LEOFF

Plan 2 Retirement Board

Salary Growth

Initial Consideration
July 25, 2012

About This Presentation

- Board requested information recently presented to SCPP, including LEOFF Plan 2
- This presentation…
  - Covers the same information, but not focused on Pension Spiking
  - Includes LEOFF Plan 2 Information
  - Does not answer all questions related to the subject
  - Does not expand on the data analysis

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Discussion Points

- Background
- Salary & Salary Growth
- Unexpected Salary Growth
- Actual Salary Growth
- Managing Salary Growth

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Background

- Studied by pension committee several times over last 20 years
- Major changes affecting salary issues
  - 1977 – Increased salary averaging, cash-out elimination
  - 1984 & 1995 – Excess compensation
  - 2001 – Exclusion of certain overtime

Background

- Recent Legislation
  - Modifying Excess Compensation Provisions (HB 2441)
  - Use of Overtime Pension Calculations (SB 6543)
- Neither bill passed
- Future legislation possible

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Salary

- Compensation used to…
  - Calculate Pension
  - Determine Contributions
- Not all included in pension benefit calculation
- Differences between Plan 1 and Plan 2

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Salary

- "Basic salary" means salaries or wages earned by a member during a payroll period for personal services

  - Including
    - Overtime payments, and
    - Salary or wages deferred under 403(b), 414(h), and 457

  - Excluding
    - Lump sum payments for deferred annual sick leave
    - Unused accumulated vacation
    - Unused accumulated annual leave
    - Any form of severance pay

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Salary

- Salary averaging period varies by plan
  - Two highest years for Plans 1
    - LEOFF Plan 1 typically uses final salary
  - Five Highest years for Plans 2/3
- Salary averaging period typically the years preceding retirement

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Salary Growth

- Salary growth expected
  - Overtime
  - Extra duty
  - Bonus
  - Promotion
  - Employment change

- Salary growth may increase pension

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Salary Growth

- Example Calculations:
  - Retire at age 62 with 30 years of service
  - Base salary of $65,000 throughout salary average period; No increases
  - $35,000 in overtime earned over the last two years prior to retirement (less than eight hours OT a week)

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Salary Growth

Example Calculation: Plan 1

Includable Compensation

- Base: $65,000 x 2yrs = $130,000
- With OT: $130,000 + $35,000 = $165,000

Final Salary

- Base: $130,000 ÷ 2 = $65,000
- With OT: $165,000 ÷ 2 = $82,500

Benefit

- Base: 2% x 30yos x $65,000 = $39,000
- With OT: 2% x 30yos x $82,500 = $49,500
- $10,500 per year increase (27%)
- Present value of lifetime pmt = $106,145

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Salary Growth

Example Calculation: Plan 2

Includable Compensation

- Base: $65,000 x 5yrs = $325,000
- With OT: $325,000 + $35,000 = $360,000

Final Salary

- Base: $325,000 ÷ 5 = $65,000
- With OT: $360,000 ÷ 5 = $72,500

Benefit

- Base: 2% x 30yos x $65,000 = $39,000
- With OT: 2% x 30yos x $72,000 = $43,200
- $4,200 per year increase (11%)
- Present value of lifetime pmt = $55,542

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Unexpected Salary Growth

- Beyond normally expected salary increases
- May be intentional; “Pension Spiking”
  - Near retirement
  - May involve employer
  - Allowable under rules
- Can significantly increase final salary and pension

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Unexpected Salary Growth

- Funding Implications
  - Increasing pension amount increases plan liabilities
  - Larger than expected increases generally not fully funded at retirement
  - Actuarial loss spread over employers and members
  - Excess compensation rules may offset some cost

- Policy Implications
  - Allowable under plan rules
  - Impacts intergenerational equity
  - Negative public perception
  - Some members may have greater opportunity
  - Difficult to determine intent

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Actual Salary Growth

- About the Data
  - Retired for service within the past 2 years
  - Estimate for a service retirement within the next year (11/2011 - 10/2012)
  - Total Sample: 557

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Actual Salary Growth

- About the Data…
  - Does not use final salary (AFC/FAS) from retirement or estimate
  - Includes only regular service earnings and overtime (calculated by total hours/period)
  - All other earning types are excluded
  - Does not identify why salary grew

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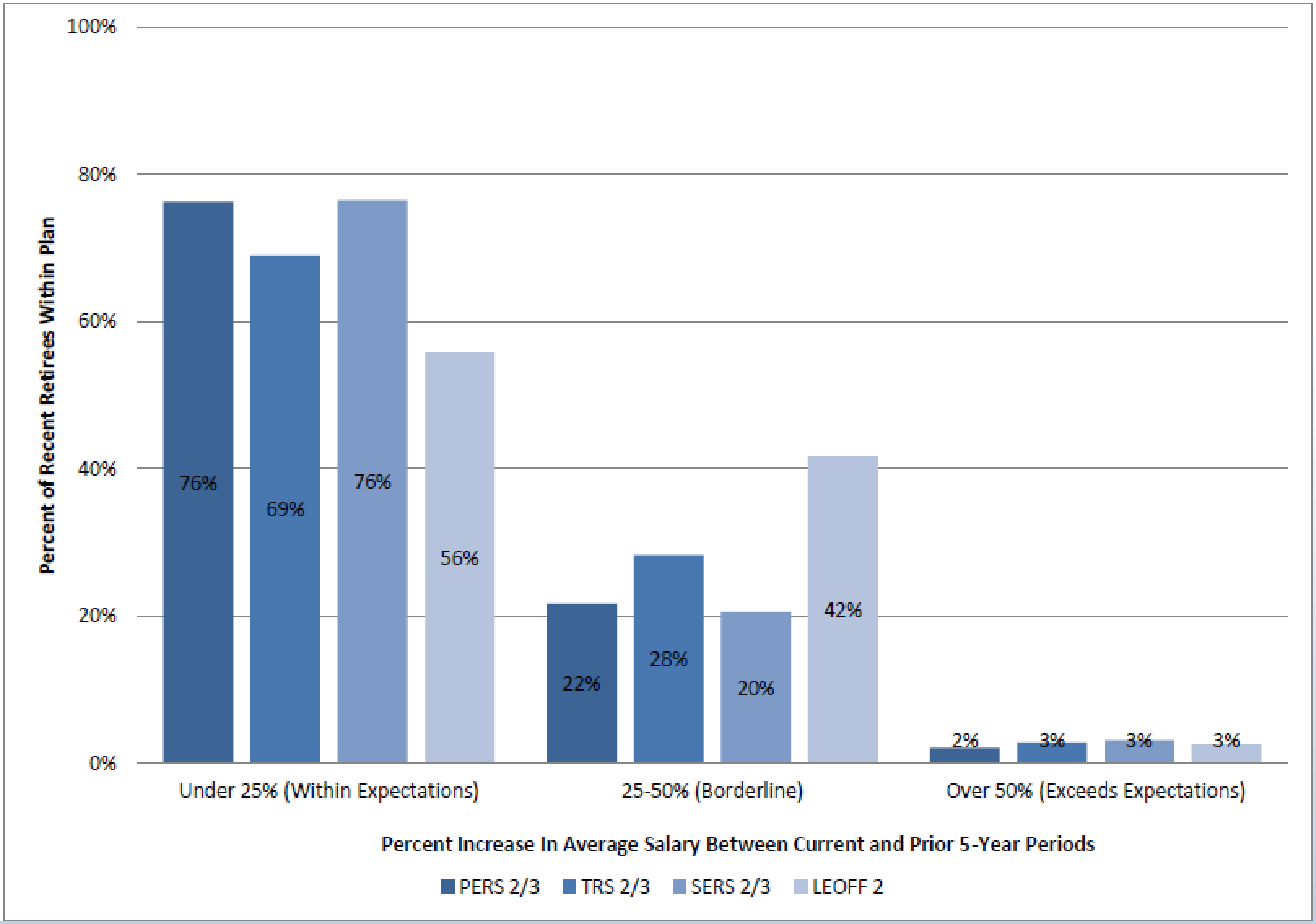
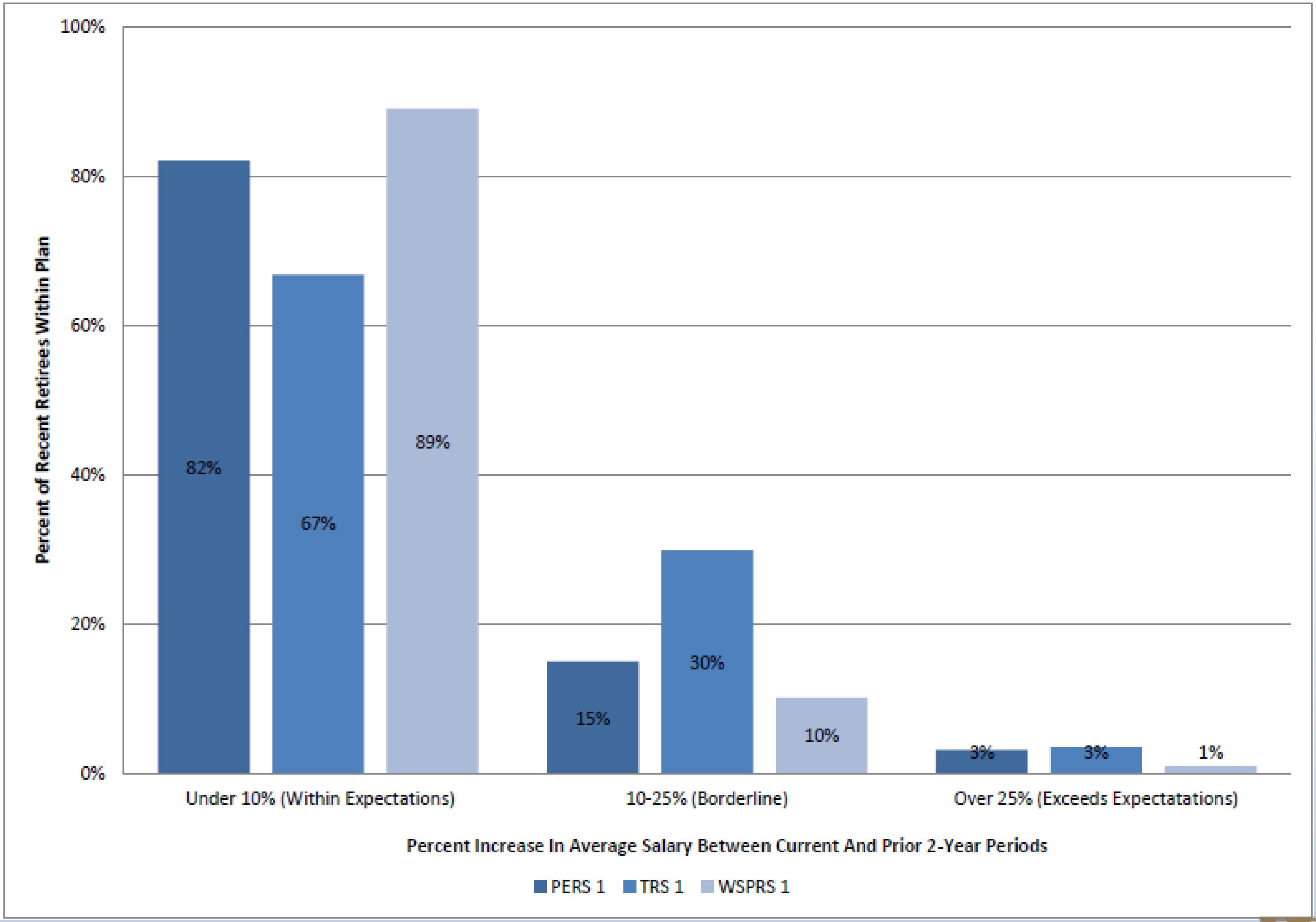
Actual Salary Growth



Actual Salary Growth



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Managing Salary Growth

Best Practices

- Defining compensation
- Excluding extraordinary income
- Longer salary averaging period
- Compensation audits and reviews
- Limits on total final compensation growth

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Managing Salary Growth

- Current Practices in Washington
  - Limiting Salary
    - – Compensation defined in RCW and WAC
    - – Up to 5 year salary averaging periods
    - – Reporting compensation as earned
  - Mitigating Cost Impacts
    - – Excess Compensation (employer liability)

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Managing Salary Growth

- Other States
  - At least 14 states in past 5 years have made changes
  - Limit or prohibit overtime, leave cash-out, lump-sum payments in pension computation
  - Caps on includable pay increases year to year
  - Employer liability for extra benefit cost

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Summary

- Certain levels of salary growth expected
- Unexpected growth may increase pension
  - Occurs through working more hours, earning more pay
  - Most increases within expected ranges; Some exceed expectations
  - Limitations to determining if creating an issue
- Existing mitigating policies

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Any Questions?

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July 25, 2012

SALARY GROWTH

Initial Consideration

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ISSUE

Understanding salary growth issues in LEOFF Plan 2.

MEMBERS IMPACTED

As of June 30, 2010 there were 16,775 active members as reported in the Office of the State Actuary's *2010 Actuarial Valuation Report*. A policy change that affects the amount of salary which may be included in the benefit calculation could affect any future retiree from the Plan.

CURRENT SITUATION

Many states have expressed concerns about the viability of retirement plan benefits and funding that date to the 2001 recession, which continued with the severe investment losses in the 2007-2009 recession. States have considered and implemented various changes, in public employee pensions, in order to help balance budgets. Many states are continuing to look at areas that can be further adjusted to improve the long-term financial footing of public pensions and reduce budget pressures. The salary that is allowed to be included in the pension calculation has been an issue evaluated by many states, in particular abuse of salary increases which can create extraordinary increase in the pension calculation. This occurrence is often referred to as “spiking” or “ballooning.”

In Washington State, several plan features are designed to mitigate the risk to the fund so that salary used in the benefit calculation is not intentionally or unintentionally inflated such that it creates an unusually higher than expected level of benefits paid out. These features include a statutory definition of salary and salary that is pensionable, five year salary averaging period (Plans 2 & 3), employer reporting processes to ensure salary deferral to correct periods, and excess compensation policies which place liability on the employer for extraordinary salary increases included in the pension.

A high level look at a data sample from recent retirees’ show most salary growth occurs within expected levels. However, there are some cases where the salary growth may slightly exceed expectations and some where salary growth included in the retirement calculation significantly exceeds expectations. More detailed data than is currently available would be required to more completely explain the magnitude and significance of the salary increases demonstrated in these two latter groups.

BACKGROUND INFORMATION & POLICY ISSUES

At a recent Select Committee on Pension Policy (SCPP) meeting, a presentation was made by Office of the State Actuary staff titled "Pension Spiking." Pension spiking is the ability for an employee or employer to artificially increase an employee's pensionable earnings use for calculating pensions. The SCPP presentation did not include LEOFF Plan 2 data. The LEOFF Plan 2 Board requested to hear the information presented to the SCPP, but inclusive of data for LEOFF Plan 2.

This report is intended to provide a broad understanding of the potential issues related to salary and salary growth in LEOFF Plan 2. Although the report does not concentrate on the specific issue of Pension Spiking, it covers that same basic information provided in the SCPP presentation.

The first section of the report provides a brief review of salary related legislative history followed by a description of salary, how it pertains to pensions, and discussion about how and why salary grows. Next is a brief section regarding the occurrence of unexpected levels salary growth and then an examination of the level of actual salary growth in the state pension plans. Last is a review of practices for managing salary including best practices, current practices in Washington State, and practices in other states.

LEGISLATIVE HISTORY

Past Legislation

Salary issues as they pertain to the calculation of benefits have been addressed multiple times by the legislature. The creation of the Plan 2 systems in 1977 included increased salary averaging periods and the elimination of cash-outs from pension calculations. In 1984, Excess Compensation was introduced which resulted in employers being billed for certain types/periods of extraordinary salary growth. Excess Compensation provisions were expanded in 1995. In 2001, certain kinds of overtime were excluded from PERS, TRS and the newly created WSPRS Plan 2.

Recent Legislation

In the 2012 legislative session, two salary related bills were introduced. Neither bill passed the Legislature.

House Bill 2441 would have limited the impact of excess compensation on contribution rates by redefining excess compensation. This bill would have added an additional definition of excess compensation, consisting of the portion of total pension-eligible compensation that exceeds one and one-half times the employee's pension compensation over the calculation period, excluding compensation from overtime, bonuses, cash outs of any form of leave, or lump-sum payments.

Senate Bill 6543 addressed the use of overtime when calculating pension benefits. This bill would have excluded overtime payments from reportable compensation for the purpose of determining the retirement allowance of members of state-administered retirement plans who first establish membership on or after July 1, 2012. This bill also required collection of an additional retirement system contribution from employers on overtime earnings of members of the state retirement plans who first established membership before July 1, 2012. The right to determine the basis on which overtime assignments are allocated to employees would have also been established as a management right for the state and may not be negotiated during state employee collective bargaining.

SALARY

As Used in Pension

Members are required to contribute a percentage of basic salary to the retirement plan. The state's and employer's contributions are also based on a percentage of each member's salary or wages. Basic salary is also a key component in the formula[1] used to calculate a retirement allowance.

Defined in Statute

Salary is defined in statute and administrative rule. Salary or wages means payments for services rendered by a law enforcement officer or fire fighter to an employer. Payments which are not for services rendered to an employer are not a salary or wage and do not qualify as basic salary. A payment from an employer to a member does not qualify as basic salary unless it meets the statutory definition of basic salary[2].

> "Basic salary" for plan 2 members, means salaries or wages earned by a member during a payroll period for personal services, including overtime payments, and includes wages and salaries deferred under provisions established pursuant to sections 403(b), 414(h), and 457 of the United States Internal Revenue Code, but excludes lump sum payments for deferred annual sick leave, unused accumulated vacation, unused accumulated annual leave, or any form of severance pay.

Appendix A: Basic Salary Table provides a detailed table of salary that is pensionable for LEOFF Plan 1 and LEOFF Plan 2.

Final Average Salary (FAS)

Most defined benefit retirement systems provide benefits that are based on a final average salary. Final Average Salary usually represents the highest earnings over a specified number of months. The period used to calculate the FAS is typically in the final years of a person's career. The most common final salary averaging period length is 36 months, but in some plans ranges from 12 to 60 months. A shorter final salary averaging period results in a higher final average salary and a higher level of benefits.

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[1] Basic salary used to calculate final average salary. Benefit Formula: 2% x Years of Service x Final Average Salary
[2] Statutory definition of basic salary contained in RCW 41.26.030(13) and WAC 415-104-311 through 415-104-405

In LEOFF Plan 2, FAS is defined in statute[3] is the monthly average of the member's basic salary for the highest consecutive sixty service credit months of service prior to such member's retirement, termination, or death. Periods constituting authorized unpaid leaves of absence are not used in the calculation of FAS. Any severance pay, or lump sum payment for unused sick leave or vacation/annual leave, is not included.

The other Washington Plan 2 & 3 systems all use a sixty month final salary averaging period. The Plan 1 systems generally use a 24 month final salary averaging period.

SALARY GROWTH

Employee salaries are expected to experience growth over time. In general, salary can be increased through working more hours, receiving a higher rate of pay, earning extra compensation in addition to base pay. Beyond pay raises, another source for increasing salary is overtime pay. As with overtime, there are several other types of compensation that are pensionable.

Other circumstances may increase salaries, such as an employee may transfer or promote to a higher paying job. Additionally, the type of employer and the employers human resource polices can have an impact. Some employers may have a policy favoring the use of overtime instead of hiring new personnel. In some instances, an employer may decide to utilize overtime rather than promoting personnel to fill a need.

Salary growth can have a significant impact on the calculation of a retirement allowance. Below are examples of a generic benefit calculation for a Plan 1 member and a Plan 2 member. These examples are only intended to demonstrate mathematically the impact of including additional salary in the pension calculation.

Most notable in these examples is the significance of the impact using a two year salary averaging period in the Plan 1 example versus a five year salary averaging period in the Plan 2 calculation. In both cases, less than eight hours of overtime per week has a large impact on the pension. This shows how a significant increase in pensionable salary could generate a larger increase in a pension calculation.

[3] RCW 41.26.030(15)(b)

The basic assumptions used in these calculations include:

- Retires at age 62 with 30 years of service
- Base salary of $65,000 throughout salary average period; No increases
- $35,000 in overtime earned over the last two years prior to retirement (less than eight hours OT a week)

Plan 1 Example Calculation:

Includable Compensation
Base: $65,000 x 2yrs = $130,000
With OT: $130,000 + $35,000 (OT) = $165,000

Final Salary
Base: $130,000 ÷ 2yrs = $65,000
With OT: $165,000 ÷ 2yrs = $82,500

Benefit
Base: 2% x 30yrs x $65,000 = $39,000
With OT: 2% x 30yrs x $82,500 = $49,500
$10,500 per year increase (27%)
Present value of lifetime pmt = $106,145

Plan 2 Example Calculation:

Includable Compensation
Base: $65,000 x 5yrs = $325,000
With OT: $325,000 + $35,000 = $360,000

Final Salary
Base: $325,000 ÷ 5 = $65,000
With OT: $360,000 ÷ 5 = $72,500

Benefit
Base: 2% x 30yos x $65,000 = $39,000
With OT: 2% x 30yos x $72,000 = $43,200
$4,200 per year increase (11%)
Present value of lifetime pmt = $55,542

UNEXPECTED SALARY GROWTH

Although employee salaries are expected to experience some measure of growth, there are occurrences where this expectation is exceeded, resulting in an unexpected level of salary growth.

A challenge with examining salary growth is determining the intent of the growth. While salary growth may simply be circumstantial, it can also be a specific attempt by the employer, employee, or both to create a substantial salary increase for an employee shortly before retiring.

For example, an employee may work extra overtime before retirement. It may not be readily determinable whether this is being done merely to increase pension, such as the employer steering overtime to an employee near retirement, or because of a legitimate staffing need (policy decision) of the employer. Regardless of intent, the overtime is reportable salary for pension purposes under the provisions of the plan.

Another example is an employee taking a higher paying job near retirement. Whether through a change in employer or a promotion, a person may receive an increase pensionable salary. This may be done with the intent of increasing pension, but could be due to a legitimate employer need. And again, it is something that can occur under the plan provisions.

Given the ways that salary can grow and impact pensions, policy makers may consider it appropriate to question whether salary growth occurs at such frequency, or to such a degree, that polices should be considered to safeguard against possible abuses such as "pension spiking."

Unexpected salary growth, particularly when it is due to intentional attempts to significantly increase pension, has plan funding implications that policy makers may want to take under consideration. As already discussed, salary growth can result in increased pension benefits. When pension benefits are increased, plan liabilities are increased; Larger than expected increases may not be fully funded at the time of retirement.

For example, a person works a large amount of overtime just before retirement but had not worked overtime on a regular basis over their career (i.e. intentional for increasing pension benefits), the amount of contributions collected would be based on a lower level of expected benefits and insufficient to cover the actual cost. This would result in an actuarial loss to the plan, which then is spread over the entire plan membership and employers through higher contribution rates.

By contrast, if a member earned the same amount of overtime every year, the pension system would collect contributions evenly through their career, and would invest that money to provide the funds necessary for payment of a pension based on average final compensation.

There are policy implications that may also be considered given the possibility of abuse to intentionally inflate a pension beyond expected levels. Although some of the sources of salary growth may be more controversial than others, it is given that the ability to use salary growth to increase pensions is possible under the plan design. There may also be a question of fairness as some members may have greater opportunity to increase salary at the end of their career. Again, this could be due to the needs or the policies of the employer demonstrating the challenge in determining the intent of the salary growth. Lastly, while affecting only a small percentage of retirement systems, and often only in select instances, headline grabbing abuses of retirement benefit enhancements, such as “pension spiking” from extraordinary salary growth near retirement, can create negative public perceptions that are harmful to all public employee pension systems.

ACTUAL SALARY GROWTH

At the May 15, 2012 meeting of the Select Committee on Pension Policy (SCPP), staff from the Office of the State Actuary presented information showing the percentage increase in salary between a current period of time and an equivalent immediately prior period of time. The underlying data was provided by the Department of Retirement Systems (DRS) from recent retirements and retirement estimates. The SCPP was presented with information for the following system plans:

- Public Employees’ Retirement System Plans 1, 2, & 3
- Teachers Retirement System Plans 1, 2, & 3
- Washington State Patrol Retirement System Plan 1
- School Employees Retirement System Plans 2 & 3

This section provides the same graphical information presented to the SCPP, with the addition of information for LEOFF Plan 2. Although illustrative, the data has some limitations in terms of showing how much final salary increases compared to expectations.

The LEOFF Plan 2 sample was drawn from members who had recently retired or had received a retirement estimate. In order to be included, a member must have either retired for service within the past 2 years (11/1/2009 - 10/31/2011) from active status, or have an estimate for a service retirement date within the next year (11/2011 - 10/2012) and be currently employed with earnings in September 2011. The total size of the sample for LEOFF Plan 2 was 557 participants.

The salary amounts compared are not the final salary figure used to calculate the retirement or estimate, as that amount may have been modified during the calculation process. Instead, the salary amounts for both the current and previous periods use only regular service earnings which includes overtime. Overtime was calculated when a member averaged over 2,100 per year for the salary period (i.e., 4,200 hours for a 2-year period or 10,500 hours for a 5-year period). All other earning types, such as leave cash-outs, are excluded. In addition to being limited in the types of compensation included, the information does not show why salary grew during a period. For example, it does not identify if a member changed employers or was promoted.

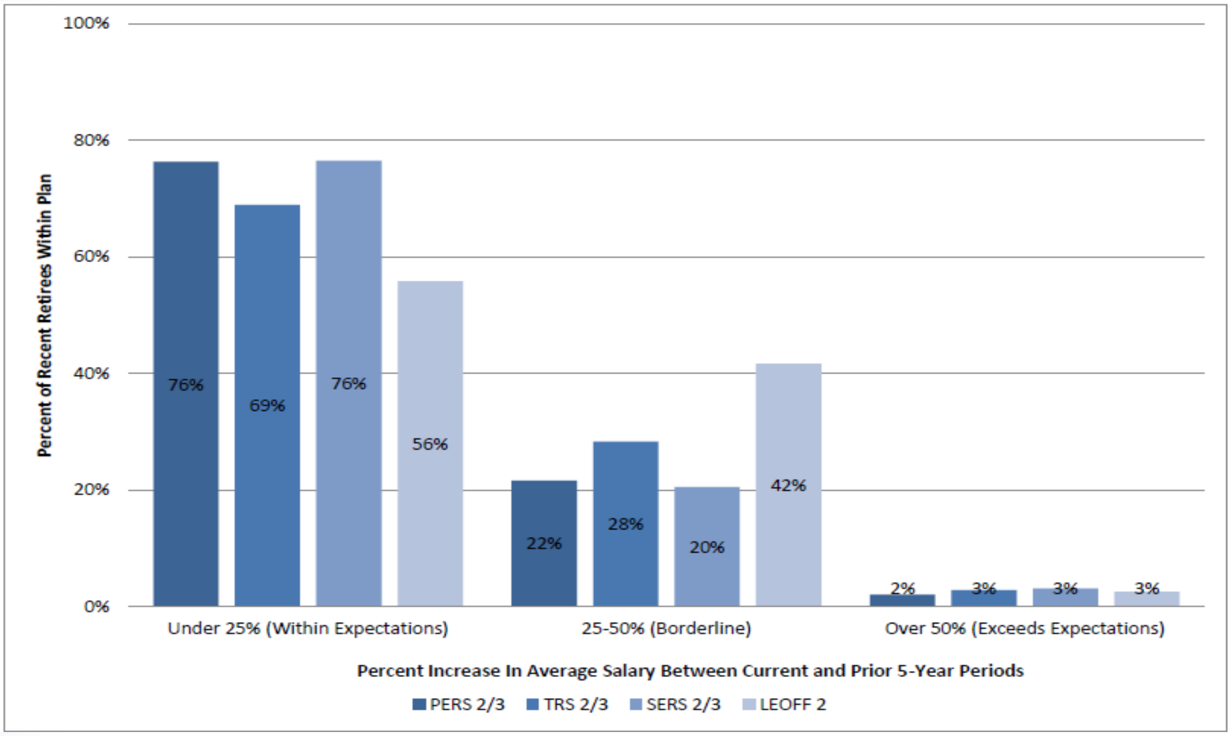
The first chart below shows the percentage increase in salary between the "current period" representing the most recent five years prior to retirement (estimate), which likely would reflect final salary, and the "prior period" which is the five year period immediately preceding the current period.

Chart 1 on the next page shows that most of the salary increases from the prior period to the current period for the Plans 2 & 3, including LEOFF, fall "Within Expectations" or under a 25% growth. In LEOFF Plan 2, 305 of the 557 (56%) participants fall in this category. Out of the 305 with salary growth within expectations, 257 (84%) had overtime in the current period. Most of this group (239) also had overtime in the prior period.

A total of 232 (42%) had salary increases that ranged from 25% to 50%. There were 175 (75%) of this group who had overtime in the current period. Most of this group (157) also had overtime in the prior period. At 42%, LEOFF Plan 2 has a much larger proportion of individuals with salary increases that ranged from 25% to 50% than the other Plan 2 systems. This level of salary growth is not necessarily unreasonable, but is faster than expected. There could be reasons that are not accounted for in this analysis, such as the merit step salary increases which tend to be longer and larger in LEOFF Plan 2 than the other Plan 2 systems.

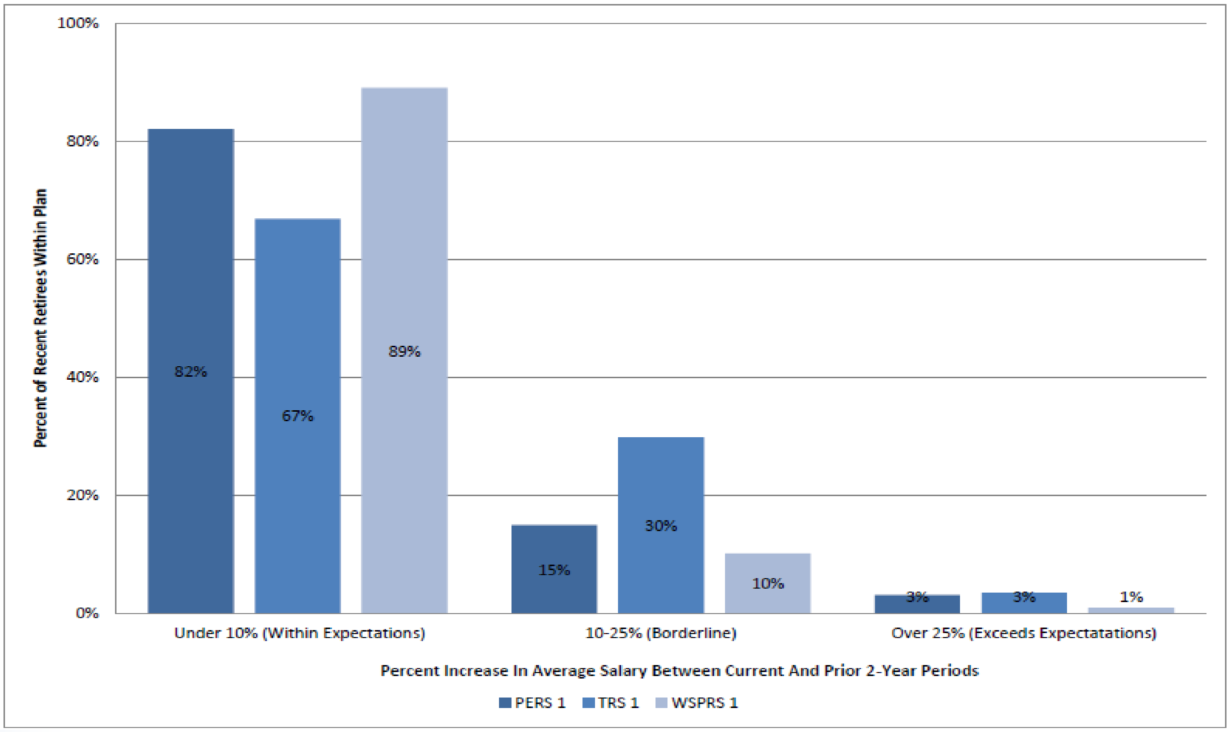
Finally, 14 (3%) participants had salary increases that clearly exceed expectations with salary growth over 50%; Nine (64%) had overtime in the current period; six of them also had overtime in the prior period. Salary growth of this magnitude (greater than 50%) is generally considered unlikely and not necessarily or readily explainable.

Chart 1



On the next page, **Chart 2** shows the salary growth for the Plan 1 systems. The key difference between the Plans 2/3 and the Plan 1 information is the longer final salary period for Plans 2/3 (5 years) and the shorter final salary period for Plan 1 (2 years). This means that the period in which salary growth can occur is shorter for Plan 1. Thus, the expected level of salary growth is lower for Plan 1 at 10% (versus 25% in Plans 2/3. Similar to the Plans 2/3, the Plan 1 data shows that most of the salary increases fall with expected growth levels.

Chart 2



Appendix B provides all of the data totals for the comparison of current and previous average salary periods in Charts 1 & 2.

MANAGING SALARY GROWTH

Best Practices

The Government Finance Officers Association (GFOA) publishes advisories and statements of best practices related to various aspects of responsibly managing defined benefit pension plans. In the 2010 advisory, "Responsible Management and Design Practices for Defined Benefit Pension Plans," the GFOA emphasized to state government and local plan sponsors to use great caution if engaging in practices that could lead to spiking of final pensionable compensation. They characterize spiking as "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." GFOA defines spiking as an unusual increase in income during the employee's final years of service that increases the employee's pension benefits.

A 2011 GFOA best practice statement, “Designing and Implementing Sustainable Pension Benefit Tiers,” describes elements to mitigate pension spiking. These best practices include design elements such as excluding extraordinary income, such as leave cash-outs and overtime, from final average compensation calculations.

Other plan design elements which have been considered best practices include longer final salary averaging periods, compensation audits and review during the calculation of benefits, limits on total final compensation growth, and charging employees a higher contribution rate on overtime[4].

Practices in Washington

The Washington State public pensions have been well ahead of the curve compared to many other state systems. Washington State enacted some of the best practices as far back as 1977 with the creation of the Plan 2 systems. More specifically, Washington State has enacted provisions that target putting boundaries or limits around pensionable compensation and mitigating cost impacts of increases during the salary averaging period. These practices include:

- Statutory definition of salary and pension inclusions and exclusions
- 5-Year salary averaging (Plans 2 & 3)
- Reporting compensation as earned
- Excess compensation (employer liability for excess cost)

Each of the State pensions systems, including LEOFF Plan 2, specifically defines what can be included as salary for pension purposes. Likewise, items that are excluded are also defined. Since 1977 with the creation of the Plan 2 systems, salary such as leave-cash-outs has been excluded under the definition. The statutory definitions allow for the limitation of extraordinary income from pension calculations. The definition of salary for LEOFF Plan 2 was discussed in more detail earlier in the report.

Since 1977, the Plan 2 systems have used a longer salary averaging period of 5 years. The salary averaging period for public pension systems tends to be between 3 and 5 years. A longer final salary averaging period, such as 5 years, is considered best practice. A longer salary averaging period makes it more difficult for employees to work a significant amount of extra hour over the longer period and it spreads end of career salary increases over a longer period which reduces the impact on the salary average.

[4] Miller, Girard. “http://www.governing.com/columns/public-money/Seeking-a-Fix-for.html.” 23 April 2003. Governing.com. 17 July 2012.

The Department of Retirement Systems requires employers to report compensation in the month that it was earned rather than the month that it was paid. This practice prevents compensation from things such as deferred wages or retroactive wage increases into the salary averaging period.

Since 1984, excess compensation has been defined in the pension statutes as consisting of specific types of reportable compensation when the payment increases the member's retirement allowance. If reportable compensation included in a retiree's retirement allowance calculation qualifies as excess compensation, then the applicable employer is responsible for the resulting liability to the pension fund. Without such an employer payment, the excess compensation-related liability would effectively be spread amongst all employers, and paid for through the contribution rate structure for the plan. Appendix C provides addition information regarding excess compensation.

Practices in Other States

At least 14 states have made changes to their pension systems in the past five years to prevent employees from increasing pensions through extraordinary salary growth. According to Keith Brainard, research director at the National Association of State Retirement Administrators, "The popular thing is to limit salary increases in the last few years of employment. Another thing is to prohibit or limit overtime and sick leave in calculating average final compensation." According to his research, excessive overtime tends to be more of a city-level issue because it's more common among public safety personnel such as fire fighters and law enforcement.

Some states, including Arkansas, Colorado, Iowa and Nevada, have set caps on how much an employee's pay can increase from year to year. Any pay that exceeds the cap won't be counted when calculating retirement benefits. In Georgia, the employer is required to cover the extra benefit costs for any pay increases that exceeds 5 percent during the 12 months before an employee's retirement. Other states, such as West Virginia and Kentucky, have eliminated lump sum payouts from being included when calculating benefits. Appendix D provides a more detailed look at what 14 other states have done in the past five years aimed at preventing salary growth spiking in the retirement calculation.

SUPPORTING INFORMATION

Appendix A: Basic Salary Table
Appendix B: Comparison of Current and Previous Average Salary Periods
Appendix C: Excess Compensation
Appendix D: Salary Practice Changes in Other States

LEOFF Plan 2 Retirement Board

APPENDIX A

BASIC SALARY TABLE WAC 415-104-299

The following table will help you determine whether certain types of payments are basic salary under LEOFF Plan 1 or 2. Be sure to read the referenced rule to ensure that you have correctly identified the payment in question. The department determines basic salary based upon the nature of the payment, not the name applied to it. See WAC 415-104-311 (Plan 1) and WAC 415-104-360 (Plan 2).

Type of Payment	LEOFF 1 Basic Salary?	LEOFF 2 Basic Salary?
Additional Duty Pay	Yes - WAC 415-104-3205	Yes - WAC 415-104-360
Allowances (i.e. uniform)	No - WAC 415-104-3404	No - WAC 415-104-390
Basic Monthly Rate	Yes - WAC 415-104-3200	Yes - WAC 415-104-360
Cafeteria Plans	No - WAC 415-104-3303	Yes - WAC 415-104-367
Deferred Wages Attached to Position	Yes - WAC 415-104-3201(1)	Yes - WAC 415-104-363(1)
Deferred Wages not attached to a Position	No - WAC 415-104-3306	No - WAC 415-104-363(2)
Disability Payments	No - WAC 415-104-340	No - WAC 415-104-380
Education Attainment Pay	No - WAC 415-104-3301	Yes - WAC 415-104-375
Employer taxes/contributions	No - WAC 415-104-3401	No - WAC 415-104-383
Fringe Benefits, including insurance	No - WAC 415-104-3402	No - WAC 415-104-385
Illegal Payments	No - WAC 415-104-3403	No - WAC 415-104-387
Leave Cash Outs/Severance	No - WAC 415-104-3304	No - WAC 415-104-401
Longevity	Yes - WAC 415-104-311	Yes - WAC 415-104-375
Overtime	No - WAC 415-104-3305	Yes - WAC 415-104-370
Paid Leave	Yes - WAC 415-104-3203	Yes - WAC 415-104-373
Payments in Lieu of Excluded Items	No - WAC 415-104-350	No - WAC 415-104-405
Performance Bonuses	No - WAC 415-104-3302	Yes - WAC 415-104-377
Retroactive Salary Increase	Yes - WAC 415-104-3202	Yes - WAC 415-104-365

Reimbursements	No - WAC 415-104-3404	No - WAC 415-104-390
Retirement or Termination Bonuses	No - WAC 415-104-3406	No - WAC 415-104-395
Shift Differential	Yes - WAC 415-104-3204	Yes - WAC 415-104-379
Special Salary or Wages	No - WAC 415-104-330	Yes - WAC 415-104-375
Standby Pay	No - WAC 415-104-3405	No - WAC 415-104-393
Tuition/Fee Reimbursement	No - WAC 415-104-3404	No - WAC 415-104-390
Workers' Compensation	Not Applicable	No - WAC 415-104-380

LEOFF Plan 2 Retirement Board

APPENDIX B

COMPARISON OF CURRENT AND PREVIOUS AVERAGE SALARY PERIODS

System Plan	One Salary Period	Total Members	Current Salary is Lower	0-25% Higher	25-50% Higher	50-75% Higher	75-100% Higher	Over 100% Higher
LEOFF 2	5 years	557	6	305	232	10	4	0
OT curr period		445	4	445	4	257	175	6
PERS 1	2 years	3,118	699	2,324	61	18	5	11
OT curr. period		607	114	468	23	1	0	1
PERS 2	5 years	5,130	235	3,684	1,107	85	13	6
OT curr. period		1,313	28	906	346	24	6	3
PERS 3	5 years	359	21	251	79	7	1	0
OT curr. period		76	2	53	19	2	0	0
WSP 1	5 years	109	23	85	1	0	0	0
OT curr. period		45	5	39	1	0	0	0
WSP 2	2 years	0	0	0	0	0	0	0
OT curr. period		0	0	0	0	0	0	0
PSERS 2	5 years	0	0	0	0	0	0	0
OT curr. period		0	0	0	0	0	0	0
SERS 2	5 years	965	67	669	202	19	5	3
OT curr. period		100	2	67	24	5	1	1
SERS 3	5 years	731	41	520	145	22	3	0
OT curr. period		82	1	58	17	5	1	0
TRS 1	2 years	1,343	193	1,104	32	10	2	2
OT curr. period		17	5	11	1	0	0	0
TRS 2	5 years	488	13	303	157	13	1	1
OT curr. period		3	0	3	0	0	0	0
TRS 3	5 years	916	38	614	240	17	2	5
OT curr. period		21	0	13	8	0	0	0
Total Members		13,716	1,336	9,859	2,256	201	36	28
Total OT curr. period		2,709	161	1,875	614	43	11	5

1. In order to be included on this report, a member must have either (a) retired for service within the past 2 years (11/1/2009 - 10/31/2011) from active status, or (b) have an estimate for a service retirement date within the next year (11/2011 - 10/2012) and be currently employed with earnings in September 2011.

2. The salary period compared is based on the length of the average salary used in a retirement benefit for a system plan. For the plans with a 2 year average salary, the most current 2 years is compared to the previous 2 years.

3. The salary amounts compared are not the AFC/FAS from the retirement or estimate as that amount may have been modified by an RSA. Instead, the salary amounts for both the current and previous periods will use only regular service earnings (i.e., "A" codes). All other earning types ("M" codes, cashouts) are excluded.

4. Overtime is when a member averaged over 2,100 per year for the salary period (i.e., 4,200 hours for a 2-year period or 10,500 hours for a 5-year period).

5. Data provided by the Department of Retirement Systems.

APPENDIX C
EXCESS COMPENSATION

Excess Compensation[5]

Since 1984 excess compensation has been defined in the pension statutes as consisting of specific types of reportable compensation when the payment increases the member's retirement allowance. If reportable compensation included in a retiree's retirement allowance calculation qualifies as excess compensation, then the applicable employer is responsible for the resulting liability to the pension fund. Without such an employer payment, the excess compensation-related liability would effectively be spread amongst all employers, and paid for through the contribution rate structure for the plan.

The employer paying employees reportable compensation that qualifies as excess compensation is liable to the pension fund for the total estimated cost of all present and future retirement benefits attributable to the excess compensation. Definition of payments as excess compensation does not affect the calculation of individual pension benefits.

Excess compensation includes the following payments, when used in the calculation of the member's retirement allowance:

- a cash-out of more than 240 hours of annual leave;
- a cash-out of any other form of leave;
- a cash-out in lieu of the accrual of annual leave;
- any payment added to salary or wages, concurrent with a reduction of annual leave;
- any payment that exceeds twice the regular daily or hourly rate of pay;
- a payment for, or in lieu of, any personal expenses or transportation allowance, to the extent that the payment qualifies as reportable compensation in the member's retirement system; or
- any termination or severance payment.

The excess compensation statutes apply to all of the retirement systems administered by the Department of Retirement Systems, including the Public Employees' Retirement System, the Teachers' Retirement System, the School Employees' Retirement System, the Law Enforcement Officers' and Firefighters' Retirement System, and the Washington State Patrol Retirement System.

[5] Initial House Analysis of House Bill 2441

APPENDIX D

SALARY PRACTICE CHANGES IN OTHER STATES

Arkansas
The salary used to calculate final average compensation cannot grow by more than 10 percent a year over the preceding year's salary.

Colorado
Has an 8 percent cap on salary increases from one year to the next that will be counted toward the calculation of highest average salary.

Georgia
Calculation of a pension for hires after July 1, 2009 cannot include a pay increase of more than 5 percent in the last 12 months of employment.
Requires an employer pay the retirement system the actuarial cost of giving a raise of more than 5 percent during the 12 months before an employee's retirement.

Illinois
If a school employee gets a pay raise of more than 6 percent, the school district, not the state, is required to fund the difference for pension benefits.

Iowa
Pension system compares the average of the highest three years, or the final average salary, to the fourth highest year's salary. If the final average salary is more than 121 percent of the fourth highest wage, the final average wage is adjusted. This approach allows for wage increases of about 10 percent in each of the highest three years.

Kentucky
Removes lump-sum compensation from calculation of average final compensation for new hires.
Requires highest five years to be the five 12-month fiscal years immediately preceding retirement.

Louisiana
Annual wage increases are capped at 10 percent when calculating average final compensation, except for legislatively enacted increases. For firefighters and police, compensation for a given year may not exceed compensation for the prior year by more than 15 percent.

Missouri

Annual wage increases are capped at 10 percent when calculating average final compensation. The cap does not apply to increases tied to changes in position or employer, or ones required by state statute.

Nebraska
The amount of compensation which would be subject to retirement cannot exceed 7 percent per year during the five years before retirement. Changes in pay that result from a collective bargaining agreement or from a substantial change in an employee's job position do not qualify as exceptions.

Nevada
Calculating of average final compensation will not include pay increases of more than 10 percent per year for the five years leading up to retirement.

New Hampshire
The definition of "earnable compensation" for calculating retirement benefits does not include end-of-career payments and a number of work-related reimbursements. If compensation in the final year of service exceeds 125 percent of final average compensation, the retiree's last employer will be assessed the cost of the excess benefit. Annual retirement benefits are capped at $120,000.

South Dakota
For the purposes of calculating benefits, compensation in an employee's last quarter cannot exceed 105 percent of any previous quarter, and the average compensation of the last four quarters cannot exceed 110 percent of any previous quarter.

Vermont
Compensation increases for teachers are capped at 10 percent per year when calculating final average compensation.

West Virginia
Lump sum payments are not included in final average salary calculation. Police and firefighters cannot receive a total, combined benefit greater than 105 percent of the highest salary received in a position covered by the pension system.

July 23, 2012

Mr. Steve Nelsen
Executive Director
LEOFF Plan 2 Retirement Board
P.O. Box 40918
Olympia, Washington 98504-0918

SUBJECT: PENSION CONTRIBUTION RATES

Dear Steve:

I am providing preliminary contribution rates from the 2011 actuarial valuation of the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 2 (LEOFF 2) and contribution rate options for the Board's consideration. The results are still considered preliminary until the concurrent external audit is complete and the Board adopts contribution rates.

The primary purpose of the valuation is to determine contribution requirements for LEOFF 2 as of the valuation date, June 30, 2011, and should not be used for other purposes. The results are based on the economic assumptions, asset value smoothing technique, and funding policies established under Chapter 41.45 RCW and adopted by the Board.

There are two key policy decisions before the Board regarding the adoption of contribution rates. The Board will consider whether to continue the current rates adopted through 2017, or adopt rates based on the results of the 2011 actuarial valuation.

Valuation Results

We provided an executive summary of the preliminary 2011 valuation results at your June board meeting. I will forward a final actuarial valuation report to the Board this fall reflecting your final decisions on rates.

Contribution Rates

In my opinion, all of the contribution rate options outlined in this communication are reasonable for funding the benefits in LEOFF 2 during the 2013-15 Biennium. In addition, the rates include the cost of medical benefits that will be paid through a 401(h) account.

The Board may choose to (1) continue current contribution rates throughout the 2013-15 Biennium, or (2) adopt rates based on the results of the 2011 actuarial valuation.

Continuing Current Rates

The rates currently collected (Attachment A) are sufficient to fund the cost of all benefits in LEOFF 2 during the 2013-15 Biennium. Current rates are based on the 2007 actuarial valuation, include subsequent temporary and supplemental rates, and were adopted by the Board through 2017.

If the Board chooses to continue these rates, no Board action is required since these rates have previously been adopted through 2017.

Adopting Rates Based on the 2011 Actuarial Valuation Results

The contribution rate levels based on the 2011 actuarial valuation are lower than the rates currently collected. If the Board elects to adopt rates based on the 2011 valuation two possible options include:

- Ninety percent of the Entry Age Normal Cost (EANC), consistent with the long-term Board funding policy (Attachment A), or
- One hundred percent of EANC, consistent with Board funding policy for 2011-13, (Attachment A).

Additional Information

At the June meeting, the Board requested additional information regarding the preliminary 2011 valuation results. Specifically, the Board was interested in seeing the effect on projected rates for the various contribution rate options outlined in this communication. At this time we were unable to produce full contribution rate projections that include optimistic and pessimistic rate paths. However, we were able to produce the expected rate paths for the contribution rate options before the Board. This information is available in Attachment B.

Based on these projections, member contribution rates are expected to drop under each option to less than 7.75 percent and then rise to a long-term rate of approximately 8.25 percent. If the Board elects to adopt the 90 percent EANC rate floor (minimum) for the next biennium, contribution rates are expected to have a larger increase following the initial drop. On the other hand, if the Board elects to maintain the current rates or continue with the short-term policy of a 100 percent EANC rate floor, rates are still expected to drop following the short-term policy period but the increase following that drop is smaller. Going forward, we believe it will be helpful for the Board to review the projections that provide the full picture of optimistic and pessimistic rate paths to assess what policy they may want to adopt for future biennia. We expect to have these projections available this fall and would suggest you replace the projections in this communication once the full projections are provided.

I hope the Board finds this information useful during their deliberations. Please don't hesitate to contact me directly should you require any additional information.

The undersigned, with actuarial credentials, meets the Qualification Standards of the America Academy of Actuaries to render the actuarial opinions contained herein.

Sincerely,

Lisa A. Won, ASA, FCA, MAAA
Actuary

Attachments
Attachment A – Contribution Rate Options
Attachment B – Projected LEOFF 2 Member Rates

cc: Kelly Fox, Chair,
LEOFF 2 Board
Matt Smith, State Actuary,
OSA

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Attachment A – Contribution Rate Options

Continue Current Rates

	Current Rates	2013-15 Rates	Difference
Member	8.46%	8.46%	0.00%
Local Employer*	5.08%	5.08%	0.00%
State	3.38%	3.38%	0.00%

**Excludes DRS administrative expense rate of 0.16%. Includes pension and medical benefits.*

2011 Actuarial Valuation 90 Percent EANC Policy

	Current Rates	2013-15 Rates	Difference
Member	8.46%	7.57%	(0.89%)
Local Employer*	5.08%	4.54%	(0.54%)
State	3.38%	3.03%	(0.35%)

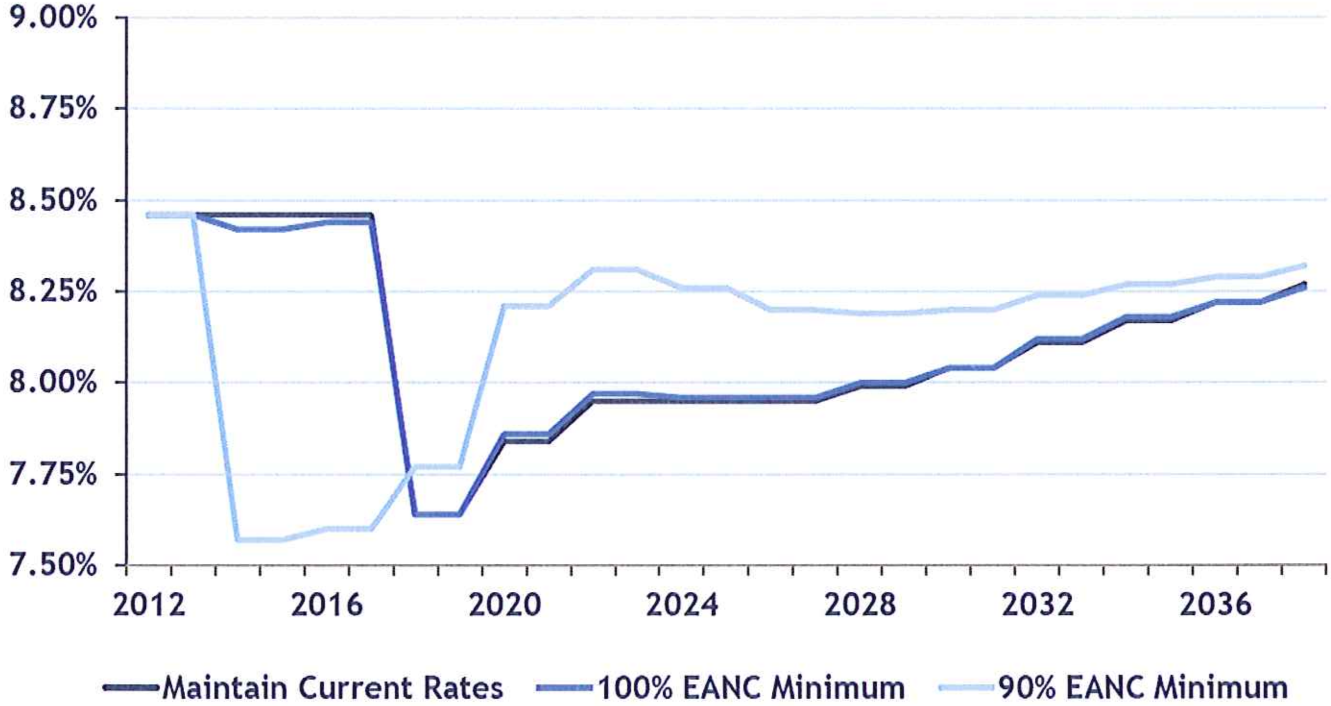
**Excludes DRS administrative expense rate of 0.16%. Includes pension and medical benefits.*

2011 Actuarial Valuation 100 Percent EANC Policy

	Current Rates	2013-15 Rates	Difference
Member	8.46%	8.41%	(0.05%)
Local Employer*	5.08%	5.04%	(0.04%)
State	3.38%	3.37%	(0.01%)

**Excludes DRS administrative expense rate of 0.16%. Includes pension and medical benefits.*

Attachment B – Projected LEOFF 2 Member Contribution Rates*



**Based on preliminary 2011 valuation results and actual ROR on assets through 5/31/2012. The assumed ROR of 7.5% is used starting in June 2012.*
*Notes: **Current Rates** are adopted through 2017 followed by the long-term funding policy with 90% EANC rate floor. **100% EANC** rate floor (minimum) in place through 2017 with 90% EANC rate floor thereafter. **90% EANC** rate floor (minimum) starts in 2013.*