Executive Summay for Final Average Salary Rule

Introduction

The two Administrative Rules codify the Fund's methodologies for calculating "Final Average Salary" ("FAS"). Because the Illinois Pension Code made significant changes to the way Members accrue Service Credit on July 3, 2011, we have divided the methodology into two Rules: the "Legacy Rule" applies to employees who <u>only</u> have Service Credit prior to July 3, 2011, while the "Day-for-Day Rule" applies to employees with any service on or after July 3, 2011.

These calculations are central to all benefit calculations. As such, great time and effort was put into developing the following Rules. However, the complex nature of the Fund's methodology results in a correspondingly complex Administrative Rule. To aid the Trustees' evaluation of the Rules, we have prepared the following executive summary explaining the context for the Rules and summarizing their major components.

Background

Article 17 of the Pension Code defines a Member's FAS as "the average annual rate of salary for the 4 consecutive years of validated service within the last 10 years of service when such average annual rate was highest." While the concept of FAS is deceptively simple, the definition contained in Article 17 can be interpreted in several ways depending on the meaning of the phrase "annual rate of salary." During numerous meetings with staff, Board Counsel, Special Fiduciary Counsel to the Board, and Grant Thornton, we considered the following three methods of calculating FAS.

First, we considered the "actual earnings" methodology, under which a Member's annual rate of salary would be equal to their actual earnings in a school year. This method is easy to calculate and straightforward to explain. However, by using only a Member's actual earnings in a given school year, this method fails to give effect to the statutory term "rate of salary." As a result, Members who work only part-time or who take leave during their final years of service would be significantly disadvantaged because a partial year's earnings would be treated as if it were their annual salary for an entire year.

Second, we considered the "annualized" salary methodology, under which the Fund would compute an annualized rate of salary for each Member by dividing their actual earnings in a school year by the percentage of the year they worked. This methodology gives effect to the term "annual rate of salary" by projecting a Member's earnings forward to determine what their annual rate of pay would have been had they worked a complete year. However, this methodology could artificially inflate the annual salaries of Members who retire immediately after receiving a promotion or wage increase, thus giving them an imputed year of "salary" at the higher rate.

Finally, we considered the "normalized" salary methodology, which has been the Fund's long-standing practice for calculating FAS. Like the annualized salary methodology, this method creates an annual "rate of Salary" for any year in which a Member worked less than a full year. However, rather than projecting *forward* based on the Member's most recent earnings, the normalization process looks *backwards* and "fills in" missing Salary entries based on the Member's actual earnings in prior years. Essentially, this methodology excludes portions of the school year in which the Member received no earnings and combines the remaining "active" periods into hypothetical full school years.

All of the Fund's benefit calculation software is based on the normalized methodology. The methodology also has the advantage of not reducing any pension benefit which would create a risk that a new methodology would diminish or impair a pension benefit in violation of the Illinois Constitution Article 13, Section 5. This methodology is also similar to the one used by TRS, which is governed by similar language related to "annual rate of salary." We believe this methodology gives effect to the statutory language while avoiding any improper inflation of pension benefits.

Executive Summary of FAS Rules

While the details of the Legacy and Day-for-Day Rules are different, both methodologies are based on the principle that a Member's "annual rate of salary" represents the Member's earnings over a "complete" school year. If a Member works a full school year, their actual earnings are equivalent to their "annual rate of salary" for that school year. However, if a Member works less than one full school year, (for instance, because they took medical leave or worked as a part-time substitute), the Member's earnings during the partial school year constitute only a portion of the Member's true "annual rate of salary." In these instances, the normalized salary methodology is employed to construct full years of salary based on their actual earnings from prior pay periods.

The Rules below compute a normalized rate of salary through a multi-step process. First, the Fund determines the time period over which the Member accrued their last ten complete years of service credit. Depending on how regularly the Member worked, this period may be greater than ten calendar years. Each period of one "complete" year of Service Credit is known as an "Annual Salary Year."

Next, the Fund determines the Member's Annual Rate of Salary for each Annual Salary Year by combining the earnings that correspond to the periods of service included in each Annual Salary Year. Thus, if a Member works one-half of a school year in two consecutive school years, the Member's Annual Salary year would be made up of the two half-years, and the Member's Annual Rate of Salary would be equal to the Member's combined earnings from both years.

Finally, the Fund calculates the Member's highest Average Rate of Salary for each period of four consecutive Annual Salary Years within the ten Annual Salary Year period. The resulting figure is the Member's FAS.

Conclusion

While the methodology described above is undoubtedly complicated, it reflects two principles that, in our view, render it the most faithful interpretation of the language of Article 17 of the Pension Code. First, the ordinary meaning of the phrase "annual rate of salary" implies a measure of earnings over a full year of work. This interpretation is consistent with the fact that, when the FAS provision in Article 17 was written, the Fund was a single-employer plan and nearly all Members' earnings were governed by collectively-bargained salary schedules. In addition, other Articles of the Pension Code (e.g. Article 7, governing IMRF) specify that a member's FAS should be based on their actual earnings. Thus, we assume the General Assembly intended the term "rate of salary" to have a meaning beyond actual earnings.

Second, while a normalized Annual Salary Year may include service credit and earnings from multiple school years, each Annual Salary Year includes only the Salary earned during the equivalent of one school year. In this way, a Member is given credit for a full year of earnings without inflating their salary based on projected or constructive earnings.