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

Contribution Rate Stability

Preliminary Report

September 22, 2004

1. Issue

The existing pension funding policies for LEOFF Plan 2 allow for the possibility of biennial contribution rates for members, employers and the State that deviate very significantly from the expected long-term costs.

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3. Members Impacted

A change to the existing LEOFF Plan 2 funding policies would impact all LEOFF Plan 2 members and employers. As of the most recent actuarial valuation there are approximately 14,560 active LEOFF Plan 2 members and 484 employers.

4. Current Situation

The required contribution rates for LEOFF Plan 2 members, employers and the State have recently experienced historic lows that were about 40% below the expected long-term cost of the plan. Contribution rates are projected to rise significantly over the next two bienniums as they return to the levels that were in place prior to 1999. Sharp short-term changes in pension contribution rates such as those experienced in LEOFF Plan 2 since 1999 can complicate the development of employer budgets.

The primary reasons for the recent contribution rate decreases and increases were higher than expected investment performance for much of the late 1990s followed by significantly lower than expected investment performance and a number of legislative changes to pension funding policies.

5. Background Information and Policy Issues

The LEOFF Plan 2 Board identified the topic of contribution rate stability as one of its top four priorities during the June 22, 2004 strategic planning session.

The 2003-05 biennial contribution rates for LEOFF Plan 2 were adopted by the Pension Funding Council in September 2002. The LEOFF Plan 2 Retirement Board will adopt the 2005-07 biennial contribution rates for LEOFF Plan 2 in September 2004.

The funding policies which determine the required contribution rates for LEOFF Plan 2 are found in statute in chapter 41.45 of the Revised Code of Washington. Two of the general funding policy goals that apply to LEOFF Plan 2 and which the funding policies are intended to achieve are:

- To dependably, systematically and fully fund Plan 2; and,
- To establish predictable long-term employer contribution rates that will remain a relatively constant proportion of future budgets.

The Aggregate Funding Method

The aggregate actuarial cost method was statutorily designated to satisfy the goal of fully funding LEOFF Plan 2. By definition, the aggregate cost method does not allow for an unfunded actuarial accrued liability (UAAL) to develop. The aggregate normal cost is determined as the level percentage of projected payroll that will fund the difference between the present value of projected benefits and the actuarial value of assets at the valuation date. As a result, any difference between the assets and the projected liability, due to short-term gains or losses, assumption changes or benefit enhancements, is automatically reflected in the annual cost of the plan and not amortized as a separate component of plan cost. In absence of an effective asset smoothing method, the aggregate cost method can produce volatile contribution rates under certain investment market cycles.

Long-Term Economic Assumptions

Certain long-term economic assumptions are also designated in RCW 41.45.035 which have an effect on pension contribution rates.

- The investment rate of return assumption is 8%;
- The growth in inflation assumption is 3.5%;
- The growth in salaries assumption, exclusive of merit or longevity increases, is 4.5%; and,
- The growth in membership assumption for LEOFF is 1.25%.

The investment return assumption was increased from 7.5% to 8% and the inflation assumption was increased from 3% to 3.5% by the Legislature in 2001. These changes had the effect of decreasing the required contribution rates.

Asset Smoothing Method
The asset smoothing method is another statutory pension funding policy found in Chapter 41.45. The purpose of a smoothing technique is to reduce the effect of annual investment performance. The current method was adopted by the legislature in 2003 and smoothes asset gains and losses over a period of up to 8 years depending on the magnitude of the deviation between the actual investment return and the 8% assumption. The Legislature had made a previous adjustment to the smoothing method in 2001. Both of these changes had the effect of decreasing the required contribution rates at the time that they were made. The LEOFF Plan 2 Retirement Board recommended adding a "market value corridor" as a safeguard to the smoothing method in order to ensure that the variance between the smoothed actuarial value of assets and the market value of the plan's assets does not become inappropriately large. This modification was adopted by the Legislature in 2004. This new pension funding policy establishes a 30% corridor for the maximum allowable deviation of the actuarial value of assets from the market value.

Actuarial Experience Studies
The State Actuary is required to submit an experience study every four years regarding demographic assumptions such as mortality, disability, salary growth and retirement experience which have an effect on the calculation of the actuarial liabilities for LEOFF Plan 2. The results of these experience studies are incorporated into future actuarial valuations. The results of the 1995-2000 Actuarial Experience Study were the basis for contribution rate reductions by the Legislature in 2002.

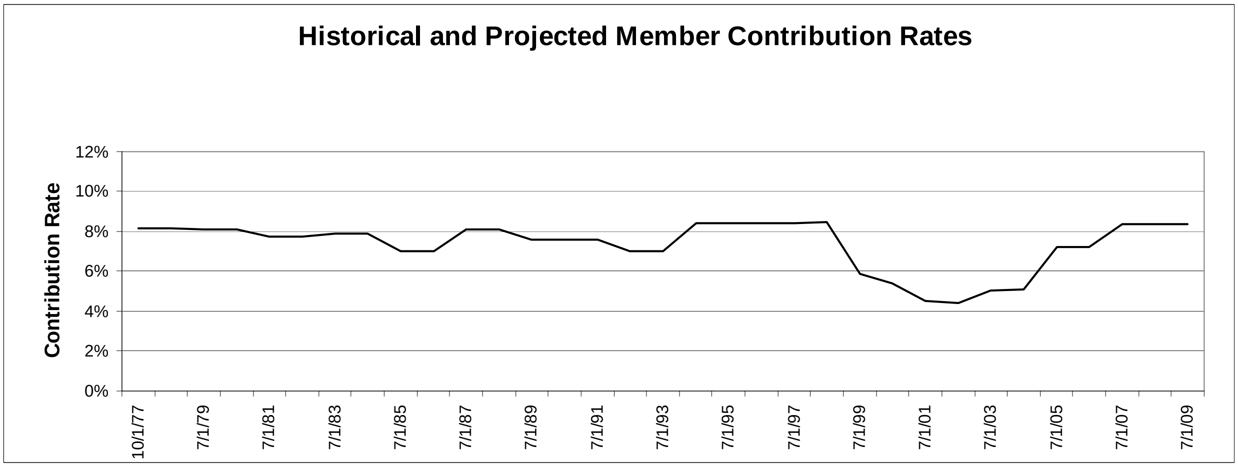
Biennial Rates
Base contribution rates for LEOFF Plan 2 were established on an ad-hoc basis prior to 1989 but generally were only changed every two years unless there was a benefit increase. A six-year contribution rate cycle was established as part of the Pension Funding Reform Act in 1989 but was amended four years later when the current biennial method was established by the Legislature in 1993. The Office of the State Actuary performs an actuarial valuation every year but statute provides that only the even-year valuations are used to set rates. However, the results of the 2001 valuation were the basis for contribution rate reductions by the Legislature in 2002. Although the State budget is adopted on a biennial basis, many local government LEOFF employers adopt budgets on an annual basis.

Supplemental Rates
The biennial base contribution rate is based on the level of benefits in place at the time the underlying actuarial valuation is performed. A supplemental contribution rate is calculated and charged whenever there is an increase to benefits as provided in RCW 41.45.070. Supplemental contribution rates for LEOFF Plan 2 are adopted by the LEOFF Plan 2 Retirement Board.

6. Supporting Information

A table of historical LEOFF Plan 2 contribution rates for member, employers and the state is included in Appendix 1. Chart One below illustrates the history of the member contribution rate and illustrates the magnitude of recent reductions as well as projected increases for the next two bienniums. The employer and State contribution rates would show a similar pattern.

Chart One



7. Options for Short-Term Rate Smoothing

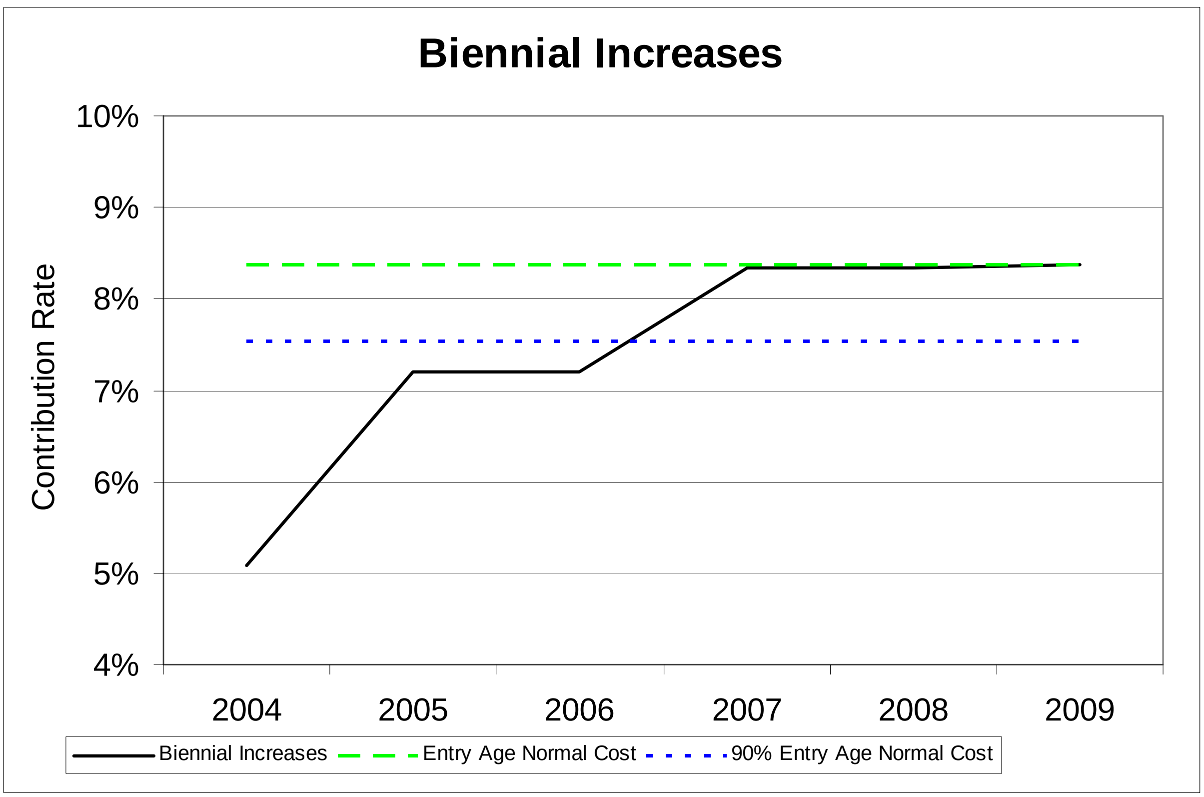
Current Funding Method and Policies
The current statutory funding methods for LEOFF Plan 2 result in projected contribution rate increase over the next four years as follows:

	Member	Employer	State
July 1, 2005	7.20%	4.32%	2.88%
July 1, 2006	7.20%	4.32%	2.88%
July 1, 2007*	8.34%	5.00%	3.34%
July 1, 2008*	8.34%	5.00%	3.34%

*The rates for 2007 and 2008 are projections and are subject to change

Chart Two below illustrates the effect of these increases on the member contribution rate when compared to the entry age normal cost of 8.37% which measures the expected long-term cost of the plan based on current benefits.

Chart Two

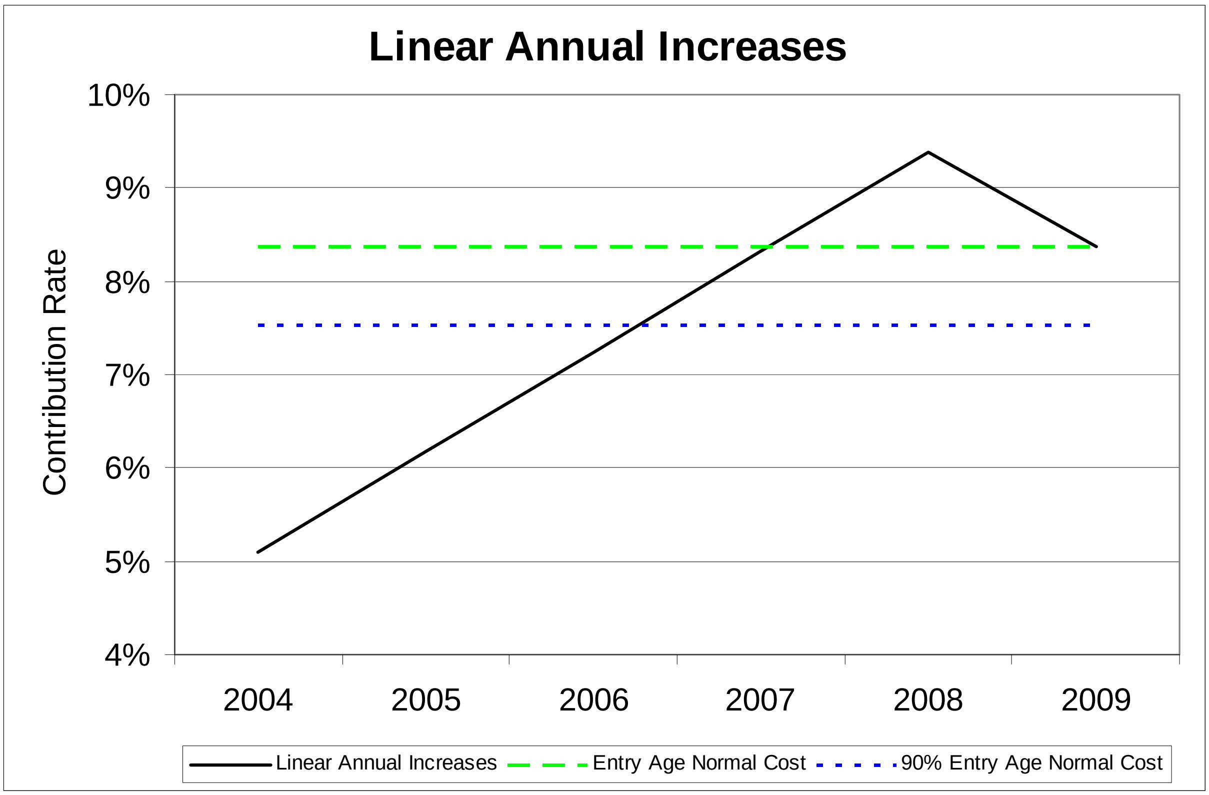


Equivalent Annual Increases:
One option that has been discussed as a means of phasing in the projected contribution rate increases would be to establish annual contribution rate increases of equal amounts over the next four years. This method would result in a higher cost at the end because the rates charged in the 2004-05 fiscal year would be lower than the rates necessary to fund the system as determined by the State Actuary in the 2003 Actuarial Valuation. The rates that would result from this method are as follows:

	Member	Employer	State
July 1, 2005	6.17%	3.69%	2.47%
July 1, 2006	7.24%	4.34%	2.90%
July 1, 2007	8.32%	4.98%	3.33%
July 1, 2008	9.39%	5.63%	3.75%

Chart Three below illustrates the effect of these increases on the member contribution rate when compared to the entry age normal cost of 8.37% which measures the expected long-term cost of the plan based on current benefits. One consequence of this option would be that the rates for fiscal year 2008-09 are projected to be significantly higher than the entry age normal cost.

Chart Three



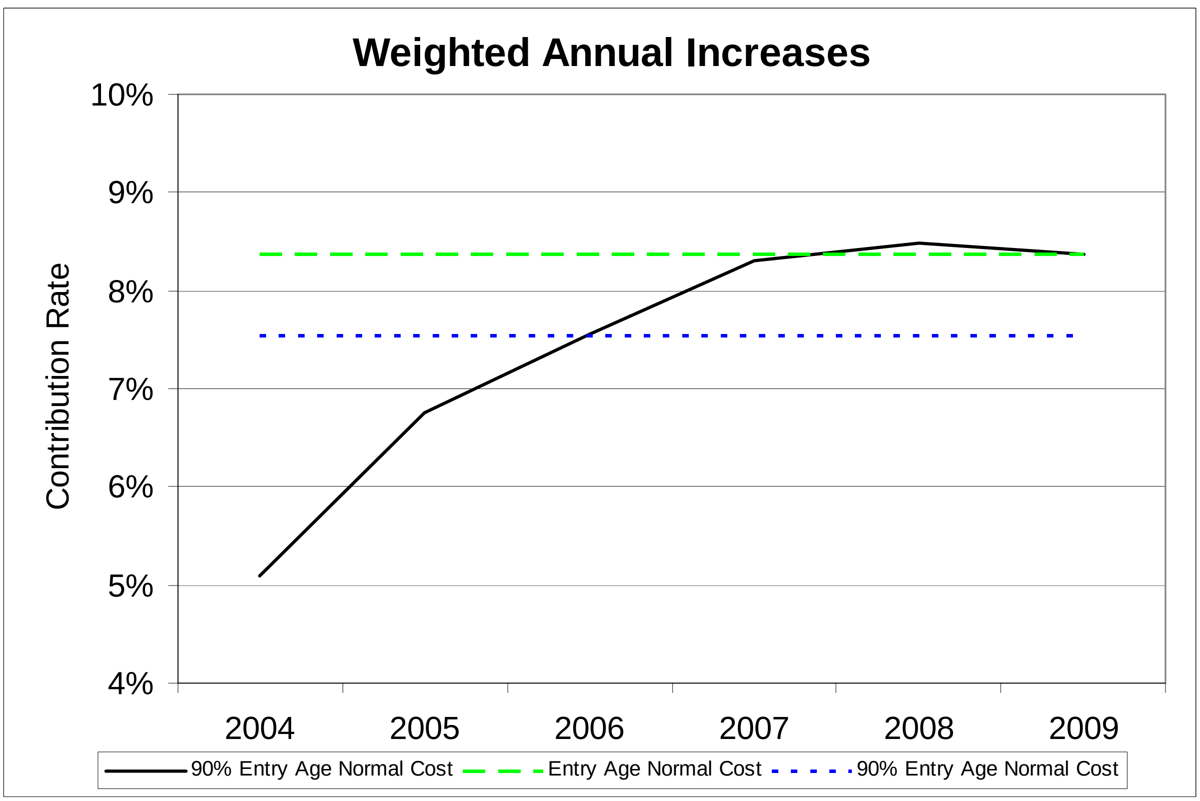
Weighted Annual Increases

The "overshoot" effect that results from equivalent annual increases could be softened if contribution rate increases for the next four years were weighted so that the increases would result in a projected rate for 2008-09 that is equivalent to the expected long-term cost of the plan. The rates that would result from this method are as follows:

	Member	Employer	State
July 1, 2005	6.75%	4.05%	2.70%
July 1, 2006	7.55%	4.53%	3.02%
July 1, 2007	8.30%	4.98%	3.32%
July 1, 2008	8.49%	5.09%	3.39%

Chart Four below illustrates the effect of these increases on the member contribution rate when compared to the entry age normal cost of 8.37% which measures the expected long-term cost of the plan based on current benefits.

Chart Four



8. Options for Ongoing Rate Stability

Ongoing Contribution Rate Stability

The options for smoothing projected contribution rate increases over the next four years that were outlined above in pages 5-7 do not address the issue of long-term rate stability. The current asset-smoothing technique should provide additional contribution rate stability in the future. However, the aggregate cost method could still produce volatile contribution rates under certain investment market cycles in the future.

Minimum Contribution Rates

One option for providing long-term contribution rate stability would be to set minimum contribution rates for LEOFF Plan 2. The State Actuary recommended a minimum contribution rate of 90% of the entry age normal cost as a means of improving long-term contribution rate stability in a July report to the LEOFF Plan 2 Retirement Board.

Corridor Funding

Another option for achieving long-term contribution rate stability would be to establish a "corridor" for rates based on either the expected long-term cost of the plan or the funded ratio of the plan. A long-term cost corridor approach would establish both a minimum and maximum rate subject to some guarantee of adequate plan funding such as the 30% market value corridor currently in place for LEOFF Plan 2. A funded ratio corridor approach would mean that rates would remain unchanged unless the plan's funding ratio fell outside a specified range. For example, in the Maryland State Retirement System the current employer contribution rate remains fixed provided that the ratio of the plan's assets to the actuarial accrued liability remains between 90% and 110%.

Statutorily Fixed Contribution Rates

One option for stabilizing employer contribution rates would be to fix them in statute. Both member and employer rates in LEOFF Plan 1 were historically fixed at 6.00%. This approach shifts all the risk of adverse experience to the State and would mark a significant departure from the cost-sharing policy established for LEOFF Plan 2 in 1977.

Appendix One

Contribution Rate History for LEOFF Plan 2

Effective Date	Member	Employer	State
10/1/77	8.14%	4.88%	3.26%
7/1/79	8.08%	4.85%	3.23%
7/1/81	7.74%	4.65%	3.09%
7/1/83	7.90%	4.74%	3.16%
7/1/85	7.00%	4.70%	3.13%
7/1/87	8.09%	4.85%	3.24%
7/1/89	7.60%	4.56%	3.04%
1/1/92	7.01%	4.21%	2.80%
9/1/93	8.41%	5.05%	3.36%
9/1/96	8.43%	5.06%	3.37%
9/1/97	8.48%	5.09%	3.39%
7/1/99	5.87%	3.52%	2.35%
5/1/00	5.41%	3.25%	2.16%
9/1/00	6.78%	4.07%	2.71%
7/1/01	4.50%	2.70%	1.80%
4/1/02	4.39%	2.64%	1.75%
7/1/03	5.05%	3.03%	2.02%
2/1/04	5.07%	3.04%	2.03%
9/1/04	5.09%	3.06%	2.03%

The employer rates shown above do not include the Department of Retirement Systems administrative expense charge which has ranged from 0.09% to 0.25% and is currently 0.19%.