



**2011**

**LEOFF MERGER  
STUDY**



**Office of the State Actuary**

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**ABOUT THIS REPORT**





## Introduction

In the 2011 session, a bill was proposed that would have merged the Law Enforcement Officers' and Fire Fighters' (LEOFF) Plan 1 and Plan 2 into a single retirement plan.

While this bill did not pass, the 2011-13 Operating Budget<sup>1</sup> contained a study mandate requiring the Office of the State Actuary (OSA) to “study the issue of merging [LEOFF 1 and LEOFF 2] into a single retirement plan.” This report is the result of that study.

## Studying the Issue

Mergers are complex and can involve more than just a merging of assets and liabilities. At a minimum, a merger of LEOFF 1 and LEOFF 2 can include the following policy considerations:

### ❖ Governance.

- ✦ Who will oversee the plan, set contribution rates, etc.?
- ✦ Should the cultures and interests of the two groups be merged?
- ✦ Will members be equally represented?

### ❖ Funding policy.

- ✦ How are costs calculated?
- ✦ Who pays those costs?
- ✦ When do they pay?
- ✦ How much do they pay?

### ❖ Benefits.

- ✦ Will benefits change or will current provisions be preserved?

### ❖ Other practical considerations.

- ✦ Will one plan absorb the other, or will they both be moved into a new plan?

This report cannot answer those questions because the answers depend on the goals that policy makers identify for a merger.

Yet those answers are precisely what drive the impacts and results from the merger and may also determine the outcomes of any tax qualification or legal challenges.

## Actuarial Analysis

Although the study mandate does not include a defined proposal, it does require actuarial analysis. Specifically, it requires OSA to analyze the impact of a merger on contribution rates, changes to available assets under a range of possible economic and demographic scenarios, and a variety of funding policies. This type of analysis cannot be completed without a defined merger proposal.

Therefore, in order to complete the analysis, we defined a hypothetical merger. In particular, we needed to adopt a method for how the plans would be merged and select a funding policy for the merged plan.

To make sure we selected a hypothetical merger proposal that was reasonable, we solicited legal analysis from counsel at the federal and state levels. The Tax and Legal Analysis section of this report will review some of the high-level tax and legal considerations identified by counsel that we considered in defining the hypothetical merger.

Based on the chosen method and funding policy, the Actuarial Analysis section of this report uses both traditional actuarial analysis and OSA's risk model to measure plan health and certain

**Mergers are complex and can involve more than just a merging of assets and liabilities.**

<sup>1</sup>ESHB 1087, 2011 c 50. Section 105 contains the study requirement and is reproduced in Appendix 1.

financial risks before and after the hypothetical merger. For comparison, we then analyzed two variations on the assumed funding policy to see how the health and risk measures changed.

### **Stakeholder Input**

Lastly, the study mandate requires OSA to solicit input from LEOFF stakeholders, and provide representative samples of their input. The Stakeholder Input section of this report describes the process we followed to solicit input from stakeholders and summarizes the input we received. Representative samples of stakeholder input received are provided in Appendix 9.



# EXECUTIVE SUMMARY



## Defining the Hypothetical Merger

Based on the legal advice and our own professional judgment, we defined a hypothetical merger for the purpose of actuarial analysis using the following assumptions.

- ❖ The hypothetical merger includes a merging of assets and liabilities of both plans.
- ❖ Member benefits will be unchanged (unreduced) by the merger.
- ❖ Plan costs and on-going contribution rates will be calculated using the funding policies in place for most of the state's open pension plans.
- ❖ Plan costs will be shared as follows:
  - ✦ Fifty percent member.
  - ✦ Thirty percent employer.
  - ✦ Twenty percent state.
- ❖ All active members of the merged plan will contribute to the plan costs.

**Generally, mergers are not prohibited under state or federal law.**

## Results of a Hypothetical Merger

When we compared the results of the hypothetical merger to the individual plans before a merger, we found that there could be either a cost or a savings, based on the future economic outlook.

On an expected basis, LEOFF 1 will have a surplus of assets before a merger. If assumptions are correct, this surplus will be incorporated into the merged plan, which is expected to drive down future contributions and result in a

The 2011-13 Operating Budget<sup>1</sup> contained a study mandate requiring the Office of the State Actuary (OSA) to “study the issue of merging [LEOFF 1 and LEOFF 2] into a single retirement plan.” This report is the result of that study.

Mergers are complex and can involve more than just a merging of assets and liabilities. Mergers can affect governance, funding policy, and benefits. These effects can also have tax and legal implications.

It is impossible to determine the precise impacts without a defined proposal. However, the study mandate requires OSA to analyze the impact of a merger on contribution rates, changes to available assets under a range of possible economic and demographic scenarios, and a variety of funding policies. In order to provide this actuarial analysis, we had to define a hypothetical merger.

## Tax and Legal Analysis

To make sure the assumptions we chose for the hypothetical merger were reasonable, we solicited tax and legal advice. From this advice we gleaned the following high-level conclusions.

- ❖ Federal law defines a “merger” as a full merger of assets and liabilities, where assets are “usable” across the merged plan.
- ❖ Generally, mergers are not prohibited under state or federal law but certain restrictions and limitations may apply depending on the approach taken.
- ❖ Most pension benefits are protected under state law, however there is disagreement on what rights are protected and whether or not there are exceptions to that protection.

<sup>1</sup>ESHB 1087, 2011 c 50. Section 105 contains the study requirement and is reproduced in Appendix 1.

## 2011 LEOFF MERGER STUDY

savings to LEOFF 2 members, local government employers, and the state, of \$91.8 million in the 2013-15 Biennium, and \$1.85 billion over 25 years.

However, if assumptions are not correct due to unfavorable conditions, the LEOFF 1 surplus will

be smaller or may not exist at all. Under these unfavorable conditions, total contributions from members, local government employers, and the state, could increase \$1.2 billion over 25 years as a result of the merger.

Total Pension Contributions Before Merger			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	\$131.5	\$131.5	\$131.5
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$131.5</b>	<b>\$131.5</b>	<b>\$131.5</b>
Local Government	197.2	197.2	197.2
<b>Total Employer</b>	<b>\$328.7</b>	<b>\$328.7</b>	<b>\$328.7</b>
<b>Total Employee</b>	<b>\$328.7</b>	<b>\$328.7</b>	<b>\$328.7</b>
<b>2013-2038</b>			
General Fund	\$3,158.2	\$3,158.2	\$5,326.4
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$3,158.2</b>	<b>\$3,158.2</b>	<b>\$5,326.4</b>
Local Government	4,737.3	4,737.3	7,512.9
<b>Total Employer</b>	<b>\$7,895.5</b>	<b>\$7,895.5</b>	<b>\$12,839.3</b>
<b>Total Employee</b>	<b>\$7,895.5</b>	<b>\$7,895.5</b>	<b>\$12,521.3</b>

*Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.*

If all assumptions are correct, the hypothetical merger would result in a savings of \$1.85 billion over 25 years.

Under pessimistic conditions, however, the 25-year total savings would become a cost of \$1.2 billion.

Change in Total Pension Contributions* - Merged Plans			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	(\$18.6)	(\$18.6)	(\$18.6)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$18.6)</b>	<b>(\$18.6)</b>	<b>(\$18.6)</b>
Local Government	(27.3)	(27.3)	(27.3)
<b>Total Employer</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>
<b>Total Employee</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>
<b>2013-2038</b>			
General Fund	(\$369.8)	(\$369.8)	(\$8.9)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$369.8)</b>	<b>(\$369.8)</b>	<b>(\$8.9)</b>
Local Government	(556.6)	(556.6)	461.2
<b>Total Employer</b>	<b>(\$926.5)</b>	<b>(\$926.5)</b>	<b>\$452.2</b>
<b>Total Employee</b>	<b>(\$926.5)</b>	<b>(\$926.5)</b>	<b>\$770.2</b>

\* Compared to Before Merger scenario.

*Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.*

## Stakeholder Input

Before a merger, LEOFF 1 is not expected to fall out of full funding and no contributions are required. However, if LEOFF 1 does fall out of full funding, the plan risks a spike in contributions prior to the year 2024 and pay-as-you-go status (a premature depletion of trust fund assets) after 2024. LEOFF 2 does not carry these same risks due to the existence of an ongoing funding policy, assumed continuation of historical funding practices, and its current plan health.

We found that merging the plans under this set of hypothetical assumptions results in relatively stable contribution rates and virtually no pay-go risk for the combined plan. However, a merger is not the only way to manage these risks, and other changes in funding policy may yield similar results without a merger.

### How the Results Change When We Vary the Funding Policy

First, we changed the funding policy for the hypothetical merger to include a 0 percent contribution rate for LEOFF 1 members. We found there was no material change to the fiscal impact of the merger, due to the relatively small number of remaining LEOFF 1 active members.

Then, we changed the funding policy to include a maximum contribution rate for LEOFF 2 members. Again we saw no material change to the fiscal impact of the merger, because under most outlooks contribution rates do not hit the assumed maximum.

The study mandate requires OSA to solicit input from LEOFF stakeholders and provide representative samples of their input. In brief, stakeholders raised concerns about how a merger may affect plan governance, member benefits, and the funding policy and fiscal health of the merged plan. In addition, stakeholders have raised concerns about potential tax and legal challenges to a merger.

Representative samples are included in Appendix 9.

Please see the main body of the report for additional details and information.

**In brief, stakeholders raised concerns about how a merger may affect plan governance, member benefits, and the funding policy and fiscal health of the merged plan.**







**TAX AND LEGAL ANALYSIS**



In the absence of a completely defined merger proposal, OSA cannot obtain definite legal opinions or findings. Additionally, OSA is not qualified to offer legal opinions or findings. However, in order to complete the actuarial analysis required by the study mandate, OSA defined a hypothetical merger and selected a funding policy for the merged plan.

In order to make sure that the methods and policies we selected were reasonable, it was important to review the tax and legal ground rules for public pension plan mergers. OSA contracted with Ice Miller, special counsel to the Attorney General's Office (AGO), for analysis of federal tax and legal issues. Additionally, the AGO provided OSA an analysis of state legal issues. This tax and legal analysis is reprinted, in full, in Appendix 4.

**In the absence of a completely defined merger proposal, OSA cannot obtain definite legal opinions or findings.**

## Tax Qualification

In order to continue receiving favorable tax treatment of contributions, benefits, and investment returns, a plan must be “qualified,” meaning it meets certain criteria defined in Internal Revenue Code (Tax Code). This issue is very important because a loss of preferential tax status would not only be costly, but it may also defeat the purpose of having a pension plan.

Three high-level conclusions about tax qualification were instructive for the purposes of our actuarial analysis.

First, under federal law, a “merger” means a full merger of assets and liabilities, where assets are “usable” across the merged plan. For our actuarial analysis of a hypothetical merger, we have assumed a merger of LEOFF 1 and LEOFF 2 under this federal definition.

Second, mergers are not forbidden under federal Tax Code. There are no set regulations for merging public plans, and the merger rules for private sector plans do not expressly apply. However, elements of those private sector rules provide a good road map to follow and can help the drafter identify areas of caution.

Third, a defined proposal is needed to fully analyze the tax qualification issues, and outside counsel may be effective in reviewing such a proposal.

## Legal

As with tax qualification, any potential legal issues will depend on how the proposal is structured. Depending on the structure, a plan merger could trigger one of several benefit protections in federal and state law.

Three high-level conclusions about benefit protections were instructive for the purposes of our actuarial analysis.

First, retirement plan mergers have occurred in Washington before. In fact, LEOFF 1 is the product of a merger of local government retirement plans. For more information on the history of LEOFF, please see Appendix 3.

Second, under the federal Tax Code, a plan merger could result in one or both plans being terminated. Plan terminations are complex and may have unintended consequences. For example, one potential result of a plan termination is the accrued benefits of all members become vested (to the extent the benefits are funded). This is likely not an issue for LEOFF 1, since all members have already met vesting requirements. However, for LEOFF 2, this means more members would be vested than are currently vested resulting in increased costs

for the plan.

It cannot be determined ahead of time if a plan termination would result from a merger because the IRS considers all facts and circumstances when determining if a plan termination has occurred. Thus, a merging of one plan with a similar plan may or may not trigger a plan termination.

Third, under state law, plan members have a contractual right (commonly called “Bakenhus rights” or the “vested rights doctrine”) to certain benefits. While it is generally agreed that these benefits must be protected, it is unclear which benefits receive that protection, what constitutes a benefit under Bakenhus, and under what circumstances does Bakenhus not apply to an otherwise covered benefit.

Two questions below were raised while selecting our assumptions for actuarial pricing. We cannot fully resolve these questions without a defined merger proposal. However, we can highlight the importance of some of these issues in setting assumptions for our actuarial analysis of a hypothetical merger.

### **1. Do current members have a contractual right to the existing funding policy?**

Funding policy is an important assumption in actuarial analysis because it determines who will pay, when they pay, and how much they pay. For example, can the state legally charge a contribution rate for LEOFF 1 members to pay for LEOFF 2 benefits and vice versa?

While we cannot provide an answer to this question, our actuarial analysis does show the actuarial impacts of attempting to mitigate these issues in the hypothetical merger through the use of varying funding policies.

### **2. Which member benefits (if any) can be changed?**

Understanding how benefits may or may not change is an important assumption for actuarial

pricing because it affects the liabilities of the merged plan.

The Bakenhus case contains a clause stating that “pension rights can be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity.” (See Crews Letter, Appendix 4.) However, to illustrate the complexity of interpretation and application, there has been over 50 years of litigation on this issue, including litigation pending as of this writing.

Again, we cannot provide an answer to the question, but for our actuarial analysis we have assumed that all benefits for LEOFF 1 and LEOFF 2 will be unchanged (not reduced) by the merger and maintained in separate tiers within the merged plan.

**There has been over 50 years of litigation on pension contract rights, including litigation pending as of this writing.**



# ACTUARIAL ANALYSIS



The study mandate requires actuarial analysis of the impact on contribution rates, and the impact on available assets under a range of possible economic and demographic experience and a variety of funding policies.

Actuarial analysis depends on assumptions and methods, and changing any one assumption or method can lead to materially different results. In order to provide the actuarial analysis required in the study mandate, we must make several assumptions and apply those assumptions through certain methods, in essence defining what a hypothetical merger could look like.

We defined a hypothetical merger because the analysis required by the study mandate is impossible to complete without a defined proposal. However, the hypothetical merger we used in our analysis is neither a recommendation nor a prediction of how a merger could be accomplished.

We will begin by analyzing current health and risks for LEOFF 1 and LEOFF 2 before a merger. We will then use the results of these measures as a baseline for comparison. We will use traditional actuarial analysis, as well as measures from OSA's risk assessment model, to develop these estimates.

Then, we will define the assumptions for the hypothetical merger and measure the resulting changes. For comparison, we will look at the impacts of the Hypothetical Merger under different funding policies. To do that, we will change the funding policy one piece at a time; each time analyzing the results using the same measures.

For each scenario, we have measured the following.

- ❖ Current and projected funded status.
- ❖ Projected contribution rates.
- ❖ Risk of pay-as-you-go, or "pay-go."
  - ✦ Pay-go occurs when the assets of the plan trust fund are

**The hypothetical merger used in our analysis is neither a recommendation nor a prediction of how a merger could be accomplished.**

prematurely depleted. We have defined pay-go as the chance a plan will exhaust its trust fund with at least \$25 million in annual benefit payments remaining.

- ❖ Contribution rates for the 2013-15 Biennium.
- ❖ Total pension contributions for the 2013-15 Biennium and over 25 years.

While we used the same measures for each of the scenarios, the display of the full complement of measures will only be included in this analysis section where appropriate. For the sake of completeness, where we have not displayed the full complement of measures in this section, the remaining measures are provided in Appendix 5.

For the projected measures, we consider all outcomes from our risk model including very unlikely, but probable events. However, in order to provide a manageable set of measures we will summarize the outcomes using the following five benchmarks. (The descriptions below apply to contribution rate measures.)

- ❖ **Very optimistic.**
  - ✦ Fifth percentile, meaning 95 percent of outcomes simulated from our model were worse than this.
- ❖ **Optimistic.**
  - ✦ Twenty-fifth percentile, meaning 75 percent of simulated outcomes were worse than this.

❖ **Expected.**

- ✦ Fiftieth percentile, meaning 50 percent of simulated outcomes results were better, and 50 percent were worse than this.

❖ **Pessimistic.**

- ✦ Seventy-fifth percentile, meaning 25 percent of simulated outcomes were worse than this.

❖ **Very pessimistic.**

- ✦ Ninety-fifth percentile, meaning 5 percent of simulated outcomes were worse than this.

Additionally, unless noted otherwise, the measures from our risk model assume the continuation of past practices in the areas of funding and benefit improvements. For example, we assume the merged plan will receive, on average, 98 percent of actuarially required contributions and the liability of the merged plan, on average, will increase by 1.09 percent each year in the future due to assumed benefit improvements in the combined plan. In the calculation of fiscal impacts, however, we assume full funding and no future benefit improvements through our 50-year projection.

For more information on the measures and the design of OSA’s risk model, please see Appendix 5.

## Before a Merger

### Current Funding Policy for LEOFF 1

There are currently no contributions being collected for LEOFF 1, because the Plan 1 funding policy does not require contributions when the plan is fully funded (RCW 41.26.080).

### LEOFF 1 Funded Status

Funded Status on an Actuarial Value Basis*	
(Dollars in Millions)	LEOFF 1
Accrued Liability	\$4,381
Valuation Assets	\$5,561
Unfunded Liability	(\$1,180)
Funded Ratio	
	2010
	127%

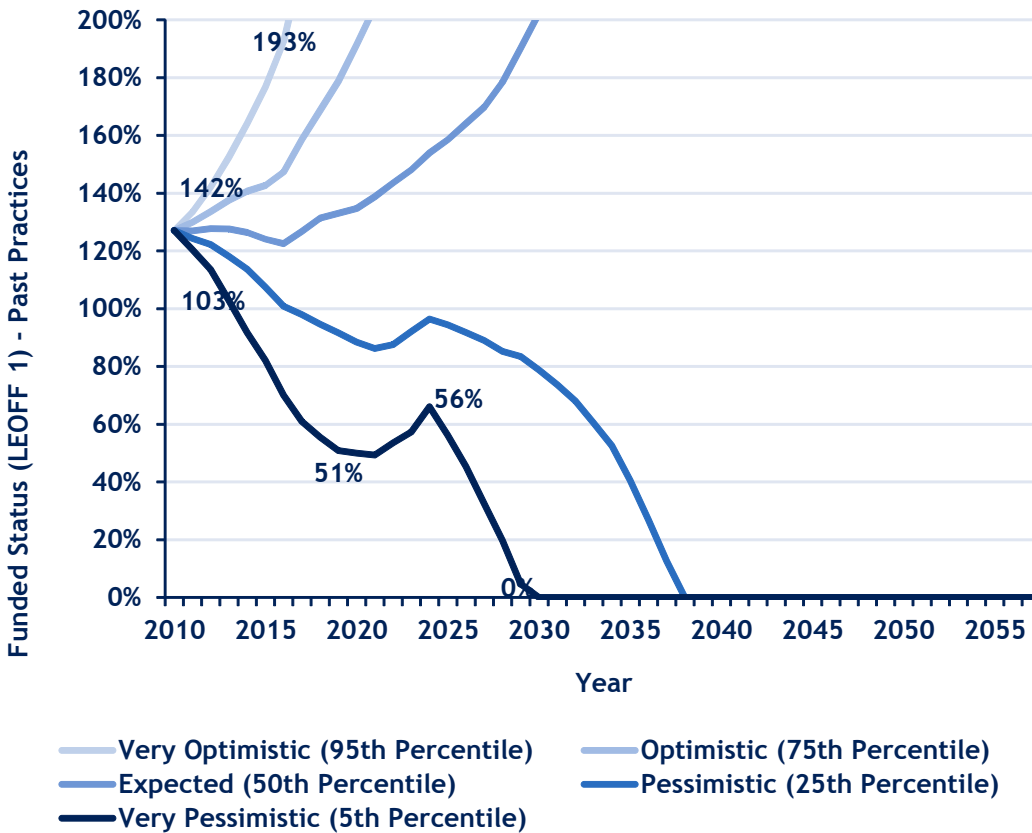
*\*Liabilities valued using the PUC cost method at an interest rate of 8%. All assets have been valued under the actuarial asset method.*

As of June 30, 2010, the funded status of LEOFF 1 was 127 percent, meaning the plan is generally healthy and has \$1.27 in actuarial assets for every present dollar of earned pension liability.

As of June 30, 2010, LEOFF 1 has a surplus of \$1.2 billion. In other words, if all assumptions are realized in the future, the plan, in today’s dollars, has \$1.2 billion more in assets than we expect it will need to cover all earned pension benefits. However, future outcomes may differ from our assumptions, and the current LEOFF 1 surplus could increase, decrease, or become an unfunded liability.



**Figure 1a - Funded Status, LEOFF 1 Before Merger**



Moving beyond June 30, 2010, Figure 1a shows the long-term projected funded status for LEOFF 1. LEOFF 1 is expected to remain fully funded (i.e. have a funded status of 100 percent or more). However, Figure 1a also shows that under pessimistic and very pessimistic scenarios, the plan falls out of full funding, and there may be no surplus.

If LEOFF 1 falls out of full funding in the future, current statute calls for two things.

**1. Reinstated contributions.**

If LEOFF 1 is not fully funded, contribution rates from Plan 1 members and their employers must be reinstated (RCW 41.26.080). As currently designed, this will have little practical effect on any unfunded plan costs.

The rates called for are 6 percent member and 6 percent employer, as calculated and collected over active Plan 1 salaries (RCW 41.26.080). There are few active members left, and all are eligible to retire. Thus, contributions would be

collected over a very small and rapidly shrinking salary base. Any contributions received by reinstating these rates would very likely be insufficient to cover unfunded plan costs.

Current law is silent on how the costs not covered by the reinstated rates should be apportioned among the member, employer, and state. For purposes of this analysis, we have assumed that the state would pay these costs as a percentage of all LEOFF salaries. This assumption is consistent with how unfunded liability was previously handled when it existed in LEOFF 1 (see Appendix 3). However, the Legislature could choose another funding policy, and doing so could produce materially different results.

**2. Amortization of unfunded costs by June 30, 2024.**

Current law states that the intent of the Legislature is to amortize all LEOFF 1 costs by June 30, 2024 (RCW 41.45.010). This is also consistent with recent past practice of

## 2011 LEOFF MERGER STUDY

the Legislature. The PFC is directed to set contribution rates accordingly (RCW 41.45.010). The closer we are to 2024, the faster the costs would need to be amortized, and the higher the contribution rates would have to rise to meet this requirement.

**Figure 1b - Contribution Rates, LEOFF 1 Before Merger**

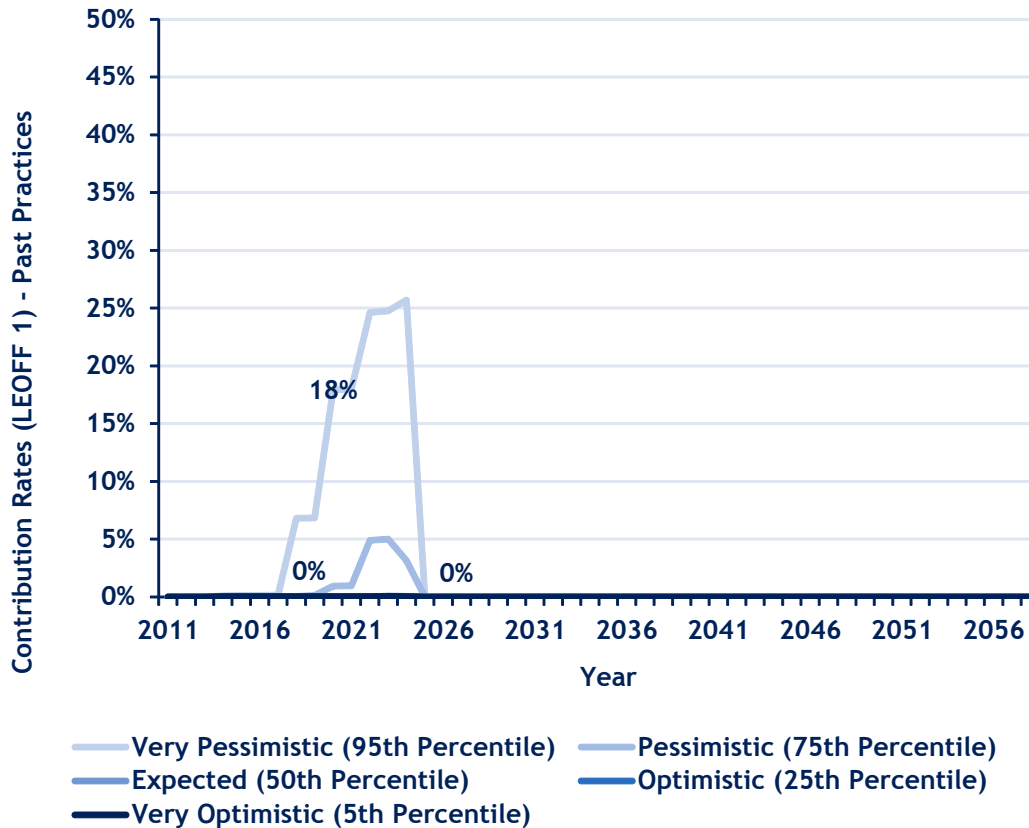


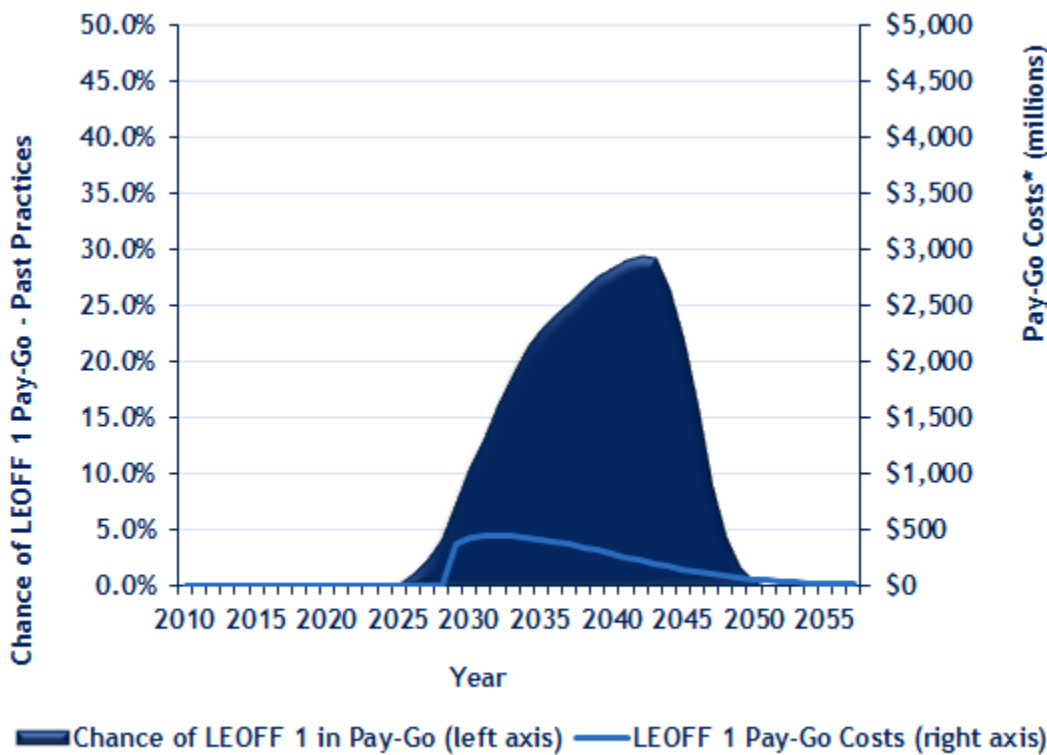
Figure 1b shows the projected Unfunded Actuarial Accrued Liability (UAAL) rates for LEOFF 1. Under most outcomes, no UAAL rates are required. However, under the pessimistic and very pessimistic scenarios, we see a spike in rates due to the re-emergence of LEOFF 1 UAAL prior to 2024. In other words, in the very pessimistic scenario LEOFF 1 UAAL rates go from zero to over 25 percent in just over a decade prior to 2024.

Following this spike is an immediate drop due to the end of assumed contributions under the funding policy. With no ongoing funding policy, no contributions are collected after 2024 under any future outlook.

The closer we are to 2024, the faster the unfunded LEOFF 1 costs would need to be amortized, and the higher the contribution rates would have to rise to meet this requirement.

LEOFF 1 Pay-Go Risk

**Figure 1c - Pay-Go, LEOFF 1 Before Merger**



\*Pay-Go costs on top of normal pension costs.

**Figure 1d**

LEOFF 1 Chance/Amount of Pay-Go - Select Years - Past Practices Before Merger		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.1%	\$0
2017	0.0%	\$0
2020	0.2%	\$0
2023	0.1%	\$0
2026	0.4%	\$0
2029	4.3%	\$0
2032	13.1%	\$442
2035	21.3%	\$430
2038	25.3%	\$368
2041	28.3%	\$288
2044	29.2%	\$202
2047	15.9%	\$127
2050	1.7%	\$73
2053	0.1%	\$38
2056	0.0%	\$18

\*Millions.

Figure 1c shows both the likelihood of LEOFF 1 entering pay-go status (left axis) and the corresponding cost should it occur (right axis). Figure 1d shows the same information in a different form. The cost, if it occurs, represents the total amount that would be owed on a pay-go basis.

Although existing unfunded costs would be amortized by 2024, unfunded plan costs could rise again after that date. Since no contributions are required after 2024 under the current funding policy, any new unfunded costs of the plan would be paid on a pay-as-you-go, or “pay-go” basis. Current law is silent on cost sharing for these new contributions, so for the purposes of our analysis we have assumed that the state would pay 100 percent of required pay-go payments.

The likelihood of Plan 1 entering pay-go peaks at over 29 percent around 2044. This means LEOFF 1 has nearly a one in three chance of

going into pay-go status at some point in the plan's life cycle.

If LEOFF 1 does enter pay-go status, the corresponding amounts are due immediately and must be paid through some combination of state and employer funds. Under unfavorable conditions, this could mean a combined state/ employer contribution of over \$440 million in one year.

After 2050, the chance and cost of pay-go both drop, due to the maturity of the plan and the decreasing number of annuitants receiving benefits.

### LEOFF 1 Summary - Before Merger

LEOFF 1 is generally healthy and on an expected basis has a surplus at June 30, 2010, of \$1.2 billion. The surplus could increase, decrease, or become an unfunded liability if future outcomes vary from our expectations.

If unfunded costs arise, current funding policy could result in a spike in contribution rates prior to the assumed 2024 amortization date. There is no funding policy after 2024, but unfunded costs could arise after 2024. If this happens, those unfunded costs would be paid on a "pay-go" basis and the immediate costs could be over \$440 million in one year.

## LEOFF 2

### Current Funding Policy for LEOFF 2

LEOFF 2 has an ongoing funding policy consisting of three elements.

1. **Statutory cost sharing policy.**
2. **Long-term rate policy.**
3. **Short-term rate stabilization (2009-17).**

### *Cost Sharing*

Under current law, plan costs for LEOFF 2 are apportioned as follows (RCW 41.26.725):

- ❖ Fifty percent member.
- ❖ Thirty percent employer.
- ❖ Twenty percent state.

### *Long Term Rate Policy*

The LEOFF Plan 2 Retirement Board (the Board) selected the Aggregate actuarial cost method to determine the actuarially required contributions for LEOFF Plan 2. This method prevents the accumulation of an unfunded actuarial accrued liability. However, a side-effect of this method is it can produce decreasing contribution rates during extended periods of above-expected investment returns followed by increasing rates during subsequent periods of below-expected returns. To prevent the adoption of temporary and short-term contribution decreases, the Board adopted minimum contribution rates. These minimum rates, or rate floors, are equal to 90 percent of the normal cost rate calculated under the Entry Age Normal (EAN) method. The normal cost under the EAN method represents the expected long-term cost of the plan, from a member's age at plan entry to their assumed retirement, if all assumptions are realized in the future and plan benefits do not change.

The Aggregate and EAN are standard actuarial cost methods. For more information, please see the glossary in Appendix 10.

### *Short-Term Rate Stabilization (2009-17)*

In the 2008 Interim, the Board adopted contribution rates equal to 100 percent of the normal cost under EAN for the period 2009-13. During the 2010 Interim, the Board voted to retain the rates adopted in 2008 for 2011-2017<sup>1</sup> to prevent the recognition of a short-term

<sup>1</sup>The adopted rates for 2011-17 also included an additional 0.01 percent member and employer rate to cover the cost of 2009 legislation.

decrease in contribution rates and to manage the risk of increasing contribution rates in the future. In other words, rates for LEOFF 2 were projected to drop briefly before rising again. By retaining the higher rates through the short drop, the rates remain stable and decrease the chance and amount of increasing future contribution requirements under pessimistic outcomes.

The current rates adopted by the LEOFF 2 Board are as follows.

- ♣ 8.46 percent member.
- ♣ 5.08 percent employer (excludes additional rate of 0.16 percent charged by DRS for plan administration).
- ♣ 3.38 percent state.

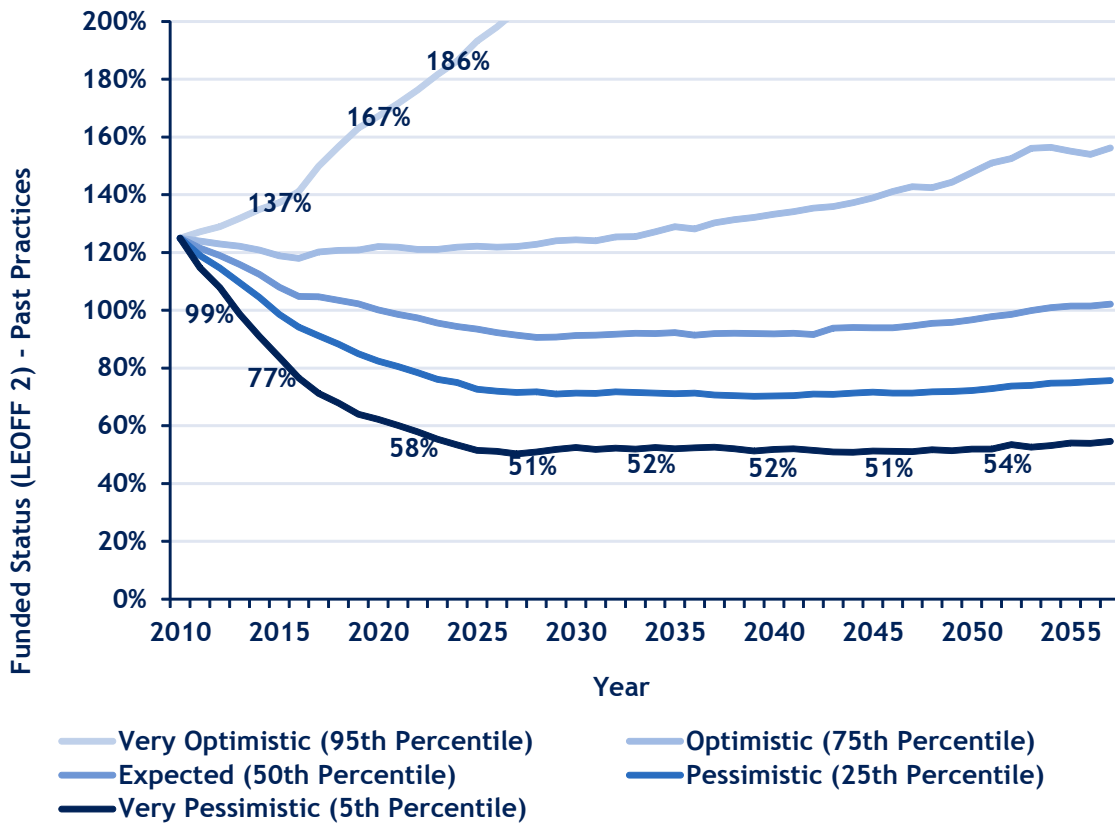
#### LEOFF 2 Funded Status

Funded Status on an Actuarial Value Basis*	
(Dollars in Millions)	LEOFF 2
Accrued Liability	\$4,863
Valuation Assets	\$6,043
Unfunded Liability	(\$1,179)
<b>Funded Ratio</b>	
<b>2010</b>	<b>124%</b>

\*Liabilities valued using the PUC cost method at an interest rate of 8%. All assets have been valued under the actuarial asset method.

As of June 30, 2010, the funded status for LEOFF 2 was 124 percent, meaning the plan is generally healthy and has \$1.24 in actuarial assets for every present dollar of earned pension liability. The 124 percent funded status indicates that LEOFF 2 is on track to systemically pre-fund all future benefits for current members including benefits based on future service credit members have yet to provide. In contrast to LEOFF 1, members of LEOFF 2, on average, have significant future service credit and expected future benefits that exceed the benefits accrued (or earned) to date. Therefore, the 124 percent funded status in LEOFF 2 does not represent a surplus like the expected surplus in LEOFF 1.

Figure 1e - Funded Status, LEOFF 2 Before Merger



Moving beyond June 30, 2010, Figure 1e shows the long-term projected funded status of LEOFF 2. On an expected basis, the funded status drops below 100 percent, but remains above 90 percent. On an optimistic and very optimistic basis, the funded status declines to a minimum of 120 percent and improves to a minimum 125 percent, respectively. Conversely, the funded status could drop to around 50 percent under the very pessimistic scenario.

However, under all outlooks the presence of an ongoing funding policy provides relative stability (meaning minimal volatility from year to year).

LEOFF 2 Projected Rates

**Figure 1f - Contribution Rates, LEOFF 2 Before Merger**

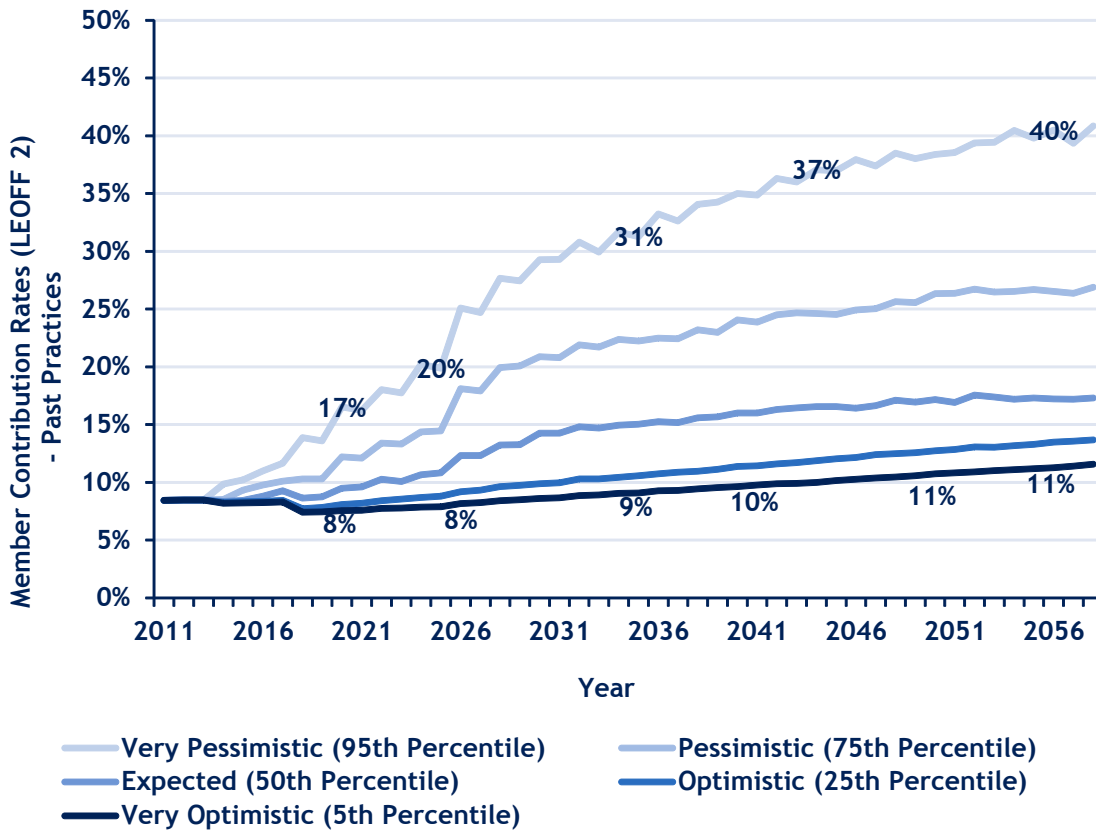
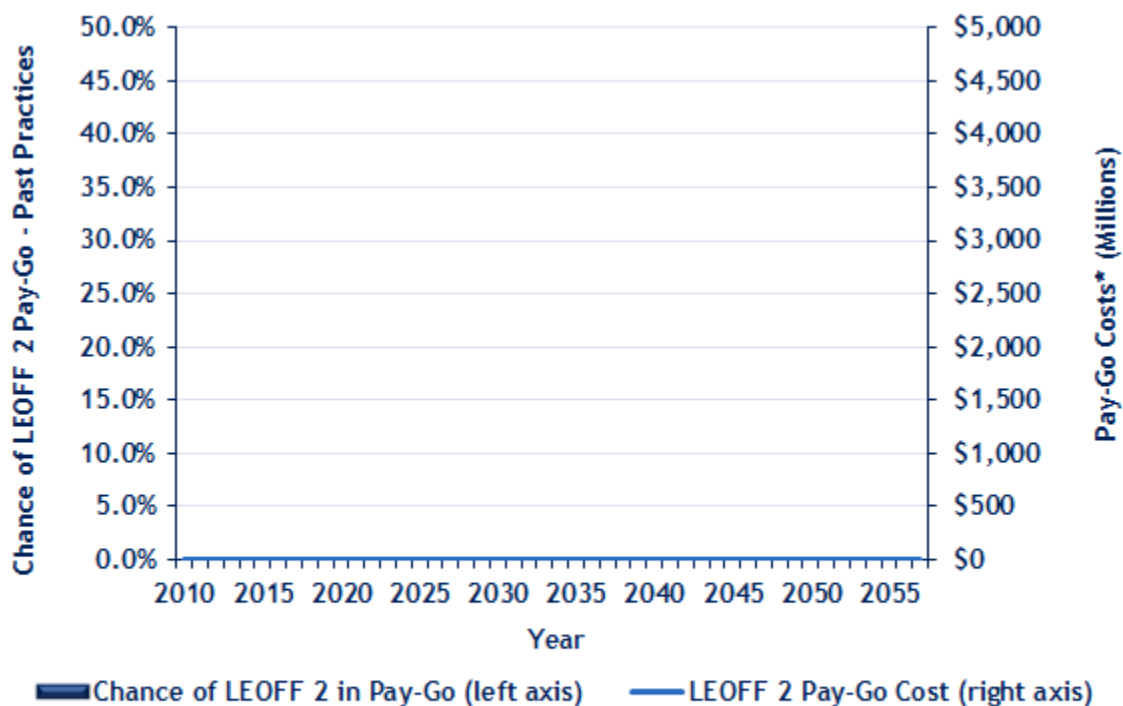


Figure 1f shows the projected member contribution rates for LEOFF 2. On an expected basis, member rates for LEOFF 2 rise to around 17 percent. On a very optimistic basis, the member rates drop to the rate floors, while on a very pessimistic basis the member rates rise up above 40 percent.

As with the projected funded status, there is minimal volatility from year to year in all outlooks due to a combination of the ongoing funding policy and rate floors.

It should also be noted that the Board can adjust rates and rate policies as necessary in real time. This ability is not contemplated by OSA’s Risk Model. The model anticipates rate increases for assumed future benefit improvements based on past practices, but assumes other funding policies remain fixed.

**Figure 1g - Pay-Go, LEOFF 2 Before Merger**



*\*Pay-Go costs on top of normal pension costs. LEOFF 2 is not expected to enter a pay-go status.*

**Figure 1h**

LEOFF 2 Chance/Amount of Pay-Go - Select Years - Past Practices Before Merger		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.0%	\$0
2017	0.0%	\$0
2020	0.0%	\$0
2023	0.0%	\$0
2026	0.0%	\$0
2029	0.0%	\$0
2032	0.0%	\$0
2035	0.0%	\$0
2038	0.0%	\$0
2041	0.0%	\$0
2044	0.0%	\$0
2047	0.0%	\$0
2050	0.0%	\$0
2053	0.0%	\$0
2056	0.0%	\$0

Figure 1g shows both the likelihood of LEOFF 2 entering pay-go status (left axis) and the cost to the state/local government if this occurs (right axis). Figure 1h shows the same information in a different form.

None of the simulations in our model produced pay-go risk for LEOFF 2 in the 50-year projection period due to the plan’s current healthy funded status and the presence of an ongoing funding policy. Of course, just because our model did not produce that result doesn’t mean it can’t happen. Thus, we cannot say there is zero chance of LEOFF 2 entering pay-go status in the next 50 years, but we can say there is virtually zero chance of this occurring.

\*Millions.



## LEOFF 2 Summary - Before Merger

LEOFF 2 is generally healthy, and the presence of an ongoing funding policy provides relative funding and rate stability under even the most pessimistic scenarios.

On an expected basis, LEOFF 2 falls out of full funding, but does not drop below 90 percent funded status. Rates could increase by more than double the current rates (to around 17 percent) on an expected basis and could rise above 40 percent on a very pessimistic basis. However, on a very optimistic basis, they could drop to the minimum rate floors.

The plan's current healthy funded status and ongoing funding policy ensure that there is virtually zero chance of LEOFF 2 entering pay-go status in the next 50 years.

## LEOFF 1 and LEOFF 2 Rates and Total Contributions

Unlike the previous measures, the following two tables are presented on a current law basis, meaning we assume full funding and no future benefit improvements through our 50-year projection.

**Figure 1i**

Contribution Rates Before Merger			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
<b>Employee (Plan 2)</b>	8.46%	8.46%	8.46%
<b>Employer</b>			
Current Annual Cost	5.08%	5.08%	5.08%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>5.08%</b>	<b>5.08%</b>	<b>5.08%</b>
<b>State</b>			
Current Annual Cost	3.38%	3.38%	3.38%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>3.38%</b>	<b>3.38%</b>	<b>3.38%</b>

Figure 1i shows the rates for LEOFF 1 and LEOFF 2 for the 2013-15 Biennium, before a merger. This table reflects two things. First, it reflects the rates adopted by the LEOFF 2 Board for 2011-17. Second, even under the pessimistic outlook, we expect no contribution rates will emerge for LEOFF 1 until after the 2013-15 Biennium.

Figure 1j

Total Pension Contributions Before Merger			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	\$131.5	\$131.5	\$131.5
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$131.5</b>	<b>\$131.5</b>	<b>\$131.5</b>
Local Government	197.2	197.2	197.2
<b>Total Employer</b>	<b>\$328.7</b>	<b>\$328.7</b>	<b>\$328.7</b>
<b>Total Employee</b>	<b>\$328.7</b>	<b>\$328.7</b>	<b>\$328.7</b>
<b>2013-2038</b>			
General Fund	\$3,158.2	\$3,158.2	\$5,326.4
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$3,158.2</b>	<b>\$3,158.2</b>	<b>\$5,326.4</b>
Local Government	4,737.3	4,737.3	7,512.9
<b>Total Employer</b>	<b>\$7,895.5</b>	<b>\$7,895.5</b>	<b>\$12,839.3</b>
<b>Total Employee</b>	<b>\$7,895.5</b>	<b>\$7,895.5</b>	<b>\$12,521.3</b>

*Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.*

Figure 1j shows how contribution rates translate into pension contributions for both systems before a merger. This table shows the contributions in the next biennium (2013-2015), as well as over 25 years.

For 2013-15, the total employer (state plus local employer) cost is about \$329 million under any outlook, with an equal total cost to LEOFF 2 members. As noted above, no LEOFF 1 contributions are made under current law when LEOFF 1 is fully funded.

Over 25 years, the expected total employer cost is just under \$7.9 billion, with an equal cost for LEOFF 2 members. There is no difference in costs between the expected and optimistic outlooks due to the presence of minimum contribution rates mentioned in the prior section.

However, under a pessimistic scenario, two things happen. First, both the total employer and member costs grow by over 50 percent. Second, the total employer and employee costs are no longer identical. As noted above, under a pessimistic scenario LEOFF 1 falls out of full funding. This increases the cost to the state, resulting in a total employer cost around \$300 million higher than the total employee cost under this outcome. (This also causes a reinstatement of contributions for LEOFF 1; 6 percent active member and 6 percent employer. However, as noted above, this has little practical effect due to the small number of LEOFF 1 active members.)

## Hypothetical Merger

For this analysis, we begin with the assumption that a merger means a merging of the assets and liabilities of both plans effective July 1, 2012.<sup>1</sup> This means the individual assets and individual liabilities of each plan become indistinguishable from one another and would be usable across the combined plan. In a sense, this is akin to individuals pooling their funds in a joint bank account, where all assets and obligations of the account belong equally to all account holders.

We have further assumed that benefits will be kept in separate tiers and will not be affected (or reduced) by the merger.

We must make additional assumptions about funding policy. Specifically, who will pay the costs of the combined plan? What share will they pay? How will the costs be calculated?

For the Hypothetical Merger, we assume that the unfunded costs of the plan will be shared following the current structure in place for LEOFF 2, which is as follows.

- ♣ Fifty percent member.
- ♣ Thirty percent employer.
- ♣ Twenty percent state.

We assume that all plan costs, as well as the resulting rates, will be calculated using the Aggregate actuarial cost method with minimum rates equal to 80 percent of the normal cost under the EAN method beginning in the 2013-15 Biennium.

### Why Did We Choose These Assumptions?

We chose to define a merger as a merging of assets and liabilities for two reasons. First, it is consistent with the definition of “merger” in federal Tax Code. Second, it is the change most likely to affect the plans on an actuarial basis.

<sup>1</sup>The assumed effective date was selected for actuarial pricing purposes only. A later effective date may be required for administrative purposes.

We chose to keep benefit provisions unaffected (unreduced) by the merger because a change in benefits is not required in a merger, and would have required us to speculate about the resulting benefit structure.

As noted above, the Aggregate and EAN are standard actuarial cost methods. We chose to use this combination of assumptions for the Hypothetical Merger because it is generally consistent with the funding policies for Washington’s open and ongoing retirement plans (with the exception of the minimum rates in LEOFF 2 and WSPRS).

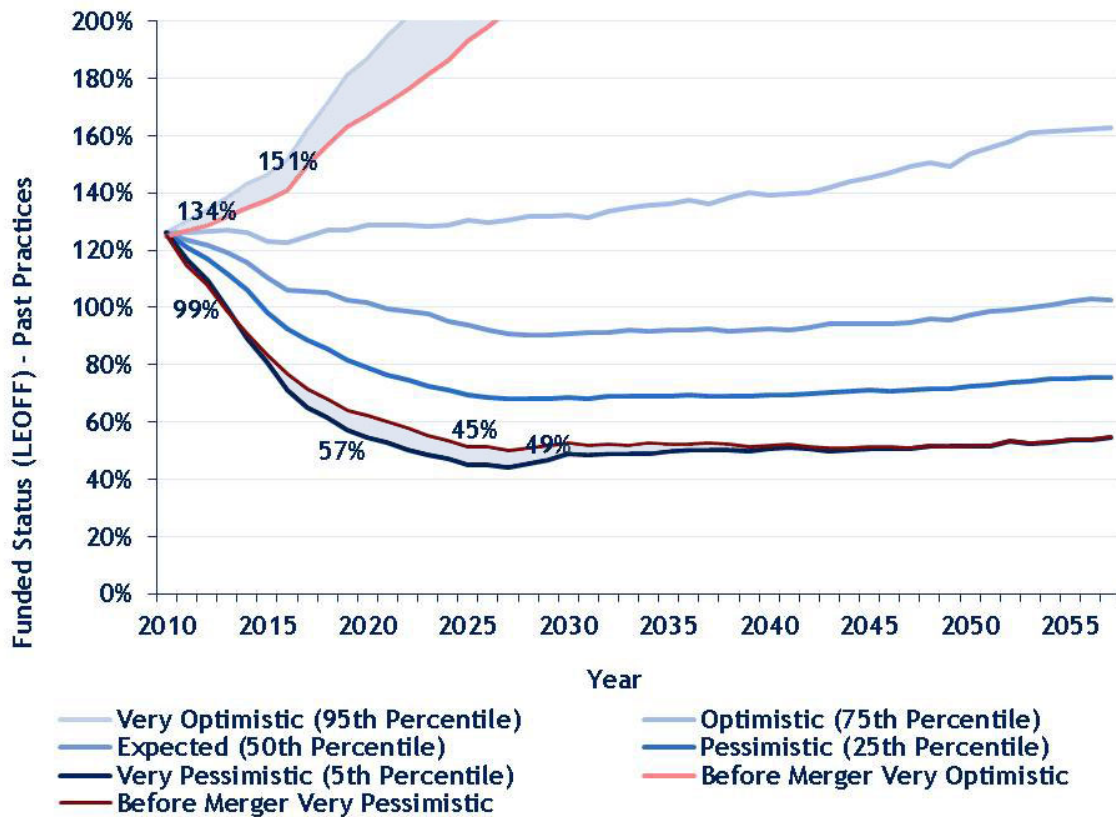
We chose the 50/30/20 cost sharing model because it is unique to LEOFF 2, and it is reasonable to think policy makers may consider using this model for any merged LEOFF plan. It was also one of the funding policies required under the study mandate.

We chose to define a merger as a merging of assets and liabilities for two reasons. First, it is consistent with the definition of “merger” in federal Tax Code. Second, it is the change most likely to affect the plans on an actuarial basis.

Funded Status

As of June 30, 2010, the expected funded status of the hypothetical merged plan would be 126 percent.

Figure 2a - Funded Status, LEOFF Merged Plans



While not identical, the projected funded status of a merged plan under these assumptions looks largely similar to the funded status for LEOFF 2 on its own before a merger.

Figure 2a compares highlighted sections of the projected funded status of LEOFF 2 before a merger (red lines) with the combined plan after the Hypothetical Merger (blue lines). Specifically, Figure 2a shows the differences in the less likely outcomes; the very optimistic and the very pessimistic. We chose to highlight these sections because this is where we saw the most difference between the before and after scenarios.

by an average of 5 percent under the very pessimistic outlook.

The reason for this change in the very pessimistic/optimistic results is that the combined plan has higher assets and liabilities than those of LEOFF 2. In very general terms, the merged plan has a larger stake in the game than LEOFF 2. In favorable times, a larger asset base stands to make greater returns. Conversely, in unfavorable times, asset losses would be relatively greater.

After the Hypothetical Merger the funded status under the very optimistic outlook increased by an average of 16 percent, while it decreased

Projected Rates

As we just saw with the projected funded status, the projected member contribution rates for the merged plan look similar to LEOFF 2 member

rates before a merger. For comparison, we will again look at highlighted sections of the before and after graphs.

**Figure 2b - Member Contribution Rates, LEOFF Merged Plans**

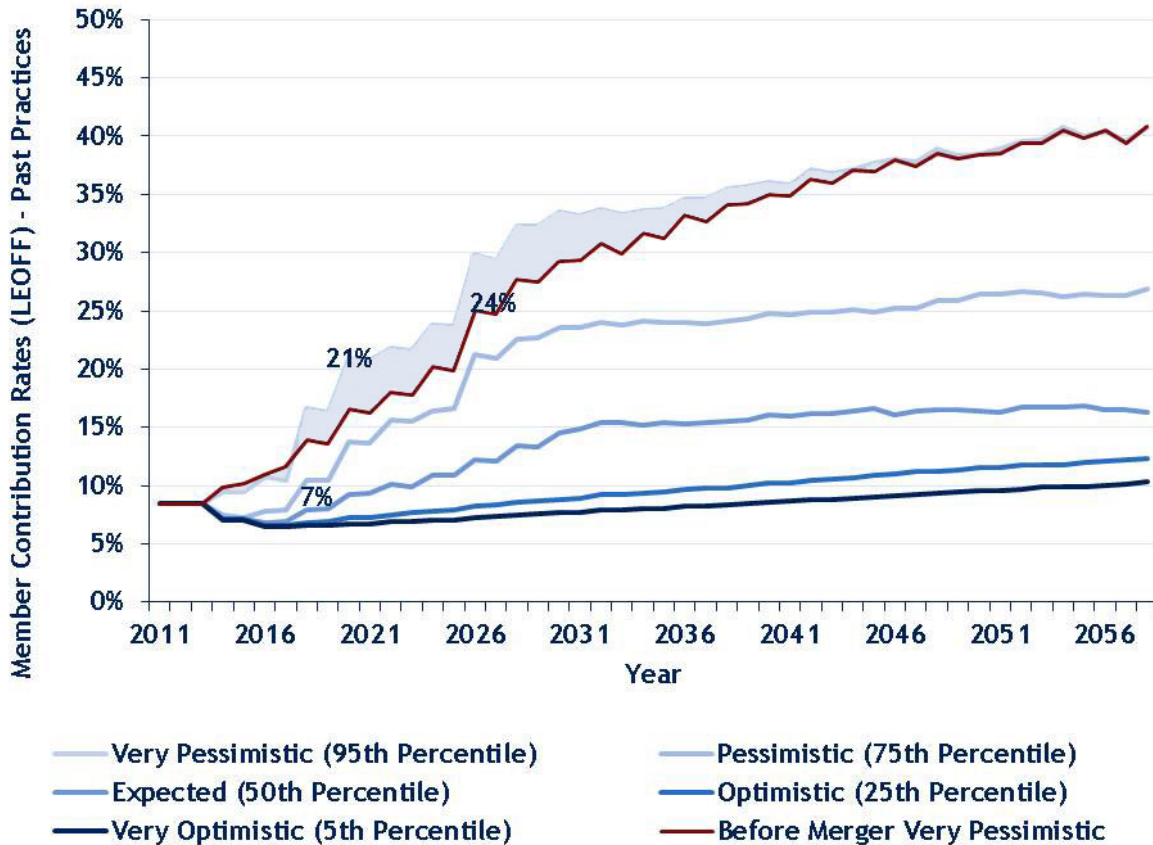


Figure 2b compares highlighted sections of the projected member contribution rates for LEOFF 2 before a merger (red line) with the combined plan member rates after the Hypothetical Merger (blue lines). With the projected funded status comparison, we saw changes in both the very pessimistic/optimistic outlooks. However, with the projected member rate comparison, we only see changes on the very pessimistic side.

The reason for the change to the very pessimistic side is consistent with the last graph, higher assets and liabilities in the merged plan than LEOFF 2. The rates in the very pessimistic outcome end up in the same place, approximately 40 percent. However, the increase builds more rapidly and occurs over a shorter period of time.

We don't see an accompanying change on the very optimistic side because of the minimum rate floors. Both before and after the merger, the very optimistic outcome shows rates hitting the minimum rate floor. The drop is lower following the Hypothetical Merger than it was for LEOFF 2 before the merger purely due to the selection of a lower minimum rate as part of the assumed funding policy. For reference, before a merger the rate floor is 90 percent of the normal cost under EAN for LEOFF 2, while the Hypothetical Merger assumes a floor of 80 percent of the normal cost under EAN.

As noted above, LEOFF 1 is expected to have a surplus. If that surplus is realized, the merged plan would incorporate it. In very general terms, this would drive down expected

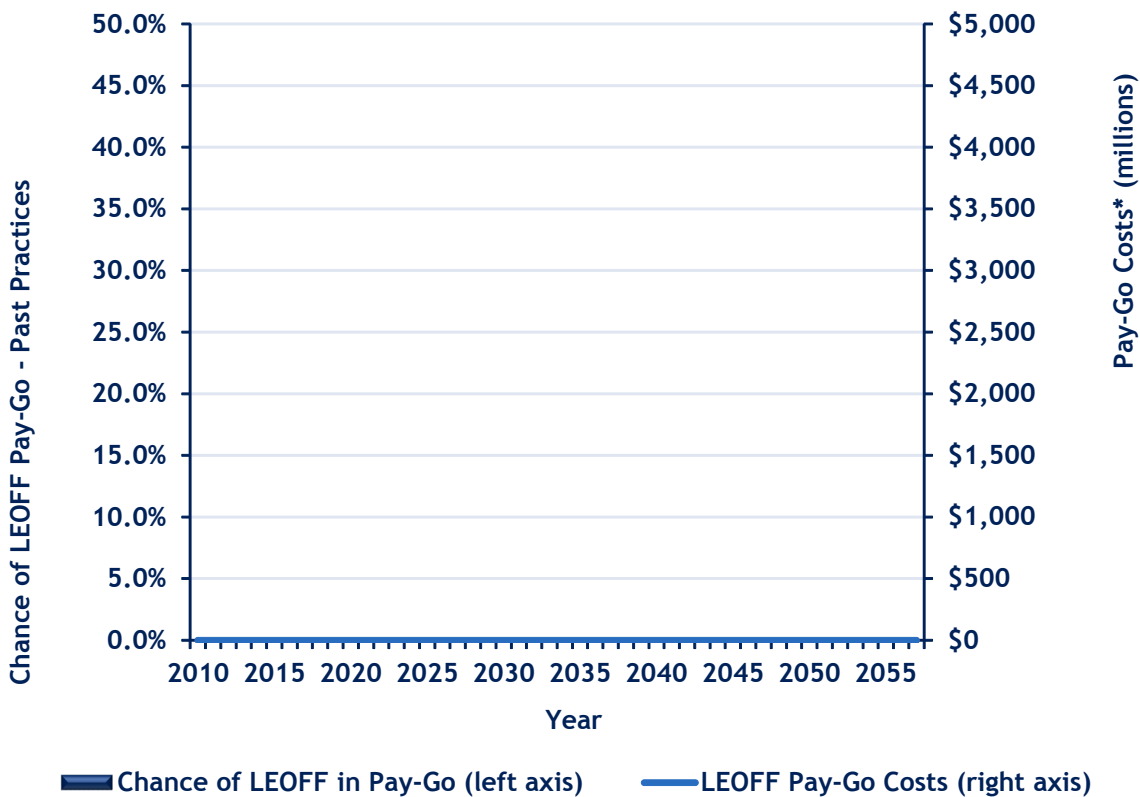
## 2011 LEOFF MERGER STUDY

contribution rates for Plan 2 members, employers, and the state until the surplus is diminished. The lower the assumed minimum contribution rate, the quicker the surplus (if it is realized) could be diminished. Conversely, the higher the assumed minimum rate, the longer the surplus would last.

Theoretically, policy makers could set contribution rate floors higher or lower than we assumed in the Hypothetical Merger. The height of the rate floor will mainly affect how long the expected surplus lasts, how long the rates stay low under very optimistic circumstances, and how high rates will go under pessimistic outcomes.

### Pay-Go Risk

**Figure 2c - Pay-Go, LEOFF Merged Plans**



\*Pay-Go costs on top of normal pension costs.

**Figure 2d**

LEOFF Chance/Amount of Pay-Go - Select Years - Past Practices		
Merged Plans		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.0%	\$0
2017	0.0%	\$0
2020	0.0%	\$0
2023	0.0%	\$0
2026	0.0%	\$0
2029	0.1%	\$0
2032	0.0%	\$0
2035	0.0%	\$0
2038	0.0%	\$0
2041	0.1%	\$0
2044	0.0%	\$0
2047	0.0%	\$0
2050	0.0%	\$0
2053	0.0%	\$0
2056	0.0%	\$0

\*Millions.

Figures 2c and 2d show both the chance of the merged plan entering pay-go status and the corresponding cost should it occur. Once again, we see a similarity between the combined plan after a Hypothetical Merger, and LEOFF 2 before a merger.

Specifically, the merged plan has a one in one thousand chance of pay-go over the next 50 years. This means very few simulations in our model resulted in pay-go for this scenario.

For comparison, before the Hypothetical Merger we saw that LEOFF 1 had over a 29 percent chance of pay-go at some point in the plan's life cycle. LEOFF 2 before the Hypothetical Merger, had virtually no chance of pay-go.

## Rates and Total Contributions

**Figure 2e**

Contribution Rates Merged Plans			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
Employee	7.24%	7.24%	7.24%
Employer	4.35%	4.35%	4.35%
State	2.89%	2.89%	2.89%

Figure 2e shows the contribution rates for 2013-15 after the Hypothetical Merger. There are two pieces to the table that stand out. First, the employee cost refers to all active members, as LEOFF 1 and LEOFF 2 members are assumed to pay equal rates under this scenario.

Second, the employee rates are lower by 1.22 percent under the Hypothetical Merger than they were in LEOFF 2 before a merger. This is largely due to the selection of a lower minimum rate assumption for the purpose of this analysis. Actual rates will depend on the funding policy adopted (and action of any governing body, if appropriate).

**Figure 2f**

Change in Total Pension Contributions* - Merged Plans			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	(\$18.6)	(\$18.6)	(\$18.6)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$18.6)</b>	<b>(\$18.6)</b>	<b>(\$18.6)</b>
Local Government	(27.3)	(27.3)	(27.3)
<b>Total Employer</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>
<b>Total Employee</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>	<b>(\$45.9)</b>
<b>2013-2038</b>			
General Fund	(\$369.8)	(\$369.8)	(\$8.9)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$369.8)</b>	<b>(\$369.8)</b>	<b>(\$8.9)</b>
Local Government	(556.6)	(556.6)	461.2
<b>Total Employer</b>	<b>(\$926.5)</b>	<b>(\$926.5)</b>	<b>\$452.2</b>
<b>Total Employee</b>	<b>(\$926.5)</b>	<b>(\$926.5)</b>	<b>\$770.2</b>

\* Compared to Before Merger scenario.

Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.

Figure 2f shows the changes to pension contributions after the Hypothetical Merger for 2013-2015, as well as on a 25-year basis.



Comparing the 2013-15 pension contributions for the Hypothetical Merger to the pension contributions before a merger (see Fig. 1j), we see that there is a first biennium savings in total employer contributions of just under \$46 million under any outlook, with an equal savings in total contributions to plan members.

However, keep in mind that the savings to members is a net savings. Under this scenario we are assuming LEOFF 1 active members will make contributions. Since they are not making contributions currently, this net savings will include an increased cost for LEOFF 1 members.

Comparing the 25-year contributions, we see an expected savings of just under \$927 million, with an equal savings in total member contributions. There is no difference in contributions between the expected and optimistic outlooks due to the assumed minimum rates. Again, this net savings will include a cost for remaining active LEOFF 1 members. Employers and the state also make contributions for the remaining LEOFF 1 active members under the assumed funding policy.

The long-term savings in the expected and optimistic outlooks is largely due to the aforementioned LEOFF 1 surplus. If realized, this surplus will drive down contribution rates and total pension contributions.

The pessimistic outlook breaks from the trend, to show a cost greater than the cost before a merger. Under the pessimistic outlook, the 25-year costs of a Hypothetical Merger increase to over \$452 million in total employer contributions, and \$770 million in total member contributions.

The 25-year savings in both the expected and optimistic outlooks had been a result of the merged plan incorporating the expected LEOFF 1 surplus. As we saw with LEOFF 1 before a merger, that surplus would be smaller or nonexistent on the pessimistic and very pessimistic outlooks before a merger. In these cases, prematurely incorporating a temporary and diminishing LEOFF 1 surplus would lead to a loss of future investment returns and result in higher future contribution rates.

Under the pessimistic outlook, there is also a cost shift from the state to the local government employers and the members. Before a merger, we assumed the state would pay almost all unfunded costs from LEOFF 1. After the Hypothetical Merger, we assume all unfunded costs are shared 50/30/20 among members, employers, and the state respectively.

## Recap of Assumptions for Hypothetical Merger

- ❖ Merging assets and liabilities.
- ❖ Aggregate funding method with minimum rates set at 80 percent of EANC.
- ❖ Active members of LEOFF 1 and 2 both contribute to combined plan.
- ❖ Costs of the plan are shared as follows:
  - ✦ Fifty percent member.
  - ✦ Thirty percent employer.
  - ✦ Twenty percent state.

## Summary Analysis of Hypothetical Merger

A merger of LEOFF 1 and LEOFF 2 is a merging of two healthy plans. A merger using the assumed policies could have either a savings or a cost. This is largely dependent on the realization of a surplus of assets from LEOFF 1; a surplus that only persists on the expected and optimistic bases.

On an expected basis, there is both short and long-term savings of about \$46 million and \$930 million, respectively, from the Hypothetical Merger. However, on a pessimistic basis, there is long-term cost to the Hypothetical Merger of about \$452 million for employers and the state, and \$770 million for members.

This contrast between expected/optimistic and pessimistic outlooks in the total costs of

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the plan illustrates the differences we saw in other measures. On an expected basis, the Hypothetical Merger looks very similar to LEOFF 2 before a merger. The main differences are in the very pessimistic/optimistic outcomes.

After the Hypothetical Merger the projected funded status under the very optimistic outcome increases, and the funded status under the very pessimistic outlook decreases. In other words, the good outcomes could get better, but the bad outcomes could get worse.

This also holds true for contribution rates. Projected member contribution rates for the combined plan on a very optimistic basis drop to the assumed rate floor, as they did for LEOFF 2 before a merger. On a very pessimistic basis, rates go just as high under a merged plan as they did for LEOFF 2 before a merger, but take less time to get there.

The presence of an ongoing funding policy provides relative rate stability from year to year, and ensures that merging the plans virtually eliminates pay-go risk. In this scenario, members, employers, and the state carry the risks of the plan in proportion to their respective cost shares.

However, if the goal for a merger is solely to stabilize projected rates or eliminate the risk of pay-go for LEOFF 1, there are other ways to do so without a merger. For example, applying an alternate funding policy in LEOFF 1 could also accomplish these goals. For more information on this, please see Appendix 5.

If the goal for a merger is solely to stabilize projected rates or eliminate the risk of pay-go for LEOFF 1, there are other ways to do so without a merger.

## Alternate Funding Policy 1: Zero Percent Contribution Rate for LEOFF 1 Members

For this scenario, we have made all the same assumptions as in the Hypothetical Merger, except that we have added a 0 percent contribution rate for LEOFF 1 members.

This assumption will not materially affect the overall costs of the plan. Instead, it only affects how costs are apportioned.

### Why did we choose this assumption?

Members of LEOFF 1 are currently not making contributions to their plan and, under current funding policy, would not begin making contributions unless the plan falls out of full funding while they are still employed. The plan is not expected to fall out of full funding. Between the current funded status, and the shrinking active membership of the plan, it is reasonable to think that policy makers may consider insulating the remaining LEOFF 1 active members from potential reinstatement of contributions as a direct result of a merger.

As a practical matter, this scenario does not materially impact the contributions to the plan following the Hypothetical Merger. It only impacts cost sharing. Because there are only 301 active members as of June 30, 2010, the impact on risk measures is almost unnoticeable when compared to the Hypothetical Merger.

For brevity, we will skip the measures with nearly identical results and proceed directly to the changes in contribution rates and total contributions. Tables and graphs for the omitted measures have been provided in Appendix 5.

Figure 3a shows the member contribution rates for 2013-15 under this scenario. The rate for LEOFF 1 members is 0 percent, reflecting the assumed rate. Otherwise, the rates for the state, employers, and LEOFF 2 members are identical to those in the Hypothetical Merger.

**Figure 3a**

Contribution Rates			
Merged Plans, No LEOFF 1 Member Contributions			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
<b>Employee</b>			
Plan 1	0.00%	0.00%	0.00%
Plan 2	7.24%	7.24%	7.24%
<b>Employer</b>			
State	4.35%	4.35%	4.35%
	2.89%	2.89%	2.89%

While other funding policies could be adopted, we assumed for the purposes of analyzing this scenario that contributions that would have been made by LEOFF 1 members are treated as deferred payments. This amount is then assumed by the merged plan and translates as slightly higher future rates for all other members, employers, and the state.

Figure 3b

Change in Total Pension Contributions* - Merged Plans, No LEOFF 1 Member Contributions			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>(\$1.5)</b>	<b>(\$1.5)</b>	<b>(\$1.5)</b>
<b>2013-2038</b>			
General Fund	\$0.0	\$0.0	\$1.8
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$1.8</b>
Local Government	0.0	0.0	5.6
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$7.5</b>
<b>Total Employee</b>	<b>(\$2.8)</b>	<b>(\$2.8)</b>	<b>\$4.5</b>

\* Compared to Merged Plans scenario.

Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.

For the 2013-15 Biennium, the total employer pension contributions are identical to the Hypothetical Merger. The total employee contributions, however, are \$1.5 million less than the Hypothetical Merger due to the 0 percent rate for LEOFF 1 active members.

On an expected basis, we see the same thing over 25 years: the total employer contributions are identical to the Hypothetical Merger, while total employee contributions drop by \$2.8 million. There is no difference between the expected and optimistic outlooks.

The loss of LEOFF 1 member contributions, although small, is large enough under a pessimistic outlook to increase plan contributions over 25 years. For total employer contributions, we see an increase of over \$7 million. For total employee contributions, we see an increase of over \$4 million.

Recap of Assumptions for Alternate Funding Policy 1

- ❖ NEW: 0 percent contribution rate for LEOFF 1 members.
- ❖ Merging assets and liabilities.
- ❖ Aggregate funding method with minimum rates set at 80 percent of EANC.
- ❖ Costs of the plan are shared as follows:
  - ✦ Fifty percent LEOFF 2 member.
  - ✦ Thirty percent employer.
  - ✦ Twenty percent state.
- ❖ REMOVED: Active members of LEOFF 1 contribute to combined plan.

Summary Analysis of Scenario

Between this scenario and the Hypothetical Merger, the change is relatively small, due to the fact that so few active LEOFF 1 members remain. The overall contributions of the plan are no different, and the same basic conclusions about the risk measures still apply.

However, there is a shift in who pays those contributions. A 0 percent contribution rate not only means LEOFF 1 members do not contribute, but the assumed funding policy may result in higher contribution rates (and resulting budget impacts) for the LEOFF 2 members, local government employers, and the state on a pessimistic basis in the future. In this scenario, the reduced risk to Plan 1 members is correspondingly transferred to Plan 2 members, employers, and the state.

## Alternate Funding Policy 2: Maximum Contribution Rate for LEOFF 2 Members

For this scenario, we have made all the same assumptions as in Alternate Funding Policy 1 (0 percent contribution rate for LEOFF 1 members), except that we have added a maximum contribution rate for LEOFF 2 members.

We have assumed a maximum contribution rate for LEOFF 2 members of 20 percent, plus 50 percent of the cost of any future benefit improvements. We refer to this type of rate ceiling as a “dynamic rate ceiling” because it adjusts for future benefit improvements. This is typical of rate ceilings for members in other state pension plans. (Specifically, similar dynamic rate ceilings are in effect for TRS 2 and WSPRS members.)

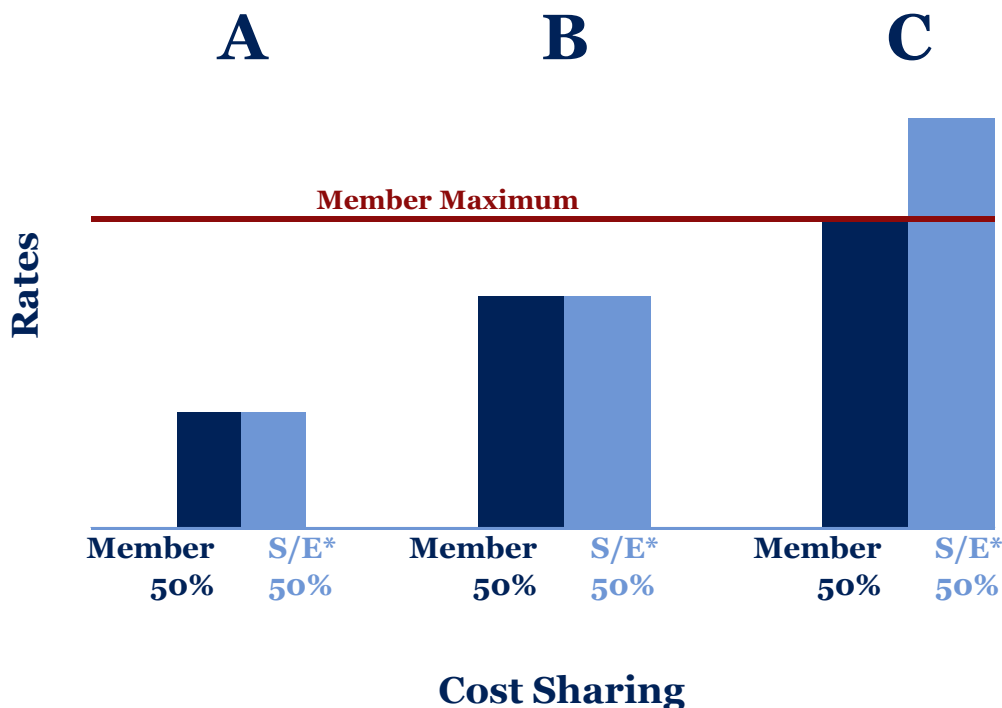
By creating a dynamic rate ceiling for LEOFF 2 members, we are assuming that if rates rise high enough that they hit the member ceiling, any additional costs of the plan will shift to either the employer or state. In other words, the 50/30/20 cost sharing model will shift under certain conditions.

Any “spill-over” to the state and employer created by rates exceeding the member maximum could theoretically be paid by the state, the employer, or both. For purposes of this scenario, we have assumed that the employer would pick up any spill-over.

However, to help illustrate the potential cost shift, it may help to simplify the cost sharing model. If you think of the state and employer shares as combined, then the costs can be split 50/50, or 50 percent member and 50 percent state and employer (“S/E”).

The Cost Sharing Graph below is a basic illustration of this rate ceiling/cost sharing concept. Parts (A) and (B) show that as costs rise, the member and state/employer rates rise equally; that is, their proportions of the total cost stay the same.

If, however, costs rise high enough, the rate ceiling stops the member rate from going any higher. Thus, part (C) shows that if costs rise high enough, the cost sharing will shift. While the total impact will depend on the plan costs and the maximum rate chosen, the cost sharing proportions could shift in the direction of 49/51, 45/55, and so on.



\*State/Employer

### Why Did We Choose This Assumption?

Under the design of LEOFF 2, members carry a certain amount of risk of unfunded liability and poor investment performance in the future. If a merger with LEOFF 1 could increase that risk, then it is reasonable to think that policy makers may consider insulating LEOFF 2 members from any increase in risk directly resulting from a merger.

### Why Did We Choose This Maximum Rate?

Practically speaking, it is impossible to perfectly isolate the risks acquired as a direct result of the merger from the risks already inherent in the plan before a merger. Thus, selecting a maximum rate for LEOFF 2 members requires us to balance insulating LEOFF 2 members from the former, without overly insulating them from the latter.

As a general rule, as the member maximum rate increases, the risk to members increases, and the risk to employers decreases. The reverse applies as the member maximum is lowered.

We chose the maximum rate based on LEOFF 2 contribution rate projections before the merger. This number (20 percent) represents the highest simulated rate in the 90th percentile under current law (meaning we did not assume the continuation of past practices). This rate was chosen for illustration purposes only, and is not intended as a recommendation for how a maximum rate should be calculated.

## Alternate Funding Policy 2: Projected Contribution Rates

As with Alternate Funding Policy 1, this scenario does not materially impact the cost of the plan following the Hypothetical Merger. It only impacts cost sharing. We therefore will skip the nearly identical measures, and move directly to the measures that have changed as a result of the assumptions in this scenario. Again, all graphs and tables for this scenario have been provided in Appendix 5

The major impact under this scenario is in contribution rates. In all prior scenarios, we showed a single rate graph for members only. Generally, showing a single graph helped to simplify the analysis because the combined rates for the state/employer were equal to the rates for the members.

Under the funding policy in this scenario, the equal rates continue, but only to a point. That’s why for this scenario we will split rate projections into a member graph and a state/ employer graph.

Figure 4a shows the projected contribution rates for LEOFF 2 members. Building from the last scenario, we have assumed that LEOFF 1 members will not contribute to the plan.

Under most outlooks, this scenario is identical to the Hypothetical Merger. The only changes are in the pessimistic and very pessimistic outlooks.

For comparison, the red line indicates the contribution rates under a very pessimistic outlook for the Hypothetical Merger. You can see that the very pessimistic line for Alternate Funding Policy 2 (light blue) is lower by 6 percent or more over the long term. In other words, a very pessimistic contribution rate under this scenario is lower for members than it was under the Hypothetical Merger. The very pessimistic line does not plateau at the 20 percent member maximum because it assumes the continuation of past practices, including the passage of future benefit improvements for the combined plan.

**Figure 4a - Member Contribution Rates, LEOFF**

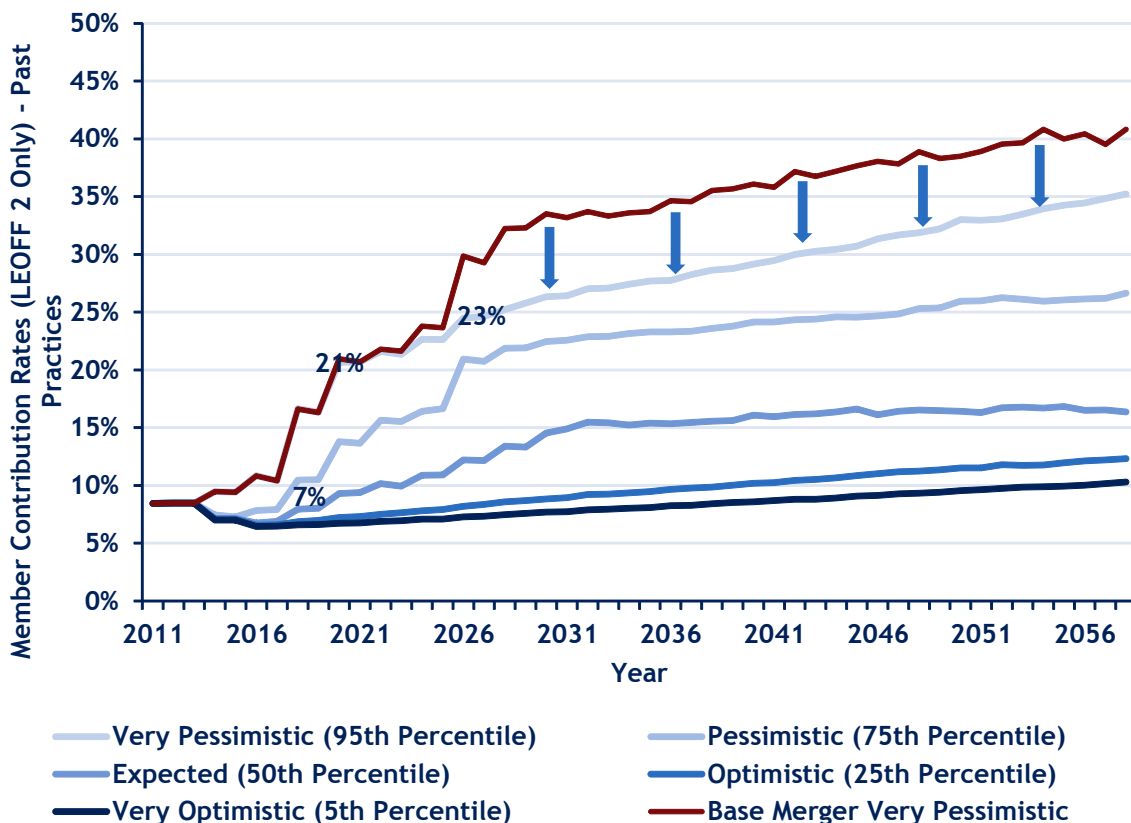
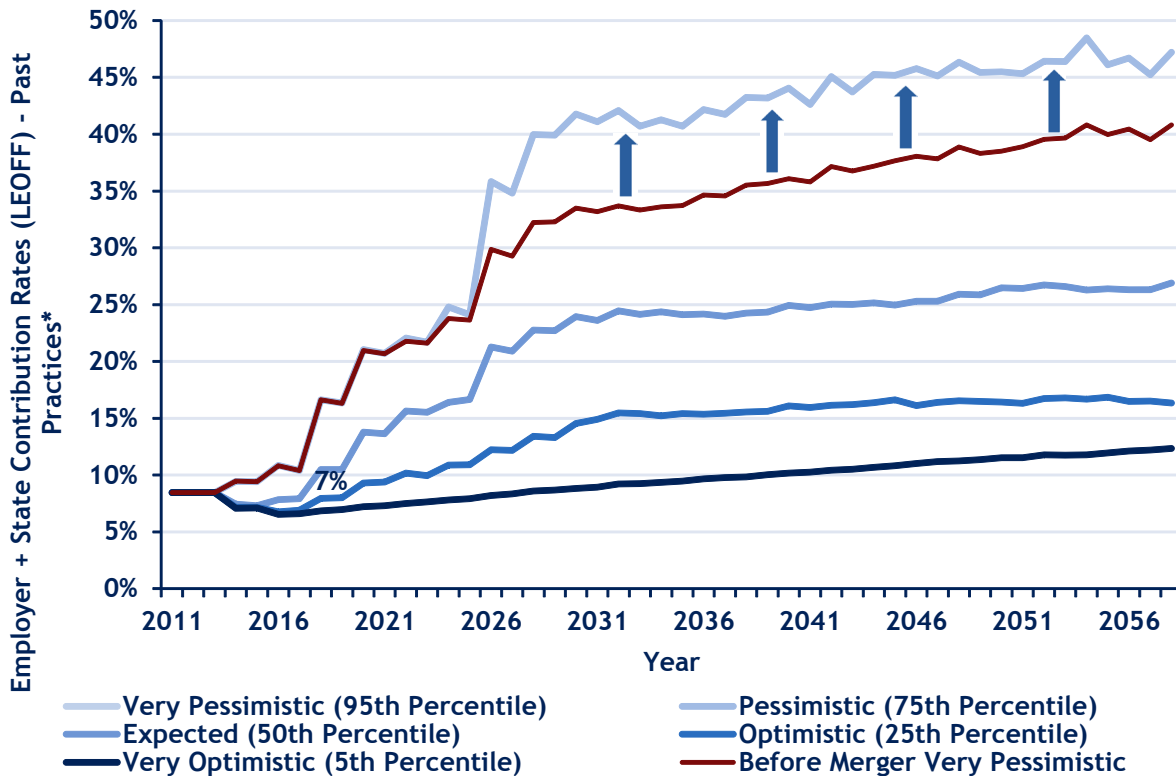


Figure 4b - Employer+State Contribution Rates, LEOFF



\*Employer pays excess rate above LEOFF 2 maximum member rate.

As stated above, the overall costs of the plan following the Hypothetical Merger are unchanged in this scenario. Logically, any reduction in the member rate must then translate to an increase in cost to the combined state/employer.

Figure 4b shows the projected contribution rates for the combined state/employer. Under most outlooks, this is identical to the Hypothetical Merger. As with the prior graph, the red line again shows the contribution rates under the very pessimistic outlook for the Hypothetical Merger.

The very pessimistic line (light blue) for the combined state/employer goes higher than the red line. This shows that when the member contribution rates hit the maximum around 2020-2025, any spill over shifts to the state/employer.

Thus, where the outcome could be as much as 6 percent better for members, it would be correspondingly worse for the state/employer on a very pessimistic basis.



## Rates and Total Contributions

**Figure 4c**

<b>Contribution Rates</b>			
<b>Merged Plans, No LEOFF 1 Member Contributions, Maximum LEOFF 2 Member Rates</b>			
<b>2013-2015 State Budget</b>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>Employee</b>			
Plan 1	0.00%	0.00%	0.00%
Plan 2	7.24%	7.24%	7.24%
<b>Employer</b>	4.35%	4.35%	4.35%
<b>State</b>	2.89%	2.89%	2.89%

Figure 4c shows the contribution rates for 2013-15 under this scenario, including the zero percent rate for LEOFF 1 members assumed in the prior scenario. Rates for the remaining categories are unchanged, since the member maximum would not kick in until later biennia, if at all.

**Figure 4d**

<b>Change in Total Pension Contributions* -</b>			
<b>Merged Plans, No LEOFF 1 Member Contributions, Maximum LEOFF 2 Member Rates</b>			
<i>(Dollars in Millions)</i>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>2013-2015</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>2013-2038</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>

\* Compared to Merged Plans, No LEOFF 1 Member Contributions scenario.

Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.

Figure 4d shows the pension contributions for 2013-15 and over 25 years. For the 2013-15 Biennium and over 25 years, total contributions to the merged plan do not change for Alternate Funding Policy 2.

The member rates only hit the member maximum in the very pessimistic outcomes on a current law basis. Thus, the cost sharing shift (“spill over”) does not occur in most of the simulations.

#### Recap of Assumptions for Alternate Funding Policy 2

- ♣ NEW: Maximum contribution rate for LEOFF 2 members of 20 percent, plus 50 percent of the cost of benefit improvements.
- ♣ NEW: Any rate in excess of the LEOFF 2 member

## 2011 LEOFF MERGER STUDY

maximum will be paid by the employer.

- ❖ Zero percent contribution rate for LEOFF 1 members.
- ❖ Merging assets and liabilities.
- ❖ Aggregate funding method with minimum rates set at 80 percent of EANC.
- ❖ Costs of the plan are shared as follows.
  - ✦ Fifty percent LEOFF 2 member, up to the member maximum.
  - ✦ Thirty percent employer, plus any “spill over” from rates exceeding the LEOFF 2 member maximum.
  - ✦ Twenty percent state.

### Summary Analysis of Scenario

As with the prior comparison scenario, the overall costs of the plan are no different from the Hypothetical Merger, and the same basic conclusions about the risk measures still apply. In this scenario, Plan 1 members continue to be insulated from contribution rate risk while the contribution rate risk to Plan 2 members is reduced. Employers absorb the risk forgone by Plan 2 members.

Under most outlooks, contribution rates will not hit the member maximum. It is only in very pessimistic outlooks that rates may hit the maximum, triggering a cost shift from Plan 2 members to employers.

Selecting a member maximum for an ongoing plan is a complex policy decision, as there is no “magic rate” that perfectly balances the risk inherent in the plan before a merger with the new risk acquired as a result of the merger.



**STAKEHOLDER INPUT**



The study mandate requires OSA to solicit input from the LEOFF 2 Board, and organizations representing members and retirees of LEOFF 1. OSA also invited local government representatives and any other self-identified representatives who asked to participate.

As authorized by the study mandate, OSA solicited the help of the Department of Retirement Systems (DRS) in facilitating two meetings with these stakeholders. These two meetings took place on August 30, 2011, and October 17, 2011. For more information on the stakeholder input process, please see Appendix 8. A copy of the interagency agreement between OSA and DRS for the

stakeholder meeting facilitation is found in Appendix 2.

At the first meeting, stakeholders were asked the following question, if a merger took place, what would their concerns be? At the second meeting, OSA shared a summary of the input received at the first meeting and the stakeholder input provided in writing. At the second meeting, OSA also asked stakeholders to confirm the accuracy of our summarization of their input.

Based on this summary, the stakeholder input received largely fell into four common themes.

<b>Governance</b>
Members and retirees do not want to lose the LEOFF 1 Medical/Disability Boards.
Consideration should be given to make sure any oversight authority represent all stakeholders.
Some stakeholders have testified to a rift between LEOFF 1 and LEOFF 2 members as a result of the introduction of HB 2097 (2011).
<b>Funding policy and fiscal health</b>
Will a merger increase costs?
If increased costs arise, who will pay?
What portion will they pay?
Plans 1 and 2 are healthy and stakeholders want to keep them that way.
Actuarial analysis of multiple scenarios (before and after) is critical.
<b>Benefits</b>
Current benefits and contribution rates should be protected.
<b>Legality</b>
What are members’ rights under federal and state law?
Would or could a merger run afoul of those rights?

Representative samples of the stakeholder input are found in Appendix 9.



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## Appendix One | Study Mandate

16	<u>NEW SECTION.</u> <b>Sec. 105. FOR THE OFFICE OF THE STATE ACTUARY</b>
17	General Fund--State Appropriation (FY 2012) . . . . . \$24,000
18	General Fund--State Appropriation (FY 2013) . . . . . \$24,000
19	Department of Retirement Systems Expense
20	Account--State Appropriation . . . . . \$3,344,000
21	<b>TOTAL APPROPRIATION . . . . . \$3,392,000</b>

The appropriations in this section are subject to the following conditions and limitations: \$75,000 of the department of retirement services account--state appropriation is for the state actuary to study the issue of merging the law enforcement officers' and fire fighters' retirement system plans 1 and 2 into a single retirement plan. The department of retirement systems shall assist the state actuary by providing such information and advice as the state actuary requests, and the state actuary may contract for services as needed to conduct the study. The results of the study shall be reported to the ways and means committees of the house of representatives and the senate by December 15, 2011.

(1) Among the issues related to the merger of the law enforcement officers' and fire fighters' retirement system plans 1 and 2 into a single retirement plan that shall be examined:

1 (a) Changes to the assets available to pay for the benefits of each  
2 plan before and after a merger based on a range of possible economic  
3 and demographic experience; and

4 (b) Changes to the projected contributions that might be required  
5 of members, employers, and the state based on a range of possible  
6 economic and demographic experience and a variety of funding policies,  
7 including both continued application of current funding policy to the  
8 benefit obligations of each plan, and application of the law  
9 enforcement officers' and fire fighters' retirement system plan 2  
10 funding policies to the combined benefits of both plans;

11 (2) The state actuary shall solicit the input of the law  
12 enforcement officers' and fire fighters' retirement system plan 2  
13 retirement board and organizations representing members and retirees of  
14 the law enforcement officers' and fire fighters' retirement system plan  
15 1 on the issue of the merger of the two plans, and include  
16 representative submissions of the input of the organizations along with  
17 the report.

## Appendix Two | Interagency Agreement

### INTERAGENCY AGREEMENT

between

STATE OF WASHINGTON

OFFICE OF THE STATE ACTUARY

and

THE DEPARTMENT OF RETIREMENT SYSTEMS

THIS AGREEMENT is made and entered into by and between the Office of the State Actuary, hereinafter referred to as "OSA," and the Department of Retirement Systems, hereinafter referred to as "DRS," made pursuant to RCW 44.44, RCW 39.34, and Chapter 50, Laws of 2011.

IT IS THE PURPOSE OF THIS AGREEMENT to provide for facilitation and research services by the DRS in furtherance of a study, hereinafter referred to as "MERGER STUDY", of the issue of merging the Law Enforcement Officers' and Fire Fighters' Retirement System Plans 1 and 2, hereinafter referred to as "LEOFF 1" and "LEOFF 2", respectively, into a single retirement plan, to provide a definition of the facilitation services that will be provided by the DRS to OSA, and to provide the terms of reimbursement for certain optional research services that may be rendered during the period of performance.

THEREFORE, IT IS MUTUALLY AGREED THAT:

#### **STATEMENT OF WORK**

The DRS agrees to furnish the facilitation and optional research services and otherwise do all things necessary for or incidental to the performance of the work set forth in Attachment "A" attached hereto and incorporated herein.

#### **PERIOD OF PERFORMANCE**

Subject to its other provisions, the period of performance of this Agreement shall commence on July 1, 2011 or the date of execution, whichever occurs sooner, and be completed on December 15, 2011, unless terminated sooner as provided herein. Final documentation of stakeholder input shall be submitted to the OSA by November 1, 2011.

#### **PAYMENT**

The parties have determined that no cost will be incurred, and no amount will be charged for facilitation services, as set forth in Attachment "A".

The parties have also determined that certain optional research services, as set forth in Attachment "A", may result in costs for the DRS, and the OSA will reimburse the DRS

for those costs provided the requirements set forth in Attachment "A" are met. The parties have further determined that the cost of these research services will not exceed \$30,000 in total for the period of performance. Payment for performance of the work shall not exceed this maximum amount unless the parties mutually agree, by amendment to this agreement, to a higher amount prior to the commencement of any work which will cause the maximum payment to be exceeded.

Compensation for the work provided in accordance with this agreement has been established under the terms of RCW 39.34.130.

### **BILLING PROCEDURE**

If the DRS incurs costs for the research services set forth in Attachment "A", the DRS shall submit an invoice for the total costs incurred, but not exceeding the maximum amount set forth in this agreement, to the OSA by December 15, 2011. Payment for approved and completed work will be made by warrant or account transfer within thirty (30) days of receipt of invoice. Upon expiration of the contract, any claim for payment not already made shall be submitted within thirty (30) days after the expiration date or the end of the fiscal year, whichever is earlier.

### **RECORDS MAINTENANCE**

The parties to this agreement shall each maintain all written records, reports and documents generated in the performance of the work set forth in Attachment "A." These records shall be subject to inspection, review or audit by personnel of both parties, other personnel duly authorized by either party, the Office of the State Auditor, and federal officials so authorized by law. All books, records, documents, and other material relevant to this Agreement will be retained for six years after expiration and the Office of the State Auditor, federal auditors, and any persons duly authorized by the parties shall have full access and the right to examine any of these materials during this period.

Records and other documents, in any medium, furnished by one party to this Agreement to the other party, will remain the property of the furnishing party, unless otherwise agreed. The receiving party will not disclose or make available this material to any third parties without first giving notice to the furnishing party and giving it a reasonable opportunity to respond. Each party will utilize reasonable security procedures and protections to assure that records and documents provided by the other party are not erroneously disclosed to third parties.

### **RIGHTS IN DATA**

Unless otherwise provided, data which originates from this Agreement shall be "works for hire" as defined by the U.S. Copyright Act of 1976 and shall be owned by DRS. Data shall include, but not be limited to, reports, documents, pamphlets, advertisements, books, magazines, surveys, studies, films, tapes, and/or sound reproductions. Data does not include Social Security Numbers, names, or other identifying data of members, retirees, or the beneficiaries of any pension system listed in RCW 41.50.030. Ownership includes the right to copyright, patent, register, and the ability to transfer these rights.

The DRS hereby grants the OSA a royalty-free, irrevocable, exclusive license to reproduce, publish or otherwise use, and to authorize others to use such data for government purposes.

### **INDEPENDENT CAPACITY**

The employees or agents of each party who are engaged in the performance of this Agreement shall continue to be employees or agents of that party and shall not be considered for any purpose to be employees or agents of the other party.

### **AGREEMENT ALTERATIONS AND AMENDMENTS**

This agreement may be amended by mutual agreement of the parties. Such amendments shall not be binding unless they are in writing and signed by personnel authorized to bind each of the parties.

### **TERMINATION**

Either party may terminate this Agreement upon ninety (90) days prior written notification to the other party. If this Agreement is so terminated, the parties shall be liable only for the performance rendered or costs incurred in accordance with the terms of this Agreement prior to the effective date of termination.

### **TERMINATION FOR CAUSE**

If for any cause, either party does not fulfill in a timely and proper manner its obligations under this Agreement, or if either party violates any of these terms and conditions, the aggrieved party will give the other party written notice of such failure or violation. The responsible party will be given the opportunity to correct the violation or failure within fifteen (15) working days. If failure or violation is not corrected, this Agreement may be terminated immediately by written notice of the aggrieved party to the other.

### **DISPUTES**

In the event that a dispute arises under this Agreement, it shall be determined by a Dispute Board in the following manner: Each party to this Agreement shall appoint one member to the Dispute Board. The members so appointed shall jointly appoint an additional member to the Dispute Board. The parties hereto shall agree to the process to be followed by said Dispute Board. The Dispute Board shall review the facts, contract terms and applicable statutes and rules and make a determination of the dispute. The determination of the Dispute Board shall be final and binding on the parties hereto. As an alternative to this process, either of the parties may request intervention by the Governor, as provided by RCW 43.17.330, in which event the Governor's process will control.

**GOVERNANCE**

This contract is entered into pursuant to and under the authority granted by the laws of the State of Washington and any applicable federal laws. The provisions of this Agreement shall be construed to conform to those laws.

In the event of an inconsistency in the terms of this Agreement, or between its terms and any applicable statute or rule, the inconsistency shall be resolved by giving precedence in the following order:

- a. Applicable State and federal statutes and rules;
- b. statement of work; and
- c. any other provisions of the Agreement, including materials incorporated by reference.

This Agreement shall be governed in all respect by the statutes and law of the State of Washington. The jurisdiction for any legal action under this Agreement shall be the Superior Court of the State of Washington. The venue for any action shall be Thurston County Superior Court.

**ASSIGNMENT**

The work to be provided under this Agreement, and any claim arising there under, is not assignable or delegable by either party in whole or in part, without the express prior written consent of the other party, which consent shall not be unreasonably withheld.

**WAIVER**

A failure by either party to exercise its rights under this Agreement shall not preclude that party from subsequent exercise of such rights and shall not constitute a waiver of any other rights under this Agreement unless stated to be such in a writing signed by an authorized representative of the party and attached to the original Agreement.

**SEVERABILITY**

If any provision of this Agreement or any provision of any document incorporated by reference shall be held invalid, such invalidity shall not affect the other provisions of this Agreement which can be given effect without the invalid provision, if such remainder conforms to the requirements of applicable law and the fundamental purpose of this Agreement, and to this end the provisions of this Agreement are declared to be severable.

**ALL WRITINGS CONTAINED HEREIN**

This Agreement contains all the terms and conditions agreed upon by the parties. No other understandings, oral or otherwise, regarding the subject matter of this Agreement shall be deemed to exist or to bind any of the parties hereto.

**CONTRACT MANAGEMENT**

The program manager for each of the parties shall be responsible for and shall be the contract person for all communications and billings regarding the performance of this Agreement.

The Program Manager for OSA is:

Aaron Gutierrez, Policy Analyst  
P.O. Box 40914  
Olympia, Washington 98504-0914  
360-786-6140

The Program Manager for DRS is:

Dave Nelsen  
P.O. Box 48380  
Olympia, WA  
360-664-7304

**IN WITNESS WHEREOF, the parties have executed this Agreement.**

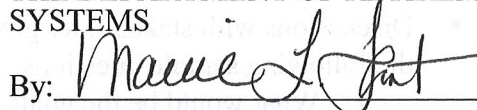
OFFICE OF THE STATE ACTUARY

By: 

Matthew M. Smith  
Title: State Actuary

Date: 8/2/11

THE DEPARTMENT OF RETIREMENT SYSTEMS

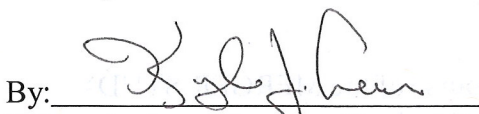
By: 

Marcie L. Frost  
Title: Deputy Director

Date: 8/11/11

APPROVED AS TO FORM ONLY:

ROB MCKENNA  
Attorney General

By:   
Title: Assistant Attorney General for the  
Office of the State Actuary

Date: August 2, 2011

By: \_\_\_\_\_  
Title: Assistant Attorney General for the  
Department of Retirement Systems

Date: \_\_\_\_\_

## ATTACHMENT "A"

**FACILITATION SERVICES**

- Prepare, plan, schedule, and conduct community meetings for the purpose of gathering stakeholder input in a manner calculated to satisfy the requirements of Chapter 50, Laws of 2011, Section 105.
- The DRS will conduct the stakeholder input process in a manner similar to the LEOFF 1 Medical Study conducted by the DRS in 2008, including, but not limited to:
  - Forming stakeholder groups
    - At a minimum, the stakeholder group or groups must include representatives of the following groups:
      - LEOFF employers
      - LEOFF 1 members
      - LEOFF 1 retirees
      - LEOFF 2 members
      - LEOFF 2 retirees
      - LEOFF 2 Board
      - Other stakeholders with an identifiable interest as determined by the DRS or the OSA
  - Facilitating discussions with stakeholder groups
    - Discussions with stakeholder groups may include, but are not limited to the following sample questions:
      - What would be the goals or benefits of a plan merger?
      - What concerns would be raised in regards to a plan merger?
      - What issues should be analyzed or addressed in the MERGER STUDY?
  - Facilitating follow up meetings, discussions, or factual presentations (as needed)
- Memorialize the meetings with documentation synthesizing both the issues raised and discussion points at a reasonable level of detail, and providing representative submissions of stakeholder input. Final documentation must be submitted by the DRS to the OSA by November 1, 2011.

**OPTIONAL RESEARCH SERVICES**

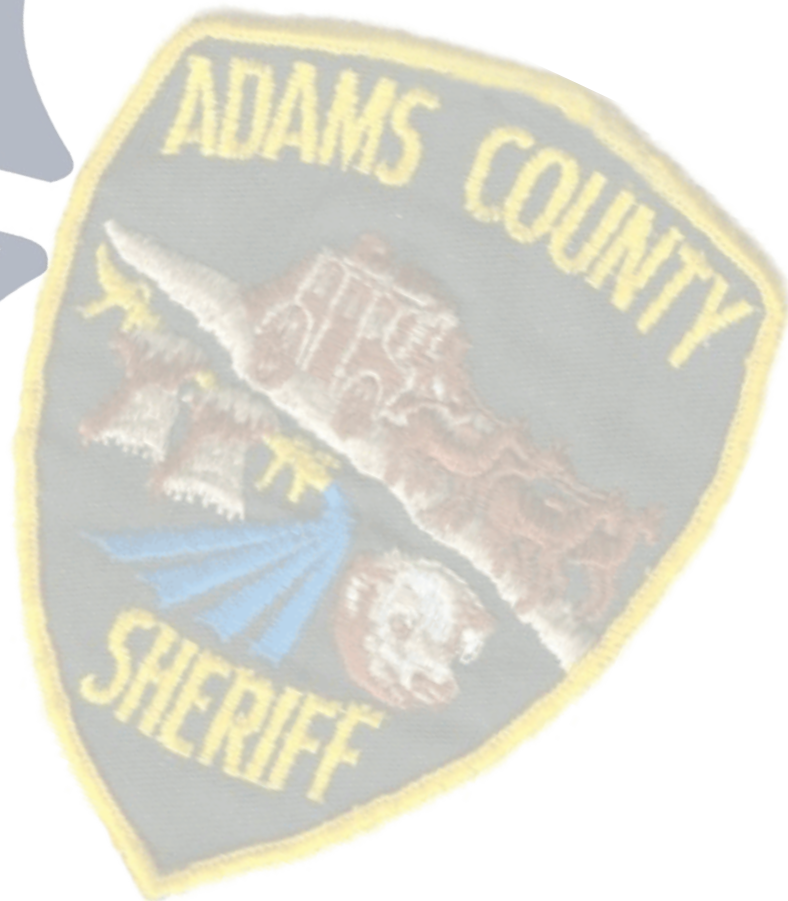
The parties acknowledge that questions may arise during the course of the MERGER STUDY that require consultation with third-party experts, such as tax or legal counsel.

Costs incurred by the DRS for engaging these consulting services will only be reimbursed by the OSA if both parties agreed in writing to engage the outside expert or consultant. The written agreement must briefly describe the nature of the engagement, and include a reasonable estimate of the time and cost involved.



## Appendix Three | LEOFF Background

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## Brief Chronology of LEOFF

Prior to the formation of LEOFF, many police officers and fire fighters participated in retirement plans administered and paid for by local governments. (Research on pre-LEOFF plans was limited to the text of the RCW, both existing and repealed. There may have been other local government retirement systems that were not codified and thus did not appear in the research.) For example, fire fighters generally participated in the Firefighter's Relief and Pension Plans (FRPs), see RCW 41.16 et seq, and RCW 41.18 et seq. Local police officers in first class cities were allowed to participate in Police Relief and Pension Plans (PRPs),<sup>1</sup> while city police officers in non-first class cities could participate in the Statewide City Employees Retirement Plan (SCERS), see RCW 41.44 et seq.<sup>2</sup> Collectively, these plans are often called the "pre-LEOFF" plans.

### Pre-LEOFF Plans Merged – LEOFF 1 Created

In 1969, the Legislature created LEOFF to merge the various police and fire pre-LEOFF plans. On March 1, 1970, all the active police and fire personnel of the pre-LEOFF plans were transferred to the new LEOFF plan, while retired members remained in their respective pre-LEOFF plans (RCW 41.26.040).

When the pre-LEOFF plans were merged, members and employers contributed to the regular costs of the plan, while the state took on responsibility for paying the unfunded actuarial accrued liability (UAAL).

<sup>1</sup>See RCW 41.20 et seq. The PRP Plans included only police officers in first-class cities.

<sup>2</sup>The SCERS included general city employees, as well as police officers who are not serving in first-class cities.

## State Restructures Retirement Systems – LEOFF 2 Created

In 1977, the state restructured its pension systems, including LEOFF. The existing PERS, TRS, and LEOFF plans were closed to new members. Each of the closed plans was designated "Plan 1" (i.e. PERS Plan 1, TRS Plan 1, and LEOFF Plan 1), and all current members and retirees maintained their membership in their respective Plan 1.

At the same time, three new plans were created. These plans were designated "Plan 2" (i.e. PERS Plan 2, TRS Plan 2, and LEOFF Plan 2). These plans had different benefit and funding structures than the Plans 1. All newly hired employees became members of their respective Plan 2.

Both LEOFF Plan 1 and LEOFF Plan 2 were directly overseen by the Legislature. This meant, for example, that the Legislature determined funding policy and set contribution rates.

### WSIB Invests Contributions

The Washington State Investment Board (WSIB) was created in 1980, see RCW 43.33A et seq. Among its duties, the WSIB is responsible for investing the state's retirement funds, including member, employer, and state contributions. These retirement funds are commingled for investment purposes, but otherwise the funds in one plan cannot be used to pay benefits in another plan.

### JCPP and PFC Created To Serve In Advisory Roles

In 1987, the Legislature created the Joint Committee on Pension Policy (JCPP). The JCPP served in an advisory role, and was tasked with studying pension issues, developing pension policy, studying the financial condition of the pension systems, appointing the State Actuary,

and making recommendations to the Legislature, see RCW 44.44.060 (repealed by 2003 c 295).

The Pension Funding Council (PFC) was created by the Legislature in 1998. The duties of the PFC include adopting contribution rates, and any changes to economic assumptions (RCW 41.45.100 and 41.45.110).

### **Citizens Enact I-790 – LEOFF 2 Board Created**

In 2002, the citizens created the LEOFF Plan 2 Retirement Board (Board) by initiative (I-790). The Board has many duties, including serving as plan fiduciary, guiding policy, setting contribution rates for the LEOFF 2 retirement plan, and providing for the design and implementation of increased plan benefits (RCW 41.26.720 and 41.26.717).

The initiative that created LEOFF Plan 2 explicitly stated that the JCPP and PFC have no authority over LEOFF Plan 2, RCW 41.26.730 (repealed by 2003 c 295). Governance for LEOFF 1 remained with the Legislature, with the PFC and JCPP serving in advisory roles.

The LEOFF 2 Board membership includes member representatives (active and retired police officers and firefighters), employer representatives, and legislators (RCW 41.26.715).

Expenses for Board staffing and plan administration are paid out of the Plan 2 expense fund (RCW 41.26.732). The State Investment Board is authorized to invest the funds in the expense fund (RCW 41.26.732). Except for investment policy, the LEOFF 2 Board has authority to set all other policies related to this fund, subject to revision by the Legislature.

### **SCPP Replaces JCPP In Advisory Role**

In 2003, the JCPP was replaced by the Select Committee on Pension Policy (SCPP). The change was essentially one of membership (adding non-legislator members), as the duties of the committee stayed the same (RCW 41.04.281). Like the JCPP, the SCPP serves in an advisory role in LEOFF 1 governance, but does not have a role in LEOFF 2 governance. However, the SCPP may form a public safety subcommittee to study pension issues affecting members of the public safety plans, including LEOFF 1 and 2 (RCW 41.04.278[2][a]).

### **Summary of Plan Benefits**

As a general rule the members of LEOFF 1 and LEOFF 2 receive many of the same types of benefits, but the plans differ in how those benefits are calculated.

The basic benefit calculations provide an illustration of these differences in plan provisions: retirees of both plans receive a defined benefit calculated as 2 percent multiplied by the member's years of service and final average salary (FAS). However, the methods used to calculate FAS are different for each plan. For LEOFF 1, FAS is the basic salary attached to the position or rank the member held at the time of retirement, provided the member held that position for at least twelve months. For LEOFF 2, FAS is the member's salary average for the highest consecutive sixty months (five years).

Another difference in the benefit provisions for the two plans is that LEOFF 2 members do not receive medical benefits. LEOFF 1 members receive 100 percent of "necessary medical services" paid for by LEOFF 1 employers (RCW 41.26.050[1]), and these payments are made outside of the employer's normal pension contributions (and outside the pension trust fund). Please see OSA's Actuarial Valuation of LEOFF 1 Medical Benefits for additional information on LEOFF 1 medical benefits.

Summary of Plan Provisions - LEOFF		
	Plan 1	Plan 2
Effective Date of Plan	3/1/70	10/1/77
Date Closed to New Entrants	9/30/77	Open
Statutory Reference	Chapter 41.26 RCW	Chapter 41.26 RCW
Normal Retirement Eligibility (age/service)	50/5	53/5
Accrued Benefit Formula	Accrual % (1%, 1.5%, 2%) x YOS (5, 10, 20) x FAS	2% x YOS x AFC; 0.25% per month pre-retirement COLA with 20 years of service
Computation of FAS/AFC	The basic salary attached to the position or rank at retirement if held for at least 12 months	Average compensation earnable for the highest 60 consecutive months
Credited Service	Monthly, based on hours worked each month	Monthly, based on hours worked each month
Vesting	5 years	5 years
Vested Benefits Upon Termination	Refund of employee contributions plus interest, or deferred retirement allowance	Refund of employee contributions (x 150% if 10 YOS) plus interest, or deferred retirement allowance
Early Retirement Eligibility (age/service)	n/a	50/20
Early Retirement Reduction Factors	n/a	3% ERF with 20 YOS
Disability Retirement Benefit	50% FAS, (max 60% if children)	Non-duty: accrued benefit, actuarially reduced; Duty, occupational: accrued benefit without actuarial reduction, minimum 10% of AFC; Duty, total: 70% of AFC with offsets for Social Security and L&I benefits, not to exceed 100% of AFC
COLA	Full CPI*	Lesser of CPI* or 3%
Minimum Benefit per Month per YOS	n/a	n/a

\*CPI: Urban Wage Earners & Clerical Workers, Seattle-Tacoma-Bremerton, WA - All Items.

## Summary of Governance

LEOFF 1 and LEOFF 2 have different governance structures. The differences in governance structure fall under two categories: plan oversight, and disability and medical review.

### Plan Oversight

LEOFF 1 is governed directly by the Legislature.

## Summary of Membership and Demographics

The PFC adopts contribution rates and economic assumptions, subject to revision by the Legislature. The SCPP also serves in an advisory role, researching issues related to LEOFF 1, and making recommendations.

In contrast, the citizens created a fiduciary board by initiative to oversee LEOFF 2. While the extent of Board authority is ultimately subject to legislative revision, current statute provides the Board with independent authority to oversee the plan. This authority includes things like the adoption of contribution rates and economic assumptions.

### Medical and Disability Review Boards

In addition to general plan oversight, LEOFF 1 local disability boards determine what constitutes the “necessary medical services” discussed in the Benefits section, above. In contrast, LEOFF 2 members do not receive these medical benefits, and any LEOFF 2 disability determinations are made by the director of the Department of Retirement Systems (RCW 41.26.470).

As the name suggests, the disability review boards also determine whether or not a LEOFF 1 member is disabled for the purposes of receiving disability benefits. However, disability determinations for LEOFF 1 may no longer be as relevant as they were in the past. LEOFF 1 disability benefits equal 50 percent of final average salary (FAS), tax-free, with an additional 5 percent for each eligible dependent up to 60 percent of FAS. However, if an active member has over 30 years of service, an after-tax retirement benefit of over 60 percent of AFS would likely exceed the tax-free disability benefit. As of June 30, 2010, the average service for LEOFF 1 active members is over 35 years, so it is likely a member suffering a disabling injury or disease would retire rather than pursue a disability claim.

Despite the fact that the two plans are both composed of police and fire firefighters, the plans differ in terms of member demographics. This difference is mainly due to the fact that LEOFF 1 has been closed to new members since 1977. Thus all current members, both active and retired, must have first been employed as a police officer or firefighter over 30 years ago.

As a result, LEOFF 1 members and retirees are comparatively older than LEOFF 2 members. As of June 30, 2010, there are only 301 active members in LEOFF 1, with an average age of 59.5. Around 96 percent of LEOFF 1 members are retired, and all remaining active LEOFF 1 members are eligible for normal retirement. In the terminology of retirement plan life-cycles, LEOFF 1 is considered to be a mature plan.

In contrast, LEOFF 2 is an open and ongoing plan. While some members have been in the plan since its inception in 1977, it also adds new members every year, thus bringing down the average age for the plan. As of June 30, 2010, the average age for LEOFF 2 active members is 42.2, with almost 90 percent of the plan’s members active, the plan is considered a relatively young plan.

## 2011 LEOFF MERGER STUDY

Summary of Plan Participants						
LEOFF	2010			2009		
	Plan 1	Plan 2	Total	Plan 1	Plan 2	Total
<b>Active Members</b>						
Number	301	16,775	17,076	356	16,951	17,307
Total Salaries (millions)	\$29	\$1,490	\$1,519	\$33	\$1,443	\$1,476
Average Age	59.5	42.2	42.5	58.6	41.6	41.9
Average Service	35.4	13.3	13.7	34.5	12.7	13.1
Average Salary	\$96,686	\$88,828	\$88,967	\$93,679	\$85,097	\$85,274
<b>Terminated Members</b>						
Number Vested	1	781	782	2	672	674
Number "Non-Vested"	46	1,707	1,753	54	1,663	1,717
<b>Retirees</b>						
Number of Retirees (All)	8,008	1,639	9,647	8,087	1,367	9,454
Average Monthly Benefit, All Retirees	\$3,523	\$2,488	\$3,347	\$3,478	\$2,309	\$3,309
Number of New "Service Retirees"	57	237	294	68	199	267
Average Monthly Benefit, New "Service Retirees"	\$6,712	\$3,228	\$3,904	\$5,819	\$3,015	\$3,729

\*Includes disabled retirees for Plan 1 only.

## Appendix four | Legal Analysis

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## A. Ice Miller Analysis



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**Re: OSA Study**

Dear Dave, Aaron, Lisa and Anne:

This letter and attached materials have been prepared in response to Dave's e-mail of August 7, 2011 and our telephone conversation of August 22, 2011. This also includes additional questions and comments by Aaron dated September 20 and September 29, 2011.

It is our understanding that the Office of the State Actuary ("OSA") has been asked to perform a study of the merger of LEOFF Plan 1 and LEOFF Plan 2. OSA and the Washington Department of Retirement Systems ("DRS") will enter into an interagency agreement to provide resources for the study. OSA will be handling the actuarial analysis of the merger, but also needs to understand if such a merger would be possible from a federal law perspective. DRS has agreed to provide legal support on this issue through their contractual arrangement with Ice Miller LLP. OSA and DRS are also asking the Attorney General's office to provide a state law analysis.

Based upon the information that you have provided to us, we understand that we are to provide you with information from a federal law perspective on the following questions.

1. What are the tax and legal "ground rules" for a plan merger, generally?
  - a. If any public pension system wanted to merge plans, what issues should be considered?



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- b. Are certain actions prohibited, or potentially problematic?
  - i. For example, are systems prohibited from merging all assets and liabilities?
- 2. Is Ice Miller aware of any federal law issues specific to Washington?
  - a. Are there high-level issues that stand out based on Ice Miller's knowledge of Washington's retirement plans?
  - b. Does it matter if the LEOFF Plan 1 is merged into LEOFF Plan 2, or vice versa?

### **TERMINOLOGY**

Before responding to your questions, we want to consider the possible meanings of the word "merger." As discussed below, under the Internal Revenue Code ("Code") "merger" has a very distinct meaning – it is the actual merger of assets and liabilities into a single plan, where the assets and the liabilities are "usable" across the plan. However, policy makers may wish to consider other forms of joint administration of the two plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – DRS administers both LEOFF Plan 1 and LEOFF Plan 2 and the Washington State Investment Board handles the investments for both plans. However, there are differences in governance. For example, LEOFF Plan 2 is governed by the LEOFF Plan 2 Board of Trustees; LEOFF Plan 1 retains local disability boards.

### **OVERVIEW OF FEDERAL LAW - MERGER**

In this section of this letter we consider the "ground rules" for a plan merger – the rules that would apply to any merger of assets and liabilities in a governmental plan.

#### **Source of Guidance**

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. Governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are subject in many cases to pre-ERISA guidance from the Internal Revenue Service ("IRS"). Governmental plans may also follow ERISA provisions by analogy.

#### **Exclusive Benefit Rule**

Code § 401(a) requires that the plan of the employer be "for the exclusive benefit of [the employer's] employees or their beneficiaries . . . ." Therefore, the plan may not benefit a person other than the employees or their beneficiaries. Accordingly, the IRS has held that "funds

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accumulated under a qualified plan in trust are intended primarily for distribution to employee participants." Rev. Rul. 72-240, 1972-1 C.B. 108. This exclusive benefit requirement applies to all qualified pension plans, including governmental plans, and, therefore, must be considered in any plan merger.

### **Qualified Plan Status**

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. Therefore, in a merger of governmental plans, it is important to ascertain or confirm the qualified status of each plan prior to the merger, as well as the qualified status of the "surviving" plan.

### **Consideration of Termination Issues**

Pre-ERISA guidance also provides that, if the merger results in the termination of one plan, then all accrued benefits under the terminating plan must be 100% vested to the extent that benefits are funded. Code § 401(a)(7)(1974). Whether a plan is terminated is generally a question to be determined with regard to all the facts and circumstances in a particular case. A plan is not considered to be terminated merely because an employer consolidates or replaces that plan with a comparable plan. Treas. Reg. § 1.401-6(b)(1); Rev. Rul. 67-213, 1967-2 C.B. 149. A comparable plan is not necessarily one of the same type, but it is one of the same category (e.g., defined benefit vs. profit-sharing). Rev. Rul. 67-213 (citing Treas. Reg. § 1.381(c)(11)-1(d)(4)). Therefore, in a merger of qualified defined benefit plans, the IRS could find that the merged plans had not terminated, but that determination is based on all the facts and circumstances.

### **Participant Elections**

In some cases, policy makers wish to give plan participants the option of whether or not to be part of a merger. It is permissible to give participants the option of moving from one plan to another so long as there is no option to receive a distribution. Rev. Rul. 67-213. However, in a governmental plan, giving existing employees a choice among plans will currently not be approved by the IRS if the choice impacts the employees' pre-tax contributions. Revenue Ruling 2006-43, 2006-35 I.R.B. 329.

### **Assets/Liabilities**

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of assets and liabilities/benefits. Code Sections 401(a)(12) and 414(l) establish merger requirements for private sector plans, which requirements are intended to demonstrate compliance with the exclusive benefit rule. Government plans, such as LEOFF Plan 1 and LEOFF Plan 2, are not required to follow these merger rules. Treas. Reg. § 1.414(l)-1(a)(1). However, we believe that certain essential elements of these federal laws provide a good road map for a merger of plans and would demonstrate to the IRS the intent of

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the legislature to comply with the exclusive benefit rule. Code § 401(a)(12) provides that, in the case of a merger, consolidation or a transfer of assets or liabilities, each participant must receive benefits on a termination basis from the plan immediately after the merger or transfer which are equal to or greater than the benefits the participant would receive on a termination basis immediately before the merger, consolidation or transfer. See also Treas. Reg. § 1.414(l)-1(a)(2). A "merger" or "consolidation" means the combining of two or more plans into a single plan.... [A] merger or consolidation will not occur if two plans are not combined into a single plan, such as by using one trust which limits the availability of assets of one plan to provide benefits to participants and beneficiaries of only that plan." Treas. Reg. § 1.414(l)-1(b)(2).

A 'transfer of assets or liabilities' occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumption of these liabilities by another plan. For example, the shifting of assets or liabilities pursuant to a reciprocity agreement between two plans in which one plan assumes liabilities of another plan is a transfer of assets or liabilities. However, the shifting of assets between several funding media used for a single plan (such as between trusts, between annuity contracts, or between trusts and annuity contracts) is not a transfer of assets or liabilities.

Treas. Reg. § 1.414(l)-1(b)(3). The term "benefits on a termination basis" means the benefits that would be provided exclusively by the plan assets pursuant to ERISA § 4044 and the regulations thereunder if the plan terminated. Treas. Reg. § 1.414(l)-1(b)(5). As noted above, for governmental plans, the pre-ERISA minimum vesting standards require 100% vesting of benefits accrued to the date of termination upon normal retirement and upon plan termination or discontinuance of employer contributions.

### **Benefit Changes**

To the extent that a merger results in there being benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law. However, from a federal law perspective, the accrued benefit of a plan member who has reached normal retirement age under the plan must be protected.

### **Plan Terms**

Any qualified plan must follow its written terms and conditions. Thus, any transaction, such as a merger, must be reflected in each involved plan's terms via an amendment. This must be done before the merger occurs. The terms of the merger could be that one plan merges into the other. Alternatively, the terms could be that a new plan is created and both existing plans would merge into the new plan.

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**Taxation**

To confirm that the merger of one plan into another does not have a taxation impact on the members, our clients have typically sought a private letter ruling ("PLR") from the IRS.

**On-going Compliance Post Merger**

After the merger, the merged plans must be maintained in compliance with Code Section 401(a).

**OVERVIEW OF FEDERAL LAW – CONSOLIDATION**

In the case of consolidation, the exclusive benefit rule must be applied – in that the plan assets of one plan could only be used for the benefit and expenses attributable to that plan.

In a consolidation, the above described issues of maintenance of qualified status, participant elections, and plan terms would still need to be considered. However, consolidation does not raise issues with regard to vesting and valuation of benefits on a termination basis.

**CONSIDERATION OF SPECIFIC ISSUES**

Based upon our discussions with you, we understand that the proposed transaction could be any of the following (we have shown what we assume are the most likely scenarios). The attached chart addresses how these scenarios should be considered.

**Merger of LEOFF 1 and LEOFF 2:**

- LEOFF 1 → LEOFF 2 (merger of assets and liabilities; no change in benefits)
- LEOFF 2 → LEOFF 1 (merger of assets and liabilities; no change in benefits)
- LEOFF 1 → LEOFF 2 (new tier with new benefits formula and/or benefit provisions and all assets and liabilities merged)

Under the Pre-ERISA rules, the merger of one plan into another plans would not be considered a termination if a qualified plan is replaced by a comparable plan (a plan of the same type) and so long as the plan assets are not distributed to the members. Therefore, from a termination perspective, it will not matter if LEOFF Plan 1 is merged into Plan 2 (or vice versa), because two conditions are met:

1. Both LEOFF Plan 1 and LEOFF Plan 2 are the same type of plan – qualified defined benefit plans under IRC Section 401(a); and
2. No distribution will be made of plan assets to active participants.

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Using Code § 414(I) as a guide, participants must be entitled to receive the same benefit after a merger or transfer of assets as they would have received before the merger. The calculation of those benefits is done on a termination basis. So, under the 414(I) model, the benefits have to be tested as though there had been a termination, even though there is not a termination. This testing of benefits would apply if LEOFF Plan 1 is merged into LEOFF Plan 2 (or vice versa).

If the merger of the two plans results in a lower cost and thus a lower required contribution rate, federal law would not dictate whether the employers' or the employees' contributions were adjusted. That would be a matter of state law and plan design.

**Merger of LEOFF 1 and LEOFF 2 into a New LEOFF:**

LEOFF 1 and LEOFF 2 → New LEOFF (new tier(s) with new benefits formula and/or provisions; assets and liabilities merged)

If the two plans were to merge into a single new LEOFF Plan 3, policy makers could choose that the benefits could stay exactly the same (two tiers incorporating current provisions), or there could be a new structure with new benefits (for example, all LEOFF Plan 3 members have the same retirement eligibility, *etc.*)

We understand the Washington AG's office is going to be advising with respect to whether benefits can be changed as part of the merger from a state law perspective.

From a federal tax law perspective, a plan participant who has reached normal retirement age or reached other vested status under the plan must be vested in his accrued benefit as of that date. It is our understanding that every participant in LEOFF Plan 1 has reached normal retirement age under the terms of the plan and has met all requirements for vesting. If our understanding is correct, then benefits accrued to date for participants in LEOFF Plan 1 cannot be changed in any merger. To the extent that participants in LEOFF Plan 2 have reached normal retirement age and met requirements for vesting, those benefits accrued to date also cannot be changed. Therefore, any benefit change that is adopted as part of a merger could only affect new members, non-vested members, and vested members prospectively.

**Consolidation:**

LEOFF 1 and LEOFF 2 → New LEOFF consolidation of administration of benefit plans; no change in benefits; with on-going segregation of assets and liabilities.

From a federal tax law perspective, there would be fewer issues to address – primarily the exclusive benefit rule.

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**IRS APPROVAL**

If some type of merged or consolidated plan is passed by the legislature, then we recommend that DRS and/or the LEOFF Plan 2 Board seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. This would be done in the next Cycle C, which opens February 1, 2013 and closes January 31, 2014. That would likely result in a 2015-2016 determination letter issuance.

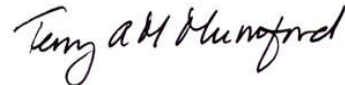
If some type of transfer is passed by the legislature, then we also recommend that DRS and/or the LEOFF Plan 2 Board seek a PLR to confirm that the transfer does not result in any tax consequences to any affected members.

Very truly yours,

ICE MILLER LLP



Mary Beth Braitman



Terry A.M. Mumford

/jls  
Attachment

**CIRCULAR 230 DISCLOSURE**

Except to the extent that this advice concerns the qualification of any qualified plan, to ensure compliance with recently-enacted U.S. Treasury Department Regulations, we are now required to advise you that, unless otherwise expressly indicated, any federal tax advice contained in this communication, including any attachments, is not intended or written by us to be used, and cannot be used, by anyone for the purpose of avoiding federal tax penalties that may be imposed by the federal government or for promoting, marketing, or recommending to another party any tax-related matters addressed herein.

WASHINGTON DEPARTMENT OF RETIREMENT SYSTEMS  
AND THE OFFICE OF THE STATE ACTUARY

CHECKLIST FOR PLAN MERGER OR CONSOLIDATION OF  
LEOFF PLAN 1 AND LEOFF PLAN 2

Step 1: Critical Initial Considerations

Action Item	Status
<p>A. <u>Only plans that are qualified under IRC § 401(a) can be merged. Is each plan a qualified plan?</u></p>	<ul style="list-style-type: none"> <li>• LEOFF Plan 1 and Plan 2 both received favorable determination letters dated 6/20/11. VCP corrections still need to be completed.</li> <li>• Because both plans have received favorable determination letters, this action item is completed unless there are new significant changes to either plan at or before the merger, in which case the ongoing status of that plan would have to be re-analyzed. In addition, if they are both merged into a new plan, that plan should be submitted for its own determination letter.</li> </ul>
<p>B. <u>Will the merger in effect mean that one or both of the plans is treated as having terminated?</u></p> <ol style="list-style-type: none"> <li>1. Under pre-ERISA guidance, a governmental plan must provide for 100% vesting of accrued benefits at the date of termination if there is a plan termination (partial or complete) or complete discontinuance of contributions, but only to the extent that benefits are funded. Code § 401(a)(7)(1974).</li> <li>2. Under IRS guidance for private sector plans, participants in a merging plan must not suffer a diminution of benefits calculated as of the date of the merger.</li> <li>3. To the extent any employees would be eligible for lump sum distributions from either plan on account of termination, retirement, death or disability, an analysis of the valuation</li> </ol>	<ul style="list-style-type: none"> <li>• Every active participant in LEOFF Plan 1 is eligible for retirement. Therefore, if LEOFF Plan 1 merges into LEOFF Plan 2, then all participants in LEOFF Plan 1 will have a nonforfeitable benefit in at least their benefits as of the date of merger, and we expect also their benefit accrued (under the merged plan's accrual structure) after the date of the merger.</li> <li>• If both plans are merged into a new plan, then the issues of termination/merger will have to be considered for both. We think one approach that should be considered is to follow the private sector general concept that each participant would be vested in their accrued benefit as of the date of the merger at a minimum. In addition, we would expect that</li> </ul>

Action Item	Status
<p>techniques would be necessary to consider termination basis valuation.</p>	<p>those vested before the merger would immediately be vested in benefits accrued after the merger (under the new Plan's accrual structure).</p>
<p>C. <u>Will participants be given an election to transfer?</u>                      If transferring plan is not terminating, the participants could be given an election whether to transfer (although we realize this may defeat some of the advantages of a merger). While the participant cannot have the option to receive the benefit directly, he or she may be given the option of leaving the benefit in the existing plan or transferring it to the new plan. Rev. Rul. 67-213; PLR 200411046; PLR 200130057.                      Where an employer consolidates or replaces a plan with a comparable plan there is not a plan termination. Treas. Reg. § 1.401-6(b)(1). Thus, in these situations the participants can be automatically transferred rather than given an election. However, Rev. Ruling 2006-43 would not currently permit existing employees to have a choice of plan membership if that choice affects member contribution levels.</p>	<ul style="list-style-type: none"> <li>• This will be a matter of plan design and will be controlled by legislation.</li> <li>• As the terms of any legislative proposal take shape, the plan termination issue should be reviewed, as well as whether any elective provisions are desired and are possible under then current IRS guidance.</li> </ul>
<p>D. <u>A merger can only be accomplished if plans are amended to provide for merger. Does each plan allow for the merger?</u>                      Revenue Ruling 67-213 allows transfers between qualified plans. However, as a prerequisite, the plans at issue must permit the transfer.</p>	<ul style="list-style-type: none"> <li>• Plan amendments via legislation would be needed to authorize the merger. The legislation should designate which plan is the "surviving plan" or alternatively, that a new plan is being created that encompasses both prior plans.</li> <li>• Plan amendments via legislation would likely be needed for consolidation.</li> </ul>
<p>E. <u>A review of the overall transaction must be completed to ensure that the merger does not violate the exclusive benefit rule.</u>                      That would be done based on the precise terms and conditions of the contemplated transaction. This would involve considerable focus on whether the transaction contemplated is a true merger.</p>	<ul style="list-style-type: none"> <li>• As the terms of any legislative proposal takes shape, the true nature of the transaction must be identified: a merger, a termination, a consolidation for administrative purposes only, etc.</li> </ul>



Action Item	Status
<p>F. <u>Merged or consolidated plan or new plan must be maintained in compliance with IRC.</u></p>	<ul style="list-style-type: none"> <li>• DRS/LEOFF Plan 2 will need to continue monitoring IRC requirements.</li> <li>• DRS/LEOFF Plan 2 will need to submit merged or consolidated plan for new determination letter in the next Cycle C (February 1, 2013 to January 31, 2014). This may require additional amendments.</li> </ul>
<p>G. <u>Participants in transferred plan should not have a taxable event.</u></p>	<ul style="list-style-type: none"> <li>• DRS/LEOFF Plan 2 should consider private letter ruling (PLR) related to merger or consolidation.</li> </ul>

**Step 2: Administration/Design Review**

Action Item	Status/Issues
<p>A. Draft amendment of the plan(s), as needed, to comply to document transaction.</p>	
<p>B. Work with actuary and trustee(s) to establish timeline for "transfer" of assets.</p>	
<p>C. Prepare communication with employees (and union representatives, if applicable) to explain transaction.</p>	

## B. Attorney General Analysis



Rob McKenna

### ATTORNEY GENERAL OF WASHINGTON

7141 Cleanwater Drive SW • PO Box 40108 • Olympia WA 98504-0108

October 14, 2011

Mr. Aaron Gutierrez  
Office of the State Actuary  
M/S: 40914  
Olympia, WA 98504-0914

**RE: Proposed Legislation for LEOFF I / LEOFF II Merger/Consolidation**

Dear Mr. Gutierrez:

You have asked our office to comment on state legal issues concerning the LEOFF I and LEOFF II merger study now being performed by the Office of the State Actuary. At this stage of the proceedings, we can give only generalized comments given that there is no specific legislation currently available for review. In addition, some of the issues that possibly may be raised in the merger involve legal issues that currently the Office of the Attorney General is in the process of litigating in other pension system-related lawsuits (Gain Sharing and Uniform COLA) and we cannot render opinions on issues that may have an unforeseen impact on the pending litigation.

Suffice it to say, if history is any guide, mergers and consolidations of pension plans are legal methods in this state for managing and operating a pension system. In 1969, ESSB No. 74 was passed by the Legislature establishing the LEOFF I pension system. The new system was designed to cover law enforcement and firefighters who were already employed in such capacities as of March 1, 1970, as well persons newly employed therein after that date. Most of these people were already participating in one of several preexisting public employees' pension systems which had been established by previous Legislatures; for example, the Washington public employees system, RCW 41.40; the state-wide city retirement system, RCW 41.44 (which itself was merged into the Washington public employees, RCW 41.40, on January 1, 1972); the pension system for volunteer firefighters, RCW 41.24; the municipally operated pension systems for paid firefighters, RCW 41.16 and RCW 41.18; and finally, the pension systems for first class city police officers, RCW 41.20. Pursuant to court precedent which I will discuss later on, the Legislature, in transferring these individuals to the new LEOFF system, made provision for the preservation of "vested rights" which these persons had already acquired based on their past service in the aforementioned retirement systems. In particular, the Legislature, in the codification of the 1969 LEOFF Act, said in RCW 41.26.040(2) that there would be no reduction in benefits. If there were any excess benefits computed to be due under the old systems, then those payments were to be made by the old systems to the employees. There were no general

## ATTORNEY GENERAL OF WASHINGTON

Mr. Aaron Gutierrez  
October 14, 2011  
Page 2

legal challenges to the LEOFF creation based on the vested rights doctrine which, as outlined above, the Legislature was careful not to transgress.

Any merger or consolidation involving public employee pension rights must not violate the “vested rights” doctrine announced in the seminal case of *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 701, 296 P.2d 536 (1956). In that case, the Washington Supreme Court stated:

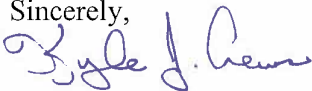
[T]he employee who accepts a job to which a pension plan is applicable contracts for a substantial pension and is entitled to receive the same when he has fulfilled the prescribed conditions. His pension rights may be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity.

Of course, it well known that there has been a vast amount of litigation over the past 50 years concerning just what changes can be made to a state pension system that does not run afoul of the *Bakenhus* test. The problem lies in the fact that while pension statutes are not in themselves contracts, they may provide the right to receive certain benefits that constitute deferred compensation for services rendered. *Noah v. State*, 112 Wn.2d 841, 774 P.2d 516 (1989). The vested rights to these pension benefits are thus often protected from subsequent impairment. This vesting as explained in *Noah* refers to “the contractual right to a pension substantially in accord with the statutes as they existed when the employee begins service.” The substance of constitutional protection granted by *Bakenhus* would mandate that the results of any merger or consolidation of the LEOFF I and II Plans would (1) uphold the reasonable expectations of the member or beneficiary and (2) not be seen as a renegeing on the promise originally made to the members when they joined the pension system.

Whether this issue comes down to a merger of LEOFF I into LEOFF II, a merger of LEOFF II into LEOFF I, a consolidation of both plans into a new entity, or some other statutory scheme to combine the systems, it is clear that initially there is constitutional authority for the Legislature to bring the systems together. However, as we preliminarily indicated at the beginning of this memorandum, without the exact language of a draft proposal for legislation, we cannot give any definitive answers as to the legality of such a plan to combine the present systems.

I hope this letter will be of assistance to you. The analysis and opinion provided herein is my own and is not an official opinion of the Attorney General or this office.

Sincerely,



KYLE J. CREWS  
Assistant Attorney General



## Appendix Five | Actuarial Analysis

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## Office of the State Actuary

*“Securing tomorrow’s pensions today.”*

### Actuarial Certification

### 2011 LEOFF Merger Study

**December 13, 2011**

This report documents the results of actuarial analysis performed by the Office of the State Actuary (“we”) concerning a hypothetical merging of the Law Enforcement Officers’ and Fire Fighters’ Retirement System (LEOFF) Plan 1 and Plan 2 into a single retirement plan. We prepared this analysis for the Washington State Legislature according to the requirements of 2ESHB 1087 (Chapter 50, Laws of 2011). However, I understand that other readers will use the information in this public report. I advise such readers to review the primary purpose of the report, not use the report for other purposes, and to seek professional guidance in their interpretation of the report.

The primary purpose of this actuarial analysis is to identify and quantify the key financial impacts and financial risks surrounding a hypothetical LEOFF merger through use of a customized and dynamic asset-liability model. The results of our analysis would likely change if a future merger proposal varies from the hypothetical merger we defined for this study. This analysis does not address all risks to the LEOFF retirement system, nor does it address all possible merger scenarios available to the Legislature. We intend readers to use the results of this study to evaluate which issues require additional analysis prior to further consideration of a potential merger.

The results of this analysis will change in the future as actual experience emerges. Please replace this report in the future if and when we publish a more up-to-date merger study or subsequent analysis on a defined merger proposal.

The actuarial analysis in this study involved a projection of future actuarial valuation results using stochastic methods on an open-group basis (projection includes future new entrants). Please see the *2010 Actuarial Valuation Report (AVR)* for the data, assumptions, and methods used in determining the initial actuarial valuation results for this projection. Please see the *2010 Risk Assessment Report* for a description of the data, assumptions, and methods used to project actuarial valuation results beyond the initial results of the 2010 AVR. Please see the body and appendices of this report for a description of the other assumptions and methods we used to complete our analysis.

The asset data we used reflects investment returns through June 30, 2011. The results of our risk analysis depend heavily on the market value of assets at the measurement date. Should the market value of assets change significantly following June 30, 2011, the results of this analysis may significantly change as well.



The Department of Retirement Systems provided unaudited 2010 member and beneficiary data to us. We checked the data for reasonableness as appropriate based on the purpose of this analysis. The Washington State Investment Board (WSIB) provided audited asset information as of June 30, 2011. We relied on all the information provided as complete and accurate. In my opinion, this information is adequate and substantially complete for purposes of this analysis.

We relied on the capital market assumptions (CMAs) from WSIB to perform our asset projections. We reviewed the CMAs for reasonableness as appropriate based on the purpose of this analysis. In my opinion, the CMAs are reasonable for purposes of this analysis.

The analysis summarized in this report involves the interpretation of many factors and the application of professional judgment. I believe that the data, assumptions, and methods used in the underlying analysis are reasonable and appropriate for the primary purpose stated above. The use of another set of data, assumptions, and methods, however, could also be reasonable and could produce materially different results. Another actuary may review the results of this analysis and reach different conclusions.

Consistent with the actuarial Code of Professional Conduct, I must disclose any potential conflict of interest. According to current state law, the Office of the State Actuary (OSA) provides actuarial assistance to both the Legislature and the LEOFF Plan 2 Retirement Board (the Board). The requirement to provide actuarial assistance to both parties does not impair my ability to act fairly. Furthermore, the Legislature mandated OSA to perform this study. The requirement to complete this study and provide actuarial assistance to the Board does not impair my ability to act fairly. I have performed all actuarial analysis of the hypothetical merger without bias or influence.

In my opinion, all methods, assumptions, and calculations are reasonable and are in conformity with generally accepted actuarial principles and applicable standards of practice as of the date of this publication.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein and is available to provide extra explanations as needed.

Sincerely,

Matthew M. Smith, FCA, EA, MAAA  
State Actuary



## Measures: Current Law vs. Past Practices

When we use the term Current Law in our analysis, it means that we assume there will be no future benefit improvements for members of either LEOFF plan, and that all future required contributions will be paid in full. Otherwise, we randomly varied all of the other assumptions described in the *2010 Risk Assessment Report* (RA) to generate Current Law results.

When we label exhibits with the term Past Practices, we use the same set of assumptions that we use for the Current Law results except we add random assumptions about future benefit improvements and percent of required contributions made. These random assumptions are based on historical data and are described in the RA.

Each exhibit in this report specifies whether the results are based on Current Law or Past Practices. However, in general, all graphs and tables showing projected funded status, projected contribution rates, and risk and amount of pay-go represent Past Practice results.

Tables in the main body of the report showing 2013-15 contribution rates and total pension contributions represent Current Law results. In other words, they assume there will be no future benefit improvements, and that all required contributions will be fully paid. For those interested in seeing contribution rate and pension contribution tables based on Past Practices, we provide those exhibits later in this appendix (Additional Exhibits section).

## Data, Assumptions, and Methods

We used the same data, methods, and assumptions as disclosed in the 2010 Actuarial Valuation Report (AVR) to find the initial actuarial valuation results for all of our projections. In all scenarios, the asset data

reflects actual investment returns through June 30, 2011.

The assumptions and methods we used to project future actuarial valuation results varied for each scenario as described below.

Our risk model is designed to generate varying results based on changes to a number of economic assumptions. We used the same data, methods, and assumptions in our risk model for this report as we described in the Risk Assessment with few exceptions. When calculating the chance of pay-go for each plan, we used the threshold value of \$25 million instead of \$50 million in annual benefit payments to determine whether or not a plan was in pay-go status for this report. In other words, if a plan exhausts its trust fund with less than \$25 million in annual benefit payments, we did not include the outcome as pay-go status. Any other exceptions to methods or assumptions for the risk model are disclosed below.

### Before Merger

We assumed that if LEOFF 1's UAAL were to re-emerge, the prior funding policy would resume. That is, members would contribute 6 percent of salary, employers would pay 6 percent of salary, and the state would be responsible for paying the UAAL contribution rates consistent with the funding method described in the 2010 AVR.

### Hypothetical Merger

For the base Hypothetical Merger, we assumed liabilities and assets would be merged, but that the benefit structure in each plan would remain unchanged (not reduced). We also assumed no change to the current governance structure.

We assumed a funding policy similar to that of LEOFF 2, but with a contribution rate floor based on 80 percent of the EANC rate instead of the long-term rate floor of 90 percent currently in place. We assumed contribution rates would be determined using the Aggregate funding

method on the combined assets and liabilities. Contributions would be collected over all salaries, regardless of which plan a member is in, and apportioned according to LEOFF 2's current cost-sharing policy:

- ❖ Fifty percent member.
- ❖ Thirty percent employer.
- ❖ Twenty percent state.

We further assumed in our risk model that future benefit improvements under the Hypothetical Merger (for combined benefits) would occur at the same rate as those for LEOFF 2 in the Before Merger scenario.

We combined assets and liabilities and applied the funding policy as described in the Assumptions section above.

### **Alternate Funding Policy 1: Zero Percent Contribution Rate for LEOFF 1 Members**

We used the same methods and assumptions as described for the Hypothetical Merger scenario, with one exception. We calculated contribution rates over all salaries, but we assumed no contributions would come from LEOFF 1 members.

### **Alternate Funding Policy 2: Maximum Contribution Rate for LEOFF 2 Members**

We used the same methods and assumptions as described in Alternate Funding Policy 1, except we applied a maximum contribution rate for LEOFF 2 members. We chose a maximum rate we believed would protect members from additional risk due to the merger, without over-protecting them from the economic risks inherent in LEOFF 2 before the merger. We used 20 percent as the maximum rate because it was the highest contribution rate in the 90th percentile of our Current Law simulations. We

assumed any excess contributions not collected from members due to the maximum contribution rate would be collected from employers instead. We also assumed the maximum LEOFF 2 member rate would increase by 50 percent of the cost of future benefit improvements when we performed risk analysis under Past Practices.

### **Alternate LEOFF 1 Funding Policy**

For this scenario (described in the next section), we assumed that the LEOFF 1 funding policy would be similar to the policies currently in statute for the Public Employees' Retirement System (PERS) Plan 1 and the Teachers' Retirement System (TRS) Plan 1. We assumed no Plan 1 contributions as long as LEOFF 1 remains in a fully-funded state. If LEOFF 1 drops below a 100 percent funded status, the unfunded liability would be amortized over a rolling ten-year period, using a minimum contribution rate of 4 percent. Please see the 2010 AVR for other details surrounding the funding policy for PERS 1 and TRS 1.

For this scenario only, we assumed the following cost-sharing policy.

- ❖ LEOFF 1 members: 6 percent.
- ❖ LEOFF 2 members: 50 percent of LEOFF 2 normal cost rate.
- ❖ Employers: 30 percent of LEOFF 2 normal cost rate (over all salaries).
- ❖ State:
  - ✦ Twenty percent of LEOFF 2 normal cost rate (over LEOFF 2 salaries).
  - ✦ LEOFF 1 UAAL rate (over all LEOFF salaries).

We applied the assumptions and funding policy described above to our risk model and measured the resulting change to each risk measure itemized in this report.

## Some Questions Answered

### What about Demographic Experience?

The study mandate calls for measures, “... based on a range of possible economic and demographic experience...” However, our risk assessment model is not currently designed for varying demographic assumptions. Instead, we focused on varying economic scenarios and funding policies for this report.

### What about the Actuarial Fiscal Note for HB 2097?

The analysis we performed for HB 2097 (2011 Legislative Session) was based on a specific merger proposal outlined in that bill. The assumptions and methods we used in that fiscal note were selected as our best estimates based on that proposal. In addition to the proposed merger, HB 2097 called for a modified short-term funding policy on state contribution rates only. The hypothetical merger we describe in this report does not line up with the proposed merger in HB 2097. Finally, the results of the fiscal note were based on liabilities and data from the 2009 AVR, while this report is based on the results of the 2010 AVR. Therefore, the two sets of analysis are not consistent and direct comparisons between the two sets are of limited value.

### Did Economic Assumptions Recently Change?

Economic assumption changes were recently adopted for both plans. In October 2011, the Pension Funding Council adopted changes to economic assumptions for LEOFF 1. In November 2011, the LEOFF Plan 2 Retirement Board adopted economic assumption changes for LEOFF 2. The analysis in this report was based on economic assumptions in place prior to October 2011. This is consistent with the

2010 AVR and the economic assumptions listed in statute. The conclusions and findings of our analysis would not materially change if we used the new assumptions.

### Is a Merger the Only Approach for Managing Risk?

A full merger of plans is not the only course of action available. How policy makers pursue changes to LEOFF will likely depend on their goals. In the main body of this report, we presented a Hypothetical Merger along with variations of that merger, which can help manage an assortment of risks. However, if the goal is to manage a specific risk, other policies can be changed to reach that goal.

#### Alternate LEOFF 1 Funding Policy

An example of a single risk that could be managed without merging plans is LEOFF 1 pay-go risk. In the Actuarial Analysis section, we mentioned this idea. If policy makers want to solely manage the risks associated with LEOFF 1 pay-go, they could consider changing the LEOFF 1 funding policy to accomplish this goal.

We studied this possibility by implementing a funding policy for LEOFF 1 like those in place for PERS 1 and TRS 1. Those plans use a variation of the Entry Age Normal Cost method, which amortizes the Unfunded Actuarial Accrued Liability (UAAL) over a rolling ten-year period when the plans are less than fully funded. Please see the 2010 AVR for the details of this funding method.

Since LEOFF 1 is currently in a surplus state, this funding method does not require contribution rates to be collected for LEOFF 1 at this time. If an unfunded LEOFF 1 liability does reappear, contribution rates will become effective for as long as the plan has an unfunded liability.

As with the other scenarios we analyzed in this study, we had a number of assumptions and policies to set. Please note that this funding

## 2011 LEOFF MERGER STUDY

policy is one of many that could be used to specifically target pay-go risk in LEOFF 1. The exact policy chosen would depend on decision makers' risk tolerance, among other considerations outlined in this report. We assumed a cost-sharing policy as described in the Assumptions and Methods section above.

We used a LEOFF 1 UAAL contribution rate floor of 4 percent, when LEOFF 1 UAAL rates are required, for this policy. Use of a different rate floor would produce different results. One way for decision makers to manage risk in this policy would be to change the length of the rolling amortization period. A shorter period would

require higher contribution levels, while paying off unfunded liabilities more quickly. Policy makers could also choose to charge the UAAL rate to employers, rather than allocate UAAL contributions from state funds. In either case, the same total contributions would be calculated - the only difference would be the source of the contributions.

The exhibits that follow show the projected results of the alternate LEOFF 1 funding policy. This policy does not change measures affecting LEOFF 2. For complete disclosure, LEOFF 2 exhibits under this policy will be displayed below in the Additional Exhibits section.

**Figure 5a - Funded Status LEOFF 1, Alternate LEOFF 1 Funding Policy**

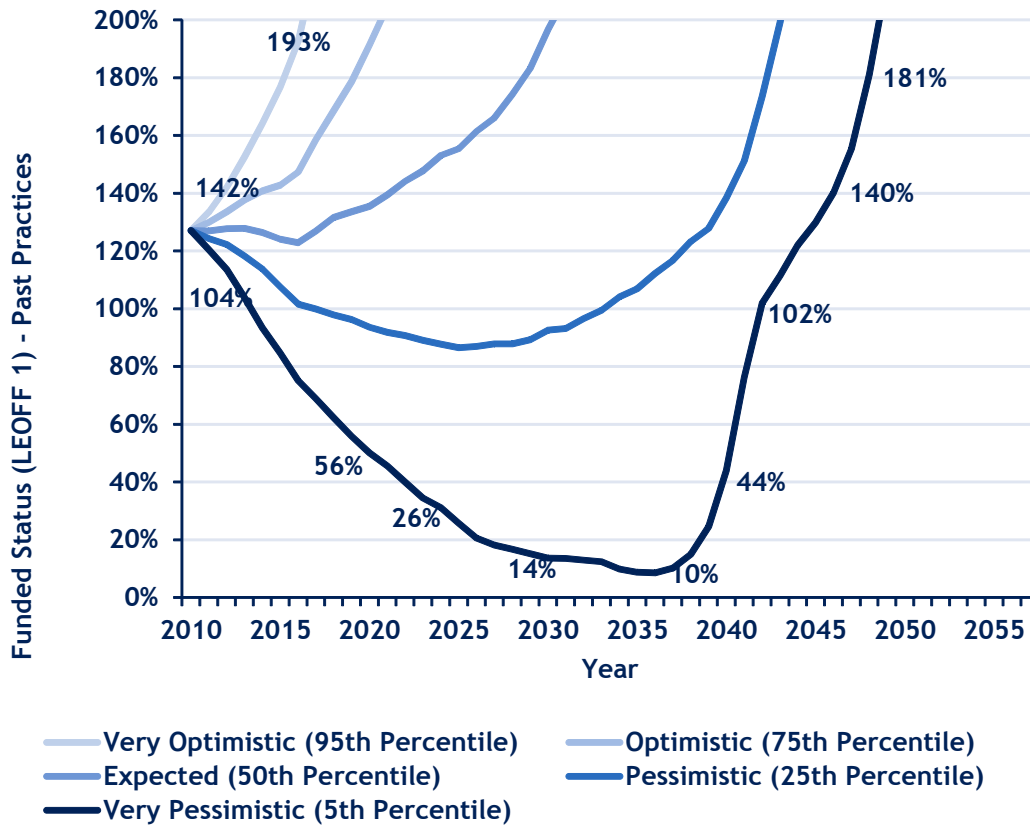


Figure 5a shows that under the alternate LEOFF 1 funding policy, the projected LEOFF 1 funded status goes near 0 percent around 2035 in the very pessimistic outcome, but it does not drop to 0 percent.

**Figure 5b - Contribution Rates LEOFF 1, Alternate LEOFF 1 Funding Policy**

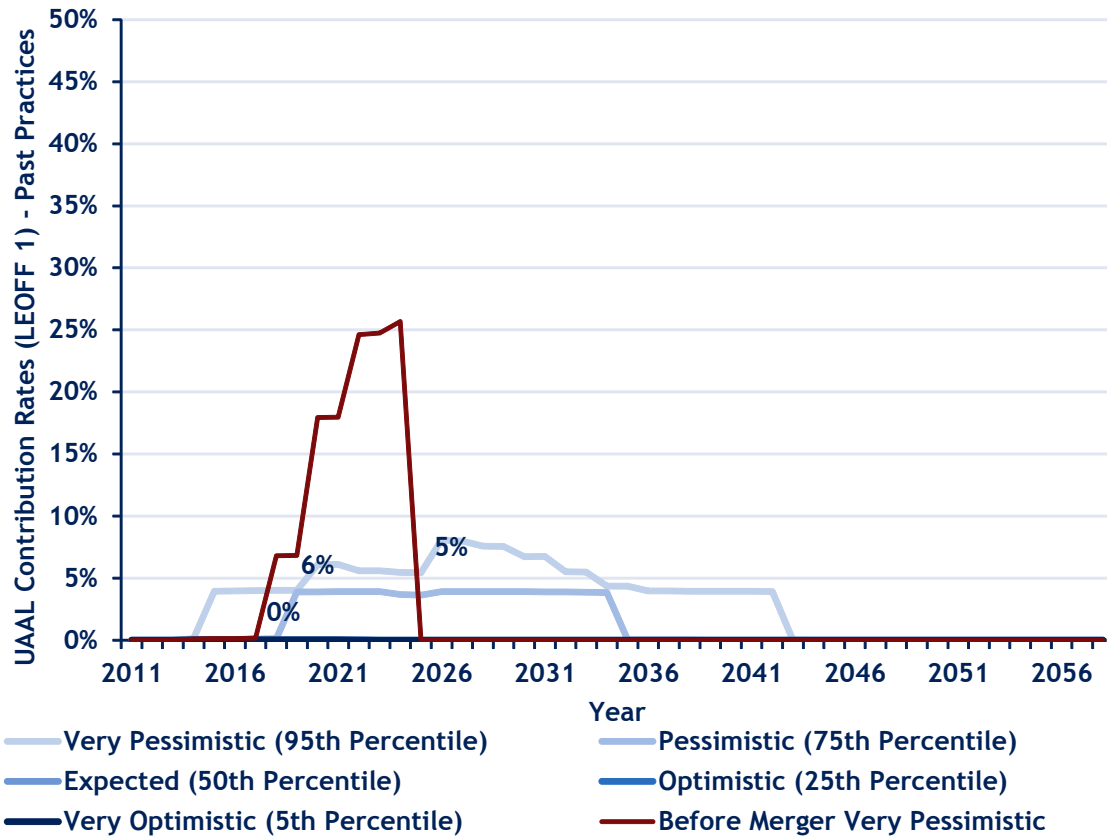


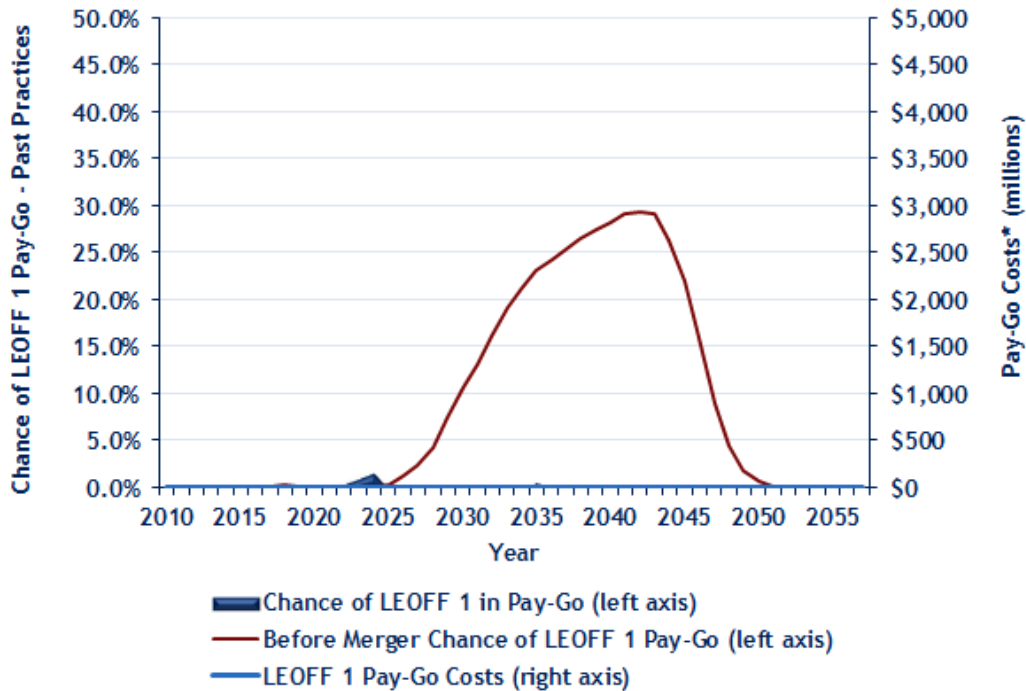
Figure 5b displays projected UAAL contribution rates and includes the very pessimistic UAAL rate curve from the Before Merger scenario (red line) for comparison. Here we can see that the rolling ten-year amortization period, combined with the 4 percent contribution rate floor, results in lower, more steady contribution rates with a longer collection period than the Before Merger policy provides.

**2011 LEOFF MERGER STUDY**

The following figures speak to the goal of this policy change. Here we see that the risk of pay-go has been virtually eliminated, even in the most pessimistic economic outcomes. The

red curve in figure 5c represents the chance of pay-go under the Before Merger scenario for comparison.

**Figure 5c - Pay-Go LEOFF 1, Alternate LEOFF 1 Funding Policy**



\*Pay-Go Costs on Top of Normal Pension Costs.

**Figure 5d**

LEOFF 1 Chance/Amount of Pay-Go - Select Years - Past Practices Alternate LEOFF 1 Funding Policy		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.0%	\$0
2017	0.0%	\$0
2020	0.2%	\$0
2023	0.6%	\$0
2026	0.3%	\$0
2029	0.4%	\$0
2032	0.1%	\$0
2035	0.2%	\$0
2038	0.0%	\$0
2041	0.0%	\$0
2044	0.0%	\$0
2047	0.0%	\$0
2050	0.0%	\$0
2053	0.0%	\$0
2056	0.0%	\$0

\*Millions.

Finally, we see the contribution rates and the change in total pension contributions from the Before Merger scenario. Since LEOFF 1 is not expected to come out of its surplus status in expected and optimistic outcomes, we only see an increase in contributions under pessimistic outcomes. There is an increased cost under this policy because we trade possible pay-go costs that occur after the funding policy ends under the Before Merger scenario (after 25 years), with pre-funding costs designed to avoid pay-go

in this scenario. If decision makers wanted to mitigate pay-go risk without virtually eliminating it, they could opt for a lower contribution rate floor or a different amortization period. In this scenario we reduced the risk of pay-go, but the trade-off would be contributing more money up-front to avoid that risk. The long-term fiscal cost savings of this alternate LEOFF 1 funding policy would occur after the 25-year period displayed below.

**Figure 5e**

Contribution Rates Alternate LEOFF 1 Funding Policy			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
<b>Employee</b>			
Plan 1	0.00%	0.00%	0.00%
Plan 2	8.46%	8.46%	8.46%
<b>Employer</b>			
Current Annual Cost	5.08%	5.08%	5.08%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>5.08%</b>	<b>5.08%</b>	<b>5.08%</b>
<b>State</b>			
Current Annual Cost	3.38%	3.38%	3.38%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>3.38%</b>	<b>3.38%</b>	<b>3.38%</b>

**Figure 5f**

Change in Total Pension Contributions* - Alternate LEOFF 1 Funding Policy			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>2013-2038</b>			
General Fund	\$0.0	\$0.0	\$374.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$374.0</b>
Local Government	0.0	0.0	0.1
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$374.1</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.1</b>

\* Compared to Before Merger scenario.

Assumes plan(s) will be funded at the actuarially required level and that no benefit improvements will occur in the future.

## Additional Exhibits

The following exhibits were omitted from the main report for the reasons stated in the main body of the report. We provide them here for additional detail.

### Before a Merger

**Figure a1**

<b>Contribution Rates</b>			
<b>Before Merger - Past Practices</b>			
<b>2013-2015 State Budget</b>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>Employee (Plan 2)</b>	8.30%	8.40%	8.94%
<b>Employer</b>			
Current Annual Cost	4.98%	5.04%	5.36%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>4.98%</b>	<b>5.04%</b>	<b>5.36%</b>
<b>State</b>			
Current Annual Cost	3.32%	3.36%	3.58%
Plan 1 Past Cost	0.01%	0.01%	0.01%
<b>Total</b>	<b>3.33%</b>	<b>3.37%</b>	<b>3.59%</b>

**Figure a2**

<b>Total Pension Contributions</b>			
<b>Before Merger - Past Practices</b>			
<i>(Dollars in Millions)</i>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>2013-2015</b>			
General Fund	\$129.6	\$131.1	\$139.5
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$129.6</b>	<b>\$131.1</b>	<b>\$139.5</b>
Local Government	193.5	195.7	208.4
<b>Total Employer</b>	<b>\$323.1</b>	<b>\$326.8</b>	<b>\$347.9</b>
<b>Total Employee</b>	<b>\$322.5</b>	<b>\$326.2</b>	<b>\$347.3</b>
<b>2013-2038</b>			
General Fund	\$3,806.0	\$5,087.4	\$7,691.5
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$3,806.0</b>	<b>\$5,087.4</b>	<b>\$7,691.5</b>
Local Government	5,699.2	7,619.8	10,845.0
<b>Total Employer</b>	<b>\$9,505.2</b>	<b>\$12,707.2</b>	<b>\$18,536.5</b>
<b>Total Employee</b>	<b>\$9,498.6</b>	<b>\$12,699.7</b>	<b>\$18,074.9</b>

*Note: Past Practices scenario assumes plan(s) will be funded below the actuarially required level and that benefit improvements will occur in the future.*



## Hypothetical Merger

### Figure a3

Contribution Rates Merged Plans - Past Practices			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
Employee	7.09%	7.15%	7.37%
Employer	4.25%	4.29%	4.42%
State	2.84%	2.86%	2.95%

### Figure a4

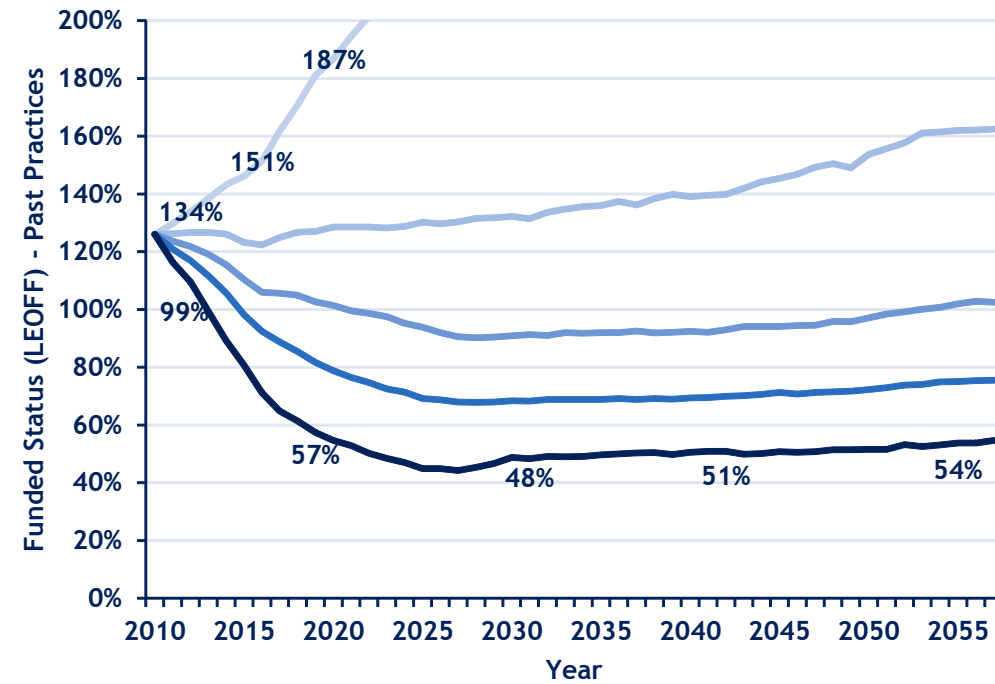
Change in Total Pension Contributions - Merged Plans* - Past Practices			
(Dollars in Millions)	Optimistic	Expected	Pessimistic
<b>2013-2015</b>			
General Fund	(\$18.9)	(\$19.4)	(\$24.3)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$18.9)</b>	<b>(\$19.4)</b>	<b>(\$24.3)</b>
Local Government	(27.5)	(28.2)	(35.7)
<b>Total Employer</b>	<b>(\$46.4)</b>	<b>(\$47.5)</b>	<b>(\$60.0)</b>
<b>Total Employee</b>	<b>(\$45.6)</b>	<b>(\$46.9)</b>	<b>(\$59.6)</b>
<b>2013-2038</b>			
General Fund	(\$425.4)	(\$17.6)	\$182.9
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$425.4)</b>	<b>(\$17.6)</b>	<b>\$182.9</b>
Local Government	(629.3)	(17.3)	967.1
<b>Total Employer</b>	<b>(\$1,054.7)</b>	<b>(\$34.9)</b>	<b>\$1,150.0</b>
<b>Total Employee</b>	<b>(\$1,047.2)</b>	<b>(\$27.2)</b>	<b>\$1,611.4</b>

\* Compared to Before Merger scenario.

Note: Past Practices scenario assumes plan(s) will be funded below the actuarially required level and that benefit improvements will occur in the future.

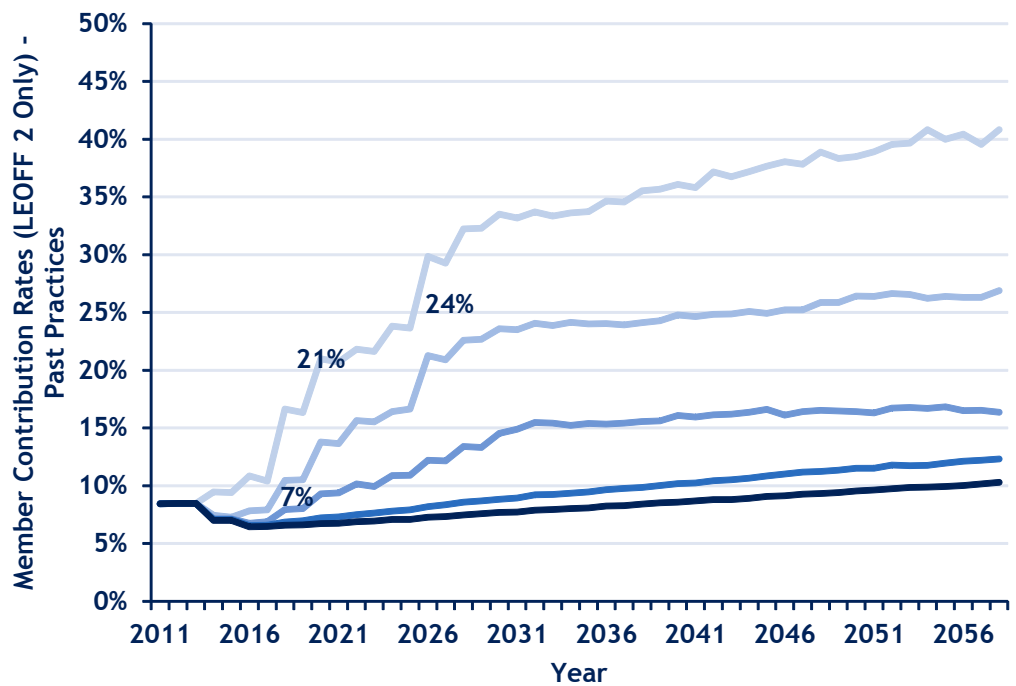
Alternate Funding Policy 1

Figure a5 - Funded Status



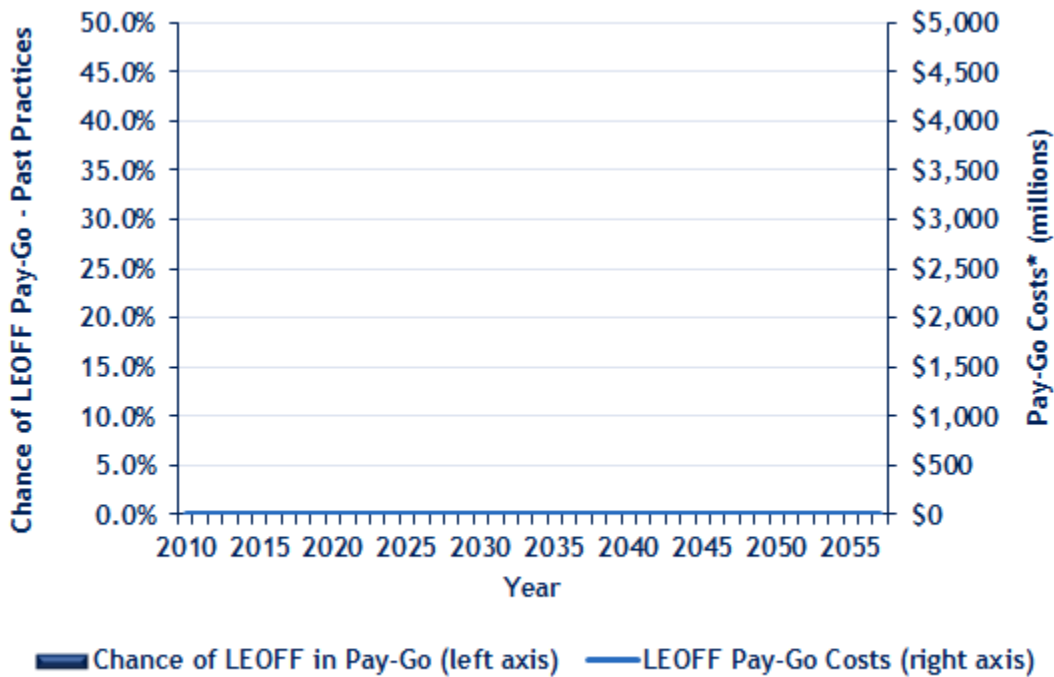
- Very Optimistic (95th Percentile)
- Optimistic (75th Percentile)
- Expected (50th Percentile)
- Pessimistic (25th Percentile)
- Very Pessimistic (5th Percentile)

Figure a6 - Projected Contribution Rates



- Very Pessimistic (95th Percentile)
- Pessimistic (75th Percentile)
- Expected (50th Percentile)
- Optimistic (25th Percentile)
- Very Optimistic (5th Percentile)

**Figure a7 - Pay-Go Graph**



*\*Pay-Go Costs on Top of Normal Pension Costs.*

**Figure a8 - Pay-Go Table**

LEOFF Chance/Amount of Pay-Go - Select Years			
Merged Plans, No LEOFF 1 Member Contributions - Past Practices			
Year	Chance	Amount*	
2011	0.0%	\$0	
2014	0.0%	\$0	
2017	0.0%	\$0	
2020	0.0%	\$0	
2023	0.0%	\$0	
2026	0.0%	\$0	
2029	0.0%	\$0	
2032	0.0%	\$0	
2035	0.0%	\$0	
2038	0.0%	\$0	
2041	0.0%	\$0	
2044	0.0%	\$0	
2047	0.0%	\$0	
2050	0.0%	\$0	
2053	0.0%	\$0	
2056	0.0%	\$0	

*\*Millions.*

**Figure a9 - No LEOFF 1 Contributions**

<b>Contribution Rates</b>			
<b>Merged Plans, No LEOFF 1 Member Contributions - Past Practices</b>			
<b>2013-2015 State Budget</b>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>Employee</b>			
Plan 1	0.00%	0.00%	0.00%
Plan 2	7.09%	7.15%	7.37%
<b>Employer</b>	4.25%	4.29%	4.42%
<b>State</b>	2.84%	2.86%	2.95%

**Figure a10 - No LEOFF 1 Contributions**

<b>Change in Total Pension Contributions -</b>			
<b>Merged Plans, No LEOFF 1 Member Contributions* - Past Practices</b>			
<i>(Dollars in Millions)</i>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>2013-2015</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>(\$1.5)</b>	<b>(\$1.5)</b>	<b>(\$1.5)</b>
<b>2013-2038</b>			
General Fund	\$1.0	\$4.0	\$3.9
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$1.0</b>	<b>\$4.0</b>	<b>\$3.9</b>
Local Government	1.3	9.0	6.9
<b>Total Employer</b>	<b>\$2.3</b>	<b>\$12.9</b>	<b>\$10.9</b>
<b>Total Employee</b>	<b>(\$1.6)</b>	<b>\$9.5</b>	<b>\$7.5</b>

\* Compared to Merged Plans scenario.

Assumes plan(s) will be funded below the actuarially required level and that benefit improvements will occur in the future.

## Alternate Funding Policy 2

Figure a11 - Funded Status

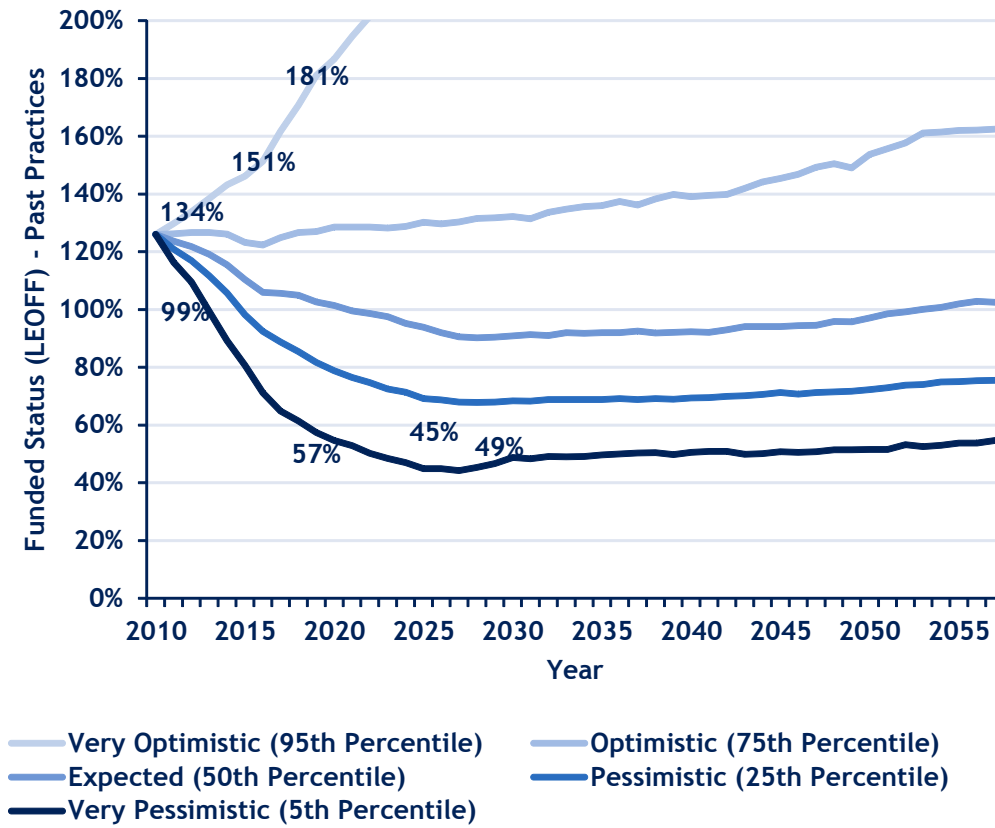
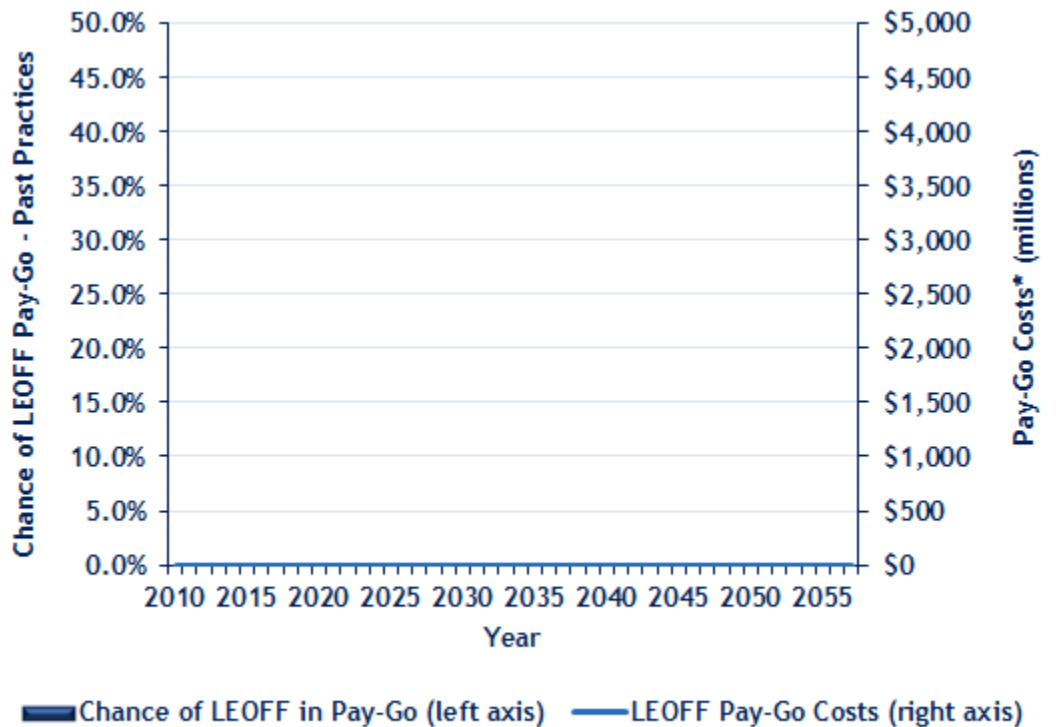


Figure a12 - Pay-Go Graph



\*Pay-Go Costs on Top of Normal Pension Costs.

**Figure a13 - Pay-Go Table**

LEOFF Chance/Amount of Pay-Go - Select Years		
Merged Plans, No LEOFF 1 Member Contributions, Maximum LEOFF 2 Member Rates - Past Practices		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.0%	\$0
2017	0.0%	\$0
2020	0.0%	\$0
2023	0.0%	\$0
2026	0.0%	\$0
2029	0.0%	\$0
2032	0.0%	\$0
2035	0.0%	\$0
2038	0.0%	\$0
2041	0.0%	\$0
2044	0.0%	\$0
2047	0.0%	\$0
2050	0.0%	\$0
2053	0.0%	\$0
2056	0.0%	\$0

\*Millions.

**Figure a14 - Merger, No LEOFF 1 Contributions, Max LEOFF 2 Member Rates**

Contribution Rates			
Merged Plans, No LEOFF 1 Member Contributions, Maximum LEOFF 2 Member Rates - Past Practices			
2013-2015 State Budget	Optimistic	Expected	Pessimistic
<b>Employee</b>			
Plan 1	0.00%	0.00%	0.00%
Plan 2	7.09%	7.09%	7.37%
<b>Employer</b>			
State	2.83%	2.83%	2.95%

**Figure a15 - Merger, No LEOFF 1  
Contributions, Max LEOFF 2 Member Rates**

<b>Change in Total Pension Contributions - Merged Plans, No LEOFF 1 Member Contributions, Maximum LEOFF 2 Member Rates* - Past Practices</b>			
<i>(Dollars in Millions)</i>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>2013-2015</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>2013-2038</b>			
General Fund	\$0.0	\$0.0	\$0.0
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
Local Government	0.0	0.0	103.5
<b>Total Employer</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$103.5</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>(\$514.7)</b>

\* Compared to Merged Plans, No LEOFF 1 Member Contributions scenario.

Assumes plan(s) will be funded below the actuarially required level and that benefit improvements will occur in the future.

## Alternate LEOFF 1 Funding Policy

Figure a16 - LEOFF 2 Funded Status

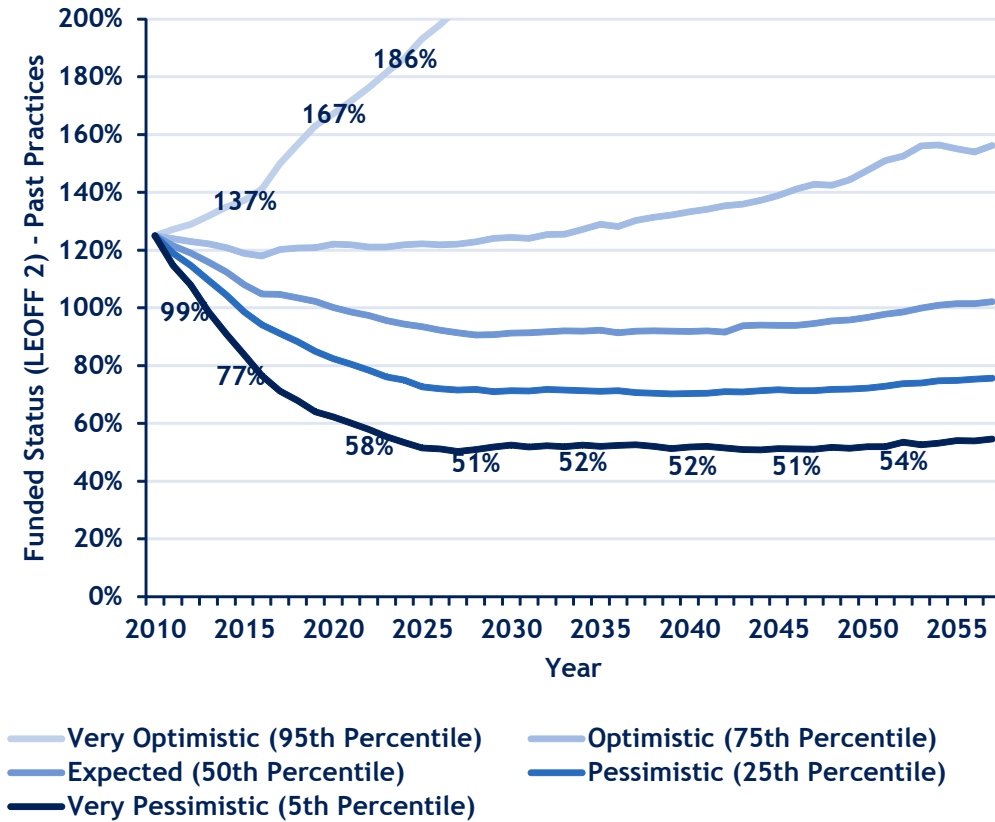
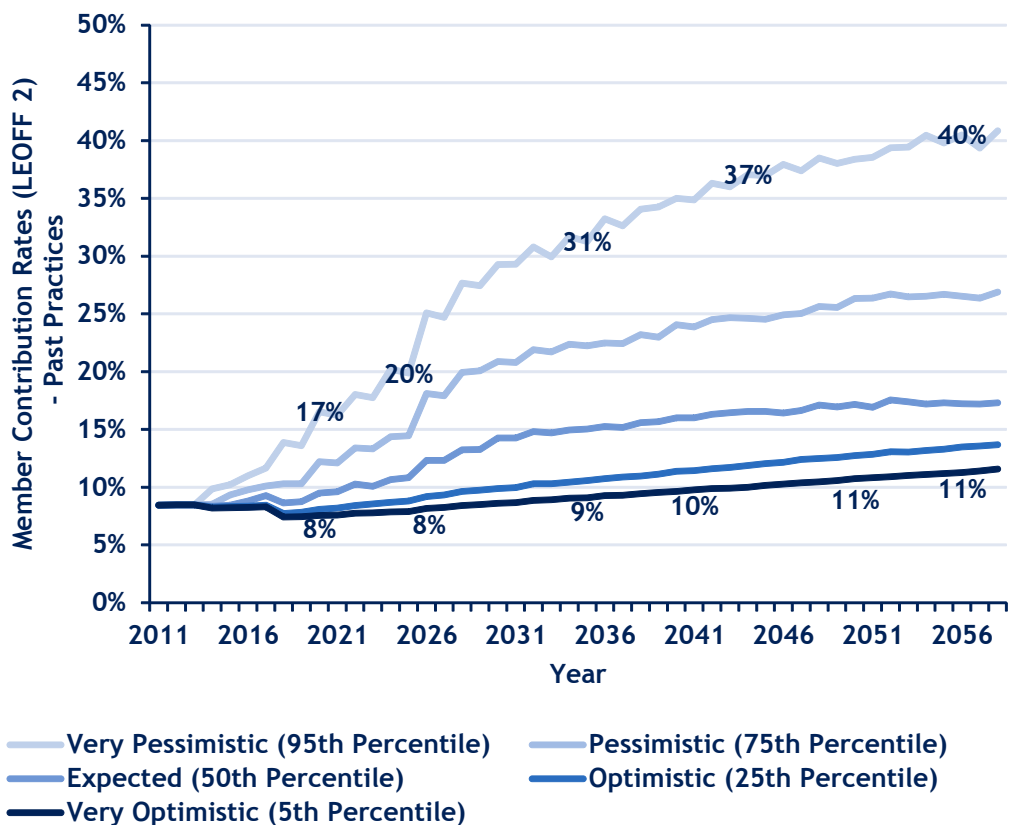
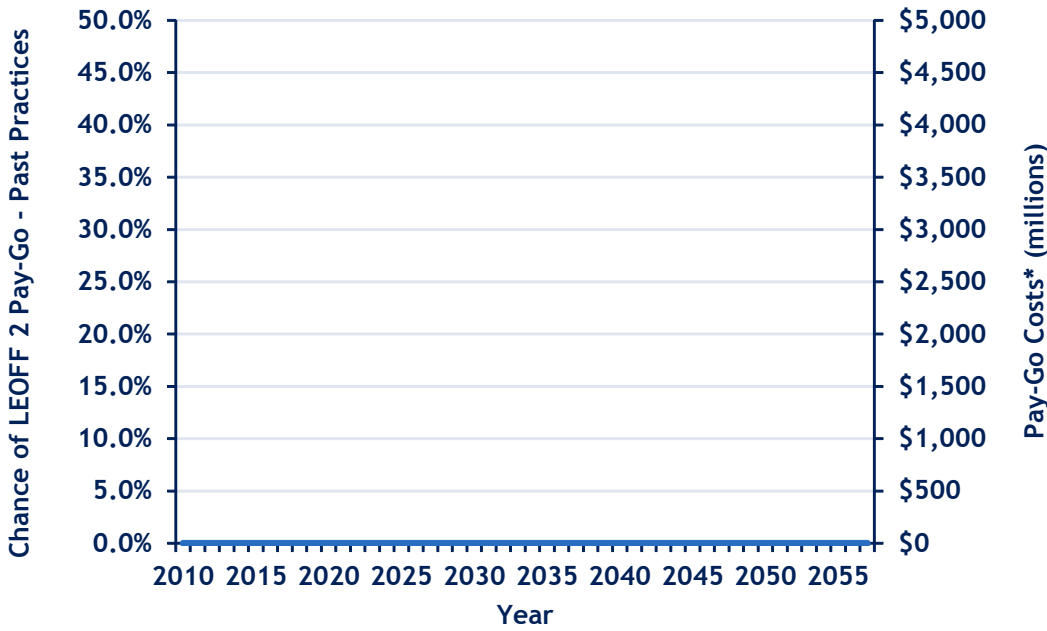


Figure a17 - LEOFF 2 Projected Contribution Rates





**Figure a18 - LEOFF 2 Pay-Go Graph**



■ Chance of LEOFF 2 in Pay-Go (left axis) — LEOFF 2 Pay-Go Cost (right axis)

*\*Pay-Go Costs on Top of Normal Pension Costs.*

**Figure a19 - LEOFF 2 Pay-Go Table**

LEOFF 2 Chance/Amount of Pay-Go - Select Years		
Alternate LEOFF 1 Funding Policy - Past Practice		
Year	Chance	Amount*
2011	0.0%	\$0
2014	0.0%	\$0
2017	0.0%	\$0
2020	0.0%	\$0
2023	0.0%	\$0
2026	0.0%	\$0
2029	0.0%	\$0
2032	0.0%	\$0
2035	0.0%	\$0
2038	0.0%	\$0
2041	0.0%	\$0
2044	0.0%	\$0
2047	0.0%	\$0
2050	0.0%	\$0
2053	0.0%	\$0
2056	0.0%	\$0

*\*Millions.*

**Figure a20 - Alternate LEOFF 1  
Funding Policy**

<b>Contribution Rates</b>			
<b>Alternate LEOFF 1 Funding Policy - Past Practices</b>			
<b>2013-2015 State Budget</b>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>Employee (Plan 2)</b>	8.30%	8.40%	8.94%
<b>Employer</b>			
Current Annual Cost	4.98%	5.04%	5.36%
Plan 1 Past Cost	0.00%	0.00%	0.00%
<b>Total</b>	<b>4.98%</b>	<b>5.04%</b>	<b>5.36%</b>
<b>State</b>			
Current Annual Cost	3.32%	3.36%	3.58%
Plan 1 Past Cost	0.01%	0.01%	0.01%
<b>Total</b>	<b>3.33%</b>	<b>3.37%</b>	<b>3.59%</b>

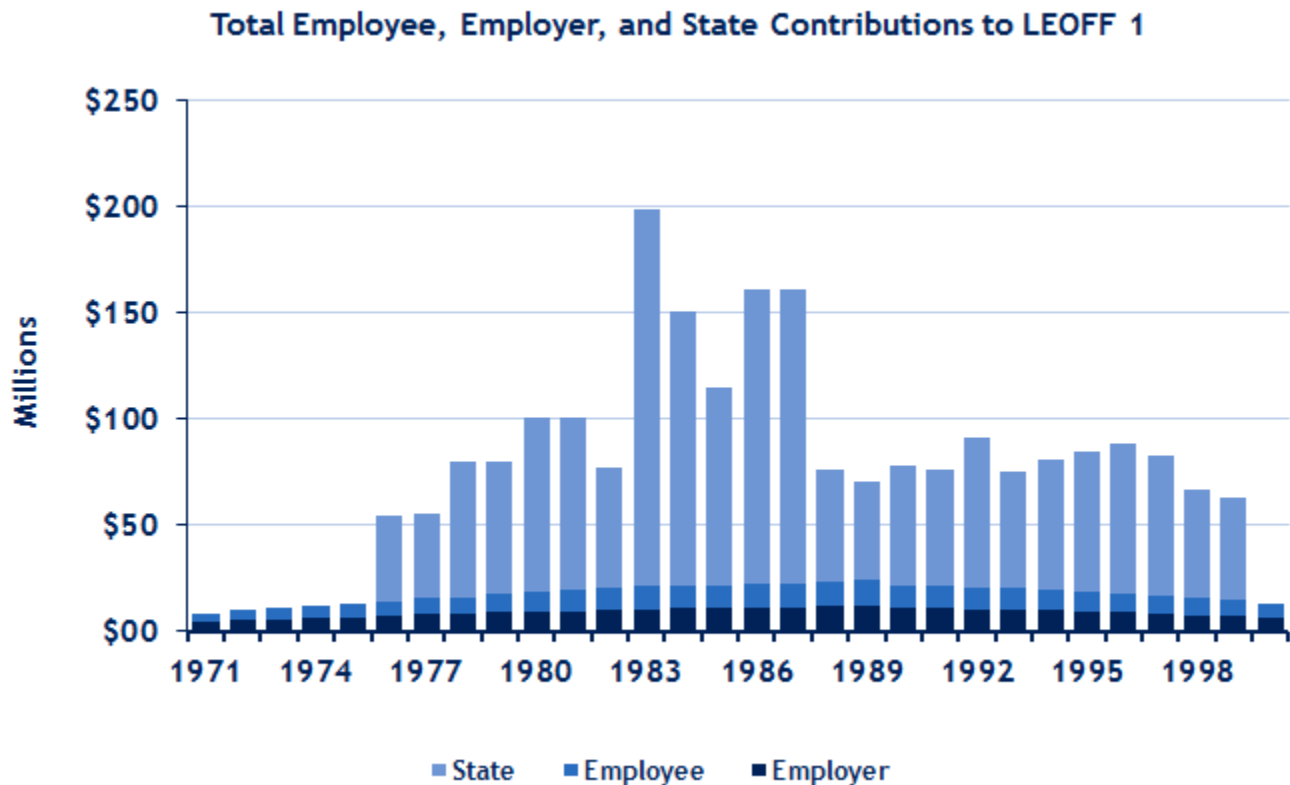
**Figure a21 - Alternate LEOFF 1  
Funding Policy**

<b>Change in Total Pension Contributions - Alternate LEOFF 1 Funding Policy* - Past Practices</b>			
<i>(Dollars in Millions)</i>	<b>Optimistic</b>	<b>Expected</b>	<b>Pessimistic</b>
<b>2013-2015</b>			
General Fund	(\$0.2)	(\$0.2)	(\$0.2)
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$0.2)</b>	<b>(\$0.2)</b>	<b>(\$0.2)</b>
Local Government	0.0	0.0	0.0
<b>Total Employer</b>	<b>(\$0.2)</b>	<b>(\$0.2)</b>	<b>(\$0.2)</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.0</b>
<b>2013-2038</b>			
General Fund	(\$4.4)	(\$5.3)	\$210.9
Non-General Fund	0.0	0.0	0.0
<b>Total State</b>	<b>(\$4.4)</b>	<b>(\$5.3)</b>	<b>\$210.9</b>
Local Government	0.0	0.0	0.2
<b>Total Employer</b>	<b>(\$4.4)</b>	<b>(\$5.3)</b>	<b>\$211.1</b>
<b>Total Employee</b>	<b>\$0.0</b>	<b>\$0.0</b>	<b>\$0.1</b>

\* Compared to Before Merger scenario.

Assumes plan(s) will be funded below the actuarially required level and that benefit improvements will occur in the future.

## Appendix Six | Historical LEOFF 1 Funding



## 2011 LEOFF MERGER STUDY

<b>Total Employee, Employer, and State Contributions to LEOFF 1</b>			
	<b>Employer</b>	<b>Employee</b>	<b>State</b>
<i>(Dollars in Millions)</i>			
1971	\$4.3	\$4.3	\$0.0
1972	\$4.9	\$4.9	\$0.0
1973	\$5.4	\$5.4	\$0.0
1974	\$5.9	\$5.9	\$0.0
1975	\$6.5	\$6.5	\$0.0
1976	\$7.1	\$7.1	\$39.8
1977	\$7.8	\$7.8	\$39.7
1978	\$8.6	\$7.4	\$63.7
1979	\$8.8	\$8.7	\$62.5
1980	\$9.3	\$9.2	\$81.7
1981	\$9.6	\$9.6	\$81.2
1982	\$10.4	\$10.4	\$56.7
1983	\$10.5	\$10.6	\$178.1
1984	\$10.7	\$10.8	\$128.7
1985	\$10.9	\$10.9	\$93.1
1986	\$10.9	\$11.0	\$139.1
1987	\$11.4	\$11.4	\$138.4
1988	\$11.7	\$11.7	\$52.5
1989	\$12.0	\$12.0	\$46.2
1990	\$10.6	\$10.7	\$56.8
1991	\$10.8	\$10.9	\$54.4
1992	\$10.4	\$10.4	\$70.3
1993	\$10.4	\$10.5	\$54.7
1994	\$9.8	\$9.8	\$61.3
1995	\$9.5	\$9.5	\$65.5
1996	\$8.9	\$8.9	\$70.9
1997	\$8.2	\$8.2	\$66.7
1998	\$7.6	\$8.3	\$50.4
1999	\$7.2	\$7.2	\$48.8
2000	\$6.3	\$6.3	\$0.0
<b>Total</b>	<b>\$266.4</b>	<b>\$266.3</b>	<b>\$1,801.2</b>

*After 2000, contributions are not required while the plan remains fully funded.*

## Appendix Seven | Other States

### Merger Studies Are Underway In Other States

OSA is aware of two studies underway in Arizona and Illinois that include, among other things, studying the feasibility of merging or combining some aspects of the public pension plans.

The Arizona study is scheduled for completion in December of 2012, with an interim report due on December 31, 2011. The Illinois report has a preliminary due date of November 1, 2011, and a final due date of January 1, 2012.

#### Arizona

More information on the Arizona study can be found here.

[https://www.azasrs.gov/content/pdf/2011\\_legislation\\_summary.pdf](https://www.azasrs.gov/content/pdf/2011_legislation_summary.pdf)

#### Illinois

More information on the Illinois study can be found here.

<http://www.ilga.gov/commission/cgfa2006/home.aspx>

The preliminary report is available here.

[http://www.ilga.gov/commission/cgfa2006/Upload/AON\\_Rpt\\_PublicEmplRetSys0509.pdf](http://www.ilga.gov/commission/cgfa2006/Upload/AON_Rpt_PublicEmplRetSys0509.pdf)

### Recent Plan Mergers In Other States

The following is a high-level summary of three recent public retirement plan mergers in other states. For additional details on these plan mergers, please consult that state's retirement system or statutes.

#### Colorado (2009)

The Denver Public Schools Retirement System (DPSRS) was consolidated with the state's Public Employees Retirement System (PERA). All provisions of the DPSRS were incorporated into PERA statutes, and the board overseeing PERA took control of the DPSRS.

This consolidation was of governance and administration only. The DPSRS assets and liabilities were not merged with PERA. Instead, a separate trust fund and plan division were established.

For more information on the plan merger, please see the CO PERA website, and the Colorado Revised Statutes 25-51-1701, et seq.

#### Minnesota (2010)

A municipal plan administered by a local government, the Minneapolis Employees Retirement Fund was merged with the state plan, the Public Employees Retirement Association (PERA). The state created a separate "MERF division" of the state retirement system. The state will manage the plan, and the state investment board will invest the assets.

This consolidation was of governance and administration only at this time. Assets and liabilities were not merged, and MERF assets are maintained in a special account. Both the City of Minneapolis and the state are responsible for funding the plan.

In the future, if the "MERF division" achieves 80 percent funded status, the division's assets and liabilities will be fully merged with the state plan.

For more information on the plan merger, please see the the MN PERA website, and Minnesota Statutes 353.01 Subd. 48, and 353.50 Subd 9.

## **Minnesota (2011)**

Two of the Minneapolis public safety plans were merged into PERA's Police and Fire Plan. No separate account was created, and the assets and liabilities of both plans were merged. The City of Minneapolis is required to make annual payments to pay off any unfunded liability.

More information about the plan merger is available on the MN PERA website, and Minnesota Statutes 353.667, and 353.668.

# Appendix Eight | DRS Stakeholder Report

11/17/11

## MERGER STUDY: LEOFF PLAN 1 & PLAN 2 DESCRIPTION OF STAKEHOLDER INPUT PROCESS

Washington State Legislature  
11/17/2011



**1. BACKGROUND**

Under Chapter 50, Laws of 2011, the Office of the State Actuary (OSA) is required to study the issue of merging the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 and Plan 2.

As part of the study, OSA is required to solicit input from the LEOFF 2 Board, and organizations representing LEOFF 1 members and retirees. OSA will also solicit input from employers of LEOFF members.

OSA contracted with the Department of Retirement Systems (DRS) to conduct and facilitate public meetings for the purpose of soliciting the required input, along with input from other identified stakeholders.

**2. AUGUST 12, 2011**

Email sent from OSA to combined group of stakeholders.

*Attachments to the email included the following: a Stakeholder\_Intro\_Letter*

**3. AUGUST 18, 2011**

Meeting notice sent from DRS to the combined group of stakeholders.

*Attachments to the email included the following: Merger Study – LEOFF Plan 1 and Plan 2 Agenda 08-30-2011*

**4. AUGUST 29, 2011**

Email sent from DRS to the combined group of stakeholders regarding the logistics for the August 30, 2011 meeting.

**5. AUGUST 30, 2011 – FIRST STAKEHOLDER MEETING**

*Location: Department of Retirement Systems, 6835 Capitol Blvd, Tumwater, WA 98501*

The process began with an initial meeting of the combined group of stakeholders.

The group was asked to discuss issues such as:

- ❖ If a plan merger took place, what would be the goals or benefits?
- ❖ If a plan merger took place, what concerns would be raised?
- ❖ What questions would lawmakers want to consider before enacting a merger?

**NOTES**

*The following questions/issues were captured during the stakeholder input meeting with the Office of the State Actuary (OSA) on August 30, 2011. This input was provided to inform the OSA of what should be addressed or answered in the study to ensure decision makers have the necessary information and background on this issue.*





## MERGER STUDY: LEOFF PLAN 1 &amp; PLAN 2

3

*Stakeholder Feedback: Questions/Concerns About The Merging Of L1/L2*

- ❖ *Research the difference between the benefit structures for both Plans. The Plans should retain their current benefit structure.*
- ❖ *Financial stability of the plans is key.*
- ❖ *Who benefits from the merger?*
- ❖ *What are the impacts of the merger?*
- ❖ *What are the parameters of the merger (positive/negative, benefit structure)?*
- ❖ *What will be the status of local disability boards?*
- ❖ *Concerns from city organizations that an increase in benefits would result in increased costs.*
  - *What are the long term risks to the LEOFF Plan 1 fund of merging, and how could that impact city costs?*
- ❖ *LEOFF Plan 2 Retirement Board: In addition to the questions already presented to OSA in writing, the following additional items should be noted:*
  - *A merger proposal should ensure the following:*
  - *No impact on benefit structure of LEOFF Plan 1 or LEOFF Plan 2*
  - *No impact on local disability boards*
  - *Merger does not transfer risk to LEOFF Plan 2 members*
  - *Adequate governance to manage risk structure*
- ❖ *What would be the impact on the cost of the merger?*
- ❖ *Funding and governance are not the same issue.*
- ❖ *How is the governance going to work?*
- ❖ *Request for an analysis regarding an effective governance structure.*
- ❖ *L2 Board authority should be clarified.*
- ❖ *Are there options to reduce administrative costs?*
- ❖ *Representation on L2 Board should be clarified in the case of a merger. (What about member representation ten years from now?)*
- ❖ *What is the merger?*
  - *Define the parameters of the merger: funding, governance, etc.*
- ❖ *Why is the focus on LEOFF Plan 1 and Plan 2? Why are the other pension systems/plans not merging?*
- ❖ *Concerns regarding the financial stability of both plans.*
- ❖ *No change in benefits for both plans and contribution rates should be protected.*
- ❖ *Will there be a LEOFF Plan 3?*
- ❖ *Can a scenario be designed that has no increases for*

## MERGER STUDY: LEOFF PLAN 1 &amp; PLAN 2

*either side (e.g. retaining a 0% member contribution rate in L1)?*

- ❖ *Can we ensure that any benefit improvements do not result in a LEOFF Plan 1 member rate?*
- ❖ *Would combined funds be available for benefit improvements?*
- ❖ *What is the current and future LEOFF Plan 1 funding policy?*
  - *If LEOFF Plan 1 falls out of full funding, who is responsible for contributions?*
- ❖ *What would be the funded status of LEOFF Plan 1 after the merger?*
- ❖ *If the plans change in any form what is the likelihood that the plans will change again? (Contractual nature of the merger)*
- ❖ *Future benefit improvements would remain subject to legislative approval*
- ❖ *Additional information on options if LEOFF Plan 1 enters pay-as-you-go status.*
- ❖ *The complexity of merging the plans is a concern.*
- ❖ *What is the likelihood of additional plan changes in future years? Changes could upset current interpretations of statutes and rules.*
- ❖ *Concerns regarding the lawsuits that would follow the merger.*

*Questions/Suggestions About The Study Format/Content*

- ❖ *Include LEOFF Plan 1 Medical Study Group report in the analysis.*
- ❖ *Include the history of LEOFF Plan 1 along with the merger study, as the history sets the tone for current issues.*
- ❖ *Request for transparency with all supporting documents for the final merger study.*
- ❖ *The format of the final merger study should list pros/cons of merging for both plans.*
- ❖ *Merger study should be objective. Provide legislature with objective analysis.*
- ❖ *Feedback to the study should not be represented as if the stakeholders agree with a proposal if all the issues or questions are addressed in the study. (i.e. the study should not be characterized as a checklist for satisfying stakeholders).*

**6. SEPTEMBER 26, 2011**

Email sent from DRS to the combined group of stakeholders regarding the following information:



## MERGER STUDY: LEOFF PLAN 1 &amp; PLAN 2

5

- ❖ A summary of input captured during the August 30, 2011 meeting with stakeholders.
- ❖ Three additional documents OSA received on this issue outside of the meeting.

The email also informed the combined group of stakeholders that DRS is looking for a location to hold a second meeting. This would take place on the 13th, 14th, or 17th of October in a location to be determined, but north of Olympia. This alternate location was requested by parties in the first meeting. The purpose of the follow-up meeting is to confirm and summarize the input already provided, receive any additional input, and deliver and discuss the federal legal analysis from Ice Miller regarding the merging of two pension plans.

*Attachments to the email included the following:*

*L1-L2 Merger Study feedback L2 Board  
L1-L2 Merger Study feedback William Kantor  
L1-L2 Merger Study feedback Richard Warbrouck  
STAKEHOLDER FEEDBACK L1-L2merger meeting*

#### **7. OCTOBER 7, 2011**

Meeting notice sent from DRS to the combined group of stakeholders regarding the logistics of October 17, 2011 meeting.

*Attachments to the email included the following: Other Area Parking Map*

#### **8. OCTOBER 12, 2011**

Meeting notice sent from OSA to the combined group of stakeholders regarding the analysis prepared by Ice Miller regarding federal implications to a possible merger.

*Attachments to the email included the following:*

*INDY-#2658191-v2-  
Washington\_DRS\_and\_State\_Actuary\_Checklist\_for\_Plan\_Merger\_of\_LEOFF\_1\_and\_2  
WDRS Ltr re OSA Study*

#### **9. OCTOBER 17, 2011 – SECOND STAKEHOLDER MEETING**

*Location: Bellevue City Hall, 450 110th Ave. NE, Bellevue, WA 98009*

The process continued with a second meeting of the combined group of stakeholders.

The group was asked to discuss issues such as:

- ❖ Confirm and summarize the input already provided;
- ❖ Receive any additional input; and
- ❖ Deliver and discuss the federal legal analysis from Ice Miller regarding the merging of two pension plans.

**NOTES:**

## MERGER STUDY: LEOFF PLAN 1 &amp; PLAN 2

*The following questions/issues were captured during the second stakeholder input meeting with the Office of the State Actuary (OSA) on October 17, 2011. This input was provided to inform the OSA of what should be addressed or answered in the study to ensure decision makers have the necessary information and background on this issue.*

*Legislature Assigned OSA To Study The Issue*

*Independent Study*

*Broader than any single bill*

*OSA's role*

- ❖ *Research*
- ❖ *Analyze*
- ❖ *Draft*
- ❖ *Make findings of fact (if appropriate)*
- ❖ *Report to Legislature*

*Stakeholder Input Process*

*We're asking stakeholders to help ensure OSA is covering all the bases possible within the time constraints*

*August meeting*

- ❖ *Staff listened and wrote down your feedback*
- ❖ *Copies were emailed for your review*

*Feedback generally fell into five themes*

*Feedback Summary: Five Common Themes*

*Benefit stability*

- ❖ *Current benefits and contribution rates should be protected*

*Plan health*

- ❖ *Plans 1 and 2 are healthy and stakeholders want to keep them that way*
- ❖ *Actuarial analysis of multiple scenarios (before and after) is critical*

*Representation*

- ❖ *Stakeholders do not want to lose the LEOFF 1 Disability Boards*
- ❖ *Consideration should be given to make sure any oversight authority (e.g. combined LEOFF Board) represents all members*

*Legality*

- ❖ *What are members' rights under federal and state law?*
- ❖ *Would or could a merger run afoul of those rights?*

*Funding policy*

- ❖ *Will a merger increase costs?*
- ❖ *If costs arise, who will pay?*
- ❖ *What portion will then pay?*

*Opportunity For Additional Input*

*Have we characterized the feedback correctly?*

*Additional feedback?*

*Ice Miller Analysis*



## MERGER STUDY: LEOFF PLAN 1 &amp; PLAN 2

7

*OSA requested analysis of the tax and legal “ground rules” for any system considering a plan merger*

*Copies were emailed for review*

*Will be reproduced in final report*

*OSA Prepared A Draft Outline*

*Detailed draft outline in meeting materials*

- ❖ *The actual contents of the final report may differ from the draft outline*

*Upcoming slides will discuss some of the highlights*

*Report will include basic background and history of LEOFF*

- ❖ *In response to stakeholder concerns that plan history sets the stage for the current situation*

*Will also include full text of all analysis (e.g. from Ice Miller), as well as representative samples of stakeholder input and correspondence*

*Draft Outline – Defining The Merger*

*What do we mean by “merging the two plans?”*

*What are the more likely merger structures?*

*What are the various considerations that go into a particular approach?*

*Additional details in handout*

*Draft Outline – Legal Issues*

*OSA cannot make determination if a merger is or is not legal*

*OSA will try to identify issues that require cautious consideration before proceeding*

*All legal analysis solicited by OSA will be reproduced in full in the final report*

*Draft Outline – Actuarial Analysis*

*“Before and after” scenarios*

- ❖ *Assessing plan health and risks before and after merger*

*Scenarios assume a full merger of assets and liabilities*

- ❖ *This means the plan assets would be indistinguishable from any other*

*Full merger of assets and liabilities is most likely to impact plans on an actuarial basis*

*Additional details in the handout*

*Actuarial Analysis: Before A Merger*

*What do the plans look under current law?*

- ❖ *Starting point*
- ❖ *Plan health*
- ❖ *Risk measures*

*Additional “before” scenarios look at what happen if/when LEOFF 1 UAAL appears*

*Actuarial Analysis: No Merger, But UAAL costs Arise*

*What if...*

- ❖ *We assume the state will not make contributions and local governments pay any unfunded liability?*
- ❖ *We assume creation of a direct contribution to LEOFF 1 to eliminate pay-go risk?*

8

## MERGER STUDY: LEOFF PLAN 1 & PLAN 2

- ❖ *We applied the PERS 1/TRS 1 amortization method to LEOFF 1?*

*Actuarial Analysis: After A Merger Of Assets And Liabilities*

*What are the impacts to plan health and risk measures if...*

- ❖ *We apply the LEOFF 2 funding policy to the merger plan?*
- ❖ *We assume a guaranteed 0 percent contribution rate for LEOFF 1 members?*
- ❖ *We assume maximum contribution rates for LEOFF 2 members?*

*Other possible scenarios TBD*

*Next Steps*

*Complete actuarial analysis*

*Draft and finalize report*

*Submit report to Legislature by December 15*



## Appendix Nine | Stakeholder Correspondence

### Representative Samples of Stakeholder Input

The study mandate requires OSA to solicit input from stakeholders, and provide representative samples of that input in the final report. Due to the volume of written submissions, OSA has not included all submissions in the report. To choose which submissions would be included, OSA reviewed submissions based on the following three criteria.

- ❖ Tone.
  - ✦ Minimize personal comments.
- ❖ Volume.
  - ✦ Limit two submissions per person.
- ❖ Topicality.
  - ✦ Comments are directly on topic.
  - ✦ Comments are primarily substantive, rather than procedural.

Selected submissions have been reproduced in full. Attachments were reviewed separately from the original submissions, unless context required them to remain together.

All remaining stakeholder input is available upon request.

August 29, 2011

Dave Nelsen and Aaron Gutierrez,

I want to thank you for keeping us up to date on the current status of the merger study committee. I regret that I will not be able to attend the August 30<sup>th</sup> meeting due to a rescheduled surgery. The Retired Firefighters of Washington Vice President Jim Fossos and Director Randy Plain will be in attendance representing the RFFOW. Not being aware of the full agenda for the first meeting or where the discussion will lead, I want to offer the following suggestions. Keep in mind that these suggestions are not an attempt to lead the group in a particular direction. The intent is to get the group on a level playing field by making all the current information available. Seeking information that is already available would only hinder the process, create extra work for staff and increase the cost of the merger study.

- Merger benefits as outlined in the DRS letter for discussion. The benefits should be listed and identified as a benefit for which group, department, agency, pension plan or membership.
- We must have a current fiscal analysis from the State Actuary for each pension plan before and after a merger, including any possible impact to any group, department, agency, pension plan, or member.
- The Washington State Council of Firefighters is on record as having told legislators that the merger is legal and constitutional. This same statement was repeated by several legislators. The information given to the legislators regarding the constitutional and legal status should be made available to the committee by the Washington State Council of Firefighters to expedite this process.
- The committee should be advised by DRS of any IRS concerns and what if any, inquiries the Department has made.
- All legal opinions or any other information the LEOFF 2 Board or Director Steve Nelsen received from Attorney Robert Klausner or from the law firm of Ice Miller should be available to the committee.
- The merger study committee should be reduced in number making it easier to manage and enhance the opportunity to reach a speedy and viable conclusion or statement of fact. There should be a distinction between committee and observers with ample opportunity for all observers and other interested parties to testify or submit a written document. I would suggest no more than two representatives from each group or organization as described in the legislation. A smaller group will also facilitate finding space for future meetings.

Thank you for your consideration of the foregoing suggestions.

Respectfully,

Richard C. Warbrouck, President Retired Firefighters of Washington



## ARE WE PLAYING A CHARADE ABOUT FUNDING?

09/17/2011

**PREAMBLE:** In 1977 LEOFF Plan 1 was determined to be fully funded. With that declaration employers' and employees no longer made contributions to that separate pension in what was known as Plan 1. The state also eliminated its participation in plan funding until an actuarial valuation became less than 100% funded. about 2001 there was an attempt to "restate" the plan. Statements were made that there would be no change in benefits and a "surplus" of about 1.3 billion dollars was to be shared with the state. This was the first attempt to change the structure of the L1 plan. Restatement and the associated sharing did not happen.

In the 2007/2009 era a significant problem was identified. OTHER POST EMPLOYMENT BENEFITS (OPEB) was a pension plan expense that had not been identified or considered. It was now determined to be a significant problem for all pensions which could alter the health of LEOFF Plan 1 significantly.

The Era mentioned above was an investment bubble that burst in 2008 with the asset bottom happening in March 2009 for LEOFF Plan 1. The bubble rise and subsequent deflation closely followed the actions of the stock market itself which is a source of asset value for the pension plans of Washington. The investment of contributions and earnings of invested assets is the source for pension payments. According to the state actuary about 3/4 of pension value is investment returns.

The pension protection act of 2006 gave a more lenient method of funding plan medical benefits by reducing plan funding to 120% funded rather than the 125% funded necessary prior to the 2006 Act. This was a significant fact in the demise of the surplus sharing attempt mentioned above and the L1 medical study.

The study was never completed. When the first phase of the study reached its end, a second phase was begun. It died at birth. The actuary's opinion was that a date certain for immunization had to be selected. On that date, market value of assets is used to determine the 120% funding level. The funding level was such that there were no assets above the 120% funding level.

**THE STUDY:** At the present time there has begun another attempt to change/eliminate LEOFF Plan 1. A poorly worded and one sided attempt was made in a Legislative Bill (HB 2097) to merge LEOFF 1 and LEOFF 2. The bill never made it out of committee because of reasonable individuals in the legislature. This was not the end. The Legislature gave the state actuary funding to study a merger of the two separate and distinct pension plans. This study was to be completed by mid December 2011.

It is a perverse use of the Actuary's good offices to express a legal opinion on such a merger. In meeting of stakeholders at DRS it was mentioned that the actuary will receive legal guidance. I believe that the Actuary's determination about the funding health of each separate entity and the health of a potential merged entity is valid, but an opinion about the legality of such a merger is outside the application of his expertise. This means that there is a more basic legal question as to the rights of each individual plan if involved in a merger. The following questions are forwarded to the representatives of DRS and the State Actuary's office per the request stated at the first stakeholder meeting.

**QUESTIONS:** The following questions are forwarded and should be answered before another stakeholder presentation.

- A. Has a determination been made about the legality of a possible merger?
  - 1. If a determination has been made, what was that determination and by whom?
  - 2. If no determination, has an opinion or opinions been offered?
    - a. Who is/are the author/authors of the opinion/opinions?
  
- B. Will the actuary make a determination of the health of each plan (L1-L2) separately?
  - 1. Will the actuary make a determination on the health of a merger plan?
  - 2. What will be the method used for the determinations of health?
  - 3. Is actuarial valuation one of the methods used for valuation? Which one?
  - 4. Will smoothing be a component of the actuarial valuation?
  - 5. Will the smoothing plan be the one presently used?
  - 6. Or one that covers the 3 to 5 year period?
  - 7. Will a determination of health be made on a market value basis on a date certain?
  - 8. Will the actuary consider no change in the present total benefit package of LEOFF 1?
    - a. Will the total CPI adjustment in April remain?
    - b. Will the present style of medical boards be addressed?
  
- C. Will some sort of schedule for additional stakeholder meetings/input be coming out soon?
  
- D. Will present economic conditions be identified by the actuary?
  - a. Will the assets as identified as those of LEOFF 1 be SIB reported amounts.
  - b. Will total CTF investment returns be used in the valuations listed above?
  - c. Will risk/reward returns be identified?
    - I. Will the 50 years investment horizon be used for actuarial valuation? for a merged plan? for the individual plans?
    - II. Will the 2024 date for immunization etc. for L1 be addressed? as a part of a merger? as a separate and distinct plan?
  
- E. Will benefits/problems for LEOFF Plan 1 be identified?
  - 1. Will the Benefits/problems as a separate-stand alone plan be identified?
  - 2. Will the benefits/problems as a part of a merged entity be defined?
  
- F. Some and hopefully all of the above questions will be addressed before the Actuary's presentation to legislators for bill consideration. It should be noted that there was a rather loud response to the benefit of a 50 year time line. Most or all the individuals involved in the input session considered such a time line as excessive for LEOFF 1 individuals.

**REMARKS:** All of the above statements and questions were made to aid in the process which will end with an Actuary's presentation to the Legislators. Personally there has to be an in depth, constructive, report that shows the benefits of such a merger with no loss of the present benefits for the "OLD". At the present time I believe that the effect on LEOFF 1 was not even considered in HB 2097. It is a lot to overcome.  
WPK 09/17/2011

317 3rd Avenue South #303  
Edmonds, Washington 98020  
October 19, 2011

**UPDATED DRAFT OF 10/23/2011**

Matthew M. Smith, FCA, EA, MAAA  
2100 Evergreen Park Drive SW, Suite 150  
Olympia, Washington 98504-0914

Mr. Smith,

This letter is meant to state my concerns about the merger study which you have been required to prepare for the Legislature by 12/15/2011. I doubt that you remember my letter/questions of January 2008, but I will answer some of the questions which have been answered for us in my opinion. Using the letter you received from Ice Miller, there are two points that are clear for me now. Your definition of merger must be made clear to the legislature because "under the Internal Revenue Code ("Code") "merger" has a very distinct meaning - it is the actual merger of assets and liabilities into a single plan, where the assets and the liabilities are "usable" across the plan". The second point is that the only thing that the Pension Protection Act of 2006 did was actually giving the state another 5% of pension funds to pay for medical benefits of the members. That means that assets above 120% funding for LEOFF 1 can be used for the employers responsibility to fund member medical benefits. That figure use to be 125% .

The redundant use of LEOFF Plan 1 is necessary because the plan is separate and distinct from all other pension plans in the state. This specifically means LEOFF2 for the merger considerations, and we (L1 & L2) can claim the title "stake holder" in its modern connotation. For that reason, comments about the merger should be identified as from which organization the author speaks/writes.

On Monday 10/17/2011 you authored the report and presentation to the Pension Funding Council about economic assumptions to be recommended by the Select Committee on Pension Policy (SCPP) to the Pension Funding Council (PFC). In my opinion it was not the worst recommendation they could have made, but it was not the best.

The following questions are asked on this date and they may change like the "contents of the final report may differ from" your outline to insure a complete understanding of your opinions that pertain to LEOFF Plan 1 members.

#### Old Questions Revisited

1. Could pension funds be used to pay medical expenses of LEOFF 1 members? Yes
2. On the merger date under the "Code" which valuation would be used?
3. Will the 2024 date be used as a check point.
4. Does growth in salaries compound the problem for a closed system not collecting contributions?
5. How would you determine the 120% funding figure for LEOFF 1?

#### New Relevant Questions

1. What are the possible merger benefits for LEOFF 1 members/beneficiaries?

As of this date I believe that there are no benefits for the members/ beneficiaries in any described merger. The State, employers, and LEOFF 2 make clear gains.

**The listed questions are not meant to be a complete list. In my opinion there are major considerations that the State Actuary has to address so that the Legislature can make an informed decision on the possible merger question.**

**Medical benefits are some of the defined benefits for active or retired LEOFF 1 plan members. The specific benefits listed in the RCW have been determined to be the minimum services to be provided. Determination of what medical benefits are to be rendered is made by a local board. The boards and court decisions have more clearly defined what the range of benefits are. These L1 member benefits must be recognized and protected in any definition of merger. There are some very distinct differences between the two plans.**

William P. Kantor LEOFF 1 retired

**UPDATED DRAFT OF 10/23/2011**

THE LAW OFFICES OF  
**J.E. FISCHNALLER**  
ATTORNEY AT LAW

Facsimile: 509-766-0477	601 S. Pioneer Way, Suite F-252 Moses Lake, WA. 98837 206-930-1818	e-mail: jef3@earthlink.net
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October 22, 2011

Matthew M. Smith, FCA, EA, MAAA  
2100 Evergreen Park Drive SW, Suite 150  
Olympia, Washington 98504-0914

RE: Brief Legal Analysis of LEOFF Plans 1 and 2 Merger

Dear Mr. Smith:

I tried my first LEOFF case in 1973 and, since that time, I have successfully handled more than 3,500 LEOFF-related matters, including many of the Appellate and Supreme Court cases that have shaped our current understanding of the Act. As a result, over the last 38 years, I have acquired what I would consider to be a good understanding of both Plan 1 and Plan 2, and would like to briefly discuss some of my concerns about a potential merger of Plans 1 and 2.

The biggest obstacle to any merger is the dissimilarity of the two plans. In fact, there are few, if any, similarities between the two plans. As you know, LEOFF Plan 1 members enjoy a whole array of benefits which are not presently available to Plan 2 members; not the least of which are the comprehensive healthcare benefits available to Plan 1 members. RCW 41.26.030(19) guarantees Plan 1 members the availability of an extensive variety of medical services. These medical benefits are, quite clearly, contractual in nature, and may not be eliminated or diminished as the result of any merger. In addition, the Act permits local Disability boards through the authority granted to them by RCW 41.26.110 and under the provisions or RCW 41.26.150(1)(b) to make an unlimited assortment of additional medical benefits available to Plan 1 members. A LEOFF Plan 1 member's right to have his or her local Disability Board continue to designate these additional medical as available to the Plan 1 members under its jurisdiction is similarly contractual in nature and not subject to elimination through merger or any other form of legislation. *Bakenhus v. City of Seattle*, 48 Wn.2d 695, 296 P.2d 536 (1956).

Matthew M. Smith, FCA, EA, MAAA  
October 22, 2011  
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In the event of a merger of the two Plans, the distinction between Plan 1 and Plan 2 members would have to be maintained, or the expense to the State would be enormous. Since virtually all of the benefits provided for Plan 1 members, including healthcare benefits, are contractual in nature and may neither be eliminated nor diminished, any merger that did away with the distinction between Plan 1 and Plan 2 members would grant present Plan 2 members access to the benefits presently enjoyed solely by Plan 1 members. Since there are many more Plan 2 members than Plan 1 members, this potential expense should be addressed by the OSA in its report concerning the feasibility of any merger.

It is not just healthcare benefits which are so dissimilar between the two plans, but almost every aspect of the two Plans is radically different. Consider, if you will, the disability provisions applicable to Plan 1 members as opposed to those for Plan 2 members.

Since the enactment of Chapter 41.26 RCW, and to the present time, LEOFF I members have had a right to take up to six months of disability leave during periods of incapacity, without respect to whether the disability was the result of a work related incident, or caused by an event entirely unrelated to the member's work. In the event that the LEOFF Plan 1 member fails to recover from their disability within the six month of allowed disability leave, the member may, in the discretion of the local Disability Board or Prior Act Board, be granted a disability retirement.

Although LEOFF Plan 2 members are allowed to take disability leave, and even disability retirement, it is only for employment related injuries or illness and the benefit itself is very different.

In addition, the standard for what constitutes a disability is quite different for Plan 1 and Plan 2 members. Under the existing caselaw, a Plan 1 member is disabled if he is no longer able to perform all of the duties of his position with at least average efficiency. A Plan 2 member, however, is only disabled if he is no longer capable of any substantial, gainful employment. In other words, the Plan 1 member need only be unable to do his present job with at least average efficiency; while the Plan 2 member must be unable to do any job, anywhere, for anyone. This is a much heavier burden to carry.

Matthew M. Smith, FCA, EA, MAAA  
October 22, 2011  
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There is, however, in my opinion, a contractual right, under *Bakenhus*, for LEOFF I members to have issues relating their disability or lack thereof decided under the less onerous of the two standards, as they always have been, and by the presently constituted Disability Boards and Prior Act Boards. It seems to me that any merger of the two Plans that failed to retain the distinction between Plan 1 members and Plan 2 members would result in present Plan 2 members acquiring the same disability rights presently enjoyed by Plan 1 members, which would likely result in a significant additional expense to both the State and to employers of the present Plan 2 members.

This brief letter has discussed just two of the areas in which I would foresee a likelihood of serious problems arising in the event of a merger of the two LEOFF Plans. There are certainly many more issues that could be discussed, but these two rather obvious examples should suffice for now.

It is perhaps too obvious to mention, but any form of merger will displease one faction or another, and raise numerous issues that will spark a plethora of litigation that will require years to sort out.

Given the relatively short time frame, I will forward this to you both by first class mail and by email. Let me take this opportunity to thank you, in advance, for taking the time to review this relatively brief analysis. I would ask that it be included in the record and as an attachment to the OSA's report concerning this matter.

Respectfully Submitted,

J.E. Fischnaller



## Retired Seattle Police Officers' Association

5020 Brighton Place – Mukilteo, WA 98275

### REPORT TO LEOFF 1 & LEOFF 2 MERGER STUDY

October 17, 2011

This document is a submission of input to the LEOFF 1 & 2 Merger study pursuant to the terms of HB 1087 Section 105 (2). It is hereby submitted by the **Retired Seattle Police Officers Association**, the **Retired Fire Fighters of Washington** and the **Washington State Association of Retired Police Officers**. Combined, these organizations represent in excess of 4,000 retired members and beneficiaries of the LEOFF Plan 1 system.

### INTRODUCTION

We would first like to thank the Legislature for including in HB 1087 the provision for soliciting input from LEOFF 1 organizations. The original legislation that proposed a merger of LEOFF 1 & 2 was developed without our knowledge and without any opportunity for input.

### EXECUTIVE SUMMARY

As we review our principal concerns about the merger it remains imperative that the events that generated this study be recognized as an important element in detailing our concerns. A great deal of distrust was generated in the process and that distrust manifests itself in our efforts to review the concept of any merger.

For this reason, we first reviewed that process and the intervening actions that have complicated the development of this review.

We would like to stress that any review of this concept is simply incomplete and misleading unless it is understood within the context of events that lead to the study itself.

Our review develops some simple conclusions that suggest the merger concept is just another bad idea that should be discarded.

**Political** – The issue developed as a substitute to a proposed change in the contribution rates for LEOFF 2. A number of political actions generated a serious break between LEOFF 1 & 2 and has spilled over into other areas. This has complicated the ability to deal with a number of issues and particularly the

### Report to LEOFF Merger Study

issue of governance. From a public policy perspective the proposed merger appears to have significantly more minuses than pluses.

**Fiscal** – Thus far little fiscal data has been produced beyond the fiscal note attached to HB 2097. Only by taking a pessimistic view does the LEOFF 1 system pose any burden to the state. Without further data it is not possible to produce any meaningful review of this issue.

**Legal** – Thus far only the Ice Miller legal review has been released. It deals only with Federal issues and clearly demonstrates that Ice Miller has little understanding of Washington pension law. Additionally the Ice Miller report strongly suggests that any merger would be extremely difficult and most likely impossible. Complicated state legal issues exist and no legal review has been provided. The LEOFF 2 Board has spent over \$30,000 on legal reviews both state and federal but they refuse to share those reviews. We believe any merger would be illegal.

**Governance** – The LEOFF 2 stakeholders have a significant investment in establishing a governance system that addresses specific LEOFF 2 issue. As currently constructed there is no opportunity for LEOFF 1 to secure any effective representation. No proposals or suggestions or studies to address this issue have been produced.

**Other Issues** – There appears to be a lack of fairness to the LEOFF 1 stakeholders in this matter. The study has been defined by OSA as a “Roadmap to merger” and the brother of the LEOFF 2 Board Director and author of the merger bill has been appointed to represent DRS in the study. Additionally the same law firm, Ice Miller, has been contracted by both OSA and the LEOFF 2 Board. The study appears to consist of only two meetings, one free form and the second structured and short. Little factual information has been provided to the stakeholders.

The concept, at least as conceived in HB 2097 remains bad public policy, it is most probably fiscally unsound, it is illegal and offers no effective means of pension governance.



Report to LEOFF Merger Study

## **MERGER CONCEPT**

As you review this section of our comments please note that these events are very important because they reveal what is seen by LEOFF 1 as a political betrayal of trust by LEOFF 2. They are important because any merger would be crippled in the development of a governance element because of that betrayal.

The first appearance of the possibility of merging LEOFF 1 & LEOFF 2 was in 2009. It was reportedly mentioned during a LEOFF 2 Board meeting. There was no substantive discussion of the concept at that time. In fact the discussion did not get mentioned in the minutes of that meeting and there was no motion to investigate or study the issue.

None the less, the Director of the LEOFF 2 Board, on his own authority contracted for and spent approximately \$20,000 to have a legal review of the concept conducted by Robert Klausner, a Florida lawyer. That review has not been made available and is still being kept from public view under a claim of attorney-client privilege.

On or about April 6, 2011, Steve Nelsen, the Director of the LEOFF 2 Board was asked to review the concept. This was allegedly at the request of a legislator. On April 8, 2011 Steve Nelsen was instructed to draft a bill for the merger. This resulted in HB 2097. It is clear that executives of the LEOFF 2 Board were aware of this development as were the two principal law enforcement and fire fighter lobbying organizations, WSCFF and WACOPS. In fact WSCFF admits to playing a major role in the development of HB 2097. In contrast it should be noted that the remainder of the LEOFF 2 board was unaware of these activities and had never authorized any such action on the part of their director.

On April 9, 2011, HB 2068 was introduced. This bill would have cut LEOFF 2 pension premiums. The sole sponsor was Rep. Van De Wege. A hearing for HB 2068 was set for April 14, 2011.

The Washington Council of Fire Fighters sought a large grass roots response to the bill and asked their members to attend the hearing. However, their members upon arriving in Olympia were dispatched to secure sponsors for HB 2097 which had been in development since at least April 6<sup>th</sup>. They secured 36 sponsors. Several legislators have reported that they were misled to believe that LEOFF 1 members were in accord with the merger proposal and were assured that the proposal was both legal and constitutional.

LEOFF 1 members first heard of HB 2097, the merger bill, on the day it was introduced, April 14, 2011. This date was also the last day for introduction of new bills in that session. LEOFF 1 members had been kept in the dark throughout the development of the concept and the presentation of the bill.

Not only was the LEOFF 1 community uninformed but so was the Select Committee on Pension Policy.

### Report to LEOFF Merger Study

The result was a firestorm of political action and the eventual mandate of this merger study. It is interesting to note the comments of Kelly Fox in this matter.

*"I regret the loss of trust and I accept responsibility as the leader of the WSCFF in facilitating it. We made a decision and it was not the right one, nor the best one. The upcoming study can provide the forum for rebuilding the trust and the WSCFF will be receptive to the concerns of ALL parties; I can promise you that."*

Unfortunately, there has been no rebuilding of trust as the study process has moved forward. If anything it has only worsened. In our view the appearance of impropriety now taints not just the political organizations but even the government organizations charged with managing the study itself. We will demonstrate how that has manifested itself as we review the study process.

### THE MERGER STUDY

We were anxious to participate in the study and were confident that we would see data and other information that would aid in making a reasonable assessment of the viability of the concept. We were promised legal opinions and actuarial reviews.

Imagine our surprise when the date of the first meeting, August 30, arrived and we had received absolutely nothing from OSA or DRS. Rather we were presented with the statement by OSA and DRS that "We see it as drafting a roadmap to merger." This statement appeared to us to put these two agencies squarely behind the concept and portrayed them as seeing the merger study as simply a device for developing the merger plan as opposed to a study as to the viability of the concept itself.

The next surprise was the discovery that the individual selected to represent DRS and to facilitate the meeting was Mr. Dave Nelsen, the brother of the LEOFF 2 Board Director and author of HB 2097.

A third surprise was the discovery that the law firm conducting the review of federal legal issues was Ice Miller. This is the same firm that also represents the LEOFF 2 Board. It certainly appears to us as a direct conflict of interest that is exacerbated by the continued refusal of the LEOFF 2 Board to release legal reviews of merger issues in which they have invested over \$30,000.

The first meeting was conducted in a Town Hall format and, while it produced a lot of comments, it was not constructive in terms of providing a substantive understanding of the concept of the implications of the concept. Having served on the LEOFF 1 Medical Benefits study committee we were disappointed to find that this study would, apparently, not offer an opportunity for the concerned stakeholders to seek some consensus.

As we write this report we are anticipating the second meeting which appears to be more structured but does not appear to offer an opportunity for consensus development. At least we are in possession of the report prepared for OSA by Ice Miller but we still have no actuarial or financial data nor do we have a promised legal review of state issues.

## Report to LEOFF Merger Study

As stakeholders we have been asked to submit our input on the merger matter. Yet the process has consistently failed to produce the types of information and data we need to make salient comments. In contrast to the LEOFF 2 Board that can spend large sums on attorney reviews and can contract with the OSA for actuarial reviews our groups lack the resources for such efforts. Consequently we are crippled in our efforts to express concerns by a lack of data.

### **PRINCIPAL CONCERNS**

#### **Bad Public Policy**

We remain convinced that the concept of merging LEOFF 1 & LEOFF 2 is bad public policy. LEOFF 1 is a mature, financially stable and healthy pension system. All members are either retired or about to retire and it has had no contributions in over ten years. Those individuals who served as Fire Fighters and Police Officers are now retired and without the protection of well-funded strong lobbying groups to protect their interests. The state made a commitment to them and that should be honored. This is not a plan to rescue an ill formed underfunded pension plan but rather to reopen a closed system and subject it to vagaries of changing focuses in a system with benefits totally foreign to those of LEOFF 1.

It is unfair to the members, it is unfair to the beneficiaries and it dishonors their service.

#### **Not Fiscally Sound**

We believe it is financially unsound as well. Unfortunately we have not been provided with the OSA actuarial analysis of the concept and cannot comment in greater depth on that issue. What information we do have suggests that the LEOFF 1 pension plan is healthy and will remain so throughout the life of its beneficiaries. Placing it in an active and dynamic pool of an open system and then utilizing those funds to the benefit of LEOFF 2 members almost certainly assures that LEOFF 1 benefits will be underfunded as those assets are siphoned off for LEOFF 2.

We are hopeful that we will see more financial data and have an opportunity to closely review that data with the State Actuary. But, absent that, we do not have faith that the merger would be fiscally sound for LEOFF 1 or the state.

#### **Illegal**

We are convinced that there are insurmountable legal issues in any attempt to merge LEOFF 1 and LEOFF 2. The Ice Miller information provided as a part of this study certainly demonstrates the tax issues are extremely complicated and would probably require a termination of both LEOFF 1 and LEOFF 2. Additionally those tax rules seem to clearly prohibit utilizing LEOFF 1 assets to enhance LEOFF 2. That alone removes the primary reason the merger was sought.

We are convinced that the state and constitutional issues are even greater obstacles to a merger. The two systems are just too dissimilar.

Report to LEOFF Merger Study

The LEOFF 2 Board continues to refuse to release legal research on the issue but contend they see “no red flags” to the merger. We see nothing but red flags after extensive legal reviews by our attorneys. This issue could be easily resolved by sharing the opinions they have denied us.

As yet the OSA has not provided the stakeholders with any legal reviews of the state level issues.

Another legal concern that would also contribute to make the concept bad public policy is the fact that the LEOFF 1 plan is legally stable. It has seen over 40 years of litigation so that there are few issues that have not been addressed. Merging the two systems would effectively destroy the case law and end up subjecting the state, local governments and stakeholders to potential litigation over issues long since settled.

**Unacceptable Governance**

LEOFF 2 stakeholders spent in excess of \$1,000,000 to conduct an initiative campaign that created the LEOFF 2 Board and invested in the LEOFF 2 community some capacity to impact the governance of their pension plan. They did this because they felt they were inadequately heard by the Select Committee on Pension Policy. They structured the new LEOFF 2 Board so that employee nominees could only be proposed by WACPOS and WSCFF. Then, as the board matured they were able to populate even the legislative position on the board with LEOFF 2 members. Obviously they have a vested interest in maintaining the status quo. In fact the board has done a relatively good job as the LEOFF 2 system remains one of the healthiest systems in the state.

In contrast, the LEOFF 1 stakeholders would have no effective representation on the LEOFF 2 board as currently constructed. Even if significant changes were made, the continuing shrinkage in LEOFF 1 membership would point to diminished representation over time.

Combine those problems with the visceral distrust of LEOFF 2 engendered by the events leading up to the study and you have created an unworkable governance formulation.

The LEOFF 1 stakeholders have long been comfortable working directly with legislators and through the Select Committee on pension governance issues. That situation combined with the facts that LEOFF 1 stakeholders have no agenda seeking benefit enhancements and the state has no shared pension contribution matching responsibilities that could be leveraged against budget needs and there is no need to subject LEOFF 1 to a different governance formula.

Any governance merger with the LEOFF 2 Board would be unacceptable and unfair to LEOFF 1.

**SUMMARY**

It should be quite clear that thus far the study has produced nothing that might provide the legislature with the necessary facts to assess the principal issues. Rather it is just a list of “concerns” but nothing that would suggest a resolution of those concerns. From our perspective the study can never be much more than a list of concerns with a few appendices.

## Report to LEOFF Merger Study

The concept, at least as conceived in HB 2097 remains bad public policy, it is most probably fiscally unsound, it is illegal and offers no effective means of pension governance for LEOFF 1.

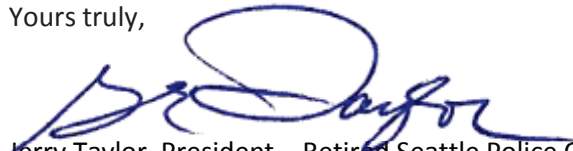
More complications arise when you consider the political machinations involved in the process and the perceived unfortunate apparent conflict of interests in the study itself.

If the legislature created the study just so the subject would go away and end the political conflict, then it should be locked in a drawer somewhere and the key disposed of. If the legislature sought to find solutions to concerns and consensus with the stakeholders, then the study has no chance of success and the legislature will again face the political firestorm surrounding the concept.

At the core of the issue are two divergent groups with different agendas. LEOFF 1 members are genuinely frightened and concerned as they see the very stability of their retirement as threatened. LEOFF 2 sees the need to expand their reach and secure access to funds from other systems. A course to some simple resolution does not seem to exist.

We remain hopeful that OSA will soon be able to release more information that will help us to better understand our concerns. We remain convinced that the LEOFF 2 Board has the responsibility to release their legal reviews as a way of enhancing everyone's knowledge of the subject.

Yours truly,



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1854 NW 195<sup>th</sup> Street, #303, Shoreline, WA 98177



Richard Warbrouck, President – Retired Fire Fighters of Washington  
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STATE OF WASHINGTON  
LAW ENFORCEMENT OFFICERS' AND FIRE FIGHTERS'  
PLAN 2 RETIREMENT BOARD

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August 3, 2011

**RECEIVED**

**AUG 3 - 2011**

Office of  
The State Actuary

Mr. Matt Smith, State Actuary  
Post Office Box 40914  
Olympia, Washington 98504-0914

Dear Mr. Smith:

At the July 27, 2011 meeting of the Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board (Board), the Board received an initial presentation on the topic of merging LEOFF Plan 1 and LEOFF plan 2. In response to the request from your office to provide input for the study that is being conducted on this topic by OSA, the Board has identified information and/or issues they would like OSA to include in the report. Many of these items were covered in the fiscal note prepared by OSA on HB 2097 during the 2011 session but the information may change as a result of the 2010 Actuarial Valuation Report.

1. How would the merger of the LEOFF Plan 1 and LEOFF Plan 2 affect the projected contribution rates for both plans and impact the Board's goal of stable contribution rates? Project rates for both plans separately, both before and after the merger. Use stochastic analysis to show the range and likelihood of possible outcomes. Please show the impact on 10% member rate risk measure. Demonstrate the impact of the merger on the possibility that LEOFF 2 member rates will exceed 10%.
2. How would the merger affect the Board's goal of full funding for LEOFF Plan 2? Provide the funding ratios for both plans before the merger and the funding ratio of the merged plan using both the actuarial and market value of assets. Please identify differences in liabilities using the projected unit credit cost method and the entry age normal cost method.
3. Are there any material differences between the current funding cycles for LEOFF Plan 1 and LEOFF Plan 2? For example, are there any differences on when rates are set or when assumptions are adopted that might create a policy issue? The Board is not familiar with the LEOFF 1 processes.
4. What funding policy differences currently exist between LEOFF Plan 1 and LEOFF Plan 2? For example, the Board is aware of differences in the salary growth assumption, payment of LEOFF 1 Unfunded Accrued Actuarial Liability by 2024, and demographic assumptions related to projected improvements in mortality. Are there others? Have projected improvements in mortality been incorporated into LEOFF 1 demographic

*Mr. Matt Smith, State Actuary*  
*LEOFF 1/LEOFF 2 Merger Study*  
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- assumptions as of the most recent valuation? If not, what is the projected liability associated with projected improvements in mortality for LEOFF 1? Does the use of the Frozen Initial Liability Cost Method for LEOFF 1 create any issues in the context of a merger?
5. What are the projected liabilities for LEOFF Plan 1? How would a merger affect those liabilities? What are the risks and risk measures? The Board is aware that both inflation and investment returns are significant risks. Are there others? Provide stochastic projections for investment returns and inflation. Please explain how these risks are mitigated or enhanced by the status of LEOFF 1? For instance, do earlier years affect investment return disproportionately because the ability to recover is limited in a closed plan with no active members?
  6. How would a merger affect the analysis of the current LEOFF Plan 1 investment policies? Does a merger eliminate any need to consider a separate investment policy for LEOFF 1 assets?
  7. What is the risk of LEOFF Plan 1 going into “pay as you go” status and how would a merger affect that risk? Are there other measures which might mitigate this risk besides a merger?
  8. What is the effect of a merger on state pension risk measures identified in the Pension Score card? For instance, what is the effect of a merger on the chance that pensions will consume more than 8% of the State general Fund? What is the effect on the total weighted score? If the total weighted score changes, would this be positive or negative and would the change be significant? Is there a risk measure associated with the impact of pension liabilities on State bond issuances?
  9. How would a merger affect the current cost policies for LEOFF 1? What are the projected costs if the State pays 100% of LEOFF 1 costs? What are the projected employer rates if any future LEOFF 1 costs are paid for via a supplemental rate charged to LEOFF employers?
  10. How would a merger affect the current 50-30-20 cost sharing policy for LEOFF 2 liabilities? How would a merger affect the current cost policy for LEOFF Plan 1? Could you continue to track LEOFF Plan 1 and LEOFF Plan 2 liabilities separately? What would rates be if current LEOFF Plan 2 cost-sharing policy was extended to cover LEOFF Plan 1 liabilities?
  11. How much revenue would be generated by resuming 6% contributions for LEOFF Plan 1 members and/or LEOFF Plan 1 employers effective July 1, 2012? How much would be generated if employers began paying the LEOFF 2 employer rate for LEOFF 1 members? What policy issues are raised when employers do not pay the same rate for all employees?

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Page 3

12. To what extent could benefits be decreased in LEOFF Plan 1 under current law if an unfunded liability emerges in LEOFF Plan 1 and the decrease in liabilities is determined to be necessary for the actuarial soundness of the plan? Do LEOFF Plan 1 members have a *Bakenhus* right to a 0% rate?
13. How would a change to a 4.5% salary growth assumption for LEOFF Plan 1 affect Present Value of Future Service for a merged plan? Would the change be significant?
14. The most recent risk assessment included a chart projecting the future LEOFF Plan 1 funded ratio. Could this chart include an overlay of the projected assets associated with those funding ratios? There are some who are assuming that a projected 160% funding ratio in the future means that the plan is projected to have a surplus of over \$1 billion. What is the underlying data that is responsible for the projected increase in the funding ratio for LEOFF 1 after 2024?
15. You are scheduled to make recommendations regarding any changes to long-term economic assumptions later this interim. Please evaluate the impact of any proposed changes on the risk measures previously discussed for merging LEOFF 1 and LEOFF 2.
16. Would it be possible to graph the actuarial value of assets over time (maybe the last 20 years) with the 30% corridor to demonstrate where the assets have fit in the corridor? Could there be a second line showing the market value of assets over the same period of time to demonstrate how much the actuarial and market values have deviated from each other.

I hope this input is helpful for your study. Please contact me if you have any questions concerning the items covered in this letter or need additional information. The Board may have additional input later this interim. They are aware of your timeframe and will make every effort to provide input in a timely manner.

Sincerely,



Steve Nelsen  
Executive Director

cc: Marcie Frost, Deputy Director



## Appendix Ten | Glossary

### *Actuarial Accrued Liability*

Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

### *Actuarial Assumptions*

Factors which actuaries use in estimating the cost of funding a defined benefit pension plan. Examples include: the rate of return on plan investments; mortality rates; and the rates at which plan participants are expected to leave the system because of retirement, disability, termination, etc.

### *Actuarial Cost Methods*

An actuarial method which defines the allocation of pension costs (and contributions) over a member's working career. All standard actuarial cost methods are comprised of two components: normal cost and the actuarial accrued liability. An actuarial cost method determines the incidence of pension costs, not the ultimate cost of a pension plan; that cost is determined by the actual benefits paid less the actual investment income.

### *Actuarial Gain or Loss*

A pension plan incurs actuarial gains or losses when the actual experience of the pension plan does not exactly match assumptions. For example, an actuarial gain would occur if assets earned 10 percent for a given year since the assumed interest rate in the valuation is 8 percent.

### *Actuarial Present Value*

The value of an amount or series of amounts payable or receivable at various times,

determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc.).

### *Actuarial Valuation Report (AVR)*

Actuarial valuations are technical reports providing full disclosure of the financial and funding status of public retirement systems administered by the Department of Retirement Systems. Valuations for odd-numbered years are also used to set contribution rates for the ensuing biennium. For those valuations, the Pension Funding Council oversees an actuarial audit of the results by an outside actuary.

### *Actuarial Value of Assets*

The value of pension plan investments and other property used by the actuary for the purpose of an actuarial valuation (sometimes referred to as valuation assets). Actuaries often select an asset valuation method that smoothes the effects of short-term volatility in the market value of assets.

### *Aggregate Funding Method*

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

### *Amortization*

Paying off an interest bearing liability by gradual reduction through a series of installments, as opposed to paying it off by one lump sum payment.

### *Annuitant*

One who receives periodic payments from the retirement system. This term includes service and disability retirees, and their survivors.

### *Contributory Plan*

A plan to which participants, as well as the employer, contribute. Under certain contributory plans participants may be required to contribute as a condition of eligibility.

### *Disability Retirement*

A termination of employment involving the payment of a retirement allowance as a result of an accident or sickness occurring before a participant is eligible for normal retirement.

### *Entry Age Normal (EAN) Funding Method*

The EAN funding method is a standard actuarial funding method. The annual cost of benefits under EAN is comprised of two components:

- ❖ Normal cost; plus
- ❖ Amortization of the unfunded actuarial accrued liability.

The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

### *Fiduciary*

(1) Indicates the relationship of trust and confidence where one person (the fiduciary) holds or controls property for the benefit of another person; (2) anyone who exercises power and control, management or disposition with regard to a fund's assets, or who has authority to do so or who has authority or responsibility in the plan's administration. Fiduciaries must discharge their duties solely in the interest of the participants and their beneficiaries, and are accountable for any actions which may be construed by the courts as breaching that trust.

### *Funded Ratio (Funded Status)*

The ratio of a plan's current assets to the present value of earned pensions. There are several acceptable methods of measuring a plan's assets and liabilities. In financial reporting of public pension plans, funded status is reported using consistent measures by all governmental entities. According to the Government Accounting Standards Board (GASB), the funded ratio equals the actuarial value of assets divided by the actuarial accrued liability calculated under the allowable actuarial methods.

### *Governmental Accounting Standards Board (GASB)*

This governmental agency sets the accounting standards for state and local government operations.

### *Market Value of Assets (MVA)*

The market value of assets is the value of the pension fund based on the value of the assets as they would trade on an open market, including accrued income and expenses.

### *Normal Cost*

Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year. The employer normal cost equals the total normal cost of the plan reduced by employee contributions.

### *Pay-As-You-Go (Pay-Go)*

A method of recognizing the costs of a retirement system only as benefits are paid. Also known as the current disbursement cost method.

### *Pension*

A series of periodic payments, usually for life, payable monthly or at other specified intervals.

The term is frequently used to describe the part of a retirement allowance financed by employer contributions. Compare with "annuity".

### *Pre-Funding*

To accumulate a reserve fund in advance of paying benefits. This is the opposite of "pay-as-you-go."

### *Present Value of Fully Projected Benefits*

Computed by projecting the total future benefit payments from the plan, using actuarial assumptions (i.e., probability of death or retirement, salary increases, etc.), and discounting the payments to the valuation date using the valuation interest rate to determine the present value (today's value).

### *Projected Unit Credit (PUC) Actuarial Cost Method*

The PUC cost method is a standard actuarial funding method. The annual cost of benefits under PUC is comprised of two components:

- ❖ Normal cost; plus,
- ❖ Amortization of the unfunded actuarial accrued liability.

The PUC normal cost is the estimated present value of projected benefits current plan members will earn in the year following the valuation date. It represents today's value of one year of earned benefits.

### *Projected Unit Credit (PUC) Liability*

The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service) based on the PUC method.

### *Qualified Plan*

An employee benefit plan approved by the Internal Revenue Service, meeting requirements

set forth in IRS Code Section 401. Contributions to such plans are subject to favorable tax treatment.

### *Reserve*

A collection of assets set aside to meet future liabilities.

### *Supplemental Cost*

A separate element of actuarial cost which results from future normal costs having a present value less than the present value of the total prospective benefits of the system. Such supplemental cost is generally the result of assuming actuarial costs accrued before the establishment of the retirement system. A supplemental cost may also arise after inception of the system because of benefit changes, changes in actuarial assumptions, actuarial losses, or failure to fund or otherwise recognize normal cost accruals or interest.

### *Unfunded Actuarial Accrued Liability (UAAL)*

The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date not covered by current plan assets.

### *Unfunded Liability or Unfunded PBO*

The excess, if any, of the pension benefit obligation over the valuation assets. This is the portion of all benefits earned to date that are not covered by plan assets.

### *Vesting*

The right of an employee to the benefits he or she has accrued, or some portion of them, even if employment under the plan is terminated. An employee who has met the vesting requirements of a pension plan is said to have a vested right. Voluntary and mandatory employee contributions are always fully vested.







## Office of the State Actuary

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