SCPP · 2016 Merger Study

EXECUTIVE SUMMARY

Select Committee on Pension Policy

Executive Summary

The budget proviso that commissioned this report required a study of the following implications of Senate Bill (SB) 6668:

- Tax and legal.
- Actuarial.
- Administrative.
- Policy.

It also required the following:

- An update of the 2011 LEOFF Merger Study.
- Receipt of stakeholder input.

Tax and Legal Summary

The Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 and the Teachers' Retirement System (TRS) Plan 1 can be merged, and a bill like SB 6668[1] is not prohibited under federal or state law. However, if re-introduced in a future legislative session, counsel has provided four ways that a similar bill can be changed that could improve the bill's likelihood of surviving a challenge under state and federal law.

1. Modify the TRS 1 statutes to reflect the merger.
2. Make the actual merger of assets and liabilities (not necessarily the entire bill) contingent on receipt of both a Private Letter Ruling and a Determination Letter from the Internal Revenue Service (IRS).
3. Modify the bill such that a new merged system is created, as opposed to a new tier within an existing system.
4. Modify the bill to further clarify that the members of one plan will not qualify for the benefits of the other.

More details on these changes are provided in the **Legal Analysis** and **Policy Analysis** sections of this report.

A "merger" is a merging of assets and liabilities of two or more qualified plans, where the combined assets are usable to pay the liabilities of both plans. This is as opposed to a "consolidation" of other aspects of a plan, such as how LEOFF 1 and TRS 1 already share the same governance, administration, and investment structure.

Aaron Gutierrez, MPA, JD
Senior Policy Analyst
360.786.6152
aaron.gutierrez@leg.wa.gov

[1] All references to SB 6668 refer to the bill introduced in the 2016 Legislative Session unless otherwise noted, or the context clearly implies otherwise.

Retirement plans must adhere to certain rules in order to remain tax qualified. Tax qualification brings several benefits, for example the ability to make pre-tax retirement contributions.

With that in mind, any proposed merger must take at least the following into consideration:

- ❖ Members must receive at least the same benefits after the merger that they would have received before the merger.
- ❖ The federal Exclusive Benefit Rule (EBR) must be adhered to, but so long as the benefits are being paid and no reversion is taking place, the IRS will consider the EBR satisfied.

As drafted, SB 6668 meets these requirements, but could benefit from the suggested changes above.

Actuarial Summary

LEOFF 1 is currently expected to have a surplus at the end of the plan's life. In other words, if all assumptions are realized in the future, LEOFF 1 will have assets remaining after all benefits for plan members and beneficiaries have been paid.

The funding policy for the merged plan created by SB 6668[2] would apply the expected LEOFF 1 surplus to the future contribution requirements of the merged plan. This results in an expected long-term total employer savings of about $1.9 billion through reduced contribution requirements over the next 25 years.

The fiscal impact of the merger, however, depends heavily on future economic outlooks. For example, under a very pessimistic outlook, where the merged plan would have insufficient assets in the future to cover all projected benefits, the merger results in a cost to employers of $3.2 billion over the next 25 years. This pessimistic scenario, or worse, occurs in 5 percent of the simulations generated by the Office of the State Actuary (OSA) for the purpose of analysis.

While there are potential risks (e.g., LEOFF 1 falling out of full funding) under current law, the impact of those risks (should they be realized) are increased by a merger. In other words, the merger doesn't create new risks, but under pessimistic scenarios the impacts of those same risks would be worse than under current law.

If these potential pessimistic outcomes are of concern to policy makers, then there are two ways the bill could be changed to help mitigate those risks.

- ❖ Eliminating or shortening the period of fixed rates would allow for more responsive and adequate funding should the need arise.

[2] For the purposes of analysis, the State Actuary considered a bill that is substantively identical to SB 6668, *but rolled one year forward*.

- ❖ Increasing the minimum Unfunded Actuarial Accrued Liability (UAAL) rates would help accommodate the higher risk associated with the added benefit payments.

Please see the **Actuarial Analysis** section of this report for more information, as well as a description of the assumptions and methods used.

Administrative Summary

As drafted, SB 6668 will result in a one-time cost of $161,020 to the Department of Retirement Systems (DRS). Please see the fiscal note included in the **Administrative Analysis** section of this report for more details.

A merger would also change the portion of retirement plan liabilities that local governments report for accounting purposes under the new Governmental Accounting Standards Board Rule 68 (effective June 15, 2014). More specifically:

- ❖ LEOFF 1 employers and the state would no longer have a LEOFF 1 asset to report on financial statements.
- ❖ TRS 1 employers would see their TRS 1 net liability reduced because of the addition of a merged LEOFF 1 asset.

Policy Summary

Policymakers may want to pursue a merger such as SB 6668 if they are seeking a way to:

- ❖ Achieve rate relief for TRS 1.
- ❖ More quickly amortize the TRS 1 UAAL, or improve its funded status.
- ❖ Manage the expected growth in the LEOFF 1 surplus.
- ❖ Establish a new funding policy for LEOFF 1.

Policy makers may want to avoid a merger if they:

- ❖ Feel that the short-term savings is outweighed by the increased risk of long-term costs.
- ❖ Do not wish to enact a merger over the objection of stakeholders.
- ❖ Would prefer to use other methods to achieve the goals above, such as creating a new funding policy for LEOFF 1.
- ❖ Prefer to maintain the status quo to see if the expected LEOFF 1 surplus is realized, or larger than expected in the future.
- ❖ Would prefer to use the expected LEOFF 1 surplus for other things, such as LEOFF 1 medical benefits, immunizing the plan, or benefit improvements.

In addition, policy makers may want to note that a merger may have implications for the *McCleary* decision.

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Stakeholder Input Summary

The SCPP received around 1,500 written responses during preparation of this report.

- Over 53 percent were members or retirees of LEOFF 1.
- Roughly 1 percent were members or retirees of TRS 1.
- Nearly 39 percent were members or retirees of LEOFF 2.
- Under 2 percent were employers of LEOFF 1/LEOFF 2 members.

Of the responses, over 87 percent were opposed to a merger. Roughly 1.5 percent were in favor, and approximately 11 percent said their response would depend on the provisions of the merger.

All the written responses the SCPP received are available verbatim here.

The SCPP also received testimony from stakeholders at most regular and executive committee meetings. Links to audio/video of the regular meetings, and audio of the executive committee meetings are available on the SCPP Merger Study website.

LEOFF 2 Report Summary

The SCPP asked for the assistance of the LEOFF Plan 2 Retirement Board in completing the LEOFF1/LEOFF 2 portion of the study mandate. The **LEOFF 1/ LEOFF 2 Merger Analysis** was prepared by LEOFF 2 Board staff and presented to the LEOFF 2 Board on December 7, 2016.