# BOARD MEETING AGENDA

AUGUST 28, 2013• 9:30AM TO 3:00PM

LEOFF
Plan 2 Retirement Board

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**LOCATION**

STATE INVESTMENT BOARD
Large Conference Room, STE 100
2100 Evergreen Park Drive S.W.
Olympia, WA 98502
Phone: 360.586.2320
Fax: 360.586.2329
recep@leoff.wa.gov



***They keep us safe,***
***we keep them secure.***

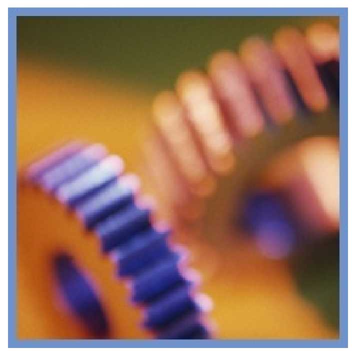
| | | |
|---|---|---|
| **1.** | **Approval of Minutes**<br>June 19, 2013 and July 24, 2013 | **9:30 AM** |
| **2.** | **WSIB Annual Presentation**<br>*Theresa Whitmarsh, Director* | **9:40 AM** |
| **3.** | **Board & Administrative Committee Elections** | **10:10 AM** |
| **4.** | **EMT's Not Being Reported in LEOFF Plan 2**<br>*Ryan Frost, Research Intern* | **10:50 AM** |
| **5.** | **Final Average Salary Protection**<br>*Ryan Frost, Research Intern* | **11:30 AM** |
| **6.** | **Administrative Update** | **12:00 PM** |
| **7.** | **Meeting Materials Posted to Website**<br>*Follow-up from July meeting* | **12:15 PM** |
| **8.** | **Correction Legislation**<br>*Ryan Frost, Research Intern* | **12:35 PM** |
| **9.** | **Salary Spiking**<br>*Paul Neal, Senior Legal Counsel* | **1:00 PM** |
| **10.** | **Career Change**<br>*Paul Neal, Senior Legal Counsel* | **1:40 PM** |
| **11.** | **Promoting Individual Savings for Retirement**<br>*Paul Neal, Senior Legal Counsel* | **2:10 PM** |
| **12.** | **Agenda Items for Future Meetings** | **2:50 PM** |

**Lunch is served as an integral part of the meeting.*

*In accordance with RCW 42.30.110, the Board may call an Executive Session for the purpose of deliberating such matters as provided by law. Final actions contemplated by the Board in Executive Session will be taken in open session. The Board may elect to take action on any item appearing on this agenda.*

Washington State
Investment Board

# WSIB Update for the LEOFF Board


Theresa Whitmarsh
Executive Director
August 2013

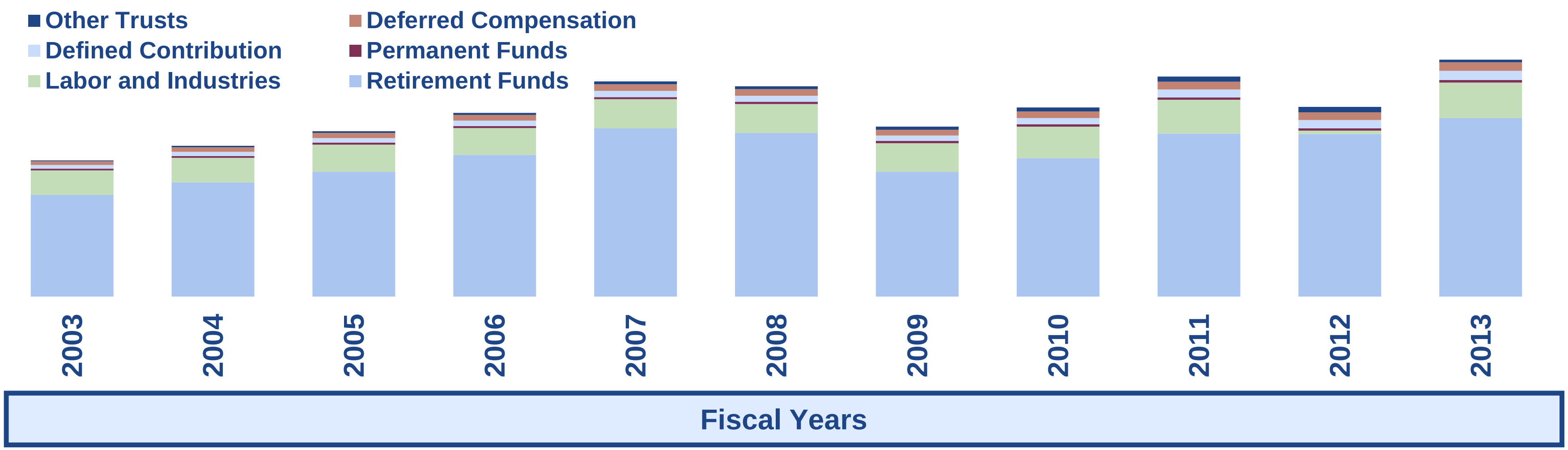
# Overview

- WSIB Investment Responsibility
- Board Oversight
- Commingled Trust Fund (CTF) Performance and Market Values
- Source of WSIB Excellent Performance
- What Risks/Threats We Face
- Economic Outlook
- CTF Well Diversified
- Conclusion

# Manage Key State Assets

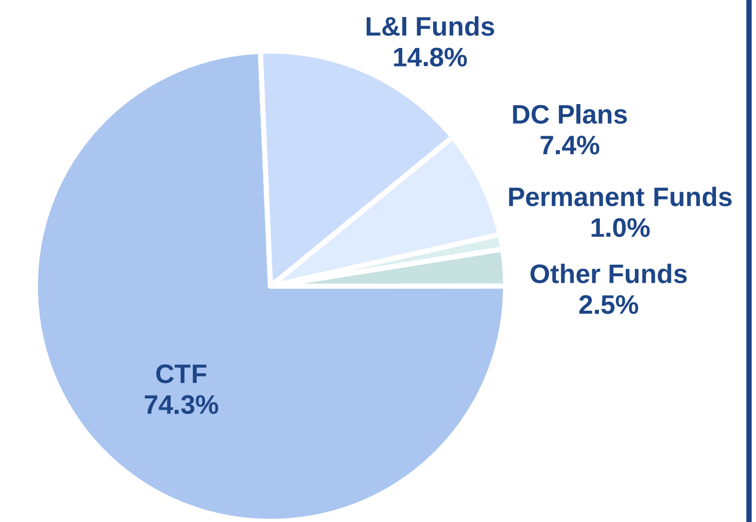
*June 30, 2013*

## Past 10 Fiscal Years




## Market Values and Allocation (in billions)

| | | |
|---|---|---|
| CTF | $67.9 | 74.3% |
| L&I Funds | $13.5 | 14.8% |
| DC Plans | $6.7 | 7.4% |
| Permanent Funds | $0.9 | 1.0% |
| Other Funds | $2.3 | 2.5% |
| Total Assets Under Management | $91.4 | |



# Overseen by an Excellent Board

**The 10 voting and 5 non-voting members of the Board are fiduciaries whose mission is to manage investments for retirement and other public funds with the exclusive benefit of beneficiaries**

**The WSIB adheres to rigorous conflict of interest policies to ensure the highest standards of ethical behavior and conduct.**

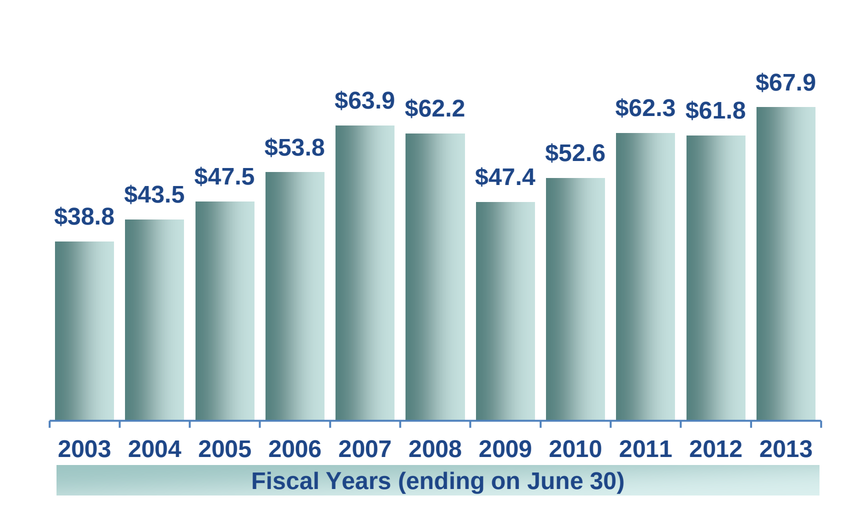
| | Appointment Authority | Name | Position |
|---|---|---|---|
| 10 Voting | Ex-Officio | Jim McIntire, Chair | State Treasurer |
| | | Marcie Frost | Director, DRS |
| | | Joel Sacks | Director, Labor & Industries |
| | Senate President | Sharon Nelson | State Senator |
| | House Speaker | Sharon Tomiko Santos | State Representative |
| | Governor | Natasha Williams | Active Member, PERS |
| | | George Masten | Retired Member, PERS |
| | | Kelly Fox | Active Member, LEOFF |
| | Superintendent of Public Instruction | Arlista D. Holman | Active Member, SERS |
| | | Mike Ragan, Vice Chair | Active Member, TRS |
| 5 Investment Professionals | Selected by the Board | Robert Nakahara | |
| | | Jeffrey Seely | |
| | | David Nierenberg | |
| | | William A. Longbrake | |
| | | Richard Muhlebach | |

WSIB

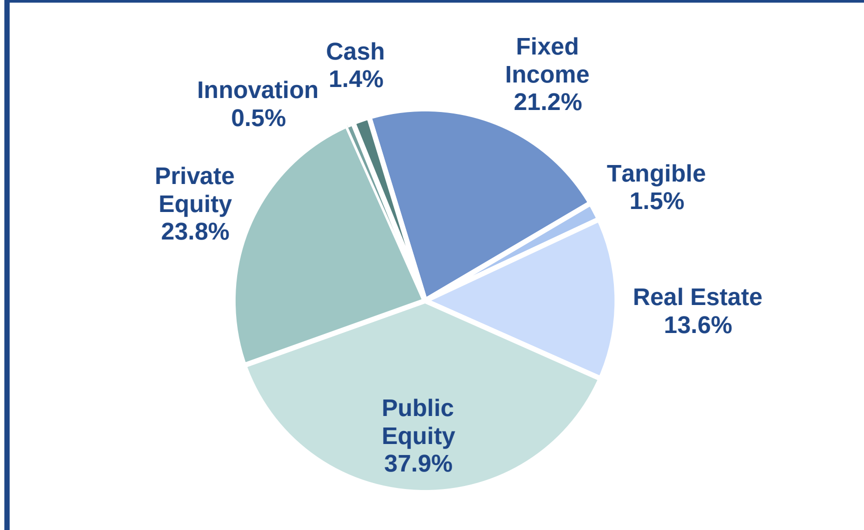
# Deliver Excellent Performance

## *Commingled Trust Fund Performance & Market Values – June 30, 2013*

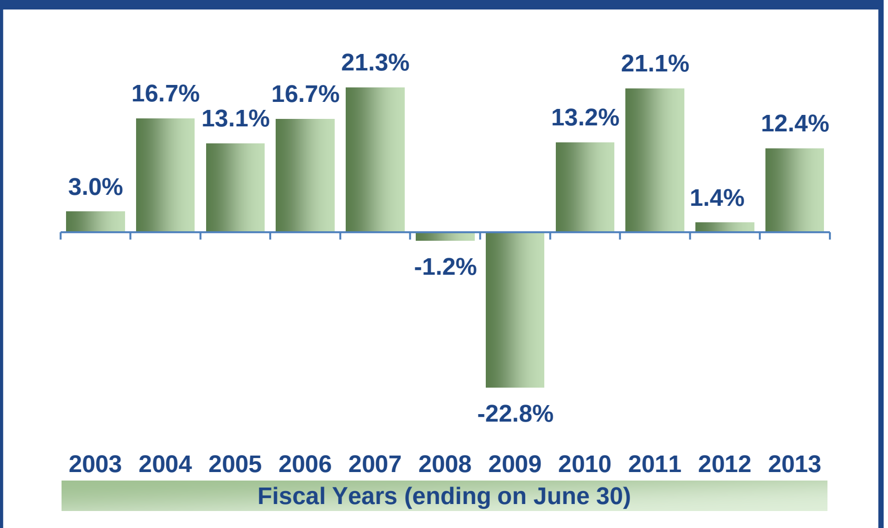
### Historical Market Value (billions)




### Actual Allocation




### Historical Fund Returns




### Market Values and Returns

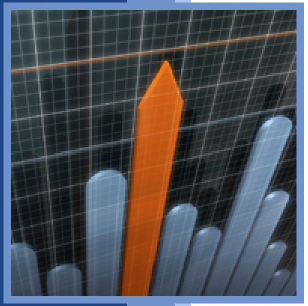
**Commingled Trust Fund (CTF) Market Values and Returns**

| | Market Value (000s) | 1 Year | 3 Year | 5 Year | 10 Year |
|---|---|---|---|---|---|
| Total CTF | $67,902,495,169 | 12.36% | 11.33% | 3.81% | 8.32% |
| Fixed Income | $14,422,417,970 | 0.80% | 4.56% | 6.41% | 5.55% |
| Tangibles | $1,031,996,930 | -1.75% | 2.27% | 1.34% | N/A |
| Real Estate | $9,244,467,624 | 17.86% | 13.54% | 0.89% | 9.51% |
| Public Equity | $25,724,015,814 | 17.83% | 13.30% | 2.94% | 7.72% |
| Private Equity | $16,170,202,574 | 13.56% | 14.12% | 4.94% | 14.03% |
| Innovation | $363,365,896 | 30.63% | -0.44% | N/A | N/A |
| Cash | $946,028,362 | 0.16% | 0.16% | 0.40% | 1.79% |

# Source of WSIB Excellent Performance

- One of the most respected institutional investors in the nation: We manage more than $90 billion in 33 funds, invested in 74 countries, on six continents in 49 currencies
- Guided by an engaged and skillful Board that has made good governance a high priority, demonstrates respect for one another and staff, has committed to continually improving its investment decision making process, and conducts itself in a fully transparent and ethical manner
- Served by a highly professional staff that has been enhanced over the last decade by drawing from the best and brightest from both the private sector and from within state service who come to us because they believe in us as a destination employer
- Served by the most sought after investment managers in the world because WSIB is a knowledgeable, fair, and consistent partner and our reputation enhances their position in the marketplace
- Aided by cutting edge technology and analytical services, as well as a robust and proprietary risk framework that gives us insights into our portfolio that when deployed correctly, will provide a significant competitive advantage over our peers
- Enjoy a terrific reputation; supported by beneficiaries who believe in the WSIB brand and respected by the Legislature for our professional investment management services

# What Risks/Threats We Face



## Value Will Be Tougher to Deliver

- Challenging capital markets that may make earning rates of returns at the level we desire not possible
  - Raises the important question of where the source of value creation will come from in the future and how will we identify those sources
- Global strategy brings with it geopolitical risks that often trump market fundamentals
  - Staff wearing out shoe leather all over the world to, more often than not, walk away from opportunities based on return/risk profiles
- Will the fiscal and monetary policy responses to the current fiscal crisis breed the next global crisis and, if so, how do we prepare
  - Cheap credit
  - Increased debt levels in developed markets

# What Risks/Threats We Face


## Value Will Be Tougher to Deliver (continued)

- Competition for partners, deals, and staff in private markets, which has been our historical competitive advantage, has intensified with the rise of sovereign wealth funds, emerging market pension funds, and family wealth offices
  - Drives up prices and fees and salaries for public fund staff with expertise in private markets
  - Valuations unsustainable in crowded markets
- Size of capital we need to deploy becomes a hindrance with limited opportunity set in certain desirable strategies
  - Small and mid-cap equities
  - Small and mid-cap buyouts
  - Small to mid opportunistic real estate

**Must reach deeper in these challenging markets to achieve the desired return**

# What Risks/Threats We Face

**Support – We Can't Take it For Granted**

- Turnover in political leadership – need for ongoing investment in educating Legislature and executive branch
  - And tough to get anyone's attention during transition
- Increased pressure for socially motivated investing/divesting
  - Divestiture of fossil fuels
  - Divesting gun manufacturers
  - In state investing
- Spillover from poor pension fund governance and investment fund performance in other states continues to create a challenge for differentiating the WSIB
- In a period of slow growth for the state with accompanying budget constraints on the general fund, difficult for the WSIB not to stand out

**Will need to tell the WSIB Story 1,000 times!**

# Economic Outlook

## Global

- Global recovery will be weak
  - **Developed world will continue to have slow growth of 0 to 2 percent while emerging markets will have below-trend growth of 4 to 5 percent**
- Productivity is key to higher-trend growth
- In many countries, monetary and fiscal policies have run their limits, implementing structural reforms becomes more urgent for recovery to be sustainable
- Emerging markets, though slowing, still have higher growth, lower debt, and lower fiscal deficits, in general, compared to the developed world
- Policy risk is high
- Other risks include geopolitical risk, protectionism, and social instability
- Problems of youth unemployment and income inequality are widespread

# Economic Outlook

## U.S.

- U.S. will continue to grow between 1 and 2 percent
- U.S. economy will continue to perform better than Europe and Japan
- Fiscal drag is still an issue
  - **Higher taxes and spending cuts will slow growth**
- Inflation will continue to be subdued
- Capital expenditures and employment are key to determining whether recovery is sustainable or not
- Housing will continue to recover, but is it sustainable?
  - **In some markets, cash-rich investors are outbidding and pricing out first-time homebuyers who rely on mortgage loans**
- Third round of Quantitative Easing (QE3) will end; timing is data dependent
- Is the economy strong enough for higher interest rates?
  - **Data is still mixed as to whether or not U.S. growth is on strong footing**
- Policy uncertainties are still weighing on consumer and business sentiment, growth, debt, and long-term fiscal balance
- Many believe QE has caused excessive risk taking

# Economic Outlook

**Eurozone**

- Still on track for negative growth in 2013
- Debt crisis is not over yet
- Governments attempt to strike a balance between growth and austerity
  - It is difficult to grow when economies are not competitive
- Fiscal and banking unions continue to be difficult to achieve
- Social instability due to high unemployment continues to be relatively high

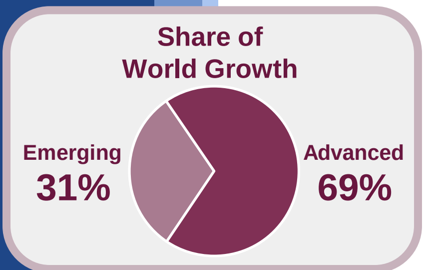
**Japan**

- Massive fiscal and monetary stimulus
- Structural reforms are needed to achieve sustainable growth

# Economic Outlook – Emerging Markets will Drive Global Growth

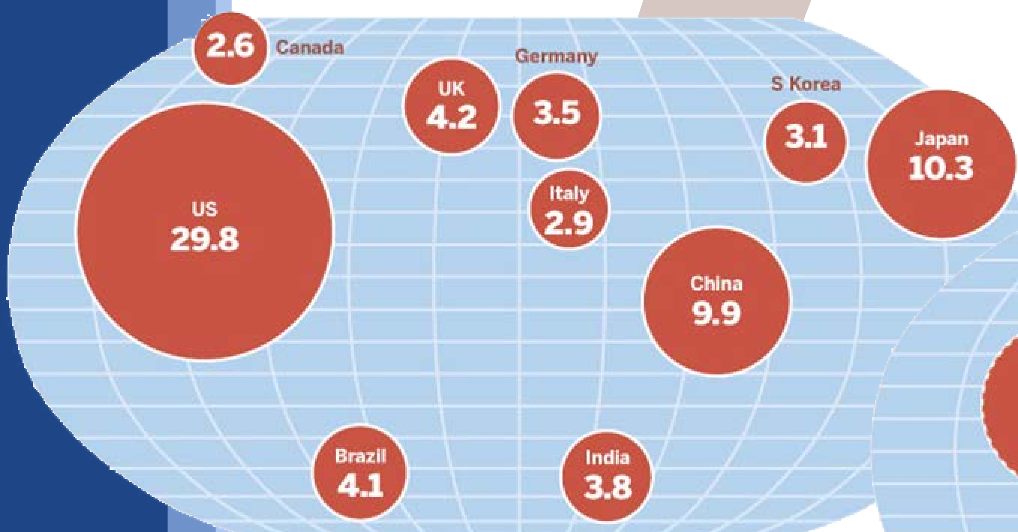
## The Top 10 Leaders of Global Growth

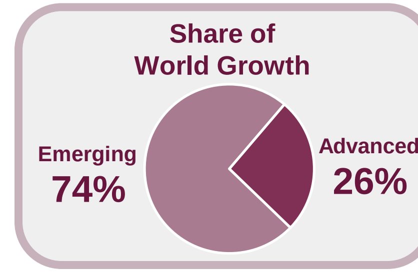
**Share of global growth (%)**




## 1982-87

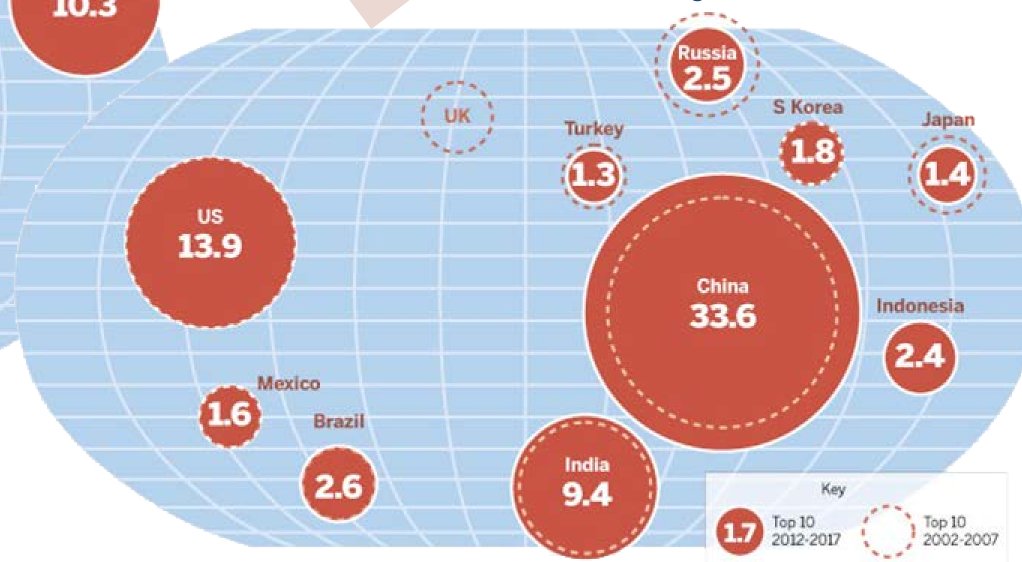
**A traditional textbook world economy: growth is concentrated in the U.S., Japan, and Europe. Living standards in the countries that industrialized 100 years earlier are still pulling away from what is still known as the third world. Rapid growth in China is only beginning to make its mark.**




## 2012-17

**The future of world growth is increasingly dominated by China, soon to be the world's largest economy. Only the U.S. and India provide any rivalry and, so weak is prospective European growth, that the EU accounts for less than 6 per cent of the global total. Only Latin America and India are increasing their share.**



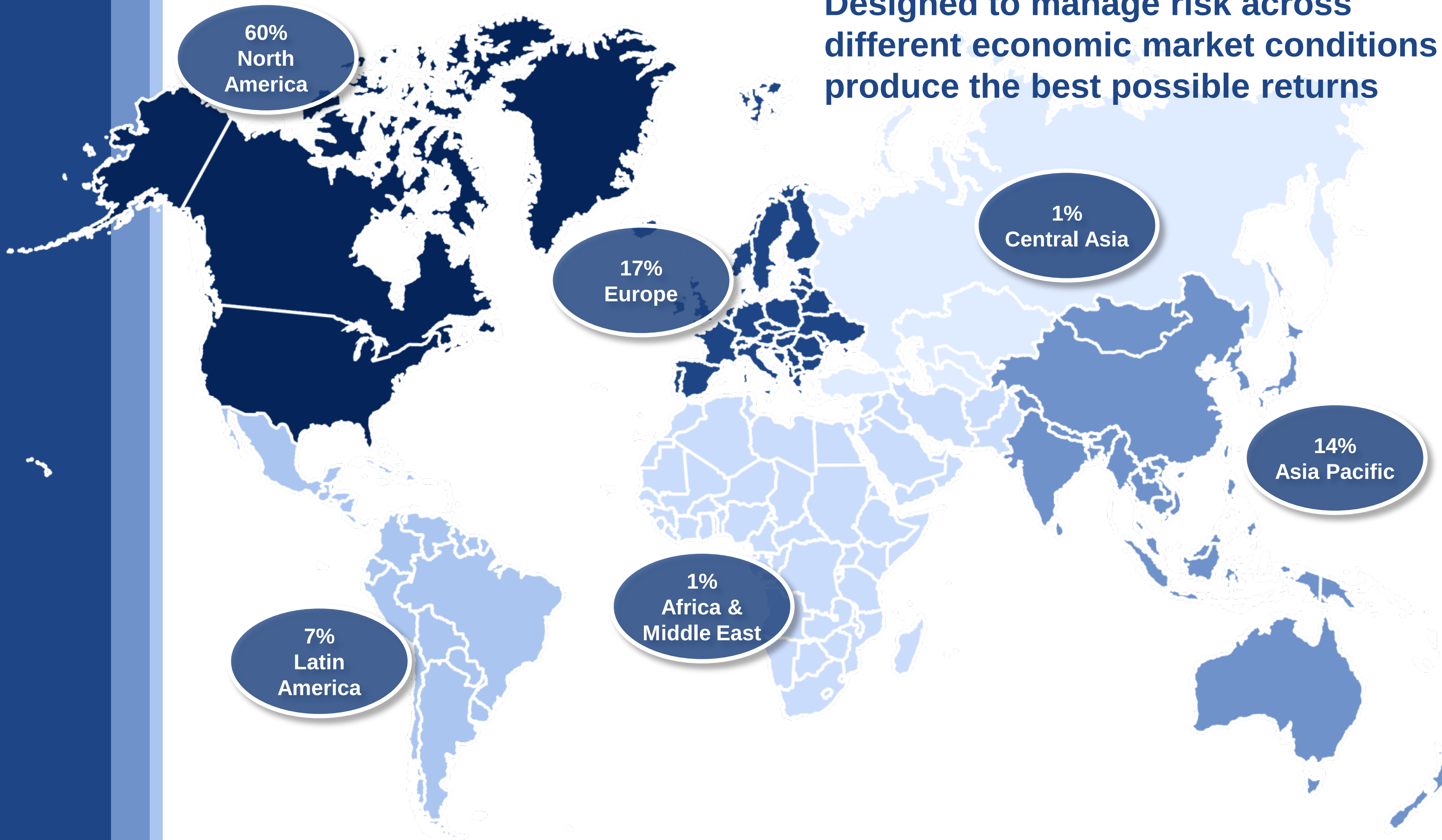

The Financial Times, June 5, 2013

WSIB

# CTF Well Diversified – Geographic Diversification

*June 30, 2013*

**Designed to manage risk across different economic market conditions to produce the best possible returns**




WSIB

# Despite Challenges – WSIB Still Performing Well

**8.68% – CTF rate of return since inception (1992) – The WSIB's long-term investment strategy has helped make Washington's public pension system one of the four best funded in the nation**

**Roughly, 84 cents of every dollar needed to pay benefits is generated by our investment returns**

**All expenses of the WSIB are funded from the earnings of the funds managed by the WSIB at no cost to state taxpayers**

**International benchmarking studies have consistently ranked the WSIB in the top number of low cost and high performing institutional investors**

RULE 6. **ELECTION AND DUTIES OF OFFICERS.**

a. The Board shall elect a Chairman and Vice-Chairman from its membership. Nominations for Chairman and Vice-Chairman shall be open during the regularly scheduled board meeting held in August. Any member may verbally nominate another member or themselves when the presiding officer declares the nominating period open. Elections for Chairman and Vice-Chairman shall be held during the regularly scheduled September board meeting. Terms for Chairman and Vice-Chairman shall be for a period of two years commencing immediately following the officers' election.

b. Both Chairman and Vice-Chairman shall be members of the Administrative Committee. One additional member shall be chosen by board members representing employer groups. Administrative Committee members shall serve two year terms that begin and end with the Chairman and Vice-Chairman's terms.

c. The Chair shall preside at all meetings of the Board and Administrative Committee, except that the Vice Chair shall preside when the Chair is not present. In their absence, an Administrative Committee member may preside.

d. Board staff shall prepare and maintain a record of the proceedings of all meetings of the Board and subcommittees of the Board.

e. The Administrative Committee shall perform all duties delegated by the Board.

f. Board members shall consult with the Executive Director before referring issues to the Assistant Attorney General so that any budget constraints may be taken into consideration. Advice from the Attorney General's Office to the Board may be subject to the attorney client privilege. When subject to the privilege, Board members are advised to maintain the advice as confidential. The privilege may be waived only by vote of the Board.

g. The Executive Director may refer requests for information or services by Board members that are directly related to current Board projects or proposals and/or require a significant use of staff resources to either the Chair or the Administrative Committee.

h. Such requests will be approved by either the Chair or by a majority vote of the Administrative Committee prior to action by staff. The Chair or Administrative Committee will consider priorities of all current projects and budget constraints in making this decision.

i. Any Board member may attend Administrative Committee meetings at any time, though participation may be restricted for time or procedural purposes.

LEOFF Plan 2 Retirement Board

August 28, 2013

# EMT'S NOT BEING REPORTED IN LEOFF

INITIAL CONSIDERATION

By Ryan Frost
Research Analyst
360-586-2325
ryan.frost@leoff.wa.gov

## ISSUE

There are fire fighters employed by LEOFF employers who are not being reported in LEOFF Plan 2.

## MEMBERS IMPACTED

Approximately 30 employers and 180 members may be affected.

## CURRENT SITUATION

The Department of Retirement Systems (DRS) ruled that Emergency Medical Technicians (EMT's) working for public hospital districts should be reported into LEOFF Plan 2 retroactive to the effective date of the SHB 1936. This means retroactive billing to the employer as well as the employee for past contributions. The Public Hospital Districts Association has appealed this DRS ruling.

This has resulted in numerous questions about employers who have employees that meet the definition of a LEOFF member, but who are not being reported in LEOFF.

This report will detail membership parameters for LEOFF 2 and PERS, as well as detail legislative history for the transfer of EMT's into LEOFF 2. Lastly this report addresses the issue of EMT's working for qualified LEOFF 2 employers, whom are being denied access to the plan.

## BACKGROUND INFORMATION

### LEOFF Plan 2 Membership

The Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) is limited in membership to specific employers, employees, and only those employees with specific training and performing specific jobs.  Generally, LEOFF is limited to full-time, fully-authorized general authority law enforcement officers and full-time, fully compensated fire fighters employed by fire departments.  Emergency Medical Technicians employed by local governments in fire departments who are also qualified fire fighters are members of LEOFF. All employees first employed in LEOFF-eligible positions since 1977 have been enrolled in LEOFF Plan 2 which allows for an unreduced retirement allowance at age 53.

## PERS Membership

A PERS eligible position is one that is normally compensated for at least 70 hours of work per month for at least five months of each year and the employer is one of the following: State government (agency, department, board, commission); Local government (including a city, town or county); Public utility district; Public institution of higher learning; Housing authority; Diking, fire, health, irrigation, park, library, port, reclamation, sewer or water district; or Airport. All employees first employed in PERS-eligible positions since 1977 have been enrolled in PERS Plan 2/3, which allows for an unreduced retirement allowance at age 65.

## Transfer of EMT's

Several local government EMT's had their jobs moved from various local government entities to fire departments. Upon meeting all the requirements to become fire fighters, such as training and applicable examinations, these EMT's employed at fire departments become members of LEOFF.

In 2003, House Bill 1202 was enacted, permitting members of LEOFF whose jobs as EMT's were moved into fire departments the opportunity to transfer past service credit from PERS into LEOFF. The LEOFF members who elect to transfer service credit earned as an EMT in PERS are required to pay the difference between the contributions that they paid into PERS, and the contributions that they would have paid into LEOFF, plus interest.

Members with service in both PERS 2 and LEOFF 2 may use the portability provisions of state retirement law to combine years of service and average salary for purposes of retirement eligibility, but the retirement ages of each plan still apply to the benefit receivable from each plan. The consequence of this is that only a reduced PERS 2/3 benefit is available to a member with service in PERS 2 and LEOFF 2 at the LEOFF 2 normal retirement age.

Prior to 2005, EMT's employed by local governments in health departments or other divisions of local governments are members of the Public Employees' Retirement System (PERS).  In 2005, Substitute House Bill 1936 was enacted amending the definition of "fire fighter" in LEOFF to include any person who is employed on a full-time, fully compensated basis as an emergency medical technician by a city, town, county or district.

Members of PERS 2 employed as EMTs were transferred to LEOFF 2 for purposes of future service. An EMT transferred to LEOFF 2 could also elect to transfer past service earned as an EMT in PERS into LEOFF 2. For the period of past service a member transferred, the member was required to pay the difference between the employee contributions made to PERS, and the contributions that would have been made had the service been performed in LEOFF 2, plus interest. The employee was required to complete this payment within five years of applying to the Department of Retirement Systems to transfer the past service credit.

Upon completing the required payment, the member's service credit and accumulated contributions, and an equal amount of employer contributions would be transferred from PERS 2 to LEOFF 2. Within five years of the completing payment for the transfer of service credit, the employer is required to pay into LEOFF 2 an amount sufficient to ensure that the contribution rates for LEOFF 2 plan will not increase due to the transfer of service.

## EMT's Employed by Hospital Districts

EMTs employed by hospital districts have historically been reported in PERS. Some of these employees requested that eligibility for membership in LEOFF Plan 2 be evaluated by the Department of Retirement Systems (DRS). DRS ruled that EMT's working for public hospital districts should be reported into LEOFF 2 retroactive to the effective date of SHB 1936 (2005) which expanded the definition of LEOFF employer to include "districts". The Public Hospital Districts Association has appealed this DRS ruling.

## Questions and Issues

This issue also raises the question about other employers who may have employees who meet the definition of a fire fighter but are not considered LEOFF employers due to their name.

# Emergency Medical Technicians Not Being Reported in LEOFF

**Initial Consideration**

**August 28, 2013**

# Issue

- There are fire fighters employed by LEOFF employers who are not being reported in LEOFF Plan 2.

LEOFF
Plan 2 Retirement Board

# Legislative History

- Emergency Medical Technicians (EMT) membership in LEOFF Plan 2 previously addressed.
- HB 1202 (2003) – EMT jobs transferred to fire department.
- SHB 1936 (2005) – EMT employed by a city, town, county or district.

LEOFF Plan 2 Retirement Board

# Background

- EMT working for public hospital districts not reported in LEOFF Plan 2.
- DRS Ruling – Report EMT's into LEOFF Plan 2 Retroactive to July 24, 2005. Public Hospital District's appealed ruling.
- Approximately 30 employers and 180 members may be affected.

LEOFF Plan 2 Retirement Board

# Issues

- Some employers hiring employees who meet fire fighter definition are not considered LEOFF Plan 2 employers.
- Some hospital district employees are currently in PERS.
- Some hospital district employees are in employer sponsored retirement plan.

# Next Steps

- Not pursue the issue at this time.
- Gather further information regarding affected employers and employees.
- Provide Comprehensive Report with policy options.

LEOFF Plan 2 Retirement Board

# Any Questions?

- **Contact:**

  Ryan Frost

  Research Analyst

  360.586.2324

  Ryan.Frost@leoff.wa.gov

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LEOFF Plan 2 Retirement Board

LEOFF
Plan 2 Retirement Board

*August 28, 2013*

# FINAL AVERAGE SALARY PROTECTION

INITIAL CONSIDERATION

By Ryan Frost
Research Analyst
360-586-2320
ryan.frost@leoff.wa.gov

## ISSUE

Members' retirement benefits will be reduced if "temporary salary reductions" after July 1, 2013 occur during their Final Average Salary (FAS) period.

## MEMBERS IMPACTED

There are 16,805 active members in LEOFF Plan 2 according to the *2011 Actuarial Valuation Report.* FAS protection affects only those active members who plan to retire within the next 5-7 years, and who are furloughed during their FAS period.

## CURRENT SITUATION

Furloughs are a method used for reducing salary and saving costs and have been utilized by employers during the recent economic downturn. These reductions can take many forms and may be either voluntarily or involuntarily unpaid leave (furlough), a temporary reduction in salary, or the loss of previously negotiated raises.

A member's benefit is calculated using the formula; 2 percent, times FAS times years of service (YOS). If a member's salary is reduced during their FAS period, it lowers their FAS, and thus lowers their benefit. Final average salary calculations were legislatively protected from being impacted by furloughs for 2009-2011 and 2011-2013. That protection ended July 1, 2013.

This report defines furloughs and why they were enacted, as well as the issue they present to an employees' pension. Furthermore, this report gives a detailed legislative history of furlough protections for employees currently in their FAS period. Lastly is a brief discussion of lifetime impacts if these protections are not renewed by Legislative action.

## BACKGROUND INFORMATION

In today's economic environment many local and state governments are facing revenue shortfalls. There may be some public service programs discontinued or restricted and there may be some employee layoffs as a result of budget restrictions. In order to balance budgets, many state and local governments, as an alternative to layoffs, are considering many ways to decrease costs.

Furloughs, a leave of absence without pay, are one method currently being used by many public employers. One advantage of using furloughs versus layoffs is employees are not terminated, yet there is a cost savings as the time off is without pay. Also, when the economy recovers there is no need to rehire and retrain the workforce. However, there are some potential negative impacts with the use of furloughs. One impact it could have is on a member's pension calculation if the furlough were to occur during the member's final average salary (FAS) period.

The LEOFF 2 Board has studied this issue in the 2005, 2009, and 2010 interims.

## Legislative History

The Legislature has taken several actions to prevent these decreases from reducing pensions, however, the legislative protection for final average salary computations ended July 1, 2013. Legislation introduced to extend final average salary protections through 2013-2015 did not pass in the 2013 session.

### 2009 Session – PERS Provided Protection for 2009-2011

During the 2009 Legislative Session, the Legislature recognized the potential impacts to a members pension benefit through the use of furloughs to help balance budgets. As a result, the Legislature passed SB 6157 (see Appendix B to see a copy of the final bill report) which allowed the pension benefit calculation to be adjusted for furloughs if the furlough occurred during the member's FAS period. While this did address the problem, it only included the Public Employees' Retirement System (PERS) pension system. Members of the other retirement systems, including LEOFF Plan 2, would not be granted the same benefit calculation adjustment. This difference in policy led the Board to send a letter to the Select Committee on Pension Policy (SCPP) to jointly sponsor legislation similar to SB 6157.

### 2010 Session – State Employees Provided Protection for 2009-2011

State agencies were directed to achieve a $69.154 million reduction in employee compensation costs from the near General Fund through mandatory and voluntary furloughs, leave without pay, reduced work hours, voluntary retirements and separations, layoffs, and other methods. (SSB 6503 – 2010). The legislation acknowledged that State agency closures would result in temporary layoff (furlough) and reduction of compensation for affected state employees and directed that temporary layoffs and reduction in compensation not affect employee seniority, vacation and sick leave accrual, or retirement benefits.

In a special session in December of 2010, the Legislature passed HB 3225 (Appendix C), which added “temporary reduction in pay implemented prior to the effective date of this section” as another item to include in adjusting the calculation of final average salary for members whose retirement benefits may be adversely affected by the temporary economic conditions. However, like the previous bill (SB 6503) this change also only includes members employed by a state agency or institution which excludes most of the LEOFF Plan 2 membership.

### 2011 – State Employee and Local Government Provided Protection for 2011-2013

The 2011 Legislative Session addressed the problem of FAS protection only covering state employees , by adding protection for local government employees as well in HB 2070 (Appendix D). The final bill report summarized that “Pensions from specified Washington retirement systems based on salaries earned during the 2011-13 biennium will not be reduced by compensation forgone by a member employed by either the state or local governments due to reduced work hours, mandatory leave without pay, temporary layoffs, or reductions to current pay if the measures are an integral part of a state or local government employer's expenditure reduction efforts.”

## Lifetime Impact

The intent of FAS protection was so that state employees who helped during the period of economic difficulty wouldn’t be punished for life for doing so. Taking a salary cut during their FAS period would affect their annual pension after retirement. People helping shouldn’t take a lifetime reduction in pension as a result of a temporary budget issue.

## Fiscal Year vs. Calendar Year Impacts

The State Legislature works on biennium while local governments work on a calendar year or annual basis. The FAS protections from the 11-13 biennium expired on July 1st, 2013. There may be a period from July through December 2013 where employees are subject to furloughs but do not have final average salary protection.  Extending protection through the 2013-2015 biennium would be necessary to protect retiree employees pension benefits.

LEOFF

Plan 2 Retirement Board

# Final Average Salary Protection

**Initial Consideration**

**August 28, 2013**

# Issue

- Members' retirement benefits will be reduced if "temporary salary reductions" after July 1, 2013 occur during their Final Average Salary (FAS) period.

# Background

- Furloughs are methods for handling a short-term economic or budget problem.
- Creates the potential for a reduction in a member's pension benefit calculation if the salary reduction occurs during the FAS period.

# Legislative History

- 2009: PERS Protected 2009-2011
- 2010: State Employees Protected 2009-2011
- 2011: State Employee and Local Government Protected for 2011-2013
- 2013: Protection Extension 2013-2015 did not pass

LEOFF Plan 2 Retirement Board

# Summary

- FAS protection expired July 1st of this year.
- A retiring member who has a furlough after July 1 and in their FAS period will have their benefits reduced for life.

# Next Steps

- Do not pursue issue at this time.
- Direct staff to prepare Comprehensive Report.

LEOFF
Plan 2 Retirement Board

# Any Questions?

- **Contact:**

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# Providing Meeting Materials to the Public

**Issue**: When does the Board want to make meeting materials available to the public via the website?

**Background**:

- The LEOFF Plan 2 Retirement Board has maintained a policy of transparency making all materials presented at Board meetings available to the public.[1] It has been the practice of the Board not to make materials available through the website until after the completion of a Board meeting.

- Meeting materials are provided to Board Members 1 week prior to a Board meeting. Historically the materials have been provided by physical mail or email.

- Materials have been made publicly available in the following manner:
  - Meeting agendas posted on Board website 1 week prior to meeting (required by law).
  - Meeting agendas distributed to interested parties 1 week prior to meeting.
  - Meeting materials (packet) distributed to interested parties 1 week prior to meeting.
  - Meeting materials (packet) posted on Board website 1 day following meeting.
  - Printed copy of materials available onsite to public the day of the meeting.

- The Board began utilizing a paperless board meeting process in July 2013. The paperless environment necessitates some process changes, which provide an opportunity to streamline the Board practice for providing meeting materials to the public.

- NovusAGENDA has a public facing web interface that can allow members to search for meetings and review materials. This feature has not been implemented yet. Staff can control when agendas and materials are viewable by the public.

[1] Excepting materials protected by Executive Session or Attorney/Client privilege

## Options:

## 1. Week Before Meeting

Meeting materials will be made available to the public on the Board's Website at the same time they are made available to Board Members. This option is used by the Washington State Investment Board.

**PRO:** Allows the public more time to review materials and preparation time for public comment.

**CON:** Possible that Board Member will be contacted before they have reviewed the materials.

## 2. Day Before Meeting

Meeting materials will be made available to the public on the Board's Website one day before the scheduled meeting date. This option is used by the Select Committee on Pension Policy.

**PRO:** Board Members have the opportunity to review materials before the public.

**CON:** Provides the public with limited time to review materials and prepare for public comment.

## 3. Day of Meeting

Meeting materials will be made available to the public on the day of the scheduled meeting date prior to the start of the meeting. This option is used by the Washington State Legislature.

**PRO:** Board Members have the opportunity to review materials before the public.

**CON:** Provides the public with least amount time to review materials and prepare for public comment.

August 28, 2013

# CORRECTIONS LEGISLATION

INITIAL CONSIDERATION
By Ryan Frost
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## ISSUE

Corrections are needed to fix errors and oversights in the statutes.

## MEMBERS IMPACTED

This issue impacts current and future Emergency Medical Technicians in LEOFF Plan 2.

## CURRENT SITUATION

The definition of fire fighter is found in RCW 41.26.030 and includes emergency medical technicians. The 2005 legislation which included emergency medical technicians in the definition of fire fighter contained an unintentional expiration date which would make emergency medical technicians ineligible for LEOFF membership in 2023.

Several of the Board's strategic partners have issues that need to be corrected for their programs. Individually, the attempts to fix some of these issues legislatively have been unsuccessful.

This report reviews a potential correction to the definition of fire fighter in LEOFF Plan 2 and identifies three other potential corrections that other organizations may be interested in partnering with the LEOFF Plan 2 Retirement Board for legislative action.

## BACKGROUND INFORMATION & POLICY ISSUES

### LEOFF Plan 2 Correction

**Definition of Fire Fighter / Emergency Medical Technicians – LEOFF Plan 2 Retirement Board**
Full-time, fully compensated law enforcement officers and fire fighters are covered by RCW 41.26 (LEOFF retirement system).

Statutory changes to the definition of fire fighter to include emergency medical technicians contain an unintentional expiration date.

Chapter 459, Laws of 2005, sec. 1, added (h) to the definition of fire fighter in RCW 41.26.030(4) to include emergency medical technicians. Section 3 of that same act provides that "This act expires July 1, 2013." Given that the entire act expires 2013, the inclusion of EMTs within the definition of fire fighter would expire along with the act.

Chapter 304, Laws of 2007, sec. 2 attempted to correct the definition expiration issue by stating "2005 c 459 s 3 (uncodified) is amended to read as follows: Section 2 of this act expires July 1, ((2013)) 2023." This would have fixed the definition expiration issue. However, section 4 of the legislation states that "This act expires July 1, 2023."

This results in undoing the "fix" in section 2 and recreates the expiration problem. This means that emergency medical technicians would no longer be eligible for participation in LEOFF after July 1, 2023.

## Other Potential Corrections

**Reserve Police Officer Survivor Education Benefit - Board for Volunteer Fire Fighters and Reserve Officers**

Prior to 2010, state institutions of higher education could optionally waive all or a portion of tuition and fees for eligible students within certain limits. Categories of eligible students included the children of law enforcement officers or fire fighters that died or became disabled in the line of duty. The definition of law enforcement officer for the purpose of the educational waiver included law enforcement officers and fire fighters under RCW 41.26 and reserve law enforcement officers and volunteer fire fighters under RCW 41.24.

Under legislation enacted in 2010, state institutions of higher education were required to waive all tuition, service fees and activity fees for children and spouses of law enforcement officers and fire fighters as defined in RCW 41.26, volunteer fire fighters as defined in RCW 41.24, or Washington State Patrol Officers, who die or become totally disabled in the line of duty.

Reserve law enforcement officers as defined in RCW 41.24 were not included in the eligibility for the required educational waivers. At the same time, the opportunity for an institution to optionally waive tuition and fees for this group was eliminated.

The LEOFF Plan 2 Retirement Board reviewed this issue during the 2012 Interim, but determined it was in the jurisdiction of the Board for Volunteer Fire Fighters and Reserve Officers. Director Nelsen sent the Board for Volunteer Fire Fighters and Reserve Officers a letter dated August 13, 2012 which informed them of this issue.

**Health Care Authority**

The Health Care Authority (HCA) administers benefits plans for the Public Employees' Benefit Board (PEBB) program serving all state agencies and higher education institutions, some political subdivisions, and some school districts. The Legislature has enacted a number of changes to PEBB affecting eligibility rules and domestic partner rules. A correction is needed to achieve a single statutory provision consistent with the various statutory changes while removing program conflicts. Changes to dependent children coverage is also needed in order to remain compliant with federal law.

The HCA recommended legislation in the 2013 session in an effort to correct the necessary statutes, but the bill (HB 1587) did not pass. The LEOFF Plan 2 Retirement Board endorsed the HCA legislation.

**Retiree Return to Work – Select Committee on Pension Policy**

The various plans of the Washington State Retirement System each contain rules prescribing the circumstances under which a retired employee may return to employment within a retirement system-covered position and continue to receive retirement benefits.

The 2011 Legislature passed Engrossed Substitute House Bill (ESHB) 1981 (Chapter 47, Laws of 2011, 1st Special Session), which made numerous changes to the rules under which a retired employee may return to employment from the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS).

Prior to the passage of ESHB 1981, retirees from the Plans 2 or 3 of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS), the School Employees' Retirement System (SERS), or the Public Safety Employees' Retirement System (PSERS) who have been separated from service for one calendar month after their accrual date may work in a retirement-eligible position for up to 867 hours per calendar year without a reduction in pension benefits.

Engrossed Substitute House Bill 1981 removed the 867-hour option for PERS Plans 2 and 3 members who return to work in other systems (e.g. TRS, SERS, etc.), meaning these retirees will experience an immediate suspension of benefits so long as they continue working. The PERS retirees who return to work in PERS-covered positions may continue to work up to 867 hours per year without a suspension of benefits. Engrossed Substitute House Bill 1981 also applied the 867-hour limit to PERS retirees working in ineligible positions.

The SCPP recommended legislation (HB 1226) in the 2013 legislative session which would have restored the provisions allowing retirees of the Public Employees' Retirement System (PERS) who return to work in positions covered by other Department of Retirement Systems-administered plans to receive benefits for the first 867 hours of employment per year and also applies the 867-hour return-to-work rules only to PERS retirees hired into eligible positions. The legislation did not pass.

LEOFF Plan 2 Retirement Board

# Corrections Legislation

**Initial Consideration**
**August 28, 2013**

# Overview

- Issue Description
- Review Definition of Fire Fighter/EMT
- Next Steps

# Issue

- Corrections are needed to fix errors and oversights in the statutes

# Definition of Fire Fighter

- 2003: Certain EMT's allowed into LEOFF
  - Act expires 2013
- 2005: EMT added to definition of fire fighter; Cross-reference added into 2003 legislation.
  - Act expires 2013
  - Should have expired specific section instead
- 2007: Death & Disability Provisions added
  - Attempted fix to 2005 legislation expiration
  - Act expiration date 2023 undoes fix; recreates problem

LEOFF Plan 2 Retirement Board

# Next Steps

- Not pursue correction at this time
- Pursue correction – LEOFF only
- Pursue corrections with other organizations

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# Any Questions?

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*August 28, 2013*

# SALARY SPIKING

INITIAL CONSIDERATION

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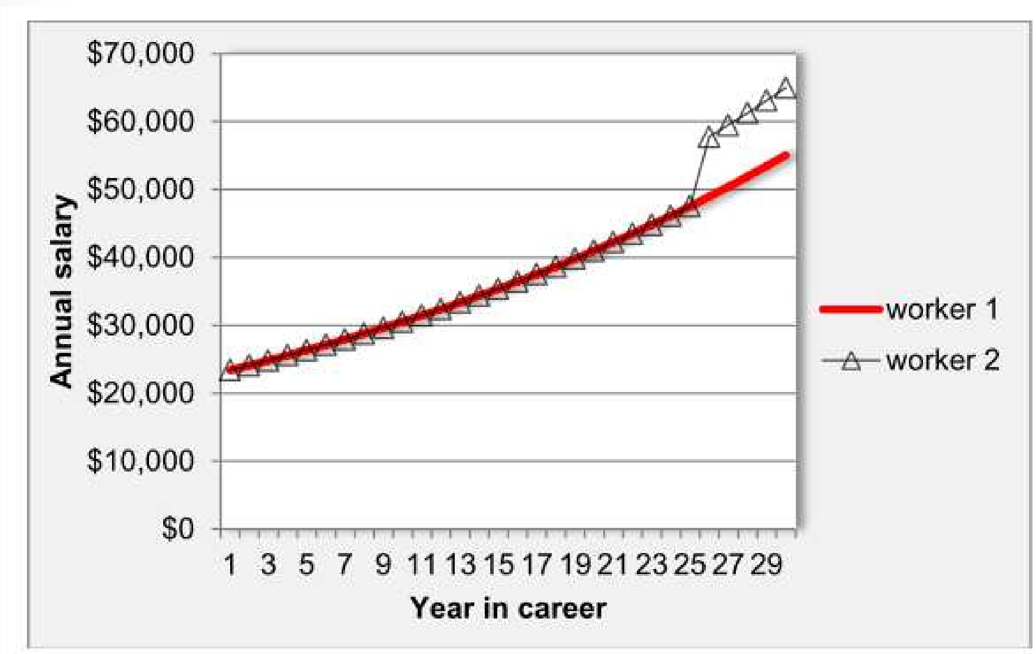
[1] Membership number as of June 30, 2011; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.
[2] LEOFF is the only system that uses the term "Final Average Salary" or FAS. Washington's other public pension systems use "Average Final Compensation" or AFC. Those terms are used interchangeably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

## 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.

## 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.

## 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

[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.

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

> 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.

[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.

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.

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)

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.

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.

## SUPPORTING INFORMATION

Appendix A: Excess compensation detail and example

Appendix B: DRS reportable compensation table for LEOFF

# 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.

**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<br><br>5 year Cumulative – Two different overtime accrual patterns, same total. | $425,000 + 225,000 = $650,000<br><br>YR 1 $130,000 $85,000<br>YR 2 $130,000 $85,000<br>YR 3 $130,000 $85,000<br>YR 4 $130,000 $197,500<br>YR 5 $130,000 $197,500<br>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 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<br>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 |

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# 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 Salary Period (AFS) increased 79% manipulating 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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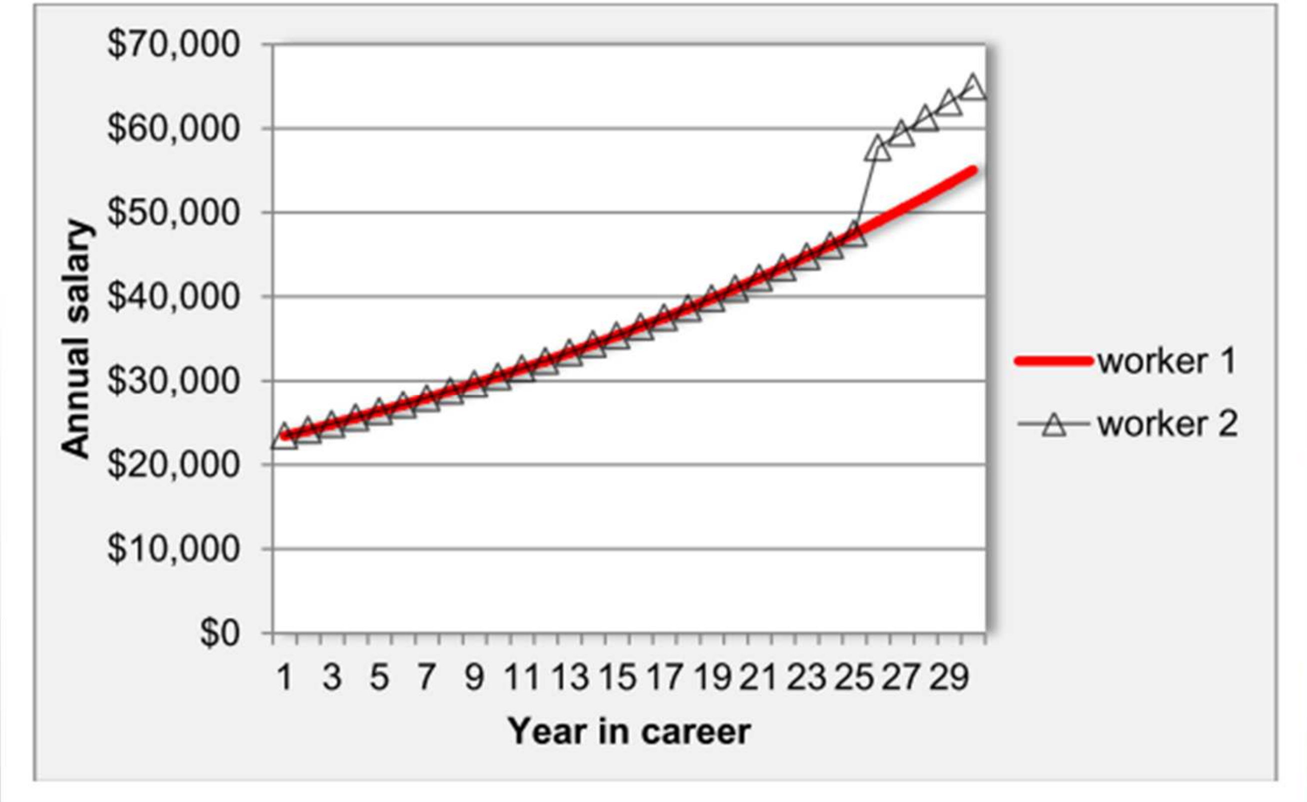
# Effect of Salary Spiking




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:
  - 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.

# 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 2011 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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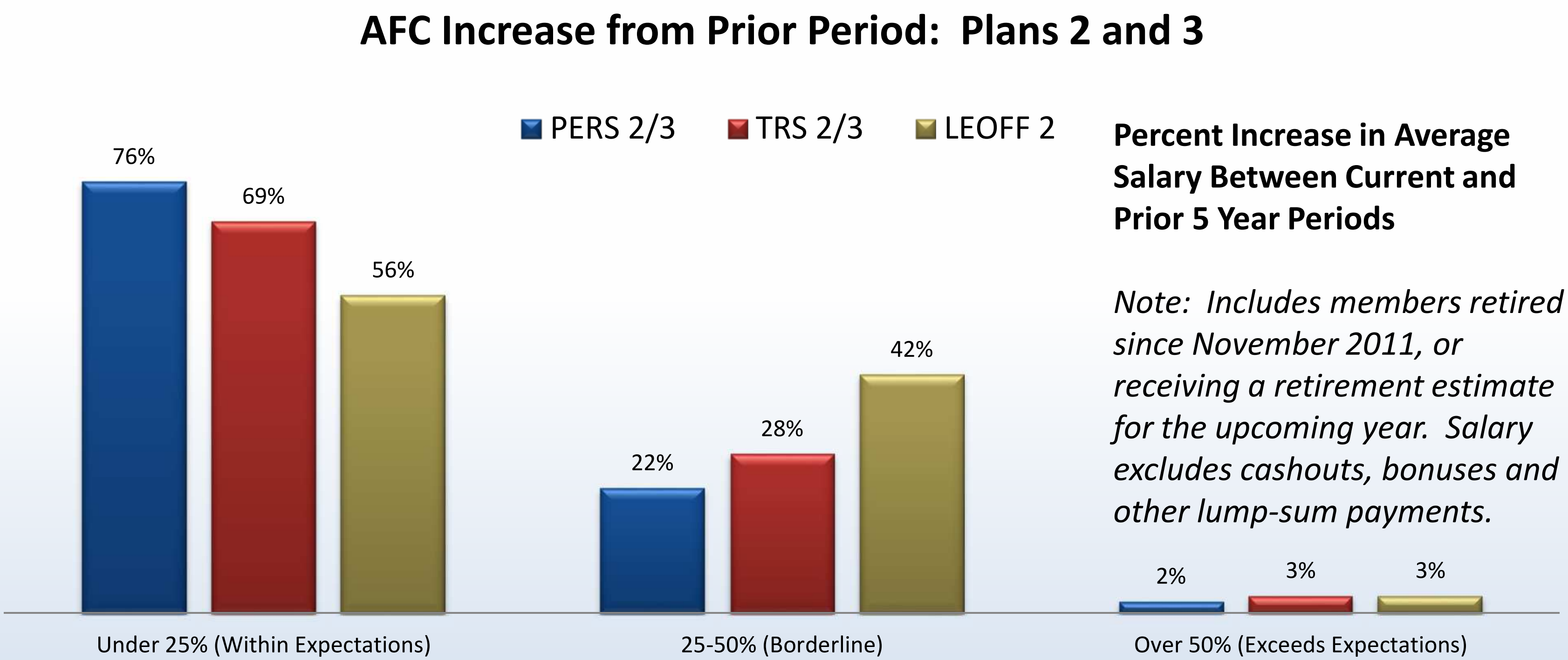
# Individual Spiking Rare




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.

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# 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

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# Any Questions?

- **Contact:**

  Paul Neal

  Senior Legal Counsel

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LEOFF Plan 2 Retirement Board

*August 28, 2013*

# CAREER CHANGE

INITIAL CONSIDERATION
By Paul Neal
Senior Legal Counsel
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## ISSUE

Abuse of "Career Change" legislation could undermine public trust that the plan is responsibly designed and professionally managed.

## MEMBERS IMPACTED

Board staff is currently working with the Department of Retirement Systems (DRS) to determine how many LEOFF Plan 2 retirees have utilized the provisions of the original 2005 Career Change bill. Assuming utilization continues at the same rate, a similar number of members would be impacted by any changes to the law. The public trust issues implicated by manipulation of the original bill impact all LEOFF Plan 2 members.

## OVERVIEW

Before 2005 a LEOFF Plan 2 retiree's pension stopped upon return to work in a job covered by any state-wide public retirement system. The LEOFF Plan 2 Board (Board) recognized members could age out of LEOFF positions before they were ready or could afford to leave the workforce. The Board proposed Career Change legislation in 2005 enabling retired LEOFF Plan 2 retiree to start a second career in non-LEOFF public employment. A retiree accepting such a job can either establish membership in another public system, thus suspending their LEOFF Plan 2 pension, or waive membership in the new system and continuing to receive a pension.

The Board intended to facilitate transition from a physically demanding profession to another, often less-well compensated, job. It did not intend to enable LEOFF Plan 2 retirees to return to work as a law enforcement officer or firefighter and continue to receive their pension. The Legislature passed the LEOFF Plan 2 Career Change bill in 2005.

The City of DuPont recently utilized an unintended loophole in the Career Change legislation to hire a LEOFF Plan 2 retiree as police chief and continue his pension. Although DuPont's former police was a full-time employee covered by LEOFF, DuPont found a way to ostensibly place their new Chief, a LEOFF Plan 2 retiree, outside of LEOFF. The City did this by redefining the position as “part-time,” i.e. 35 hours a week. The sole reason for this action was to move a law enforcement officer position into PERS to take advantage of the Career Change legislation.

This report will explain the difference between the Board’s Career Change policy and the retire-rehire policy in PERS and TRS; identify unintended consequences of the Career Change law, explain how the loophole works, and discuss media reaction to DuPont’s utilization of that loophole.

## BACKGROUND INFORMATION & POLICY ISSUES

When creating LEOFF Plan 2 in 1977, the Legislature prohibited members from receiving a pension while engaged in retirement system covered employment. If a LEOFF Plan 2 retiree entered public employment covered by LEOFF, the Public Employees’ Retirement System (PERS), or the Teachers’ retirement system (TRS), that member’s pension would be suspended. Over subsequent years the suspension requirement was expanded to include employment in positions covered by the School Employees’ Retirement System (SERS) or the Public Safety Officers’ Retirement System (PSERS). RCW 41.26.500.

## CAREER CHANGE VS. RETIRE-REHIRE

The LEOFF Career Change bill is sometimes confused with retire-rehire provisions governing PERS and TRS. Retire-rehire was enacted in 2001 and has been in the news, and before the Legislature, repeatedly since then. The retire-rehire law was intended to allow PERS and TRS retirees to supplement their pensions by working in part-time or temporary positions. Current retire-rehire provisions allow PERS and TRS retirees to work 867 hours per year while collecting their full pension. This allows part-time work or a temporary assignment to full-time work.

The retire-rehire law does not apply to LEOFF Plan 2. Its policy of assisting both employers and employees by facilitating part-time or temporary work by experienced workers stands in marked contrast to the Career Change policy.

### Career Change Legislation

The Board studied the LEOFF Plan 2 pension suspension provisions in 2004. The policy considerations underlying the action ultimately taken by the Board were discussed in the LEOFF Plan 2 staff presentation:

> The normal retirement age for LEOFF Plan 2 (53) is an age at which a person is generally considered to still be in the prime of their productive employment period although they may no longer be capable of performing the duties of a law

enforcement officer or fire fighter. A LEOFF Plan 2 member who separates from LEOFF employment at age 53 may be expected to seek continued full-time employment in a non-LEOFF capacity for a number of reasons including income, access to health care coverage and the ability to qualify for social security or earn additional pension benefits to supplement those provided by LEOFF Plan 2.

Public employment offers a number of potential second careers to LEOFF 2 members where the skills developed in their LEOFF positions can be utilized. However, LEOFF Plan 2 members who seek to continue in public employment following separation or retirement from LEOFF may be restricted from establishing membership in a second public retirement system or receiving their LEOFF pension. Thus, there are barriers to transitioning to public employment after completing a career in LEOFF.

When a LEOFF Plan 2 retiree becomes employed in an eligible position covered by another state pension system the retiree will have their LEOFF pension suspended. Additionally, the retiree would normally be prohibited from participating as a member in the other state pension system and accruing a second pension. These pension provisions may make continued public employment an unviable option for LEOFF Plan 2 retirees.

LEOFF Plan 2 staff presented three different options to the Board, including providing the same retire-rehire provisions available in PERS and TRS. But the Board's concern was not supplementing a pension with part-time work. Its issue was transitioning from a law enforcement officer or fire fighter career to a new career. Accordingly, the Board declined the option to adopt retire-rehire instead proposing Career Change legislation. Those provisions, enacted in RCW 41.26.500, allow a LEOFF Plan 2 retiree who starts a new career in public employment other than as a law enforcement officer or fire fighter to either:

- Establish membership in a new public retirement system suspending their LEOFF Plan 2 pension; or
- Opt out of the second public retirement systems and continue to receive their LEOFF Plan 2 pension while pursuing their second career.

It was not the intention of the Board nor the Legislature to allow a retired LEOFF Plan 2 member to return to work as a law enforcement officer or fire fighter and continue receiving a LEOFF Plan 2 pension. The City of DuPont has taken advantage of a loophole created by the intersection of the Career Change law and the pre-existing LEOFF definition of law enforcement officer to do exactly that.

## UNINTENDED CONSEQUENCE OF CAREER CHANGE LAW

The City of DuPont's full-time Chief of Police recently retired from LEOFF. The City hired a LEOFF Plan 2 retiree to replace him. The new Chief was originally hired on an interim basis and served full-time for approximately 3 months. Following DRS's recent disallowance of DuPont's claim that its Fire Chief was an independent contractor and the resulting suspension of the Fire Chief's LEOFF Plan 1 pension, the interim Police Chief "…notified the city of his intention to terminate his interim contract 'out of fear and confusion from the recent audit findings,[1]"

To allow the retiree to work as Police Chief and receive his LEOFF 2 pension, the City reclassified the Police Chief's position from full-time to "part-time" requiring 35 hours per week. It does not appear any change in duties accompanied the change in hours. The City redefined the position to reclassify it from LEOFF to PERS to fit within LEOFF Plan 2's Career Change provisions.

This loophole relies on an aspect of LEOFF's definition of a "Law Enforcement Officer":

> "Law enforcement officer" beginning January 1, 1994, means any person who is commissioned and employed by an employer on a **full time**, **fully compensated** basis to enforce the criminal laws of the state of Washington generally, with the following qualifications:
>
> …
>
> (c) Only such **full time** commissioned law enforcement personnel as have been appointed to offices, positions, or ranks in the police department which have been specifically created or otherwise expressly provided for and designated by city charter provision or by ordinance enacted by the legislative body of the city shall be considered city police officers;

RCW 41.26.030(18) (emphasis added). Firefighters must also be full-time, fully compensated to qualify for LEOFF, RCW41.26.030(16). LEOFF is somewhat unique in limiting membership to full-time employees. PERS, TRS, SERS, include part-time employees if they work at least 70

[1] *DuPont police chief to work part time, retain benefits*, The Olympian, July 31, 2013.

hours per month[2]. A review of the role of volunteer firefighters and reserve police officers helps explain why the Legislature set the bar for LEOFF membership so high.

**Part-time Law Enforcement Officers and Fire Fighters**

LEOFF's full-time requirement springs from a unique aspect of the fire fighter and law enforcement officer professions. A number of Washington's communities are served by Volunteer Fire Fighters and/or Reserve Police Officers. These part-time public safety officers belong to the Volunteer Firefighters and Reserve Police Officers' Retirement System, Chapter 41.24 RCW.

Volunteer Firefighters and Reserve police officers have the same authority and duties as their full-time counterparts when called into service. The distinction is they do not work full-time:

> "Reserve officer" includes any law enforcement officer who does not serve as a law enforcement officer of this state on a full-time basis, but who, when called by such agency into active service, is fully commissioned on the same basis as full-time officers to enforce the criminal laws of this state[3];

Washington's Courts recognize a similar distinction between LEOFF eligible fire fighters and volunteer firefighters, noting the distinction between full time vs. part time/volunteer controls whether the firefighter goes into LEOFF or the Volunteer system[4]. Similarly, when discussing LEOFF eligibility for police matrons the Court noted: "that plaintiffs are full-time employees, they are regularly employed as opposed, for example, to police reservists…[5]"

"Full-time" is not defined in the LEOFF statute, nor has it been defined by the Courts[6]. DRS adopted a rule in 1995 defining full time as "regularly scheduled to work at least 160 hours per month," i.e. at least 40 hours per week for at least 20 days, WAC 415-104-011(3). Coming ten

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[2] An "eligible position" for PERS, PSERS, and TRS Plan 2/3 is a position that normally requires 70 or more hours per month for at least 5 months per year. The relatively new retirement system of PSERS, created for public safety officers who are not fully commissioned law enforcement officers, also requires full-time employment.

[3] WAC 139-05-810(1).

[4] *Schrom v. Board for Volunteer Fire Fighters*, 153 Wn.2d 19, 27, 28, 100 P.3d 814 (2004).

[5] *Beggs v. City of Pasco*, 93 Wn.2d 682, 685, 611 P.2d 1252 (1980).

[6] *Tucker v. Department of Retirement Systems of State*, 127 Wn.App. 700, 706, 113 P.3d 4 (2005); The closest the Court has come is to uphold DRS determinations that persons performing law enforcement or firefighter duties less than half time do not meet the statutory full time requirement, see *Buckley v. Department of Retirement Systems*, 116 Wn.App. 1, 65 P.3d 1216 (2003); *International Ass'n of Fire Fighters Local 3266, AFL-CIO v. Department of Retirement Systems, State of Wash*., 97 Wn.App. 715, 987 P.2d 115 (1999).

years before the Career Change law, the rule had no impact on post-retirement employment laws when adopted. The 2005 Career Change legislation unintentionally created the loophole used by DuPont. Prior to that time a LEOFF Plan 2 retiree's pension would be suspended upon reentering covered employment regardless of what public position he or she entered. Redefining a LEOFF position as a PERS position would have been pointless, as it would not prevent suspension of the retiree's pension.

That is no longer the case. Even though the DuPont's Police Chief is a commissioned position created by the city to enforce the criminal laws of the State of Washington generally, i.e. a law enforcement position, DuPont has reduced the hours to make it a PERS position so its Police Chief can continue to receive a LEOFF Plan 2 pension.

DRS has fielded similar inquiries seeking the same result by focusing on the "fully compensated" eligibility requirement. Some examples include questioning whether a LEOFF Plan 2 retiree is not fully compensated, and therefore not LEOFF eligible, if he or she did not receive health care benefits, or earned annual leave at a lesser rate than other employees with similar experience. These inquires are designed to take advantage of the high bar to LEOFF membership used to distinguish between LEOFF eligible law enforcement officers and fire fighters and volunteer or part-time law enforcement officers and fire fighters. They seek to use that policy for an unintended purpose: to enable retirees to work as a law enforcement officer or fire fighter and continue to receive their pension.

## MEDIA RESPONSE TO PART-TIME DUPONT POLICE CHIEF

The Associated Press and the Daily Olympian recently published articles reporting on DuPont's arrangement[7]. Publishers of the Associated Press article include the Seattle Times, the Bellingham Herald, the Spokesman Review, and the Kansas City Star.

The Olympian followed up with an editorial confusing the 2005 Career Change bill with the 2001 Retire-Rehire provisions legislation, mistakenly claiming the 2001 law allowed LEOFF Plan 2 retirees to return to work as law enforcement officers or fire fighters for 1800 hours per year (35 hours per week x 52) while receiving a benefit. Neither the 2001 law nor the 2005 career change legislation intended that result. Further, that result cannot be accomplished without

[7] *DuPont police chief will collect salary, $90,000-a-year pension*, Associated Press, published in Seattle Times August 3, 2013.

redefining a full-time position as a part-time job. Nonetheless, the Olympian included the Career Change law in its call for a full repeal of retire-rehire[8].

## SUMMATION

The Board recommended the Career Change bill to enable retired law enforcement officers and firefighters to transition to a new career. Redefining a position to enable a LEOFF Plan 2 retiree to work as a law enforcement officer while still drawing a LEOFF 2 pension violates that intent. Misusing the Career Change law to draw a LEOFF Plan 2 salary while working as a law enforcement officer undermines both public trust in the LEOFF Plan 2 system and the legitimate policy goals of the original law.

[8] *Time for Retire-Rehire to End in This State*, Daily Olympian, August 8, 2013.

LEOFF

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# Career Change

**Initial Consideration**

**August 28, 2013**

# Issue

- Abuse of "Career Change" legislation could undermine public trust that the plan is responsibly designed and professionally managed.

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# Background

- Recent action by City of DuPont re-designating Police Chief position as "part-time" in order to facilitate a LEOFF Plan 2 retiree filling the position and continuing to draw his pension.
- Unintended Consequence of 2005 Career Change legislation undermines legitimate policy of the law.



LEOFF Plan 2 Retirement Board

# Post-Retirement Employment Restrictions

- **LEOFF Plan 2 benefits suspended if retiree returned to work in any public position (pre-2005).**
- **LEOFF Plan 2 Board 2004 study noted:**
  – At age 53 an employee ages out of LEOFF but can continue to work in less strenuous profession;
  – Retiree skills can translate well to a new career, often with a public employer;
  – Original pension suspension law discouraged career change.

LEOFF Plan 2 Retirement Board

# Board Recommended Career Change Law

- **LEOFF Plan 2 retiree to begin a second career in a non-LEOFF position and:**
  - Establish membership in the new public retirement system suspending their LEOFF Plan 2 pension; or
  - Choose not to establish membership in the new public retirement system and continue to receive their LEOFF Plan 2 pension while pursuing their second career.
- **Legislature enacted new law in 2005.**

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# Unintended Consequence

- **DuPont needed to replace its full-time police chief. It wished to hire a LEOFF plan 2 retiree. The retiree did not wish to lose his LEOFF pension.**
  – DuPont converted LEOFF position (police chief) into PERS by re-designating it "part-time".
  – Loophole in career change law allowed LEOFF Plan 2 retiree to return to law enforcement career and continue to receive pension.

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# How the Loophole Works

- **Unintended intersection of valid policies.**
- **Career Change policy.**
  – Facilitate transition to less strenuous non-LEOFF career.
- **LEOFF membership policy.**
  – Full-time.
  – Fully Compensated.

# Full Time, Fully Compensated

- **LEOFF members must be "full time, fully compensated" places.**
  - Career officers and fire fighters in LEOFF.
  - Volunteer fire fighters and reserve police officers in Volunteer Firefighter and Reserve Police Officer Retirement System, Chapter 41.24 RCW.
- **"Full time, fully compensated" not defined in statute or case law.**



LEOFF Plan 2 Retirement Board

# Full Time, Fully Compensated – DRS Rule

- **DRS adopted definition in rule in 1995, WAC 415-104-011.**
  - "Full time" means at least 160 hours per month;
  - "Fully compensated" means earning the same salary and benefits as other employees of same rank and position.
- **DRS rule adopted 10 years before the career change law.**
  - At that time no intersection with post-retirement employment.
  - A part-time or less than fully compensated LEOFF Plan 2 retiree would still have stopped receiving pension.



LEOFF Plan 2 Retirement Board

# Media

- **Recent articles reporting on DuPont.**
  - Transition Police Chief from full-time to part time.
  - Receive "over $170,000" in salary and pension.
- **Follow-up editorial in Olympian.**
  - Mistakenly identified LEOFF Plan 2 Career Change as part of 2001 PERS & TRS retire-rehire bill;
  - Called for repeal of Retire-rehire and Career Change.



LEOFF Plan 2 Retirement Board

# Summary

- Career Change enables transition to a new career.
- Redefining a position to enable a LEOFF Plan 2 retiree to work as a law enforcement officer while still drawing a LEOFF 2 pension violates that intent.
- Misuse undermines public trust in the LEOFF Plan 2 system and the legitimate policy goals of the original law.



LEOFF Plan 2 Retirement Board

# Next Steps

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

# Any Questions?

- **Contact:**

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August 28, 2013

# PROMOTING INDIVIDUAL SAVINGS FOR RETIREMENT

INITIAL CONSIDERATION

By Paul Neal
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## ISSUE

Members are not able to take advantage of a recent IRS ruling which provides new options for managing savings in retirement.

## MEMBERS IMPACTED

New options encouraging members retirement savings as part of LEOFF Plan 2 would be available to all 16,805 active LEOFF Plan 2 members[1].

## OVERVIEW

The LEOFF Plan 2 defined benefit Plan, the first leg of the three-legged retirement stool, provides a defined lifetime payout that does not vary with investment return. Retirees must devise their own distribution strategy for the second leg of the stool, individual retirement savings. Members can reduce the risk of outliving their assets if they convert at least some of those assets into a lifetime annuity.

LEOFF Plan 2 members may purchase an additional monthly benefit through the LEOFF Plan 2 trust fund by buying up to 5 years of additional service credit at the time retirement. Under current law, only Plan 3 members (TRS, PERS & SERS[2]) can convert contributions to an annuity from their retirement system.

Leveraging the existing LEOFF Plan 2 infrastructure to authorize accumulation of savings and/or converting that account to a monthly benefit through the LEOFF Plan 2 trust fund would provide a cost-effective mechanism to encourage retirement savings. This can be particularly important for LEOFF Plan 2 members since many do not participate in social security through their employer.

This report examines federal laws encouraging retirement savings, the costs of savings for retirement, different mechanisms for annuitizing retirement savings, and a recent IRS ruling authorizing annuitizing retirement savings through LEOFF Plan 2.

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[1] Membership number as of June 30, 2011; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.
[2] Teachers' Retirement System (TRS); Public Employees' Retirement System (PERS); School Employees' Retirement System (SERS).

## BACKGROUND INFORMATION & POLICY ISSUES

The LEOFF Plan 2 Retirement Board began studying ways to encourage increased retirement savings during the 2004 Interim. The Board recommended legislation allowing purchase of up to five years of service credit at retirement. The Legislature passed that recommendation in 2005 (HB 1269). That same year the Department of Retirement Systems (DRS) began offering the annuities through the Plan 3 programs. The Purchase of Annuity topic was studied by the Board during the 2006, 2007, 2008 and 2009 Interims reaching the Final Proposal stage in 2006, 2008 and 2009, but no legislation was recommended. The topic was deferred for joint consideration with the Select Committee on Pension Policy (SCPP) for the 2009 Interim. No further action was taken.

> *The paradox is that investors recognize that their retirement savings will need to last longer than ever before but they aren't making plans to ensure they will actually have the money they need. There tends to be a false sense of security when it comes to Planning for retirement. We hope that the money will somehow be there when we need it but we're not taking the action required to ensure it is. This is a serious problem, and addressing it must become an urgent priority.*
>
> Noel Archard, Head of BlackRock Canada.
> July 2013

## SAVING FOR RETIREMENT

**Federal Law Encouraging Retirement Savings**

The federal tax code encourages individuals to save for, and invest in, retirement:

- Qualified deferred compensation plans, such as the IRS §457 plan offered through the Department of Retirement Systems (DRS) deferred compensation program, permit an individual to authorize pre-tax salary deductions for deposit into a personal investment account. Many LEOFF Plan 2 employers offer these types of plans to employees. Upon separation from employment a member may leave the funds invested or select a distribution option.

- Members may transfer funds between government defined benefit pension Plans like LEOFF Plan 2 and deferred compensation accounts such as 457, 403(b), and 401(k) Plans. This helps members manage retirement savings as they change employers.

- Purchase of up to five years of service credit or “air-time” was authorized in the Federal Pension Protection Act.

- A recent IRS revenue ruling[3] allows members with funds in a deferred compensation account maintained by an employer to roll the funds over into their defined benefit plan and convert those funds to an annuity from the defined benefit Plan.

[3] Internal Revenue Bulletin 2012-8; issued February 21, 2012.

Using these federal provisions, some state and local government pension plans allow member fund transfers, including funds from tax-deferred accounts, into the primary defined benefit plans to purchase additional service credit or an annuity.

## THE COST OF SAVING - DEFERRED COMPENSATION FEES

DRS operates a deferred compensation program under 26 U.S.C. §457, commonly called a "457 Plan". Washington's political subdivisions may participate in DRS's 457 Plan, or use another administrator, such as ICMA-RC. Administrative fees vary significantly. Comparing private administrator fees to DRS's annual .13% fee can be challenging since private administrators tend to use variable fee schedules rather than the flat fee charged by DRS, as demonstrated by the fee comparison table included as Appendix A.

The average net annual fee of the private 457 plan administrators examined in Appendix A is 1.29%, nearly 10 times the .13% charged by DRS. DRS's lower fees facilitate a larger accumulation from the same member contributions[4]:

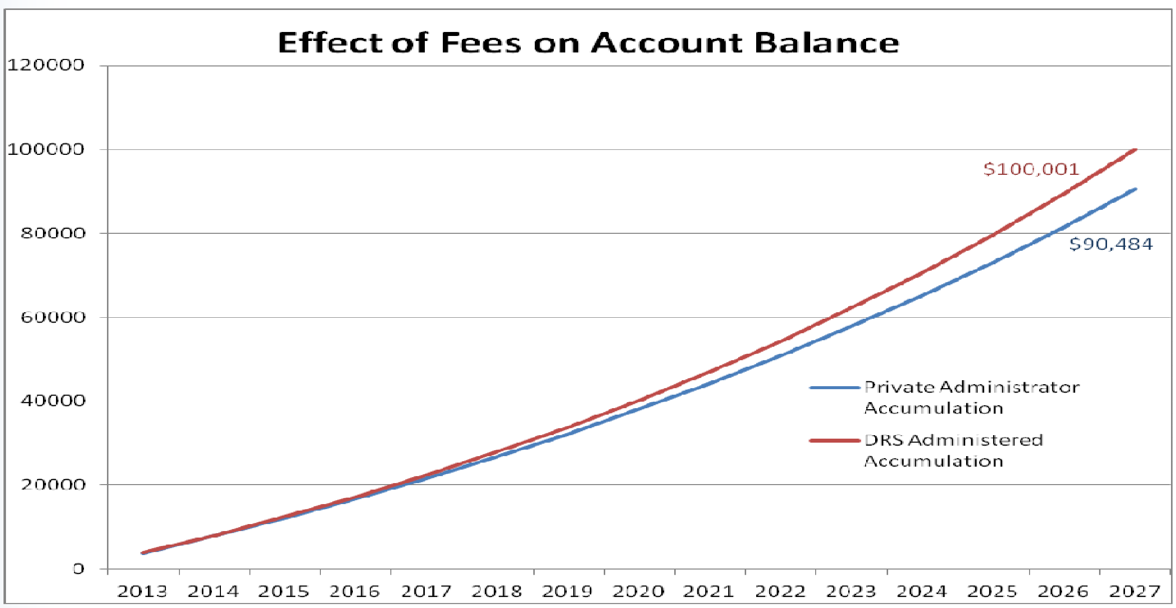


**Figure 1**

[4] The comparison assumes $3,602 per year contribution for 15 years, earning interest at LEOFF PLAN 2's assumed rate of 7.5%, less annual fees.

## ANNUITIZING ASSETS

Annuities can convert retirement savings into a guaranteed monthly income (this process is called annuitization) for a specified period of time. A life annuity provides that income for the member's lifespan in exchange for a lump-sum dollar amount paid up front. Deferred compensation plans do not normally allow for the distribution of assets in the form of an annuity directly from the fund. LEOFF Plan 2 members wishing to annuitize their retirement savings must purchase the annuity through an insurance company.

The price/value of the annuity depends in part upon the features selected by the purchaser. The terms and conditions of an annuity contract specify features such as whether the annuity will be for a single life or a joint annuity (like a survivor benefit feature), the payment frequency, adjustments for cost of living, and death provisions. Different methods for annuitizing assets are listed below, though not all are currently available to LEOFF Plan 2 members.

**Trust Fund Annuity Purchase**

TRS Plan 3, SERS Plan 3, and PERS Plan 3 members and survivors may convert some or all of the funds from their Plan 3 member account to a life annuity, RCW 41.50.088. The features and options of the Plan 3 annuities administered by DRS are detailed in Appendix B. This option is not available to LEOFF Plan 2 members.

DRS calculates the annuity that can be purchased for a given lump sum using an age based actuarial table to compute the monthly benefit per $1.00 of accumulation for defined benefits. There is no limit on the amount of funds in the member account that can be converted to an annuity.

RCW 41.32.067 also allows TRS Plan 1, 2 and 3 members to purchase additional benefits through a member reserve contribution which is actuarially converted to a monthly benefit at the time of retirement. The statute was passed to provide teachers with out-of-state service credit a mechanism for transferring contributions from a prior system into TRS[5].

**Service Credit Purchase**

LEOFF Plan 2 members can annuitize retirement savings by purchasing up to five years of additional service credit at the time of retirement. To purchase service credit under this option the member pays the actuarial present value of the resulting increase in the member's benefit. A member may pay all or part of the cost of the additional service credit with an eligible transfer from a qualified retirement plan. For more information on the history and methodology for calculating service credit purchases, see Appendix C.

[5] *See* Laws of 1991 c 278 § 2.]

The federal 5-year "air time" limit works out to a maximum of $86,484 that could be converted to a monthly benefit by the average LEOFF Plan 2 member[6], see Appendix C. This is a key difference between a Plan 3 annuity conversion and a service credit purchase: the Plan 3 conversion does not have a maximum amount limit.

**Commercial Market Annuity**

Retirement savings can be annuitized by purchasing an annuity policy through insurance agents, financial planners, banks and life insurance carriers. However, only life insurance companies issue policies. Generally, commercial market annuities do not offer all the same features as the Plan 3 trust fund annuity and do not provide as favorable a payout. A primary reason for the payout difference is the different interest rate used to calculate the value of the annuity. Private insurers use a lower interest rate, due in part to the inclusion of a reasonable profit:

> [A] private insurer will provide the annuity based on an interest rate of about 4 percent, whereas DRS will provide the annuity based on an interest rate of about 8%.[7].

The interest rate differential drives a significant difference in payout amounts between private annuity contracts and contributions annuitized through the trust fund. Five different insurance companies quoted the monthly annuity with a 3% annual COLA they would provide the average LEOFF Plan 2 retiree[6] for $100,000:

| Insurance Company | Quote |
|---|---|
| American General | $389 |
| Aviva | $402 |
| Fidelity & Guaranty Life | $421 |
| Genworth Life Insurance | $406 |
| Integrity Life Insurance | $400 |
| **Average** | **$404** |

If that same average LEOFF Plan 2 member were able to leverage the institutional advantages of the retirement system by annuitizing $100,000 within the LEOFF Plan 2 system, the payout would be $578.14[8]. That's a 43% increase over the average commercial quote, or $174 more per month for life.

[6] Age 56 with 17 years of service credit and a final average salary of $5000 per month.
[7] 2010 State Actuary 2010 fiscal note on the Board's purchase of annuity proposal.
[8] $100,000 x .0057814 (conversion factor from DRS table for 56 year-old LEOFF member) = $578.14 monthly life annuity

The chart below uses the 15 year accumulations calculated in figure 1 and estimates the annuity those accumulations would purchase from either an insurance company or the LEOFF Plan 2 trust fund.


**Figure 2**

Current state law does not allow annuitization of retirement savings through the LEOFF Plan 2 trust fund. A recent IRS ruling gives the green light to such a program.

## NEWLY AVAILABLE ALTERNATIVE: ANNUITIZATION THROUGH 401(A) PLAN

Federal tax law allows public defined benefit plans to add a member savings account within the plan, sometimes referred to as a companion account or “sidecar”. Contributions to the employee savings account may be made by the employer or the employee and may be either pre-tax or after tax depending on plan design.

Under the recent IRS ruling cited above, a retirement savings account can be annuitized within the 401(a) defined benefit plan to obtain an additional monthly benefit paid through the trust fund. This can be done either through a employee savings account administered within the 401(a) plan or by rolling over retirement savings from another plan such as a 457 plan.

A “sidecar” plan administered through LEOFF Plan 2 could leverage the institutional advantages available to active members as participants in an existing state-administered Plan. Those advantages include the lower fees charged by DRS to administer the savings plan, and the more favorable annuity payout when purchased through the existing LEOFF Plan 2 trust fund.

**Potential Risks**

The purchase of an annuity through the LEOFF Plan 2 trust fund would not have a cost to the system[9] under current actuarial assumptions. There is, however, a potential risk to the fund if those assumptions change or actual experience falls below assumed levels. When an annuity is purchased, the member locks in the actuarial assumptions in place at that time. A subsequent change in assumptions may knock the annuity out of actuarial equivalency.

For instance, the Actuary's 2010 fiscal note assumed a trust fund annuity would be calculated using the fund's 8% interest assumption. The Board has since reduced that assumption to 7.5%. An annuity locked in with an 8% interest assumption would be "too high" under a 7.5% assumption, causing a $12,980 actuarial loss to the fund[9].

## SUPPORTING INFORMATION

Appendix A: Deferred Compensation Fee Comparison *will need to be reordered*

Appendix B: Plan 3 annuity purchase option features

Appendix C: Service Credit Purchase history and example

Appendix D: OSA draft fiscal note

[9] *See* OSA fiscal note on 2010 annuity purchase proposal, Appendix C.

Appendix A

## DEFERRED COMPENSATION FEE ANALYSIS

An approximation of annual fees for private administration of a 457 deferred compensation plan was derived by working from a table developed by The City of Duluth in 2013 to allow employees to compare costs of 4 different 457 Plan administrator. Fees were highly variable. Board staff averaged the fees of each provider and then averaged those to derive a net average estimated annual fee. Given the small sample and the assumptions that had to be made in averaging, this is a "ball park" figure provided solely for purposes of comparison.

| | **Hartford Life Deferred Compensation Plan** | | **ICMA Retirement Corporation Deferred Compensation Plan** | | **Minnesota State Deferred Compensation Plan MNDCP – (Great West)** | | **NationwideDeferred Compensation Program** | |
|---|---|---|---|---|---|---|---|---|
| | **Original data** | **Average fee** | **Original data** | **Average fee** | **Original data** | **Average fee** | **Original data** | **Average fee** |
| Annual Account Fees | No | 0 % | No. | 0% | No | 0% | No. | 0% |
| Daily Asset-Based Charges | 75 - 90 bps | .825 % | 0.55% administration fees on all assets; additional 0.15% fee on assets in non-proprietary funds. | .55% | 0.10% annual administrative fee, charged only on the first $100,000 in an individual account. | .1% | 0.50% annual administrative fee on all variable fund assets. 0.25% annual administrative fee on fixed account option. | .375% |
| Fund Operating Expenses | Varies by investment option, from 0.0% to 2.42% | 1.21% | Fund expenses range from 0.46% to 1.40% | .93% | Fund expenses range from 0.01% to 0.93%. | .47% | Fund expenses range from 0.00% to 1.40%. | .7% |
| ***Net fee estimate*** | **2.035%** | | **1.48%** | | **.57%** | | **1.075%** | |
| ***Average for all plans*** | **1.29%** | | | | | | | |

# APPENDIX B
# CURRENT ANNUITY PURCHASE FEATURES

The purchase of annuity currently administered by DRS through the Plan 3 programs includes the following features:

| WSIB Investment Program Annuity Features and Options | |
|---|---|
| **Contract Provider** | Washington State |
| **Minimum Purchase Price** | $25,000 |
| **Annuity Payment Frequency** | Monthly |
| **Rescission Period** | 15 calendar days from date of purchase |
| **Single Life Annuity** | • Provides regular payment for as long as annuitant lives.<br>• Automatic 3% Annual Cost of Living Adjustment (COLA)<br>• Conversion option to Joint Life Annuity<br>• Balance Refund |
| **Joint Life Annuity** | • Provides regular payment for as long as member or joint annuitant is alive.<br>• Joint annuitant survivorship options: 100%, 66 2/3%, or 50%<br>• Automatic 3% Annual COLA<br>• Monthly payment pops-up to Single Life Annuity amount if joint annuitant predeceases member.<br>• Balance Refund |

***Annuitant*** – The member/owner who purchases the annuity; the payee who receives lifetime monthly payments.

***Balance Refund*** – Any remaining balance equal to the original purchase price minus the total of all annuity payments made to the single or joint annuitants, may be refunded to the specified beneficiary.

***Conversion Option*** – If a single life annuity is purchased and then a subsequent marriage occurs, a one-time opportunity is available to convert to a joint life annuity with the new spouse as the joint annuitant. If a joint annuity is purchased with someone other than a spouse named as the joint annuitant, the annuity may be converted to a single life annuity after payments have begun.

***Joint Annuitant*** – The person designated to receive an ongoing payment in the event of the annuitant's death.

***Pop-up*** – An increase from a joint annuity payment amount to the full single life annuity amount if the annuitant outlives the joint annuitant.

***Rescission Period*** – A period of time (typically 7 to 15 days) during which the terms of the contract may be canceled or altered

## APPENDIX C
## SERVICE CREDIT PURCHASE

Since 2005 the inception of the service credit purchase of "air time" benefit through August of 2007, 15 service credit purchase billings have been requested from DRS and paid in full. The average cost of all fifteen billings was $103,045. The average benefit increase from the fifteen billings was $597 per month. The average break-even point is just over 14 years, or age 69.

**LEOFF Plan 2 SC Purchases at Time of Retirement**

| Year Paid | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | Grand Total |
|---|---|---|---|---|---|---|---|---|---|
| Number of PSC Bills Paid | 6 | 10 | 11 | 15 | 30 | 42 | 57 | 43 | 214 |
| Average Cost of PSC Bill | $106,853 | $102,102 | $85,391 | $99,161 | $119,527 | $123,924 | $120,245 | $132,699 | $118,876 |
| Average SC Months of PSC Bill | 55 | 53 | 44 | 48.5 | 54.6 | 51.8 | 48.4 | 54.3 | 51.3 |

A five year service credit purchase by an average LEOFF Plan 2 retiree who, at the time of retirement, is 56 with 17 years of service, and a monthly final average salary of $5,000 is detailed below:

**Service Credit Purchase Calculation**

**1. Calculate Base Benefit**: 2% × 17 YOS × $5,000 = $1,700 per month

**2. Add 5 Years Of "Air Time":** 2% × 22 YOS × $5,000 = $2,200 per month

**3. Calculate Increase in Monthly Benefit from Additional Service Credit:**

$2,200 - $1,700 = $500 increase per month

**4. Calculate Service Credit Purchase Cost:** $500 ÷ 0. 0057814 [10] = $86,484

[10] The factor for the "Monthly benefit per $1.00 of accumulation for defined benefit Plans" for an age 56 LEOFF Plan 2 member from WAC 415-02-340.

# APPENDIX D
# OSA FISCAL NOTE OF 2010 ANNUITY PURCHASE PROPOSAL

Attached Separately

# DRAFT
# ACTUARY'S FISCAL NOTE

| RESPONDING AGENCY: | CODE: | DATE: | PROPOSAL [NAME or Z-NUMBER]: |
|---|---|---|---|
| **Office of the State Actuary** | **035** | **12/07/09** | **LEOFF 2 Annuity Purchase** |

## WHAT THE READER SHOULD KNOW

The Office of the State Actuary ("we") prepared this draft fiscal note based on our understanding of the proposal as of the date shown above. We intend this draft fiscal note to be used by the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 2 Board throughout the 2009 Interim only. If a legislator introduces this proposal as a bill during the next Legislative Session, we will prepare a final fiscal note based on that bill language. The actuarial results shown in this draft fiscal note may change when we prepare our final version for the Legislature.

We advise readers of this draft fiscal note to seek professional guidance as to its content and interpretation, and not to rely upon this communication without such guidance. Please read the analysis shown in this draft fiscal note as a whole. Distribution of, or reliance on, only parts of this draft fiscal note could result in its misuse, and may mislead others.

## SUMMARY OF RESULTS

This proposal would authorize the Department of Retirement Systems (DRS) to provide optional actuarially equivalent annuity purchases from the Law Enforcement Officers' and Fire Fighters' (LEOFF) Plan 2 retirement fund to LEOFF Plan 2 members and survivors.

This proposal does not impact the expected actuarial funding of the system. Please see the body of this draft fiscal note for a detailed explanation.

## WHAT IS THE PROPOSED CHANGE?

### Summary Of Change

This proposal impacts the LEOFF Plan 2 by authorizing DRS to provide optional actuarially equivalent annuity purchases from the LEOFF Plan 2 retirement fund to LEOFF Plan 2 members and survivors. The proposal allows members to purchase annuities prior to retirement. DRS would develop the life annuity benefit schedules no later than December 31, 2010.

Assumed Effective Date: 90 days after session.

### What Is The Current Situation?

Plan 3 members may purchase a similar annuity with contributions invested in the Total Allocation Portfolio of the Washington State Investment Board (WSIB) investment program, but only at the time of retirement. LEOFF Plan 2 members may purchase up to five years of additional service by paying the full actuarial value of the service at the time of retirement.

### Who Is Impacted And How?

We estimate this proposal could affect all 16,626 active members of LEOFF Plan 2 with the option of improved benefits.

We estimate this proposal will increase the benefits for a typical member by providing the option to annuitize their retirement savings. Annuitizing their money provides a member security against outliving their assets. In addition, the annuity offered to them through DRS will cost far less than an annuity bought from a private insurer. A private insurer calculates annuities based on a lower interest rate to account for risk and profit.

For example, a private insurer will provide the annuity based on an interest rate of about 4 percent, whereas DRS will provide the annuity based on an interest rate of about 8 percent. For a member age 55 buying a $10,000 life annuity, this would mean they would pay a private company about $165,000, whereas they would pay DRS about $110,000.

## WHY THIS PROPOSAL DOES NOT HAVE A COST

### Why This Proposal Does Not Have A Cost

This proposal does not have an expected cost because the member is paying the full actuarial value.

### Who Will Pay For These Costs/Savings If They Arise?

The member will pay the actuarially equivalent value of the annuity.

However, as the experience of the system emerges, if the payment is more or less than the actual value of the annuity, then LEOFF Plan 2 contribution rates will increase or decrease accordingly.

## HOW WE VALUED THESE COSTS

### Assumptions We Made

We assumed that the payments made by the members will equal the full actuarial value of the annuity. We would need to make several assumptions to determine the purchase price of the annuity:

- Expected rate of investment return.
- Expected rate of mortality for the annuitant.
- The annuity start date – the member's retirement date (if purchased prior to retirement).

As with any actuarial calculation that involves estimating future events, actual experience may differ from the underlying assumptions made. When actual experience differs from what we assumed would occur, the system experiences an actuarial gain or loss. An actuarial gain would decrease plan liabilities (or increase assets); whereas, an actuarial loss would increase plan liabilities (or decrease assets). Therefore, we cannot say with certainty that this proposal will not impact plan liabilities in the future.

If the members who purchase annuities, on average, live shorter/longer than assumed, the system will experience actuarial gains/losses in the future. If the actual rate of investment return is more/less than the assumed rate, the system will experience actuarial gains/losses from this assumption as well. For these two assumptions, we will not know whether a gain or loss has occurred until DRS has made all payments under the annuity contract.

The assumed annuity start date, or member's retirement date, will also produce a source of actuarial gain or loss for members who purchase annuities prior to their retirement date. For this particular assumption, we can determine whether an actuarial gain or loss has occurred at the time of retirement. DRS may have the option to adjust the purchase price or adjust the annuity amount (a "true up") at the time of retirement to eliminate this source of gain/loss. Without such an adjustment, the potential for significant actuarial gain/loss, on an individual member basis, exists for this particular assumption.

Otherwise, we developed these costs using the same assumptions as disclosed in the 2008 Actuarial Valuation Report.

## HOW THE RESULTS CHANGE WHEN THE ASSUMPTIONS CHANGE

To determine the sensitivity of the actuarial results to the best-estimate assumptions selected for this pricing we varied the following assumptions:

- **Mortality rate** – We determined the cost to the system if the annuity amount was calculated based on higher mortality rates than what actually occurs over time (people lived longer than assumed). For this sensitivity we used 100 percent of scale AA mortality improvement rather than the assumed 50 percent.
- **Investment returns** – We determined the cost to the system if the annuity amount was calculated based on a higher investment returns than what actually occurs over time (investments pay less than assumed). For this sensitivity we used a 7.5 percent investment return rather than the assumed 8 percent.
- **Annuity start date** – We determined the cost to the system if the annuity amount was calculated based on a later retirement date than what actually occurs over time (people start collecting the annuity earlier than assumed). For this sensitivity we used a start age of 53 rather than an assumed age of 55.
- **All of the above** – We determined the cost to the system if all three of the assumptions are incorrect, as described above, at the same time.

The table below shows the expected results versus the four sensitivity runs outlined above. The example outlines the impact due to one member currently age 40 who purchases an annuity with $100,000. When all three occur at once, the liability is larger than the sum of each of the three individually because of the interaction of these assumptions.

**Sensitivity Example – 40-Year- Old Male Purchases Retirement Annuity With $100,000**

| Scenario | Cash Paid From Member To Plan | Present Value of Plan Annuity | Cost to the System |
|---|---|---|---|
| 1) Expected | $100,000 | $100,000 | $0 |
| 2) Lower Mortality Than Expected | $100,000 | $102,549 | $2,549 |
| 3) Lower Asset Returns Than Expected | $100,000 | $112,980 | $12,980 |
| 4) Earlier Retirement Age Than Expected | $100,000 | $120,794 | $20,794 |
| 5) Scenarios 2, 3, and 4 | $100,000 | $138,777 | $38,777 |

*Assumes annuity calculation based on 3% COLA, and 90%/10% male/female mortality blend.*

## ACTUARY'S CERTIFICATION

The undersigned hereby certifies that:

1. The actuarial cost methods are appropriate for the purposes of this pricing exercise.
2. The actuarial assumptions used are appropriate for the purposes of this pricing exercise.
3. The data on which this draft fiscal note is based are sufficient and reliable for the purposes of this pricing exercise.
4. Use of another set of methods and assumptions may also be reasonable, and might produce different results.
5. This draft fiscal note has been prepared for the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 2 Board.
6. This draft fiscal note has been prepared, and opinions given, in accordance with Washington State law and accepted actuarial standards of practice as of the date shown on page one of this draft fiscal note.

This draft fiscal note is a preliminary actuarial communication and the results shown may change. While this draft fiscal note is meant to be complete, the undersigned is available to provide extra advice and explanations as needed.

Matthew M. Smith, FCA, EA, MAAA
State Actuary

## GLOSSARY OF ACTUARIAL TERMS

**Actuarial Accrued Liability:** Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

**Actuarial Present Value:** The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc.).

**Aggregate Funding Method:** The Aggregate Funding Method is a standard actuarial funding method. The annual cost of benefits under the Aggregate Method is equal to the normal cost. The method does not produce an unfunded liability. The normal cost is determined for the entire group rather than on an individual basis.

**Entry Age Normal Cost Method (EANC):** The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- Normal cost.
- Amortization of the unfunded liability.

The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

**Normal Cost:** Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

**Projected Unit Credit (PUC) Liability:** The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

**Projected Benefits**: Pension benefit amounts which are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

**Unfunded PUC Liability:** The excess, if any, of the Present Value of Benefits calculated under the PUC cost method over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

**Unfunded Actuarial Accrued Liability (UAAL):** The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that are not covered by plan assets.

LEOFF
Plan 2 Retirement Board

# Promoting Individual Savings for Retirement

Initial Consideration

August 28, 2013

# Issue

Members are not able to take advantage of a recent IRS ruling which provides new options for managing savings in retirement.

LEOFF
Plan 2 Retirement Board

# Retirement Savings

- **3 Legs of Retirement stool:**
  - LEOFF Plan 2 Pension
  - Individual Savings
  - Social Security
- **Many LEOFF Plan 2 employers are not in Social Security, making encouragement of individual savings even more important.**

LEOFF
Plan 2 Retirement Board

# Federal Tax Law Encourages Savings

- Qualified deferred savings plans allowing member pre-tax contributions.
- Rollovers between qualified plans allowed to enhance savings flexibility.
- Purchase of up to 5 years of “air time”.

LEOFF
Plan 2 Retirement Board

# 2012 IRS Ruling

- **Internal Revenue Bulletin 2012-8 issued February 21, 2012.**
  - Allows a member of a 401(a) defined benefit plan to annuitize tax deferred retirement savings.
  - Allow employees to maintain a “sidecar” savings account within defined benefit trust fund.

LEOFF Plan 2 Retirement Board

# Existing Options

- Payroll deductions to 457 plan.
- Purchase  "Air time" – may be done with rollover.

# Enhancing Existing Options

- "Sidecar" Savings Plan - Leverage existing infrastructure to combine positive features of air time and 457 plan.
- Allow conversion of lump sum to an annuity paid through LEOFF 2 trust fund like air time but without the 5 year limit.

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# Potentially Lower Fees

- DRS administered 457 plan has very low fees compared to privately administered plans.
- DRS charges flat annual fee of .13%;
- Apples to apples comparison with private plans challenging because of different fee structure.

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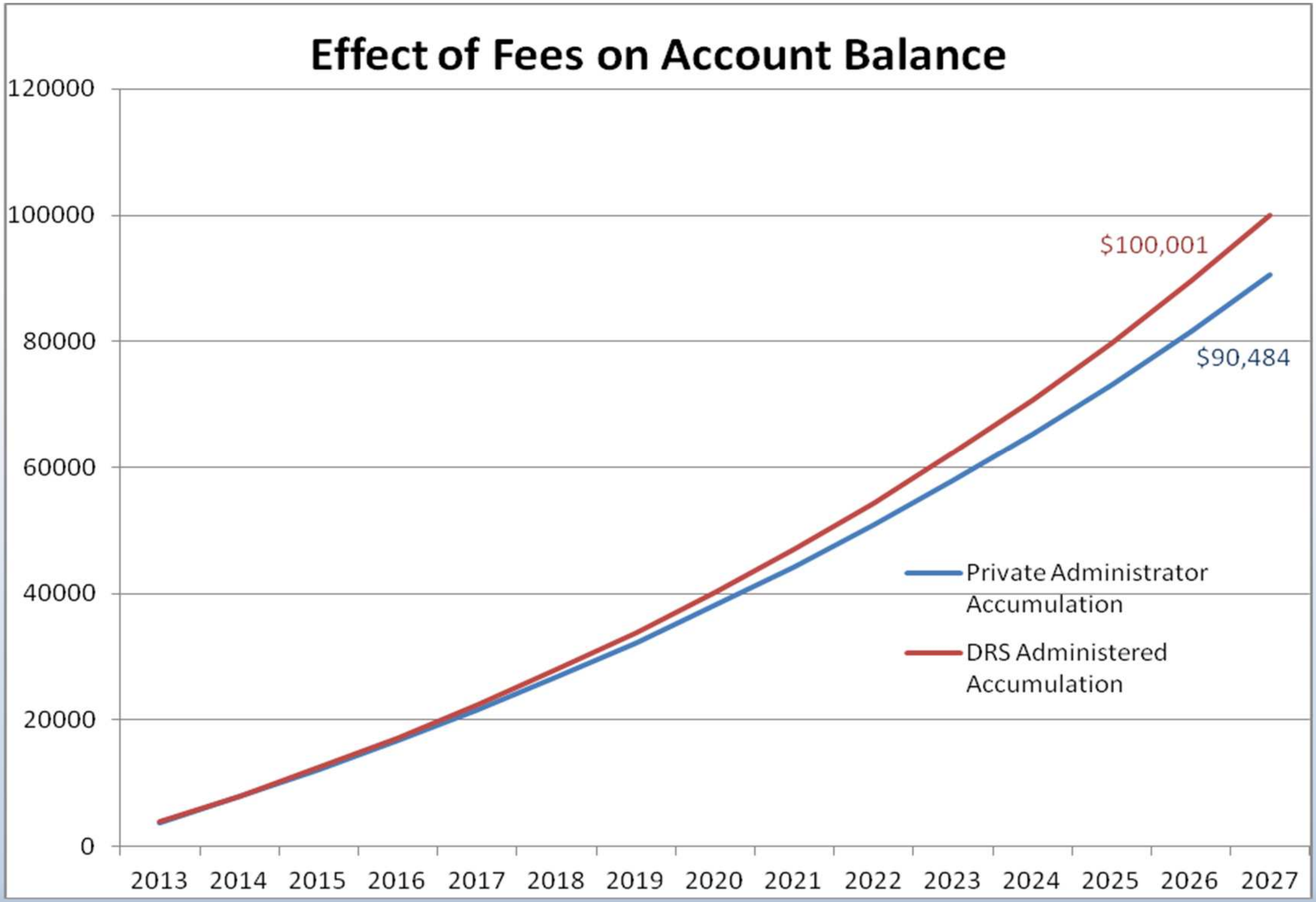
# Estimating Private Administrator Fees

| | Hartford Life Deferred Compensation Plan | | ICMA Retirement Corporation Deferred Compensation Plan | | Minnesota State Deferred Compensation Plan MNDCP – (Great West) | | Nationwide Deferred Compensation Program | |
|---|---|---|---|---|---|---|---|---|
| | Original data | Average fee | Original data | Average fee | Original data | Average fee | Original data | Average fee |
| Annual Account Fees | No | 0 % | No. | 0% | No | 0% | No. | 0% |
| Daily Asset-Based Charges | 75 - 90 bps | .825 % | 0.55% + 0.15% fee on non-proprietary funds assets | .55% | 0.10% | .1% | 0.50% on variable assets. 0.25% on fixed account. | .375% |
| Fund Operating Expenses | Varies from 0.0% to 2.42% | 1.21% | From 0.46% to 1.40% | .93% | From 0.01% to 0.93%. | .47% | From 0.00% to 1.40%. | .7% |
| ***Net fee estimate*** | **2.035%** | | **1.48%** | | **.57%** | | **1.075%** | |
| ***Average*** | **1.29%** | | | | | | | |

# Lower Fees Benefit Member



# More Favorable Annuity Purchase Through LEOFF Plan 2

Superior annuity: “[A] private insurer will provide the annuity based on an interest rate of about 4 percent, whereas DRS will provide the annuity based on an interest rate of about 8%”.

-- *OSA fiscal note on Board’s 2010 purchase of annuity proposal.*

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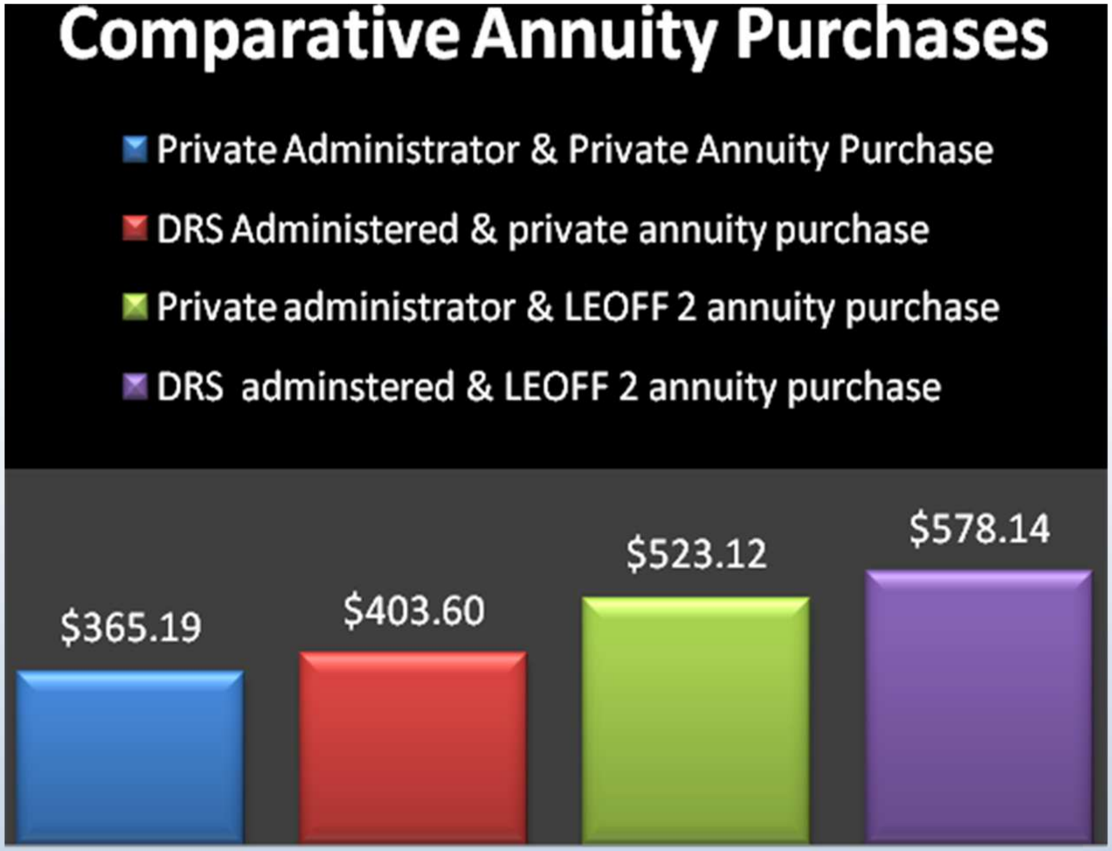
# Different Administrator Different Outcomes

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# Summary

- New IRS ruling allows 401(a) defined benefit plans like LEOFF Plan 2 to annuitize retirement savings within the plan.
- Annuitization within plan can leverage existing infrastructure to member's benefit.
- Providing that benefit to members would require legislation.

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# Next Steps

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

# Any Questions?

- **Contact:**

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# 2013
# AGENDA ITEMS CALENDAR

| MEETING DATE | AGENDA ITEMS |
| --- | --- |
| **January 23, 2013** | Meeting Canceled |
| **February 27, 2013** | Meeting Canceled |
| **March 27, 2013** | Meeting Canceled |
| **April 24, 2013** | Meeting Canceled |
| **May 29, 2013** | Meeting Canceled |
| **June 19, 2013** | 2013 Legislative Session Update<br>Interim Planning<br>Board Operating Policy Changes<br>Board Expectations Check-in<br>WSIPP Study Follow-up<br>Medicare Briefing |
| **July 24, 2013** | DRS Administrative Update, Marcie Frost<br>CEM Benchmarking Results, Mark Feldhausen<br>Background on Economic Experience Study, Lisa Won<br>Orientation Manual<br>Paperless Board Meeting Training |
| **August 28, 2013** | Board & Administrative Committee Elections<br>WSIB Annual Presentation, Theresa Whitmarsh<br>Final Average Salary Protection, Initial Consideration<br>Correction Legislation, Initial Consideration<br>EMT's Not Being Reported in LEOFF Plan 2, Initial Consideration<br>Salary Spiking, Initial Consideration<br>Promoting Individual Saving for Retirement, Initial Consideration<br>Career Change, Initial Consideration<br>Meeting Materials Posted to Website |
| **September 25, 2013** | Board & Administrative Committee Elections<br>WSIPP Study Follow-up<br>Annual Board Member Training, Dawn Cortez |
| **October 16, 2013** | Long Term Economic Assumptions – Office of the State Actuary<br>2014 Proposed Meeting Calendar |
| **November 20, 2013** | Funding Report<br>2014 Meeting Calendar Adoption |
| **December 18, 2013** | |