



LONG TERM ECONOMIC ASSUMPTIONS

PRELIMINARY REPORT

LEOFF Plan 2 Retirement Board

November 16, 2011

OVERVIEW

- Issue
- Background
- Policy Options



ISSUE

- The State Actuary has made recommendations to change the long-term economic assumptions.

Assumption	Current	Recommended
Inflation	3.50%	3.00%
General Salary Growth	4.50%	3.75%
Annual Investment Return	8.00%	7.50%
Growth in System Membership	1.25%	1.25%



BACKGROUND

- Pension Funding Council (PFC) Adoption
- Adopt Office of the State Actuary (OSA) recommendation
 - Investment Return to 7.90%
 - Re-evaluate in two years
- Subject to revision by Legislature



POLICY OPTIONS

- **Option 1:** Do not adopt any of the recommendations for changing the long-term economic assumptions.



POLICY OPTIONS

- **Option 2:** Adopt the OSA recommended changes for the LEOFF Plan 2 long-term economic assumptions.



POLICY OPTIONS

- **Option 3:** Adopt the OSA recommended changes for the LEOFF Plan 2, but with a five biennium phase-in for the investment return assumption (same as SCPP recommendation).



POLICY OPTIONS

- **Option 4:** Adopt the OSA recommended changes for the LEOFF Plan 2, except for only reducing the investment return assumption from 8.00% to 7.90% starting in 2013-2015, with review in two years (same as PFC Adoption).



POLICY OPTIONS


- **Option 5:** Recommend legislation to clarify the long-term economic assumptions as they apply to LEOFF Plan 2 and governance of the long-term economic assumptions.



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QUESTIONS?






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

Long-Term Economic Assumptions Preliminary Report

November 16, 2011

1. Issue

The State Actuary has made the recommendations to change the long-term economic assumptions.

2. Staff

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3. Members Impacted

This issue may affect all members of LEOFF Plan 2. As of June 30, 2010 there were 16,775 active members and 1,639 retirees as presented by the Office of the State Actuary (*2010 Preliminary Actuarial Valuation Results, Lisa Won, September 28, 2011*).

4. Current Situation

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:

- Annual Investment Rate of Return – 8 percent
- General Salary Growth – 4.5 percent (4.0 percent all other plans)
- Inflation – 3.5 percent
- Growth in System Membership – 1.25 percent

The accuracy of these assumptions is reviewed every two years because of their importance and potential impact on plan funding. The individual assumptions are inter-related; As such, any changes to these assumptions should be considered collectively rather than individually.

5. Background Information and Policy Issues

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:

- Annual Investment Rate of Return – 8 percent
- General Salary Growth – 4.5 percent (4.0 percent all other plans)
- Inflation – 3.5 percent
- Growth in System Membership – 1.25 percent

The accuracy of these assumptions is reviewed every two years¹ 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.

Annual Investment Return

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.

General Salary Growth

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.

Inflation

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

¹ In the Fall of Odd numbered years, SB 5014 (2007)

growth as well as greater costs for benefits such as a cost of living adjustment² for LEOFF Plan 2 retirees that are directly tied to inflation.

Growth in System Members

This assumption projects how much the membership of LEOFF Plan 2 will increase each year. There were 16,775 actively employed LEOFF 2 members as of June 30, 2010. 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 are not applicable to funding in LEOFF Plan 2. This assumption is used in amortization of Plan 1 UAAL in PERS and TRS.

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.

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.

Actuary 2011 Recommendations

The State Actuary has made the following recommendations to change the long-term economic assumptions for LEOFF Plan 2.

Assumption	Current	Recommended
Inflation	3.50%	3.00%
General Salary Growth	4.50%	3.75%
Annual Investment Return	8.00%	7.50%
Growth in System Membership	1.25%	1.25%

² The LEOFF Plan 2 COLA is based on the change, if any, in the consumer price index -- Seattle, Washington area for urban wage earners and clerical workers, all items, compiled by the bureau of labor statistics, United States department of labor.

Similarly, the State Actuary has made the recommendations to Pension Funding Council (PFC) and Select Committee on Pension Policy (SCPP) to change the long-term economic assumptions for the other state plans.

Assumption	Current	Recommended
Inflation	3.50%	3.00%
General Salary Growth	4.00%	3.75%
Annual Investment Return	8.00%	7.50%
Growth In System Members	0.90% (TRS)	0.80% (TRS)
	1.25% (Others)	0.95% (Others)

The OSA recommended to the PFC and the SCPP to ‘Phase-In’ the recommended change to the Annual Investment Return assumption over the next five biennia (reaches 7.50% in 2021-2023).

SCPP Recommendation to PFC

At their October 18, 2011 meeting, the SCPP recommended to the PFC to adopt the OSA Long-Term Assumption Changes as presented, including the five biennia phase-in of the return assumption.

PFC Adoption

At their October 24, 2011, the PFC adopted the changes recommended by the OSA except for the investment return assumption. Instead of the recommended phase in, the PFC adopted a change in the investment return assumption from 8.0% to 7.90% for the 2013-2015 biennium with a review of the assumption in two years. The assumptions adopted by the PFC are “subject to revision by the legislature”³.

Governance

The Pension Funding Council reviews information provided by the State Actuary and adopts changes to the long-term economic assumptions established in RCW 41.45.035. Any changes adopted by the council are subject to revision by the legislature. While the pension funding council adopts changes for all the other Washington State retirement plans, it has no applicability or authority over matters relating to LEOFF Plan 2.

The LEOFF Plan 2 Retirement Board was given the authority to set long-term economic assumptions for LEOFF Plan 2 in 2003 under RCW 41.26.720. Any changes adopted by the Board may be subject to revision by the legislature.

³ RCW 41.45.035(3)(b)

Policy Considerations

There are two areas of policy which the Board may choose to consider. The first area is actuarial in terms of adopting, or not adopting, changes to the long-term economic assumptions. The second area addresses procedural issues for clear documentation of long-term economic assumptions adopted for LEOFF Plan 2.

Actuarial Considerations

The Board has been presented with the OSA recommendations for changes to the long-term economic assumptions for LEOFF Plan 2. There are four different options which the Board may want to consider:

1. Do not adopt any of the recommendations for changing the long-term economic assumptions.
2. Adopt the OSA recommended changes for the LEOFF Plan 2 long-term economic assumptions.
3. Adopt the OSA recommended changes for the LEOFF Plan 2, but with a five biennium phase-in for the investment return assumption (same as SCPP recommendation).
4. Adopt the OSA recommended changes for the LEOFF Plan 2, except for only reducing the investment return assumption from 8.00% to 7.90% starting in 2013-2015, with review in two years (same as PFC Adoption)

Procedural Considerations

The long-term economic assumptions for all the state retirement plans are documented in statute (RCW 41.45.035). Historically, the economic assumptions were adopted collectively for all the plans and did not require definition or applicability by plan in the statute. In 2009, the salary growth assumption was changed for all of the plans, except LEOFF Plan 2. The new assumption and the plans that it applied to was specified in statute.

If the Board adopts assumptions that are different than the other plans, confusion may be created as to which assumptions apply to LEOFF Plan 2. The current statute is written in such a manner that in general appears like it would apply to LEOFF Plan 2. Also, since the LEOFF Plan 2 economic assumptions adopted by the Board are documented in the Actuarial Valuation confusion could occur since the statute and Actuarial Valuation would not have the same assumptions.

The Board may want to consider if it wants to pursue legislation to clarify the long-term economic assumptions statute with respect to LEOFF Plan 2. At the September 28, 2011 Board Meeting, the Board also discussed the possibility of legislatively addressing the Governance issues for setting assumptions for LEOFF Plan 2.

6. Policy Options

Options 1-4 are mutually exclusive options, meaning that only one of the four options can be chosen. Option 5 address additional procedural considerations discussed by the Board and may be adopted in addition to one of the other four options.

Option 1: Do not adopt any of the recommendations for changing the long-term economic assumptions.

Option 2: Adopt the OSA recommended changes for the LEOFF Plan 2 long-term economic assumptions.

Option 3: Adopt the OSA recommended changes for the LEOFF Plan 2, but with a five biennium phase-in for the investment return assumption (same as SPCP recommendation).

Option 4: Adopt the OSA recommended changes for the LEOFF Plan 2, except for only reducing the investment return assumption from 8.00% to 7.90% starting in 2013-2015, with review in two years (same as PFC Adoption).

Option 5: Recommend legislation to clarify the long-term economic assumptions as they apply to LEOFF Plan 2 and governance of the long-term economic assumptions.

7. Supporting Information

- RCW 41.26.720
- RCW 41.45.035
- Draft Bill Language

RCW 41.26.720

Board of trustees — Powers — Meeting procedures — Quorum — Judicial review — Budget.

(1) The board of trustees have the following powers and duties and shall:

(a) Adopt actuarial tables, assumptions, and cost methodologies in consultation with an enrolled actuary retained by the board. The state actuary shall provide assistance when the board requests. The actuary retained by the board shall utilize the aggregate actuarial cost method, or other recognized actuarial cost method based on a level percentage of payroll, as that term is employed by the American academy of actuaries. The actuary retained by the board shall adjust the actuarial cost method to recognize the actuarial present value of future revenue that will be included in the calculation of the market value of assets pursuant to RCW 41.26.805(2), using the methods and assumptions employed by the state actuary in RCW 41.26.805(9). In determining the reasonableness of actuarial valuations, assumptions, and cost methodologies, the actuary retained by the board shall provide a copy of all such calculations to the state actuary. If the two actuaries concur on the calculations, contributions shall be made as set forth in the report of the board's actuary. If the two actuaries cannot agree, they shall appoint a third, independent, enrolled actuary who shall review the calculations of the actuary retained by the board and the state actuary. Thereafter, contributions shall be based on the methodology most closely following that of the third actuary;

(b)(i) Provide for the design and implementation of increased benefits for members and beneficiaries of the plan, subject to the contribution limitations under RCW 41.26.725. An increased benefit may not be approved by the board until an actuarial cost of the benefit has been determined by the actuary and contribution rates adjusted as may be required to maintain the plan on a sound actuarial basis. Increased benefits as approved by the board shall be presented to the legislature on January 1st of each year. The increased benefits as approved by the board shall become effective within ninety days unless a bill is enacted in the next ensuing session of the legislature, by majority vote of each house of the legislature, repealing the action of the board;

(ii) As an alternative to the procedure in (b)(i) of this subsection, recommend to the legislature changes in the benefits for members and beneficiaries, without regard to the cost limitations in RCW 41.26.725(3). Benefits adopted in this manner shall have the same contractual protections as the minimum benefits in the plan. The recommendations of the board shall be presented to the legislature on January 1st of each year. These measures shall take precedence over all other measures in the legislature, except appropriations bills, and shall be either enacted or rejected without change or amendment by the legislature before the end of such regular session;

(c) Retain professional and technical advisors necessary for the accomplishment of its duties. The cost of these services may be withdrawn from the trust;

(d) Consult with the department for the purpose of improving benefit administration and member services;

(e) Provide an annual report to the governor and the legislature setting forth the actuarial funding status of the plan and making recommendations for improvements in those aspects of retirement administration directed by the legislature or administered by the department;

(f) Establish uniform administrative rules and operating policies in the manner prescribed by law;

(g) Engage administrative staff and acquire office space independent of, or in conjunction with, the department. The department shall provide funding from its budget for these purposes;

(h) Publish on an annual basis a schedule of increased benefits together with a summary of the minimum benefits as established by the legislature which shall constitute the official plan document; and

(i) Be the fiduciary of the plan and discharge the board's duties solely in the interest of the members and beneficiaries of the plan.

(2) Meetings of the board of trustees shall be conducted as follows:

(a) All board meetings are open to the public, preceded by timely public notice;

(b) All actions of the board shall be taken in open public session, except for those matters which may be considered in executive session as provided by law;

(c) The board shall retain minutes of each meeting setting forth the names of those board members present and absent, and their voting record on any voted issue; and

(d) The board may establish, with the assistance of the appropriate office of state government, an internet web site providing for interactive communication with state government, members and beneficiaries of the plan, and the public.

(3) A quorum of the board is six board members. All board actions require six concurring votes.

(4) The decisions of the board shall be made in good faith and are final, binding, and conclusive on all parties. The decisions of the board shall be subject to judicial review as provided by law.

(5) A law enforcement officers' and firefighters' retirement system plan 2 expense fund is established for the purpose of defraying the expenses of the board. The board shall cause an annual budget to be prepared consistent with the requirements of chapter 43.88 RCW and shall draw the funding for the budget from the investment income of the trust. Board members shall be reimbursed for travel and education expenses as provided in RCW 43.03.050 and 43.03.060. The board shall make an annual report to the governor, legislature, and state auditor setting forth a summary of the costs and expenditures of the plan for the preceding year. The board shall also retain the services of an independent, certified public accountant who shall annually audit the expenses of the fund and whose report shall be included in the board's annual report.

[2008 c 99 § 5; 2003 c 2 § 5 (Initiative Measure No. 790, approved November 5, 2002).]

Notes:

Findings -- Purpose -- 2008 c 99: See note following RCW 41.26.800.

RCW 41.45.035

Long-term economic assumptions — Asset value smoothing technique.

(1) Beginning July 1, 2001, the following long-term economic assumptions shall be used by the state actuary for the purposes of RCW 41.45.030:

- (a) The growth in inflation assumption shall be 3.5 percent;
- (b) The growth in salaries assumption, exclusive of merit or longevity increases, shall be 4.5 percent;
- (c) The investment rate of return assumption shall be 8 percent; and

(d) The growth in system membership assumption shall be 1.25 percent for the public employees' retirement system, the public safety employees' retirement system, the school employees' retirement system, and the law enforcement officers' and firefighters' retirement system. The assumption shall be .90 percent for the teachers' retirement system.

(2) Beginning July 1, 2009, the growth in salaries assumption for the public employees' retirement system, the public safety employees' retirement system, the teachers' retirement system, the school employees' retirement system, plan 1 of the law enforcement officers' and firefighters' retirement system, and the Washington state patrol retirement system, exclusive of merit or longevity increases, shall be the sum of:

- (a) The growth in inflation assumption in subsection (1)(a) of this section; and
- (b) The productivity growth assumption of 0.5 percent.

(3)(a) Beginning with actuarial studies done after July 1, 2003, changes to plan asset values that vary from the long-term investment rate of return assumption shall be recognized in the actuarial value of assets over a period that varies up to eight years depending on the magnitude of the deviation of each year's investment rate of return relative to the long-term rate of return assumption. Beginning with actuarial studies performed after July 1, 2004, the actuarial value of assets shall not be greater than one hundred thirty percent of the market value of assets as of the valuation date or less than seventy percent of the market value of assets as of the valuation date. Beginning April 1, 2004, the council, by affirmative vote of four councilmembers, may adopt changes to this asset value smoothing technique. Any changes adopted by the council shall be subject to revision by the legislature.

(b) The state actuary shall periodically review the appropriateness of the asset smoothing method in this section and recommend changes to the council as necessary. Any changes adopted by the council shall be subject to revision by the legislature.

[2009 c 561 § 2; 2004 c 93 § 2; 2003 1st sp.s. c 11 § 1; 2001 2nd sp.s. c 11 § 6.]

Notes:

Effective date -- 2009 c 561: See note following RCW 41.45.010.

Effective date -- 2003 1st sp.s. c 11: "This act is necessary for the immediate preservation of the public peace, health, or safety, or support of the state government and its existing public institutions, and takes effect July 1, 2003." [2003 1st sp.s. c 11 § 4.]

Effective date -- 2001 2nd sp.s. c 11: See note following RCW 41.45.030.

Draft Bill Language - Long Term Economic Assumptions

AN ACT Relating to actuarial funding of the law enforcement officers' and firefighters' retirement system plan 2; amending RCW 41.45.035.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

(1) Except as provided in subsection (4), ~~(B)~~beginning July 1, 2001, the following long-term economic assumptions shall be used by the state actuary for the purposes of RCW 41.45.030:

(a) The growth in inflation assumption shall be 3.5 percent;

(b) The growth in salaries assumption, exclusive of merit or longevity increases, shall be 4.5 percent;

(c) The investment rate of return assumption shall be 8 percent; and

(d) The growth in system membership assumption shall be 1.25 percent for the public employees' retirement system, the public safety employees' retirement system, the school employees' retirement system, and the law enforcement officers' and firefighters' retirement system. The assumption shall be .90 percent for the teachers' retirement system.

(2) Beginning July 1, 2009, the growth in salaries assumption for the public employees' retirement system, the

Draft Bill Language - Long Term Economic Assumptions

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(a) The growth in inflation assumption in subsection (1)(a) of this section; and

(b) The productivity growth assumption of 0.5 percent.

(3)(a) Beginning with actuarial studies done after July 1, 2003, changes to plan asset values that vary from the long-term investment rate of return assumption shall be recognized in the actuarial value of assets over a period that varies up to eight years depending on the magnitude of the deviation of each year's investment rate of return relative to the long-term rate of return assumption. Beginning with actuarial studies performed after July 1, 2004, the actuarial value of assets shall not be greater than one hundred thirty percent of the market value of assets as of the valuation date or less than seventy percent of the market value of assets as of the valuation date. Beginning April 1, 2004, the council, by affirmative vote of four council members, may adopt changes to this asset value smoothing technique. Any changes adopted by the council shall be subject to revision by the legislature.

Draft Bill Language - Long Term Economic Assumptions

(b) The state actuary shall periodically review the appropriateness of the asset smoothing method in this section and recommend changes to the council as necessary. Any changes adopted by the council shall be subject to revision by the legislature.

(4)(a) Changes in the long-term economic assumptions, recognition of asset values that vary from the long-term investment rate of assumption, or limits on the extent to which the market value of assets can deviate from the actuarial value of assets used in actuarial studies on the law enforcement officers' and firefighters' plan 2 retirement system shall be adopted by the law enforcement officers' and firefighters' retirement board pursuant to RCW 41.26.720. Any changes adopted by the board shall not be subject to revision by the legislature.

(b) Beginning with the 2011 Law Enforcement Officers' and Fire Fighters Plan 2 Retirement Board Actuarial Valuation Report, the following long-term economic assumptions shall be used by the state actuary for the law enforcement officers' and firefighters' plan 2:

(i) The growth in inflation assumption shall be 3.0 percent;

(ii) The growth in salaries assumption, exclusive of merit or longevity increases, shall be 3.75 percent;

Draft Bill Language - Long Term Economic Assumptions

(iii) The investment rate of return assumption shall be 7.5 percent; and

(iv) The growth in system membership assumption shall be 1.25 percent