BOARD MEETING AGENDA
July 23, 2014 - 9:30 AM

LOCATION

STATE INVESTMENT BOARD
Large Conference Room, STE 100
2100 Evergreen Park Drive S.W.
Olympia, WA 98502
Phone: 360.586.2320
Fax: 360.586.2329
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1. **Approval of June 18, 2014 Minutes**	9:30 AM
2. **Funding Pension Plan Benefits** Robert Klausner, Esquire	9:35 AM
3. **Executive Session - Potential Litigation**	10:30 AM
4. **Experience Study and Actuarial Valuation Update** Lisa Won, Senior Pension Actuary	11:30 AM
5. **Actuarial Audit Presentation** Mark Olleman & Daniel Wade, Consulting Actuaries, Milliman	12:00 PM
6. **Contribution Rate Adoption** Ryan Frost, Research Analyst	12:30 PM
7. **Administrative Update**	
• **SCPP Update**	2:00 PM
• **Outreach Activities**	
8. **Agenda Items for Future Meetings**	2:30 PM

Lunch is served as an integral part of the meeting.

In accordance with RCW 42.30.110, the Board may call an Executive Session for the purpose of deliberating such matters as provided by law. Final actions contemplated by the Board in Executive Session will be taken in open session. The Board may elect to take action on any item appearing on this agenda.

Funding Pension Plan Benefits

Report Type:
Educational Briefing

Presenter Name and Title:
Robert Klausner, Esquire

Summary:
Mr. Klasuner will provide the Board with expert consultation on funding pension plan benefits.

Robert Klausner is the principal in the law firm of Klausner, Kaufman, Jensen & Levinson. For 35 years, he has been engaged in the practice of law, specializing in the representation of public employee pension funds. The firm represents state and local retirement systems in more than 20 states.

Pursuant to RCW 43.10.065, the CONTRACTOR does not have authority toprovide legal advice or provide a legal opinion to the Board or its staff,which will be provided by the Office of the Attorney General pursuant to RCW43.10.040

Strategic Linkage:
This item supports the following Strategic Priority Goals:
Enhance the benefits for the members., Maintain the financial integrity of the plan., Inform the stakeholders.

ATTACHMENTS:

	Description	Type
🗋	Funding Pension Plan Benefits Presentation	Presentation

KLAUSNER
KAUFMAN
JENSEN &
LEVINSON

A PARTNERSHIP OF PROFESSIONAL ASSOCIATIONS
ATTORNEYS AT LAW

WASHINGTON STATE LAW ENFORCEMENT OFFICERS AND FIREFIGHTERS PLAN 2

EDUCATIONAL AND FIDUCIARY PLANNING UPDATE

Olympia, Washington
July 23, 2014

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The Impact of Municipal Bankruptcy, Pension Financing, and the Challenges for Pension Fiduciaries

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By: Robert D. Klausner

I. WHAT IS HAPPENING IN BANKRUPTCY COURT?

A. What Are the Facts?

On July 17, 2013 the City of Detroit filed a petition for protection from creditors under Chapter 9 of the Bankruptcy Code, making it the largest municipal bankruptcy filing in U.S. history. The filing, like those in Stockton and San Bernardino has implications most notably for bond holders and participants in the two city retirement systems.

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To date, there is little history regarding the application of the bankruptcy law to municipal pensions. Two high profile bankruptcy cases filed by municipal governments have sharply focused the effect of Chapter 9 of the Bankruptcy Code on pension obligations.

B. A Discussion of the Cases.

The City of Prichard, Alabama became the first city in American history to completely default on its employee pension obligations. Prichard sought protection under Chapter 9 of the Bankruptcy Code relating to municipal debt obligations. The automatic stay prevented pursuit of a number of actions by the city's creditors including its employees. The bankruptcy petition was dismissed as not meeting the test under Chapter 9 and has since made some partial pension payments since the automatic stay was dissolved. The petition was later reinstated after the Alabama Supreme Court ruled that the City had authorization under state law to file. Proceedings in 2013 continued to center on whether the petition should again be dismissed.

Vallejo, California received judicial approval to break its collective bargaining agreements in its bankruptcy proceedings. As Vallejo is a participant in the California Public Employees Retirement System (CalPERS), it has no local retirement plan. The unanswered question from the Vallejo decision is whether a city that rejects a collective bargaining agreement also is relieved of its obligations under a pension plan. Vallejo settled its bankruptcy without impairing its pension obligations.

At issue in both Stockton and San Bernardino is whether the Supremacy Clause of the U.S. Constitution will permit a bankruptcy court to disregard state constitutional pension protections. In Stockton, the court has already relieved the City of certain post-retirement health care obligations.

The City of Stockton reached an agreement in October 2013 with other creditors and will continue in CalPERS with no change in benefits. The City was able to convince the bond holders that the loss of pension benefits would so disrupt the remaining workforce that recovery of the City would be impossible. That has not stopped the bankruptcy judge from explaining the likelihood fo a ruling finding that pensions are not protected from bankruptcy

Central Falls, Rhode Island was sued in an adversarial proceeding by its teachers' union over the effect of that city's bankruptcy proceedings on retirement benefits when municipal bondholders were protected in the bankruptcy plan at the expense of retired and active employees. Bond holders suffered no loss, while retirees took pension cuts of up to 55%. By contrast, a bankruptcy plan by Stockton, California placed the onus on bondholders and no recommended changes to the City's obligations to the California Public Employees Retirement System.

In San Bernardino, the bondholders are demanding that the pension system "share in the pain" endured by all creditors in bankruptcy who receive less than full compensation. This set the stage for a legal challenge by the bond insurer for a pension obligation bond issue as to the relative rights of bondholders versus pensioners in Detroit as well. The Bankruptcy Judge in October 2013 ruled that San Bernardino was "eligible" to proceed in bankruptcy and lumped CalPERS in with other creditors despite claims by the State that it was immune to such claims. That eligibility issue as it relates to pensions is already on appeal to the U.S. Court of Appeals for the 9th Circuit.

II. WHAT IS DIFFERENT ABOUT DETROIT?

A. The Detroit case is of particular significance in that, unlike California, Michigan has an express provision in its state constitution which makes pensions a contract between the employee and public employer. The City and the bondholders contend that the federal law overcomes this state constitutional provision. On July 18, 2013, a state judge in Lansing, the state capital, held that the constitutional provision expressly prevents the Governor from authorizing Detroit's emergency financial manager from seeking bankruptcy protection.

B. The Ruling.

The federal bankruptcy judge held a lengthy trial to determine if Detroit was "eligible" to file for bankruptcy. The issue is whether the State Legislature in Michigan could authorize a bankruptcy that could affect pensions if the Pensions Clause in Michigan prohibits any law impairing pensions. A ruling on eligibility took place on December 3, 2013.

The Bankruptcy Judge held that despite the constitutional provision, the Supremacy Clause of the U.S. Constitution allowed the Court to treat the pension contract the same as any other contract in bankruptcy - it can be impaired in a plan of adjustment.

C. The Plan of Adjustment and the Pending Appeal.

On February 21, 2014 the City filed a 440 page plan of adjustment outlining in detail the treatment proposed for all creditors, including pensioners.

In summary, the plan proposes reducing general employee benefits between 26% and 30%, which would push nearly a quarter of all retirees below the poverty line. The current plan for existing employees would be replaced with a hybrid plan.

Police and fire retirees, who do not have Social Security, would receive approximately 94% of pension benefits. Current workers would also be placed in a hybrid plan.

No COLAs would be paid for 10 years and a restructuring of the respective boards of trustees' investment authority would be required. In addition the plans would have assumed rates of return of 6.5% for PFRS and 6.25% for the GRS.

On Friday, February 21, 2014, the United States Court of Appeals for the 6th Circuit agreed to hear the legal question of whether Detroit was eligible to file for Chapter 9 with the ability to impair the pension contract.

In March, a revised POA was filed seeking cuts of up to 49% for general retirees and 32% for public safety. In addition, efforts continue to restructure the boards to remove stake holders from having an effective voice in their retirement systems.

Mediation efforts have resulted in a substantially less draconian result of 6% cuts for general retirees and loss of the COLA for a period of time and no reduction for public safety, also with a period of COLA loss. Contained within that proposal, however, is a "hard freeze" of accrued benefits.

As of the date of this outline, the membership of the plans has approved the settlement. The insurance company for the bond holders has vigorously objected and its objections are scheduled to be heard by the U.S. 6th Circuit Court of Appeals on July 30. The retirement system, the retiree committee and the unions eligibility objections are also scheduled for that date but it is unknown if that argument will be heard in light of the apparent success of the medication.

D. The Real Constitutional Issue.

The real constitutional issue was not a state versus federal sovereignty issue. Instead it had to do with the plain reading of the Michigan Constitution. If the state constitution prohibits laws which impair contract and the bankruptcy law allows a bankruptcy only if state law allows it, then how could Michigan pass a state law which violates its own constitution by allowing the pension contract to be impaired?

III. WHAT DOES THIS MEAN FOR THE NEW BATTLE IN ILLINOIS?

A. Like Michigan, the Illinois Constitution prohibits any impairment of the Pension Contract. The Illinois Pensions Clause is actually broader than the Michigan clause which addresses "accrued benefits." While that term is subject to debate as to whether it means benefits earned to date or the formula in effect when a member vests, that is not open to debate in Illinois. The benefit structure in effect when a firefighter is hired is the base benefit which cannot be reduced.

A state cannot file for bankruptcy in Chapter 9 of the Federal Bankruptcy Code. A city cannot file for bankruptcy unless the state government where it is located has passed a law authorizing the filing. Illinois and 26 other states do not have a general bankruptcy filing law for cities. A petition by Washington Park, Illinois was denied in 2010 because Illinois did not have a state law authorizing bankruptcy.

Illinois does have a law for cities in financial distress. The Local Government Financial Planning and Supervision Act, 50 ILCS 320 provides a means for addressing municipal insolvency. 50 ILCS 320/9 (b)(4) allows a commission established under the law to recommend filing a petition. The Bankruptcy Court in the case of *In re Slocum Lake Drainage District of Lake County*, 336 B.R. 387 (Bkrtcy. N.D. Ill 2006) dismissed a bankruptcy proceeding due to the absence of a commission under the Financial Planning and Supervision Act recommending such a filing and the absence of a general state law authorizing a Chapter 9 petition. Even if the law was found to constitute legislative authorization, the law must still otherwise comport with the rest of the state constitution.

B. The Battle in Illinois.

The Illinois Legislature made an important change in state law when it reduced pension benefits in 2013. It effectively overturned an earlier state Supreme Court decision which said that pension plan members could sue over underfunding. The new law allows suits to force funding if the state fails to meet the statutory funding requirements. Will this new right be a sufficient quid pro quo for the dramatic benefit reductions? The lawsuits have already begun and consolidated into a class action affecting more than 600,000 workers and retirees.

C. A New Ruling on Health Care May be a Bellweather

In a very important decision of first impression reached on July 3, the Illinois Supreme Court held that the General Assembly was precluded from impairing or diminishing health insurance subsidies provided to state retirees.

Effective July 1, 2012, Public Act 97-695 eliminated the statutory standards[1] for the mandatory state contribution to health insurance premiums for members of the three state retirement systems. Instead, Act 97-695 required the Director of the Illinois Department of Central Management Services to administratively determine, annually, the amount of health insurance premiums that will be charged. To facilitate the implementation of the new system, Act 97-695 permits the new contributions to be altered through emergency rules. This amendment "fundamentally altered" the state's obligation to contribute toward the cost of health insurance coverage.

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[1] *The health care subsidy differs depending on when employees retiree, including in some cases a 5% contribution for each year of creditable service uon which the pension benefit is based.*

Members of the State Employees Retirement System (SERS), the State Universities Retirement System (SURS) and the Teacher Retirement System (TRS) brought four class actions challenging the constitutionality of the health insurance reduction under various theories including: violation of the Illinois Constitution pension protection clause (Article XIII, Section 5), contracts clause, separation of powers, along with common law claims based on contract and promissory estoppel theories.

The defendants, including the Governor, and State Treasurer moved to dismiss. The trial court granted the motion dismissing all of the complaints. The Supreme Court agreed to allow direct review, permitting the case to proceed straight to the state's highest court. The Supreme Court also allowed members of the City of Chicago's healthcare programs to file an amicus brief on behalf of the plaintiffs. The City of Chicago filed an amicus brief on behalf of the defendants.

Plaintiffs argued that the prior law requiring the state to make specified contributions toward health insurance premiums constitutes a benefit of membership in the retirement systems. Plaintiffs further argued that the amendments diminished and impaired membership benefits in violation of the pension protection clause.

The state argued that its contributions to retiree health premiums are not codified in the pension code and are not paid from the assets of the retirement system. According to the state, health insurance premiums are fundamentally different from pension annuities and therefore not covered by the protections of the pension protection clause.

As framed by the Court, the question presented was whether a health insurance subsidy provided in retirement qualifies as a benefit of membership. Holding that it does, the Court observed that health benefits were provided in 1970 when the pension protection clause was adopted by the voters.

While all some of the health benefits are governed by group health insurance statues and others are covered by the pension code, "eligibility for all of the benefits is limited to, conditioned on, and *flows directly from membership* in one of the State's various public pension systems." (emphasis added).

The Court gave the pension protection clause its plain and ordinary meaning that all retirement benefits, including subsidized health care are considered benefits of membership in the retirement system and covered by the pension protection clause. If the drafters of the constitutional provision had intended to only protect "core" pension annuity benefits they could have so specified. The Court refused to rewrite the clause to include restrictions that the drafters did not express and the voters did not approve. Because the Court was able to decide the case based on the plain language of the pension protection clause, it did not need to rely on the underlying debates, which nevertheless support the Court's conclusion. A single Justice dissented reasoning that the subsidized health insurance benefits are not "pension benefits" based on a narrow reading of the pension protection clause.

Kanerva v. Weems, 2014 WL 2978472 (Ill. July 3, 2014)

IV. PUTTING BANKRUPTCY IN PERSPECTIVE

A. Who Can be a Chapter 9 Debtor?

Not every city can be a debtor in Chapter 9. Only municipalities in states that specifically authorize their municipalities to file can use Chapter 9. States may not file for bankruptcy.

Twenty-four (24) states permit municipal bankruptcy. Most limit the filings to specified specialized service districts such as utility, waste removal, or drainage entities. Washington states permits cities to file for bankruptcy without limitations.

B. Recent Use of Chapter 9.

Since 2011 there have only been 33 Chapter 9 filings. Several were dismissed. Since the inception of Chapter 9 in 1937, there have been 651 bankruptcy filings by cities.

There has been no trending toward the use of bankruptcy as a means of avoiding pension obligations.

V. HOW ARE THE RATINGS AGENCIES VIEWING THE ISSUE?

In a recent public statement, a major rating agency observed long-term liability that pension liabilities must be managed.

Focus is on affordability and sustainability with no preference for method of addressing liability.

Important elements of analysis include carrying charge, funding trends; amortization periods and material actions to address liability.

VI. FINAL THOUGHTS ON MUNICIPAL BANKRUPTCY.

The substantial adverse consequences for a community following a bankruptcy generally acts as a strong disincentive. The limits of state constitutional protections for pension are, however, strongly implicated in the pending bankruptcy cases. Already, the leading cases are making their way to two separate federal appeals courts. Ultimately the issue will be settled in these federal courts, or possibly, the United States Supreme Court.

VII. READING THE SIGNS AND OMENS.

Emerging from the trends suggested by bankruptcies and direct constitutional assaults is a clear division in legal thought concerning what is an "accrued benefit."

Is an accrued benefit just the value of retirement credits earned to the date of a statutory change or does an accrued benefit include the formula itself? The answer seems to be a resounding "it depends" recently demonstrated in an decision of the Arizona Supreme Court.

In a closely watched decision, the Arizona Supreme Court issued a unanimous opinion on February 20, 2014 *in Fields v. Elected Officers Retirement Plan,* 2014 WL 644467 (Ariz. 2/20/14) upholding a trial court decision finding that a reduction in post retirement benefits to retired judges and other elected officials violated the Pensions Clause of the Arizona Constitution.

In 1998, the electors of Arizona adopted constitutional protection for retirement benefits against impairment or diminution. Notwithstanding that public referendum, the Legislature altered the guaranteed post retirement benefit formula in 2011, causing a substantial reduction in the gain sharing formula. In response, a group of retired judges filed suit claiming that the legislation was an unconstitutional impairment of the pension contract. An Arizona trial court agreed and struck down the law, holding that the post retirement benefit was a vested financial benefit that was directly and adversely affected by the S.B. 1609.

On appeal to the Supreme Court of Arizona, the Retirement System argued that the impairment was financially necessary, applying a traditional federal impairment of contract test which balances the contract against public necessity. The Supreme Court rejected that argument finding that the Pension Clause in the Arizona Constitution was intended to add an additional measure of protection to pension benefits. Perhaps even more important is the Court's finding that the term "benefit" includes the formula by which future payments will be calculated. Otherwise stated, the "benefit increase formula" is itself a protected "benefit."

The Arizona Pension Clause, Article 29(C) of the Arizona Constitution, provides that membership in a public retirement system is a "contractual relationship." The pension clause further specifies that "public retirement system benefits shall not be diminished or impaired."

As a threshold matter, the Court noted that the sitting Justices are not members of the class of retired judges who brought suit. Nevertheless, the Court acknowledged that the Justices are members of the Elected Officials' Retirement Plan and will be eligible for benefits upon their retirement. The Court further observed that no party had asked for their recusal. Even if recusal had been requested, the Court reasoned that the rule of necessity would apply because disqualification would result in denial of the litigants' constitutional right to have a properly presented question adjudicated.

Next, the Court explained that it would apply a *de novo* standard to review S.B. 1609. The Court began by presuming that the amendment was constitutional, recognizing that the plaintiffs bear the burden of overcoming the presumption of constitutionality.

On the merits, the Court began by addressing the argument that the case should be resolved by using only a federal Contract Clause analysis used by the U.S. Supreme Court in *Energy Reserves Group v. Kansas Power & Light*, 459 U.S. 400 (1983). "But accepting this argument would render superfluous the latter portion of §1(C), the Pension Clause, which prohibits diminishing or impairing public retirement benefits." Accordingly, the Court refused to apply the lower federal standard, which would treat the Arizona Pension Clause as "essentially meaningless." Similarly, the Court reasoned that the Pension Clause "confers additional, independent protection for public retirement benefits separate and distinct from the protection afforded by the Contract Clause."

Turning to the benefit formula used to calculate future benefit increases, the Court agreed with plaintiffs that the term "benefit" includes the "benefit-increase formula." The State and the Plan had argued that the term "benefit" only includes "the right to receive payments in the amount determined by the most recent calculation." Looking to the history of the Pension Clause, the Court observed that the benefit formula predated the Pension Clause. When the original version sunsetted in 1994, the legislature removed the sunset in 1996 "unqualifiedly extending benefit increases in perpetuity." Two years later, the legislature reinstated the 4% cap and the voters approved the Pension Clause, affording public retirement benefits constitutional protection in 1998.

The Court also rejected the argument that the Pension Clause only protected liquidated amounts, rather than the statutory formula. Of course, monthly benefits are determined using a statutory formula. The legislature has "never promised to pay a specific dollar amount; rather, it has provided a formula by which the promised amount is calculated." As the legislature itself demonstrated when it passed S.B. 1609, lowering the benefit requires changing the formula. A contrary interpretation would place the "base benefit" outside the scope of Pension Clause protection because the base benefit is the direct product of a formula. Thus, the promised "benefit" necessarily includes the right to use the promised statutory formula.

In reaching this conclusion, the Court confirmed that its interpretation of the Pension Clause was consistent with prior Arizona cases. In particular, in *Yeazell v. Copins*, 402 P.2d 541 (Az. 1965), the Arizona Supreme Court held that an employee was entitled to have their retirement benefits calculated based on the formula in effect when employment began, rather than a less-favorable formula adopted during employment. Effectively affirming *Yeazell*, the Court held that plaintiffs had a right to "the existing formula by which his benefits are calculated as of the time he began employment and any beneficial modifications made during the course of his employment."

For additional guidance, the Court looked to the use of the term "benefit" in other states that have similar constitutional protections. For example, New York and Illinois have also determined that benefit calculation formulas are constitutionally protected. Additionally, the Court recognized that unlike the narrowly protections in some states, the Arizona Pension Clause extends broadly and unqualifiedly to "public retirement system benefits," not merely "accrued" benefits.

After concluding that the benefit formula was constitutionally protected, the Court proceeded with its analysis of whether S.B. 1609's amendments impaired retirement system benefits. By retroactively preventing the transfer of $31 million to the Plan's COLA reserve, only a 2.47% benefit increase was paid in 2011 instead of the expected 4% increase. Moreover, no benefit increase was paid in 2012 or 2013, when a 4% increase would otherwise have been payable.

The Court further observed that S.B. 1609 makes it more difficult for retirees to receive future benefit increases by raising the rate of return required to fund a benefit increase from 9% to 10.5%. By tying benefit increases to the funding ratio, the likelihood of receiving the maximum 4% benefit was further diminished.

At the same time cases continue in Florida, Texas, California, Colorado, Washington, and Ohio over constitutional protection of employee benefits. For the time being, the questions remain unanswered.

VII. CANADIAN FUNDS FACE SIMILAR ISSUES WITH DIFFERENT LAWS

A. Background regarding Canadian regulation of Public Plans

According to Melissa Kennedy (General Counsel for Ontario Teachers) "There's a tsunami of pension reform that has been happening the last couple of years."

In 2012 the Supreme Court of Canada held that the federal government does not have to separately account for pensions or repay a $28 billion surplus that was withdrawn in 1999 from the Federal Public Service system. Plaintiffs unsuccessfully claimed that their equitable interest was protected by a fiduciary duty on the part of the government or by a constructive trust. The court unanimously held that the accounts were not "separate funds containing assets, but rather were accounting ledgers." The court further rejected the constructive trust argument, holding that the government was not subject to a fiduciary obligation in favor of the plan members. *See Public Institute of the Public Service of Canada v. Canada, 2012 SCC 71*;

http://scc-csc.lexum.com/scc-csc/scc-csc/en/item/12778/index.do

Each province has the ability to regulate "registered plans". Forty percent of all registered plans in Canada are governed by the Ontario Public Benefits Act.

The Pension Benefits Act was the first statute in any Canadian jurisdiction to regulate pensions. There are now 8,350 registered pension plans which fall under the jurisdiction of the Ontario Superintendent of Financial Services, appointed by the Financial Services Commission of Ontario.

Pension regulation in Canada falls under **provincial jurisdiction** by virtue of the **"property and civil rights" power, Section 92(13)** under the Constitution Act of 1867. This is the most powerful and expansive of the provisional constitutional provisions.

This year Quebec tabled Bill 79 (An Act to provide for the restructuring of municipal db plans). If adopted it would have imposed 50/50 cost sharing between municipalities and their employees (limiting the municipality to 50% of the normal cost); would trigger restructuring if funded status was below 85%. The bill is not dead, but will apparently return with a second bill this spring to restructure private plans.

Of the 40 largest public plans in the world, 4 are Canadian. Canadian public portfolios are often run/invested internally with direct investments of up to in 35% alternatives. Canadian pioneered this style of investing by bringing investments in house (and paying staff private sector compensation).

B. Bankruptcy in Canada - Legislative framework[1]

The Canadian federal government has power over bankruptcy, while provinces retain control and responsibility over municipalities. Canada does

[1] The following summary is substantially based on the discussion by John R. Sandrelli and Valerie Cross, *American Municipal Bankruptcies: the View from Canada.* Annual Review of Insolvency Law 2013 - Dr. Janis P Sarra, Editor

not have an equivalent to America's Chapter 9 of the U.S. Bankruptcy Code. Canada's Bankruptcy and Insolvency Act (BIA) does not explicitly indicate whether or not municipal corporations are eligible to go bankrupt. Compared to the US, Canada has a very different government framework for municipal financial distress. Municipal bankruptcy is not contemplated in federal bankruptcy law.

Judicial decisions dating back to the 1930's such as *Que´bec (Commission Municipale) v Aylmer (Ville) (Que´bec)* have held that the "Bankruptcy Act is not applicable to municipal and school corporations." A Que´bec a provincial statute created a municipal commission that 1) approved municipal loans, 2) could investigate the financial administration of a municipality, and 3) if a municipality defaulted—take control of its operations. The statute was challenged as ultra vires. The Que´bec court disagreed, finding the statute was intra vires. According to the court, the statute primarily related to the matter of municipal institutions, and could also be justified as 1) property and civil rights, 2) the administration of justice, and 3) matters of a purely local nature. There was no conflict with the BIA, which the Court ruled was not applicable to municipal corporations.

In 1995, the Insolvency Institute of Canada's Working Group examined the question of whether municipal corporations should be brought under the BIA and recommended "municipal corporations should not be brought under the BIA's entities eligible to go bankrupt".

Today the provinces have considerable power over municipalities. Most provinces have created municipal boards or commissions that have oversight for certain municipal activities and, in particular, a mandate to watch municipal budgets closely and exert express control over municipal borrowing and debt. If necessary, these provincial administrators and supervisors also have the ability to intervene and take control of defaulting municipalities.

Provincial legislatures have also created strict legislative frameworks within which municipal finances must operate. For example, the provinces have set strict balanced budget laws for municipalities; requiring that cities cannot run operating deficits. In setting annual budgets, Canadian municipal councils generally must provide for all debts coming due in the year for which the city's general rates are levied.

Other municipal financial provincial laws enforced by the provincial bodies cover permissions for borrowing to finance capital projects, city debt limits and financial reporting. If a city were to run into financial trouble despite these limits on borrowing and balanced budget laws, provinces generally also have provisions in their municipal Acts that allow the provincial board to take control of the defaulting city — doing whatever is necessary to return the city to financial health.

The legislative situation today in Canada can be summed up as follows: "while municipal councils are invested with considerable discretionary power in the field of fiscal management. . .the legislatures have withheld complete autonomy and retained a substantial measure of control over municipal finances". The regime shapes up to give Canada a much tighter and consistent country-wide program of municipal monitoring and financial control than the American framework.

C. Defaulting municipalities

Many provinces have adopted remedial legislation for defaulting municipalities. For example, Part III of the Municipal Affairs Act gives Ontario's Ministry of Municipal Affairs supervisory jurisdiction over defaulting municipalities. The power can be enacted upon request: 1) of the Ministry; or 2) of a municipality by resolution of its council; or 3) of the creditors of a municipality with claims representing 20 per cent or more of the city's indebtedness. If the Board is satisfied the municipality has: 1) failed to meet its debenture [bond] debt or interest thereon; 2) failed to discharge other debts by reason of financial difficulties; or 3) has or may become financially involved or embarrassed to the extent that default may ensue or difficulty may arise in providing for current expenditures, the Board may make an order vesting in the Ministry control and charge over the administration of the municipality's affairs. Similarly, the Que´bec Commission has a process for declaring municipalities in default. If a city in Nova Scotia fails to pay debt, the council can be declared vacant and a new council can be appointed.

In Ontario and other provinces, if the Ministry's power over a defaulting municipality is enacted, the Ministry takes complete financial control of the local council. The powers of the Ministry are extensive and include: control over revenues, expenditures, sinking funds, accounting and audits, assessments, estimates, rating and collection of rates and borrowing for current expenditures.

Ordinarily, absent a statutory provision, municipal debenture holders are confined to the remedies for a breach of the promise to pay by the corporation. In the case of a defaulting municipality, statutes in many provinces do permit that debenture indebtedness maybe consolidated, refunded, postponed, or a compromise may be entered into with a majority of debenture holder. New debentures may be issued in exchange for outstanding ones; terms for payment and interest on debts may be varied.

VIII. THE FUNDING FIGHT IN NEW JERSEY

In a pair of very recent decisions arising from forced pension reform in New Jersey, courts render one decision favorable to retirees while rejecting a claim for immediate funding in the other.

In *Berg v. Christie,* 2014 WL 2883872 (N.J. Super. A.D. 6/26/2014), the New Jersey Superior Court Appellate Division considered a claim by retired public employees and labor organizations seeking a declaration that the statute suspending COLAs was unconstitutional. Specifically, the plaintiffs claimed that a 2011 law suspending COLAs until the funding of the retirement systems improved was invalid. At the same time, as the Legislature approved an additional funding measure to help retire the unfunded liability, the Governor issued an Executive Order reducing the state contribution by $1.3 billion.

Despite that continued failure to fund the systems, the evidence showed that COLAs could be paid for approximately the next 30 years without the additional funding. As a result, no specific appropriation was necessary to fund the COLAs. In light of that finding the Court rejected arguments by the State that the claims of plaintiffs were barred by the debt and appropriation clauses of the New Jersey Constitution. The Court appears to have left this question open, however, if proper funding is not eventually restored.

The Appeals Court also found that the COLA was like any other retirement benefit and was constitutionally and statutorily protected against impairment as a non-forfeitable contract right set forth in state law. The ability of the Legislature to amend the pension acts did not include the right to eliminate COLAs already vested in the participants.

The members had also challenged the law on the basis that it impaired the obligation of contract. Unlike breach of contract suits, impairment cases may be defended on a public welfare basis. As the trial court failed to address this balancing test the case was remanded back to the trial court for further proceedings. In closing, the Court admonished the political branches of the government to have the "political will to preserve the systems and satisfy prior commitments made to public employees and retirees."

In a related case, a New Jersey trial judge declined to issue a preliminary injunction relating to the Executive Order to reduce funding in fiscal 2014 or to prevent a veto of additional funding and the tax legislation supporting it in fiscal 2015. In *Burgos v. State*, Superior Court Mercer County Law Division, Docket No. L-1267-14 (6/25/2014), the Court considered a request by a group of public employees and unions to issue a preliminary injunction preventing the execution of the Governor's executive order cutting retirement funding. The Governor similarly amended the budget proposal for fiscal 2015 to also prevent payment of the full actuarially-required contribution. New Jersey has failed to pay its full ARC since 1997. Reform legislation sponsored by the Governor in 2010 and 2011 was supposed to phase in full funding over a 7-year period.

The Court found that it had both a duty and jurisdiction to hear the challenge. As a result, the Court rejected the idea that separation of powers prevented the Court from hearing the matter. The Court did find that the members' claims concerning fiscal 2015 were premature. At the time of the decision, the budget had not been adopted. The Court declined to speculate on the results of that process.

The Court also rejected a request for a preliminary injunction. Generally, to warrant an injunction, the harm suffered must be irreparable. Generally, monetary damages do not form a basis for irreparable harm. In the end, the Court was unwilling to substitute its judgment for that of the Executive Branch as to how to deal with a fiscal emergency situation in the closing weeks of the budget year.

IX. WHAT DOES ALL OF THIS MEAN FOR LEOFF PLAN 2

A. FUNDING

B. OWNERSHIP OF ASSETS

C. WITHDRAWAL LIABILITY FOR CITIES IN DEFAULT

D. EFFECT ON THE MEMBERS OF A MUNICIPAL BANKRUPTCY

E. DUTIES OF TRUSTEES IN UNDERFUNDING MATTERS

F. DUTIES OF TRUSTEES IN BENEFIT CHANGE MATTERS

X. CONCLUSIONS

IF YOU HAVE ANY QUESTIONS OR COMMENTS CONCERNING THIS PRESENTATION, CONTACT ROBERT D. KLAUSNER, ESQUIRE, KLAUSNER, KAUFMAN, JENSEN & LEVINSON, 10059 NW 1ST COURT, PLANTATION, FLORIDA 33324, (954) 916-1202, FAX (954) 916-1232, EMAIL bob@robertdklausner.com, WEBSITE: www.robertdklausner.com

Experience Study and Actuarial Valuation Update

Date Presented:
7/23/2014

Presenter Name and Title:
Lisa Won, Senior Pension Actuary

Summary:
The Office of the Sate Actuary (OSA) will provide an update of the Demographic Experience Study and Actuarial Valuation results.

Strategic Linkage:
This item supports the following Strategic Priority Goals:
Maintain the financial integrity of the plan.

ATTACHMENTS:

Description	Type
Experience Study and Actuarial Valuation Update	Presentation

LEOFF Plan 2 Experience Study And Actuarial Valuation Results Update

Lisa Won, ASA, FCA, MAAA,
Senior Actuary

Office of the State Actuary
"Securing tomorrow's pensions today."

July 23, 2014

Today's Presentation

- Highlight changes from preliminary results
- Additional review of duty disability assumption
- Review contribution rates and budget impacts
- Decisions for today's meeting
- Update to administrative factors

No Changes To The Preliminary Results

- Independent actuarial audit found demographic assumptions reasonable
  - Current method for setting base mortality assumption reasonable
    - Improvement suggested by Milliman
    - No impact to current results
    - OSA will implement in next experience study
- Audit of actuarial valuation results have found no material differences at this time

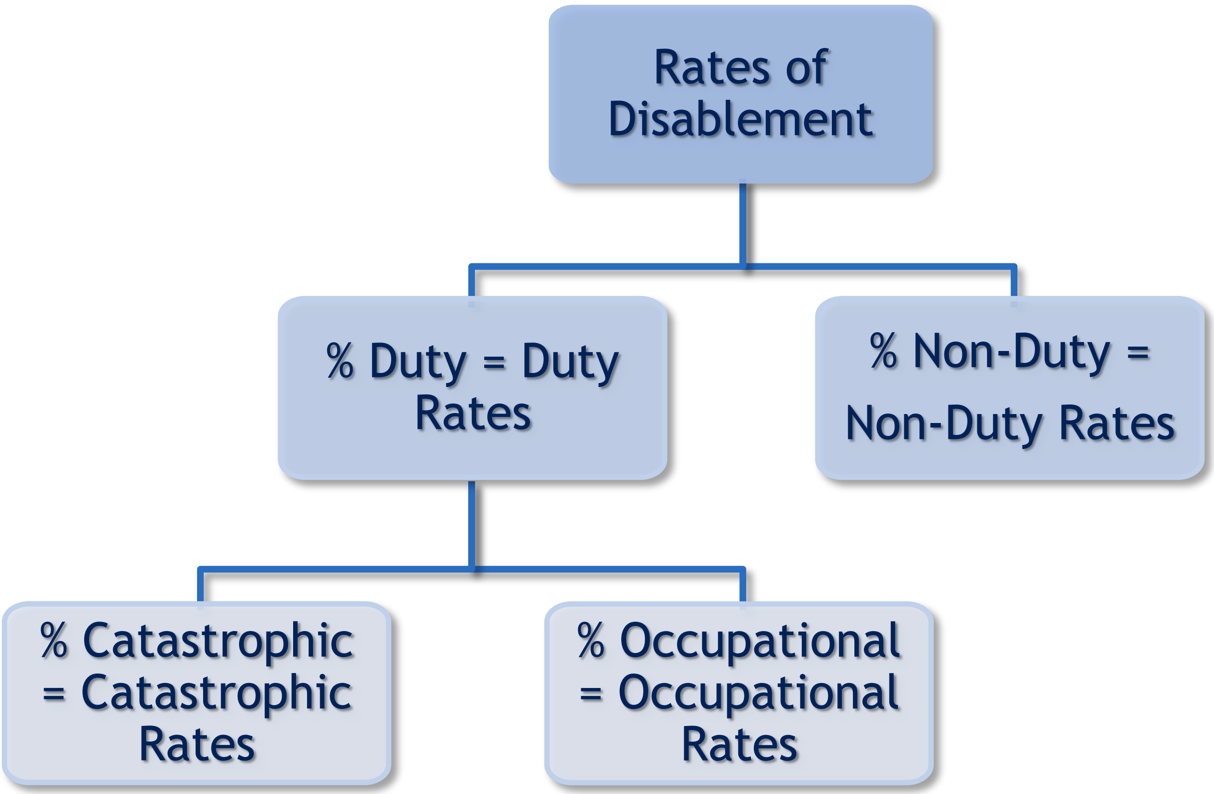
Summary Of Updates To Current Assumptions

- Mortality
  - Changes to reflect lower mortality rates since last study
  - Updates to projected increases in life spans from 50 percent of Scale AA to 100 percent of Scale BB
  - Increases short-term costs
  - Most significant assumption change in this experience study
- Retirement
  - Changes to reflect later retirement
  - Decreases short-term costs
- Termination
  - Changes to reflect fewer terminations
  - Decreases short-term costs

Summary Of Updates To Current Assumptions *(Continued)*

- Disability
  - Adjustments made to overall disability rates and percent duty disability
  - No changes made to percent total disability
  - Increases short-term costs
- Salary increases
  - Changes to "service based" salary increase assumptions
  - Lowered early career increases and extended salary scale
  - Increases short-term costs
- Miscellaneous assumptions
  - Increases short-term costs
- Full Experience Study Report available this fall

Actuarial Model For Disability Benefits



Duty Disability Assumption Developed By Occupation

- Current assumption developed after the 2007 expansion of occupational disease definition
- Assumes 100 percent of Fire Fighter (FF) disabilities are duty related
- Assumes Law Enforcement Officer (LEO) duty-related disabilities are 95 percent at age 20, decreasing to 70 percent at age 55
- Limited data available for this study
  - FF experience lower than current occupational assumption
  - LEO experience higher than current occupational assumption

Duty Disability Experience By Occupation

LEOFF 2 Disability Counts Among Fire Fighters by Year			
Year*	All Disabilities	Duty Disabilities	Ratio
2005	12	10	0.83
2006	10	9	0.90
2008	11	9	0.82
2009	10	8	0.80
2010	8	7	0.88
2011	12	11	0.92
2012	5	4	0.80
Total	**68**	**58**	**0.85**

**Omitted 2007 due to odd-length valuation period.*

LEOFF 2 Disability Counts Among Law Enforcement Officers by Year			
Year*	All Disabilities	Duty Disabilities	Ratio
2005	12	8	0.67
2006	21	19	0.90
2008	15	10	0.67
2009	19	17	0.89
2010	15	13	0.87
2011	11	7	0.64
2012	5	3	0.60
Total	**98**	**77**	**0.79**

**Omitted 2007 due to odd-length valuation period.*

Duty Disability Rates Apply To All Members

- Rates are blended and applied to the plan as a whole
- Current assumption is good overall fit
- Minor adjustment made to reflect change in percent of FF for the plan (from 43 percent to 45 percent)
- Development of assumption will be revisited next experience study with more data
  - Occupational assumption
  - Blended result

Small Adjustment To Blended Duty Disability Rates*

LEOFF 2 – Percent Of Disabilities That Are Duty Related			
2005-2012			
Age	Actual	Old Assumption	New Assumption
20	0.00%	97.15%	97.25%
25	100.00%	95.71%	95.86%
30	100.00%	94.30%	94.50%
35	0.00%	92.85%	93.11%
40	100.00%	91.45%	91.75%
45	100.00%	88.60%	89.00%
50	80.00%	85.75%	86.25%
55	40.00%	82.90%	83.50%
60	80.00%	82.90%	83.50%
65	0.00%	82.90%	83.50%
70	0.00%	82.90%	83.50%

**Sample of rates shown. Rates vary by each age.*

Duty Disability Rates Are Good Fit To Experience

LEOFF Plan 2 Duty Disability Experience 2005-2012*					
Age	Actual	Old Expected	Old A/E	New Expected	New A/E
20-24	0	0	0.00	0	0.00
25-29	1	1	1.04	1	1.04
30-34	2	2	1.06	2	1.06
35-39	11	10	1.09	10	1.08
40-44	15	14	1.04	14	1.03
45-49	19	19	0.99	19	0.99
50-54	43	47	0.91	48	0.90
55-59	30	34	0.88	34	0.88
60-64	13	13	0.98	13	0.97
65+	1	1	1.21	1	1.20
Total	**135**	**142**	**0.95**	**143**	**0.95**

**Omitted 2007 due to odd-length valuation period. Totals and ratios may not agree due to rounding.*

Actuarial Valuation Results – Funded Status

Funded Status At June 30			
(Dollars in Millions)			
		2013	2012
a.	Present Value of "Earned" Benefits	$6,859	$6,071
b.	Market Value of Assets	7,637	6,640
c.	Deferred Gains/(Losses)	(225)	(581)
d.	Actuarial Value of Assets (b-c)	7,862	7,222
e.	Unfunded Liability (a-d)	($1,003)	($1,150)
f.	**Funded Ratio (d/a)**	115%	119%

Note: Totals may not agree due to rounding.

2015-2017 Contribution Rate Options

Employee and Employer/State Contribution Rates				
	Adopted	Before ExpStudy 100% EANC	After ExpStudy 90% EANC	After ExpStudy 100% EANC
Employee	8.41%	8.60%	7.97%	8.85%
Employer*	5.05%	5.16%	4.78%	5.31%
State	3.36%	3.44%	3.19%	3.54%

**Excludes current administrative expense rate of 0.18%.*

Budget Impacts For Next Two Biennia

- 2015-2017 and 2017-2019 budget impacts only
  - No long-term impacts provided
- Assumptions updated again in six years
- Actual costs based on actual benefits paid and actual investment returns on contributions made

2015-2017 and 2017-2019 Budget Impacts

Increase in Budget			
(Dollars in Millions)	Before ExpStudy 100% EANC	After ExpStudy 90% EANC	After ExpStudy 100% EANC
2015-2017			
General Fund	$3	($10)	$13
Non-General Fund	$0	$0	$0
Total State	$3	($10)	$13
Local Government	$4	($15)	$20
Total Employer	$7	($24)	$34
Total Employee	$7	($24)	$34
2017-2019			
General Fund	$3	($11)	$15
Non-General Fund	$0	$0	$0
Total State	$3	($11)	$15
Local Government	$5	($16)	$22
Total Employer	$8	($27)	$37
Total Employee	$8	($27)	$37

Budget impacts reflect difference between current contribution rates and the rates from the 2013 AVR only.
Totals may not agree due to rounding.

Contribution Rate Decision For This Meeting

- Maintain current rates through 2015-17
  - 8.41 percent Employee
- 90 percent EANC rate from 2013 AVR
  - 7.97 percent Employee
- 100 percent EANC rate from 2013 AVR
  - 8.85 percent Employee
- All options presented here are reasonable based on the current funding policy adopted by the Board

Administrative Factors

- Consider updating when assumptions change
- OSA will begin process once all assumptions are final
  - Consult with DRS and LEOFF 2 Board
  - Calculate updated factors
- DRS implemented standardized adoption schedule
  - Allows time for public review and communicating to members
  - One year process from receiving new factors to implementing them
  - Goal is to adopt factors for an October 1 implementation
- Updated factors expected to be effective October 2016

Questions?

Actuarial Audit Presentation

Date Presented:
7/23/2014

Presenter Name and Title:
Mark Olleman & Daniel Wade, Consulting Actuaries, Milliman

Summary:
The independent actuary conducting the audit of the Actuarial Valuation and the Demographic Experience Study will provide an update on the status of the audit.

Strategic Linkage:
This item supports the following Strategic Priority Goals:
Maintain the financial integrity of the plan.

ATTACHMENTS:

Description	Type
Actuarial Audit Presentation	Presentation

LEOFF Plan 2 Retirement Board Actuarial Audit

July 23, 2014 Board Meeting

Presented by:

Mark Olleman, FSA, EA, MAAA
Daniel R. Wade, FSA, EA, MAAA

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Purpose & Scope

- **Purpose**: Review OSA's work and confirm that the results of the valuation and the most recent experience study are reasonable.
- **Scope:**
  - Full independent replication of June 30, 2013 Actuarial Valuation
  - Full independent review of Experience Study

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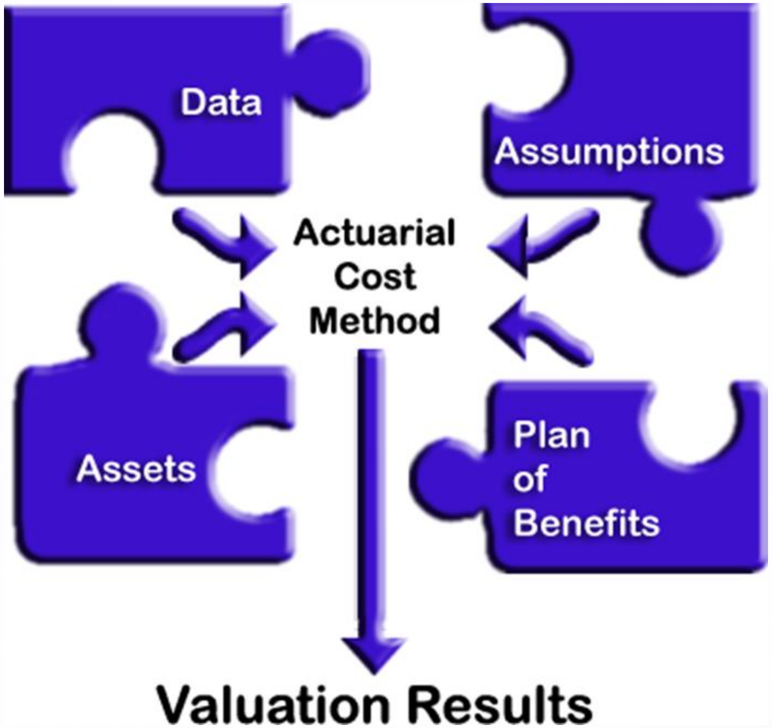
Bottom Line

- What you need to know
  - OSA's actuarial work is reasonable and appropriate
    - Good match on liabilities and contribution rates
    - Package of assumptions is reasonable
  - Recommendations
    - No changes needed to 2013 valuation
    - Recommendations for changes in methodology for future valuations and experience studies

Actuarial Valuation

We will review the process starting with results and going backwards.



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Actuarial Liabilities

- Parallel valuation results
  - Close match in total
  - Good match by benefit type and group

(in $Millions)	LEOFF 2 Results OSA	Milliman	O / M Ratio
Present Value All Future Benefits			
Retirement	$7,636.7	$7,621.7	100.2%
Termination	230.9	229.6	100.6%
Death	232.9	243.0	95.8%
Disability	350.9	346.1	101.4%
Total Actives	**$8,451.4**	**$8,440.4**	**100.1%**
Terminated Vested	$143.8	$141.2	101.8%
Terminated Not Vested	9.8	9.8	100.0%
Total Inactive, not in Payment	**$153.6**	**$151.0**	**101.7%**
Retired	$1,484.7	$1,495.1	99.3%
Disabled	123.1	120.9	101.8%
Survivor	68.8	67.7	101.6%
LOP Liability	32.2	32.4	99.4%
Total Annuitants	**$1,708.8**	**$1,716.1**	**99.6%**
Total Members	**$10,313.8**	**$10,307.5**	**100.1%**

% of Pay Contribution Rates

- Parallel valuation results
  - Aggregate Normal Cost close
    - If used, members and employers pay 50% of amount shown below
  - Entry Age Normal Cost Rate (EANC) close
    - Current contribution rates based on 100% of EANC split 50/30/20

	LEOFF 2 Results		
(in $Millions)	OSA	Milliman	O / M Ratio
Potential Contribution Calculations			
a. Present Value All Future Benefits	$10,313.8	$10,307.5	100.1%
b. Actuarial Value of Assets	-7,862.3	-7,862.4	100.0%
c. Present Value Future Contributions	$2,451.5	$2,445.1	100.3%
d. Present Value of Future Salaries	$17,562.8	$17,473.4	100.5%
e. Aggregate Normal Cost = c / d	13.96%	13.99%	99.8%
Entry Age Normal Cost Rate	17.70%	17.72%	99.9%
50% (Potential Employee)	8.85%	8.86%	99.9%
30% (Potential Employer)	5.31%	5.32%	99.9%
20% (Potential State)	3.54%	3.54%	99.9%

New Recommendations

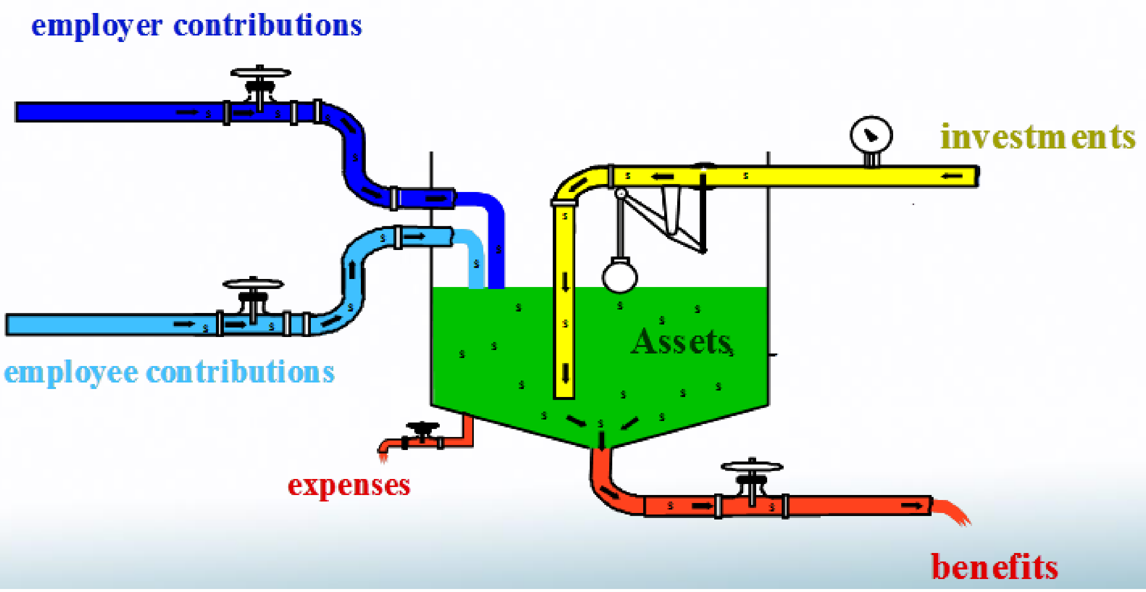
- Entry age is being calculated using current age minus truncated service.
  - Milliman believes it would be better to round instead of truncate.
  - This would cause a small, perhaps 3% decrease in the EANC.
  - No cause for concern. Small impact and conservative.
  - Milliman recommends changing method next year.
- Other changes concerning the methodology used to set assumptions
  - Do not cause material impacts
  - Detailed in audit report

Recommendations from Prior Audit

- OSA chose to disclose funded ratios with Projected Unit Credit method for one more year.
  - Will change with implementation of GASB 67/68 which requires use of Entry Age method
- Comment related to WSIB asset balances not quite matching DRS balances continues to apply.
- All other material recommendations implemented
- Some changes regarding the valuation of OPEB changes not made; however, we do not consider these material to the overall valuation of the system benefits

Aggregate Cost Method

- **<u>Aggregate Normal Cost</u>** equals the level % of projected pay to fund the difference between the present value of projected benefits and the actuarial value of assets.
  - All projected contributions go in one bucket, and are
  - spread evenly over the projected value of future salaries.
- Gains and losses cause the normal cost to go up and down.



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Aggregate Cost Method

- Does not calculate liability independent of the assets, however OSA uses Projected Unit Credit to accomplish that.
- All projected future contributions spread over projected salaries
  - Good for agency risk
  - Excellent for demographic matching
- High level of tail volatility management
  - Tail volatility occurs when bases used to amortize Unfunded Actuarial Accrued Liability (UAAL) expire. Since Aggregate does not calculate a UAAL this issue does not exist.
- Conference of Consulting Actuaries Draft White Paper classifies Aggregate as “Acceptable” if supplemental calculations disclose the Entry Age: Normal Cost, Liability and Amortization Period. If not, then “Acceptable with conditions.”

Entry Age Normal Cost (EANC)

- Based on the “Entry Age” Cost Method
- **<u>Entry Age Normal Cost</u>** is the level % of pay that will fund a member’s benefit if paid over his or her entire career.
  - Equals **expected** annual cost
  - Very stable
- Expected cost assumes all actuarial assumptions come true.

Experience different than expected will develop a positive or negative Unfunded Actuarial Accrued Liability which for most Systems using the Entry Age cost method causes their contributions to be different than the Normal Cost.

LEOFF Plan 2 Funding Policy

- Currently paying fixed rates equal to 100% of the Entry Age Normal Cost
- Temporary funding policy through June 30, 2017
- Considerations
  - Increases short term rate stability (and possibly long term)
  - Provides some margin for adverse experience
  - Avoids contributions less than expected long term cost of benefits
  - Requires consistent monitoring to maintain proper funding since contributions do not automatically adjust to:
    - Experience different than assumed
    - Assumption changes

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Membership Data

- Reviewed data supplied by DRS
  - Reviewed for reasonableness
  - Confirmed that all necessary information was included
- Reviewed data used in OSA's valuation
  - Performed independent data editing
    - Edits made for outliers and salary adjustments made for members with less than one year of service.
    - Compared to preliminary participant data summary posted on OSA's website.
  - Conclusion
    - Data used by OSA in valuation looks very good.

Membership Data *(Continued)*

LEOFF 2

	OSA	Milliman	Ratio OSA/Milliman
Active Members			
Total Number	16,687	16,687	100.0%
Total Salaries (millions)	$ 1,597	$ 1,597	100.0%
Average Age	43.5	43.5	100.0%
Average Service	14.6	14.6	100.0%
Average Projected Compensation	$ 95,694	$ 95,708	100.0%
Retirees and Survivors			
Total Number	2,782	2,782	100.0%
Average Monthly Pension	$ 3,151	$ 3,151	100.0%
Number of New Service Retirees	402	403	99.8%
Avg Monthly Pension for New Svc Retirees	$ 4,091	$ 4,082	100.2%
Terminated Members			
Total Number Vested	698	698	100.0%
Total Number Non-Vested	1,565	1,565	100.0%

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Actuarial Value of Assets

- Smoothing method
  - Layered recognition of gains and losses, with length of recognition based on deviation from expectation (maximum of eight years)
  - Data provided by WSIB and DRS
    - Totals and breakdown by Plan taken from DRS data
    - Monthly cash flows taken from WSIB data.
    - End of Year total market values do not perfectly match between the two sources but are close.
- Independent calculation by Milliman based on sources of data
  - Both Milliman and OSA calculated $7.862B for LEOFF Plan 2
- Asset method and calculations are reasonable

Experience Study

- Importance of reasonable assumptions
- Assumption types
  - Demographic assumptions
    - Set based largely on LEOFF recent experience
  - Economic Assumptions
    - Set based on global forecasts
    - Not studied this year. Comments are last in this presentation.

Mortality

- Two parts
  - Base table: What is the probability today of living another year?
  - Improvement scale: People are living longer. How much longer?
- Base table
  - Milliman has reviewed OSA's work and had multiple discussions.
  - OSA found members with larger benefits are living longer. In conjunction with excluding non-retired lives, no significant changes to results, but the method will be incorporated into future studies.
- Improvement scale
  - OSA is recommending Scale BB.
  - Milliman believes this is reasonable.
  - Society of Actuaries February 2014, MP-2014 Report states:
    - Scale BB was developed using 1950 – 2007 Social Security data.
    - Scale BB was tested to be consistent with two large public plans.

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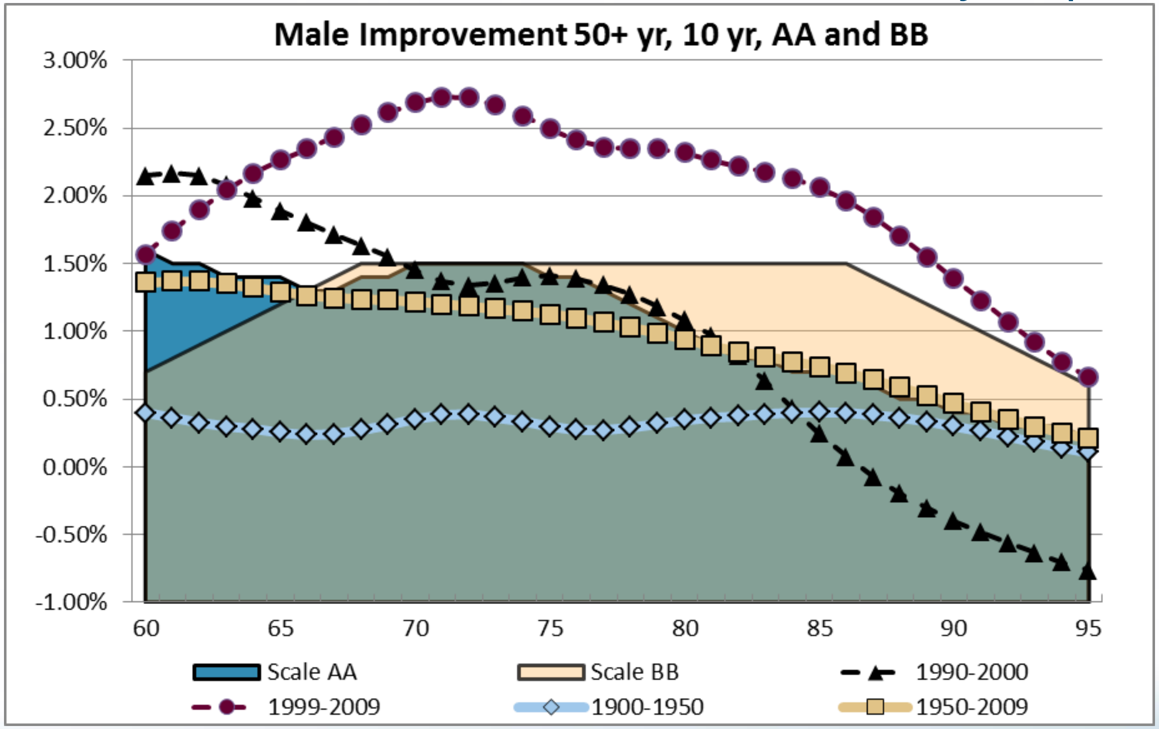
Future Mortality Improvement *(additional detail)*

- No one knows how rapidly mortality will improve
- There are many reasonable assumptions
- Further research shows
  - Compared to Milliman's calculations with Social Security Data Scale BB is generally:
    - lower than 1999 – 2009 improvement, and
    - higher than 1990 – 2000 improvement.
  - Scale BB is lower than CalPERS experience from 1997 - 2011
- Other Public Retirement Systems
  - Have generally not gone past Scale AA yet
  - Generational Mortality Projection
    - Half Scale AA generationally: Washington
    - Full Scale AA generationally: Oregon, Idaho, Seattle, Tacoma, Utah
    - Full Scale BB generationally: Wyoming
  - Differing Static Mortality Projections
    - CalPERS, CalSTRS, Montana PERS, Montana TRS, Colorado

(Private Plans generally use IRS mandated static projections for both IRS and accounting purposes.)

Male Comparison: Scales AA & BB to SSA Data*

- Over ages 60 to 95, Male Scale BB is:
  - Generally higher than the 59 year average 1950 – 2009.
  - Lower than the most recent 10 year average 1999 – 2009.
  - Higher than the 10 year average from 1990 – 2000.
- Note significant difference between two consecutive 10 year periods



* Averages calculated by Milliman using Social Security Administration data.

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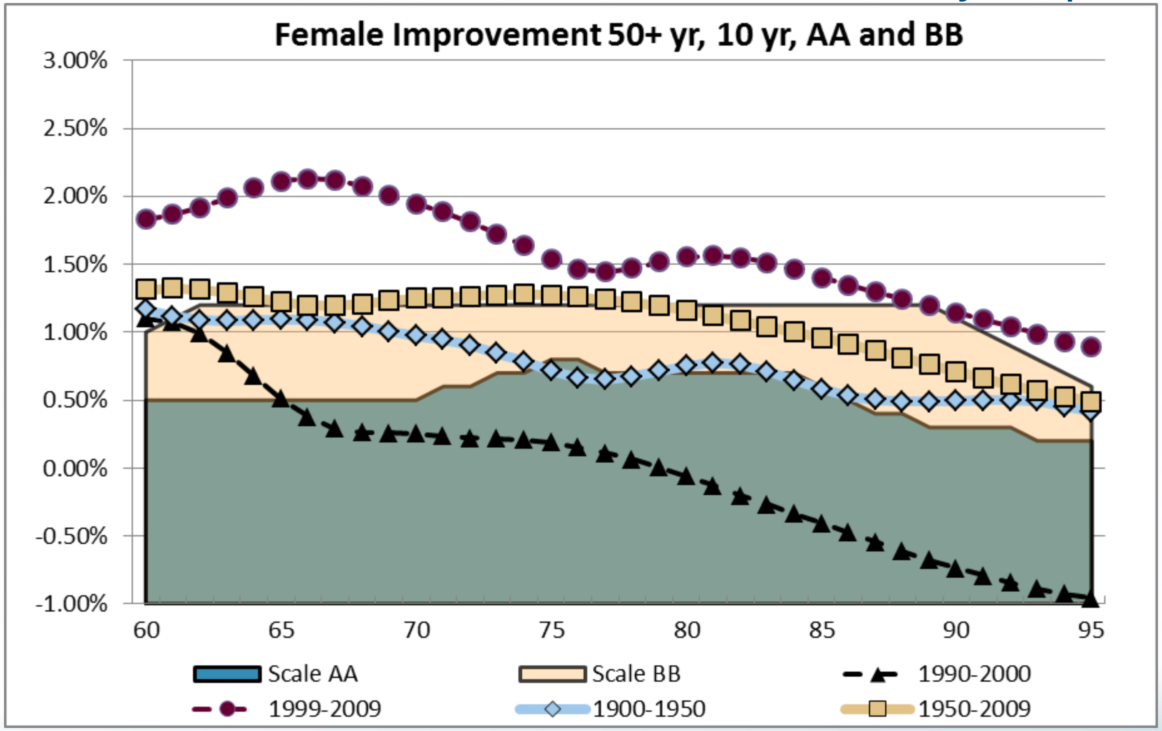
Female Comparison: Scales AA & BB to SSA Data*

- Over ages 60 to 95, Female Scale BB is:
  - Generally close to the 59 year average 1950 – 2009.
  - Lower than the most recent 10 year average 1999 – 2009.
  - Higher than the 10 year average from 1990 – 2000.
- Note significant difference between two consecutive 10 year periods



*** Averages calculated by Milliman using Social Security Administration data.**

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Salary Increases – Merit

- Actuaries use different approaches for developing this assumption.
- Subjectivity involved in determination of component for across-the-board productivity.
- Data from 1984 – 2009 used.
- Recommendations are reasonable.

Service Retirement

- Lower actual rates than previously assumed for LEOFF 2 at nearly all ages.
- OSA recommended partial reflection of differences.
- Data from 1995 to 2012 used.
- Recommendations are reasonable.

Disability Retirement

- Only used more recent data as benefit structure changed in 2005
- Data from 2005 to 2012 used.
- As with retirements, history generally shows lower actual than previously expected for LEOFF 2.
- Recommended generally lower assumptions to better match history.
- Also separated non-duty from duty and considered catastrophic.
- Recommendations are reasonable.

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Termination

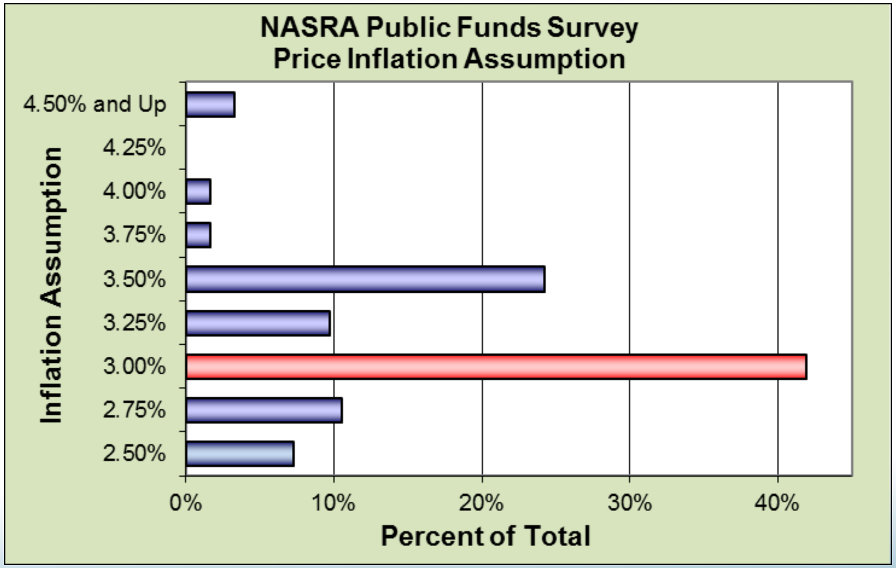
- Agree with service based approach
- Agree with opinion that only minor changes required for LEOFF 2.
- Data from 1995 to 2010 used.
- Recommendations are reasonable.

Other Assumptions

- Miscellaneous assumptions impacting LEOFF 2
  – Spouse age difference
  – Percentage taking annuities vs. refund of contributions
  – Percentage of Final Average Salary paid for Total Disability Benefit.
  – Minimum/Maximum/Default salaries and ages used for outliers and those with little service.
- Recommendations are reasonable.

Price Inflation and Wage Growth

- Price inflation assumption (3.00%) is reasonable
  - In line with historical averages.
  - Slightly higher than some forecasts.
  - Most common assumption for public systems.
- General wage growth (3.75%)
  - 0.75% higher than price inflation assumption
  - Reasonable



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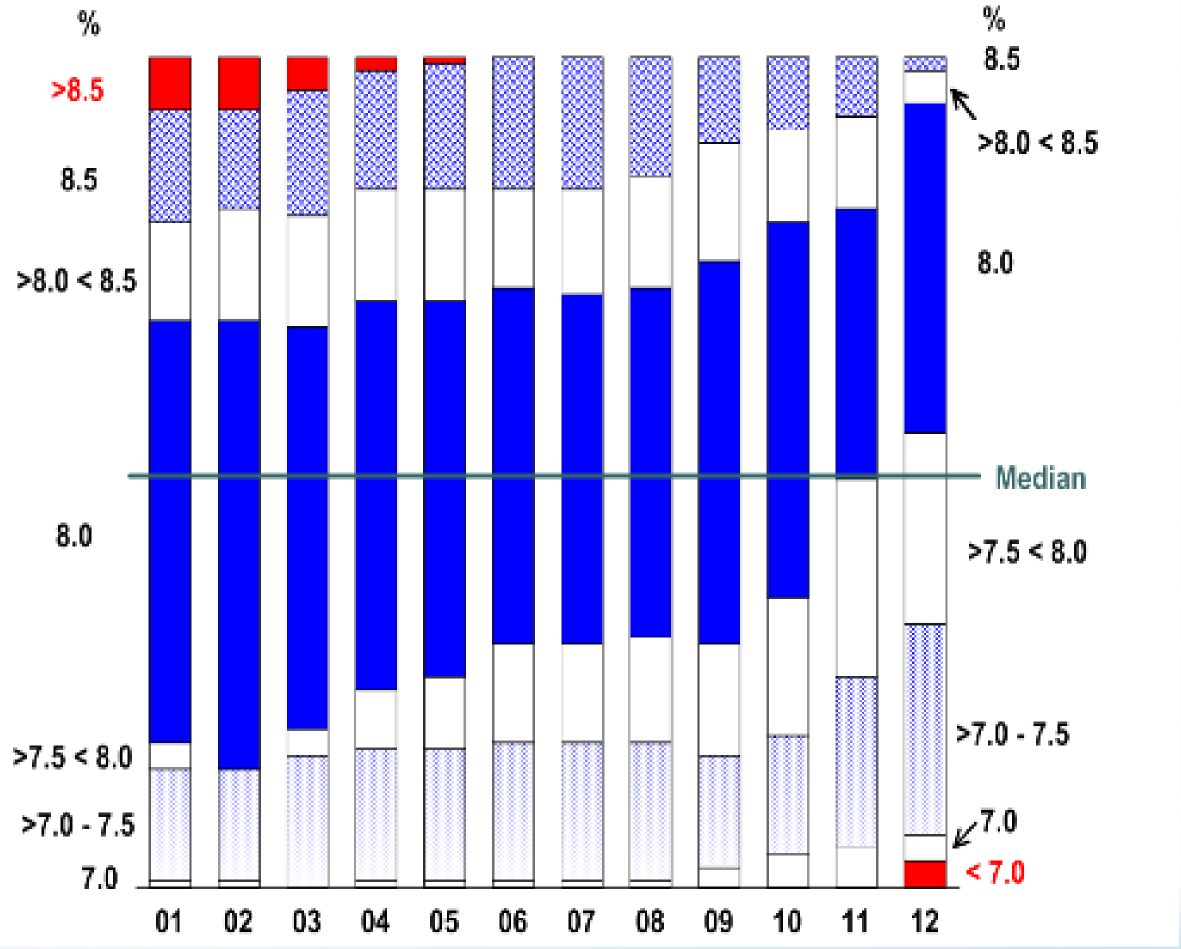
Investment Return

- Modeled expected return
  - Net of expenses
  - Used WSIB's target asset allocation and Milliman's capital market assumptions
  - We projected a long-term return of 7.57% per year
    - Based on 2013 environment – slightly lower expectations now
  - Other capital market assumptions could be used, including WSIB's from which OSA calculated 7.40% expectation.
- Revised actuarial standard may affect actuary's future recommendations
- Bottom Line
  - The 7.50% assumption is reasonable

Decreasing Investment Return Assumptions

Median is currently 7.75% based on NASRA's Public Fund Survey*:



*** Results from November, 2013 Public Fund Survey shown above**

Summary

- Recommendations
  - Modify calculation of entry age in future valuations
  - Implement some method changes pertaining to the setting of assumptions
  - Modifications to the valuation of OPEB benefits for future valuations (not material to the overall valuation of system benefits)

- Conclusion
  - The valuation accurately represents the actuarial condition of the System.
  - The assumptions and methods are reasonable.

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Your Questions?

Caveats and Disclaimers

This presentation is based on the data, methods, assumptions and plan provisions described in our actuarial audit report. The statements of reliance and limitations on the use of this material is reflected in the actuarial audit report and apply to this presentation.

These statements include reliance on data provided, on actuarial certification, and the purpose of the report.

Milliman's work product was prepared exclusively for the LEOFF 2 Board for a specific and limited purpose. It is a complex, technical analysis that assumes a high level of knowledge concerning LEOFF 2 operations, and uses LEOFF 2 data, which Milliman has not audited. It is not for the use or benefit of any third party for any purpose. Any third party recipient of Milliman's work product who desires professional guidance should not rely upon Milliman's work product, but should engage qualified professionals for advice appropriate to its own specific needs.

Contribution Rate Adoption

Report Type:
Final Proposal

Date Presented:
7/23/2014

Presenter Name and Title:
Ryan Frost, Research Analyst

Summary:

The Board is required by law to adopt member, employer, and state LEOFF Plan 2 contribution rates for the 2015-17 biennium no later than July 31, 2014.
The Board has previously adopted rates through June 30, 2017 but may consider changes. The Board will be presented with four options to consider.

Strategic Linkage:
This item supports the following Strategic Priority Goals:
Maintain the financial integrity of the plan.

ATTACHMENTS:

Description	Type
Contribution Rate Adoption Presentation	Presentation
Contribution Rate Adoption Report	Report

LEOFF
Plan 2 Retirement Board

Contribution Rate Setting

Final Proposal
July 23, 2014

Discussion Points

- Statutory Duty to Set Rates
- Goals and Achievements
- Options

LEOFF
Plan 2 Retirement Board

Statutory Duty

- Board Authorized to Set Rates
  - RCW 41.26.725
- Set Rates in Even-numbered Years
  - RCW 41.45.0604

LEOFF
Plan 2 Retirement Board

Goals and Achievements

- Fully-funded Status
  - Maintain 100% or Better Funded Status
  - Projection of Fully-funded Status through 6/30/2017
- Stable Contribution Rates
  - Predictable Increases
  - Level Rates through 6/30/2017

LEOFF Plan 2 Retirement Board

Options

1. Maintain Existing Contribution Rates

- 100% of EANC based on 2011 Valuation Report
  - 8.41% Member, 5.05% Employer, 3.36% State

LEOFF Plan 2 Retirement Board

Options

2. Adjust Contribution Rates to New EANC

a. 100% of EANC <u>Before</u> Updated Assumptions

- 8.60% Member, 5.16% Employer, 3.44% State

b. 100% of EANC <u>After</u> Updated Assumptions

- 8.85% Member, 5.31% Employer, 3.54% State

Options

3. Switch to an Aggregate Funding Method with a 90% Floor

- Aggregate After Updated Assumptions
  - 7.97% Member, 4.78% Employer, 3.19% State

Comparison

OPTION	MEMBER	EMPLOYER	STATE
Option 1: Maintain Existing Rates	8.41%	5.05%	3.36%
Option 2a: 100% EANC Before Updated Assumptions	8.60%	5.16%	3.44%
Option 2b: 100% EANC After Updated Assumptions	8.85%	5.31%	3.54%
Option 3: Aggregate/90% Floor After Updated Assumptions	7.97%	4.78%	3.19%

Any Questions?

- **Contact:**

Ryan Frost

Research Analyst

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LEOFF Plan 2 Retirement Board

July 23, 2014

CONTRIBUTION RATE SETTING

FINAL PROPOSAL
By Ryan Frost
Research Analyst
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ISSUE STATEMENT

The short-term policy issue to be addressed by the Board is to determine whether or not the existing fixed contribution rates should remain in effect or be adjusted to reflect the Preliminary Results of the *2013 Actuarial Valuation Report*.

OVERVIEW

The Board is required by law to adopt member, employer, and state LEOFF Plan 2 contribution rates for the 2015-17 biennium no later than July 31, 2014. The Board has previously adopted rates through June 30, 2017 but may consider changes.

The current adopted contribution rates are 8.41% member, 5.05% employer and 3.36% state and are effective through June 30, 2017. The contribution rate is calculated at one hundred percent of the entry age normal cost (EANC) of the plan based on the Actuary's *2011 Actuarial Valuation Report*.

BACKGROUND & POLICY ISSUES

DUTY TO SET CONTRIBUTION RATES

The Board has a statutory duty to set contribution rates for LEOFF Plan 2 in even-numbered years. Prior to the creation of the Board on July 1, 2003 under Initiative 790, basic contribution rates for LEOFF Plan 2 were set by the Pension Funding Council (PFC), subject to revision by the Legislature. The PFC would receive contribution rate recommendations from the Office of the State Actuary (OSA) on all of the state retirement plans, including LEOFF Plan 2. This process is still used today for all of the other state retirement systems. After the creation of the Board, OSA now makes contribution rate recommendations for LEOFF Plan 2 directly to the Board and the Board sets contribution rates. Rates set by the Board may be subject to Legislative Revision.

MAINTAINING FINANCIAL INTEGRITY OF THE PLAN – STRATEGIC PLAN

In 2004 the Board, as part of its strategic plan, set maintaining the financial integrity of the plan as of its top priorities. Maintaining the stability of contribution rates was one of the objectives set for reaching this goal. The first step in achieving stable rates was to increase contribution rates to meet the levels needed to fund current benefits. The Board realized the contribution rates which had been artificially low could not be raised to the full extent needed without creating financial hardships for the members, employers and state. Instead, the Board adopted a four-year plan of annual increases to raise rates through June 30, 2009 (see appendix A).

The Board then adopted two policies to further stabilize long-term contribution rates. One was the adoption of a minimum contribution rate of 90% of the EANC of the plan. The second was to establish a funding corridor. Under the funding corridor policy a 30% maximum and minimum ratio of actuarial to market asset value was established. This helps ensure rates do not remain artificially too high or low. In addition to these policies the Legislature passed a statutory funding policy in 2003 that allows gains and losses to be "smoothed" over a period of up to eight years, depending on the magnitude of the deviation between actual investment return and the current return assumption.

TEMPORARY FUNDING POLICY CHANGES

In July 2008 the Board adopted a temporary change in funding policy by adopting fixed rates for the next four years (July 1, 2009 through June 30, 2013) that were equal to 100% of the EANC as of June 30, 2007. In July 2010, as part of their two-year rate-setting cycle, the Board reviewed the existing funding policy and moved to extend the current temporary funding policy through June 30, 2017.

This temporary funding policy allows the Board to maintain rate stability and 100% funded status through June 2017. The Board's policy will allow for the fund to recognize all of the losses from 2008 and 2009 without having to increase contribution rates. Most Washington pension plans will have significant pressure to increase rates in the next biennia as they recognize the same losses from 2008 and 2009.

At the July 2012 Meeting, the Board decided to adjust the temporary funding policy enacted in 2010 by adopting rates based on 100% of the Entry Age Normal Cost (EANC) from the *2011 Actuarial Valuation Report,* rather than continuing to use the rates from the *2007 Actuarial Valuation Report.*

MORTALITY IMPROVEMENTS AFFECT RATES

According to Office of the Chief Actuary (OCACT) for the Social Security Administration (SSA), factors contributing to generally rapid overall rate of improvement during past century include: Access to primary medical care, discovery and availability of antibiotics and immunizations, clean water supply and waste removal, and a rapid growth in the standard of living.[1] All of these factors contributing to one another result in longer life spans, and thus more pension payments to be made.

The principal factor affecting the increase in proposed rates for the upcoming biennium is the switch from Scale AA to Scale BB on the RP-2000 Mortality table.

Scale AA was first released in 2005, and adopted by the board in August 2006. However, "a noticeable degree of mismatch between Scale AA rates and actual mortality experience for ages under 50, and the Scale AA rates were lower than actual mortality improvement rates for most ages over 55."

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[1] OSA Preliminary Presentation to LEOFF 2 Board at June 18th, 2014 Meeting

This separation of assumed rates and actual experience led to the Office of the State Actuary implementing an interim scale in 2012 called Scale BB.

Scale BB is meant to do two things: first to align assumptions to be more in line with experience, and second to prepare for the upcoming change in the soon to be released RP-2014 mortality table which uses a 2-dimensional scale for the first time. Rather than simply looking at age only as was done in the past, a 2D scale looks at age and the year of birth.

POLICY OPTIONS

Option 1: Maintain Existing Fixed Contribution Rate through June 30, 2017

Under this option the Board is not required to do anything. The contribution rates will continue at 100% of the EANC based on the *2011 Actuarial Valuation Report*. The rates under this option would be: 8.41% Member, 5.05% Employer, and 3.36% State.

Option 2a: Adjust Contribution Rates to New EANC without Updated Assumptions

Under this option the Board would adopt a contribution rate of 100% of the EANC, with no updated assumptions, based on the Preliminary Results of the *2013 Actuarial Valuation Report.* The rates under this option would be: 8.60% Member, 5.16% Employer, and 3.44% State.

Option 2b: Adjust Contribution Rates to New EANC with Updated Assumptions

Under this option the Board would adopt a contribution rate of 100% of the EANC including the updated assumptions, based on the Preliminary Results of the *2013 Actuarial Valuation Report.* The rates under this option would be: 8.85% Member, 5.31% Employer, and 3.54% State

Option 3: Switch to Aggregate Rate with a 90% Floor with Updated Assumptions

Under this option the contribution rate would be based on the aggregate actuarial cost of the plan as of the *2013 Actuarial Valuation Report* with updated assumptions; and with adjustments, as needed, for a 90% rate floor and the 30% maximum/minimum asset corridor. The rates under this option would be: 7.97% Member, 4.78% Employer, and 3.19% State.

OPTION COMPARISON	MEMBER	EMPLOYER	STATE
Option 1: Maintain Existing Rates	8.41%	5.05%	3.36%
Option 2a: 100% EANC Before Updated Assumptions	8.60%	5.16%	3.44%
Option 2b: 100% EANC Before Updated Assumptions	8.85%	5.31%	3.54%
Option 3: Aggregate/90% Floor After Updated Assumptions	7.97%	4.78%	3.19%

SUPPORTING INFORMATION

Appendix A: 2005 – 2009 Weighted Annual Contribution Rate Increase Schedule

Appendix B: Historical Contribution Rates

Appendix C: Rate-Setting Statutes

Appendix D: Funding Methods Defined

APPENDIX A

2005-2009 WEIGHTED ANNUAL CONTRIBUTION RATE INCREASE SCHEDULE

YEAR	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%

APPENDIX B
HISTORICAL CONTRIBUTION RATES

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%
7/1/05	6.75%	4.05%	2.70%
9/1/05	6.99%	4.20%	2.79%
7/1/06	7.79%	4.68%	3.11%
9/1/06	7.85%	4.72%	3.13%
7/1/07	8.60%	5.17%	3.43%
9/1/07	8.64%	5.19%	3.45%
7/1/08	8.83%	5.30%	3.53%
7/1/09	8.45%	5.07%	3.38%
9/1/09	8.46%	5.08%	3.38%
7/1/13	8.41%	5.21%	3.20%
9/1/13	8.41%	5.05%	3.36%

APPENDIX C
RATE-SETTING STATUTES

RCW 41.26.725
Board of trustees — Contributions — Minimum and increased benefits

(1) The board of trustees shall establish contributions as set forth in this section. The cost of the minimum benefits as defined in this plan shall be funded on the following ratio:

Employee contributions	50%
Employer contributions	30%
State contributions	20%

(2) The minimum benefits shall constitute a contractual obligation of the state and the contributing employers and may not be reduced below the levels in effect on July 1, 2003. The state and the contributing employers shall maintain the minimum benefits on a sound actuarial basis in accordance with the actuarial standards adopted by the board.

(3) Increased benefits created as provided for in RCW 41.26.720 are granted on a basis not to exceed the contributions provided for in this section. In addition to the contributions necessary to maintain the minimum benefits, for any increased benefits provided for by the board, the employee contribution shall not exceed fifty percent of the actuarial cost of the benefit. In no instance shall the employee cost exceed ten percent of covered payroll without the consent of a majority of the affected employees. Employer contributions shall not exceed thirty percent of the cost, but in no instance shall the employer contribution exceed six percent of covered payroll. State contributions shall not exceed twenty percent of the cost, but in no instance shall the state contribution exceed four percent of covered payroll. Employer contributions may not be increased above the maximum under this section without the consent of the governing body of the employer. State contributions may not be increased above the maximum provided for in this section without the consent of the legislature. In the event that the cost of maintaining the increased benefits on a sound actuarial basis exceeds the aggregate contributions provided for in this section, the board shall submit to the affected members of the plan the option of

paying the increased costs or of having the increased benefits reduced to a level sufficient to be maintained by the aggregate contributions. The reduction of benefits in accordance with this section shall not be deemed a violation of the contractual rights of the members, provided that no reduction may result in benefits being lower than the level of the minimum benefits.

(4) The board shall manage the trust in a manner that maintains reasonable contributions and administrative costs. Providing additional benefits to members and beneficiaries is the board's priority.

[2003 c 93 § 1; 2003 c 2 § 6 (Initiative Measure No. 790, approved November 5, 2002)].

RCW 41.45.0604
Contribution rates — Law enforcement officers' and firefighters' retirement system plan 2.

(1) Not later than July 31, 2008, and every even-numbered year thereafter, the law enforcement officers' and firefighters' plan 2 retirement board shall adopt contribution rates for the law enforcement officers' and firefighters' retirement system plan 2 as provided in RCW 41.26.720(1)(a).

(2) The law enforcement officers' and firefighters' plan 2 retirement board shall immediately notify the directors of the office of financial management and department of retirement systems of the state, employer, and employee rates adopted. Thereafter, the director shall collect those rates adopted by the board. The rates shall be effective for the ensuing biennial period, subject to any legislative modifications.

[2007 c 280 § 3; 2003 c 92 § 4.]

APPENDIX D
FUNDING METHODS DEFINED

Aggregate Funding Method[2]

The aggregate funding method is a standard actuarial funding method. The annual cost of benefits under the aggregate method is equal to the normal cost. The method does not produce an unfunded actuarial accrued liability. The normal cost is determined for the entire group rather than on an individual basis.

Entry Age Normal Cost Method (EANC)[3]

The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components: normal cost plus amortization of the unfunded liability. The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

Fixed Normal Cost Method: Variation of Entry Age Normal Cost Method

Under the Entry Age Normal Cost (EANC) method, there are two components: the normal cost, and the UAAL (surplus or deficit) which is amortized over time. Under the fixed normal cost (FNC) method, the amortization of the unfunded liability is eliminated. Instead, rates are tied to the normal cost and the UAAL will fluctuate up and down (within the corridor) depending on investment performance. This method provides more stable rates than the EANC

[2] "Glossary of Actuarial and Pension Terms". Office of the State Actuary. 13 Jan 2012. Web. 3 July 2012.
[3] "Glossary of Actuarial and Pension Terms". Office of the State Actuary. 13 Jan 2012. Web. 3 July 2012.

SCPP Update

ATTACHMENTS:

	Description	Type
🗋	SCPP Agenda	Report

Select Committee on Pension Policy

P.O. Box 40914
Olympia, WA 98504-0914
actuary.state@leg.wa.gov

Regular Committee Meeting

July 15, 2014
10:00 a.m. – 12:00 p.m.*
Senate Hearing Room 4
Olympia

AGENDA

10:00 a.m.	1.	**Approval Of Minutes**
10:05 a.m.	2.	**Update On Preliminary Audit Results –** Darren Painter, Policy and Research Services Manager

Educational Briefings

10:20 a.m.	3.	**History Of Post-Retirement Employment –** Devon Nichols, Policy Analyst
10:40 a.m.	4.	**Plan 1 UAAL –** Aaron Gutierrez, Senior Policy Analyst

Public Hearing/Possible Executive Session

11:00 a.m.	5.	**Contribution Rate Recommendation To PFC** – Devon Nichols
12:00 p.m.	6.	**Adjourn**

**These times are estimates and are subject to change depending on the needs of the Committee.*

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Select Committee on Pension Policy

Executive Committee Meeting

July 15, 2014
12:30 p.m. – 1:30 p.m.*
Senate Conference Rooms A/B/C
Olympia

AGENDA

12:30 p.m.	(A)	**Approval of Minutes**
12:35 p.m.	(B)	**AAG Update**
12:45 p.m.	(C)	**Follow-Up From Today's Full Committee Agenda**
1:00 p.m.	(D)	**September Meeting Agenda**
1:15 p.m.	(E)	**Constituent Correspondence**
1:20 p.m.	(F)	**Discussion/Other Business**
1:30 p.m.	(G)	**Adjourn**

**These times are estimates and are subject to change depending on the needs of the Committee.*

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Agenda Items for Future Meetings

ATTACHMENTS:

	Description	Type
	Agenda Items for Future Meetings	Report

LEOFF Plan 2 Retirement Board

2014
AGENDA ITEMS CALENDAR

MEETING DATE	AGENDA ITEMS
January 22, 2014	2014 Legislative Update
February 26, 2014	2014 Legislative Update
March 26, 2014	2014 Legislative Update 2014 Interim Planning
April 16, 2014	Meeting Cancelled
May 28, 2014	Local Government DCP Participation, Initial Consideration Final Average Salary Protection, Initial Consideration Alternate Revenue Update SCPP Coordination Demographic Experience Study Education – OSA Annual Attorney General Training – Dawn Cortez, AAG Parliamentary Procedure Review – Dawn Cortez, AAG
June 18, 2014	Contribution Rate Setting Contribution Rate Preview – OSA Demographic Experience Study Recommendation – OSA DRS Benchmarking – Mark Feldhausen, Budget and Benchmarking Director Actuarial Audit Presentation – Mark Olleman, Milliman Alternate Revenue, Educational Briefing
July 23, 2014	Funding Pension Plan Benefits – Robert Klausner, Esquire Experience Study and Actuarial Valuation Update – Lisa Won, Actuary Actuarial Audit Presentation – Mark Olleman & Daniel Wade, Milliman Contribution Rate Adoption – Ryan Frost
August 27, 2014	Washington State Investment Board Annual Update Comparing Deferred Benefit and Defined Benefit Contribution Plans Local Government DCP Participation, Work Session Final Average Salary Protection, Comprehensive Report
September 24, 2014	Demographic Experience Study, Final Report – OSA LEOFF 2 Actuarial Valuation – OSA FY14 Independent Audit Results, Steve Davis DRS Annual Administrative Update
October 22, 2014	2015 Proposed Meeting Calendar
November 19, 2014	2015 Meeting Calendar Adoption
December 17, 2014	