LEOFF
Plan 2 Retirement Board

LEOFF 1/LEOFF 2 Merger Study

COMPREHENSIVE REPORT FOLLOW-UP

November 9, 2016

PRESENTATION GOALS

- Specific Principles of Plan Mergers
  - Applied to LEOFF 1/LEOFF 2
    - Background & history
  - Frequently Asked Questions
  - Question & answer format
  - Conversational style

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WHAT IS A "MERGER"

- One of two ways a plan can end
  - Financial transaction with legal consequences
    - Plan assets are combined
    - Plan liabilities are combined
    - Plan benefits are unchanged
    - Analogous to a "marriage" of plans
  - "Termination" - Winding up of obligations
    - Any remaining liabilities are annuitized
    - Any remaining assets revert to the plan sponsor
    - Analogous to a "death" of a plan

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WHAT IS THE PURPOSE OF A MERGER?

- "Win-Win"
  - Investment opportunities
  - Risk mitigation
  - <u>Funding improvements/savings</u>

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HOW WOULD A MERGER AFFECT THE STATE BUDGET?

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

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WHO OWNS THE LEOFF 1 SURPLUS?

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

This does not mean a merger is impossible

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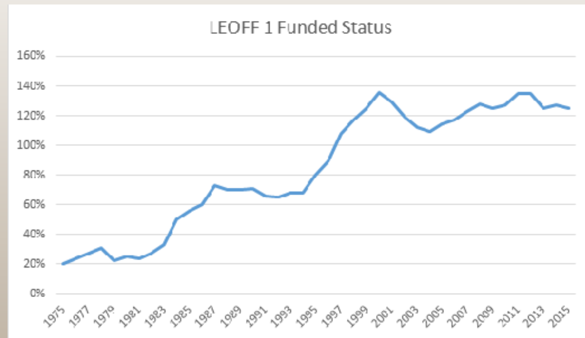
HOW DID THE LEOFF 1 SURPLUS HAPPEN?



Investment returns from 1995 – 2000 far exceeded expectations

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HOW DID THE LEOFF 1 SURPLUS HAPPEN?

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

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CAN SURPLUS ASSETS BE USED TO PAY RETIREE MEDICAL COSTS?

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

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HOW MUCH IS THE LEOFF 1 SURPLUS?

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

  But, 3 important variables:
  - What is the current data?
  - Market value or "smoothed" value?
  - What assumptions are used?

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HOW DOES A MERGER AFFECT BENEFITS?

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

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IS A MERGER LEGAL?

<u>State Law Issues</u>

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

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IS A MERGER LEGAL?

State Law Issues

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

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IS A MERGER LEGAL?

State Law Issues

Advice sought from State Attorney General

- What are the Washington Constitution Contracts Clause issues when two public pension plans are merged?
  - Does the funded status of the plans, both before and after merger, impact these issues?
  - Does the open or closed status of the plans, both before and after merger, impact these issues?
  - Does a reduction in the aggregate amount of employer contributions after merger impact these issues?
  - Does a change in employer sponsors for the merging plans impact these issues?
  - Does a change in plan governance for the merging plans impact these issues?
- Are there Washington state law fiduciary issues when the Legislature approves the merger of two public pension plans?
- Does a merger affect the possibility of the LEOFF Plan 1 COLA being reduced or repealed?

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IS A MERGER LEGAL?

Federal Law Issues

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

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IS A MERGER LEGAL?

Federal Law Issues

- Advice sought from State Attorney General
- Ice Miller responding to a number of questions regarding the merging of LEOFF 1 with TRS 1 or LEOFF 2

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

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

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

Analysis requested from Office of the State Actuary

There are two clear financial risks associated with a merger. Part of understanding these risks is understanding how these risks are increased if LEOFF 1 assets are used for other purposes such as rate reductions for the state or benefit payments to plan members.

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

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

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

- What is the likelihood of LEOFF 1 going under 100% funding ratio?
- How does that likelihood change using a 7.5% earnings assumption?
- How does that likelihood change using different economic scenarios? (Similar to modeling for HERP)
- How does that likelihood change if the CTF earns 5% on average for the next 10 years?
- How does that likelihood change if LEOFF 1 annuitants receive $5,000 each as an additional benefit?
- What are the greatest risks to a LEOFF Plan 1 UAAL reemerging?
- What are the consequences of a LEOFF Plan 1 UAAL reemerging? (State payments as a percentage of LEOFF 2 salary base? Employer payments?)

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

- How has the "Pay-Go Risk" analyzed in the 2011 LEOFF Merger Study by OSA changed since the publication of that report? Can you provide an update of the chart from that report that overlays the future risk of going into "pay-go" status and the amount of projected cost?
- Have the life expectancy recommendations of OSA been fully incorporated into the liabilities of LEOFF Plan 1?
- What is the current annual projected amount of LEOFF 1 benefit payments into the future? I believe that this is an exhibit already in the valuation report. It will be helpful to demonstrate how long LEOFF Plan 1 is expected to remain open.
- When OSA did the fiscal note for the proposed TRS 1/LEOFF 1 merger during the 2016 legislative session, the actuarial data was updated from the most recent actuarial valuation to the date of the fiscal note. Can you do a similar estimate for a LEOFF 1/LEOFF 2 merger?
- Is there a way to estimate the monthly changes to the LEOFF 1 "surplus" using the most recent monthly fund market value from WSIB and an estimate of how much LEOFF 1 liabilities have changed since the most recent valuation? For instance, can you estimate the projected change in liabilities from June 2015 to June 2016 and use $1/12^{th}$ of that number as an approximation for the monthly change?

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

A merger will result in a new funding ratio for the merged plan.

- What would the impact on that new funding ratio be if the State contributions were zero for the next two biennia?
- Would a merger impact the current rates charged to LEOFF 2 members or employers?
- What impact would a 0% state rate for two biennia have on the likelihood of future rate increases becoming necessary?

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

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

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HOW DOES A MERGER AFFECT INVESTMENT POLICY?

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

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NEXT STEPS

- The next presentation is scheduled for December 7, 2016
  - Analysis from Attorney General and State Actuary will be presented

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QUESTIONS

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