later transferred to microfiche. This storage method appears to be effective for maintaining an individual's data, but the lack of data in an electronic format hinders the ability to analyze data in aggregate. When data is converted from an electronic format to a printed format its availability for widespread use is diminished and the act of conversion may be an unnecessary restriction to accessibility.

Maintenance of Data in Electronic Form Would Allow Aggregate Analysis

Analysis of aggregated trends in compensation and service history for members of MPERA-administered defined benefit retirement systems cannot be conducted efficiently in the absence of electronic data. Users must turn to hard copy data for use in analysis, which may be effective for individual cases but does not lend itself

to efficient analysis of large groups of member histories. Large amounts of data are required to analyze trends in a meaningful way. For example, an estimate of how commonly a retiree's benefit is based on something other than normal service history could be developed if sufficient information were available.

MPERA staff members also have occasional need to access individual compensation and service histories after a member has retired and even individual case analysis is hindered by the need to find a file, locate information within the file, and export hard copy data to a useful format. If this data had been available in a readily accessible electronic format, these unnecessary steps could have been eliminated, resulting in a more efficient method for MPERA staff accessing service and compensation data.

Retention Practices Could be Updated due to Changing Demands, Technology

The existing practices related to electronic retention of data have been in place for a number of years without change. They may have originally been devised during a period of time when electronic data storage was prohibitively expensive. Since the practice was originated, technological advances have decreased the costs of data storage, MPERA has hired an internal auditor to whom electronic data could be useful, and we have entered an era of increased scrutiny of public sector pensions. MPERA is currently reassessing its electronic data retention practices. MPERA staff will likely require the ability to conduct more analysis of pension trends in the future than in the past. To achieve this, access to electronic data will be necessary.

RECOMMENDATION #3

We recommend the Montana Public Employee Retirement Administration develop electronic data storage for compensation and service data to allow for efficient use and analysis of data.

Information Collection Practices Could Improve Calculation Efficiency

Both agencies collect compensation and service history information for active members, but the compensation reported is not broken down into component parts, such as how much is base pay, how much is overtime and how much is a bonus. MPERA's employer reporting handbook requires that earnings are reported as total gross compensation paid to the employee during the pay period, including regular, overtime and leave

components. TRS's employer handbook states that employers are allowed to report member earnings based on 9-10-or 12-month contracts and that termination pay may not be included in a member's regular wages but does not distinguish between other types of compensation.

Statutes Distinguish between Different Types of Reportable Compensation

Statutes relating to both MPERA and TRS-administered retirement systems distinguish between different types of compensation for the purposes of determining highest average compensation and calculating benefits. Some systems restrict the types of earnings that are included in compensation for retirement purposes. For example, FURS excludes overtime earnings from retirement benefit calculation and TRS excludes nonannual incentive or bonus payments.

State retirement administrators in other states collect the information that will effectively and efficiently allow the accurate calculation of retirement benefit amounts. For example, the Wyoming Retirement System (WRS) requires employers submit data for each member's level of "acceptable compensation" as defined by the WRS Board. The WRS reviews the contributions and limits increases in an employee's highest average salary if it is found ineligible compensation is reported.

The North Dakota Public Employees Retirement System also requires participating employers distinguish between pensionable and nonpensionable types of compensation by reporting it separately. Employers report a member's gross monthly salary, and also report separately, "compensation such as bonuses, retroactive pay adjustments, adjustments to salary for months other than the current month, or for months when no contributions were made are reported."

Benefit Analysts Must Request Additional Information, Some Compensation could be Erroneously Credited

When questions arise regarding the composition of compensation, retirement administration staff members must question payroll clerks and await response. During the course of audit work, we noted benefit analysts posed questions to payroll clerks to determine things such as whether any reported compensation was retroactive in nature, whether any compensation included leave payouts, or in the case of TRS, whether compensation included bonuses or summer earnings.

For the systems which currently restrict the types of compensation that count towards retirement benefits, some types of compensation are more likely to be erroneously credited towards a member's pension than if employers reported the composition of

a member's compensation. During the audit, we noted a case in which an MPERA benefit analyst questioned a month's compensation for a FURS member. The payroll clerk stated that the amount in question was the regular monthly pay plus a retroactive payment, partially composed of overtime. The benefit analyst rightfully excluded the overtime amount from the benefit calculation, but it was unknown whether other months may also have included some portion of overtime compensation.

The Teachers' Retirement System collects employment contracts for members upon termination, but initially only for the last year of service. Additional contracts are requested as required on a case by case basis. These contracts help the agency identify types of compensation. But, if TRS does not collect contracts for all years used to calculate highest average compensation or otherwise require employers to submit a breakdown of compensation by type, it is possible that employers may not always submit reportable compensation accurately.

Information Collection Systems Could Improve Efficiency

The information collection systems in place at the agencies were not designed to delineate between different types of compensation. Over time, the landscape of public sector employee compensation has changed. Employers may be compensating employees in ways that were unexpected at the time the systems were designed. The changing nature of compensation design is not limited to employer practices as the types of reportable compensation allowed within a particular retirement system are also subject to change at the discretion of the legislature. For example, in each of the past two sessions, an attempt was made to include overtime as reportable compensation for FURS members.

It may be challenging for TRS and MPERA to frequently adapt to the changing environment because of system implementation demands upon agency IT staff and participating employers. Agencies, in conjunction with other concerned stakeholders such as participating employers, should determine whether changes to existing methods of information collection could be made to increase efficiency in collecting wage and service information. Such changes could include:

- As systems are replaced, revising existing web reporting systems to distinguish between types of compensation.
- Requiring employers to submit upon termination of a member the breakdown of compensation during the period of highest average compensation.
- Seeking alternative sources of compensation information by compensation type to verify reportable compensation is accurately reported by employers.

RECOMMENDATION #4

We recommend the Montana Public Employee Retirement Administration and the Teachers' Retirement System collect information that is delineated by compensation type where types of reportable compensation are designated in state law.

Montana Public Employee Retirement Administration

Teachers' Retirement System

Agency Response

PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION

A-1

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November 29, 2010

Tori Hunthausen, CPA
Legislative Auditor
Room 160, State Capitol
PO Box 201705
Helena, MT 59620-1705

Dear Ms. Hunthausen,

We have reviewed the recommendations included in the Performance Audit "Analysis of Retirement Benefit Inflation in Montana's State Pension Systems." As noted in the audit report, public pension funds across the nation have attracted significant headlines in recent months due to the fear of benefit inflation and unfunded retirement benefits. It is encouraging to be recognized for the controls we have in place to identify and investigate cases where compensation is higher than anticipated.

It is important to recognize that compensation types and compensation increases by employers are allowed within the scope of the law. However, benefit increases attributed to these payments can contribute to negative public perception of the systems. We are pleased to see in your report that benefit inflation, even though it can and does occur, is a relatively rare practice and unlikely impacts the solvency of the systems.

Recommendation #1

We recommend the Legislature consider whether the elements of compensation used in calculating retirement benefits within Montana Public Employee Retirement Administration-administered systems' should be revised.

Response

Concur. As noted in the performance audit report, retirement benefits are based on the highest average compensation, years of service and a multiplier. In addition, the definition of compensation differs across retirement systems. In some cases overtime, bonus pay, dual employment, and legislative service can enhance a member's final retirement benefit.

Among other legislative proposals, the Public Employees' Retirement Board is proposing an increase in the number of months used to determine the member's highest average compensation for new hires in the Public Employees' Retirement System, Game Wardens' and Peace Officers' System and the Sheriffs' Retirement System. If the legislation is passed it would be more difficult to inflate compensation over a period of 60 months instead of 36 months.

To reduce the likelihood of retirement benefit inflation, the legislature may wish to consider revising the elements of compensation used in calculating retirement benefits for newly hired employees.

Recommendation #2

Response
Not applicable to MPERA.

Recommendation #3
We recommend the Montana Public Employee Retirement Administration develops electronic data storage for compensation and service data to allow for efficient use and analysis of data.

Response
Concur. The Montana Public Employee Retirement Administration's database systems were created in the 80's and 90's using an IDMS mainframe platform. At that time, mainframe storage costs were high. It was determined then that the cost of maintaining compensation history after a member retired outweighed the need for the data to be stored electronically.

MPERA staff has recognized the need for the development of new database and software systems as outlined in our state IT plan. In fiscal year 2010, MPERA concluded our analysis of the needs and risks of the current database systems and began exploring the available technology for a replacement system. A business case has been approved by the Public Employees' Retirement Board in support of a system replacement project. The project will include document imaging and a new pension administration software system; inclusive of workflow, document storage, on-line member access, and increased electronic data collection and storage.

Since a new system will not be in place for a minimum of four years, MPERA recognizes that the removal of electronic data that has been submitted over the course of a member's career is not efficient and that lower cost data storage is available. MPERA is reviewing our current practice of removing compensation and service data. We hope to have a storage process in place to retain this data by the end of calendar year 2011.

Recommendation #4

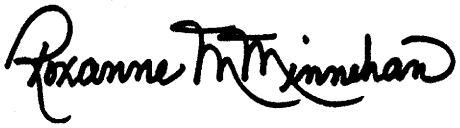
We recommend the Montana Public Employees' Retirement Administration and the Teachers' Retirement System collect information that is delineated by compensation type where types of reportable compensation are designated in state law.

Response

Concur. As the audit establishes, in this recommendation and the previous, more detailed data is needed for the administration of the retirement systems. The current mainframe technology is nearing obsolescence and with restricted data collection options does not support changes necessary to efficiently manage our retirement systems. In addition, support of IDMS technology is dwindling. The system replacement project discussed above will address employer compensation reporting. This will include, but may not be limited to, payment for over-time or compensatory time, bonuses, leave and retroactive adjustments.

We appreciate the professionalism demonstrated by the audit staff and would like to extend our thanks to you and your staff for the courtesy and consideration offered to MPERA during the audit.

Sincerely,



Roxanne M. Minnehan
Executive Director

TEACHERS' RETIREMENT SYSTEM

BRIAN SCHWEITZER, GOVERNOR

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November 24, 2010

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Tori Hunthausen, Legislative Auditor
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Helena MT 59620-1705

Dear Ms. Hunthausen:

Thank you for the opportunity to reply to the performance audit report of the Teachers' Retirement System and the Montana Public Employee Retirement Administration. Our reply is limited to the recommendations directed to the Teachers' Retirement System.

Recommendation # 2:
We recommend the Teachers' Retirement System clarify the exceptions to the compensation growth limit.

Response: Concur

The statute (19-20-715, MCA) restricting compensation growth to 10 percent was enacted by the Montana Legislature in 1989. The statement of intent attached to the legislation stated that the legislature intends that the Board's rules exempt from the 10 percent statutory cap increases that:

(1) result from collective bargaining agreements;
(2) have been granted by the employer to all other similarly situated employees; or
(3) have been received as compensation for summer employment.

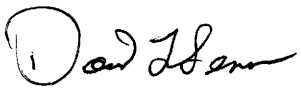
The legislative intent to allow exceptions to the 10% cap seems, today, to be out of step with the policy statement cited in the audit report (19-20-102(2), MCA), which was enacted in 2007. For this reason, the TRS Board has prepared legislation (LC 408) that would, among other things, limit exceptions to the 10 percent cap to only changes in compensation that result from movement on an employer adopted salary matrix, and remove the Board's authority to grant exceptions. This legislation, if approved, would be effective July 1, 2011, and would apply to the calculation of all benefits effective after July 1, 2011.

Recommendation # 4:
We recommend the Montana Public Employee Retirement Administration and the Teachers' Retirement System collect information that is delineated by compensation type where types of reportable compensation are designated in state law.

Response: Conditionally Concur

We agree that delineation of compensation by type could provide useful information for audit purposes and to verify that all compensation types have been reported correctly for purposes of calculating retirement benefits. We also recognize that it will take a considerable amount of effort and time on the part of the retirement system and participating employers to redesign human resource and compensation reporting systems. It is the intent of the TRS to include enhancements to collect more specific compensation information as current information systems are enhanced or replaced. However, time and budget constraints at the local level may limit the ability of participating employers to make the corresponding changes in their reporting capabilities in the same timeframe. TRS will have to be considerate of the local funding issues in its efforts to expand reporting requirements. TRS is also looking at potential alternative sources for more comprehensive compensation reporting information, such as compensation information gathered by the Office of Public Instruction.

Sincerely,



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Executive Director
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DLS/mm