LEOFF
Plan 2 Retirement Board

Salary Spiking

Initial Consideration
August 28, 2013

Issue Statement

Salary spiking in Public Pension plans undermines public trust that LEOFF Plan 2 is designed responsibly and managed professionally.

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Context

- Recent pension spiking issues:
  - State Patrol Lieutenant Average Final Compensation (AFC) increased 79% using overtime.
  - LEOFF 1 pension spiking recently in press.
- Build on recent pension spiking analysis:
  - Office of the State Actuary (OSA).
  - Washington State Institute of Public Policy (WSIPP).
  - Board Reports from 2012.

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Salary Spiking Defined

"Salary Spiking":

Manipulating compensation during the Final Average Salary Period to increase ("balloon")retirement allowances.

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Salary Spiking Example

- Two Plan 2 members have an identical salary history up until the last 5 years.
  - Worker 1 continues to receive regular salary increases, without any overtime.
  - Worker 2 receives the same increases but also works 5 hours of overtime per week for the last 5 years of his career.

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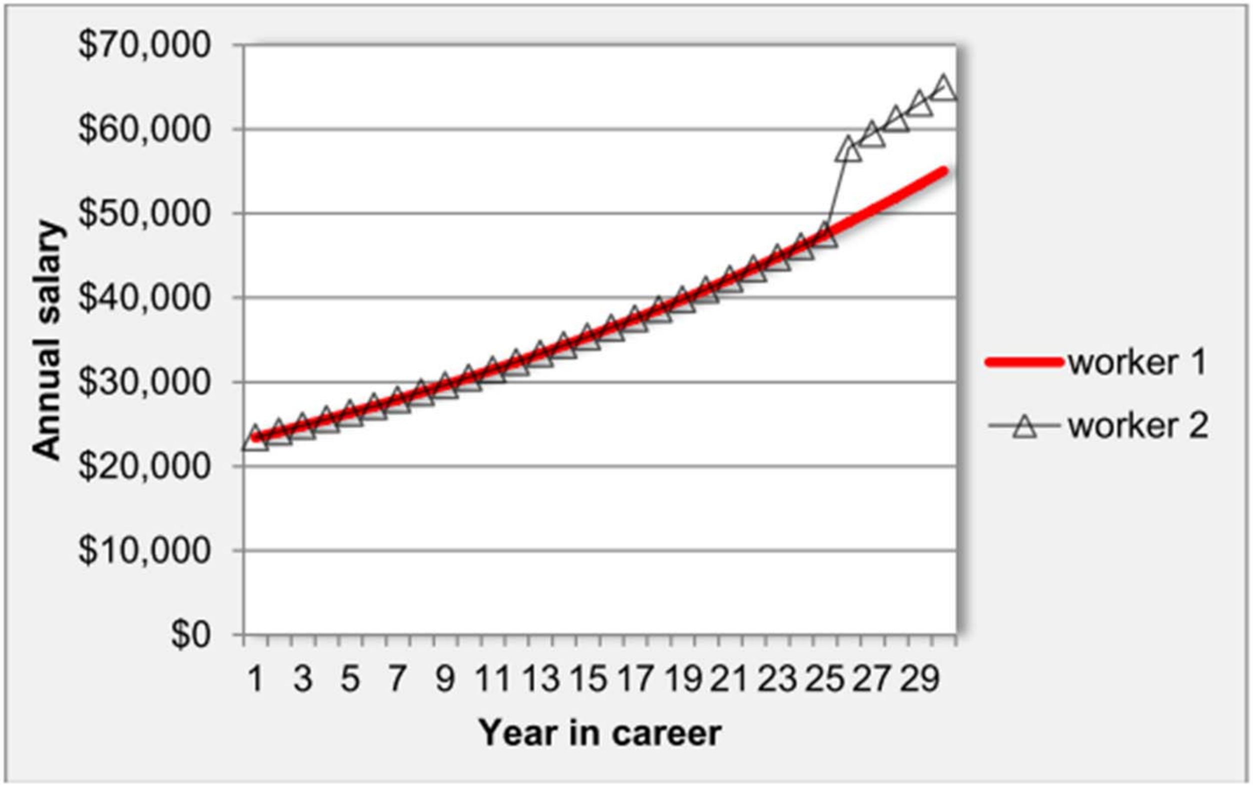
Effect of Salary Spiking



Worker 2 contributes an extra $2500 towards his pension and receives an additional benefit with a present value of $97,000.

Types of Spiking

- Systemic – applies to most or all retiring employees of a given employer:
  - Leave cashouts (PERS & TRS plan 1 only)
  - Contracted severance payments
  - Retirement Bonus
- Individual:
  - Overtime manipulation
  - Additional contracts

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LEOFF Plan 2 Spiking

- LEOFF Plan 2 definitions preclude many common forms of spiking:
  - Termination payments, i.e. Leave cashouts, excluded;
  - 5-year FAS period:
    - Different from LEOFF Plan 1
    - Even a dramatic increase in last few months would not raise AFC much.

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LEOFF Plan 2 Spiking

- LEOFF Plan 2 spiking possible by manipulating:
  - Overtime
  - Longevity pay
  - Special Salary or Wages; educational attainment pay for example
  - WAC 415-104-299, Basic Salary Table (Report Appendix B)

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Salary Spiking Issues

OSA identified two Issues in 2012 analysis:

1. Actuarial Cost: Actuarial cost to plans if salary increases "exceed expected levels."

2. Public Trust: "…pension spiking…may weaken public trust in the state retirement systems;

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Systemic Spiking Can Have Significant Costs

When spiking is systemically applied to an entire group of employees costs can be high.

"The impact of including termination payments when computing the "average final compensation" is not insignificant, amounting to an annual cost of between $5 and $6 million. In 1975, the total employee and employer rate of contributions was 13 percent of all compensation. If PERS had not included termination payments in computing benefits, the rate would have been 12.4 percent of all compensation."

Washington Ass'n of County Officials v. Washington Public Emp. Retirement System Bd., 89 Wn.2d 729, 731 (Wash. 1978)

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Individual Spiking – Actuarial Cost Indeterminate

- OSA could not isolate an actuarial cost for overtime spiking.
- WSIPP study included OSA data and State Personnel System (HRSM) data - Findings on overtime:
  - Most members tend to work roughly the same number of hours before and during AFC period.
  - Those who worked overtime during AFC period also worked overtime in prior periods.
  - There are exceptions but "extreme increases are rare."
  - Hours during AFC tended to decline.

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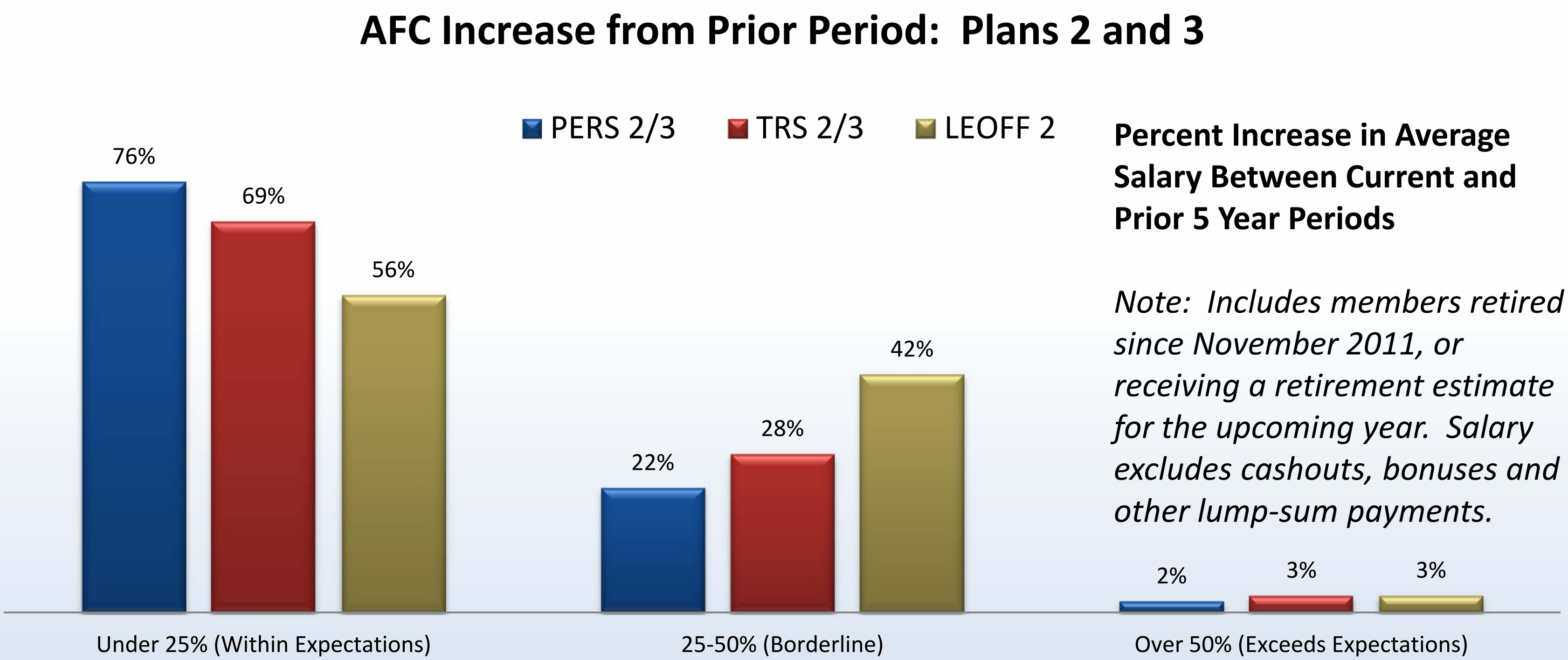
Individual Spiking Rare



Percent Increase in Average Salary Between Current and Prior 5 Year Periods

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

Few retirees exceed actuary's expectation of AFC increases. That is, small number that leads to actuarial cost.

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Individual Spiking - Actuarially Significant Cost?

Unlikely that individualized spiking causes actuarially significant costs.

- Not enough incidents outside of the scope of actuarial assumptions to cause increase in contribution rates.
- It does not follow that individual spiking is not a problem/risk.

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Individual Spiking – Recent WSP Example

State Patrol Lieutenant – 2011: Manipulated overtime to increase salary 79% during AFC period. Fraud charges filed alleging the individual:

- In charge of assigning overtime; assigned a disproportionate amount to himself
- Did not actually work all the time claimed;
- Had to work around safeguards in reporting system to include overtime that was excluded by statute.

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Individual Spiking – Recent LEOFF Plan 1 Examples

Pension Spiking reported by AP articles:

> “Last-minute pay raises have boosted some police officers’ and fire fighters’ annual pensions by thousands of dollars a year, and may end up draining a state-run pension plan of $1 million or more.”
>
> --*Seattle Times*, April 6, 2013

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Individual Spiking – Recent LEOFF Plan 1 Examples

Could only happen this dramatically in closed LEOFF Plan 1 system.

- All other plans average salary.
- Pension spiking risk reduced even further in plans 2/3 by 5 year averaging period.

Spiking Undermines Public Trust in Public Plans

Citizens are not mollified by lack of cost to current taxpayers:

"The state employees win, the public sector unions win because they get higher dues, the politicians who let this kind of immoral and unethical behavior happen win via campaign donations and support from the unions but guess who loses? Us regular working families who are seeing state financial support of our universities cut and more levies and taxes to pay these thieves."

"The fact that some abuses (of the sort revealed in the Times' story) have occurred no more proves the hopeless impropriety of defined pension plans than examples of medical fraud prove the irredeemable corruption of Medicare and Medicaid. Indeed, one way to ensure the failure of any plan is to ignore examples of abuse that occur, and to throw up our hands in despair at ever achieving a more honest administration."

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Agreements Raise Issues

"I will also point out what others have noted.....the guys mentioned as examples of egregious acts are all management/Fire Chiefs. They are not the guys who run into burning buildings or fight with gang members. They are management..."

Comment on Seattle Times LEOFF 1 Spiking Article

Recurrent theme in spiking issues – agreements.

- WSP Lieutenant self-assigned overtime with lax oversight;
- LEOFF 1 spiking issues :
  - "Veteran managers" in Lakewood;
  - Fire Chief receives $3,123/mo salary increase in final months
  - Fire Chief 57% salary increase for last 3 months.

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Fits into Larger Narrative

Pension manipulation resonates with American distrust of public officials:

"Skepticism of government is as old as the republic. It's part of Americans' cultural identity, and over the years, a healthy dollop of distrust has served as a check on government excesses. Today, however, distrust of government and elected officials appears more like a rigid cynicism."

Trust in government: the Season of Discontent.

2010 NPR Series

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Spiking is "Rational"

Pension spiking meets definition of 'Rational Behavior':

> "A decision-making process that is based on making choices that result in the most optimal level of benefit or utility for the individual. Most conventional economic theories are created and used under the assumption that all individuals taking part in an action/activity are behaving rationally."
> *Investopedia*

Employer spiking practices "[I]nflate pensions of their retiring employees at relatively little cost to themselves."
DRS employer notice 84-002

"It (spiking retiring LEOFF 1 member salaries) worked out dollars and cents-wise — from the city's standpoint, that is."
Former City official quoted in Seattle Times

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Anti-Spiking Efforts In Washington

In 1970s Leave cashouts became a common and expensive form of spiking. *County Officials* Court ruled in 1978 PERS had to continue including leave cashouts (termination payments) in pension calculation.

– Legislature tried to prevent spiking by stopping payment of leave cashouts for PERS 1 state employees.

– The Supreme Court ruled State could not discontinue leave cashouts because of effect on PERS Plan 1 pensions. *State employees v. State, 98 Wn.2d 677, 685 658 P.2d 634 (1983).*

– Legislature responded by passing excess compensation law in 1984.

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Excess Compensation Assesses Cost to Employers

- DRS explained excess compensation (employer notice 84-02):
  - Employers adopted spiking to “inflate … employee’s pensions at little cost to themselves”;
  - Additional costs spread over all employers;
  - Legislature enacted excess compensation legislation to charge the responsible employers for the extra cost.
- When employers began receiving bills, many cut back on leave cash outs. No longer rational.

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Recent Study and Legislation

- Analysis by WSIPP and OSA.
- Companion studies by LEOFF Plan 2 Board staff.
- SB 6543 (2010) excluding overtime from pensionable compensation.
- SB 5392 (2013) – Defined AFC increases of over 50% as excess compensation.
- SB 5916 (2013) – reduced trigger point to 125%.

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Summary

- Pension spiking raises issues of cost and public trust.
- Spiking issues in other plans can create a public trust and fairness issue which can be a risk to LEOFF Plan 2.
- Research show that LEOFF Plan 2 does not have a systemic spiking issue.
- Individual spiking could occur and can create a public trust and fairness issue which can be a risk to LEOFF Plan 2.

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Next Steps

- Not pursue the issue at this time
- Provide Comprehensive Report with policy options

Any Questions?

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APPENDIX B
LEOFF REPORTABLE COMPENSATION TABLE

LEOFF REPORTABLE COMPENSATION TABLE

Type of Payment	LEOFF Plan 1 Basic Salary	LEOFF Plan 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 415-104-3201 (2)	No - WAC 415-104-363 (2)
Differential Military Pay	Yes - DRS Notice 08-019	Yes - DRS Notice 08-019
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	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 Pay	Yes - WAC 415-104-330 RCW 41.26.030 13(a)	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
Shared Leave	No - WAC 415-104-311	Yes - DRS Email 10-009
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
Worker's Compensation	Not Applicable	No - WAC 415-104-380

Excess Compensation Billings in LEOFF Plan 2
According to the Department of Retirement Systems, there have not been any excess compensation billings issued under LEOFF Plan 2.

Excess compensation calculation example: Plan 2 member retires at 53 with 25 years

Variables	
Regular Salary (over Five years)	$85,000 ($425,000)
Overtime Included in FAS	$225,000
Final Average Salary, INCLUDING overtime 5 year Cumulative – Two different overtime accrual patterns, same total.	$425,000 + 225,000 = $650,000 YR 1 $130,000 $85,000 YR 2 $130,000 $85,000 YR 3 $130,000 $85,000 YR 4 $130,000 $197,500 YR 5 $130,000 $197,500 TOTAL $650,000 $650,000
Actuarial Factor (WAC 415-02-340)	0.0054978

Calculations
1. Monthly Benefit Calculation • $650,000/60mo = $10,833.33 (FAS/Month) • 2%*25y*$10,833.33 = $5416.67 2. Excess Compensation Threshold • $425,000 x 1 ½ = $637,500 • $637,500/60 mo =$10,625 • 2%*25y*$10,625 = $5,312.50 3. Monthly Benefit Over Threshold • $5,416.67 - $5,312.50 = $104.17 4. Excess Compensation Billing to Employer • $104.17 ÷ 0.0054978 = $18,947.58

Excess Compensation Provisions: RCW 41.50.150, WAC 415-02-140
Actuarial Factor: WAC 415-02-340

APPENDIX A
EXCESS COMPENSATION DETAIL

The following detailed description and example of the excess compensation law, RCW 41.50.150, is taken from the December 12, 2012, LEOFF Plan 2 Board initial consideration report on excess compensation:

Excess Compensation

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 across the plan and paid for through the contribution rate structure.

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. An employer must pay the excess compensation bill within thirty days of the receipt of the billing. Any unsettled bill will be assessed an interest penalty of one percent of the amount due for each month or fraction thereof beyond the original thirty-day period. The Director of the Department of Retirement Systems may in the director's discretion decline to bill the employer if the amount due is less than fifty dollars. Excess compensation billings do 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;
- 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;
- any termination or severance payment; or
- the portion of any payment, including overtime payments, that exceeds twice the regular daily or hourly rate of pay.

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 Fire Fighters' Retirement System, and the Washington State Patrol Retirement System. The provision regarding overtime is the only type of payment applicable to LEOFF Plan 2 for excess compensation.

SUPPORTING INFORMATION

Appendix A: Excess compensation detail and example

Appendix B: DRS reportable compensation table for LEOFF

The SCPP directed its staff to develop draft legislation expanding the definition of excess compensation, though the Committee did not vote to endorse the final bill draft. Some members expressed concern about assessing excess compensation on payments that did not reflect salary manipulation, such as mandatory overtime or overtime consistently earned over a member's career.

An individual legislator on the SCPP introduced the draft legislation during the 2013 session. SSB 5392 would have required DRS to bill an employer for excess compensation if FAS increased by 150% or more over the prior period. Another version of this proposal, SSB 5916, was introduced later in session reducing the proposed trigger point to 125%. Neither bill passed.

LEOFF 1 Base Salary Spiking

In April 2013, the Seattle Times published an article documenting LEOFF Plan 1 salary spiking. LEOFF Plan 1 is particularly susceptible to salary spiking because the pension is based on the final salary paid to the member, rather than an average of salary paid over time. The article documents increases in base salary shortly before retirement that significantly increased pensions for a defined group of LEOFF 1 retirees. The increases were paid under either individual contracts with the affected employee or very narrowly drawn contract amendments that expired shortly after the affected employees' retirement. DRS followed up on the cases documented by the Associated Press and disallowed some, but not all, of the increases.

One on line comment to the Times article, after first distinguishing LEOFF Plan 1, where the abuses occurred, from LEOFF Plan 2, which 99% of current firefighters and law enforcement officers belong to, stated: "I will also point out what others have noted.....the guys mentioned as examples of egregious acts are all management/Fire Chiefs. They are not the guys who run into burning buildings or fight with gang members. They are management..."

SUMMATION

The common theme running through the recently reported incidents of pension ballooning is that, unlike the systemic pension ballooning targeted by the original excess compensation law, these were temporary, individual arrangements effecting 1 or at most a handful of individuals. While these may not generate an actuarially significant cost, they undermine public trust in public pension plans. Regardless of what pension plan the salary spiking occurs in, the erosion of public trust presents a risk to all plans.

reporting system to misreport voluntary overtime, which is excluded from WSPRS's definition of earnable compensation.

Soon after the news broke, Legislators introduced Senate Bill 6543 banning overtime from the definition of reportable compensation. While the bill did not pass, the Legislature did commission a WSIPP review of overtime and excess compensation. The SCPP also requested analysis and a presentation from OSA.

One issue complicating the analysis by both OSA and WSIPP is DRS does not capture overtime as a separate data element. OSA approximated overtime by looking at total compensation and backed out cashouts, bonuses, and other lump sum payments. OSA was not able to back out increases resulting from promotions or regular raises, as DRS does not capture those as separate data elements either.

OSA compared the salary increases it found during an employee's years prior to retirement to the salary increases it expected. Ninety-seven percent of LEOFF Plan 2 members retiring or requesting estimates had salary increases within expected levels during their FAS periods. Of the 3% (14) of participants with unexpected levels of salary growth[17], nine had overtime in the current period; six of them also had overtime in the prior period.

WSIPP reviewed the data from OSA and also looked at data from the state personnel reporting system (HRMS). HRMS identifies overtime as a separate data element, but only covers state employees and only goes back to 2006. After reviewing both excess compensation and overtime from both OSA and HRMS data, the WSIPP report concluded:

- "Excess compensation is rare, especially among members of open plans."
- "In all Washington's state-administered public pension systems, average monthly hours are not systemically higher during AFC periods."
- "Exhibit 23 (detailing employee hours before and during AFC period) illustrates some important points.
    - First, most members tend to work roughly the same number of hours before and during the AFC period. Those who work overtime during the end of their career tended to also do so earlier in their career….
    - Second, there are exceptions – hours increased substantially for some members, and extreme increases are rare.
    - Third, hours decline for some members."

[17] OSA identified "higher than expected" salary growth as over 50%. It does not follow that those increases were from overtime, as they could have come from promotions or other non-spiking sources.

constitutional contract doctrine prohibiting the exclusion of leave cashouts from PERS Plan 1 pension calculations required the State to continue paying those cashouts so they could increase pensions. *State employees v. State,* 98 Wn.2d 677, 685 658 P.2d 634 (1983).

PERS Plan 1 and TRS Plan 1 were required to continue including leave cashouts in the pension calculation and the State could not stop paying them. Faced with that situation the Legislature devised an elegant solution: excess compensation.

The Legislature defined excess compensation as: "any payment that was used in the calculation of the employee's retirement allowance, except regular salary and overtime…" The statute specifically identified leave cashouts and "any other termination or severance payment used in the calculation of the employees' retirement allowance[15]." DRS calculates the increase to the individual's pension from the excess compensation, determines the present value of the additional benefit stream, and bills the employer whose pay practices caused the pension ballooning for the extra pension cost.

The excess compensation law did not change pensions and thus did not run afoul of the constitutional protections relied on in *County Officials* and *State Employees.* The retiree still gets the full pension, but the employer no longer gets to pass the cost onto others. Once employers starting being charged for the full cost of their salary spiking practices, a number of them stopped[16]. After the Legislature passed the excess compensation law, providing leave cashouts to boost employee pensions was, generally speaking, no longer rational behavior.

RECENT INDIVIDUAL PENSION SPIKING AND LEGISLATIVE RESPONSES

Salary spiking engenders a strong negative public reaction. Recent incidents documented in the media have been no exception.

Overtime Abuse and Response

In 2011, a retiring Washington State Patrol Lieutenant earned an additional 79% on top of his base salary from overtime. The Lieutenant self-assigned his overtime, subject to review from his Captain. After the overtime issue came to light the Captain was demoted and reassigned and the State Patrol commissioned an outside investigation. The resulting criminal charges alleged the Lieutenant did not work all the overtime claimed and that he manipulated the

[15] Laws of 1984 c 184 § 1, RCW 41.50.150
[16] See for instance *Abels v. Snohomish County Public Utility Dist. No. 1*, 69 Wn.App. 542, 546-548, 849 P.2d 1258 (1993)

While it is the retiree that receives the spiked pension, the employer can also benefit. A recent Seattle Times article documented several local government employers providing temporary salary increases to LEOFF Plan 1 members:

> (City officials) said in interviews that the late raises were designed to incentivize retirements by boosting pension values. They said the local fire officials were having budget troubles and were interested in some staff retirements to help with a potential merger with a nearby fire district[12].

When questioned about a temporary salary bump that appeared to result in the retirement of 8 senior employees, a former city official stated: “It worked out dollars and cents-wise — from the city’s standpoint, that is[13].”

HISTORY OF ANTI-SPIKING EFFORTS IN WASHINGTON

For as long as there has been spiking, pension administrators have worked to combat it. Termination payments, primarily leave cashouts, were identified as a costly source of pension spiking in the 1970’s. In 1977, Washington’s Legislature disallowed those payments in the Plan 2 systems. It could not, however, constitutionally amend the definition of compensation in the PERS and TRS Plan 1 systems to exclude those payments[14].

Recognizing the cost to the system and, ultimately, to employers, the Washington Association of County Officials sued PERS to discontinue inclusion of termination payments (leave cashouts) in PERS Plan 1 pension calculations. The Supreme Court ruled the long-standing practice of including termination payments in pension calculations had become part of the constitutionally protected pension contract and could not be discontinued. See *Washington Ass'n of County Officials v. Washington Public Emp. Retirement System Bd.,* 89 Wn.2d 729, 731 (1978).

Since termination payments could not be excluded from PERS Plan 1 pension calculations, the Legislature attempted to prevent salary spiking by discontinuing leave cashouts for PERS 1 members. The Legislature reasoned that if the payments were not made, they could not be included in the pension calculation. The Supreme Court believed otherwise, ruling the same

[12] *State feels bite of workers' 'pension spiking'*, Seattle Times, April 6, 2013.
[13] *Ibid.*
[14] Termination payments had always been excluded from LEOFF Plan 1 as “special salary.” See RCW 41.26.030(4)(a), WAC 415-104-330.

> government excesses. Today, however, distrust of government and elected officials appears more like a rigid cynicism[8].

Regardless of the actuarial cost in dollars and cents, the erosion of public trust is a high price paid by all public pension system members when individual employees make “special” arrangements to balloon their pensions.

WHY DO EMPLOYERS AND EMPLOYEES SPIKE SALARIES?

Salary spiking is a perennial pension policy issue, repeatedly studied in Washington over the last 20 years[9]. Nor is the issue unique to Washington. If spiking salary causes so much public outrage and undermines public trust in the plan, why do employers and employees’ repeatedly engage in it? One plausible answer can be found in basic economic theory. Employers and employees cooperate to spike salaries because it is rational:

> “Rational behavior” means: A decision-making process that is based on making choices that result in the most optimal level of benefit or utility for the individual. Most conventional economic theories are created and used under the assumption that all individuals taking part in an action/activity are behaving rationally[10].

The Department of Retirement Systems (DRS) succinctly explained the rational basis for salary spiking in a 1984 Employer Notice:

> Over the last few years, certain employers, notably some units of local government, have adopted practices which inflate pensions of their retiring employees at relatively little cost to themselves. Since a single basic rate is charged to all PERS employers, the extra retirement costs generated by these few employers have been spread over all employers[11].

Spiking provides a benefit to the retiree that far outweighs the cost to either the retiree or the retiree’s employer. That is, it is rational.

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[8] *Trust in government: the Season of Discontent.* 2010 NPR Series.
[9] The Joint Committee on Pension Policy studied salary spiking by school administrators in 1994, PERS Plan 1 in 1995, Washington State Patrol Retirement System in 1999-2000; and by PERS employers in 2002.
[10] Investopedia – http://www.investopedia.com/terms/r/rational-behavior.asp.
[11] DRS Notice No. 84-002.

been found in LEOFF Plan 2, due in large part to a plan design that makes spiking difficult to pull off. It does not mean, however, that salary spiking is not a risk for the LEOFF Plan 2 system.

The Erosion of Public Trust

A recent Associated Press article uncovered LEOFF Plan 1 pension spiking that significantly increased pensions for a handful of retiring LEOFF Plan 1 members. LEOFF Plan 1 was closed to new members 36 years ago, with only 186 active members remaining. Further, the system is 135% funded, and has not cost taxpayers any additional money ever since contributions stopped in 2000. That is, there was no unfunded cost incurred as a result of the salary manipulations. These facts, though pointed out, were of little or no relevance to members of the public reacting to the article, which included the following comments:

> The state employees win, the public sector unions win because they get higher dues, the politicians who let this kind of immoral and unethical behavior happen win via campaign donations and support from the unions but guess who loses? Us regular working families who are seeing state financial support of our universities cut and more levies and taxes to pay these thieves.

Note the commentator generalized the issue to include all state employees. Less caustic commentators still recognized a problem:

> The fact that some abuses (of the sort revealed in the Times' story) have occurred no more proves the hopeless impropriety of defined pension plans than examples of medical fraud prove the irredeemable corruption of Medicare and Medicaid. Indeed, one way to ensure the failure of any plan is to ignore examples of abuse that occur, and to throw up our hands in despair at ever achieving a more honest administration.

The recurrent theme in the recent pension spiking incidents is one-time arrangements made either by or on behalf of highly placed employees. This self-dealing fits into a long-standing narrative of public distrust of government.

> Skepticism of government is as old as the republic. It's part of Americans' cultural identity, and over the years, a healthy dollop of distrust has served as a check on

ISSUES RAISED BY SALARY SPIKING.

OSA's report identified two issues raised by salary spiking:

- Cost: "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 onto other plan participants and future generations of taxpayers."

- Erosion of Public Trust: "…pension spiking…may weaken public trust in the state retirement systems."

The Cost of Salary Spiking

When salary spiking practices are systematically applied to all retiring employees or a large group, costs can be significant. PERS Plan 1 leave cashouts increased employer contributions rates in the 1970s by .6% of salary[6], a significant cost given the size of the PERS salary base. The Legislature has greatly reduced that cost by excluding termination payments in the Plan 2 systems and charging most Plan 1 termination payment spiking to the individual employer through excess compensation, explained in more detail on pages 7 and 8.

The cost of individualized spiking is more difficult to isolate. OSA's report stated it could not quantify the cost of overtime spiking. It did note that AFCs beyond the expected range can cause a cost to the plan. By the same token, salary increases within that range do not generate the costs identified by the actuary because they are not "higher-than-expected".

For instance, the Actuary's report identified salary increases up to 25% during the AFC period as "within the expected range" and salary increases up to 50% were not yet outside the range but were "borderline[7]." The higher cost was, therefore, funded over the employee's career, and not passed on to future generations of taxpayers. That does not mean late career salary increases do not increase individual member pensions, but more than 95% of increases are within the Actuary's assumptions and, presumably, funded through the contribution rate.

Recent analysis by the LEOFF Plan 2 Board, OSA, WSIPP, and the Associated Press indicate current salary spiking is an individualized affair, rather than a systemic problem. Much of the cost is accounted for in the Actuary's assumptions. The spiking practices that do exist have not

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[6] *Washington Ass'n of County Officials v. Washington Public Emp. Retirement System Bd.*, 89 Wn.2d 729, 731 (1978).

[7] Similarly, the cost of including leave cashouts in PERS Plan 1 discussed in *County Officials* generated a 13% combined PERS contribution rate. That rate would have been 12.4% but for the inclusion of termination payments. That is, the Actuary recognized the cost of that salary spiking and factored it into the calculation of rates, i.e. it was not "higher-than-expected". *County Officials*, supra.

RECENT SALARY SPIKING RESEARCH

The previous example is drawn from the significant amount of research and analysis developed over the last 2 years examining salary spiking:

- Washington State Institute of Public Policy (WSIPP) study on Retiree Benefits in Public Pension Systems focusing in part on impacts on pensions and pension costs from overtime and excess compensation (2012);
- Office of the State Actuary (OSA) analysis and presentations to the Select Committee on Pension Policy (SCPP) on overtime usage and salary spiking (2012);
- LEOFF Plan 2 Initial Consideration reports on Salary Growth (July 2012) and Excess Compensation (December 2012).
- Investigative journalism examining LEOFF Plan 1 salary spiking: "a two-year Associated Press investigation that included more than 100 interviews, 94 public-records requests and a review of thousands of pages of government emails, meeting notes, contracts, actuarial reports and payroll records, along with more than 30 government data sets."[4] (2013).

None of the research revealed any salary spiking or excess compensation payments in LEOFF Plan 2, but when those activities take place in any public plan, they impact public trust in all public plans. The erosion of public trust is of particular concern in today's environment, where some urge replacing public defined benefit plans with defined contribution plans.[5]

Although the LEOFF Plan 2 plan design makes pension spiking less likely, it does not preclude it entirely. LEOFF Plan 2 includes overtime, special salary, and longevity pay as allowable salary. These types of salary are susceptible to manipulation if there is a meeting of the minds between an employer and an employee.

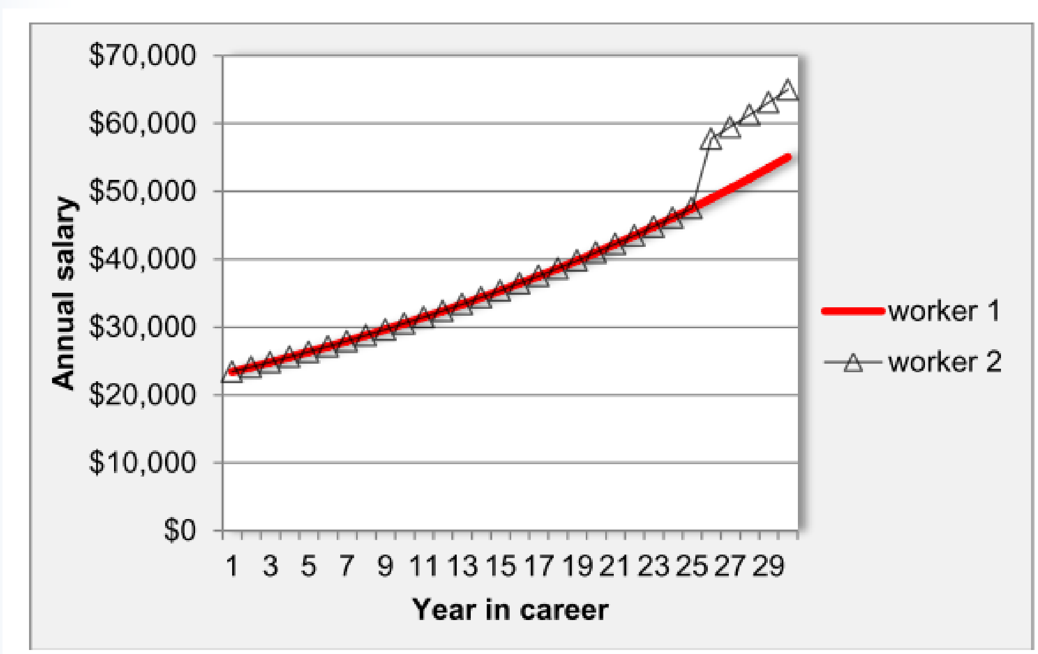
Salary spiking can be divided into two types: 1) End of career compensation increases provided to all or a class of employees, i.e. leave cashouts; and 2) specially negotiated salary increases provided to individuals or small groups of employees.

[4] *State feels bite of workers' 'pension spiking'*, Seattle Times, April 6, 2013.
[5] *See* Sen. Orin Hatch *After Detroit, Replace Public Pensions*, July 31, 2013, http://www.hatch.senate.gov/public/index.cfm/2013/7/after-detroit-replace-public-pensions.

BACKGROUND INFORMATION & POLICY ISSUES

Salary spiking, also called "pension ballooning" refers to the practice of maximizing salary during the FAS period in order to increase the member's pension. Members pay contributions based on their salary throughout their career, with the goal of eventually drawing a pension that is based on that salary. While a certain level of salary increase is assumed and factored into contribution rates, a dramatic spike at the end of one's career can result in a disproportionate pension. The Plan 1 systems are especially susceptible to salary spiking because of shorter salary averaging periods.

The impact of pre-retirement salary increases is shown in the example below, originally developed by the Washington Institute for Public Policy (WSIPP). In the example, two Plan 2 members have an identical salary history up until the last 5 years. Worker 1 continues to receive regular salary increases, without any overtime. Worker 2 receives the same increases but also works 5 hours of overtime per week for the last 5 years of his career:



In this example, worker 2 contributes an extra $2,500 towards his pension and receives an additional benefit with a present value of $97,000. The worker and employer contributions cover only a small portion of the value of the additional benefit[3].

[3] P. 49, 59, Appendix E, *Retiree Benefits in Public Pension Systems*, Washington State Institute for Public Policy, December, 2012.

LEOFF Plan 2 Retirement Board

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SALARY SPIKING

INITIAL CONSIDERATION

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ISSUE

Salary spiking in public pension plans undermines public trust that LEOFF Plan 2 is designed responsibly and managed professionally.

MEMBERS IMPACTED

Salary spiking in LEOFF Plan 2 potentially benefits a limited number of individuals who are in a position to make special compensation arrangements. The resulting erosion of public trust undermines the Plan to the detriment of all 16,805 active LEOFF Plan 2 members[1].

CURRENT SITUATION

Public defined benefit plans are under increased scrutiny due in part to the significant unfunded liability in other public plans, such as those in Illinois, or the recently bankrupt city of Detroit. This heightened scrutiny underlines the importance of ensuring LEOFF Plan 2 is designed responsibly and professionally managed. Manipulation of pensions through salary spiking undermines that task. Salary manipulation in one plan undermines public trust in all plans.

"Salary spiking" refers to manipulation of salary prior to retirement to increase Final Average Salary (FAS[2]), thus increasing the monthly pension payments. Recent examples of pension spiking in the Washington State Patrol Retirement System (WSPRS) and LEOFF Plan 1 have enhanced public scrutiny of salary practices. While none of the recent examples were in LEOFF Plan 2, public opinion tends to regard public pensions as a group.

This report will: Review recent research on salary spiking in Washington State; Examine the issues raised by salary spiking; Discuss why salary spiking is attractive to employers and employees; and review some of the history of spiking, focusing on recent examples.

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[1] Membership number as of June 30, 2011; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.
[2] LEOFF is the only system that uses the term "Final Average Salary" or FAS. Washington's other public pension systems use "Average Final Compensation" or AFC. Those terms are used interchangeably in this report.