



June 22, 2016
Plan Merger

EDUCATIONAL BRIEFING

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ISSUE STATEMENT

The merger of two separate retirement plans into one plan creates a number of legal, policy, and financial issues for plan beneficiaries and sponsors that must be considered by trustees of each plan.

OVERVIEW

There have been several legislative proposals since 2010 to merge State public pension plans, including the Law Enforcement Officers' and Fire Fighters' Plan 2 (LEOFF Plan 2), in order to save the State money by reducing State contributions to the new plan. The debate over these proposals has raised questions of whether the proposals are legal under state or federal law; how the merger impacts the State budget; and how the merger affects member benefits, plan governance and plan funding.

This report will provide an explanation of the issues raised by plan mergers. The analysis of these issues will not be specific to any past legislative proposal. Rather, the goal of this report is to increase understanding of the general principles that underlie all mergers which will serve as the foundation for a follow-up report specific to LEOFF Plan 2.

BACKGROUND

The Law Enforcement Officers' and Fire Fighters' (LEOFF) Retirement System was created in 1970 by merging a number of separate city and county retirement plans into one state-wide plan. The administration of the plan and the investment of fund assets was the responsibility of the Public Employees' Retirement System (PERS) Board.

The responsibility for administering the LEOFF Retirement System benefits was transferred from the PERS Board to the newly-created Department of Retirement Systems (DRS) in 1977. DRS continues to administer LEOFF member benefits to this day. A new tier of benefits, LEOFF Plan 2, was also created in 1977 for all members hired on or after October 1, 1977. The PERS Board continued to invest the LEOFF Retirement Systems fund, which included assets and liabilities of both LEOFF Plan 1 and LEOFF Plan 2, until 1981 when the Board was abolished and investment authority for the fund was transferred to the newly-created State Investment Board (SIB) where it remains today.

The Pension Funding Act of 1989 (c. 272, laws of 1989) split the assets and liabilities of the LEOFF Retirement System into separate funds for LEOFF Plan 1 and LEOFF Plan 2. Both funds are commingled for investment purposes as part of the Commingled Trust Fund administered by the SIB but assets and liabilities are accounted for separately.

Initiative 790 in 2003 (C. 2, laws of 2004) created the Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board. Board members are fiduciaries to LEOFF Plan 2 and their duties include: adopting member, employer and state contribution rates for the plan; adopting the actuarial assumptions for the plan; and, recommending policy changes regarding the plan to the Legislature. LEOFF Plan 2 is currently the only state-administered retirement plan with a fiduciary oversight board.

The Select Committee on Pension Policy (SCPP) recommends policy changes for the other state retirement plans. The Pension Funding Council adopts contribution rates for the other state retirement plans. The Office of the State Actuary (OSA) provides actuarial services for all the state retirement plans including LEOFF Plan 2. The SIB invests the assets of all the state retirement plans including LEOFF Plan 2. DRS administers all the state retirement plans including LEOFF Plan 2.

Legislative History

Senate Bill 6166 in 2001 proposed terminating LEOFF Plan 1 and using some of the assets of the fund for state purposes as well as for the cost to "restate" the plan and pay for a one-time payment to LEOFF Plan 1 beneficiaries. The bill did not pass the legislature.

House Bill 2350/Senate Bill 6563 in 2012 proposed merging LEOFF Plan 1 with LEOFF Plan 2 and reducing the State contribution to the merged plan. That bill was recommended by the LEOFF Plan 2 Retirement Board did not pass the legislature.

Senate Bill 6668 in 2016 proposed merging LEOFF Plan 1 with the Teachers' Retirement System (TRS) Plan 1 and reducing the State contributions to pay the unfunded liability in TRS Plan 1.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2ESHB 2376, sec. 106) for the SCPP to work with the LEOFF Plan 2 Board, DRS, and OSA to study the legal, financial and policy issues raised by merging the LEOFF Plan 1 Retirement Fund with the LEOFF Plan 2 Retirement Fund and the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

POLICY ISSUES

What is a “merger” of retirement plans?

A merger of two separate retirement plans combines all of the assets and liabilities of each plan into one new plan. In its simplest terms, a merger is a purely financial transaction.

Why would anyone want to merge retirement plans?

This combination of assets and liabilities can offer advantages to both plans related to investment opportunities, liability management and funding improvements. The member demographics of the plans may also present an opportunity for risk mitigation. But, a merger also comes with risks so it is prudent for any trustee or fiduciary of a plan considering a merger to inform themselves of these risks and take steps to mitigate those risks as part of any merger.

What is the history of plan mergers in Washington?

Plan mergers are more common in the context of private sector Taft-Hartley pension plans but there have been several mergers of public pension plans in the State of Washington. The Law Enforcement Officers’ and Fire Fighters’ (LEOFF) Retirement System was originally created in 1970 by merging the assets and most of the liabilities of separate retirement plans administered by city and county employers throughout the State. In 1972, the Statewide City Employers’ Retirement System was merged into the Public Employers’ Retirement System (PERS).

How does a merger affect plan benefits?

A merger does not require that all members of the new plan receive the same benefits. Typically, the new plan continues the same benefits previously provided to members and beneficiaries as separate tiers of benefits.

State law prohibits a merger from reducing benefits provided to members. Benefits can be increased in the same piece of legislation that merges plans but any benefit increase is separate and distinct from the merger itself.

How does a merger impact the State budget?

Public pension plans in Washington all receive some state funding, either as a percentage of salary for active employees or as an appropriation to reduce the unfunded liability of the plan (or both). Any significant impact to the State budget from a merger will be a key issue for state policy makers in considering a merger.

Past merger proposals involving LEOFF Plan 1 have included reductions in state funding to the newly created plan in consideration of the very healthy funding status of LEOFF Plan 1. Any long-term state budget risks or benefits created by a merger should also be evaluated.

What legal issues are raised by plan mergers?

A merger of public retirement plans raises questions of both federal and state law.

Public pension plans must be qualified under federal law in order for members and plan sponsors to receive favorable tax treatment for their contributions and earnings. So, when a merger creates a new plan, that new plan must be reviewed by the Internal Revenue Service to determine if it is qualified. The Internal Revenue Service recently issued notice that they will cease doing plan determination letters for existing plans. However, they will continue to issue plan qualification determinations for new plans including a new plan created by a merger. The current estimated turnaround time for a determination is six months.

One of the key requirements for a retirement plan to be qualified is that assets must be held in trust for the exclusive benefit of the plan beneficiaries. Some of the additional criteria used to evaluate a proposed merger include: are the plans open or closed to new members; do the plans have similar employers; are the plans over-funded or under-funded; and, are the plans demographics compatible?

Washington case law on pensions is based on the principle that pension benefits are part of a contract between the employer and employee which cannot be diminished by state law. So, a merger cannot reduce benefits. Similarly, the courts have held that the funding which underlies the benefit promise is also subject to protection. So, a merger that diminishes current or future plan funding needs to be evaluated according to these protections.

How does a merger affect plan governance?

The Pension Funding Council adopts contribution rates for LEOFF Plan 1. The Select Committee on Pension Policy studies policy issues related to LEOFF Plan 1 benefits and recommends any changes to the Legislature.

The LEOFF Plan 2 Retirement Board adopts contribution rates for LEOFF Plan 2, studies policy issues related to the plan and recommends any changes to the Legislature.

Any changes to the governance of the plans being merged requires careful consideration. Some state courts have held that the right of plan members to have their plan governed by an independent board of trustees who owe a fiduciary duty to the plan is a benefit of plan subject to the same legal protections as other plan benefits. That question has not been decided by Washington courts.

Mergers in the private sector are typically arm's length transactions between two different plans with separate governing bodies and separate plan sponsors. The trustees of each plan have a fiduciary responsibility to ensure that a proposed merger is in the best interest of their plan's members and negotiate the terms of the merger accordingly. But, there are no governing boards for any of the state-administered public pension plans in Washington other than LEOFF Plan 2. If the State is the plan sponsor for both plans in a merger and if there are no fiduciaries

responsible for looking out for the interests of the plan members, then there is a risk that only the State's interests will be represented.

How does a merger affect plan funding?

When the assets and liabilities of two separate retirement plans are merged, the funding ratio of the newly created plan is certain to be different from the prior funding ratios of the merged plans. The funding ratio of a plan plays an important part in determining the ongoing funding policies of that plan so the impact of a merger on the funding ratios and ongoing funding policies of the merged plans becomes an important consideration.

No State, member or employer contributions for LEOFF Plan 1 have been required since 2001 because of the positive funding status of the plan. Contributions to LEOFF Plan 1 could be reinstated if the plan's funding status decreased due to adverse investment or actuarial experience. Any potential future member contributions would not be significant due to the low number of members currently active in the plan so the responsibility for any potential future funding requirements would fall on LEOFF employers and the State.

The funding ratio of the new plan will be lower than the funding status of LEOFF Plan 1 because LEOFF Plan 1 currently has the highest funding ratio in the State.

How does a merger affect investment policy?

All the assets of State-administered pension plans in Washington are currently part of the Commingled Trust Fund (CTF) invested by the Washington State Investment Board. The CTF uses the same investment policy for all plans regardless of the plan's funded status or beneficiary demographics.

All of the merger proposals regarding LEOFF Plan 1 have included keeping the new fund in the CTF so that there would be no change in investment policy. A merger of two plans within the CTF into a new plan that remains in the CTF would not require any sale of assets that could create transactions costs for the new plan or other plans in the CTF.

What is a plan termination and how does it apply to a plan merger?

One question that often arises when discussing merger is what happens to any remaining assets in a fund when it closes? Federal case law has said that when a plan is terminated and all the liabilities to beneficiaries have been satisfied, any remaining assets revert to the plan sponsor. Both LEOFF employers and the State contributed to LEOFF Plan 1 so both would have a sponsorship claim to any remaining assets when there are no more beneficiaries. However, the office of the State Actuary estimates that there will continue to be some LEOFF 1 beneficiaries for more than 40 years.

This holding is sometimes oversimplified and stated as a principle that all surplus assets in a fund belong to the fund sponsor(s). But, that is not accurate for several reasons. First, a plan "termination" is a separate process under federal law from merger and different legal requirements apply. A merger does not allow for fund assets to be distributed to the plan sponsors. Second, while a plan exists, all assets in the plan are held in trust for the exclusive benefit of the plan's beneficiaries. The possible disposition of any potential remaining assets if the plan is terminated in the future is not relevant to the legal status of those assets today.

SUPPORTING INFORMATION

Appendix A: Merger Study Budget Proviso (2016 3rd sp.s. c 4 s 106)

During the 2016 legislative interim, the select committee on pension policy shall study Senate Bill No. 6668 (LEOFF 1 & TRS 1 merger) and report on the tax, legal, fiscal, policy, and administrative implications. In conducting the study, the select committee on pension policy shall also update its 2011 study of law enforcement officers' and firefighters' retirement system plans 1 and 2. In preparing this study, the department of retirement systems, the attorney general's office, the law enforcement officers' and firefighters' retirement system plan 2 board, and the office of the state actuary shall provide the select committee on pension policy with any information or assistance the committee requests. The committee shall also receive stakeholder input on the bill as part of its deliberation. The select committee on pension policy shall submit this report to the legislature by January 9, 2017.



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June 22, 2016

PRESENTATION GOALS



▶ General Principles of Plan Mergers

- Not specific to any proposals
 - Background & History
- Frequently Asked Questions
- Question & Answer format
- Conversational Style

WHAT IS A “MERGER”

- ▶ **One of two ways that a plan can end**
 - **Financial transaction with legal consequences**
 - Plan assets are combined
 - Plan liabilities are combined
 - Plan benefits are unchanged
 - Analogous to a “marriage” of plans

WHAT IS A PLAN TERMINATION?



- ▶ **One of two ways that a plan can end**
 - **Winding up of obligations**
 - Any remaining liabilities are annuitized
 - Any remaining assets revert to the plan sponsor
 - Analogous to a “death” of a plan
 - **Merger and termination are very different concepts**

WHAT IS THE PURPOSE OF A MERGER?

▶ “Win-Win”

- Investment Opportunities
- Risk Mitigation
- Funding Improvements

HAVE MERGERS HAPPENED BEFORE?

- ▶ Yes, plan mergers have happened in Washington
 - Private sector Taft-Hartley plans
 - Public sector plans
 - LEOFF Plan 1 creation
 - State-Wide City Employees Retirement System

HOW DOES A MERGER AFFECT BENEFITS?

- ▶ **A plan merger does not affect benefits**
 - **State law prevents reduction in benefits**
 - **The merger legislation may have additional sections that affect benefits**

STATE LAW ISSUES



- ▶ **Benefits are protected**
 - **Benefit reduction protections – Bakenhus**
 - **Plan funding protections - Weaver**

FEDERAL LAW ISSUES



- ▶ **Public plans must be “qualified” in order to receive favorable tax treatment**
 - **Contributions are made on a pre-tax basis, earnings are not taxed**
 - **Assets held in trust – Exclusive Benefit rule**
 - **Restrictions on contributions – CODA, deferral limits**
 - **Requirements for payouts – mandatory distributions**

HOW DOES A MERGER AFFECT THE STATE BUDGET?

- ▶ A plan merger can reduce required State contributions to the new plan
 - Base contributions
 - Supplemental contributions to reduce a plan's unfunded liability

DOES A MERGER AFFECT PLAN GOVERNANCE?

- ▶ **A merger may affect plan governance**
 - **In a private-sector merger, the governing bodies of the merged plans are replaced by a new governing body**
 - **Not all public plans in Washington have a governing body**
 - **LEOFF Plan Retirement 2 Board**

HOW DOES A MERGER AFFECT PLAN FUNDING?



- ▶ A merger may change both the short-term and long-term needs of the plan
 - The Funding Ratio of the merged plan may differ from the original plans
 - Required contributions may change
 - The Normal Cost of the benefits in the merged plan is not different
 - Payout schedule may change

HOW DOES A MERGER AFFECT INVESTMENT POLICY?

- ▶ **A merger of state-administered public plans in Washington does not affect investment policy**
 - **All plans are administered by the Washington State Investment Board**
 - **All plans are currently invested in the Commingled Trust Fund**

NEXT STEPS



- ▶ **The next presentation is scheduled for July 27, 2016**
 - **The presentation will cover the same topic areas as this presentation**
 - **Specific information and analysis will be provided related to LEOFF Plan 2**

QUESTIONS

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