



LEOFF PLAN MERGER 2012 LEGISLATION REVIEW

**LEOFF Plan 2 Retirement Board
January 25, 2012**

OVERVIEW

- Background/Follow-Up to previous July 2011 presentation
- Summary of HB 2350
- Policy issues raised by a merger
- OSA Study
- Discussion and questions are encouraged



ISSUE DESCRIPTION

- Legislation has been introduced in the 2012 Legislative Session to merge LEOFF Plan 1 and LEOFF Plan 2
- A financial merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds raises a number of issues for plan members and retirees, LEOFF employers and the State related to potential budget impacts, funding policies, governance, and benefits



BACKGROUND - INVESTMENT

- The LEOFF Plan 1 retirement fund and the LEOFF Plan 2 retirement fund are commingled for investment purposes
- The Commingled Trust Fund earned 21.14% for the 2010-11 fiscal year which will be reflected in the upcoming actuarial valuations for both plans



BACKGROUND - CONTRIBUTIONS

- Contributions for LEOFF Plan 1 have been suspended since 1999/2000
- Contributions for LEOFF Plan 2 are adopted by the Board as a percentage of payroll pursuant to a 50/30/20 cost sharing arrangement between members, employers and the State
- Rates through June 30, 2017 are:
 - 8.46% Member
 - 5.08% Employer
 - 3.38% State



BACKGROUND – ACTUARIAL FUNDING METHOD

- LEOFF Plan 1 uses a variation of the Frozen Initial Liability Cost Method
- LEOFF Plan 2 uses the Aggregate Funding Method to calculate the normal cost or expected long-term cost of the plan



BACKGROUND – LONG-TERM ECONOMIC ASSUMPTIONS

- Current Assumptions for LEOFF Plan 2 are:

Investment Rate of Return	7.50%
Salary Growth	3.75%
Inflation	3.00%
Growth in Membership	1.25%

- Current Assumptions for LEOFF Plan 1* :

Investment Rate of Return	7.90%**
Salary Growth	3.75%
Inflation	3.00%
Growth in Membership	0.95%

*Adopted by the Pension Funding Council 10/24/11; Subject to revision by the Legislature

**Assumption for 2013-2015; Phase-In to 7.50% by 2021-2023.



BACKGROUND – DEMOGRAPHIC ASSUMPTIONS

- Different demographic assumptions are calculated for LEOFF Plan 1 and LEOFF Plan 2 including:
 - Future rates of retirement and disability
 - Total length of service
 - Life expectancy after retirement
 - Life expectancies of surviving spouses and other beneficiaries



BACKGROUND – ASSET VALUE “SMOOTHING”

- The value of assets used in the Actuarial Valuation Report is not the actual market value of assets
- The Actuarial Value of Assets smoothes investment returns over time depending on how much the actual rate of return deviates from the expected rate of return
- Both LEOFF Plans 1 and 2 have a very large amount of deferred investment losses
 - LEOFF Plan 1 \$976 million as of June 30, 2010
 - LEOFF Plan 2 \$961 million as of June 30, 2010



BACKGROUND – ASSET VALUE CORRIDOR

- Both LEOFF Plan 1 and LEOFF Plan 2 have a requirement that the Actuarial Value of Assets cannot be less than 70% nor more than 130% of the Market Value of Assets
- The ratio was 119% for LEOFF Plan 2 as of June 30, 2010



BACKGROUND – FUNDED STATUS

- The funded status was 124% for LEOFF Plan 2 and 127% for LEOFF Plan 1 as of June 30, 2010 when using the actuarial value of assets
- The funded status was 104% for LEOFF Plan 2 and 105% for LEOFF Plan 1 as of June 30, 2010 when using the market value of assets
- This reporting method calculates liabilities using the Projected Unit Credit actuarial cost method which is not used in either LEOFF Plan 1 or LEOFF Plan 2



BACKGROUND - GOVERNANCE

- The LEOFF Plan 2 Board adopts contribution rates and actuarial policies and recommends benefit changes to the Legislature
- LEOFF Plan 1 falls under authority of the Select Committee on Pension Policy and the Pension Funding Council



BACKGROUND – LEGISLATIVE HISTORY

- HB 2097 in 2011 proposed a financial merger of LEOFF Plan 1 and LEOFF Plan 2 but did not pass
- The 2011-13 biennial operating budget included a requirement for the Office of the State Actuary to study issues related to merging LEOFF Plan 1 and LEOFF Plan 2
- SB 6166 in 2001 would have closed LEOFF Plan 1 and distributed surplus fund assets but did not pass



BACKGROUND – LEGAL FRAMEWORK

- “Exclusive Benefit” rule in federal law
- Merger case law in other states but none in Washington
- *Bakenhus* and subsequent cases in Washington provide limits on benefit changes and funding requirements



BILL SUMMARY – GOVERNANCE

- Board adopts contribution rates, actuarial tables, actuarial assumptions and funding for both plans
- Board actions not subject to legislative revision if certified reasonable
- Fire fighter and law enforcement representatives may be from either Plan 1 or Plan 2



BILL SUMMARY – CONTRIBUTION RATES

- State contribution to LEOFF Plan 2 suspended for remainder of 2011-13 biennium
- LEOFF Plan 1 contribution rates remain 0.00% for remainder of 2011-13 biennium
- LEOFF Plan 1 contribution rates set by Board beginning 7/1/2013



BILL SUMMARY – FUNDING

- Future costs of both LEOFF Plan 1 and LEOFF Plan 2 funded on 50/30/20 ratio (member/employer/state)



BILL SUMMARY – BOARD ADMINISTRATION

- Expense fund to pay Board administrative expenses not subject to allotment
- LEOFF Board and DRS authorized to use retirement fund assets to protect the fund



BILL SUMMARY – BENEFITS

- LEOFF Plan 1 participants guaranteed to receive same LEOFF Plan 1 benefits after the merger as before the merger, including LEOFF Plan 1 Disability Boards
- LEOFF Plan 2 participants guaranteed to receive same LEOFF Plan 2 benefits after the merger as before the merger



POLICY ISSUE – COMMINGLED INVESTMENT

- How does a merger affect the analysis of whether or not LEOFF Plan 1 should remain in the Commingled Trust Fund?



POLICY ISSUE – INVESTMENT VOLATILITY

- Would a merger require additional measures to either reduce investment volatility or manage investment volatility?



POLICY ISSUE – LEOFF PLAN 1 UNFUNDED LIABILITY

- There is a statutory requirement to pay off any unfunded liability in LEOFF Plan 1 no later than June 30, 2024
- LEOFF Plan 1 currently does not have an unfunded liability



POLICY ISSUE – LEOFF PLAN 1 SUPPLEMENTAL RATE

- If an unfunded liability emerges in LEOFF Plan 1, the State could pay that expense by charging a supplemental contribution rate to LEOFF employers as a percentage of LEOFF Plan 2 payroll
- This method was used by the State to pay the cost of the unfunded liabilities in PERS 1 and TRS 1
- Some cost likely to pass to LEOFF Plan 2 members through bargaining



POLICY ISSUE – FINANCIAL EFFICIENCIES

- An increase in assets in LEOFF Plan 1 currently cannot reduce costs for employers or the State
- An increase in assets in a merged plan could reduce costs for members, employers and the State



POLICY ISSUE – RISK TRANSFER

- The risk of any future costs for LEOFF Plan 1 currently lies primarily with the State and employers. LEOFF Plan 2 member risk is indirect and hard to quantify
- In a merged plan, the risk for employers and the State would likely be reduced. LEOFF Plan 2 members would bear a direct risk
- The risk may be positive



POLICY ISSUE – ASSET VALUE CORRIDOR

- The current ratio of the actuarial value of assets to the market value of assets increases the risk that poor investment returns in the future could spike contribution rates
- This risk is likely to remain until the investment losses from 2008-2009 have been fully recognized



POLICY ISSUE – FUNDING AUTHORITY

- The long-term cost of insufficient contributions or inaccurate long-term assumptions is magnified in a merged plan
- The importance of rate-setting and adopting assumptions is increased in a merged plan
- This authority is currently the subject of debate and could be clarified in either statute or litigation



POLICY ISSUE – BOARD COMPOSITION

- To what extent would a merger affect the composition of the LEOFF Board?



OSA STUDY

- Projected impact on contribution rates
- Projected impact on funding status
- Differences in funding schedules
- Differences in funding policies
 - Salary Growth Assumption
 - Projected improvements in life expectancy



OSA STUDY

- Impact of merger on projected LEOFF Plan 1 liabilities
- Impact of merger on LEOFF Plan 1 investment policies
- Impact on LEOFF Plan 1 “Pay as You Go” risk
- Impact of merger on State pension risk measures
 - Pension contributions exceeding 8% of General Fund State (GFS)
 - Bond rating



OSA STUDY

- Effect of merger on projected unfunded liability costs for the State, employers and LEOFF Plan 2 members
 - State pays all costs
 - Employers pays all costs via supplemental rate
 - State, employers and Plan 2 members pay costs according to 50/30/20 split
- Possibility of separate funding policies for LEOFF Plan 1 and LEOFF Plan 2 liabilities



OSA STUDY

- Risk of decrease in LEOFF Plan 1 benefits under current law
- Effect of changing to a 4.5% Salary Growth Assumption for LEOFF Plan 1
- Demonstrate the projected future funding status of LEOFF Plan 1 using both funded ratio and size of fund



LEOFF PLAN MERGER
2012 LEGISLATION REVIEW

DISCUSSION
&
QUESTIONS





STATE OF WASHINGTON
LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS'
PLAN 2 RETIREMENT BOARD

2012 Merger Bill Summary

State Savings - State contributions to LEOFF 2 are suspended immediately upon passage of the bill for the remainder of the 2011-13 biennium saving as much as \$80 million general fund (Sections 1 & 22). There is no reduction in employer or member rates.

LEOFF 1 & 2 Benefit Protections – All LEOFF 1 benefits, including local disability board benefits, are guaranteed to not be reduced (Section 5). The same protection is applied to LEOFF 2 member benefits.

Governance – The LEOFF Board would have the authority to adopt contribution rates, actuarial methods and actuarial assumptions for both LEOFF 1 and LEOFF 2. The Board's actions would not be subject to legislative revision as long as they were certified as reasonable by the State Actuary (Sections 9, 13 & 16). Board members could be appointed from either LEOFF 1 or LEOFF 2 (Section 7). The LEOFF Board would have greater authority over the Board's budget. (Section 11) Legal expenses could be paid from the retirement fund (section 20).

Future LEOFF Funding – The assets in the LEOFF 1 retirement fund are currently projected to be sufficient to meet the future liabilities of the plan but there is some risk that increased costs could put LEOFF 1 into pay-as-you-go ("pay-go") status. The two primary risks of increased costs for LEOFF 1 liabilities are 1) less-than-expected investment returns; and 2) higher-than-expected inflation.

A merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds commingles the liabilities of both plans. So, an increase in LEOFF 1 costs would become the shared responsibility of LEOFF members, LEOFF employers and the State according to the 50-30-20 ratio currently in place for LEOFF 2 (Section 10). The risk of LEOFF 1 going into pay-as-you-go "pay-go" status is reduced to zero.

The requirement to pay off any unfunded liability in LEOFF 1 by 2024 is eliminated (Section 12).

Both LEOFF Plan 1 and LEOFF Plan 2 currently have a very substantial amount of unrecognized investment losses from the historically poor investment returns of 2008-2009 so the challenge to maintain stable contribution rates and full funding of the merged system, particularly over the next five years, is significant.

HB 2350 – Merging LEOFF Plan 1 & Plan 2

TOPIC	BEFORE	AFTER
Governance	The LEOFF Plan 2 Retirement Board adopts contribution rates, actuarial tables, actuarial assumptions, and funding policies for LEOFF Plan 2.	The LEOFF Retirement Board adopts contribution rates, actuarial tables, actuarial assumptions, and funding policies for both LEOFF Plan 1 and LEOFF Plan 2. The actions of the Board must be certified as reasonable by the State Actuary or they are subject to legislative revision.
	Fire fighter and law enforcement representatives on the LEOFF Plan 2 Board members must be Plan 2 members or retirees. At least one member of the Board must be a retiree.	Fire fighter and law enforcement representatives on the LEOFF Board may be members or retirees from either LEOFF Plan 1 or LEOFF Plan 2. At least one member of the Board must be a retiree.
Contribution Rates	LEOFF Plan 2 contribution rates are: 8.46% Member 5.08% Employer 3.38% State	LEOFF Plan 2 contribution rates for the remainder of the 2011-13 biennium are: 8.46% Member 5.08% Employer 0.00% State
	LEOFF Plan 1 contribution rates are set in statute at 0.00% for members, employers and the State.	LEOFF Plan 1 contribution rates are set in statute at 0.00% for members, employers and the State for the remainder of the 2011-13 biennium. LEOFF Plan 1 contribution rates will be set by the LEOFF Board beginning July 1, 2013.
Benefits		LEOFF Plan 1 participants are guaranteed to receive the same benefits after the merger as before the merger, including benefits granted by LEOFF Plan 1 Disability Boards. LEOFF Plan 2 participants are guaranteed to receive their same LEOFF 2 benefits.
Funding	Future costs of LEOFF Plan 2 will be funded on a 50/30/20 ratio among members, employers and the State. Future costs of LEOFF Plan 1 are currently a statutory obligation of the State.	Future costs of both LEOFF Plan 1 and LEOFF Plan 2 will be funded on a 50/30/20 ratio among members, employers and the State.
Board Administration	The expense fund to pay LEOFF 2 Board administrative expenses is subject to the allotment process.	The expense fund to pay LEOFF Board administrative expenses is not subject to the allotment process.
	The Department of Retirement Systems is the only agency authorized to use retirement fund assets to protect the fund.	The LEOFF Board and the Department of Retirement Systems are both authorized to use retirement fund assets to protect the fund.