



Salary Growth Assumption Final Proposal

LEOFF Plan 2 Retirement Board

July 23, 2008

Issue Description

- Office of the State Actuary is recommending 0.25% reduction in the salary growth assumption.

Background Summary

- Board required to adopt assumptions
- Recommended reduction in general salary assumption based on experience study
- Economic assumptions in statute
- Scheduled review in 2009

Assumptions

- Used for calculating long-term funding and costs
- Best projection of future plan experience
- Two general categories
 - Economic
 - Demographic

Economic Assumptions

- Four long-term economic assumptions in statute
 1. Growth in Inflation – 3.5 percent
 2. Investment Rate of Return – 8 percent
 3. Growth in System Membership – 1.25 percent
 4. Growth in Salaries – 4.5 percent

General Salary Growth Assumption

- Two components form assumption
 1. Inflation component – 3.5%
 2. Non-inflation component – 1.0%



Key Issues

- Coordination with Pension Funding Council
- Scheduled review of economic assumptions
- Separation of non-inflation component of salary growth from the economic assumption
- Contribution rate reduction

Option 1: Adopt Recommendation

- Adopt recommended 0.25% general salary assumption reduction in 2008
- Reduction in total contribution rate of 0.42%
 - 0.21% Member
 - 0.13% Employer
 - 0.08% State

Option 2: Not Adopt Recommendation

- Do not adopt recommended 0.25% general salary assumption reduction in 2008
- Opportunity for future review

Salary Growth Assumption

Questions?

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

Salary Growth Assumption Final Report

July 23, 2008

1. Issue

The Office of the State Actuary is recommending a reduction of 0.25% in the salary growth assumption.

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3. Members Impacted

As of September 30, 2006 there were 15,718 active members and 779 retirees as reported in The Office of the State Actuary's *2006 LEOFF Plan 2 Actuarial Valuation Report*. A change to the salary growth assumption would affect contribution rates and impact all LEOFF Plan 2 members, as well as all LEOFF Plan 2 employers and the State.

4. Current Situation

The powers and duties of the Washington State Law Enforcement Officers' and Fire Fighters' (LEOFF) Plan 2 Retirement Board include the requirement that the Board adopt actuarial tables, assumptions and cost methodologies in consultation with an enrolled actuary retained by the Board [RCW 41.26.720].

The results of the 2001-2006 Actuarial Experience Study are now being presented to the Board. The State Actuary will recommend new actuarial tables, assumptions and cost methodologies to the Board as a result of the Experience Study. The recommendations from the State Actuary will include a reduction in the general salary growth assumption.

The general salary growth assumption is one of four economic assumptions and is currently set in statute at 4.50%. The Office of the State Actuary is recommending a 0.25% reduction in the general salary growth assumption to make it 4.25%.

The long-term economic assumptions for all Washington State systems and plans are scheduled for review during the 2009 Interim.

5. Background Information and Policy Issues

Introduction to Assumptions

In order for an actuary to calculate the long-term funding costs of a retirement system, certain assumptions need to be made. These assumptions represent the actuary's best projection of future plan experience. Generally, assumptions fall into two categories, economic assumptions and demographic assumptions.

Economic assumptions have significant financial influence on the plan. The economic assumptions that have the most significant impact on the statement of plan liabilities used by most actuaries include the rate of inflation (inflation assumption), the rate of interest earnings on investments (the interest assumption), the rate of anticipated salary increases for plan members (the general salary assumption), and the anticipated increase in the size of the covered payroll of the plan (the membership growth assumption)¹.

Demographic assumptions tend to be more specific to the plan being evaluated, and are dependent on such factors as the age and life expectancy of plan members. Examples of demographic assumptions include withdrawal rates for covered employees, mortality rates, retirement rates, disability rates, etc.

The accuracy of any actuarial projection depends largely on how closely actual experience matches the assumptions made in the projection over the long term. Because many of the assumptions are related to each other, actuarial assumptions should not be considered independently of one another and should be reasonable when considered as a whole.

Economic Assumptions

There are four long term economic assumptions used by the State Actuary for the evaluation and calculation of the experience and financial conditions of the Washington State retirement systems. The economic assumptions prescribed in statute² are:

- Growth in Inflation – 3.5 percent
- Investment Rate of Return – 8 percent
- Growth in System Membership – 1.25 percent
- Growth in Salaries³ – 4.5 percent

The Pension Funding Council (PFC) reviews the long-term economic assumptions and may adopt changes based on experience and financial information presented to the council regarding the condition of each state retirement system. Any changes adopted by the PFC are subject to revision by the Legislature.

¹ The membership growth assumption does not have an impact on funding in LEOFF Plan 2 as it is primarily used for calculating contributions necessary to pay for UAAL. LEOFF does not have a UAAL.

² RCW 41.45.035; Economic assumptions first set in statute by the 2001 Legislature.

³ “exclusive of merit or longevity increases” – RCW 41.45.035(1)(b)

The LEOFF Plan 2 Retirement Board has the duty and statutory authority⁴ to adopt the assumptions for LEOFF Plan 2. The PFC has no applicability or authority over the assumptions relating to LEOFF Plan 2⁵. Any changes adopted by the LEOFF Plan 2 Retirement Board may be subject to revision by the Legislature.

General Salary Growth Assumption

The “growth in salaries assumption” is also commonly referred to as the “general salary growth assumption”. The general salary growth assumption is currently 4.5%. Based on the 2008 Experience Study results, the State Actuary is recommending a 0.25% reduction in the general salary growth assumption, to make it 4.25%.

Components of General Salary Growth

As an employee progresses through his or her career, increases in pay are expected to come from various sources. Two of these sources are the components that form the general salary growth assumption. These two sources are: (1) the inflation component, and (2) the non-inflation component. Both of these components are described below:

1. Inflation Component – This component is the inflation assumption and as used in the general salary assumption reflects the expected basic general salary increase for employees. The current inflation assumption prescribed in statute is 3.50%. The inflation assumption is long term in nature and is usually set using historical economic information blended with projected future experience using actuarial judgment.

In the *2006 Public Fund Survey* published by the National Association of State Retirement Administrators, the median inflation assumption used by 109 large public retirement funds in their 2005 valuations remained unchanged from the 3.50% used in their 2004 valuations.

2. Non-Inflation Component – This component can be difficult to define and is often assigned various labels or terms which can be confusing. Thus, it should be clear what this component does not include. First, this component does not include inflation, since that is already accounted for in the inflation component as described above. Secondly, it does not include, as labeled in the statute⁶, “merit or longevity increases”.

What this component can be described as representing is increases from non-inflation sources, which are sometimes termed “productivity increases” or “real average pay increases” since they are considered to be derived from the ability of an organization or an economy to produce goods and services in a more efficient manner. As that occurs, at least some portion of the value of these improvements can provide a source for pay

⁴ RCW 41.26.720

⁵ RCW 41.26.730

⁶ RCW 41.45.035(1)(b) The growth in salaries assumption, exclusive of merit or longevity increases, shall be 4.5 percent {emphasis added}

increases which are typically assumed to extend to all employees “across the board.” The State and Local Government Workers Employment Cost Index produced by the Department of Labor provides evidence that “real average pay increases” have averaged about 0.7% - 1.0% annually during the last 10 - 20 years.

Policy Issues

The Office of the State Actuary is recommending a change in the general salary assumption. Although the LEOFF Plan 2 Board has the authority to adopt such a change for LEOFF Plan 2, the other state plans must abide by the assumption as set in statute. This raises several questions.

Should the Board coordinate such a change with the Pension Funding Council which makes the recommendation for the other state pension plans? A statutory change in the 2009 Legislative Session would be required for the other plans to enact this assumption change, should it be desired. If the Board adopted the change and it was not adopted for the other plans, where would the economic assumptions be published for LEOFF Plan 2?

The long-term economic assumptions are statutorily scheduled for review every two years. The next review of the long-term economic assumptions will occur in 2009 and any recommended changes could be adopted by the 2010 Legislature. Adopting an economic assumption in 2008 with the experience study would be off the current review cycle. Additionally, there is a question if the non-inflation component of the general salary assumption is truly an economically driven variable, rather than a demographically driven variable derived from the composition of the membership. If this component is demographic in nature, then it may be appropriate to adopt with the experience study.

6. Policy Options

Option 1: Adopt recommended 0.25% General Salary Assumption reduction in 2008

If the assumption change is adopted, the total contribution rate impact would be a reduction of 0.42% (0.21% member, 0.13% employer, 0.08% state)⁷.

Option 2: Do not adopt the recommended 0.25% General Salary Assumption reduction in 2008

⁷ Calculated from Smith, Matthew M. Memo to Steve Nelsen, Executive Director Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board, Olympia, WA. 21 July 2008. Attachment D 2009-11 Rates, minus Attachment C 2009-11 Rates.