

# BOARD MEETING AGENDA

September 21, 2016 - 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

recep@leoff.wa.gov

- |   |          |
|---|----------|
| <b>1. Approval of Minutes</b>   | 9:30 AM  |
| <b>2. Washington State Investment Board Annual Update</b><br>Theresa Whitmarsh, Executive Director                          | 9:40 AM  |
| <b>3. Financial Audit Results</b><br>Steve Davis, Davis Accounting & Audit Services   | 10:15 AM |
| <b>4. Administrative Factors</b><br>Lisa Won, ASA, FCA, MAAA, Deputy State Actuary  | 10:45 AM |
| <b>5. Presumptive Medical</b><br>Ryan Frost, Research and Policy Manager  | 11:15 AM |
| <b>6. Individual Health Savings Accounts</b><br>Ryan Frost, Research and Policy Manager                                     | 11:30 AM |
| <b>7. LEOFF Plan Comparison</b><br>Ryan Frost, Research and Policy Manager  | 11:45 AM |
| <b>8. Administrative Update</b> <ul style="list-style-type: none"><li>• SCPP Update</li><li>• Outreach Activities</li></ul> | 12:00 PM |
| <b>9. Board Member Annual Training</b><br>Tor Jernudd, Assistant Attorney General   | 12:15 PM |
| <b>10. Standby Pay</b><br>Paul Neal, Senior Research and Policy Manager   | 12:50 PM |
| <b>11. Final Month Payment</b><br>Paul Neal, Senior Research and Policy Manager   | 1:05 PM  |
| <b>12. Plan 1/Plan 2 Merger Study</b><br>Steve Nelsen, Executive Director   | 1:20 PM  |
| <b>13. Public Testimony</b>   | 2:15 PM  |
| <b>14. Agenda Items for Future Meetings</b>   | 2:45 PM  |

Steve Nelsen, Executive Director

**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.*

# BOARD MEETING MINUTES

JULY 27, 2016 - DRAFT



## TRUSTEE AND STAFF ATTENDANCE

In Attendance	Mr. Kelly Fox, Chair – Olympia Fire District
Teleconference	Mr. Jason Granneman, Vice Chair – Clark County Sheriff's Office
In Attendance	Representative Jeff Holy – Spokane Police Department (Retired)
In Attendance	Representative Kevin Van De Wege – WA State Representative
In Attendance	Senator Judy Warnick – WA State Senator
Absent	Councilmember Dave Upthegrove – King County Council District 5
Teleconference	Mr. Wally Loucks – Spokane County Sheriff's Office
In Attendance	Mr. Mark Johnston – Vancouver Fire Department
In Attendance	Mr. Paul Golnik – WA Fire Commissioners Association
In Attendance	Mr. David Cline – City of Tukwila
Absent	Mr. Michael White – Valley Regional Fire Authority

## CALL TO ORDER

The LEOFF Plan 2 Retirement Board met in the Washington State Investment conference room in Olympia, Washington on July 27, 2016. A quorum of the members was present at this meeting.

OPENING	David Cline called the meeting to order at 9:33AM and requested those present to take a moment of silence to honor those who had fallen since the last the Board meeting.
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## 1. APPROVAL OF MINUTES

MINUTES APPROVED	It was moved to approve the Board meeting minutes from June 22 <sup>nd</sup> , 2016. Motion was seconded. The Board approved the minutes without objection.
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## 2. VALUATION AUDIT RESULTS

Nick Collier and Daniel Wade, Consulting Actuaries at Milliman presented an overview of their actuarial audit for the 2015 valuation. No recommended changes are being made.

## 3. CONTRIBUTION RATE ADOPTION

Ryan Frost, Research and Policy Manager presented the options for contribution rate setting for the next two biennium. Rates have already been previously adopted, but the Board has the opportunity to adopt new rates in July. The following three options were presented to the Board for consideration.

Option	Member	Employer	State
1: Maintain Existing Adopted Rates for 2017-2019	8.85%	5.31%	3.54%
2: 100% EANC from 2015 Valuation	8.75%	5.25%	3.50%
3: 90% EANC from 2015 Valuation	7.88%	4.73%	3.15%

# BOARD MEETING MINUTES

JULY 27, 2016 - DRAFT



MOTION	It was moved to adopt option #2 for the next two biennium. The motion was seconded. The motion passed unanimously.
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## 4. DRS ANNUAL UPDATE

Jacob White, Legal and Legislative Services Manager at the Department of Retirement Systems, gave a Year in Review presentation to the Board. Executive Director Marcie Frost joined the meeting after the first break and addressed the Board.

MOTION	A motion was made to add the topic of Final Month Payment to the 2016 agenda items calendar. Motion was seconded. The motion passed unanimously.
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## 5. ADMINISTRATIVE UPDATE

Steve Nelsen, Executive Director, gave his administrative update to the board. The August 24<sup>th</sup> meeting will be cancelled. The next meeting will be September 21<sup>st</sup>, 2016. Director Nelsen will begin to conduct the annual Expectation Interviews and plans to complete these by the October 18<sup>th</sup> meeting. A quarterly budget update will be given at the next meeting.

At the last SCPP meeting they had an update on the merger study. A survey was sent to members of stakeholder groups. Survey results and comments are to be compiled and shared at a later date.

SCPP UPDATE	The SCPP is scheduling round table meetings as an open discussion forum regarding merger. The first meeting is scheduled for July 27 <sup>th</sup> at 2pm, directly following the LEOFF 2 Board meeting.
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OUTREACH	Director Nelsen and Ryan Frost attended the WSCFF 77 <sup>th</sup> Annual Convention in Vancouver, WA. Tammy Harman attended the Stand With Those That Serve event and provided outreach.
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## 6. AGENDA ITEMS FOR FUTURE MEETINGS

Steve Nelsen, Executive Director, reviewed items for upcoming board meetings.

## 7. LEOFF 1 / LEOFF 2 MERGER STUDY – INITIAL CONSIDERATION

Steve Nelsen, Executive Director, presented an initial consideration presentation on a LEOFF 1 and LEOFF 2 merger study. A comprehensive report presentation is scheduled for the September 21<sup>st</sup>, 2016 meeting. Specific information and analysis will be provided related to LEOFF Plan 2.

MOTION	A motion was made to direct staff to work with the AAG to discuss and clarify legal issues. Motion was seconded. The motion was carried.
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## 8. PUBLIC TESTIMONY

The following people addressed the Board:

# BOARD MEETING MINUTES

JULY 27, 2016 - DRAFT



Josh Weiss, Director of Policy and Legislative Relations, Washington State Association of Counties  
Jim Fossos, Vice President of the Retired Fire Fighters of Washington  
Jerry Taylor, President of Retired Seattle Police Officers Association  
Candice Bock, Government Relations Advocate, Association of Washington Cities  
Dave Peery, Secretary of the LEOFF 1 Coalition

## ADJOURNMENT

There being no further business, the meeting was adjourned at 12:32 PM.

NEXT MEETING	The next meeting of the LEOFF Plan 2 Retirement Board is scheduled for September 21, 2016 at the Washington State Investment Board located at 2100 Evergreen Park Drive SW Olympia, WA 98502.
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## Washington State Investment Board Annual Update

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Theresa Whitmarsh, Executive Director

**Summary:**

Annual plan assets update from the Director of the State Investment Board.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Maintain the financial integrity of the plan., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ WSIB Update	Presentation

## Washington State Investment Board Update



Theresa Whitmarsh, Executive Director  
Washington State Investment Board  
September 21, 2016



## Who We Are – At a Glance



**The Washington State Investment Board (WSIB) is one of the largest and most diversified institutional investment managers in the United States.**

- ▣ **\$108.5 billion assets under management as of June 30, 2016**
- ▣ **17 pension funds**
- ▣ **5 Labor and Industries insurance funds**
- ▣ **13 Permanent and other trust funds**

**The WSIB invests globally and employs both internal/external managers, along with both active and passive strategies:**

- ▣ **74 different countries**
- ▣ **Across 6 continents**
- ▣ **49 currencies**
- ▣ **More than 12,000 investment holdings**





## Who We Are – Board Member Transitions at the WSIB



### **Board comprised of 15 members**

- ▣ 10 voting members drawn from a diverse group of system owners
- ▣ 5 non-voting investment experts selected by the voting members

### **This fall we will see several significant changes in Board membership/roles:**

- ▣ Kelly Fox, LEOFF Plan 2 chair, now chairs the WSIB. He has served us since February 2013 and is serving his second 3-year term.
- ▣ State Treasurer – November election will determine whether Duane Davidson (Benton County) or Michael Waite (Seattle area) fills this ex-officio seat.
- ▣ Department of Retirement Services – Tracy Guerin, Deputy Director of the Office of Financial Management (OFM), has been appointed by the Governor to replace Marcie Frost, who was hired as CEO of CalPERS.
- ▣ Senator Mike Hewitt has retired. His replacement will be appointed this fall by the President of the Senate (Lieutenant Governor), based on majority membership of the Senate.
- ▣ Representative Timm Ormsby is expected to continue on the Board unless the GOP gains a majority in the House of Representatives and appoints its own replacement.



## Who We Are – Retirement Plans at the Core

*June 30, 2016*

- ▣ Defined Benefit (DB) plans and hybrid DB/Defined Contribution (DC) plans commingled into one investment fund run by the WSIB:

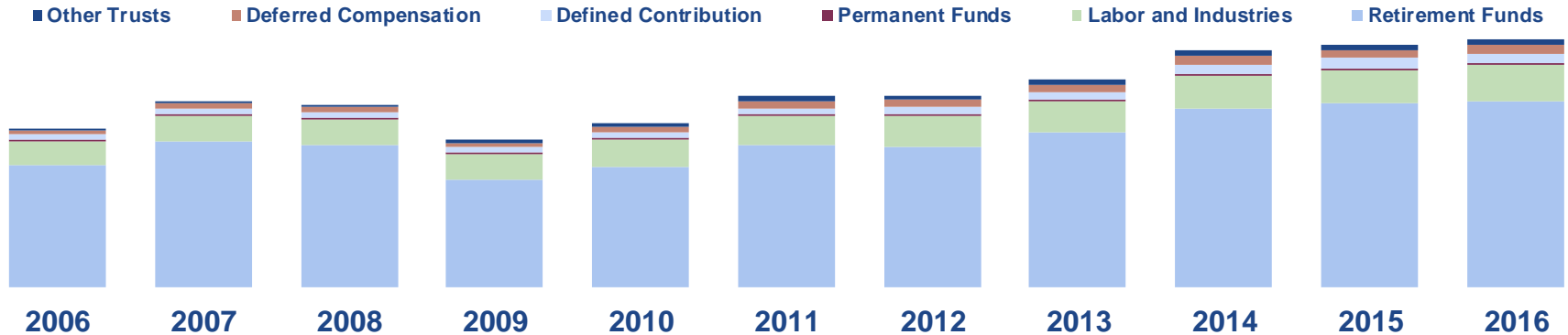
Defined Benefit Plans	Market Value
Public Employees' Retirement System Plan 1 (PERS)	\$7,004,152,424
Public Employees' Retirement System Plan 2/3	\$31,547,441,363
Teachers' Retirement System Plan 1 (TRS)	\$5,429,869,201
Teachers' Retirement System Plan 2/3	\$15,188,610,160
Volunteer Fire Fighters' Relief & Pension Fund (VOLFF)	\$184,478,154
Washington State Patrol Retirement System Plan 1 (WSPRS)	\$1,042,574,750
Washington State Patrol Retirement System Plan 2	\$41,835,372
Law Enforcement Officers' & Fire Fighters' Plan 1 (LEOFF)	\$5,309,406,988
Law Enforcement Officers' & Fire Fighters' Plan 2	\$10,070,325,142
School Employees' Retirement System Plan 2/3 (SERS)	\$5,415,245,336
Public Safety Employees' Retirement System Plan 2 (PSERS)	\$391,009,208
<b>Total</b>	<b>\$81,624,948,099</b>

Defined Contribution Plans	Market Value
Deferred Compensation Program (DCP)	\$3,619,753,403
Judicial Retirement Account (JRA)	\$11,038,953
<b>Total</b>	<b>\$3,630,792,356</b>

# Who We Are – Total Assets Under Management

June 30, 2016

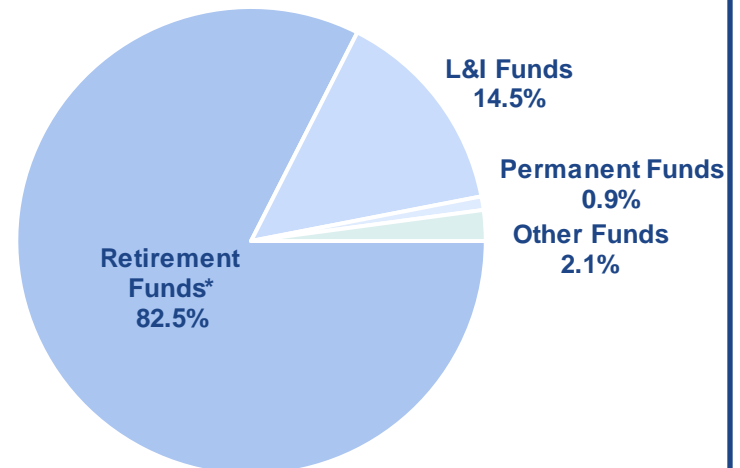
## Past 10 Fiscal Years



Fiscal Years

## Market Values and Allocation (in billions)

Retirement Funds*	\$89.5	82.5%
L&I Funds	\$15.7	14.5%
Permanent Funds	\$1.0	0.9%
Other Funds	\$2.3	2.1%
<b>Total Assets Under Management</b>	<b>\$108.5</b>	



# What We Do – Diversification Across Asset Classes



- WSIB seeks diversification across the portfolio and within each asset class.
- Each asset class contains its own range of risk/return potential.
- WSIB is known for its early emphasis on private equity, and this has allowed us to create a strong reputation in the marketplace.

Low Risk

High Risk

## FIXED INCOME

Treasury Bills   Credit Bonds   High Yield

## REAL ESTATE

Unlevered   Levered

Developed Markets   Emerging Markets

Fully Developed   Raw Land

## PUBLIC EQUITY

Developed Markets   Emerging Markets

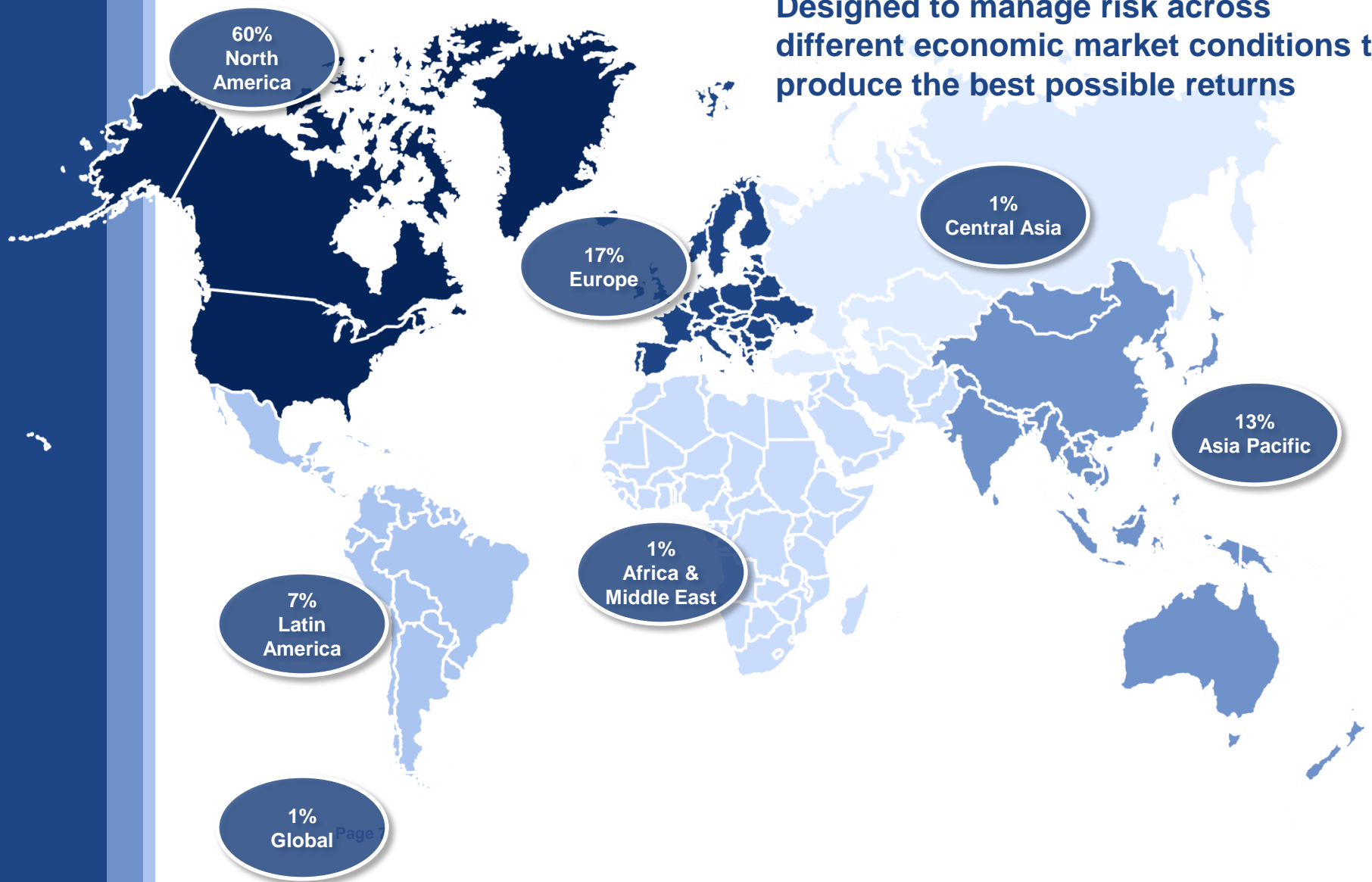
Large Cap   Small Cap

## PRIVATE EQUITY

Mezzanine Debt   Large Buyouts   Venture Capital

## What We Do – Diversification Across the Globe

Designed to manage risk across different economic market conditions to produce the best possible returns





# What We Do – Diversification Across Public and Private Markets

## Public Equity

### Objective

- ▣ Capital appreciation
- ▣ Liquidity

### Approach

- ▣ Externally-managed
- ▣ Significant passive management
- ▣ Globally-oriented
- ▣ Scale helps keep costs low

## Fixed Income

### Objective

- ▣ Diversification
- ▣ Liquidity

### Approach

- ▣ Actively internally-managed
- ▣ High-quality portfolio
- ▣ Credit-oriented

## Private Equity

### Objective

- ▣ Long-term growth and appreciation
- ▣ Diversification

### Approach

- ▣ Strong relationships with like-minded partners
- ▣ Equity in quality growth companies
- ▣ Buyouts; very little venture capital

## Real Estate

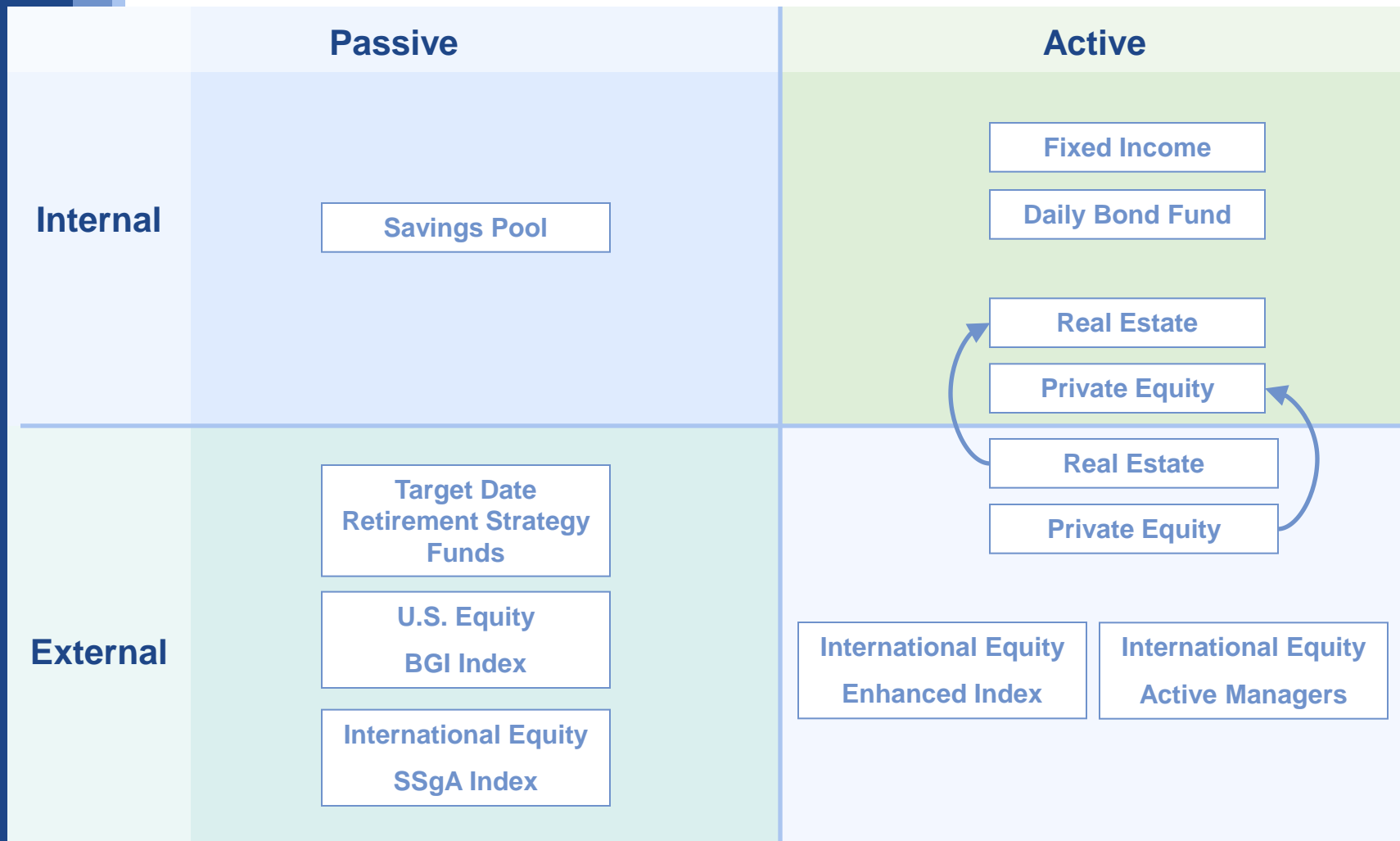
### Objective

- ▣ Long-term growth and appreciation
- ▣ Global diversification
- ▣ Income generation

### Approach

- ▣ Investing in life's essentials: agriculture, social needs, energy
- ▣ Direct stakes in operating companies

# What We Do – Diversification by Investment Strategy





## Powerful Forces – A Puzzling Market Environment



### Low Growth, Low Rates

- ▣ Global economies are growing very slowly.
- ▣ Fed reluctant to raise interest rates in fragile environment.
- ▣ U.S. is bright spot, but capital markets are relatively expensive.
- ▣ Lack of corporate investment in favor of share buybacks.

### Signs of Uncertainty

- ▣ Bonds largely outperformed stocks over the last year.
- ▣ 10-year Treasury yield hit record low in July.
- ▣ Germany, Japan and Switzerland post negative interest rates.
- ▣ Brexit – more mystery than clarity:
  - ▣ Will the UK-domiciled companies move to the Continent?
  - ▣ How will this affect free movement of business/labor/people?
  - ▣ How will EU investments be affected long term?
- ▣ Reversals:
  - ▣ Emerging market equities were lagging a year ago, now leading.
  - ▣ Energy and materials: cycling from weak to strong to weak.





# Powerful Forces – Realistic Market Assumptions and Contributions



## Capital Markets Stance

- ▣ Seeing lower market assumptions, but gently (7.8 to 7.7 percent).
- ▣ The real challenge is to manage expectations.
- ▣ Need to maintain discipline and investment approach.
- ▣ Remember we've been here before (low return environments).
- ▣ Our investment profile (asset allocation) is not typical for most investors, so our experience will vary from the norm too.
- ▣ Our focus is on discriminating for investment quality, not diversification alone.
- ▣ Our focus is on long term outcomes, not short-term gains or safety.

## Contributions Stance

- ▣ Employers and employees must maintain honest contribution rates as reflection of discount rates.
- ▣ Avoid the pitfalls of underfunded pension plans.
- ▣ Instill transparency with beneficiaries and stakeholders, not fear.
- ▣ Strong working relationships between WSIB, Actuary and Pension Funding Council.



## Our Distinctions – What Makes WSIB Different from Most Investors?

### Our Investment Strategy

- ❑ Public equity is mostly passively-managed, and it has no internal management at this time.
- ❑ Fixed income is a 100 percent internally-managed and 100 percent actively-managed program.

### Our Focus

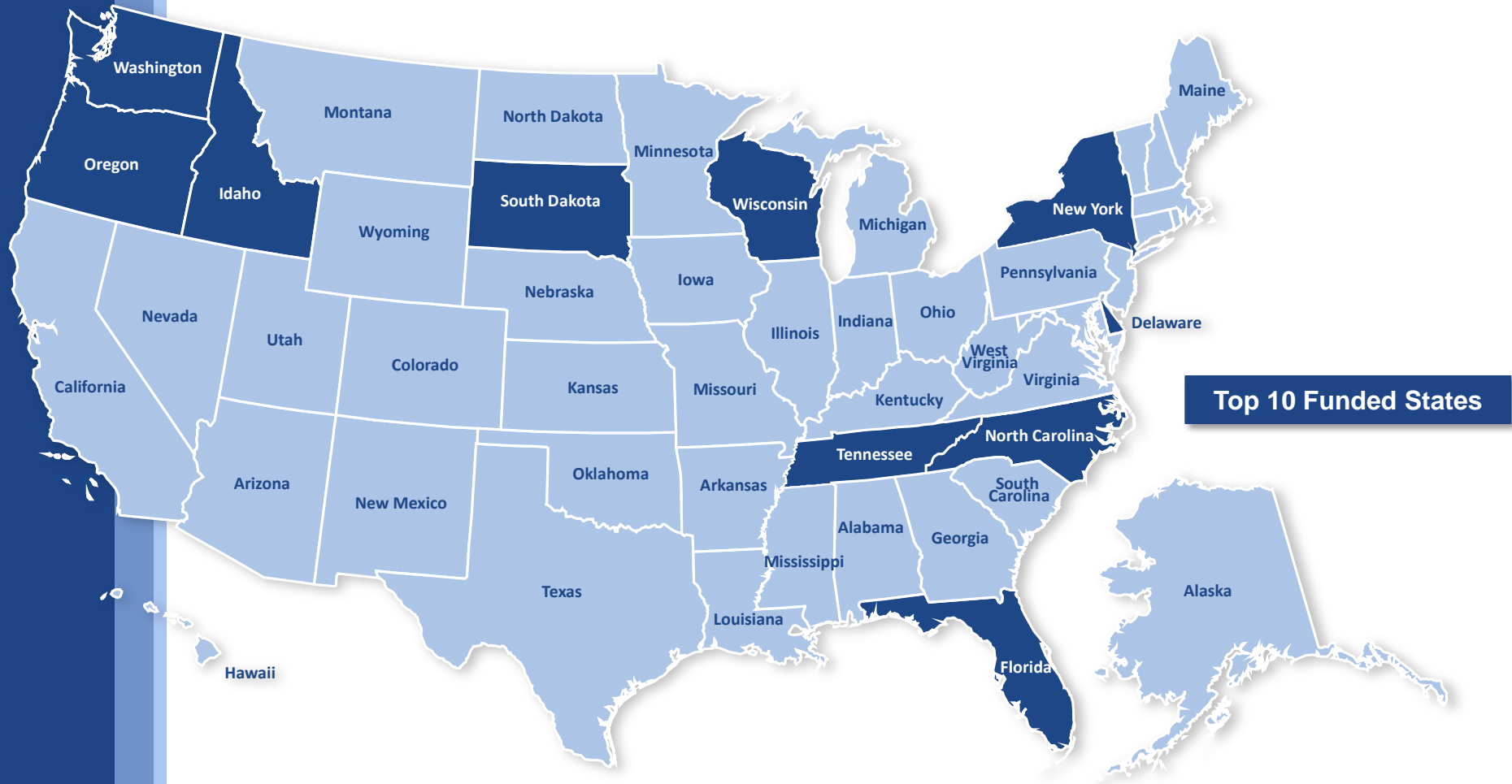
- ❑ We continue to explore ways to invest where the growth is—currently in emerging markets.
- ❑ We continually explore “smarter” ways to maximize our investment returns at a prudent level of risk.
- ❑ Market turmoil simply means investment return opportunity for patient long-term investors with discipline.

### Our People

- ❑ Our staff takes tremendous pride in working for the exclusive benefit of the more than 400,000 members who rely upon the WSIB to manage the security of their financial futures.

# Our Results – Maintaining a Strong Funded Status

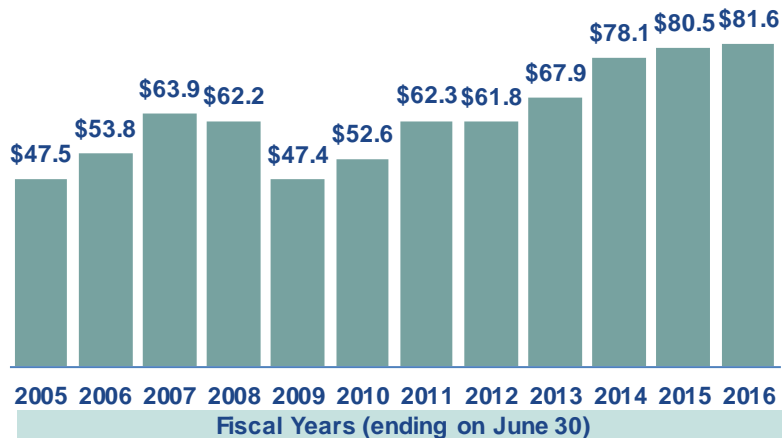
*One of the Best Funded Pension Systems in the Nation*



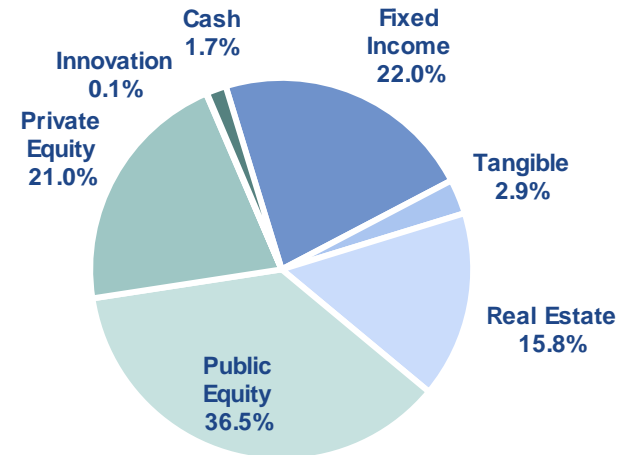
# Our Results – Commingled Trust Fund Performance and Market Values

June 30, 2016

## Historical Market Value (billions)



## Actual Allocation



## Historical Fund Returns

Return Since Inception of the  
Commingled Trust Fund (CTF)  
(Since June 1992):

**8.53%**

## Market Values and Returns

### Commingled Trust Fund (CTF) Market Values and Returns

	Market Value (000s)	1 Year	3 Year	5 Year	10 Year
Total CTF	\$81,624,948,098	2.65%	8.03%	7.51%	6.18%
Fixed Income	\$17,990,489,328	4.77%	3.65%	3.44%	5.78%
Tangibles	\$2,396,374,903	-0.77%	2.59%	1.61%	N/A
Real Estate	\$12,881,161,786	10.43%	12.56%	12.79%	7.48%
Public Equity	\$29,828,707,115	-2.60%	7.03%	6.36%	4.75%
Private Equity	\$17,108,949,429	4.67%	11.80%	10.81%	8.98%
Innovation	\$63,807,984	-4.80%	5.81%	6.90%	N/A
Cash	\$1,355,457,553	0.32%	0.18%	0.17%	1.18%



## Financial Audit Results

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Steve Davis, Davis Accounting & Audit Services

**Summary:**

Audit of expenditures of the LEOFF Plan 2 Board for the year ended June 30, 2016.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Maintain the financial integrity of the plan., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ Audited Financial Statement	Report
▣ Letter to Board	Correspondence

**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS  
PLAN 2 RETIREMENT BOARD**

**AUDITED SCHEDULE OF EXPENDITURES  
(Budget Allotment to Actual)**

**For the Year Ended  
June 30, 2016**

**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS  
PLAN 2 RETIREMENT BOARD  
For the Year Ended June 30, 2016**

**TABLE OF CONTENTS**

<b>Independent Auditor's Report</b>	<u>Page</u> 1
<b>Financial Statements:</b>	
Schedule of Expenditures – Budget Allotment to Actual	2
Notes to Schedule of Expenditures	3 - 5

**Davis Accounting Tax & Audit Services**

123 Fir Street NE  
Olympia, WA. 98506

**INDEPENDENT AUDITOR'S REPORT**

To the Board  
Law Enforcement Officers & Firefighters Plan 2 Retirement Board  
PO Box 40918  
Olympia, WA 98504-0918

I have audited the accompanying schedule of expenditures and related notes to the schedule of expenditures (schedule and notes) of the Law Enforcement Officers & Firefighters Plan 2 Retirement Board for the year ended June 30, 2016.

***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of the schedule and notes in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the schedule and notes that are free from material misstatement, whether due to fraud or error.

***Auditor's Responsibility***

My responsibility is to express an opinion on schedule and notes based on my audit. I conducted my audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I plan and perform the audit to obtain reasonable assurance about whether the schedule and notes are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule and notes. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule and notes, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the schedule and notes in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, I express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the schedule and notes.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

***Opinion***

In my opinion, the schedule and notes referred to above present fairly, in all material respects, the expenditures of the Law Enforcement Officers and Firefighters Plan 2 Retirement Board for the year ended June 30, 2016 in accordance with accounting principles generally accepted in the United States of America.



DAVIS ACCOUNTING TAX & AUDIT SERVICES

Olympia, WA  
September 13, 2016



**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS PLAN 2 RETIREMENT BOARD**  
**SCHEDULE OF EXPENDITURES**  
**For the Year Ended June 30, 2016**

	<u>BUDGET</u>	<u>ACTUAL</u>	<u>VARIANCE</u>
Salaries & wages	\$ 599,824	\$ 597,764	\$ (2,060)
Employee benefits & payroll taxes	188,448	155,363	(33,085)
Personal service contracts	25,000	12,204	(12,796)
Goods & services - supplies & materials	3,600	(963)	(4,563)
Goods & services - communications	12,576	10,738	(1,838)
Goods & services - utilities	5,592	6,200	608
Goods & services - rentals & leases	45,960	45,954	(6)
Goods & services - repairs & maintenance	0	780	780
Goods & services - printing & reproduction	18,708	25,707	6,999
Goods & services - employee development	38,000	35,550	(2,450)
Goods & services - furniture & equipment leases	6,276	4,498	(1,778)
Goods & services - subscriptions	3,108	1,637	(1,471)
Goods & services - facilities & related services	4,224	4,040	(184)
Goods & services - data processing	8,000	8,757	757
Goods & services - Attorney General's Office	21,996	13,890	(8,106)
Goods & services - personnel services	2,676	1,319	(1,357)
Goods & services - insurance	25	90	65
Goods & services - other purchased services	139,080	139,673	593
Other goods & services	900	6,105	5,205
Travel, lodging & subsistence	58,656	56,932	(1,724)
Capital outlays	5,304	0	(5,304)
 Total Expenditures	 <u>\$ 1,187,953</u>	 <u>\$ 1,126,238</u>	 <u>\$ (61,715)</u>

The accompanying notes are an integral part of this schedule of expenditures.

**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS PLAN 2 RETIREMENT BOARD**  
**NOTES TO SCHEDULE OF EXPENDITURES**  
**For the Year Ended June 30, 2016**

**Note 1 – Summary of Significant Accounting Policies**

The Law Enforcement Officers & Fire Fighters Plan 2 Retirement Board (the Board) was created through a taxpayer initiative approved by voters in November 2002. The schedule of expenditures – budget allotment to actual of the Board has been prepared in conformity with generally accepted accounting principles as applied to governments. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles.

**A. Reporting Entity, Background & Activities:**

An eleven-member board, appointed by the Governor of the State of Washington, governs the Board. Board members are appointed from the following groups of individuals:

- Three must be active law enforcement officers who participate in the plan (Beginning with the first vacancy before or after January 1, 2007, one of the members must be a retired law enforcement officer who is a member of the plan).
- Three must be active fire fighters who participate in the plan (Beginning with the first vacancy before or after January 1, 2007, one of the members must be a retired fire fighter who is a member of the plan).
- Three must be representatives of employers
- One must be a member of the State House of Representatives
- One must be a member of the State Senate

The Board is empowered to oversee the Law Enforcement Officers & Fire Fighters Plan 2 Retirement system (LEOFF 2). They do not maintain custody or manage the investments of the plan. The custody and investment management function is the responsibility of the Washington State Investment Board (SIB). The Board is required to 1) adopt actuarial tables, assumptions and cost methodologies; 2) adopt contribution rates for LEOFF Plan 2; as well as other related duties. Some specific duties relating to the expenditures of the Board are;

**Professionals & technical advisors:**

- Retain Professionals & technical advisors necessary to accomplish the board's duties.

**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS PLAN 2 RETIREMENT BOARD**  
**NOTES TO SCHEDULE OF EXPENDITURES**  
**For the Year Ended June 30, 2016**

**Note 1 – Summary of Significant Accounting Policies, Continued**

Actuary:

- Consult with an enrolled actuary retained by the board (The state actuary shall provide assistance when the board requests.)
- The actuary used must provide the State Actuary with copies of its valuations, assumptions and cost methodology for a reasonableness review.
- If the two actuaries do not agree, a third actuary must be appointed by the board and state actuary.

Other Costs:

- Engage administrative staff and acquire office space
- Board members shall be reimbursed for travel and education expenses as provided in RCW 43.03.050 and 43.03.060

**B. Basis Of Accounting And Reporting:**

All payroll, reporting and accounting functions are handled by the Washington State Department of Enterprise Service's Small Agency Financial and HR Services and recorded in the State of Washington's Accounting & Financial Reporting System under Agency #341.

The Board uses the modified-accrual basis of accounting with a measurement focus on current financial resources. Therefore, the purchase of non-current assets such as property, plant and equipment is not deemed to be an asset for financial reporting purposes. Instead, these costs are reflected as expenditures in the year they are incurred.

**C. Subsequent Events Evaluation:**

Management has evaluated for subsequent events through September 13, 2016, the date the financial statements were available to be issued. No material subsequent events were identified by management.



**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS PLAN 2 RETIREMENT BOARD**  
**NOTES TO SCHEDULE OF EXPENDITURES**  
**For the Year Ended June 30, 2016**

**Note 1 – Summary of Significant Accounting Policies, Continued**

**D. Budgetary Process:**

The Board must develop an annual budget consistent with the requirements of chapter 43.88 RCW. This budget draws funding from the investment income of the LEOFF Trust fund held by the State Investment Board.

The Board's budget is subject to the OFM allotment process but is not subject to legislative appropriation. Allotments may be adjusted on a quarterly basis. Monthly allotments are not binding but are used as a tool to ensure the total biennium budget is not exceeded.

The Board's operating expenses are paid from a sub-account of the LEOFF Plan 2 Retirement Fund (the expense fund).

**E. Expenditure Authority (RCW 41.26.732):**

The authority to establish all policies relating to the expense fund, other than the investment policies of the SIB, resides with the Board. With the exception of investments by, and expenses of, the SIB, disbursements from the expense fund may be made only on the authorization of the board.

The expense fund may be spent only for the purposes of defraying the expenses of the Board. Expenses include, but are not limited to:

- Salaries and expenses of personnel
- Lease payments
- Travel
- Goods & services
- Audits
- Other general costs of conducting board business

**LAW ENFORCEMENT OFFICERS & FIRE FIGHTERS PLAN 2 RETIREMENT BOARD**  
**NOTES TO SCHEDULE OF EXPENDITURES**  
**For the Year Ended June 30, 2016**

**Note 2 – Commitments**

The Board, Acting through the Washington State Department of Enterprise Services, entered into an operating lease for office space through April 30, 2019. The agreement calls for monthly lease payments of \$3,829.50. In addition to monthly lease payments the Board is also required to pay the landlord for its prorata share (5.36%) of water, sewer, garbage and restroom supplies as well as the cost of electricity and natural gas directly attributable to the office space occupied.

Upon expiration of the lease term on April 30, 2019, The Board may renegotiate the lease for another five (5) year term, allow the lease to become a month to month lease, or vacate the premise.

The lease may be cancelled and terminated by either party any time provided written notice of such cancellation and termination shall have been given at least one-hundred eighty (180) days prior to the effective date thereof. The Board has not provided such written notice and was therefore obligated, at June 30, 2016, to pay rents through December 28, 2016. The minimum lease payment through December 28, 2016 was approximately \$22,660.

**Note 3 – Related Party Transactions**

The Board obtains goods and services from other departments and agencies within the State of Washington through interagency agreements. The terms of such agreements are developed through the State's budgetary process and are generally designed to recover the cost of the goods or services. The following significant services were provided by various state agencies under such arrangements during the year ended June 30, 2016.

Actuarial services related to pension plan administration, benefits and rates are provided by the State Actuary and billed to the Board in equal monthly amounts. The total cost of such services was approximately \$105,000.

Various accounting, human resources, data processing and other administrative services are provided by the Department of Enterprise Services through the small agency accounting and administrative services divisions. The total cost of such services was approximately \$45,000.

Legal support is provided by the State Attorney General's office. The total cost of such services was approximately \$14,000.





## Davis Accounting Tax & Audit Services

123 Fir Street NE  
Olympia, WA. 98506

September 13, 2016

To the Board

Law Enforcement Officers' and Firefighters Plan 2 Retirement Board

I have audited the schedule of expenditures and related notes (the schedule of expenditures) of Law Enforcement Officers' and Firefighters' Plan 2 Retirement Board (LEOFF 2) for the year ended June 30, 2016, and has issued my report thereon dated September 13, 2016. Professional standards require that I provide you with information about my responsibilities under generally accepted auditing standards (and, if applicable, *Government Auditing Standards* and the Uniform Guidance), as well as certain information related to the planned scope and timing of my audit. I have communicated such information in my letter to you dated September 2, 2016. Professional standards also require that I communicate to you the following information related to my audit.

### Significant Audit Findings

#### *Qualitative Aspects of Accounting Practices*

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by LEOFF 2 are described in Note 1 to the schedule of expenditures. No new accounting policies were adopted and the application of existing policies was not changed during the year ended June 30, 2016. I noted no transactions entered into by the Organization during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the schedule of expenditures in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. I did not identify any such sensitive estimates affecting the financial statements

Certain financial statement disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosure affecting the financial statements was:

The disclosure of Commitments in Note 2 to the financial statements provides information regarding LEOFF's future obligations under its office lease agreement.

The financial statement disclosures are neutral, consistent, and clear.

#### *Difficulties Encountered in Performing the Audit*

I encountered no significant difficulties in dealing with management in performing and completing my audit.

#### *Corrected and Uncorrected Misstatements*

Professional standards require us to accumulate all misstatements identified during the audit, other than those that are clearly trivial, and communicate them to the appropriate level of management. There were no misstatements requiring such communication or correction to the financial statements.

#### *Disagreements with Management*

For purposes of this letter, a disagreement with management is a financial accounting, reporting, or auditing matter, whether or not resolved to my satisfaction, that could be significant to the schedule of expenditures or the auditor's report. I am pleased to report that no such disagreements arose during the course of my audit.

**Davis Accounting Tax & Audit Services**

123 Fir Street NE  
Olympia, WA. 98506

*Management Representations*

I have requested certain representations from management that are included in the management representation letter dated September 13, 2016.

*Management Consultations with Other Independent Accountants*

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the Organization's schedule of expenditures or a determination of the type of auditor's opinion that may be expressed on those statements, my professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To my knowledge, there were no such consultations with other accountants.

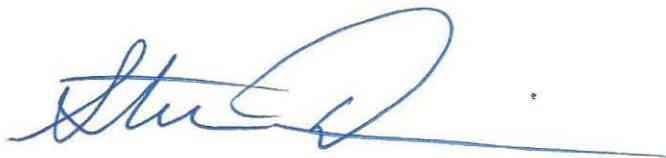
*Other Audit Findings or Issues*

I generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the Organization's auditors. However, these discussions occurred in the normal course of my professional relationship and my responses were not a condition to my retention.

Other Matters

This information is intended solely for the use of the LEOFF Plan 2 Board and management of LEOFF 2 and is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,



Steve Davis, CPA  
Davis Accounting Tax & Audit Services



## **Administrative Factors**

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Lisa Won, ASA, FCA, MAAA, Deputy State Actuary

**Summary:**

New administrative factors are needed for retired members who elect to purchase an annuity during the retiree annuity purchase window.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Enhance the benefits for the members., Maintain the financial integrity of the plan.

**ATTACHMENTS:**

Description	Type
▢ Administrative Factors	Presentation



## Administrative Factors

Lisa Won, ASA, FCA, MAAA  
Deputy State Actuary

Presentation to:  
LEOFF 2 Board

Office of the State Actuary  
"Supporting financial security for generations."

September 21, 2016

## Today's Presentation

- Background information
- New factor comparison
- Recommendation
- Next steps



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### Background – What Are Administrative Factors?

- Administrative factors adjust pensions for optional payment forms
  - Optional payments should be cost-neutral to the plan as a whole - “Actuarial Equivalence”
- Best actuarial equivalence includes all eligible members in the development of the factors

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### Background – Why Is This Before The Board?

- The Board has authority to adopt factors for LEOFF 2
  - DRS adopts factors for all other plans
- SSB 6264 passed in 2016 Session and provides LEOFF 2 retired members with a one-time opportunity to purchase additional annuity
  - Actuarial Fiscal Note assumes actuarial equivalent administrative factors
- Two different administrative factors used for annuity purchase
  - Annuity purchase factors are based on age at purchase and payable for the members’ lifetime
  - Joint and Survivor (J&S) factors convert the single life annuity so it’s payable on the life of both the member and their beneficiary
    - Current factors are not actuarially equivalent since they are based on average age at retirement, not average age of current retirees



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### Joint & Survivor Option Factors

- J&S factors reduce a member's benefit to provide an ongoing benefit for their survivor
- Three types of survivor benefits available under the plan:
  - J&S 100 percent
  - J&S 50 percent
  - J&S 66 2/3 percent
- New factors needed for retired members
  - Current J&S factors are based on members at retirement
  - Members electing J&S option after retirement need larger reduction since the cost to provide an ongoing survivor benefit increases as the member ages

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### Administrative Factors Include Policy Decisions Of The Board

- Incorporate mortality improvement trends
- Blend male and female mortality rates
- Blend healthy and disabled mortality rates



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### Joint & Survivor Factor Comparison

- J&S factors vary based on the member's age and the age of their joint annuitant when the benefit commences
- Compares the value of a single life annuity to a joint life annuity
- J&S factors reduce a member's benefit to recognize additional cost of providing a benefit payable on two lives

#### Percent Change From 2015 'At Retirement' Factors

	J&S 100%	J&S 50%	J&S 66.67%
<b>MIN</b>	(0.94%)	(0.48%)	(0.64%)
<b>AVG</b>	(4.94%)	(2.84%)	(3.60%)
<b>MAX</b>	(8.49%)	(5.11%)	(6.38%)

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### Joint & Survivor Factor Example

- Impact on \$2,000 additional monthly retirement benefit purchased by a 65 year old member electing J&S 100 percent (age difference = 3)

	Current	New	Change
<b>J&amp;S Factor</b>	0.855	0.822	(3.93%)
<b>Monthly Benefit</b>	\$1,710	\$1,644	(\$66)

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## Recommendations

- We recommend adopting new J&S administrative factors to apply to current retired members who purchase an additional annuity
  - Best estimate of life expectancies for impacted members
  - Best actuarial equivalence (accuracy) for cost of optional benefits
  - Consistent with assumptions used in the actuarial valuation to determine funding requirements of the plan
  - Consistent with the analysis prepared for SSB 6264

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## Next Steps

- OSA has provided additional information and tables of new factors
  - Used for members in retirement electing to purchase additional annuity
  - Current J&S factors remain for members electing a survivor option at the time of retirement
- Board adopts final factors
- DRS will use new factors during the temporary window, January 1, 2017 through June 1, 2017



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## Questions?



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## Presumptive Medical

**Report Type:**

Initial Consideration

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Ryan Frost, Research and Policy Manager

**Summary:**

For law enforcement officers, there are currently no presumptive medical conditions covered for occupational diseases or disabilities. For fire fighters, certain cancers not currently covered by the occupational disease presumption should be covered.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Enhance the benefits for the members., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ Presumptive Medical	Presentation
▣ Presumptive Medical	Report



# **Presumptive Medical**

INITIAL CONSIDERATION

September 21, 2016



# ISSUE

- ▶ For law enforcement officers, there are currently no presumptive medical conditions covered for occupational diseases or disabilities.
- ▶ For fire fighters, certain cancers not currently covered by the occupational disease presumption should be covered.

# OVERVIEW

- ▶ **What is a presumption?**
- ▶ **What presumptive diseases and disabilities are currently covered for FF?**
- ▶ **What diseases are not covered for FF?**
- ▶ **Law enforcement officer presumption?**

# BACKGROUND

- ▶ **Number of fire fighters stricken with cancer is rising**
- ▶ **Fire fighters are more likely than the general public to become afflicted with various cancers**
- ▶ **Twice as many fire fighters were diagnosed with malignant mesothelioma**
  - Rare type of cancer caused by exposure to asbestos
  - Currently not covered under FF presumption

# FF PRESUMPTION HISTORY

## ▶ 1987

- Respiratory disease added

## ▶ 2002

- Heart problems added
- Certain cancers added
- Infectious diseases added
- 10 years of service requirement

# FF PRESUMPTION HISTORY CONT.

## ► 2007

- More heart problems added
- More cancers added
- Recovery of litigation costs and fees added

# LEO PRESUMPTION HISTORY

## ► 1991

- Legislature resolution to look into occupational illnesses/injuries for LEO's and FF's
  - FF cancers above national average, LEO cancers similar to national average
  - Limited information available on LEO cancer risks

## ► 1992

- Infectious diseases higher for LEO's
  - Causal association tough to prove

# LEO PRESUMPTION HISTORY CONT.

## ► New CDC study

- 2019 projected completion date
- Assess police stress over 12 year period
- Examine stress and association with heart and lung disease
- Study will be among first of its kind

# FEDERAL BENEFITS

## ▶ **Public Safety Officers Benefits Act (PSOB)**

- Line of duty death benefit for FF's and LEO's

## ▶ **Hometown Heroes Survivor Benefits Act**

- Expanded PSOB to cover heart attacks and strokes in line of duty for FF's and LEO's
- This act changed how presumptive diseases were treated at the federal level monumentally



# **PRESUMPTIVE LAWS NATIONALLY**

## **► Fire Fighters**

- 37 different states

## **► Law Enforcement Officers**

- 28 different states
  - 20 have heart attack or cardiovascular disease
  - 11 have respiratory or lung disease
  - 6 have hypertension
  - 5 have cancer
  - 3 have stroke

# CONTACT

Ryan Frost

Research and Policy Manager

[ryan.frost@leoff.wa.gov](mailto:ryan.frost@leoff.wa.gov)

(360) 586-2324



## INITIAL CONSIDERATION

By Ryan Frost  
Research and Policy Manager  
360-586-2325  
ryan.frost@leoff.wa.gov

## ISSUE STATEMENT

For law enforcement officers, there are currently no presumptive medical conditions covered for occupational diseases or disabilities. For fire fighters, certain cancers not currently covered by the occupational disease presumption should be covered.

## OVERVIEW

Under the state's Industrial Insurance Act (Act), a worker who, in the course of employment, is injured or suffers disability from an occupational disease is entitled to certain benefits. To prove an occupational disease, the worker must show that the disease arose "naturally and proximately" out of employment.

For fire fighters who are members of LEOFF 2, there is a presumption that certain medical conditions are occupational diseases. Those conditions are: respiratory disease; heart problems; specified cancers; and infectious diseases. With respect to heart problems, the problems must be experienced within 72 hours of exposure to smoke, fumes, or toxic substances; or experienced within 24 hours of strenuous physical exertion due to firefighting activities.

The following cancers are currently not covered under the presumption for fire fighters in LEOFF 2:

- Mesothelioma
- Adenocarcinoma
- Stomach cancer
- Esophageal cancer
- Buccal cancer
- Pharynx cancer
- Nonmelanoma skin cancer
- Breast cancer

In addition, methicillin-resistant staphylococcus aureus (MRSA) is not listed under infectious diseases, and stroke is included under the same limitations as heart problems (problems must be experienced within 72 hours).

Law enforcement officers are not protected by a presumption for occupational illness/injury in Washington State. While the occupational illness/ injury provisions in the Workers' Compensation statutes do apply to law enforcement officers, the burden of proof to qualify for these benefits falls on the member. Federal law contains a presumption for heart attack and stroke under the Public Safety Officers' Benefit (PSOB) program which applies to law enforcement officers in Washington State.

## **BACKGROUND & POLICY ISSUES**

Recent studies, most notably one released in 2016 by the Center for Disease Control<sup>1</sup> (CDC), had some startling findings. The CDC found that the number of fire fighters stricken with cancer is rising, and that fire fighters are more likely than the general public to become afflicted with various cancers as a direct result of workplace exposure suffered while combating fires. The study also found that in comparison to the general public, twice as many fire fighters were diagnosed with malignant mesothelioma, a rare type of cancer caused by exposure to asbestos. Mesothelioma is currently not covered under presumption in LEOFF 2.

The CDC also found more cases of certain cancers among younger fire fighters; fire fighters under 65 years of age had more bladder and prostate cancers than expected. When comparing fire fighters to each other, the chance of lung cancer diagnosis or death increased with the amount of time spent at fires, and the chance of leukemia death increased with the number of fire runs.

### **Fire Fighter Presumptive Coverage Provisions in Washington**

In 1987, the Legislature passed Engrossed Substitute Senate Bill 5801, which created a presumption that certain diseases were occupationally related for industrial insurance purposes for only fire fighters. As originally passed, this bill only included respiratory disease as an occupational disease.

The 2002 Legislature amended the definition of occupational disease to include heart problems that are experienced within seventy-two hours of exposure to smoke, fumes, or toxic substances; certain cancers; and infectious diseases. The presumption of cancer as an occupational disease only applies to a fire fighter, where the cancer develops or manifests itself after the fire fighter has served at least 10 years, and was given a qualifying medical examination upon becoming a fire fighter that showed no evidence of cancer. Time served as a

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<sup>1</sup> <http://www.cdc.gov/niosh/pgms/worknotify/pdfs/ff-cancer-factsheet-final.pdf>

volunteer fire fighter does not count towards the 10 years of service required for presumptive cancer coverage.<sup>2</sup>

The 2007 Legislature further expanded the occupational disease presumption for fire fighters. A presumption of occupational disease was added for heart problems that are experienced within 24 hours of strenuous physical exertion due to firefighting activities. "Firefighting activities" means fire suppression, fire prevention, emergency medical services, rescue operations, hazardous materials response, aircraft rescue, and training and other assigned duties related to emergency response.

Certain cancers were also added to the list of cancers presumed to be occupational diseases.

The cancers added included:

- Prostate Cancer, diagnosed prior to 50
- Colorectal cancer
- Multiple Myeloma
- Testicular cancer

The presumption of occupational disease may be rebutted by a preponderance of evidence, including, but not limited to use of tobacco products, physical fitness and weight, lifestyle, hereditary factors, and exposure from other employment or non-employment activities.

Since July 1, 2003, the presumption of occupational disease has not applied to a fire fighter who develops a heart or lung condition and who is a regular user of tobacco products or who has a history of tobacco use. After terminating from service the presumptions are extended such that a member can qualify for benefits for a period of three calendar months for each year of service, out to a maximum of sixty months following the last date of employment. For example, a member who separates from service after a 10-year career will be covered under the presumption for 2 ½ years (30 months) after the date of separation from employment.

The 2007 Legislation also included provisions for the recovery of litigation costs and fees. When a determination involving the presumption of occupational disease for fire fighters is appealed to the Board of Industrial Insurance Appeals (BIIA), or to any court and the final decision allows the claim for benefits, the BIIA or the court must order that all reasonable costs of the appeal be paid to the fire fighter or his or her beneficiary.

## **Law Enforcement Officers Presumption**

During the 1991 Washington State Legislative Session, Senate Floor Resolution 8674 requested the Department of Labor and Industries to conduct a study of the unique occupational

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<sup>2</sup> The 2002 bill originally listed a broader set of cancers within the presumption than was passed in the final version of the bill. The original bill included the following types of cancer: Breast Cancer, Reproductive System Cancer, Central Nervous System Cancer, Skin Cancer, Lymphatic System Cancer, Digestive System Cancer, Hematological System Cancer, Urinary System Cancer, Skeletal System Cancer, and Oral System Cancer.

illness/injury hazards encountered by law enforcement officers and fire fighters. The Department of Labor and Industries was specifically asked to address the incidence of cancer and heart disease and the problems of proof associated with occupation illnesses/injuries. The study, conducted with the assistance of the Department of Health and the University of Washington, was completed December 1, 1992. An advisory committee was also established with representatives from stakeholder organizations.

With respect to law enforcement officers and cancer, the study reported that based on the available epidemiologic evidence that the overall risk of cancer among law enforcement officers was similar to that of the general population. The study reported with respect to law enforcement officers and circulatory disease, that while the stresses associated with law enforcement officers are thought to increase the risk of ischemic heart disease, most epidemiologic studies found law enforcement officers to have a risk of death due to circulatory disease similar to, or only slightly above, that of the general population. Despite the available evidence suggesting increased risk of heart disease, there was not enough evidence from which to draw firm conclusions. The study reported that very few studies of this specific nature about law enforcement officers had been performed and current studies were limited to available death records which lack many specific details.

Infectious diseases for law enforcement officers, which were not included in the 1992 study, have been more readily covered in recent research. Findings suggest that law enforcement officers have significantly elevated statistical rates for a number of diseases, but despite these statistical findings, they do not necessarily prove causal association.

Fortunately, a new study paid for by the Center for Disease Control seeks to find out how the rigors of police work — from traumatic sights and sounds, to long work shifts and high demand levels — affects officers. The research will assess police stress over a period of 12 years by examining measures of stress and the association of these measures with cardiovascular and metabolic diseases. Its findings will be used to provide translational information to improve prevention practices. This study will be among the first of its kind to look at the long-term effects of stress on police health.

### **Presumptive Coverage Provisions at Federal Level – PSOB**

The Public Safety Officers' Benefits (PSOB) Act was enacted in 1976 to assist in the recruitment and retention of law enforcement officers and fire fighters. State and local law enforcement officers and fire fighters are covered for line-of-duty deaths occurring on or after September 29, 1976.

As defined by Congress in Public Law 90-351 (Sec. 1217), a public safety officer includes individuals serving a public agency in an official capacity, with or without compensation, as a law enforcement officer or fire fighter. The PSOB Program provides death benefits in the form

of a one-time financial payment to the eligible survivors of public safety officers whose deaths are the direct and proximate result of a traumatic injury sustained in the line of duty.

Beneficiaries of the PSOB Death Benefits Program must comply with the PSOB Office's administrative review process by producing sufficient evidence to show that the public safety officer died as the direct and proximate result of a personal injury sustained in the line of duty. The PSOB Act only covers deaths resulting from traumatic injuries sustained in the line of duty. The PSOB Act does not have extensive coverage for occupational diseases, however, heart attack deaths are covered in some instances.

On December 15, 2003, President Bush signed into law the Hometown Heroes Survivor Benefits Act (S. 459 / H.R. 919), which expanded the PSOB program to cover public safety officers who die of heart attacks or strokes in the line of duty. The death benefit is payable to the survivors of a public safety officer who "has died as the direct and proximate result of a personal injury sustained in the line of duty."

Prior to the Hometown Heroes Survivor Benefits Act, in almost every incidence of death by heart attack or stroke it had been ruled that the heart attack or stroke was not a direct result of an injury sustained in the line of duty and the families received no benefits even though the deaths were clearly triggered by the rigors of the job. The Hometown Heroes Survivor Benefit Act was intended to correct that deficiency in the law, by ensuring that a public safety officer who suffers a fatal heart attack or stroke while on duty or not later than 24 hours after participating in a physical training exercise or responding to an emergency situation, is presumed to have died in the line of duty for purposes of public safety officer survivor benefits.

## **States with Presumptive Laws**

Currently 37 different states have some sort of presumptive disease and disability law for fire fighters, while only 28 states have presumptions for law enforcement officers.

In the 28 states with a law enforcement presumption, the most commonly occurring presumptions are for heart attack or cardiovascular disease which is covered by 20 states, and respiratory or lung disease which is covered by 11 states. A handful of states also have a presumption for hypertension (6), cancer (5), and stroke (3). Fifteen of the states with a law enforcement presumption include one or more occupational illness caused by infectious disease. In most cases, occupational disease is specifically defined by illness type; however some states use a general definition of occupational disease which broadly includes the specific diseases covered in other states. The most common occupational diseases covered by a presumption for law enforcement include: hepatitis (9), tuberculosis (7), HIV/AIDS (5), meningococcal meningitis (3), and other or generally defined (6).



## Individual Health Savings Accounts

**Report Type:**

Initial Consideration

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Ryan Frost, Research and Policy Manager

**Summary:**

There is a gap in healthcare coverage for public safety employees from the time of retirement to when Medicare coverage begins.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Enhance the benefits for the members., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▢ Individual Health Savings Accounts	Report
▢ Individual Health Savings Accounts	Presentation





September 21, 2016

# Individual Health Savings Accounts

## INITIAL CONSIDERATION

By Ryan Frost  
Research and Policy Manager  
360-586-2325  
ryan.frost@leoff.wa.gov

## ISSUE STATEMENT

There is a gap in healthcare coverage for public safety employees from the time of retirement to when Medicare coverage begins.

## OVERVIEW

Health insurance premiums have increased rapidly over the recent past, growing a cumulative 138% between 1999 and 2010 and outpacing cumulative wage growth of 42% over the same period.<sup>1</sup> Therefore, it's important for members to begin saving for healthcare costs in retirement, now.

LEOFF Plan 2 members have the opportunity to take a normal retirement at age fifty-three, or take an early retirement at age fifty. Some members have access to retiree medical plans sponsored by the Public Employees' Benefits Board (PEBB), however many local employers do not participate in PEBB plans, and retiree medical coverage can be hard to find and expensive especially before reaching Medicare eligibility at age sixty-five.

SB 6071 (Appendix A) was introduced in the 2015 session to help ensure access to retiree medical coverage for LEOFF Plan 2 members through the use of appropriate tax-authorized spending accounts or Voluntary Employee Benefit Accounts. These accounts would allow employees to contribute income now to help pay for their future medical premiums. As allowed by the IRS, these accounts may also allow employer contributions if bargained for at the local level. This bill did not receive a hearing.

## BACKGROUND & POLICY ISSUES

There are different accounts available to help pay for post-retirement healthcare costs. A few of those options are:

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<sup>1</sup> Kaiser Family Foundation/Health Research and Educational Trust, Employer Health Benefits 2010 Annual Survey.

## **Voluntary Employees' Beneficiary Association (VEBA)**

A VEBA is a tax-free post-retirement medical expense account used by retirees and their eligible dependents to pay for eligible medical expenses. The plan is funded by the amount of unused sick leave that an employee has at the time of retirement, which is contributed by the employer into the plan. The benefit of this plan is the amount of sick leave left at retirement is paid out in full to the plan and is not subject to tax, which would reduce the amount one would receive.

VEBA plans are considered welfare benefit plans under federal tax law and are tax-exempt under Section 501(c)(9) of the Internal Revenue Code. Contributions to a VEBA are therefore tax-deductible and the funds grow tax-deferred. There are no tax penalties for early distributions from the VEBA, and assets are protected from creditors.

The primary benefit of a VEBA is the tax savings on the initial deposit of funds into the account. Many individuals withdraw their VEBA funds very quickly to cover medical expenses. Others may wish to save the account for future use, and invest for long term growth.

If upon a member's death there are unused funds in the VEBA, and the member is survived by their legal spouse or dependent children (or other dependents as defined by the IRS), they will be able to use the remaining funds in the account for their eligible health care expenses. If a member has no surviving spouse or dependent(s), any remaining funds will be forfeited and redistributed pro rata among the remaining participants.

## **Health Savings Account (HSA)**

HSAs were created in 2003 so that individuals covered by high-deductible health plans could receive tax-preferred treatment of money saved for medical expenses. An HSA may be funded by both employer and employee contributions, within IRS established limits, to finance health care costs. The contributions are invested over time and can be used to pay for qualified medical expenses, which include most medical care such as dental, vision and over-the-counter drugs. This was enacted as part of the Medicare Prescription Drug Improvement and Modernization Act of 2003 and the rules are found in Section 223 of the Internal Revenue Code. Contribution limits for 2016 are relatively high, \$3,350 for an individual or \$6,750 for family coverage, but can be used for healthcare costs at any time, they are not restricted to only paying healthcare in retirement.

Savings can be used tax-free preretirement for qualified medical expenses for yourself, spouse or dependents, even if they are not covered under the high-deductible plan. Otherwise savings are tax-deferred until withdrawal. At 65 years old, you will avoid a 20 percent penalty even if not used for medical expenses. The increased flexibility over IRAs, 401(k)s and other retirement savings accounts is leading many private employers across the country to opt into creating these accounts for their employees.

### ***Advantages***

- Contributions can come from various sources, including you, your employer, a relative and anyone else who wants to add to your HSA.
- Contributions made through payroll deposits (through your employer) are typically made with pre-tax dollars, which means they are not subject to federal income taxes. Your employer can also make contributions on your behalf, and the contribution is not included in your gross income.
- Contributions made with after-tax dollars can be deducted from your gross income on your tax return, which means you may owe less tax at the end of the year.
- Withdrawals from your HSA are not subject to federal (or in most cases, state) income taxes if they are used for qualified medical expenses.
- Any interest or other earnings on the assets in the account are tax free.
- If you have money left in your HSA at the end of the year, it rolls over to the next year.
- The money in your HSA remains available for future qualified medical expenses even if you change health insurance plans, change employers or retire. Funds left in your account continue to grow tax free.

### ***Disadvantages***

- Even though you are paying less in premiums each month, it can be difficult – even with money in an HSA – to come up with the cash to meet a high deductible.
- Your healthcare costs could exceed what you had planned for, and you may not have enough money saved in your HSA to cover expenses.
- You may be reluctant to seek healthcare when you need it because you don't want to use the money in your HSA account.
- If you withdraw funds for non-qualified expenses before you turn 65, you'll owe taxes on the money plus a 20% penalty. After age 65, you'll owe taxes but not the penalty.
- You have to keep your receipts to prove that withdrawals were used for qualified health expenses.

### **Flexible Spending Account (FSA)**

If you have a health plan through your employer, aka a cafeteria plan, you can use a Flexible Spending Account (FSA) to pay for copayments, deductibles, some drugs, and some other health care costs.

An FSA, also known as a flexible spending arrangement, is a special account you put money into that you use to pay for certain out-of-pocket health care costs. You don't pay taxes on this money. This means you'll save an amount equal to the taxes you would have paid on the money you set aside.

Employers may make contributions to your FSA, but aren't required to. A few fast facts about FSAs:

- FSAs are limited to \$2,550 per year per employer. If you're married, your spouse can put up to \$2,550 in an FSA with their employer too.
- You can use funds in your FSA to pay for certain medical and dental expenses for you, your spouse if you're married, and your dependents.
  - You can spend FSA funds to pay deductibles and copayments, but not for insurance premiums.
  - You can spend FSA funds on prescription medications, as well as over-the-counter medicines with a doctor's prescription.
  - FSAs may also be used to cover costs of medical equipment like crutches, supplies like bandages, and diagnostic devices like blood sugar test kits.

You generally must use the money in an FSA within the plan year. At the end of the year, you lose any money left over in your FSA, so it's important to plan carefully and not put more money in your FSA than you think you'll spend within a year on things like copayments, coinsurance, drugs, and other allowed health care costs.

Comparison						
	Source of Funds	Annual limits	Use it or lose it?	When can \$ be used?	Tax free contributions?	Tax-free withdrawal?
<b>VEBA</b>	Unused sick leave	None	No	Post-retirement	Yes	Yes
<b>HSA</b>	Any type of contributions	\$3350-single \$6750 - family	No	Any time	Yes	Yes
<b>FSA</b>	Any type of contributions	\$2250	Yes	Within 1 calendar year of deposit	Yes	Yes

## SUPPORTING INFORMATION

Appendix A: SB 6071

# Appendix A

S-1426.1

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## SENATE BILL 6071

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State of Washington

64th Legislature

2015 Regular Session

By Senators Hobbs and Conway

Read first time 02/25/15. Referred to Committee on Ways & Means.

1       AN ACT Relating to authorizing benefit funding accounts for  
2 members of the law enforcement officers' and firefighters' retirement  
3 system plan 2; amending RCW 41.04.208 and 41.26.740; adding a new  
4 section to chapter 41.26 RCW; and creating a new section.

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

6       NEW SECTION.     **Sec. 1.**     (1) Public safety employees, such as  
7 firefighters, police officers, and corrections officers, participate  
8 in the law enforcement officers' and firefighters' retirement system  
9 plan 2 and have the opportunity to retire at age fifty-three or take  
10 an early retirement at age fifty. Many members of the law enforcement  
11 officers' and firefighters' retirement system plan 2 have access to  
12 the retiree medical plans sponsored by the public employees' benefits  
13 board, however many local employers do not participate in the medical  
14 program, and retiree medical coverage can be hard to find and  
15 expensive especially before reaching medicare eligibility generally  
16 at age sixty-five.

17       (2) It is the intent of the legislature to help ensure access to  
18 retiree medical coverage for the public safety employees listed in  
19 subsection (1) of this section, especially for the nonmedicare  
20 retirees, and to assist employees in planning for their retirement  
21 and future medical benefit needs through the use of appropriate tax-

## Appendix A

authorized spending accounts that will allow employees to voluntarily contribute to their benefit accounts to help pay for their future medical premiums. As allowed by the internal revenue service, the accounts may also allow employer contributions as bargained locally.

**Sec. 2.** RCW 41.04.208 and 2004 c 173 s 1 are each amended to read as follows:

(1) Unless the context clearly requires otherwise, the definitions in this subsection apply throughout this section.

(a) "Disabled employee" means a person eligible to receive a disability retirement allowance from the Washington law enforcement officers' and firefighters' retirement system plan 2 and the public employees' retirement system.

(b) "Health plan" means a contract, policy, fund, trust, or other program established jointly or individually by a county, municipality, or other political subdivision of the state that provides for all or a part of hospitalization or medical aid for its employees and their dependents under RCW 41.04.180.

(c) "Retired employee" means a public employee meeting the retirement eligibility, years of service requirements, and other criteria of the Washington law enforcement officers' and firefighters' retirement system plan 2 and the public employees' retirement system.

(2) A county, municipality, or other political subdivision that provides a health plan for its employees shall permit retired and disabled employees and their dependents to continue participation in a plan subject to the exceptions, limitations, and conditions set forth in this section. However, this section does not apply to a county, municipality, or other political subdivision participating in an insurance program administered under chapter 41.05 RCW if retired and disabled employees and their dependents of the participating county, municipality, or other political subdivision are covered under an insurance program administered under chapter 41.05 RCW. Nothing in this subsection or chapter 319, Laws of 2002 precludes the local government employer from offering retired or disabled employees a health plan with a benefit structure, copayment, deductible, coinsurance, lifetime benefit maximum, and other plan features which differ from those offered through a health plan provided to active employees. Further, nothing in this subsection precludes a local government employer from joining with other public agency employers,

## Appendix A

1 including interjurisdictional benefit pools and multi-employer  
2 associations or consortiums, to fulfill its obligations under chapter  
3 319, Laws of 2002.

4 (3) A county, municipality, or other political subdivision has  
5 full authority to require a person who requests continued  
6 participation in a health plan under subsection (2) of this section  
7 to pay the full cost of such participation, including any amounts  
8 necessary for administration. However, this subsection does not  
9 require an employer who is currently paying for all or part of a  
10 health plan for its retired and disabled employees to discontinue  
11 those payments.

12 (4) Payments for continued participation in a former employer's  
13 health plan may be assigned to the underwriter of the health plan  
14 from public pension benefits or may be paid to the former employer,  
15 as determined by the former employer, so that an underwriter of the  
16 health plan that is an insurance company, health care service  
17 contractor, or health maintenance organization is not required to  
18 accept individual payments from persons continuing participation in  
19 the employer's health plan.

20 (5) After an initial open enrollment period of ninety days after  
21 January 1, 2003, an employer may not be required to permit a person  
22 to continue participation in the health plan if the person is  
23 responsible for a lapse in coverage under the plan. In addition, an  
24 employer may not be required to permit a person to continue  
25 participation in the employer's health plan if the employer offered  
26 continued participation in a health plan that meets the requirements  
27 of chapter 319, Laws of 2002.

28 (6) If a person continuing participation in the former employer's  
29 health plan has medical coverage available through another employer,  
30 the medical coverage of the other employer is the primary coverage  
31 for purposes of coordination of benefits as provided for in the  
32 former employer's health plan.

33 (7) If a person's continued participation in a health plan was  
34 permitted because of the person's relationship to a retired or  
35 disabled employee of the employer providing the health plan and the  
36 retired or disabled employee dies, then that person is permitted to  
37 continue participation in the health plan for a period of not more  
38 than six months after the death of the retired or disabled employee.  
39 However, the employer providing the health plan may permit continued  
40 participation beyond that time period.



## Appendix A

(8) An employer may offer one or more health plans different from that provided for active employees and designed to meet the needs of persons requesting continued participation in the employer's health plan. An employer, in designing or offering continued participation in a health plan, may utilize terms or conditions necessary to administer the plan to the extent the terms and conditions do not conflict with this section.

(9) If an employer changes the underwriter of a health plan, the replaced underwriter has no further responsibility or obligation to persons who continued participation in a health plan of the replaced underwriter. However, the employer shall permit those persons to participate in any new health plan.

(10) The benefits granted under this section are not considered a matter of contractual right. Should the legislature, a county, municipality, or other political subdivision of the state revoke or change any benefits granted under this section, an affected person is not entitled to receive the benefits as a matter of contractual right.

(11) This section does not affect any health plan contained in a collective bargaining agreement in existence as of January 1, 2003. However, any plan contained in future collective bargaining agreements shall conform to this section. In addition, this section does not affect any health plan contract or policy in existence as of January 1, 2003. However, any renewal of the contract or policy shall conform to this section.

(12) Counties, municipalities, and other political subdivisions that make a documented good faith effort to comply with the provisions of subsections (2) through (11) of this section and are unable to provide access to a fully insured group health benefit plan are discharged from any obligations under subsections (2) through (11) of this section but shall assist disabled employees and retired employees in applying for health insurance. Assistance may include developing and distributing standardized information on the availability and cost of individual health benefit plans, application packages, and health benefit fairs.

(13) The office of the insurance commissioner shall make available to counties, municipalities, and other political subdivisions information regarding individual health benefit plans, including a list of carriers offering individual coverage, the rates charged, and how to apply for coverage.

## Appendix A

(14) Counties, municipalities, and other political subdivisions that employ public safety employees participating in the law enforcement officers' and firefighters' system plan 2 must set up tax appropriate flexible spending accounts or voluntary employee benefit accounts that allow employees to contribute and accrue savings for retiree medical premiums. The tax accounts must be consistent with existing state law, the internal revenue code, and the regulations adopted by the internal revenue service. To the extent allowed by the internal revenue code, accounts may be authorized to accept contributions from employers.

NEW SECTION.     **Sec. 3.**   A new section is added to chapter 41.26 RCW to read as follows:

(1) The department, in consultation with the law enforcement officers' and firefighters' retirement system plan 2 board, shall assist employers of law enforcement officers and firefighters in the formulation and adoption of a plan, policies, and procedures designed to guide, direct, and administer the voluntary employee benefit account established in RCW 41.04.208 for public safety employees. The program and plan documents must be developed in consultation with the employers of law enforcement officers and firefighters.

(2) A plan document describing the requirements shall be adopted and administered by the department and be available as a template for local employers. The department shall represent the state in all matters concerning the administration of the plan. The state may engage the services of a professional consultant or administrator on a contractual basis to serve as an agent to assist or perform the administrative functions necessary in carrying out the purposes necessary to establish the voluntary employee benefit account or alternative internal revenue service authorized spending account.

**Sec. 4.**   RCW 41.26.740 and 2003 c 92 s 7 are each amended to read as follows:

(1) All expenses of the department and the office of the state actuary related to the implementation of chapter 2, Laws of 2003 shall be reimbursed from the law enforcement officers' and firefighters' retirement system expense fund under RCW 39.34.130.

(2) All expenses of the department and the office of the state actuary related to the implementation of the accounts required in sections 2 and 3 of this act shall be reimbursed from the law

## Appendix A

1 enforcement officers' and firefighters' retirement system expense  
2 fund under RCW 39.34.130.

--- END ---



# Individual Health Savings Accounts

INITIAL CONSIDERATION

SEPTEMBER 21, 2016

# ISSUE

- ▶ **There is a gap in healthcare coverage for public safety employees from the time of retirement to when Medicare coverage begins**

# OVERVIEW



- ▶ **Health insurance premiums have increased rapidly over the recent past**
  - Growing a cumulative 138% between 1999 and 2010
  - Outpacing cumulative wage growth of 42% over the same period
- ▶ **It's important for members to begin saving for retiree health costs**

# OVERVIEW

## ► SB 6071

- Introduced in the 2015 session to help ensure access to retiree medical coverage for LEOFF Plan 2 members through the use of appropriate tax-authorized spending accounts or voluntary employee benefit accounts
- These accounts would allow employees to contribute income now to help pay for their future medical premiums



# BACKGROUND



- ▶ **There are different accounts currently available to help pay for post-retirement healthcare costs**
  - Voluntary Employees' Beneficiary Association (VEBA)
  - Health Savings Account (HSA)
  - Flexible Spending Account (FSA)

# VEBA

## ► **Voluntary Employees' Beneficiary Association**

- Funded by the amount of unused sick leave that an employee has at the time of retirement
- The amount of sick leave is paid out in full to the plan and is not subject to tax
- Able to pass on any remaining funds in the account to eligible dependents
- Funds are forfeited if no eligible participant exists

# HSA

## ► Health Savings Account

- Tax favored savings account
  - Must be covered by a “high deductible health plan”
- May be funded by both employer and employee contributions
- Contributions are invested over time and can be used to pay for qualified medical expenses
- Contribution limits
  - \$3350 for an individual
  - \$6750 for family coverage

# HSA

## ► Advantages

- Others can contribute to your HSA
- Pre-tax contributions
- Tax-deductible contributions
- Tax-free withdrawals
- Earnings are tax-free
- Funds roll over
- Portable
- Convenient

# HSA

## ► Disadvantages

- High deductible plan requirement
- Unexpected healthcare costs
- Pressure to save
- Taxes and Penalties
- Recordkeeping
- Fees

# FSA

## ► Flexible Spending Account

- Health plan must be through your employer
- Pay for out of pocket health care costs
- Tax free
- \$2550 limit per year, per employer
- Funds can be spent on you, your spouse, or your dependents
  - Pays for deductibles and co-pays
  - Doesn't pay for medical premiums

# FSA

## ► Flexible Spending Account

- Can be used to pay for prescriptions and medical equipment
- Money must be used within the plan year
  - Money doesn't roll over into next year
  - Don't put more money into an FSA than you think you'll spend

# COMPARISON

	Source of Funds	Annual limits	Use it or lose it?	When can \$ be used?	Tax free contributions?	Tax-free withdrawal?
VEBA	Unused sick leave	None	No	Post-retirement	Yes	Yes
HSA	Any type of contributions	\$3350-single \$6750 - family	No	Any time	Yes	Yes
FSA	Any type of contributions	\$2250	Yes	Within the plan year	Yes	Yes



# QUESTIONS?

## ► **Contact:**

Ryan Frost

Research and Policy Manager

(360) 586-2325

[ryan.frost@leoff.wa.gov](mailto:ryan.frost@leoff.wa.gov)



## LEOFF Plan Comparison

**Report Type:**

Educational Briefing

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Ryan Frost, Research and Policy Manager

**Summary:**

The Board asked for a comparison of LEOFF Plan 2 to other open plans across the country. This presentation presents the findings.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:  
Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▢ Plan Comparison	Report
▢ Plan Comparison	Presentation



September 21, 2016

## LEOFF Plan 2 Comparison Report

### EDUCATIONAL BRIEFING

By Ryan Frost

Research and Policy Manager

360-586-2325

ryan.frost@leoff.wa.gov

### OVERVIEW

The Board asked for a comparison of LEOFF Plan 2 to other open plans across the country. A total of 160 public pension plans were surveyed. This comparison is based on the following 5 measurements:

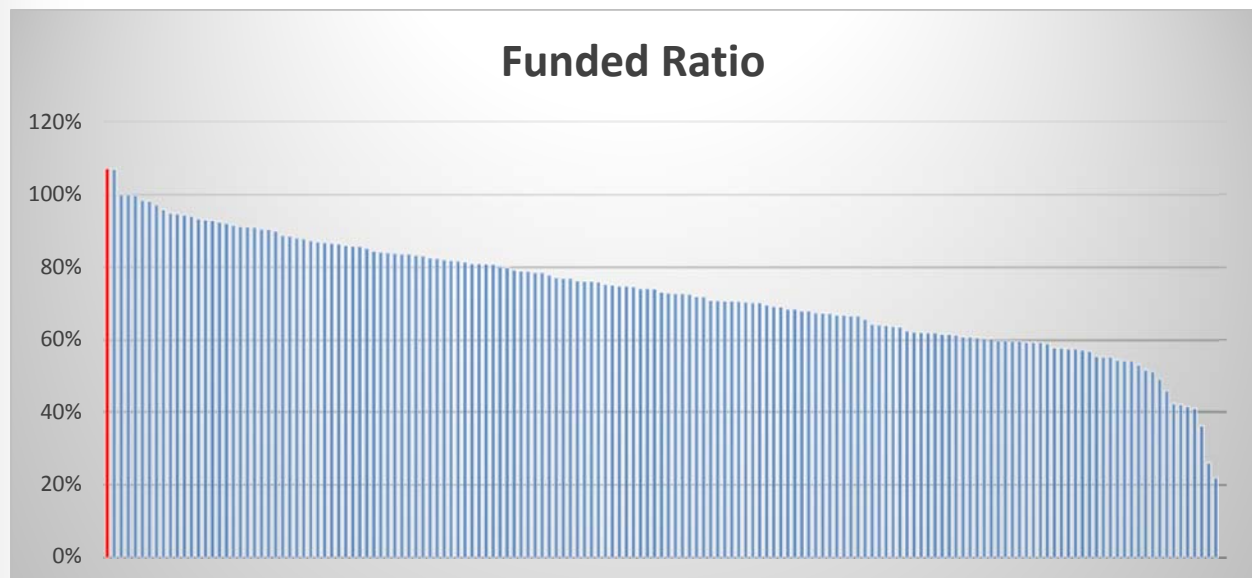
- Funded status
- Assumed Rate of Return on Investment
- Total Normal Cost of the Pension Plan
- Average Benefit in Retirement
- Average Salary

LEOFF Plan 2 will be highlighted in red in all of the corresponding charts.

### COMPARISONS

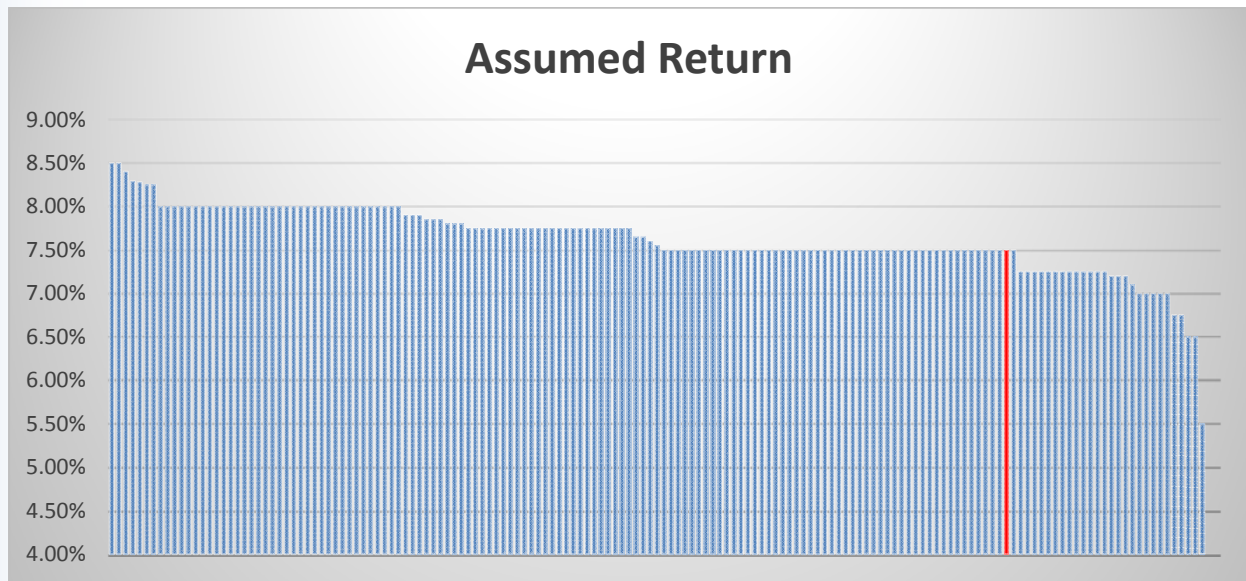
#### Funded Status – T-1<sup>st</sup>/160 plans

LEOFF Plan 2 is ranked as the highest funded public pension plan in the country, with a funded ratio of 107%. One other plan, the DC fire and police plan, also shares that title with a funded ratio of 107%. The average funded status nationwide is 73%.



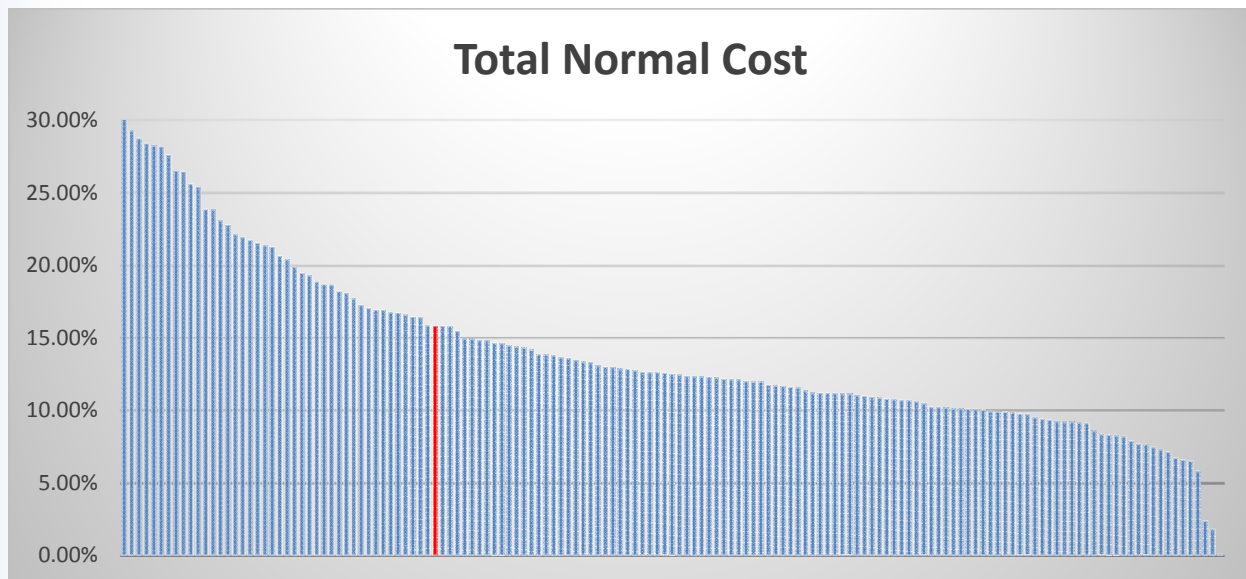
### Assumed Rate of Return

LEOFF Plan 2 assumes a 7.5% rate of return on investments, putting it slightly below the national average of 7.61%.



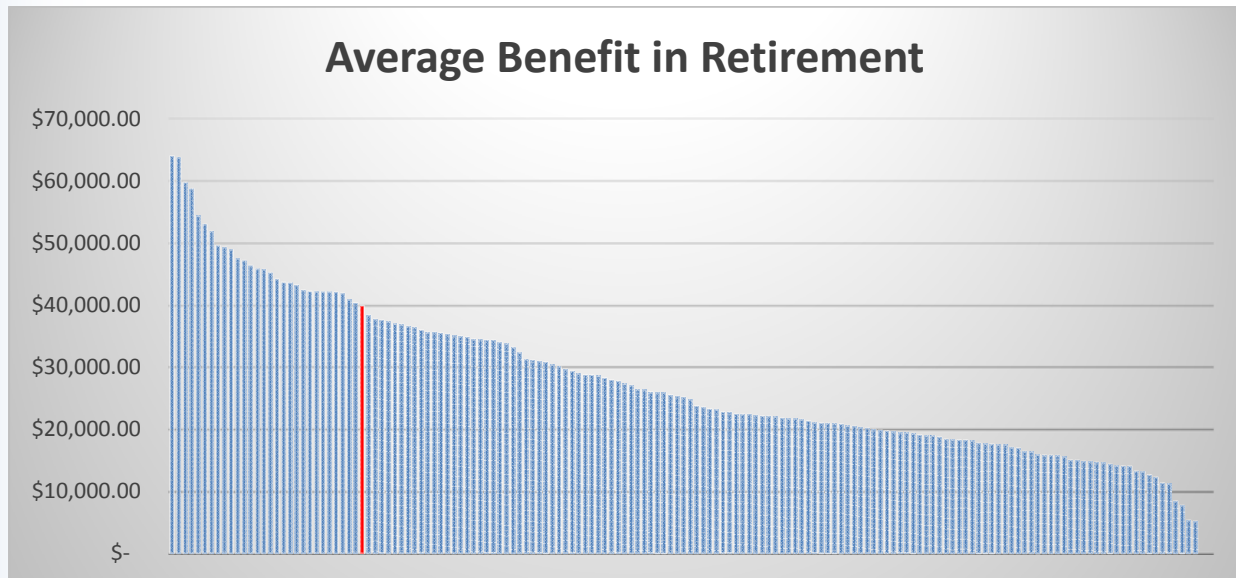
### Total Normal Cost – 43<sup>rd</sup>/160 plans

The total normal cost of LEOFF Plan 2 currently sits at 15.82% of pay, putting it slightly above the average public plan which is 14.07% of pay.



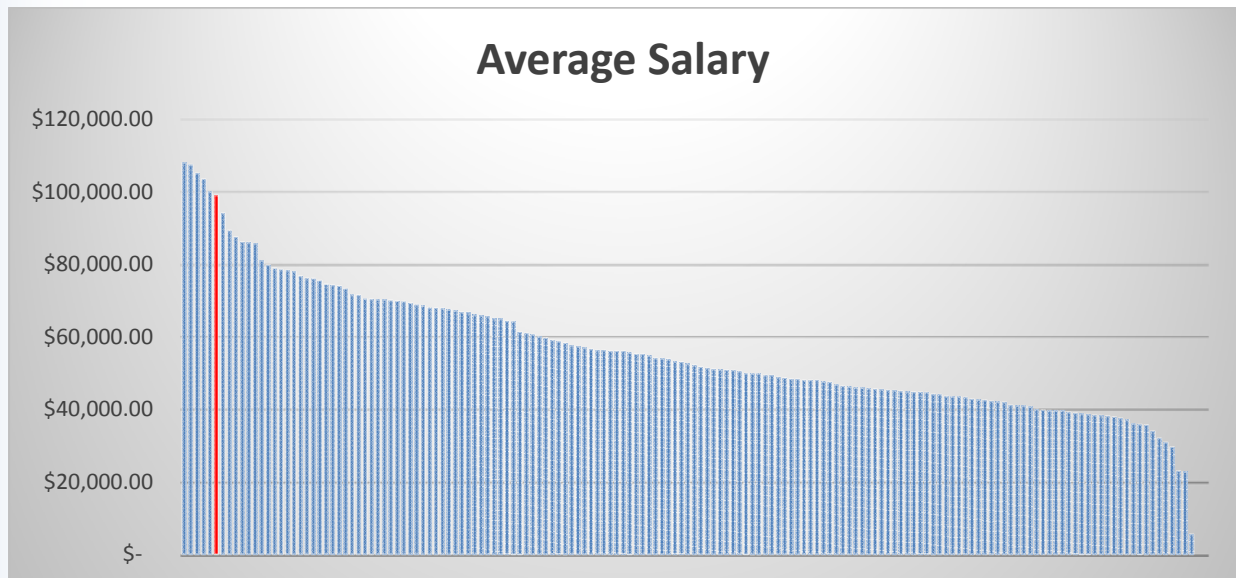
### Average Benefit in Retirement – 29th/160 plans

The LEOFF Plan 2 average yearly benefit in retirement is \$40,320, well above the national average of \$27,829.



### Average Salary – 6<sup>th</sup>/160 plans

The average salary in LEOFF Plan 2 is \$99,048, while the national average is at \$56,354. Of the top 8 highest salaried plans, 7 of them are police and fire plans.



## SUPPORTING INFORMATION

Appendix A: Full Spreadsheet with additional measurements



# **LEOFF Plan 2 Comparison Report**

EDUCATIONAL BRIEFING

September 21, 2016

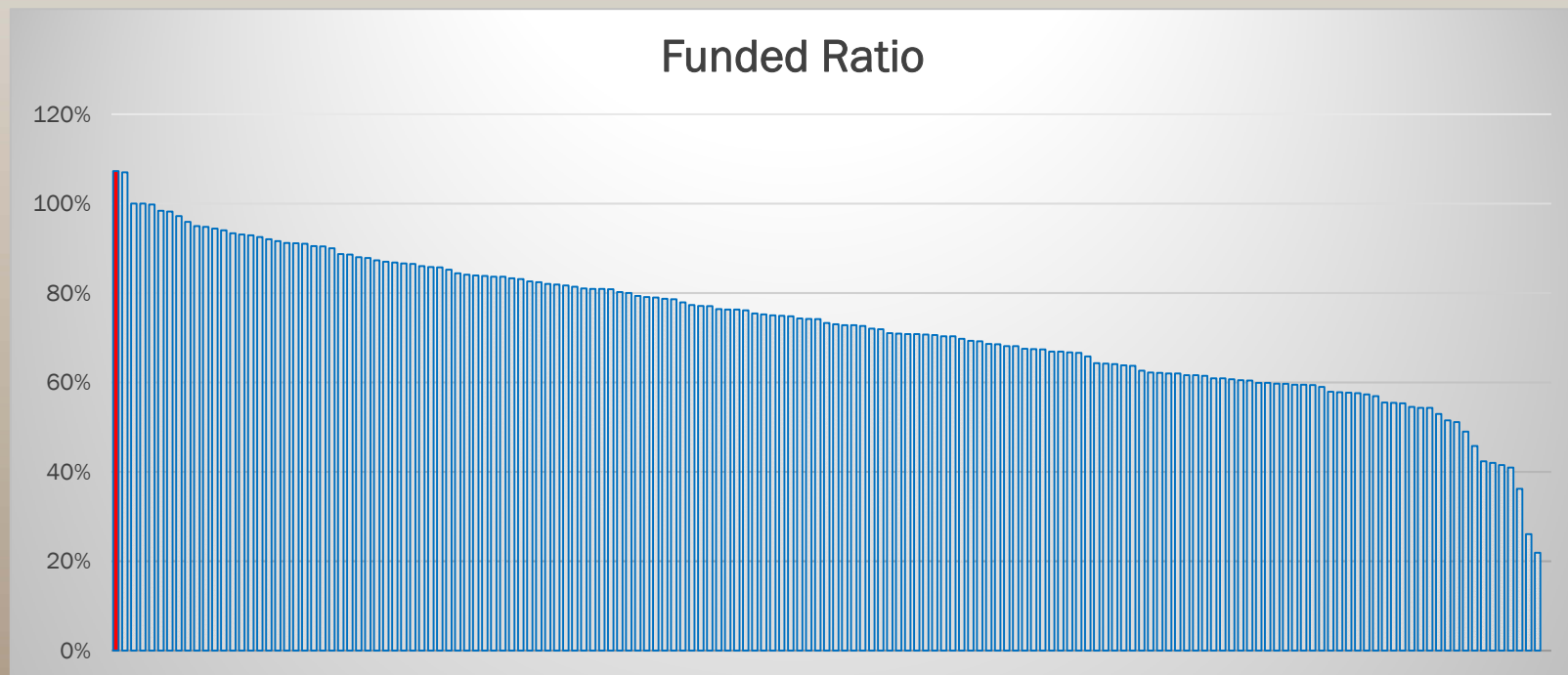
# OVERVIEW

- ▶ Board asked for a comparison of LEOFF Plan 2 to other open plans across the country
- ▶ Total of 160 public pension plans were surveyed
- ▶ This comparison is based on the following 5 measurements:
  - Funded status
  - Assumed Rate of Return on Investment
  - Total Normal Cost of the Pension Plan
  - Average Benefit in Retirement
  - Average Salary
- ▶ LEOFF Plan 2 will be highlighted in red in all of the corresponding charts



# FUNDED STATUS

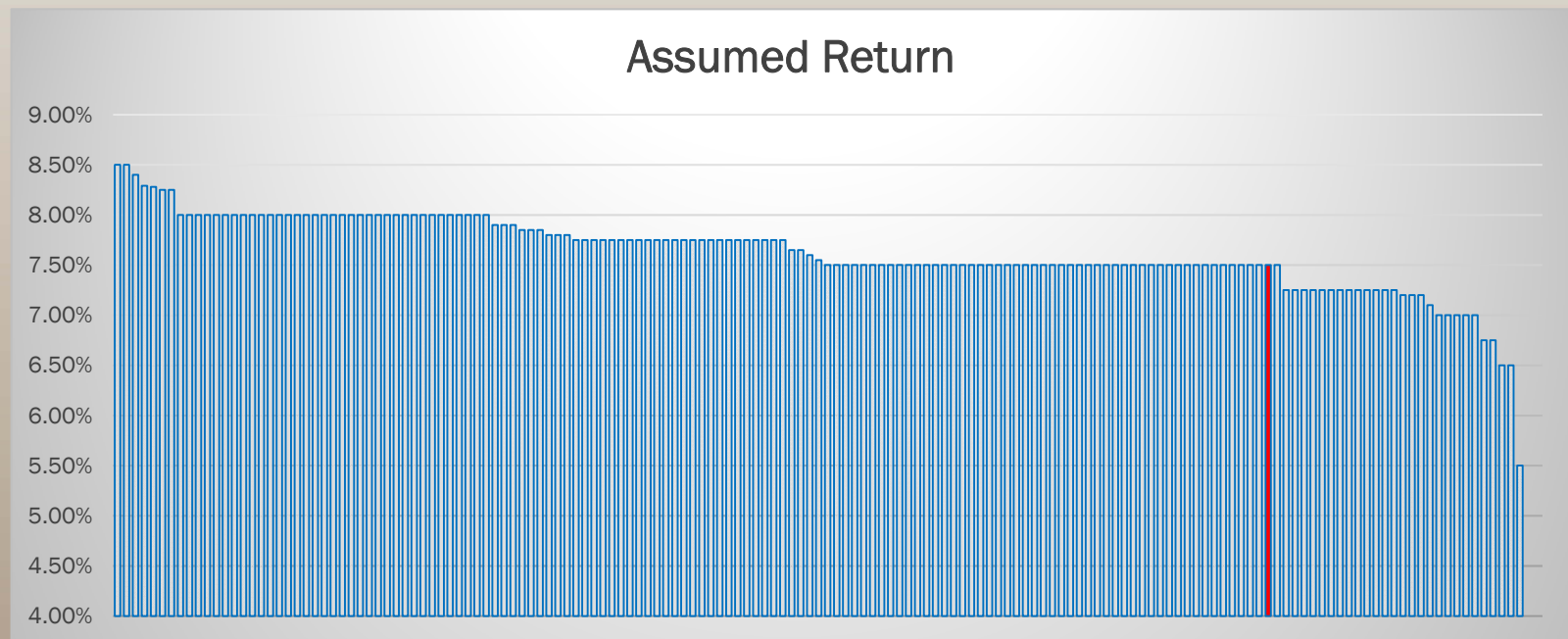
- ▶ Highest funded public pension plan in the country, with a funded ratio of 107%
- ▶ The DC fire and police plan also at 107%
- ▶ The average funded status nationwide is 73%





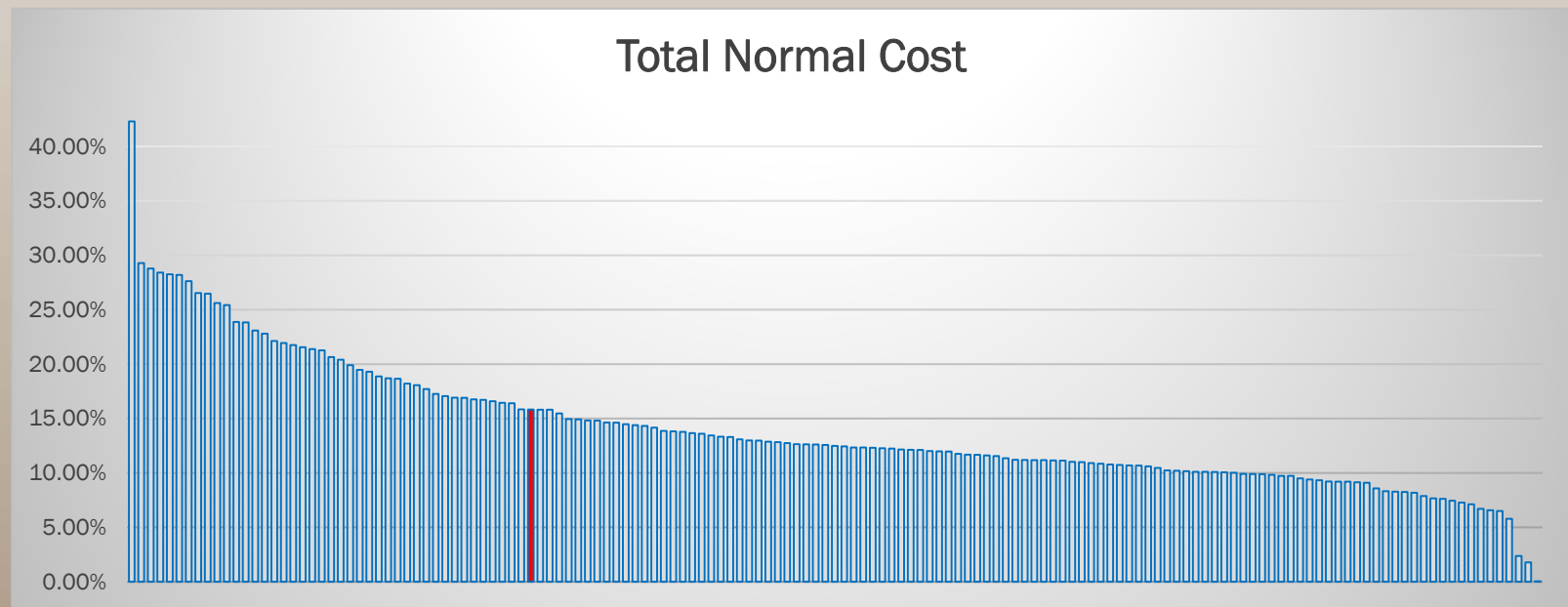
# ASSUMED RATE OF RETURN

- ▶ **LEOFF Plan 2 assumes a 7.5% rate of return on investments**
- ▶ **Slightly below the national average of 7.61%**



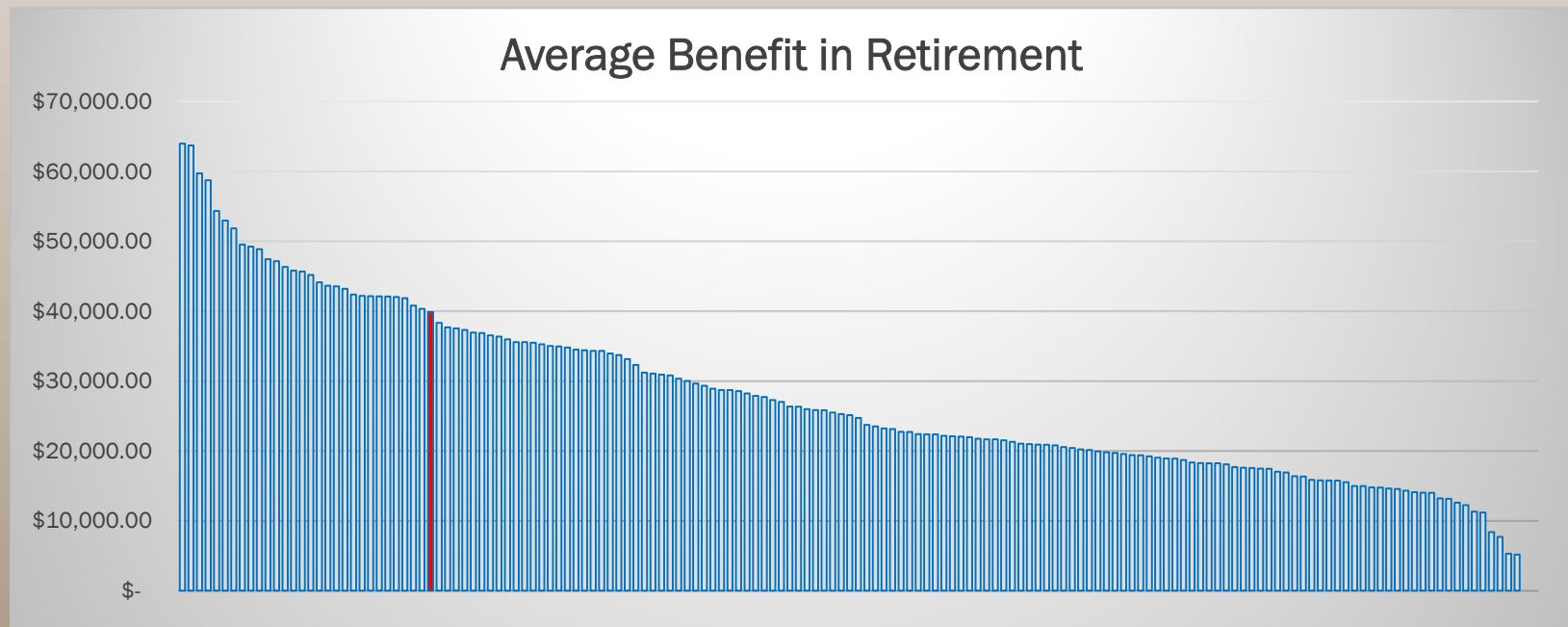
# TOTAL NORMAL COST

- ▶ LEOFF Plan 2 currently sits at **15.82%** of pay
- ▶ Slightly above the national average of **14.07%** of pay
- ▶ **43<sup>rd</sup>** out of 160 plans



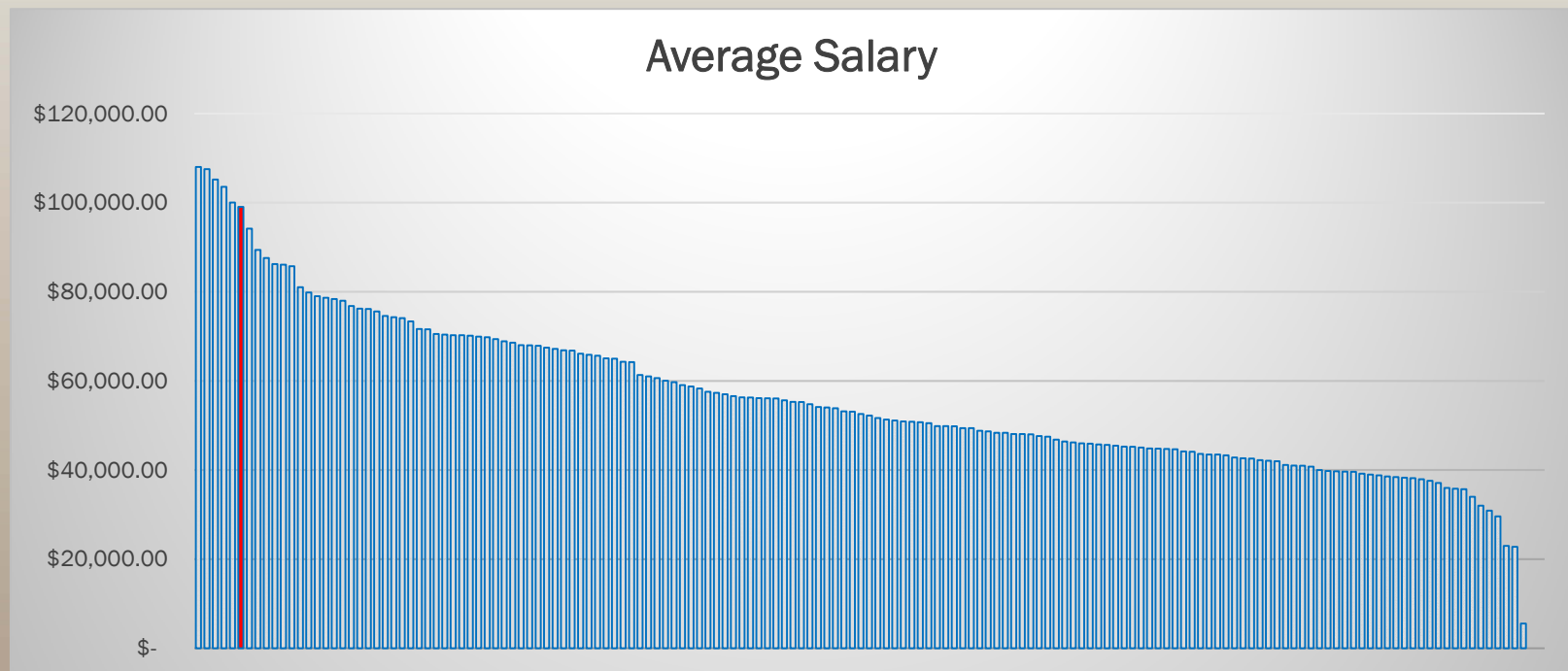
# AVERAGE BENEFIT IN RETIREMENT

- ▶ The LEOFF Plan 2 average yearly benefit in retirement is \$40,320
- ▶ Higher than the national average of \$27,829
- ▶ 29<sup>th</sup> out of 160 plans



# AVERAGE SALARY

- ▶ LEOFF Plan 2 average salary is \$99,048
- ▶ National average is \$56,354
- ▶ 6<sup>th</sup> out of 160 plans



# CONTACT

**Ryan Frost**

**Research and Policy Manager**

**[ryan.frost@leoff.wa.gov](mailto:ryan.frost@leoff.wa.gov)**

**(360) 586-2325**

# Select Committee on Pension Policy

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

## Regular Committee Meeting

September 20, 2016  
10:00 a.m. – 12:30 p.m.\*  
House Hearing Room A  
Olympia

### AGENDA

- |            |  |
|------------|--|
| 10:00 a.m. | <b>1. Approval of Minutes</b>  |
| 10:05 a.m. | <b>2. Merger Study</b> – Aaron Gutierrez, Senior Policy Analyst, and Matt Smith, State Actuary |
| 10:35 a.m. | <b>3. Break</b>  |
| 10:40 a.m. | <b>4. Update on PFC Adoption</b> – Graham Dyer, Actuarial Analyst                              |
| 10:45 a.m. | <b>5. DRS Update</b> – Presenter to be Determined  |
| 11:05 a.m. | <b>6. LEOFF 2 Board Update</b> – Steve Nelsen, Executive Director, LEOFF 2 Board               |
| 11:25 a.m. | <b>7. WSPRS Study</b> – Lauren Rafanelli, Associate Policy Analyst                             |
| 11:55 a.m. | <b>8. Plan Membership Default: Initial Briefing</b> – Aaron Gutierrez                          |
| 12:10 p.m. | <b>9. Age-Based Plan Opt-Out: Initial Briefing</b> – Aaron Gutierrez                           |
| 12:30 p.m. | <b>10. Adjourn</b>   |

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

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**Senator Barbara Bailey**

**John Boesenberg**  
*PERS/Higher Ed Employers*

**\*Representative Bruce Chandler, Vice Chair**

**\*Senator Steve Conway, Chair**

**Annette Creekpau**  
*PERS Employers*

**\*Randy Davis**  
*TRS Actives*

**\*Beverly Freeman**  
*PERS Employers*

**\*Tracy Guerin, Director**  
*Department of Retirement Systems*

**\*Bev Hermanson**  
*PERS Retirees*

**Senator Steve Hobbs**

**Robert Keller**  
*PERS Actives*

**Representative Matt Manweller**

**Byron Olson**  
*PERS Employers*

**Representative Timm Ormsby**

**Senator Mark Schoesler**

**David Schumacher, Director**  
*Office of Financial Management*

**Representative Derek Stanford**

**J. Pat Thompson**  
*PERS Actives*

**Robert Thurston**  
*WSPRS Retirees*

**David Westberg**  
*SERS Actives*

*\*Executive Committee*

(360) 786-6140  
Fax: (360) 586-8135  
TDD: 711  
[leg.wa.gov/SCPP.htm](http://leg.wa.gov/SCPP.htm)



## **Board Member Annual Training**

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Tor Jernudd, Assistant Attorney General



## Standby Pay

**Report Type:**

Initial Consideration

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Paul Neal, Senior Research and Policy Manager

**Summary:**

Standby pay is not part of basic salary (reportable compensation) used in computing LEOFF Plan 2 contributions and pensions.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Enhance the benefits for the members., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ Standby Pay	Report
▣ Standby Pay	Presentation





September 21, 2016  
**Standby Pay**

## INITIAL CONSIDERATION

By Paul Neal  
Senior Research & Policy Manager  
360-586-2327  
[paul.neal@leoff.wa.gov](mailto:paul.neal@leoff.wa.gov)

## ISSUE STATEMENT

Standby pay is not part of basic salary (reportable compensation) used in computing LEOFF Plan 2 contributions and pensions.

## OVERVIEW

Some LEOFF Plan 2 members receive standby pay while off-duty in exchange for being prepared to report to work on short notice. This payment is not considered compensation for services rendered and thus is not reportable compensation for LEOFF Plan 2.

Sometimes, payment for being in standby status is reported to DRS:

- If standby pay is paid as overtime for a reduced number of hours, for instance, one hour of overtime paid for one shift on standby; or
- If the position is in PERS.

This report discusses the current status of standby pay in LEOFF Plan 2 and PERS to help the Board determine whether to pursue the issue further.

## MEMBERS IMPACTED

Many law enforcement officers and fire fighters do not receive standby pay. They are generally subject to call-up if an emergency requires more resources than available from on-duty staff. Fire fighters receiving standby pay tend to be in positions that, while required at a fire scene, are not necessarily present at the fire station 24/7. This can include fire inspectors and public information officers.

## BACKGROUND & POLICY ISSUES

### **Standby Pay is Not Basic Salary in LEOFF**

Standby pay is a nominal rate of pay provided in exchange for the employee being available to come to work quickly if called, though he or she might not be called. While on standby an employee is usually confined to a specified geographic area and prohibited from consuming

alcohol or other intoxicants. If the employee is called in, he or she usually earns overtime for periods actually worked.

The Department of Retirement Systems (DRS) excludes standby pay from basic salary because it does not consider standby pay compensation for services rendered, see RCW 41.26.030(4)(b) and WAC 415-104-393. While ready to work if called, an employee on standby is engaged in personal activities, not performing work for their employer.

### **Some LEOFF Members Earn Standby Pay**

An informal survey of Washington fire fighters turned up the following examples of earned standby pay. Arrangements vary depending upon the local collective bargaining agreement.

#### ***When Can Fire Fighters Earn Standby Pay?***

Some Washington fire fighters can earn standby pay in the following situations:

- Positions assigned to work 8 hour shifts may be required to muster after hours in the event of a fire. Those positions include:
  - Fire investigators, Fire Marshals, or Public Information Officers:
  - Battalion Chiefs and/or Deputy Chiefs
- A station that combines career and volunteer fire fighters may have a career fire fighter on standby to respond to a fire call to aid volunteers.
- If a chief is absent, a lieutenant may be designated to respond to an incident in the chief's stead and earn standby as the chief would.
- At least one jurisdiction pays standby pay to crews in fire camps while working on state mobilizations.

#### ***When Can Law Enforcement Officers Earn Standby Pay?***

Law enforcement officers on special squads such as detectives may earn pay for being on standby.

#### ***How Much is Standby Pay?***

The rate of pay varies. Some examples:

- Fire Fighters:
  - Reduced rate of pay – some jurisdictions pay an hourly standby wage at a reduced rate of pay such as 10% of regular pay;
  - Reduced hours – some jurisdictions pay a full overtime wage for a reduced number of hours. For instance, one employer pays one hour of overtime for a 12 hour standby shift.
- Law Enforcement Officers:
  - 4 hours pay for being on standby, additional pay if called in for more than 4 hours;
  - No standby pay but guaranteed 4 hour pay minimum if called in.

### ***Some Standby Compensation is Reported***

Whether an employee's standby pay is reportable can depend on the employer's payroll and personnel classifications:

- Standby pay paid as overtime or regular pay. If a jurisdiction tracks standby pay as a separate type of pay, it is not reported to LEOFF. If, however, the pay is paid as overtime or straight time for a reduced number of hours, the amount would be coded as reportable pay and reported to DRS.
- Standby pay to PERS employees: A LEOFF fire inspector or public information officer would not have standby pay reported. If an employer classified their fire inspectors or public information officers as PERS positions any standby pay received is reportable.

### **Standby Pay is Reportable Compensation in PERS**

In 1995 the Legislature found standby pay should be reported in PERS, despite not being compensation for service rendered. It added the following language to the definition of PERS reportable compensation (compensation earnable):

"Compensation earnable" for plan 2 and plan 3 members also includes the following actual or imputed payments, which are not paid for personal services:

...

(vi) Compensation that a member receives for being in standby status. For the purposes of this section, a member is in standby status when not being paid for time actually worked and the employer requires the member to be prepared to report immediately for work, if the need arises, although the need may not arise.

RCW 41.40.010(8)(b).

## **NEXT STEPS**

At the juncture the Board may:

1. Direct staff to present a comprehensive review at the November Board meeting; or
2. Take no further action.

## **SUPPORTING INFORMATION**

Appendix A: Standby pay WACs for LEOFF Plan 2 and PERS

### LEOFF Plan 2

#### WAC 415-104-393

##### **Standby pay is not LEOFF Plan II basic salary.**

Payments to a member for time not actually worked when the member must be available to work if the need arises, are not a salary or wage for services rendered. Any such payment does not qualify as basic salary for LEOFF Plan II.

**Example:** Some employers provide payments to a member at less than the member's regular hourly rate in exchange for the member being available to come into work after h shift if called, although the member may not be called. Such payments, often ref as "standby pay," are not basic salary for LEOFF Plan II.

### PERS Plan 2

#### WAC 415-108-469

##### **Standby pay.**

Some employers pay employees for being on "standby." A member is on standby when not being paid for time actually worked and the employer requires the member to be prepared to report immediately for work if the need arises, although the need may not arise. Because the member is not actually working, the member is not rendering service. However, RCW [41.40.010\(8\)](#) specifically identifies standby pay that meets the above requirements as reportable compensation. Although included in the definition of compensation earnable, time spent on standby is excluded from the definition of "service," see RCW [41.40.010\(9\)](#).



# **Standby Pay**

INITIAL CONSIDERATION

September 21, 2016

# ISSUE

- ▶ **Standby pay is not part of basic salary (reportable compensation) used in computing LEOFF Plan 2 contributions and pensions**
- ▶ **Standby Pay is**
  - **Less than full pay for**
  - **Being available to be called in, though employee may not be called in**

# STANDBY PAY IS NOT BASIC SALARY

► Pay for being available to be called in for work is

- Not considered pay for services rendered
- Not reportable basic salary in LEOFF
- Not used in calculating:
  - Contributions
  - Pensions

# WHO EARNS STANDBY PAY?

## ► Fire Fighters:

- Employees working 8 hour shifts required to muster for fire such as:
  - Fire investigators, Fire Marshals, or Public Information Officers
  - Battalion Chiefs and/or Deputy Chiefs
- Career fire fighters called in to supervise volunteers
- Lieutenant backfilling for absent chief
- Employees mobilized for fire camps

## ► Law Enforcement Officers: Special squad members, such as detectives



# HOW IS STANDBY PAY PAID?

- ▶ **Reduced rate of pay –**
  - **Example: 10% of regular pay**
- ▶ **Full overtime rate for reduced number of hours**
  - **Example: 1 hour overtime pay for 12 hours of standby**
- ▶ **Regular rate for reduced number of hours**
  - **Example: 4 hours regular pay for 16 hours standby**

# WHEN IS STANDBY PAY REPORTED?

- ▶ Overtime or regular pay rate - If standby pay is paid at overtime or regular pay rate:
  - Coded and therefore reported as overtime or regular pay.
  - Not pay for services rendered so should not be reported.
- ▶ PERS Employees. 1995 PERS law:
  - Recognizes standby pay is not for services rendered but
  - Designates it as reportable in PERS
  - If a jurisdiction has PERS fire inspectors or public information officers their standby pay is reportable

# NEXT STEPS

- ▶ **Direct staff to prepare comprehensive report for November meeting**
- ▶ **Take no further action at this time**

# CONTACT

**Paul Neal**

**Senior Research and Policy Manager**

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**(360) 586-2327**



## Final Month Payment

**Report Type:**

Initial Consideration

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Paul Neal, Senior Research and Policy Manager

**Summary:**

When a retiree dies in the middle of the month, DRS must assess and collect a reimbursement from the member's estate for that portion of the month following the retiree's death.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Enhance the benefits for the members., Provide the stakeholders with a voice in plan governance., Maintain the financial integrity of the plan., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ Final Month Payment	Presentation
▣ Final Month Payment	Report



# Final Month Payment

INITIAL CONSIDERATION

September 21, 2016

# ISSUE

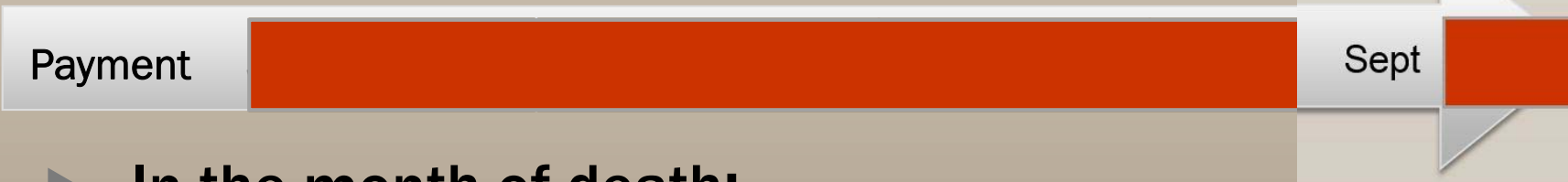
- ▶ When a retiree dies in the middle of the month, the Department of Retirement Systems (DRS) must assess and collect a reimbursement from the member's estate for that portion of the month following the retiree's death.
- ▶ Burden on retiree's heirs
- ▶ Administrative work for DRS
  - Calculating
  - Contacting
  - Collecting

# WHY IS THERE AN OVERPAYMENT?

- ▶ Retirement allowances accrue daily beginning on the first of the month



- ▶ Benefits paid at the end of the month after a full month's benefit has accrued



- ▶ In the month of death:
  - Benefit stops accruing on the day of death
  - Benefit paid for the whole month



# OVERPAYMENT EXAMPLE

- Full month's accrual: \$4,200
- Accrual if member dies on 10th: \$1400
- Overpayment \$2,800

# AMENDMENT PROPOSAL

- ▶ To allow payment of full final month's payment
- ▶ Cost to pay full final month's benefit:
  - Actuary calculating
  - (Small individual increase) X (all retirees) = ?
- ▶ DRS decision package to Governor – not approved

# NEXT STEPS?

- ▶ **Direct staff to prepare a Comprehensive Report**
- ▶ **No further action at this time**

# CONTACT

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*September 21, 2016*

## Final Month Payment

### INITIAL CONSIDERATION

By Paul Neal  
Senior Research & Policy Manager  
360-586-2327  
paul.neal@leoff.wa.gov

### ISSUE STATEMENT

When a retiree dies in the middle of the month, DRS must assess and collect a reimbursement from the member's estate for that portion of the month following the retiree's death.

### OVERVIEW

LEOFF Plan 2 provides a monthly pension payment for life. That pension ends when the retiree, or his or her survivor beneficiary, dies. When the retiree or beneficiary dies part-way through the month, the Department of Retirement Systems (DRS) must recoup the payment attributable through the remainder of the month.

Some heirs have complained that repayment of a portion of the final pension benefit places an undue burden on them. Identifying the amount, contacting the retiree's heirs, and collecting an overpayment also creates an administrative workload for DRS.

DRS asked the Governor's office to approve a request bill allowing retirees to keep their full last month's benefit. The State Actuary is working on a cost estimate for that bill. At the time of this report, it appears the Governor is not authorizing DRS to proceed with a request bill.

### BACKGROUND & POLICY ISSUES

Upon retirement, the member receives a benefit payable "throughout such member's life."<sup>1</sup> If the member selects a beneficiary, and the beneficiary survives the member, the benefit is paid "throughout the life" of the beneficiary.<sup>2</sup>

Retirement allowances accrue from the first day of the calendar month following the retiree's separation.<sup>3</sup> The retiree does not accrue a full month's retirement allowance until the last day of the month. As such, DRS pays retirement allowances in monthly installments at the end of the month.

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<sup>1</sup> RCW 41.26.460(1)(a)

<sup>2</sup> RCW 41.26.460(1)(b)

<sup>3</sup> RCW 41.26.490

When a retiree dies in the middle of the month he or she has accrued a benefit only through the day of death, i.e. less than the full month. Since retirement allowances are made in full monthly installments, the beneficiary receives a full month's retirement allowance. Consequently, an overpayment of the retiree's allowance occurs. Under current law, DRS has a fiduciary duty to identify and recoup that overpayment.

**Example**

The average monthly benefit of LEOFF 2 member's retiring in 2014:	\$4200
<u>Accrual if retiree dies on the 10<sup>th</sup>:</u>	<u>\$1400</u>
Overpayment	\$2800

Some heirs feel recoupment of the overpayment places an undue burden on them. It also creates a labor intensive administrative impact on DRS.

DRS asked the Governor's office to approve a request bill allowing retirees to keep their full last month's benefit. The State Actuary is working on a cost estimate for that bill. At the time of this report, it appears the Governor is not authorizing DRS to proceed with a request bill.

**NEXT STEPS**

1. Direct staff to provide a Comprehensive Report
2. Take no further action at this time



## Plan 1/Plan 2 Merger Study

**Report Type:**

Comprehensive Report

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Steve Nelsen, Executive Director

**Summary:**

A financial merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds raises a number of issues for plan members and retirees, LEOFF employers and the State related to funding policies, governance, and potential budget impacts. These issues should be studied by LEOFF 2 trustees.

**Strategic Linkage:**

This item supports the following Strategic Priority Goals:

Provide the stakeholders with a voice in plan governance., Maintain the financial integrity of the plan., Inform the stakeholders.

**ATTACHMENTS:**

Description	Type
▣ Merger Study Report	Report
▣ Plan 1/Plan 2 Merger Study	Presentation



August 24, 2016

## LEOFF 1/LEOFF 2 Merger Study

### COMPREHENSIVE REPORT

By Steve Nelsen

Executive Director

360-586-2320

[steve.nelsen@leoff.wa.gov](mailto:steve.nelsen@leoff.wa.gov)

### ISSUE STATEMENT

A financial merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds raises a number of issues for plan members and retirees, LEOFF employers and the State related to funding policies, governance, and potential budget impacts. These issues should be studied by LEOFF 2 trustees.

### OVERVIEW

A merger of the LEOFF 1 and LEOFF 2 retirement funds could affect all current and future member participants and annuitants in LEOFF Plan 1 and LEOFF Plan 2. According to the Preliminary 2015 Actuarial Valuation Report, as of June 30, 2015, LEOFF Plan 2 had 17,019 active participants and 3,710 annuitants; LEOFF Plan 1 had 82 active participants and 7,507 annuitants.

The Law Enforcement Officers' and Fire Fighters' (LEOFF) Retirement System is a cost-sharing multiple-employer retirement system. Membership includes all full-time, fully compensated, commissioned law enforcement officers, and firefighters. There are two tiers in the LEOFF system referred to as LEOFF Plan 1 and LEOFF Plan 2. Both LEOFF Plan 1 and LEOFF Plan 2 provide defined retirement benefits which are financed from a combination of investment earnings, employer and employee contributions, and contributions from the State.

The LEOFF Plan 1 retirement fund and the LEOFF Plan 2 retirement fund are separate trust funds. The assets of each fund may be used solely to pay for the liabilities of the associated retirement plan. The funds are commingled for investment purposes but they are accounted for separately and reported separately in both annual financial reports and annual actuarial valuations.

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.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2016 3rd sp.s. c 4 s 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 either the LEOFF Plan 2 Retirement Fund or the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

This report will provide an explanation of the issues raised by a merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds. 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 would apply to any merger of these plans.



## BACKGROUND & POLICY ISSUES

### Benefit Administration and Investment of the Retirement Funds

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 LEOFF Retirement fund was established to pay for the liabilities of this new retirement system. The administration of the LEOFF Retirement System and the investment of fund assets was initially 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. On October 1, 1977, the original LEOFF system (Plan 1) was closed to new members and a new tier of benefits, LEOFF Plan 2, was established for all new LEOFF members. LEOFF Plan 2 currently remains open. 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 Washington State Investment Board (WSIB) 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 managed by the SIB but assets and liabilities are accounted for separately.

The WSIB has the responsibility for investing all the state administered pension funds, including both the LEOFF Plan 1 retirement fund and the LEOFF Plan 2 retirement fund. The statutory mandate for the WSIB is to maximize return at a prudent level of risk.<sup>1</sup> The retirement funds collectively are called the Commingled Trust Fund (CTF). Established on July 1, 1992, the CTF is a diversified pool of investments including fixed income, public equity, private equity, real estate and tangible assets.

The CTF return was 4.93 % for the 2014-2015 fiscal year. The net assets held in trust for all the pension and benefit funds in the CTF totaled \$80.5 billion as of June 30, 2015. The net assets held in trust for LEOFF Plan 2 was \$9.83 billion or approximately 12% of the total pension and benefit funds in the CTF. The net assets held in trust for LEOFF Plan 1 was \$5.61 billion or approximately 7% of the total pension and benefit funds in the CTF.

### LEOFF 1 Contributions

LEOFF Plan 1 is a cost-sharing multiple employer retirement system which has been funded by a combination of contributions from three parties: the employers, the employees, and the state. Initially, the contribution rates for LEOFF Plan 1 were set at 6% of salary for both employees and employers and totaled approximately \$266 million. State contributions were made by ad hoc legislative appropriations unrelated to employee salaries and totaled approximately \$1,801 million. The relative historical share of contributions to the Plan 1 fund from the three parties is: 77% from state appropriations, 11.5% from employer contributions, and 11.5% from employee contributions.

The assets of the LEOFF Plan 1 retirement fund came to exceed the total actuarial liabilities of the system during the late 1990s when there was an extended period of much higher-than-expected

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<sup>1</sup> RCW 41.33A.110

investment returns. The state ceased making appropriations to the plan after June 30, 1999. Member and employer contributions were statutorily suspended in June 2000.

The Office of the State Actuary provides an Actuarial Valuation Report to the Pension Funding Council every two years and the Council has the authority adopt any changes to the state contribution rate for LEOFF 1 as may be required. There were approximately 82 active LEOFF Plan 1 members and 7507 annuitants as of June 30, 2015.

## **LEOFF 2 Contributions**

LEOFF Plan 2 is a cost-sharing multiple employer retirement system which is funded by a combination of contributions from three parties pursuant to a statutory cost sharing formula under which the members pay 50% of the total annual required contributions, the employers pay 30%, and the State pays 20%.<sup>2</sup> These costs are charged to members, employers and the State as a percentage of the member's salary.

The cost of the plan is evaluated annually by the Office of the State Actuary in their annual Actuarial Valuation Report. The contribution rates are adopted periodically by the LEOFF Plan 2 Retirement Board<sup>3</sup> based on the current and projected costs of the plan, the current and projected funding status of the plan and three statutory funding goals:

- To fully fund the plan;<sup>4</sup>
- To establish long-term state, employer and member contribution rates which will remain a relatively predictable and stable portion of future state, employer and member budgets;<sup>5</sup>and,
- To fund, to the extent feasible, all benefits for plan 2 members over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service.<sup>6</sup>

The LEOFF Plan 2 Retirement Board has adopted modifications to the second goal to include the additional objective of rate stability and to reflect the interests of employers and members, not just the State. The original statutory goal was simply, "To establish long-term employer contribution rates which will remain a relatively predictable portion of future state budgets."

Rates are also adjusted periodically by the LEOFF Plan 2 Retirement Board to reflect increased costs as a result of benefit improvements.<sup>7</sup> The current contribution rates adopted by the LEOFF Plan 2 retirement Board through June 30, 2017 are 8.46 percent member, 5.08 percent employer, and 3.38 percent State. There were approximately 17,019 active LEOFF Plan 2 members and 3,710 annuitants as of June 30, 2015.

## **Funding Policies**

Both LEOFF Plan 1 and LEOFF Plan 2 are valued and funded according to a complex arrangement of actuarial funding methods, long-term economic assumptions, demographic assumptions and actuarial funding policies. Many of these policies are the same for both plans but there are some differences which are important to understand and consider in the context of a financial merger of the plans.

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<sup>2</sup> RCW 41.26.725(1)

<sup>3</sup> RCW 41.26.725 and RCW 41.45.0604

<sup>4</sup> RCW 41.45.010(1)

<sup>5</sup> RCW 41.45.010(4)

<sup>6</sup> RCW 41.45.010(5)

<sup>7</sup> RCW 41.45.070

## Actuarial Funding Method

A variation of the Frozen Initial Liability Cost Method is used in LEOFF Plan 1 to determine the normal cost of the plan and the actuarial accrued liability for retirement and other pension benefits. Under this method, the Unfunded Actuarial Accrued Liability (UAAL) is equal to the unfunded actuarial present value of projected benefits less the actuarial present value of future normal costs for all active members and is reset at each valuation date. The present value of future normal costs is based on the aggregate normal cost for LEOFF Plan 2 and the resulting UAAL is amortized by June 30, 2024 as a level percentage of projected system payroll. The projected payroll includes pay from LEOFF Plan 2 as well as projected payroll from future new entrants. There is currently a positive UAAL for LEOFF Plan 1.

There is a statutory funding policy to fully amortize any unfunded liability which may emerge in LEOFF 1 no later than June 30, 2024.<sup>8</sup> Both the State and LEOFF employers are likely to incur increased costs if LEOFF Plan 1 comes out of fully funded status which would create a need for LEOFF Plan 1 funding policies to be developed and coordinated with LEOFF Plan 2 funding policies established by the Board.

The Aggregate Cost Method is used in LEOFF Plan 2 to determine the normal cost and the actuarial accrued liability. Under this method, the unfunded actuarial present value of fully projected benefits is amortized over the future payroll of the active group. The entire contribution is considered normal cost and no UAAL exists.<sup>9</sup>

The LEOFF Plan 2 Retirement Board has used a variation of the Entry Age Normal Cost Method since 2009 to match contribution rates to the expected long-term cost of the plan.

## Long-Term Economic Assumptions

In order to calculate the necessary current contribution rates for a plan, it requires projecting the future costs of paying out plan benefits, projecting the future value of current retirement fund assets and future contributions, and converting these projections into present day values. These calculations require the use of long-term economic assumptions. The long-term economic assumptions for LEOFF Plan 2 are adopted by the LEOFF Plan 2 Retirement Board. The long-term economic assumptions for LEOFF Plan 1 are set in statute.

Assumption	LEOFF 2	LEOFF 1
Investment Rate of Return	7.50%	7.70%
Salary Growth	3.75%	3.75%
Inflation	3.00%	3.00%
Growth in Membership	1.25%	1.25%

## Demographic Assumptions

Assumptions about future non-economic events are also an important necessary component of the overall funding policies for both LEOFF 1 and LEOFF 2. Key demographic assumptions include:

- Members' future rates of retirement and disability.
- Their total length of service.
- Their life expectancy after retirement.
- The life expectancies of their surviving spouses and other beneficiaries.

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<sup>8</sup> RCW 41.45.010(2)

<sup>9</sup> 2009 LEOFF Actuarial Valuation Report, Office of the State Actuary p. 36

The Office of the State Actuary performs an experience study at least once every six years to determine at what rate the above factors have actually occurred in the retirement systems.<sup>10</sup> The experience study compares actual experience to the assumptions and, if necessary, OSA makes adjustments to the rates for future actuarial valuations. For LEOFF Plan 2, any changes recommended by OSA must be adopted by the LEOFF Plan 2 Retirement Board.<sup>11</sup>

The most recent demographic experience study was published by the Office of the State Actuary in September, 2014. The study covered experience from 2007-2012. The study reported experience in LEOFF 1 separate from LEOFF 2 and developed different assumptions for each plan. One of the recommendations of that study was to modify mortality assumptions to take into account projected future improvements in life expectancy. These recommendations were adopted by the LEOFF 2 Board and incorporated into actuarial assumptions for LEOFF 2. The recommendations were adopted by the Legislature for LEOFF Plan 1.

### **Actuarial Value of Assets v. Market Value of Assets (“Smoothing”)**

For the actuarial valuation report, the Office of the State Actuary calculates the actuarial value of assets using an asset smoothing method adopted by the Legislature in 2003. The asset smoothing method applies to both LEOFF Plan 1 and LEOFF Plan 2. Each year OSA determines the amount the actual investment return deviates from the expected investment return and smooths that year’s gain or loss over a period of up to 8 years according to how much the actual gain or loss differs from the assumed gain.

### **Asset Value Corridor**

Additionally, to ensure the actuarial value of assets maintains a reasonable relationship to the market value of assets, a 30% asset value corridor was statutorily adopted in 2004.<sup>12</sup> This means that the actuarial value of assets may not exceed 130% nor drop below 70% of the market value of assets. The asset value corridor applies to both LEOFF 1 and LEOFF 2. On June 30, 2015, the asset value ratio for LEOFF 2 was 95% and for LEOFF 1 was 96%

### **The Funded Status of LEOFF 1 and LEOFF 2**

The funded status of a plan is calculated by comparing the plan’s assets to the present value of earned pension benefits of the plan’s members. A plan’s funded status can vary significantly depending on the assumptions and methods used to determine the value of the plan’s assets and liabilities. The Office of the State Actuary has historically reported the funding status for both LEOFF 1 and LEOFF 2 by comparing the actuarial value of assets (AVA) to the liabilities of the plan calculated using the Projected Unit Credit (PUC) actuarial cost method and the long-term earnings assumption.

The use of this particular funded status reporting method is helpful for comparing a plan’s funding progress over time, measuring the impact of assumption changes, or serving as a standard for comparing plans that use different funding methods. However, this particular funded status measurement can also be very misleading if taken out of context. The funded ratio may appear either overstated or understated to the extent that the actuarial value of assets deviates substantially from the market value of assets.

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<sup>10</sup> RCW 41.45.090

<sup>11</sup> RCW 41.26.720

<sup>12</sup> RCW 41.45.035(3)(a)

## Governance

### ***LEOFF Plan 2***

Effective July 1, 2003, the LEOFF Plan 2 Retirement Board was established by Initiative 790 to provide governance of LEOFF Plan 2. The Board's duties include adopting contribution rates, actuarial assumptions, and actuarial methods. The Board is also responsible for studying pension issues and recommending policy changes to the Legislature for the LEOFF Plan 2 retirement plan.

### ***LEOFF Plan 1***

In 2003 the Select Committee on Pension Policy (SCPP) was established by the Legislature to study pension issues, develop pension policies, and make recommendations to the Legislature.<sup>13</sup> The SCPP is a 20-member committee composed of elected officials, stakeholder representatives, employer representatives, and the Directors of the Department of Retirement Systems and the Office of Financial Management. Prior to 2003, the Joint Committee on Pension Policy (JCPP) performed these duties.

The SCPP meets during the legislative interim. Its specific areas of interest include benefits design, retirement eligibility requirements and pension funding methods. The SCPP receives the results of actuarial audits administered by the Pension Funding Council, and reviews and makes recommendations to the Pension Funding Council regarding changes to retirement assumptions or contributions rates. Under current law, the SCPP may form a public safety subcommittee to study pension issues affecting members of LEOFF, the Public Safety Employees Retirement System (PSERS), and the Washington State Patrol Retirement System (WSPRS).<sup>14</sup>

## **Legislative History**

House Bill 2097 in 2011 proposed merging LEOFF Plan 2 with LEOFF Plan 1 and temporarily reducing the State contribution to the merged plan. That bill did not pass the legislature.

Section 105 of the 2011 budget required the Office of the State Actuary to study the issue of merging LEOFF plans 1 and 2 into a single fund. The results of the study were reported to the ways and means committees of the House of Representatives and the Senate in December, 2011.

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.

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.

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<sup>13</sup> RCW 41.04.281

<sup>14</sup> RCW 41.04.278(2)(a)

## Legal Framework

Under federal law, the assets of a tax-qualified retirement plan such as LEOFF Plan 1 and LEOFF Plan 2 may be used only for the exclusive benefit of members of the plan.

There is a body of state case law across the country regarding plan mergers which may be illustrative of potential issues in evaluating a merger but there is no similar case law in Washington.

There is a significant body of Washington case law defining members' rights to retirement benefits and to have their retirement plan funded on a sound actuarial basis.

## POLICY ISSUES

### What is a “merger” of LEOFF Plan 2 with LEOFF Plan 1?

A merger of the LEOFF Plan 2 Retirement System with the LEOFF Plan 1 Retirement System would combine all of the assets and liabilities of each system into one new system. In its simplest terms, a merger is a purely financial transaction.

### Why would anyone want to merge LEOFF Plan 2 with LEOFF Plan 1?

Past merger proposals have included a temporary reduction in State contributions to the new plan. If the funding status of the new plan is improved compared to the current status of LEOFF Plan 2, then that would decrease the risk of poor investment experience in the future creating a need to increase contributions to LEOFF Plan 2 members, employers and the State. The member demographics of the plans, and the fact that LEOFF Plan 2 is an open system while LEOFF Plan 1 is a closed system, may also present opportunities for risk mitigation.

But, a merger also can create new risks so it is prudent for LEOFF Plan 2 Retirement Board members to inform themselves of these risks and take steps to mitigate those risks as part of any merger since Board members have a fiduciary duty to the plan.

### How much is the surplus in LEOFF Plan 1?

The preliminary results of the 2015 Actuarial Valuation prepared by the Office of the State Actuary indicate that as of June 30, 2015, LEOFF Plan 1 had \$4.307 billion in liabilities and an actuarial value of assets of \$5.404 billion for a surplus of \$1.097 billion. However, any evaluation of the LEOFF Plan 1 surplus in the context of a LEOFF 2/LEOFF 1 merger must consider three important questions:

1. What is the surplus as of today?
2. How does the market value of assets (MVA) differ from the actuarial value of assets (AVA)?
3. How does the calculation of LEOFF 1 liabilities differ from LEOFF 2?

**Today's Value:** The current Actuarial Valuation Report (AVR) prepared by the Office of the State Actuary (OSA) is based on asset and liability information as of June 30, 2015. The Washington State Investment Board (WSIB) updates the market value of plan assets monthly. There is no monthly projection of liabilities for LEOFF Plan 1. The most recent investment report from the WSIB (July 2016) indicated a market value for LEOFF Plan 1 of \$5.387 billion which is lower than the value of assets in the 2015 AVR.



It is also important to note how investment performance since June 2015 has differed from the projections used to calculate future liabilities in the 2015 AVR. LEOFF Plan 1 is expected to earn 7.7%/year. However, actual investment returns for the 2015/16 fiscal year were just 2.65%.

**Market Value/Actuarial Value:** The Actuarial Value of Assets (AVA) is calculated by smoothing investment gains and losses over a period of up to 8 years depending on how much the actual investment returns differ from the projected investment returns. The AVA for LEOFF Plan 1 as of June 30, 2015 was \$5.404 billion. The Market Value of Assets (MVA) is the actual value of assets in the fund as of a certain date. The MVA for LEOFF Plan 1 as of June 30, 2015 was \$5.610 billion. So, as of June 2015 there were \$206 million in deferred gains in LEOFF Plan 1.

Using a “smoothing method” is an appropriate and accepted method of reducing the effect of investment return volatility on contribution rates. But, using a “smoothed value” of assets may not be as appropriate for purposes other than rate-setting. For instance, if the legislation merging LEOFF 2 with LEOFF 1 includes “spending” some of the surplus assets in the form of contribution rate reductions, then it would be appropriate to consider the impact on the fund using both the actuarial value and the market value.

**Calculating LEOFF 1 liabilities:** The long-term economic assumptions used by both LEOFF Plan 2 and LEOFF Plan 1 are identical in most respects and both systems have adopted the expected improvements in life expectancy recommended by the Office of the State Actuary (OSA). However, there is one significant difference related to the expected future return on investments. The LEOFF Plan 2 Retirement Board has adopted the 7.5% earnings assumption recommended by OSA. The investment assumption for LEOFF Plan 1 is 7.7%.

It would be important to know how the financial risks of a LEOFF 2/LEOFF 1 merger would differ using a 7.5% investment return assumption.

### **Who does the LEOFF Plan 1 surplus belong to?**

All the assets in LEOFF Plan 1 are held in trust for the exclusive benefit of the beneficiaries of LEOFF Plan 1. The fact that LEOFF Plan 1 may have a “surplus” or more assets at a point in time than it is projected to need does not affect the legal status of any of the assets in the fund.

The idea that “surplus assets in the fund belong to the plan sponsor” is a concept related to closing or terminating a plan and is discussed later in this report. Neither the existence of a surplus nor a merger allow for fund assets to be distributed or diverted to a plan sponsor.

### **How does a merger affect LEOFF Plan 2 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 would a LEOFF 2/LEOFF 1 merger impact the State budget?**

LEOFF Plan 2 receives 20% of the cost of the plan from the State as an appropriation from the General Fund. That appropriation will be approximately \$130 million in the 2015-17 biennium. The required biennial appropriation for 2017-19 has yet to be determined but is likely to increase due to projected

growth in the LEOFF Plan 2 membership and salary base. LEOFF Plan 1 also has received a portion of its funding from the State in the past but no contributions have been required since 2001.

Past LEOFF 2/LEOFF 1 merger proposals have included temporary reductions in state funding to the newly created plan in consideration of the very healthy funding status of LEOFF Plan 1. For example, if the State contributions to pay for LEOFF Plan 2 benefits in the new plan were reduced to 0% for the next two biennia, the State would recognize approximate budget savings of over \$260 million. Any long-term state budget risks or benefits created by a merger should also be evaluated.

### **What legal issues are raised by a LEOFF 2/LEOFF 1 merger?**

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.

The State Attorney General's Office is responsible for this evaluation. The firm of Ice Miller has been used as a Special Assistant Attorney General in the past to provide advice related to federal tax to the LEOFF Plan 2 Retirement Board, the Department of Retirement Systems, the State Senate and the Select Committee on Pension Policy.

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 (*Bakenhus*). So, a merger cannot reduce benefits. Similarly, the courts have held that the funding which underlies the benefit promise is also subject to protection (*Weaver*). So, a merger that diminishes current or future plan funding needs to be evaluated according to these protections.

The State Attorney General's Office is responsible for this evaluation. The firm of Klausner and Kaufman has been used as a Special Assistant Attorney General in the past to provide advice related to plan terminations to the Washington State Senate and advice related to mergers to the LEOFF Plan 2 Retirement Board.

### **How would a LEOFF 2/LEOFF 1 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. A merger would not require any changes.

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. A merger would not require any changes.



Any changes to the governance of LEOFF Plan 2 would require careful consideration. For instance, how would a temporary State contribution rate reduction to LEOFF 2 fit with the role of the LEOFF Plan 2 Retirement Board to adopt contribution rates for LEOFF Plan 2?

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, such as the LEOFF Plan 2 Retirement Board, is a benefit of the 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. The terms of any merger of LEOFF Plan 2 and LEOFF Plan 1 would be established by the State Legislature in legislation.

### **How would a LEOFF 2/LEOFF 1 merger affect plan funding?**

LEOFF Plan 2 has a current funding ratio of 105%. LEOFF Plan 1 has a current funding ratio of 125%. When the assets and liabilities of LEOFF Plan 2 and LEOFF Plan 1 are merged, the funding ratio of the newly created plan would be approximately 112%.

The fact that the funding ratio of a merged LEOFF 2/LEOFF 1 system would be over 100% means that there would likely be no short-term change in funding policy required for either plan. The funding ratio of a system plays an important part in determining the ongoing funding policies of that system so the impact of a merger or any reductions in future contributions on the projected future funding status of the merged plans becomes an important consideration.

The costs of LEOFF Plan 2 are funded 50% by members, 30% by employers and 20% by the State. The required contributions are adopted as a percentage of member salary by the LEOFF Plan 2 Retirement Board. The rates adopted by the Board are currently 8.41% for member, 5.05% for employers and 3.36% for the State through June 30, 2017. The Board is scheduled to adopt rates for the 2017-19 biennium and the 2019-21 biennium at their July 27, 2016 meeting.

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.

Any merger proposal must be carefully analyzed to evaluate the risk that insufficient contribution rates, underfunding, or poor economic or demographic experience in LEOFF 1 would impact the rates charged to LEOFF 2 members, employers or the State.

### **How would a LEOFF 2/LEOFF 1 merger affect investment policy?**

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

A merger that included keeping the new fund in the CTF would mean 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.

### ***Commingled Investment***

There has been some consideration in the past as to whether LEOFF 1 assets should remain invested in the commingled trust fund or whether it would be more appropriate to invest these assets in a more conservative fund to minimize the risk of investment volatility since LEOFF 1 has been closed to new members since 1977 and the future benefits payments are more predictable, have a shorter duration and would be easier to immunize. However, there is a cost associated with a lower earning assumption. Since LEOFF 2 is an open and ongoing plan, merging LEOFF 1 with LEOFF 2 would affect analysis of this issue.

### **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 private plan is terminated and all the liabilities to beneficiaries have been satisfied, any remaining assets revert to the plan sponsor (*Hughes Aircraft*). It is unclear how that holding would be applied in the context of a public plan termination. Both LEOFF employers and the State contributed to LEOFF Plan 1 so both would have a sponsorship claim to any remaining assets. The State Senate proposed a termination of LEOFF Plan 1 in 2001 which included annuitizing existing LEOFF 1 liabilities and a distribution of surplus assets to the State, LEOFF 1 employers and a payment to LEOFF 1 beneficiaries.

A termination can also occur when the last beneficiary of a plan dies and there are no longer any benefits owed. The office of the State Actuary estimates that there will continue to be some LEOFF 1 beneficiaries for more than 40 years.

The principle that surplus assets in a terminated plan belong to the plan sponsor has sometimes been misapplied to discussions of a plan merger 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, as long as a plan has beneficiaries, 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 does not alter the legal status of those assets while the plan is active.

### **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 the police pension plan of ten first-class cities with the fireman’s pension fund of 42 separate systems throughout the State. In 1972, the Statewide City Employers’ Retirement System was merged into the Public Employers’ Retirement System (PERS).

### **What would happen if LEOFF 1 has an unfunded liability in the future?**

There is a statutory funding policy to fully amortize any unfunded liability which may emerge in LEOFF 1 no later than June 30, 2024.<sup>15</sup> If an unfunded liability emerges in LEOFF 1, this policy requirement could significantly impact funding requirements for LEOFF members, employers and the State in a merged

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<sup>15</sup> RCW 41.45.010(2)

plan. There is no funding policy for LEOFF 1 after June 30, 2024 so it is unclear what would be done if an unfunded liability emerges after that date.

### ***LEOFF 1 Supplemental Rate***

When an unfunded liability emerged in both PERS Plan 1 and TRS Plan 1, the State adopted a supplemental rate to cover this cost which is charged to employers as a percentage of salary of all PERS or TRS employees, not just those in Plan 1. If an unfunded liability were to emerge in LEOFF Plan 1, the State could adopt a similar supplemental rate to cover that cost. The additional cost to LEOFF employers would likely be shared with LEOFF 2 members indirectly through the bargaining process since less money would be available for salaries, equipment and other expenses.

### ***Financial Efficiencies***

There are currently no required contributions to LEOFF Plan 1 from the State, employers or members and haven't been any required contributions for some time. Therefore, any increase in assets, such as from positive investment performance, will not decrease plan costs. Assets in the retirement fund are strictly protected under federal law for pension plans and cannot be withdrawn from the fund and used for any state or employer purpose.

A merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds could commingle both the assets and liabilities of each plan. Therefore, any increase in assets due to positive economic or demographic experience could decrease plan costs for LEOFF members, LEOFF employers and the State.

### ***Risk Transfer/Sharing***

The assets invested in the LEOFF 1 retirement fund are currently projected to be sufficient to meet the projected liabilities of the plan. Currently, the State (and possibly LEOFF employers) would be responsible for any increased plan costs and required contributions in the future. The two primary risks of increased costs are 1) less-than-expected investment returns; and 2) higher-than-expected inflation. A merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds could commingle the liabilities of both plans. So, an increase in LEOFF 1 costs could become the shared responsibility of LEOFF 2 members, LEOFF employers and the State.

### **LEOFF 2 Board Request for State Actuary Study**

The Office of the State Actuary (OSA) has been asked to provide analysis to assist the Board's report to the legislature. There are two clear financial risks associated with a merger. Part of understanding these risks is understanding how these risks are increased if LEOFF 1 assets are used for other purposes such as rate reductions for the state or benefit payments to plan members.

- 1) The risk that LEOFF 1 will dip below 100% funding at some time in the future and require additional contributions; and,
- 2) The risk that LEOFF 1 will go into "pay-go" status.

There is a perception that the demographics of LEOFF 1 (virtually all retirees, no active salary base) increase the sensitivity of the plan to near-term deviations from actuarial assumptions, particularly the investment return assumption which has a high degree of annual volatility. Can OSA perform sensitivity analysis to verify or refute that perception? For instance, a 7.7% earnings assumption may be reasonable in the long-term but may be challenging in the short-term due to low near-term inflation expectations.

What is the likelihood of the LEOFF 1 funding ratio going under 100%?

- A. How does that likelihood change using a 7.5% earnings assumption?
- B. How does that likelihood change using different economic scenarios?

- C. How does that likelihood change if the CTF earns 5% on average for the next 10 years?
- D. How does that likelihood change if LEOFF 1 annuitants receive \$5000 each as an additional benefit?
- E. What are the greatest risks to a LEOFF Plan 1 UAAL reemerging?
- F. What are the consequences of a LEOFF Plan 1 UAAL reemerging? (State payments as a percentage of LEOFF 2 salary base? Employer payments?)

How has the “Pay-Go Risk” analyzed in the 2011 LEOFF Merger Study by OSA changed since the publication of that report? Can you provide an update of the chart from that report that overlays the future risk of going into “pay-go” status and the amount of projected cost?

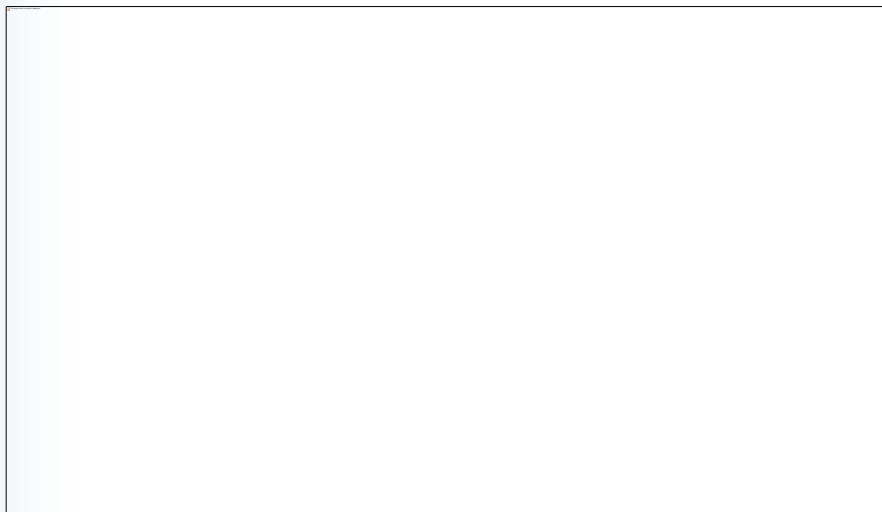
What is the current annual projected amount of LEOFF 1 benefit payments into the future? This will be helpful to demonstrate how long LEOFF Plan 1 is expected to remain open.

When OSA did the fiscal note for the proposed TRS 1/LEOFF 1 merger during the 2016 legislative session, the actuarial data was updated from the most recent actuarial valuation to the date of the fiscal note. Can OSA do a similar estimate for a LEOFF 1/LEOFF 2 merger? What information would you require?

Is there a way to estimate the monthly changes to the LEOFF 1 “surplus” using the most recent monthly fund market value from the State Investment Board and an estimate of how much LEOFF 1 liabilities have changed since the most recent valuation? For instance, can you estimate the projected change in liabilities from June, 2015 to June 2016 and use 1/12 of that number as an approximation for the monthly change?

### **How has the LEOFF Plan 1 funding ratio changed over time?**

The chart below demonstrates the reported funding ratio of LEOFF Plan 1 since the plan’s inception.



The rapid increase in the plan’s funding ratio from 1995 to 2001 is attributed primarily to extraordinarily positive investment return experience. State contributions at the time were calculated on an expected return of 7.75% per year and experience averaged over 20% per year during this period. The inflation assumption used at the time was 4.5% which also overstated the required contributions from the State. Member and employer contributions were fixed at 6% of pay per year.

## What is the proportionate share of LEOFF 1 contributions from members, employers and the State?

The total contributions paid into LEOFF Plan 1 from its inception are:

- State- \$1,801 million
- Employer- \$266 million
- Employee- \$266 million

The ratio of contributions would be 77.2% State, 11.4% employers, and 11.4% members. Applying this ratio to the projected surplus of \$1.097 billion for LEOFF Plan 1 in the most recent actuarial valuation report would result in \$847 million for the State, and \$125 million for both employers and employees. Dividing the member share by the number of plan annuitants as of the date of the last valuation would be approximately \$16,700/annuitant.

In addition to contributions, the State paid approximately \$13.3 million in benefit payments to LEOFF Plan 1 retirees immediately following the inception of the plan. “For the first two years of the system, LEOFF is funded on a pay-as-you-go basis. The State of Washington has assumed the obligation to fund the present unfunded liability (estimated to be \$400 million) over a period of not more than 40 years, and current costs which are not covered by the 12% contribution paid by employees and employer.”<sup>16</sup>

### Can “excess assets” in LEOFF 1 be used to pay for retiree health care?

Internal Revenue Code Section 420(b) allows defined benefit pension plans that would remain funded above 125% to use assets for retiree medical costs or life insurance through 2025. LEOFF Plan 1 had a funding ratio of 125.47% as of June 30, 2015 according to the most recent actuarial valuation. The excess of 0.47% when applied to the fund value would be just over \$25 million.

## SUPPORTING INFORMATION

### Merger Study Budget Proviso (2016 3<sup>rd</sup> 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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<sup>16</sup> Comparison of Public Employee Retirement Systems in the State of Washington, Institute of Governmental Research in cooperation with public pension commission, December 1970.



# **LEOFF 1/LEOFF 2 Merger Study**

COMPREHENSIVE REPORT

September 21, 2016

# **PRESENTATION GOALS**

## **► Specific Principles of Plan Mergers**

- **Applied to LEOFF 1/LEOFF 2**
  - **Background & history**
- **Frequently Asked Questions**
- **Question & answer format**
- **Conversational style**

# WHAT IS A “MERGER”

- ▶ One of two ways 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
  - “Termination” - Winding up of obligations
    - Any remaining liabilities are annuitized
    - Any remaining assets revert to the plan sponsor
    - Analogous to a “death” of a plan



# WHAT IS THE PURPOSE OF A MERGER?

## ▶ “Win-Win”

- Investment opportunities
- Risk mitigation
- Funding improvements/savings

# HOW WOULD A MERGER AFFECT THE STATE BUDGET?

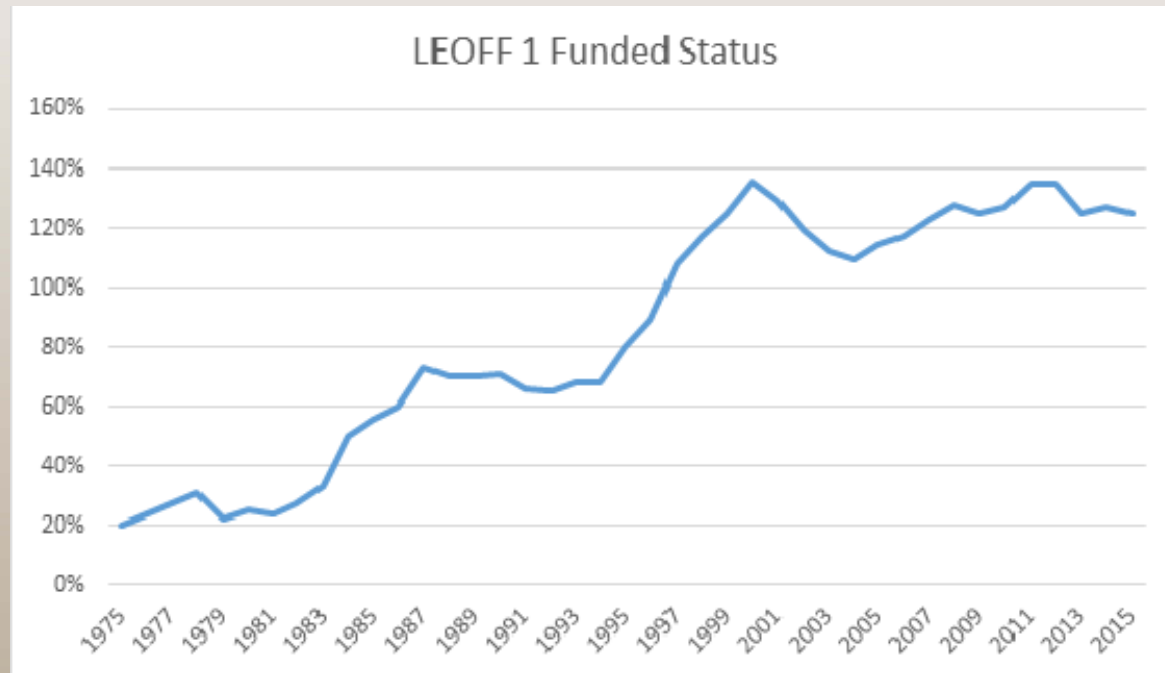
- ▶ A plan merger can reduce required State contributions to the new plan
  - Base contributions
  - Supplemental contributions to reduce a plan's unfunded liability
  - State contributions to LEOFF 2 are approximately \$130 million/biennium

# WHO OWNS THE LEOFF 1 SURPLUS?

- ▶ All assets in the LEOFF 1 fund are held in trust for the exclusive benefit of LEOFF 1 beneficiaries - “Exclusive Benefit Rule”

**This does not mean a merger is impossible**

# HOW DID THE LEOFF 1 SURPLUS HAPPEN?



**Investment returns from 1995 – 2000 far exceeded expectations**

# HOW DID THE LEOFF 1 SURPLUS HAPPEN?

- ▶ What is the proportionate share of member, employer and state contributions to LEOFF 1?
  - State 77%
  - Members 11.5%
  - Employers 11.5%

# **CAN SURPLUS ASSETS BE USED TO PAY RETIREE MEDICAL COSTS?**

## **► Yes, With Limits**

- **Only assets in excess of 125% of funding can be used**
- **Temporary federal provision expires in 2025 and has several requirements**

# HOW MUCH IS THE LEOFF 1 SURPLUS?

- ▶ The preliminary 2015 actuarial valuation report identifies the LEOFF 1 surplus at \$1.097 billion

But, 3 important variables:

- What is the current data?
- Market value or “smoothed” value?
- What assumptions are used?

# HOW DOES A MERGER AFFECT BENEFITS?

- ▶ **A plan merger does not affect benefits**
  - **New plan would have 2 tiers - LEOFF 1 and LEOFF 2 - with same benefits as now**
  - **State law prevents reduction in benefits**
  - **The merger legislation may have additional sections that affect benefits**



# IS A MERGER LEGAL?

## State Law Issues

- ▶ **Benefits are protected**
  - **Benefit reduction protections – Bakenhus**
  - **Plan funding protections – Weaver**
- ▶ **A legal merger is possible**

# IS A MERGER LEGAL?

## State Law Issues

- ▶ What types of issues may be important?
  - Funding status
  - Employer type
  - Open or closed plan/demographics
  - Liability shift
  - LEOFF 2 governance

# IS A MERGER LEGAL?

## Federal Law Issues

- ▶ Public plans must be “qualified” in order to receive favorable tax treatment
  - Qualification requires IRS review and approval
  - Qualification provides tax benefits and bankruptcy protection
  - A merger would require the new plan to seek qualification

# WHAT ARE THE ACTUARIAL RISKS FROM A LEOFF 1/LEOFF 2 MERGER?

- ▶ **Re-emergence of LEOFF 1 unfunded liability**
  - Decrease in future funding to LEOFF 2 increases risk that funding ration could dip below 100%
    - Required contributions may change
- ▶ **Risk transfer to LEOFF 2 members?**
  - Can mitigate this risk in legislation
- ▶ **OSA is currently performing actuarial risk analysis for LEOFF 2 Board**

# **DOES A LEOFF 1/LEOFF 2 MERGER AFFECT PLAN GOVERNANCE?**

- ▶ **A merger does not need to affect current pension plan governance**
  - **LEOFF 2: LEOFF 2 Board**
  - **LEOFF 1: SCPP and PFC**
  
- ▶ **LEOFF 1 disability boards are unchanged by a merger of LEOFF pension plans**

# HOW DOES A MERGER AFFECT INVESTMENT POLICY?

- ▶ **A LEOFF 1/LEOFF 2 merger would not affect investment policy**
  - **Both plans are administered by the Washington State Investment Board**
    - **Both plans are currently invested in the Commingled Trust Fund**
  - **Merger of LEOFF 1 with open plan might address some LEOFF 1 risks**

# NEXT STEPS

- ▶ **The next presentation is scheduled for November 23, 2016**
  - **Analysis from Attorney General and State Actuary will be presented**

# QUESTIONS

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**Executive Director**

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## **Agenda Items for Future Meetings**

**Date Presented:**

9/21/2016

**Presenter Name and Title:**

Steve Nelsen, Executive Director

**Summary:**

2016 calendar of agenda items

**ATTACHMENTS:**

Description	Type
▢ Agenda Items Calendar	Report

MEETING DATE	AGENDA ITEMS
<b>January 27</b>	2016 Legislative Update
<b>February 24</b>	2016 Legislative Update
<b>March 23</b>	2016 Legislative Update
<b>April 27</b>	Legislative Update 2016 Interim Planning Retiree Return to Work, Educational Briefing Quarterly Budget Update
<b>May 25</b>	Contribution Rate Adoption Process– Lisa Won, OSA Draft Merger Study Work Plan Draft Interim Work Plan Workforce Retirement Trends and Statistics, Educational Briefing Non-LEOFF Fire Fighters, Educational Briefing
<b>June 22</b>	Valuation Audit Preview – Mark Olleman & Daniel Wade, Milliman LEOFF 2 Preliminary Actuarial Valuation Results – Lisa Won, OSA Contribution Rate Preview Public Pension Administration Benchmarking Analysis – Mike Heale, CEM & Mark Feldhausen, DRS Volunteer Fire Fighters and Reserve Officers Briefing – Brigitte Smith, BVFF Plan 1/Plan 2 Merger Study – Educational Briefing Draft Merger Study Work Plan Retiree Return to Work, Initial Consideration Draft Interim Work Plan Public Testimony
<b>July 27</b>	Valuation Audit Results – Nick Collier, Milliman Contribution Rate Adoption DRS Annual Update – Marcie Frost, DRS Plan 1/Plan 2 Merger Study – Initial Consideration Public Testimony
<b>August 24</b>	<i>CANCELLED</i>
<b>September 21</b>	WSIB Annual Update – Theresa Whitmarsh, WSIB Financial Audit Results – Davis Accounting Retiree Annuity Purchase Administrative Factors – Lisa Won, OSA Presumptive Medical – Initial Consideration Individual Health Savings Account – Initial Consideration LEOFF Plan Comparison – Educational Briefing Board Member Annual Training – Tor Jernudd, AGO Standby Pay – Initial Consideration Final Month Payment – Initial Consideration Plan 1/Plan 2 Merger Study – Comprehensive Report Public Testimony
<b>October 18</b>	<i>Offsite meeting, Strategic Planning Proposed 2017 Meeting Calendar</i>
<b>November 23</b>	Plan 1/Plan 2 Merger Study – Comprehensive Report Follow-Up Retiree Annuity Purchase Administrative Factors Adoption – Lisa Won, OSA 2015 LEOFF Actuarial Valuation Report Public Testimony
<b>December 7</b>	2017 Meeting Calendar Adoption Risk Assessment Study – OSA Plan 1/Plan 2 Merger Study – Final Proposal Public Testimony