Final Average Salary Preliminary Follow-up Report

LEOFF Plan 2 Retirement Board

October 22, 2008

Issue

- Shortening the final average salary (FAS) period from sixty-months would increase retirement benefits and increase plan costs

Final Average Salary

- Generally, the shorter the time period, the higher the calculation. This is especially true as wages rise over time.

Example: 25 Years of Service

	FAS 5 Year	FAS 3 Year	FAS 2 Year
2006	$74,500	$74,500	$74,500
2005	$72,000	$72,000	$72,000
2004	$69,100	$69,100	
2003	$66,400		
2002	$64,300		
Average	$69,260	$71,867	$73,250

	2% x FAS x YOS	Monthly
Benefit w/5-year FAS	2% x $69,260 x 25 = $34,630	$2,885.83
Benefit w/3-year FAS	2% x $71,867 x 25 = $35,934	$2,994.50
Benefit w/2-year FAS	2% x $73,250 x 25 = $36,625	$3,052.08

Policy Issues

- Consistency with other plans
- Pension Ballooning
- Intergenerational Equity

Options

- 24-Month FAS Include All Service Credit
- 24-Month FAS Prospective Service Credit
- 36-Month FAS Include All Service Credit
- 36-Month FAS Prospective Service Credit

Costs

Costs from the Office of the State Actuary

Option	Member Rate	Employer Rate	State Rate
24-month All Service	2.98%	1.79%	1.19%
24-month Prospective Service	1.42%	0.85%	0.57%
36-month All Service	1.92%	1.15%	0.77%
36-month Prospective Service	0.93%	0.56%	0.37%

24-Month Final Average Salary

Questions?

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

Final Average Salary

Preliminary Follow-up Report

October 22, 2008

1. Issue

Shortening the final average salary (FAS) period from sixty to twenty-four months would increase retirement benefits and increase plan costs.

2. Staff

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3. Members Impacted

As of June 30, 2007 there were 16,099 active members and 924 retirees as reported in the Office of the State Actuary's *2007 Actuarial Valuation Report*. Changing the FAS could impact all LEOFF Plan 2 members.

4. Current Situation

A member's current benefit is calculated using the following formula:

2% x Years of Service x Final Average Salary

Final average salary is defined as the monthly average of the member's basic salary for the highest consecutive sixty service credit months of service, prior to such member's retirement, termination, or death. Periods constituting authorized unpaid leaves of absence may not be used in the calculation of final average salary.

5. Background Information and Policy Issues

Benefit Formula

A defined benefit plan is a retirement income plan that provides specific benefits that are defined as soon as the member joins the plan. Typically, the formula equals a specified percentage, multiplied by years of creditable service, multiplied against a defined salary. Usually, the member must reach a certain age as well, to be eligible to retire.

Service credit is provided only for service rendered as a fire fighter or law enforcement officer after establishing membership in the Plan. One service credit month is granted for each calendar month in which basic salary is received for 90 or more hours. No more than one service credit month may be obtained during any calendar month, even if basic salary is received for more than 90-hours from each of two employers in a month.

Beginning September 1, 1991, a 1/2 service credit month is granted for any month in which basic salary for at least 70-hours, but less than 90-hours, is received. A 1/4 service credit month is granted for basic salary received for less than 70-hours in a month. Years of service are calculated by dividing total service credit months by 12.

Final Average Salary

Final average salary (FAS) uses a predetermined number of months or years to determine an average monthly salary. The LEOFF Plan 2 system uses the highest consecutive sixty service credit months to determine the FAS. If a member has a break in service, those months in which the member is not employed are ignored. For example, if a member terminated employment on June 30, 2004 and didn't become employed again until January 1, 2005, and retired on June 30, 2005, the six-month period between June 30, 2004 and January 1, 2005 would be ignored, for the purpose of calculated consecutive service credit months.

Reviews of other states' plans reveal there are a number of different periods used to calculate final average salary. Some systems use a period of one year, while others, like LEOFF Plan 2, use five years.

Generally, if a shorter period is used for the years of service, the FAS calculation will be higher. This is especially true as wages rise over time.

In addition to the time period used in the calculation, another integral part of the calculation is to determine what is included in salary or "Basic Salary" as it is defined in law for LEOFF Plan 2 members. Some plans may include overtime earnings, lump sum payments for deferred annual sick leave, unused accumulated vacation, unused accumulated annual leave, holiday pay or any form of severance pay.

LEOFF Plan 2 defines "Basic Salary" as salaries or wages earned by a member during a payroll period for personal services, including overtime payments and shall include wages and salaries deferred under plans established under 403(b), 414(h) and 457 of the United States Internal Revenue Code. Lump sum payments for deferred annual sick leave, unused accumulated vacation, unused accumulated annual leave, or any form of severance pay are specifically excluded from “Basic Salary”.

Final Average Salary in Other Washington State Plans

PERS Plans 2 & 3, TRS Plans 2 & 3, SERS Plans 2 & 3, WSPRS Plan 2 and PSERS, like LEOFF Plan 2, use the highest consecutive sixty-months (5 years) of service credit. PERS Plan 1 uses the greatest compensation earnable by a member during any consecutive two-year period of service credit months. TRS Plan 1 uses the two highest compensated consecutive years of service for calculating average final compensation. WSPRS Plan 1 uses the average monthly salary received by a member during the member’s last two years of service or any consecutive two-year period of service, whichever is greater.

What is included in salary varies among the systems and plans. For example, WSPRS Plan 1 and Plan 2 both exclude any overtime for earnings related to highway projects (construction projects) or voluntary overtime earned on or after July 1, 2001. For those state patrolmen commissioned on or after July 1, 2001 the exclusion includes lump sum payments for deferred annual sick leave, unused accumulated vacation, unused accumulated annual leave, holiday pay, or any form of severance pay. PERS Plans 2 and 3 are similar to LEOFF Plan 2.

Final Average Salary in Other State Pension Plans

A 2004 study of “State Police” plans by *Workplace Economics, Inc*. found the most commonly used final average salary definition includes average salary for the three highest years of service earnings or average salary for the highest three consecutive years of service earnings.

In addition to the *Workplace Economics, Inc.* study, Appendix A shows the FAS periods for other states’ police and fire fighter systems.

Policy Issues

All of the plan 2 systems currently use a sixty-month salary period to calculate a retirement benefit. Changing from a sixty-month period to a twenty-four or thirty-six month period would be a break from that policy.

Another issue is the possibility of “pension ballooning” if the FAS time frame is shortened. Part of the plan 2 design was to have a longer FAS period to mitigate “pension ballooning”. The shorter the time period, the greater the relative effect of salary increases, due to overtime, promotions, etc., on FAS.

Lastly, the decision of whether or not to apply the benefit change for all service or prospectively brings up the issue of intergenerational equity. Intergenerational equity is basically having a member pay for the benefit he or she receives. If the change is applied to all service, then in essence the younger members pay for the older members since the older service was not paid for at the time it was earned.

6. Policy Options

Option 1: 24-Month Final Average Salary Period – Apply to All Service Credit
Under this option a twenty-four month FAS period would be used in the calculation of a retirement benefit for all service credit a member has earned in LEOFF Plan 2. According to a cost study done by the Office of the State Actuary (OSA) in July of 2005, the cost of including all service would increase the total contribution rate by 2.64% (1.32% member, .79% employer, .53% state). A new cost estimate will be provided by OSA.

Option 2: 24-Month Final Average Salary Period – For Service Earned Prospectively
Under this option a twenty-four month FAS period would be used to calculate a benefit only to service credit earned after the effective date of the bill. For service credit earned prior to the effective date, the sixty-month FAS period would be used to calculate a member's retirement benefit. According to a cost study done by the Office of the State Actuary (OSA) in July of 2005, the cost of including prospective service would increase the total contribution rate by 1.28% (.64% member, .38% employer, .26% state). A new cost estimate will be provided by OSA.

Option 3: 36-Month Final Average Salary Period – Apply to All Service Credit
Under this option a thirty-six month FAS period would be used in the calculation of a retirement benefit for all service credit a member has earned in LEOFF Plan 2. The Office of the State Actuary will be providing a cost estimate.

Option 4: 36-Month Final Average Salary Period – For Service Earned Prospectively
Under this option a thirty-six month FAS period would be used to calculate a benefit only to service credit earned after the effective date of the bill. For service credit earned prior to the effective date, the sixty-month FAS period would be used to calculate a member's retirement benefit. The Office of the State Actuary will be providing a cost estimate.

7. Supporting Information

Appendix A: Retirement Comparison Table – Retirement Benefit Formula as of May 2005

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System	Formula	FAS	Member Contribution	Employer Contribution
Alaska Public Employees Retirement System	[2% x 1st 10 yrs x FAS] + [2.5% x 10+yrs x FAS]	3HC[1]	7.5%	8.42%
Arizona Public Safety Personnel Retirement System	2.5% x YOS x FAS	3HC/10[2]	7.65%	7.66%
Arkansas Local Police & Fire Retirement System	2.5% x FAS x YOS 1.5% x FAS x YOS when eligible for unreduced Soc Sec if covered	3HC/10	6%	?
Colorado Fire and Police Pension Association	[2% x 1st 10 yrs x FAS] + [2.5% x 10+yrs x FAS]	3H	8%	8%
Delaware County & Municipal Police/Fire Pension	2.5% x FAS x YOS	3HC	7%	8.3%
Indiana: Police Officers' & Firefighters' Pension & Disability Fund	50% of Base Salary + 1% of Base Salary for each six months after 20 YOS	Final Year	6%	21%
Kansas Police and Firemen's Retirement System	2.5% x FAS x YOS		7%	11.15%
Louisiana:				
Maryland Pension System for Local Fire Fighters and Police Officers	1.5% X YOS X FAS	3HC	8%	7.58%
Nevada Police/Fire Sub-Fund of the Nevada Public Employees Retirement System	[(2.5% x YOS x FAS, for service prior 7/1/01) + 2.67% x YOS x FAS, for service after 7/1/01)]	3HC	14.75%	14.75%
New Jersey Police and Firemen's Retirement System	2% x YOS x FAS $20< Y \leq 25$ = 50% FAS 65/20 = 50% FAS + [3% x FAS x YOS 20-25] ≥ 40 = 70% FAS	1H	8.5%	Actuarial determined for each employer.
New Mexico PERA –Police	Plan 1: 2% × YOS × FAS Plan 2: 2.5% × YOS × FAS Plan 3: 2.5% × YOS × FAS* Plan 4: 3% × YOS × FAS* Plan 5: 3.5% × YOS × FAS*	3HC	7% 7% 7% 12.35% 16.3%	10% 15% 18.5% 18.5% 18.5%
New Mexico PERA - Fire	Plan 1: 2% × YOS × FAS Plan 2: 2.5% × YOS × FAS Plan 3: 2.5% × YOS × FAS* Plan 4: 3% × YOS × FAS* Plan 5: 3.5% × YOS × FAS*	3HC	8% 8% 8% 12.8% 16.2%	11% 17.5% 21.25% 21.25% 21.25%
New York Police and Fire Retirement System	≥ 20 = 2% x FAS x YOS <20 = 1.66% x FAS x YOS	3HC	3% for 10 yrs	5.8%
Ohio Police and Fire Pension Fund	[2.5% x 1st 20 yrs x FAS] + [2% x (21st to 25th) x FAS] + [1.5% x (26th to 33rd) x FAS]	3H	10%	19.5% (P) 24% (F)
South Carolina Police Officers Retirement System	2.14% x FAS x YOS	3HC	6.5%	10.30%[3]
Washington LEOFF Plan 2	2% × FAS × YOS	5HC	5.09	3.06[4]

[1] Tier II benefits (Entered system between 1986 and 1996.

[2] 3HC/10 = 3 highest consecutive earning years within a 10 year window.

[3] South Carolina: In addition, employer also contributes 0.15% for group life insurance, 3.3% for retirement insurance surcharge, and 0.20% for accidental death benefit.

[4] The state also pays a contribution rate of 2.03%.

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Average Final Compensation (AFC) Proposal

We have calculated the preliminary impacts of changing the length of the AFC averaging period for LEOFF Plan 2. We have calculated four different scenarios: two-year AFC and three-year AFC - both for all service (retroactive) and future service only (prospective).

We expect retirement behavior would likely change (increases cost) and members would likely work more overtime to increase their AFC (increases cost) if this proposal passed. We included a small decrease in the average retirement age (by shifting retirement rates) and an overtime load for this pricing.

All other assumptions and methods are the same as those disclosed in the 2007 Actuarial Valuation Report.

Below we present the contribution rate increase for current members (effective September 1, 2009) and the first biennium and 25-year budget impacts:

Preliminary Impact on Contribution Rates					
		Retroactive		Prospective	
Effective 9/1/2009		2-Year	3-Year	2-Year	3-Year
LEOFF 2	Employee	2.98%	1.92%	1.42%	0.93%
	Employer	1.79%	1.15%	0.85%	0.56%
	State	1.19%	0.77%	0.57%	0.37%

Preliminary Budget Impacts					
		Retroactive		Prospective	
(Dollars in Millions)		2-Year	3-Year	2-Year	3-Year
2009-2011	GF-S	$34	$22	$16	$11
	Total Employer	85	55	40	27
25 Year	GF-S	638	414	313	205
	Total Employer	$1,595	$1,034	$782	$513