SB2750

TESTIMONY BY KALBERT K. YOUNG
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE SENATE COMMITTEE ON JUDICIARY AND LABOR
ON
SENATE BILL NO. 2750

February 8, 2012

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Senate Bill No. 2750 proposes to revise the allowability of certain employee compensation for the calculation of retirement pension if the overall compensation in the final years of service are determined to have been enhanced through means of "spiking." The bill provides definitions for determining that spiking has occurred and establishes the threshold limitations for calculating the effect on an employee's final compensation. In preventing spiking of pension benefits, this bill will also address some of the impact on the unfunded actuarial accrued liability of the Employees' Retirement System (ERS) by limiting the amount of compensation included in "average final compensation" and requires employers to pay the additional costs resulting from spiking.

The Department of Budget and Finance strongly supports this Administration bill which will allow the ERS to minimize the effect of spiking. The ERS has an unfunded actuarial accrued liability of $8.164 billion (as of June 30, 2011). The strategy of spiking is not the only contributing factor for the unfunded liability, but there is no doubt that individuals whose retirement pension is bolstered as a result of spiking, have contributed to the overall systems' unfunded liability. Spiking can, and does, occur within all governmental employers in the State and is an inequitable financial advantage to certain ERS beneficiaries that is to the detriment of all other beneficiaries of the ERS.

Senate Bill No. 2750 limits the amount an employee's salary can contribute to determining their annual pension amount, but it also places certain responsibility and accountability on employers whose employees' compensation is spiked in the immediate years prior to retirement. Such spiking action is the most detrimental to the funding liability of the ERS. Employers and employees contribute to the ERS amounts equal to a percentage of compensation. However, when employees' compensations are spiked just prior to retirement, that employees' pension benefit is enhanced beyond a rate of what either the employer or employee have contributed to the ERS. This contributes to the unfunded liability and is inequitable to the detriment of other beneficiaries because it compromises the overall viability of the ERS. The Administration believes that stability in the level of benefits received is an important factor in facilitating the ERS' ability to eventually eliminate its unfunded liability and ensure the long-term viability of the system.

The Department of Budget and Finance encourages the Senate Committee on Judiciary and Labor to support Senate Bill No. 2750.

TESTIMONY BY WESLEY K. MACHIDA
ADMINISTRATOR, EMPLOYEES' RETIREMENT SYSTEM
STATE OF HAWAII
TO THE SENATE COMMITTEE ON JUDICIARY AND LABOR
ON
SENATE BILL NO. 2750

FEBRUARY 8, 2012

RELATING TO THE EMPLOYEES' RETIREMENT SYSTEM

Chair Hee and Members of the Committee,

The provisions of S.B. 2750 address "pension spiking" and represent one way in which public pension funds across the nation have been dealing with their growing pension and unfunded liabilities.

The ERS Board of Trustees strongly supports this bill as it will help to strengthen the integrity and sustainability of the ERS through proper funding, assist in addressing the growing pension liabilities, and eliminate benefit inequities.

The 2011 Legislature took an important step in addressing the growing pension liabilities when it passed the benefit changes for new hires starting after June 30, 2012. Although the changes enacted are significant, they affect the long-term future liabilities of the ERS. The solutions proposed in this bill will address unanticipated increases currently occurring in the ERS Unfunded Liability (reported at $8.164 billion as of June 30, 2011) and help to ensure ERS' future sustainability.

The continued volatility and uncertainty of the investment markets, increasing longevity of ERS members, payroll declines (employer contributions are based on total payroll), and others have a significant impact on the increasing unfunded liability. In FY2011, employee and employer contributions were $715 million and almost $1 billion in benefit payouts were made. This means that approximately $300 million was liquidated from the investment portfolio to pay benefits. So far in FY2012, contributions of $425 million were received and $600 million in benefit payouts were made with $175 million being liquidated to cover the payouts. If these trends continue without significant increases to the investment portfolio, more solutions will be needed to prevent the investment corpus from being depleted.

As a solution, some states have converted from a defined benefit structure to a defined contribution structure. To do so would be detrimental to the ERS members and costly to employers and taxpayers over the next 15 years given the ERS' large unfunded liability. Rather than changing the structure, the restrictions to pension spiking being proposed in this bill is another appropriate step toward ERS' sustainability.

This bill addresses the unexpected increases in benefits of members of the Employees' Retirement System (ERS) and in the unfunded liability of the System by limiting the amount of compensation included in the "average final compensation" of new and current members (delayed by 3 years) and by requiring employers of current members to pay the costs attributable to additional benefits resulting from "pension spiking."

"Pension spiking" is the process whereby public sector employees significantly increase their compensation (through overtime, etc.) in the years immediately preceding retirement in order to receive a larger pension that they otherwise would be entitled to receive.

Public employers and ERS members provide contributions that fund a member's retirement benefits over the member's anticipated employment period, so that there will be sufficient money to pay the member's retirement benefit. For the career government employee, this could entail a span of between 25 or 30 years of service. If an employee's pay suddenly increases substantially in the final years of employment, the employee's retirement benefits (which are based on the employee's three or five highest paid years) can be increased dramatically without the years of contributions required to fund the increase. This, in turn, increases the unfunded actuarial accrued liability of the ERS.

The impact of pension spiking is described and illustrated below. Assume that a member's average final compensation for the first 25-27 years of employment totaled $50,000. Without spiking and with "normal" salary increases, the last three years of pay would compute to an average final compensation of $56,243 and an annual maximum allowance of $33,746. However, if this member's average salary during the last three years increased to $200,000 due to overtime or other non-base pay, the member's pension would be spiked to an annual maximum allowance of $120,000. The additional contributions on the spiked pay received by the ERS would cover less than 2 years of the additional $86,254 in benefits that would need to be paid.

As indicated below, the ERS' unfunded liability based on this one example is increased by $1,134,720.

Description	Service Years	Average Final Compensation (Highest 3 years)	Annual Pension (Maximum Allowance)	**Actuarial Accrued Liability (unfunded liability) at Retirement**
Without Spiking	25 -27; 28 -30	$50,000; $56,243	$33,746	**$443,946**
With Spiking	25 - 27; 28 - 30	$50,000; $200,000	$120,000	**$1,578,666**
Difference		**$143,757**	**$86,254**	**$(1,134,720)**

If this sample case was multiplied several times as noted, for instance, in the December 2011 report by the City Auditor regarding excessive overtime pay of 10 EMS employees, the estimated impact/increase of the ERS' Unfunded Liability would be approximately $4 million (determined by the ERS Actuary - with certain assumptions).

As the ERS is a cost sharing, multi-employer plan, if the employers of ERS members with "spiked" benefits do not pay the additional cost resulting from spiking, the costs would be borne by all employers as part of the increase in the unfunded accrued liability of the Employees' Retirement System.

The ERS Board of Trustees reviewed several options recommended by the ERS Actuary to remedy pension spiking and looked at the impact of overtime and other non-base pay on the unfunded liability. Furthermore, the Board discovered that there were at least 10 systems that excluded or restricted overtime in their pension calculations and there were 15 states that have anti-spiking provisions in their laws (as reported by the National Association of State Retirement Administrators). It was also reported that many of these states implemented a more strict criteria than that included in this bill. After reviewing the recommendations from the ERS Actuary and the pension spiking laws enacted by other states, the ERS Board took a moderate and balanced approach in its recommendation of the pension spiking criteria included in this bill. This criteria is summarized as follows:

- **For employees who become ERS members after June 30, 2012:** Limit the amount of compensation that can be included in the calculation of the member's retirement benefits if the member's non-base pay (such as overtime or bonuses) during the member's "high-five" years exceeds limits based on the average of the member's non-base pay during the last 10 years of the member's service.

- **For existing members:** Limit the amount of compensation that can be included in the calculation of the member's retirement benefits if the member's non-base pay during the member's "high-three" or "high-five" years exceeds limits as noted above; however, this calculation would only be applied to periods after June 30, 2015.

- **For existing members:** Require the member's last employer to pay the additional costs resulting from sudden increases in the member's non-base pay during the member's final years of employment.

Based on a sample group of about 5,000 members who retired from 2008 to 2010, the ERS Actuary calculated that more than 670 (or about 13%) of those retirees would meet the pension spiking criteria in this bill. The resulting impact/increase on the ERS' Unfunded Liability was over $39 million.

The ERS Board of Trustees believes that this proposed legislation is needed to help with the ERS' unfunded liability and to mitigate inequities. The overall goal is to ensure the sustainability of the ERS and the sufficiency of monies to pay promised benefits. Therefore, the ERS Board strongly supports the passage of this bill.

Thank you for the opportunity to testify on this important measure.

DEPARTMENT OF BUDGET & FISCAL SERVICES

CITY AND COUNTY OF HONOLULU

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PETER B. CARLISLE
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DIRECTOR

February 8, 2012

The Honorable Clayton Hee, Chair
and Members of the Committee on
Judiciary and Labor
The Senate
State Capitol
Honolulu, Hawaii 96813

Dear Chair Hee and Members:

Subject: Senate Bill 2750
Relating to the Employee's Retirement System

The City and County of Honolulu supports the intent of Senate Bill 2750 to address the effects of spiking on the unfunded liability of the Employees' Retirement System; however, we have a number of questions on the method being used to determine "spiking" and the resultant impact to the employee and the employer. Accordingly, we suggest a cautious approach to the bill.

We recognize that some extreme situations involving City employees have come to light recently that may have played a part in creating an urgency to address spiking. We want to assure you that to the extent we are able, within the bounds of the collective bargaining agreements we are subject to and without affecting public safety, we are taking steps to address the situation. That being said, this is a complex issue and we have only recently become aware of the approach being endorsed by the ERS Board.

While we value the efforts of the Board, we have not had an opportunity to review in-depth the formula and its effects, nor have we had a chance to question the actuaries regarding the method that will be used to assess the employer. We believe that a thorough review and understanding is essential to ensuring the fair and equitable resolution (from both the employer's and employees' perspectives) that we understand the Board is seeking. Below are just three examples of situations we wish to explore further:

- To what extent are recurring differentials, paid for virtually all hours the employee is at work, resulting in a "spiking" determination—for example, the 25% hazard pay differential paid to solo bike officers?

- To what extent has "spiking" been considered in the setting of the new employer contribution rates—which for police and fire go from 19.7% this year to 25% on July 1, 2015?
- The bill currently requires the last employer of the employee who retired in the previous year to pay the costs associated with that employee's spiking. However, the spiking may have occurred prior to the period during which the employee worked for that last employer. If the bill's intent is to charge the employer for the costs of their employees' spiking, this provision should be revised.

The City is committed to efforts to address the ERS unfunded liability. Last year we fully supported the measure that will increase substantially our employer contributions to the ERS. We have also supported measures to add a county representative to the ERS Board so that we may have input on, and a comprehensive understanding of, measures such as these. At this point, we do not believe we have the understanding necessary to support all the provisions in this measure.

Thank you for the opportunity to testify on Senate Bill 2750.

Yours truly,

Michael R. Hansen

Michael R. Hansen, Director
Department of Budget & Fiscal Services

for Noel T. Ono, Director
Department of Human Resources

POLICE DEPARTMENT
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OUR REFERENCE CO-VYH

February 8, 2012

The Honorable Clayton Hee, Chair
and Members
Committee on Judiciary and Labor
The Senate
State Capitol
Honolulu, Hawaii 96813

Dear Chair Hee and Members:

Subject: Senate Bill No. 2750, Relating to the Employees' Retirement System

I am Cary Okimoto, Captain of the Human Resources Division of the Honolulu Police Department (HPD), City and County of Honolulu.

The HPD strongly opposes the passage of Senate Bill No. 2750. This bill would amend the definition of "compensation" used in calculating retirement benefits and fracture the HPD's staffing and operations.

The passage of this bill will hamper the retention of frontline and secondary supervisors who are eligible to retire. Presently, the HPD has 230 sworn personnel who fall into this category. This number does not reflect the amount of civilian personnel who are also eligible to retire and whose exodus will impact the public and the HPD.

Additionally, the HPD does not have sufficient time and resources to recruit, process, and train journey-level police officers to replace the expected number of vacancies that will occur as a result of this bill. This will definitely impact operations and delivery of services to the community.

Thank you for the opportunity to testify.

APPROVED:

LOUIS M. KEALOHA
Chief of Police

Sincerely,

CARY OKIMOTO, Captain
Human Resources Division

SHOPO

STATE OF HAWAII ORGANIZATION OF POLICE OFFICERS

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February 7, 2012

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The Honorable Clayton Hee
Chairman
Judiciary & Labor Committee
Hawaii State Capitol
415 S. Beretania Street, Room 407
Honolulu, Hawaii 96813

Re: **SB No. 2750**

Dear Chairman Hee:

On behalf of the State of Hawaii Organization of Police Officers ("SHOPO"), I respectfully submit my written testimony in opposition to SB No. 2750.

I currently serve as the President of SHOPO, which is the public union that represents our hard working police officers who serve in all four (4) county jurisdictions.

I have heard SB No. 2750 referred to as the "spiking" bill and understand its stated purpose is to discourage "spiking" by public employees, who engage in the practice of intentionally inflating their high three incomes to increase their retirement benefits.

I can tell you that SHOPO does not in anyway condone the practice of "spiking" and does not support it in any shape or form. However, we do not have sufficient and adequate information regarding the extent of the alleged problem and how, if at all, it involves our brother and sister officers.

What we do know is that in our working arena, paid overtime in the various county police departments is closely monitored and highly scrutinized by management. An officer is not permitted to work overtime in any jurisdiction without the prior approval and consent of an authorized supervisor. This practice and mode of self regulation keeps careful tabs on the amount of overtime being earned by any one officer. There are no doubt instances where an officer will be required to work overtime hours that may result in an increase in his/her overall pay. However, this cannot and does not occur without the full knowledge and consent of a supervisor and management.

Therefore, we believe that any bill that attempts to address the issue of "spiking" should address the issue at its core. In this case, it seems that the problem may perhaps rest with management's ability or lack of ability to adequately supervise its employees to prevent "spiking" from occurring in the first place. "Spiking," as a practice, can only occur with the consent of management personnel. Management controls an employee's earned overtime and having sole control over overtime places the responsibility to avoid "spiking" squarely on management's shoulders.

While we have heard the recent media stories relating to "spiking" that has occurred with the Emergency Medical Services, we would also like to hear how it occurred before we jump to any conclusions in the matter. We are also seeking information on any statistical data that may have been relied upon or used to support the underlying rationale for SB No. 2750. This would give us the opportunity to further evaluate our position and view on this particular bill.

Thank you for the opportunity to submit our written testimony and please rest assured that we will continue to keep an open mind on this very important issue.

Respectfully submitted,

Tenari R. Maafala

TENARI MA'AFALA
SHOPO PRESIDENT