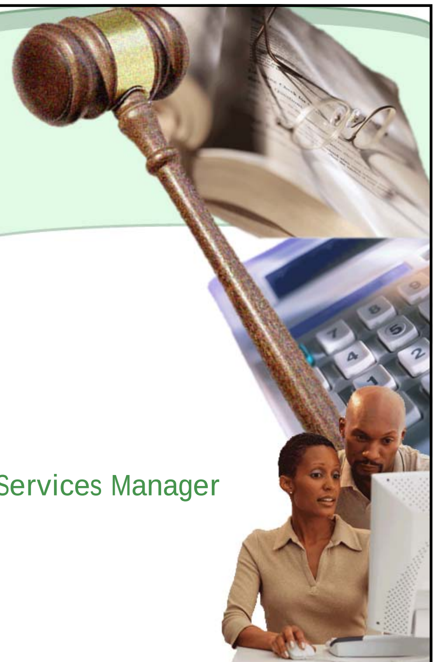
Select Committee on Pension Policy



Pension Spiking

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Why An Educational Briefing Today?

- Pension spiking can be controversial
  - Usually allowable under plan rules
  - Can create unexpected costs
  - May be perceived as "abusing the system"
- Can weaken public confidence in the retirement systems
  - Sometimes makes headlines

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Goals For Today's Educational Session

- Provide understanding of pension spiking
  - What it is
  - How it occurs
  - How often it occurs
  - Policies in place to manage it
  - Why it can be hard to prevent
- No specific issue before the committee
- No action is required

What Is Pension Spiking?

- AKA "pension ballooning"
- Inflating average final compensation for the purpose of increasing the pension amount
  - Beyond normally expected salary increases
- Typically occurs near retirement
- Allowable under plan rules
- May involve employer

How Can Pension Spiking Occur?

- Working more hours
- Receiving a higher rate of base pay
- Receiving extra compensation
  - On top of base pay

Possible Sources Of Pension Spiking

- Overtime
- Extra contract/extra duty pay
- Bonuses
- Promotions
- Moving from part-time to full-time
- Leave cash-outs

Examples Of Pension Spiking

- Individual
  - Working extra overtime/extra duties before retirement
  - Taking a higher paying job near retirement
  - Saving up sick and annual leave to cash out at retirement
- Employer and individual
  - Steering overtime to employees nearing retirement
  - Creating extra duties with additional salary for someone nearing retirement

Pension Spiking Not A New Topic

- Studied several times over last twenty years
- Studies focused on different groups
  - School administrators (1994)
  - PERS 1 (1995)
  - WSPRS (1999-2000)
  - PERS employers (2002)
- Primarily done by JCPP

Legislature Has Addressed Pension Spiking Before

- 1977: Creation of PERS & TRS Plan 2
  - Increased salary averaging period
  - Eliminated cash-outs from pensions
- 1984: Excess compensation provisions
  - Billing employers for certain types of pension spiking
- 1995: Expanded definition of excess compensation
  - Include additional types
  - Required public disclosure of pay practices
- 2001: Creation of WSPRS Plan 2
  - Similar changes as for PERS & TRS
  - Excluded certain kinds of overtime from pensions

Bills Related To Pension Spiking Introduced In 2011

- Excess Compensation (HB 2441)
  - Would have expanded the definition of excess compensation
    - Compensation exceeding one and a half times the base salary used in the pension calculation
- Plans 2/3 Overtime (SB 6543)
  - Would have excluded overtime from includable compensation for most new hires
  - Would have created an employer contribution rate for overtime for current members
- Neither passed the Legislature
  - HB 2441 passed the House

Compensation Is Key To Pension Spiking

- How compensation is used in pension calculations is key to understanding
  - How pension spiking works
  - What can be done to manage it
- Next several slides dig into the details

Type And Timing Of Compensation Matters

- Not all compensation impacts the pension benefit
- Only what is used in the pension calculation
  - Qualifying payment
  - Earned during the salary averaging period
- Technical term is Average Final Compensation (AFC)

AFC Period Varies By Plan

- Two highest years for Plans 1
  - Exception: LEOFF 1 typically uses final salary
- Five highest years for Plans 2/3
- Typically the years preceding retirement

What Compensation Is Included In AFC?

- Compensation for services required by the job
  - Some exceptions in various systems and plans
- Examples of includable compensation
  - Base salary
  - Overtime
  - Bonuses for work performed
  - Leave cashed out (Plan 1)

Some Compensation Is Excluded From AFC

- Compensation for reasons other than service
  - Some exceptions in various systems and plans
- Examples of excluded compensation
  - Separation or retirement incentives
  - Severance pay
  - Reimbursements
  - Leave cashed out (Plans 2/3)

Example: How Pension Spiking Inflates Pensions

- Assumptions
  - Retire at age 62 with 30 years of service
  - Base salary of $65,000 throughout the AFC period
    - No increases
  - $35,000 in overtime earned over the last two years prior to retirement
    - Less than eight hours OT a week
- Different calculation for Plan 1 and Plans 2/3
  - AFC period differs
  - Implications for pension spiking

Pension Spiking Example: Plan 1 (Two-Year AFC)

- Includable compensation
  - Base: $65,000*2=$130,000
  - With OT: $130,000+$35,000=$165,000
- AFC
  - Base: $130,000/2=$65,000
  - With OT=$165,000/2=$82,500
- Benefit
  - Base: 2%*30 years*$65,000 AFC=$39,000
  - With OT: 2%*30 years*$82,500 AFC=$49,500
    - $10,500 per year increase (27%)
    - Present value of lifetime payment=$106,145

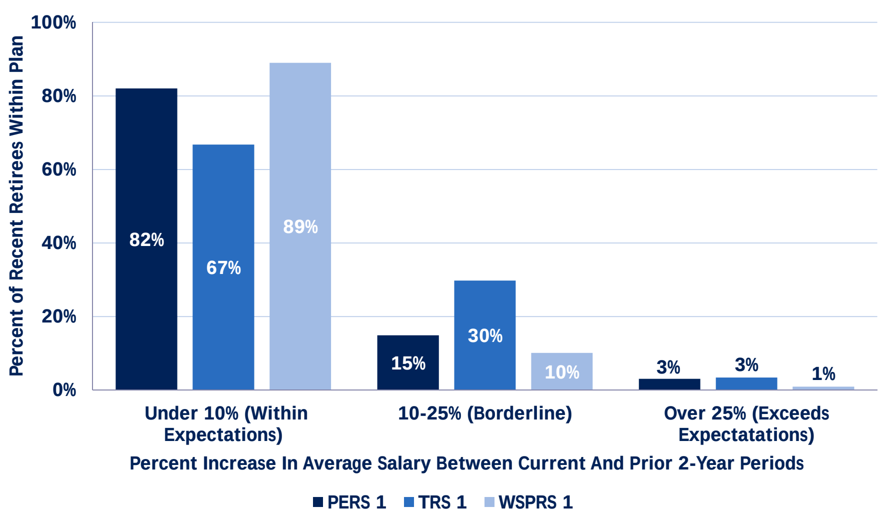
Pension Spiking Example: Plan 2 (Five-Year AFC)

- Includable compensation
  - Base: $65,000*5=$325,000
  - With OT: $325,000+$35,000=$360,000
- AFC
  - Base: $325,000/5=$65,000
  - With OT=$360,000/5=$72,000
- Benefit
  - Base: 2%*30 years*$65,000 AFC=$39,000
  - With OT: 2%*30 years*$72,000 AFC=$43,200
    - $4,200 per year increase (11%)
    - Present value of lifetime payment=$55,542

How Often Does Pension Spiking Occur?

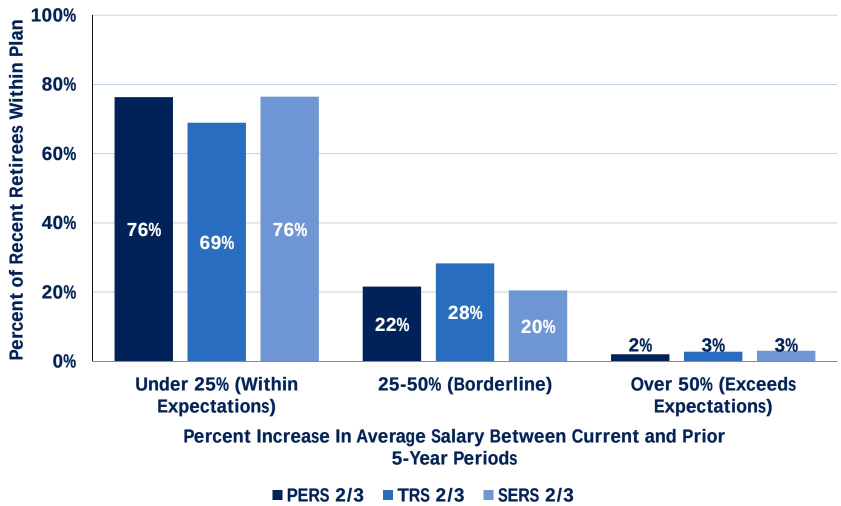
- Difficult question to answer
  - Salary increases are expected through retirement
  - Data limitations
    - Types of compensation not always broken out
    - Doesn't show intent
- Data shows how much AFC increases
  - Most increases fall within expected range
  - Some significantly exceeded
- AFC increases that significantly exceed expected range may indicate pension spiking

AFC Increase From Prior Period: Plan 1



Note: Includes members retired since November 2011, or receiving a retirement estimate for the upcoming year. Salary excludes cash-outs, bonuses and other lump-sum payments.

AFC Increase From Prior Period: Plans 2/3



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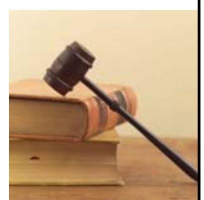
Several Policies In Place To Mitigate Pension Spiking

- Limiting salary
  - Defining compensation
  - Salary averaging
  - Reporting compensation as earned
- Managing cost impacts
  - Excess compensation rules

Includable Compensation Is Defined In Statute

- Definition places bounds on what goes into the pension calculation
- Definition excludes some pay practices more susceptible to pension spiking
  - Compensation not related to service
  - Retirement bonuses
  - Leave cash-outs in open plans
  - Etc.

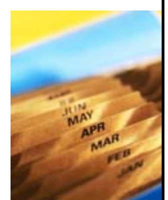


Longer AFC Period Reduces Impact Of Pension Spiking

- The more years included in the averaging period, the less each year impacts the final AFC
  - Two-year AFC, each year=50% of the total
  - Five-year AFC, each year=20% of the total
- Earlier pension spiking example
  - Same individual, working same amount of OT
  - Two-Year AFC: $10,500 per year increase (27%)
  - Five-Year AFC: $4,200 per year increase (11%)
- Likely more difficult for employees to work a lot of extra hours for a longer period of time

Reporting As Earned Prevents Shifting Compensation Into AFC Period

- DRS requires compensation to be linked to the month it is earned, not the month it is paid
- Prevents intentional loading of salary into AFC period
  - Deferred wages
  - Retroactive wage increase



Employers Are Charged For Excess Compensation

- Certain payments are allowed in some systems, but create an additional billing to the employer if it increases the benefit
  - Amount billed is the full actuarial value of the benefit increase
- Types of payments that cause excess compensation billing
  - Annual leave cash-out over 240 hours
  - All other leave cash-outs
  - Personal or transportation allowances
  - Severance payments earned over time
  - The portion of any payment (such as overtime) that exceeds twice the hourly or monthly rate of pay

Pension Spiking Has Implications For Plan Funding

- Increasing the pension amount increases plan liabilities
- Larger than expected increases are generally not fully funded at the time of retirement
  - Contributions collected based on lower expected benefits
    - Insufficient to cover the actual cost
  - Actuarial loss to the plan
- Loss is spread over employers and Plan 2 members
  - Resulting in higher contribution rates
- May be offset by excess compensation billings in some cases

Policy Implications Of Pension Spiking

- Allowable under plan rules
- Impacts intergenerational equity
  - Extra costs are not fully funded at retirement
  - Not fully paid for by the members spiking their pension
  - Results in cost shifting
- Can undermine public confidence in the retirement systems
  - May be perceived as abusing the system
- Some sources might be more controversial than others
- Some members may have greater opportunity
- It can be hard to determine intent

Why Is Pension Spiking Hard To Prevent?

- Opportunity and incentive is inherent in the plan design
  - Final salaries usually have the biggest impact
    - Many ways to increase
- Members have contractual rights to benefit provisions
  - Including those that contribute to pension spiking
- Some pay practices more susceptible to pension spiking
  - Overtime, bonuses, extra compensation, etc.
  - May be standard practices for an industry
  - May serve HR needs

Recap

- Pension spiking is inflating AFC for purposes of increasing pensions
- Occurs through
  - Working more hours
  - Receiving more pay
- Most AFC increases for recent retirees within expected range
  - A small percentage exceed
- Several policies in place to mitigate the impact of spiking
  - Limiting the increase in benefit
  - Billing employers for extra costs
- Spiking can be difficult to prevent
  - Plan design provides incentive
  - Certain pay practices susceptible
  - Likely contractual rights