PUBLIC PENSION PLAN FUNDING

The Policies of LEOFF Plan 2

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Governor's Proposed 2009-11 Pension Budget

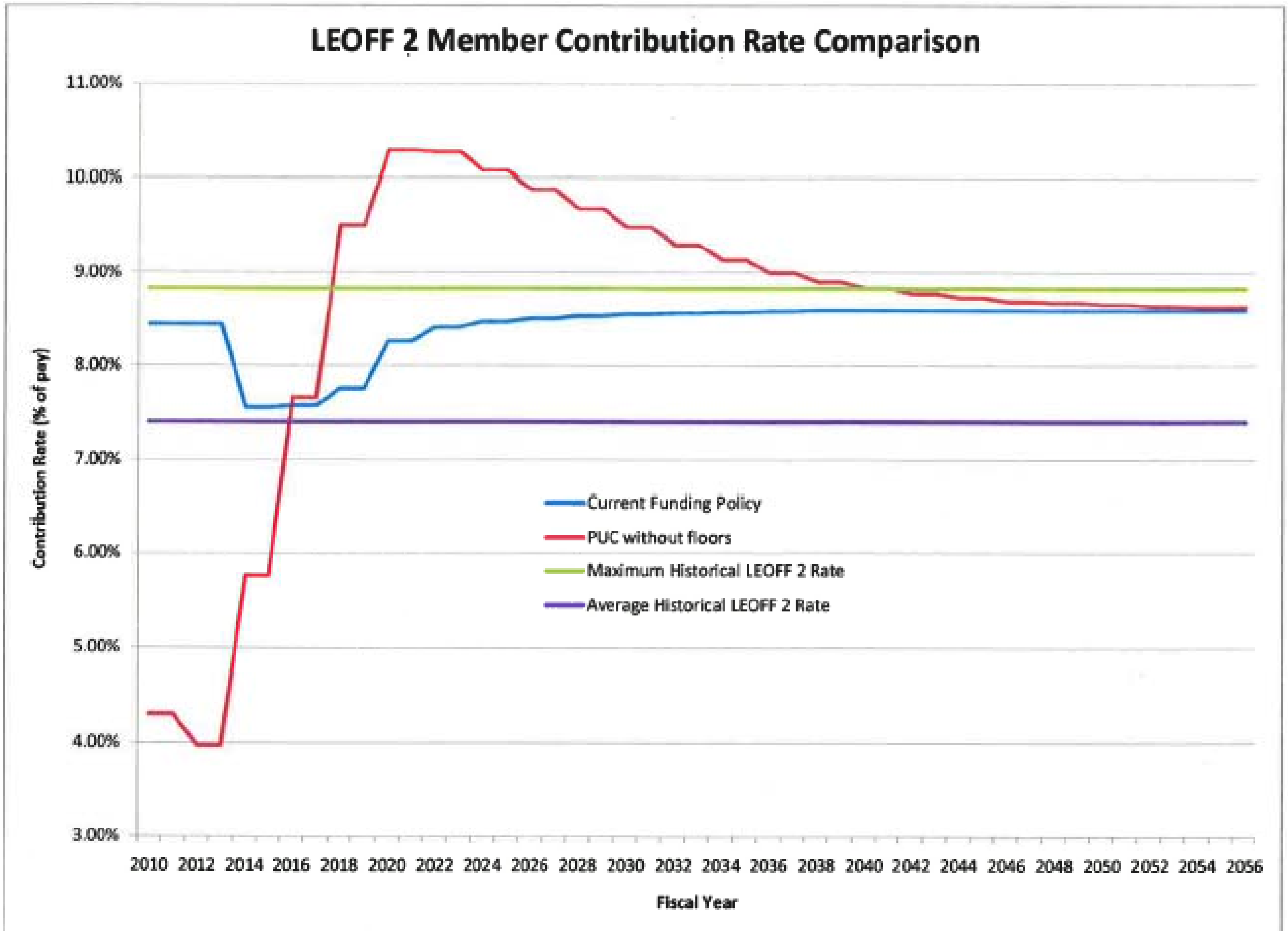
- Proposed budget included several changes that affect all plans, including LEOFF Plan 2
  - Funding Method Change
  - Mortality Assumption Suspension
  - General Salary Assumption Change
  - Minimum Contribution Suspension

FUNDING METHOD

- Change funding method from Aggregate Method to Projected Unit Credit (PUC)

- Member Rate Impact – 2.64% Decrease

PROJECTED CONTRIBUTION RATES



Mortality Assumption

- Suspend projected mortality improvement assumption changes for 2009-11 Biennium
  - LEOFF Plan 2 Retirement Board (L2B) and Pension Funding Council (PFC) adopted mortality improvement assumption changes recommended by State Actuary.

- Member Rate Impact - 0.56% Decrease

General Salary Increase Assumption

- Lower General Salary Increase assumption from 4.5%to 4.0%
  - L2B did not adopt any change to general salary assumption
  - PFC adopted change from 4.5% to 4.25%

- Member Rate Impact – 0.80% Decrease

Minimum Contribution Rate Floors

- Suspend the minimum contribution rate floor for 2009-11 Biennium
  - L2B adopted minimum contribution rate in 2004
  - PFC adopted minimum contribution rate in 2005

- Suspension of rate floor necessary to reach rate in Governor's Proposal
  - Entry Age Normal Cost after changes = 7.95%
  - Rate Floor with changes = 7.20% (90% of EANC)
  - Member rate for Governor's Proposal = 2.95%

Contribution Rate/Fiscal Impact

- Net effect of these changes according to the Office of the State Actuary is as follows:
  - Member rate decreases to 2.95% (a change of -5.5%).
  - Employer rate decreases to 1.77% (a change of -3.3%).
  - State rate decrease to 1.18% (a change of -2.2%).

- Resulting savings total for the biennium from LEOFF Plan 2
  - $68.3 million General Fund State
  - $102.4 million for local government employers.

Questions?

LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS' PLAN 2 RETIREMENT BOARD

PUBLIC PENSION PLAN FUNDING

THE POLICIES OF LEOFF PLAN 2

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This report:

- Provides a comprehensive review of the current policy framework for funding LEOFF Plan 2.
- Presents the point of view of the LEOFF Plan 2 Retirement Board regarding the Board's pension funding policy decisions.
- Describes the potential consequences of pension funding policy changes that are being considered by the Legislature in the 2009 legislative session.
- Provides a historical record of LEOFF Plan 2 funding policies.

PUBLIC PENSION PLAN FUNDING EXECUTIVE SUMMARY

INTRODUCTION

The funding of public pension plans is a complex relationship of several different, and sometimes conflicting, policies including the choice of a funding method, long-term economic assumptions, assumptions regarding member behavior, and budget constraints. This report will describe each of these policy areas, explain the role they play in the overall issue of pension funding and how they relate to each other, document when and why these policies were set the way they are, and examine the potential consequences of future changes. The report will focus on how these topics relate to the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 2 (LEOFF Plan 2).

FUNDING METHODS

The choice of a funding method is a core issue for a pension plan because the funding method determines the way the cost of the plan will be financed over time in much the same way that the choice of a style of mortgage determines the way in which the cost of a house is financed over time. All standard funding methods will accomplish the same goal of completely funding the cost of the plan just like either a fixed-rate mortgage or an adjustable-rate mortgage can be used to pay for a house. This report will examine two of the standard pension funding methods commonly used for funding pension plans across the county; the "Aggregate Funding Method" which is currently used to fund LEOFF Plan 2 and the "Projected Unit Credit Method."

THE AGGREGATE FUNDING METHOD

When LEOFF Plan 2 was created in 1977, the Aggregate Funding Method was chosen by the Legislature as the plan's funding method because it was particularly well suited to accomplish two pension funding policy goals which were considered important at that time; long-term stability in contribution rates and full funding of the plan on an ongoing basis. The Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board adopted the policy goals of contribution rate stability and full funding of LEOFF Plan 2 as part of the Board's Strategic Plan in 2004 and has reaffirmed use of the Aggregate Funding Method to accomplish these goals.

The Aggregate Funding Method promotes long-term stability in contribution rates because it is designed to fund the cost of the plan as a level percentage of pay over a member's working career. The contribution rates paid by the plan members and their employers would theoretically remain unchanged for the member's entire career if the plan's long-term economic assumptions and assumptions regarding member behavior were 100% accurate. To the extent that those assumptions prove inaccurate, any difference between what is expected and what is experienced, such as lower than expected investment returns, is reflected in the plan's cost each time the plan is reviewed and a new long-term rate is calculated. A plan using the Aggregate Funding Method will always be 100% funded if the required contributions are paid; it will never have a surplus or an unfunded liability.

THE PROJECTED UNIT CREDIT FUNDING METHOD

The Projected Unit Credit (PUC) Funding Method is more commonly used as a reporting tool by public pension plans rather than an actual method for calculating contribution rates. In the interest of uniform financial reporting, the Government Accounting Standards Board has required all public plans across the country, including LEOFF Plan 2, to use the PUC Funding Method to report the plan's funding status since 1996 even if a different method is actually being used to fund the plan.

The PUC Funding Method uses a lower cost when a member first enters the workforce and a higher cost as the member approaches retirement. One consequence of this "back-loaded" funding method is that annual pension contributions will have less time to accumulate investment earnings so a greater proportion of the overall cost of the plan will be paid through contributions. Employers with an aging workforce that use PUC as a funding method will see their pension expense rise over time.

CHANGING THE FUNDING METHOD

A plan's funding method is a core element of the plan so a change in the plan's funding method represents a significant change in policy much like a homeowner's decision to refinance a mortgage. The risks and benefits of such a switch, both long-term and short-term, should be carefully considered.

Changing the funding method for LEOFF Plan 2 from the Aggregate Funding Method to the PUC Funding Method would require lower contribution rates over the next 4-6 years but higher contribution rates for the next 35-40 years.

The Legislature has considered the issue of switching from the Aggregate Funding Method to the PUC Funding Method a number of times since 2002 but has decided against switching every time. A similar proposal is currently before the Legislature in the 2009 legislative session.

LONG-TERM ECONOMIC ASSUMPTIONS

There are four long-term economic assumptions that are used to estimate the future cost of LEOFF Plan 2 in order to develop accurate current contribution rates for funding the plan. These economic assumptions currently are:

- Growth in Inflation – 3.5 percent
- Investment Rate of Return – 8 percent
- Growth in Salaries – 4.5 percent
- Growth in System Membership – 1.25 percent

The accuracy of these assumptions is reviewed every two years because of their importance to plan funding. Inaccurate assumptions will result in the need to change contribution rates, up or down, depending on whether the assumptions were too conservative or too aggressive. These economic assumptions were established in statute by the Legislature in 2001. The LEOFF Plan 2 Retirement Board was given the authority to set long-term economic assumptions for LEOFF Plan 2 in 2003 and has reaffirmed the use of these assumptions.

THE GROWTH IN INFLATION ASSUMPTION

This assumption projects how much inflation there will be each year. Generally, projecting higher inflation means you would also expect higher investment returns and higher salary growth as well as greater costs for benefits such as a cost-of-living adjustment for LEOFF Plan 2 retirees that are directly tied to inflation.

THE INVESTMENT RATE OF RETURN ASSUMPTION

This assumption projects how much the assets invested in the LEOFF Plan 2 Retirement Fund will earn each year and is often referred to as the "earnings assumption." Investment returns that are greater than the assumed rate of return will drive contribution rates down and investment returns that are less than the assumed rate of return will drive contribution rates up. Changes to this assumption have the greatest impact on contributions rates.

THE GROWTH IN SALARIES ASSUMPTION

This assumption projects how much the average salary of LEOFF Plan 2 members will increase each year. This measurement is used for "across the board" pay increases so it excludes some of the scheduled pay increases that may take place early in a person's career. Projecting future salaries is important because a member's salary is one of the key pieces of information that will be used to calculate that member's retirement benefit. Salary growth that is greater than expected will drive contribution rates up and salary growth that is less than expected will drive contribution rates down.

THE GROWTH IN SYSTEM MEMBERSHIP ASSUMPTION

This assumption projects how much the membership of LEOFF Plan 2 will increase each year. There were 16,099 actively employed LEOFF 2 members as of June 2007. Increasing the number of plan members means that more members are contributing to the plan but it also means that more members are earning benefits. Changes to this assumption have the least impact on contribution rates.

CHANGING LONG-TERM ECONOMIC ASSUMPTIONS

Each of the long-term economic assumptions affects the others. This is particularly true of the inflation assumption which is a core piece of both the earnings assumption and the salary growth assumption. For that reason, changes to these assumptions should be evaluated for reasonableness or accuracy together as a group and not as separate individual assumptions.

Lowering the Salary Growth Assumption - The most recent proposed change to any of the long-term economic assumptions was a recommendation by the State Actuary in 2008 to lower the salary growth assumption from 4.5% to 4.25%. The Governor's proposed 2009-11 biennial operating budget for the State included a provision lowering the salary growth assumption to 4.0%.

The LEOFF Plan 2 Board reaffirmed using the current 4.5% assumption for LEOFF Plan 2 in 2008 so that the effect of changing this assumption could be evaluated along with all the long-term economic assumptions in 2009.

DEMOGRAPHIC ASSUMPTIONS

Member behavior also plays a crucial role in determining the cost of a pension plan. So in order to estimate the future cost of the plan and determine the appropriate current contribution rates to fund the plan, assumptions are required for things like how long a member will live, when a member will choose to retire, and the likelihood that a member will become disabled during their career. These assumptions are referred to as "demographic assumptions." The accuracy of these assumptions is reviewed every six years in an experience study which compares the expected behavior of the pension plan's population to what was actually experienced.

LIFE EXPECTANCY ASSUMPTIONS

How long a person lives is probably the most important factor in determining the ultimate cost of their pension. The longer a person lives after retirement, the more costly their pension will be. LEOFF Plan 2 uses a combination of national studies, actual experience in Washington State and projected improvements in future life expectancy to develop these assumptions. Studies show that LEOFF Plan 2 members are more likely to be killed during their career than the average worker and are more likely to develop certain types of cancer as a result of their employment. However, a LEOFF Plan 2 member who is healthy when they retire is generally expected to live as long as other retirees from other professions.

RETIREMENT ASSUMPTIONS

When a person retires is an important factor in estimating the cost of their pension because they switch from making contributions to the plan to receiving benefits from the plan. Generally, the earlier a person retires, the more costly their pension will be. LEOFF Plan 2 allows a member to receive a reduced retirement as early as age 50 in some cases and allows for an unreduced benefit when a member reaches age 53. However, the experience in the plan so far has been that most members work beyond age 53 before retiring.

DISABILITY ASSUMPTIONS

LEOFF Plan 2 provides a number of benefits to a member who is temporarily or permanently disabled because of a work-related injury or illness so correctly estimating the number of members who will receive these benefits is important to estimating the cost of the plan. Studies show that LEOFF Plan 2 members are more likely to suffer a work-related injury or illness than the average worker.

FUNDING POLICIES

Pension plans commonly have other goals related to plan funding in addition to the primary goal of ultimately providing the necessary funding to pay the full costs of the plan. These goals may influence the choice of a funding method and they may also lead pension plans to adopt funding polices which modify the plan's funding method to support those other goals.

Two such goals for LEOFF Plan 2 are stable short-term contribution rates and full funding on an ongoing basis.

STABLE CONTRIBUTION RATES

Stable contribution rates result in more predictable budget obligations for plan members, local government employers and the State which helps them prepare to meet their future funding obligations. The LEOFF Plan 2 Retirement Board has adopted contribution rate stability as one of the key elements of the Board's strategic plan for LEOFF Plan 2.

There are a number of policies which have been adopted by the LEOFF Plan 2 Retirement Board in order to moderate short-term swings in contribution rates.

1. Smoothing investment gains or losses over a period of time
2. Asset value corridor
3. Minimum contribution rates
4. Multi-year rate plans

SMOOTHING INVESTMENT RETURNS

The current assumption is that assets invested in the LEOFF Plan 2 Retirement Fund will earn 8% per year over the long-term. However, on a year-by-year basis, the investment return is almost certain to be higher or lower than 8% which results in a "gain" or "loss" when compared to the 8% earnings expectation. Public pension funds commonly "smooth" or phase in the recognition of these annual investment gains or losses over a period of time in order to soften the effect of short-term financial market volatility on contribution rates because averaging investment returns over a period of time will result in greater contribution rate stability over that same period of time. The current smoothing method for LEOFF Plan 2 recognizes investment gains or losses over a period of as much as eight years.

ASSET VALUE CORRIDOR

Smoothing investment returns results in a variance between the true market value of the assets in a retirement fund and the assumed value which is used to determine the contribution rates for the plan. An asset value corridor ensures that the variance stays within a set amount which increases contribution rate stability during periods of unusual investment gains or losses. LEOFF Plan 2 uses a 30% market value corridor which means that the actual market value of assets may not drop below 70% of the assumed value of assets or rise above 130% of the assumed value of assets.

MINIMUM CONTRIBUTION RATES

Minimum contribution rates are often referred to as a "rate floor" and are used to ensure that short-term contribution rates do not drop below the expected long-term cost of the plan by more than a set amount. A rate floor is particularly useful for stabilizing contribution rates during periods of better than expected investment returns and when there are short-term variances in plan funding levels resulting from changes to assumptions or the plan funding method. The LEOFF Plan 2 Retirement Board adopted 90% of the expected long term cost of the plan as the contribution rate floor for LEOFF Plan 2.

MULTI-YEAR RATE PLANS

Adopting a multi-year contribution rate plan is another useful method for improving the short-term predictability of contribution rates. The contribution rate may vary during the period of the plan or remain level depending on plan funding needs. The LEOFF Plan 2 Retirement Board adopted a four-year schedule for contribution rates in 2008 which set rates for the entire period exactly equal to the expected long-term cost of the plan.

FULL FUNDING ON AN ONGOING BASIS

In addition to short-term contribution rate stability, the Legislature adopted a goal of long-term contribution rate stability when LEOFF Plan 2 was first created. The term used to describe this goal in statute is "intergenerational equity" or the concept that each generation of members, employers and taxpayers pays for the benefits that they receive. Costs for current member benefits are not passed on to future generations.

There are two common causes of long-term contribution rate volatility; underfunding and benefit improvements. The Aggregate Funding Method used in LEOFF Plan 2 supports the goal of long-term contribution rate stability because this funding method eliminates the risk of plan underfunding (or overfunding).

Benefit improvements also increase the cost of the plan. Benefit improvements that apply to retired members or to past service credit for current members may raise a concern that the current generation of members is paying for past benefits so this issue has been considered carefully by the LEOFF Plan 2 Board any time that the Board has recommended a benefit improvement to the Legislature.

CONCLUSION

The current framework for funding LEOFF Plan 2 is a result of several decisions such as choosing the aggregate funding method, adopting long-term economic assumptions, setting member behavior assumptions, and modifying the funding method to provide contribution rate stability. Each of these policy areas plays an important role in plan funding and every current policy used in LEOFF Plan 2 has been carefully considered by the LEOFF Plan 2 Board as to how that policy supports the Board's strategic goals to fully fund the plan and keep contribution rates stable.