In Brief

Issue

Statute defines certain types of employee compensation such as overtime and bonuses exceeding certain thresholds as "excess compensation." Employers are required to pay the additional costs to the retirement system for excess compensation paid to members.

Some policy makers may question whether current statutory provisions are sufficient to mitigate the potential impact of excess compensation on the state's retirement systems and may seek to expand the provisions.

Member Impact

Excess compensation provisions do not directly impact members' benefits. However, this issue may impact any public employer paying excess compensation through increased employer billings.

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Excess Compensation

Current Situation

Statute defines certain types of employee compensation such as overtime and bonuses exceeding certain thresholds as "excess compensation." Employers paying excess compensation are generally billed for the additional cost to retirement system resulting from excess compensation. These provisions are designed to mitigate the financial impact of certain pay practices on the retirement systems.

Some policy makers may question whether current statutory provisions are sufficient to mitigate the potential impact of excess compensation on the state's retirement systems. These policy makers may seek to expand the definition of excess compensation to include additional compensation amounts.

During the 2012 Legislative Session, a bill was introduced that would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump sums. The bill (HB 2441) did not pass the Legislature.

This raises the following key question for policy makers considering this issue:

- Is the current definition of excess compensation sufficient, or should it be expanded?

Background

Excess Compensation Is Defined In Statute

Statue defines certain types of employee compensation—if used in the calculation of a member's benefit—as excess compensation. This generally includes compensation beyond regular hourly wages or monthly salary. Specifically, excess compensation is defined in RCW 41.50.150 as including the following types of payments.

- A cash out of annual leave in excess of 240 hours.*
- A cash out of any other form of leave.*
- A payment for any personal expense that is reportable compensation.
- The portion of any payment, including overtime or bonuses, that exceed twice the regular rate of pay.
- Any termination or severance payment.*

The definition of excess compensation only applies to payments that impact a member's benefit calculation. Compensation paid outside a member's Average Final Compensation (AFC) ** period or directly excluded from AFC does not impact the pension calculation and does not meet the definition of excess compensation. Also, pension contributions are not collected on excluded compensation.

Excess compensation only applies to payments that impact a member's benefit calculation.

For example, the Plans 2/3 use a five-year AFC period. This means that payments to a Plans 2/3 member otherwise meeting the criteria but paid more than five years prior to retirement typically won't impact the pension and would not be billed. Also, the Plans 2/3 exclude certain types of payments such as leave cash outs and severance pay from AFC. Again, these types of payments to a Plan 2/3 member won't impact the pension calculation, do not have contributions collected on them, and would not be billed. More information about what types of payments are included and excluded from AFC is provided in the educational briefing on pension spiking presented at the May SCPP meeting.

According to DRS, the majority of excess compensation billings are related to leave cash outs for Plan 1 members. Relatively few billings are created for overtime or bonuses—only 11 employer billings over the last three years.

**These payments are excluded from the salary used for pension calculations for Plan 2/3 members and no contributions are collected on them.*

***AFC is the technical term for the salary used in calculating a pension. It is generally the highest consecutive two or five years of includable compensation.*

Employers Are Generally Billed For Excess Compensation

Employers are generally billed for the present value of the increase to the member's lifetime pension benefit.

Employers paying excess compensation are generally billed for the present value of the excess compensation's increase to the member's lifetime pension benefit. These billings are calculated by the Department of Retirement Systems (DRS) at the time of retirement. DRS first calculates the increase in the member's monthly benefit attributable to the excess compensation. Then DRS calculates the actuarial present value of that increase using factors provided by actuaries.

Calculating billings at the time of retirement removes uncertainty around a member's ultimate retirement age and the compensation used in the pension calculation. Generally speaking, removing this uncertainty improves the accuracy of actuarial estimates of the cost impact of excess compensation.

Employers are also subject to public disclosure requirements before entering into an employment contract that includes excess compensation. Statute requires employers to disclose, at a public meeting, the nature of the compensation and provide an estimate of the excess compensation billings it will generate. See RCW 41.50.152.

The Impact Of Overtime/Bonuses Is Not Determinable At This Time

Some policy makers may choose to focus on overtime and bonuses.

Policy makers evaluating whether existing excess compensation provisions are sufficient may want to know the impact of certain salary practices on members' benefits. They may further choose to focus on overtime and bonuses since these are includable* in the AFC for the state's open plans (Plans 2/3) and have received media attention in the past.

Salary data does not distinguish overtime and bonuses from other earnings.

It is not possible to determine at this time how much overtime and bonuses are increasing members' AFCs and benefits.** Actuaries cannot estimate the impact because current salary data does not distinguish overtime and bonuses from other earnings. The employer reporting system used by DRS is not capable of collecting salary data at the necessary level of detail. DRS is planning on upgrading its employer reporting system. The planned new system will allow overtime and bonuses to be distinguished from other earnings. Once the new system is up and running, it will likely take a few years of reporting for actuaries to estimate the impact of overtime and bonuses with reasonable confidence.

Staff analysis found most AFC increases fall within an expected range.

While it cannot directly answer the question of overtime's impact, a staff analysis of increases in AFC for recent retirees done earlier this interim is informative. The analysis found that most increases fell within an expected range, based on long-term salary growth assumptions. Around 3 percent of recent retirees had AFC increases that clearly exceeded expectations. However, this analysis was not able to isolate overtime and bonuses from other earnings. More information on this analysis, including data, limitations, and methods, is available in the educational briefing on pension spiking presented at the May SCPP meeting.

**Other types of potential excess compensation such as leave cash outs and severance pay are excluded from the AFC for Plan 2/3 members.*

***Overtime and bonuses that remain a relatively stable percentage of a member's compensation over the career do not create unexpected costs for the retirement systems. It is when overtime and bonuses significantly increase prior to retirement that unexpected costs can occur.*

Provisions were expanded in 1995 to include payments exceeding twice the regular rate of pay.

Provisions Have Been Expanded Before

The basic excess compensation provisions were first established in 1984. At that time, an exception was made for payments made pursuant to a labor agreement currently in force. The provisions were expanded in 1995 to include payments exceeding twice the regular rate of pay. This occurred following a study of excess compensation and employer pay practices by the Joint Committee on Pension Policy.

More information on the development of excess compensation provisions is provided in **Appendix A**.

Example

John is a Plan 2 member. He retires at age 65 with 25 years of service and an AFC of $40,000. The last year he worked, his regular wage was $20/hour and he was covered by a labor agreement that provided $45/hour for working on a holiday. John worked three holidays the year before he retired. John's excess compensation, the impact on his benefit, and the resulting employer billing are shown below:

Calculating billings requires many steps.

- **Excess compensation for the three holidays is $120 calculated as follows.**
  - ◊ 24 hours * ($45/hr -2*$20/hr)=$120.
- **The excess compensation will increase his monthly benefit by $1/month calculated as follows:**
  - ◊ Accrual rate: 2%*25 years of service=50%.
  - ◊ Increase in monthly AFC: $120/60 months AFC period=$2/month.
  - ◊ Increase in monthly benefit=50%*$2/month=$1/month.
- **John's employer will be billed $143.27 for the excess compensation paid to John.** This is based on the actuarial present value factor for John's age and plan and calculated as follows:
  - ◊ $1/month increase in pension dived by 0.0069789 actuarial present value factor = $143.27.

More information about the calculation of excess compensation billings and other examples are available in [WAC 415-02-140.](WAC 415-02-140)

Legislative/Committee Activity

A 2012 Bill Would Have Expanded The Definition Of Excess Compensation

During the 2012 Legislative Session, a bill was introduced that would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump-sums. The bill (HB 2441) passed the House, and the Senate Committee on Ways and Means, but did not pass the Legislature.

A bill was introduced that would have expanded the definition of excess compensation.

The bill would have included reportable compensation exceeding one-and-one-half times a member's base salary amount in the definition of excess compensation. The base salary amount, for purposes of the calculation, is reportable compensation excluding overtime, bonuses, leave cash-outs, and lump sum payments. The bill would have impacted all of the state-administered retirement systems.

The actuarial fiscal note indicated that, due to a lack of data, the savings that could emerge under the bill were indeterminate. Policy analysis for this bill is provided below in the **Analysis of HB 2441** section.

The SCPP Discussed Excess Compensation Earlier This Year

The topic of excess compensation was discussed in the general educational briefing on pension spiking given by staff at the May SCPP meeting. In their discussions following the staff briefing, the Executive Committee directed staff to prepare a more detailed briefing focused on excess compensation provisions and HB 2441.

Other States

Information on excess compensation in other state plans was recently gathered by the Washington State Institute of Public Policy (WSIPP) as part of a statutorily mandated pension study.

One other state bills employers for excess compensation.

The WSIPP study found one other state that bills employers for excess compensation: Illinois. According to the study, Illinois bills employers for any salary increase exceeding 6 percent of a member's final average salary.

WSIPP will be reporting the results of their study to the Legislature and the SCPP in December.

Policy Analysis

This issue raises the following key policy question:

- Is the current definition of excess compensation sufficient, or should it be expanded?

In responding to this issue, policy makers will likely consider the impacts of excess compensation, how often it occurs, contractual rights, and the implications of increasing employer billings for pension and Human Resources (HR) policy.

Excess Compensation Can Impact Intergenerational Equity

Excess compensation can impact intergenerational equity by increasing members' benefits beyond what was assumed for funding purposes. Intergeneration equity calls for the cost of members' benefits to be paid for by the taxpayers who received the value of the members' services. Intergenerational equity has been adopted as a goal for the Plans 2/3 by the SCPP (Goal 5e), and is codified in funding statute (RCW 41.45.010).

When a member's benefit is based on a higher-than-expected AFC there is an additional cost to the system.

Pension contributions are collected over a member's career based on many actuarial assumptions including future salary increases. Cash outs, bonuses, overtime, and other types of excess compensation have the potential to increase a member's AFC beyond what is expected under the assumptions. When a member's benefit is based on a higher-than-expected AFC there is an additional cost to the system that emerges when the member retires. This extra cost has not been funded at retirement and is passed on to other plan participants and future generations of taxpayers. This passing on of costs runs counter to the principle of intergenerational equity.

Provisions Are Designed To Mitigate Impacts On The Retirement Systems

Billing employers for excess compensation offsets the impact on the retirement systems.

Excess compensation provisions require employers to pay for the additional cost to the retirement systems resulting from excess compensation. Billing employers for excess compensation offsets the impact on the retirement systems. It also reduces the likelihood that the costs of excess compensation are passed on to other plan participants.

Employer billings do not offset all impacts of overtime, bonuses, and cash outs on the retirement system since payments below the statutory threshold do not trigger a billing. For example, overtime and bonuses that do not exceed twice the member's regular rate of pay are not billable.

The provisions do not prohibit employers from paying certain types of compensation, nor do they prohibit the use of excess compensation when calculating a member's benefit. Other pension statutes address the types of compensation that are included and excluded from the AFC used in pension calculations. These other provisions were discussed in the educational briefing on pension spiking presented at the May SCPP meeting.

Overtime And Bonuses May Meet Some HR Needs

Policy makers seeking changes to excess compensation provisions may wish to weigh HR needs against impacts on the pension system. Billing employers for excess compensation may serve as a disincentive for certain pay practices and may limit employer flexibility in providing compensation.

Overtime may be used to manage labor shortages and bonuses may be used to recruit and retain workers.

Employers may use overtime, bonuses, and other types of compensation beyond regular wages to meet HR needs. For example, overtime may be used as a way to address temporary labor shortages without hiring additional employees. Bonuses may be used as a way to recruit and retain desired workers. In some cases, these pay practices may be standard for a particular occupation or industry and may be expected by employees. Overtime is fairly common in public safety occupations and performance bonuses are often found in certain financial services occupations. Finally, some pay practices that may result in excess compensation may be contained in collectively bargained labor agreements.

The SCPP has adopted a goal on balanced long-term management that speaks to this issue. SCPP Goal 2 calls for the pension systems to be managed in such a way as to create stability, competitiveness, and adaptability, with responsiveness to human resource policies for recruiting and retaining a quality public workforce. Given this goal, some policy makers may wish to consider whether changes to excess compensation might impact employers in a way that could negatively impact workforce management or run counter to recruitment and retention policies.

Current Members Likely Have Contractual Rights To Use Excess Compensation In Benefit Calculations

Some policy makers may prefer to exclude certain types of compensation.

In responding to this issue, some policy makers may prefer to exclude certain types of excess compensation from AFC entirely. However, contractual rights will likely limit the flexibility of policy makers to change the definition of AFC for current members. Courts have generally held that members have a contractual right to the formula used to calculate their benefits. AFC is one component of the benefit formula and is defined in statute. Given this, current members likely have a contractual right to the current definition of AFC when calculating their benefits. This definition includes overtime, bonuses, leave cash outs,* and other types of lump sum payments.

**In the Plans 1 only.*

Changing Employer Billings Does Not Impact Contractual Rights

Policy makers can likely change excess compensation provisions without raising contractual rights issues.

Unlike changing the definition of AFC, policy makers can likely change excess compensation provisions without raising issues of contractual rights. Changing employer billings for excess compensation does not have the same contractual rights implications as changing the definition of AFC. Employer billings for excess compensation do not change the formula used to calculate members' benefits and therefore do not impact members' contractual rights.

Increasing Employer Billings Has Implications For Cost Sharing And Plan Costs

Expanding the definition of excess compensation to cover more types of payments will likely increase employer billings for excess compensation. Increasing employer billings has implications for cost sharing and plan costs related to excess compensation.

Increasing billings may result in a cost sharing shift or a savings to the plan.

If employers do not change their pay practices, increased billings may result in a cost sharing shift. Increased excess compensation billings would bring additional contributions into the plan. These additional contributions will offset more of the cost of excess compensation and result in a savings to the plan. In effect, this would shift some costs related to excess compensation from all plan participants to the specific employers paying the excess compensation. However, as discussed earlier, increasing employer billings for excess compensation may cause some employers to change their pay practices.

If employers change their pay practices it may lower plan costs. Employers may choose to reduce the amount of excess compensation they pay in order to avoid higher billings. If this occurs, it may result in a decrease in the AFC used to calculate members' benefits. This would reduce the plan's liability for benefits and result in a savings to the plan.

Analysis Of HB 2441

The Executive Committee directed staff to include HB 2441 in the initial policy briefing on excess compensation. As discussed under **Legislative/Committee Activity** above, HB 2441 was introduced during the last session. The bill, if enacted, would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump sums. This section analyzes the policy and cost implications of the changes to excess compensation provisions in this bill.

Expands The Definition Of Excess Compensation

HB 2441 expands the definition of excess compensation. The expanded definition would include increases in AFC exceeding 50 percent of a member's regular* earnings. This provision is designed to capture increases due to overtime, bonuses, leave cash outs, and other lump sum payments. These pay practices may be typical for some, but not necessarily all, employers.

The new provision would work with existing provisions related to overtime and bonuses to capture additional compensation.

The new provision would work with existing provisions related to overtime and bonuses to capture additional compensation. Current provisions are designed to address compensation increases from individual payments. The new provision is designed to address increases in total compensation over the AFC period. While there may be some overlap for certain payments, each provision measures excess compensation differently and would capture different amounts.

**Excludes overtime, bonuses, leave cash out, and other lump sums.*

Will Likely Generate More Employer Billings For A Relatively Small Percentage Of Benefit Calculations

The expanded definition would flag additional types of compensation as excess compensation. This will likely generate more employer billings—unless employers change their pay practices. However, it may take time for employers to change existing pay practices, particularly those in labor agreements.

While relatively rare, extreme cases may be perceived as abuse.

As discussed earlier, a staff analysis of AFC increases for recent retirees found that most increases fell within an expected range. Around 3 percent of AFC increases exceeded expectations. For this analysis, exceeding expectations amounted to more than a 50 percent increase in compensation for a Plan 2/3 member over a ten-year period. This suggests that a relatively small percentage of members are likely to have increases in AFC exceeding the 50 percent threshold required under the bill. However, even one extreme case may garner media attention and be perceived as abuse.

The staff analysis of AFC increases was not specific to the provisions in HB 2441, and the results, while informative, may not be entirely applicable. The staff analysis measured AFC increases differently than under the bill and was not able to distinguish the source of the increase.

May Generate Billings For Overtime That Does Not Result In Unexpected Costs

As drafted, this bill may result in excess compensation charges for high overtime positions where the overtime does not result in unexpected costs to the retirement systems. This bill would charge employers for excess compensation whenever overtime comprises more than 50 percent of a member's AFC. However, overtime* that remains a relatively stable percentage of a member's compensation over the career does not create unexpected costs for the retirement systems. This is the case even for high levels of overtime. It is when overtime significantly increases prior to retirement that unexpected costs can occur.

**This analysis also applies to bonuses or other lump sum payments.*

May Provide A Disincentive For Certain Pay Practices, Which Could Impact Recruitment And Retention

A large enough disincentive may limit employer flexibility in providing compensation.

This bill will likely increase employer billings for excess compensation and may create a disincentive for certain pay practices such as overtime, bonuses, leave cash outs, and other lump sum payments. As discussed earlier, a large enough disincentive may limit employer flexibility in providing compensation and may cause some employers to change pay practices. Changing pay practices can impact HR policies around recruitment and retention.

Will Likely Result In An Indeterminate Savings To The Retirement Systems

The actuarial fiscal note for HB 2441 indicated that this bill would likely result in a savings to the retirement systems. However, the amount of any savings is indeterminate due to lack of data.

More information on how the savings could emerge is available in the fiscal note.

Conclusion

Excess compensation provisions are designed to mitigate the impact on the retirement systems of certain pay practices such as overtime, bonuses, and cash outs. Current provisions require employers to pay the additional cost to the retirement system resulting from excess compensation. Some policy makers may question whether current statutory provisions sufficiently mitigate the potential impact of excess compensation.

Policy makers may weigh potential benefits to the pension system against potential impacts on employers.

In responding to this issue, policy makers will likely consider the impacts of excess compensation, how often it occurs, contractual rights, and the implications of increasing employer billings on HR policies and plan costs. Policy makers considering an increase in employer billings for excess compensation may weigh potential benefits to the pension system against potential impacts to employers' ability to manage their workforce and recruit and retain employees.

A bill introduced during the 2012 Legislative Session would have expanded the definition of excess compensation to capture additional compensation related to overtime, bonuses, leave cash outs, and lump sums. This bill, if enacted, would have likely generated more employer billings for a relatively small percentage of benefit calculations and resulted in a savings to the retirement systems.

Revised Bill Draft

At the November meeting, the Committee directed staff to work with DRS to prepare a revised bill draft. The purpose of the revision is to address stakeholder concerns around possible billings for high-overtime occupations where the overtime is not creating unexpected costs for the retirement systems.

A revised bill draft expanding the definition of excess compensation is attached. The revised draft is designed to capture increases in AFC of more than 50 percent from the prior salary averaging period as a result of overtime, bonuses, leave cash outs, and lump sum payments. Compared to HB 2441, the revised bill maintains the 50 percent increase threshold, but measures the increase from the prior salary averaging period.

The revised bill will likely:

- **Generate more employer billings than under current law for a relatively small percentage of benefit calculations.** Similar to HB 2441, the expanded definition would flag additional types of compensation as excess compensation. This will likely generate more employer billings—unless employers change their pay practices. However, the number of new billings each year will likely be small. As discussed above, AFC increases of more than 50 percent from the prior period will likely occur relatively infrequently.
- **Avoid billing where overtime is not creating unexpected costs.** The revised bill calculates excess compensation based on the increase in compensation from the prior salary averaging period. This differs from HB 2441, which measured excess compensation based on the relative proportion of overtime and regular earnings. Under the revised bill, an excess compensation billing would not be generated for overtime that is relatively consistent across the periods. As discussed above, this type of overtime does not create unexpected costs to the retirement systems.
- **Result in an indeterminate savings to the retirement systems.** As discussed above, increasing excess compensation billings will likely result in a savings to the retirement systems. However, similar to HB 2441, the amount of savings under this bill is indeterminate due to lack of data.

Appendix A

History Of Key Developments In Excess Compensation Statute

- **1984 c 184 s 1 (SHB 843)** the excess compensation statute was created in section one of the act. It established the requirement that the employer pay the present value of retirement benefits based on excess compensation at the time of the employee's retirement. Excess compensation included, but was not limited to, lump sum payments for any form of leave, personal expenses, or severance pay.
- **1995 c 244 s 1 (SSB 5118)** calculation of excess compensation was amended to specifically include any compensation that exceeded twice the regular rate of pay. Prior to passage, the Joint Committee on Pension Policy found that certain employers appeared to avoid excess compensation charges by disguising certain types of payments as additional regular salary or overtime.
- **1995 c 387 s 1 (SB 5990)** created RCW 41.50.152, including the requirement that employers fully disclose the excess compensation impact of a proposed compensation provision at a public meeting.

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