SCPP · 2016 Merger Study

POLICY ANALYSIS

Select Committee on Pension Policy

LEOFF 1/TRS 1 Merger: Policy Analysis

This section of the report explores the policy implications of a merger of the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 and Teachers' Retirement System (TRS) Plan 1, as well as some additional background items not covered in depth in other reports. It also explores the implications of Senate Bill (SB) 6668[1], should a similar bill be enacted in a future legislative session.

Caveat

This portion of the report was prepared independently of the legal analysis performed by the Attorney General's Office and Ice Miller, LLP (Ice Miller), in the **State Legal Analysis** and **Federal Legal Analysis** sections of this report, but relies on that analysis for its conclusions. Readers are strongly advised to read the *2016 SCPP Merger Study Report* in whole, and consult with their own counsel before making any decisions, or relying on the statements in this section.

Background

LEOFF 1 is unlike most retirement plans in the nation in that it has a funded status over 100 percent, which some have interpreted as being "overfunded". This naturally gives rise to questions about what, if anything, should be done with any excess funds that are not needed to pay for retirement benefits. Legislative bills dating back as far as 2001 would have utilized this expected surplus in one way or another.

At the same time, the state has several underfunded plans; most notably the Public Employees' Retirement System (PERS) Plan 1 and TRS 1. It is understandable that some may ask whether or not it is possible or beneficial to merge either PERS 1 or TRS 1 with LEOFF 1 to use one to help the other.

Given the requirements of the study proviso[2], the following analysis considers a merger of LEOFF 1 and TRS 1. However, some of this analysis could also be applied to a merger of LEOFF 1 and PERS 1, or PERS 1 and TRS 1, if either were proposed.

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[1] SB 6668, 2016.
[2] 2ESHB 2376, (Chapter 36, Laws of 2016, Section 106).

Policy Analysis

This section will attempt to distill the high-level takeaways from the attached reports, followed by some potential pros and cons of a merger of LEOFF 1 and TRS 1, as well as other considerations that may be of interest to policy makers.

Legal and Tax Qualification Concerns (and Impacts to Benefits)

Context

The final arbiter for any law is the court system. All new laws enacted by the Legislature are subject to challenge and can be overridden by the courts, and it is impossible to predict the outcome of court decisions with 100 percent certainty.

With this in mind, counsel was asked:

- ❖ Can LEOFF 1 and TRS 1 be merged?
- ❖ If so, is SB 6668 a reasonable way to accomplish such a merger?
- ❖ If the Legislature chooses to enact a merger, what can be done to put the state in the best position to succeed?

The SCPP's assigned Assistant Attorney General (AAG) conducted the state law analysis, and Ice Miller, LLP, (serving as special AAG) conducted an analysis under federal tax law. Both have provided their professional opinions; the full text is included in this report.

Stakeholders solicited other legal opinions on this issue, and submitted them to the committee. Those opinions are reproduced verbatim along with other stakeholder correspondence on the SCPP Merger Study page. SCPP counsel and Ice Miller reviewed those opinions before issuing their own.

Summary of Analysis

Based on the legal analysis in the **State Legal Analysis** and **Federal Legal Analysis** sections of this report, LEOFF 1 and TRS 1 can be merged, and SB 6668 is one way to accomplish that. However, there are several things that policymakers will want to consider if enacting a bill like SB 6668, or any merger.

To be more specific, mergers of qualified plans are not generally prohibited, but must be consistent with certain requirements; the highlights are discussed in the following paragraphs, but the full details are available in other sections of this report.

The legal analysis also provides four suggestions for changes to SB 6668 that would improve the bill's likelihood of surviving a challenge; each of which is listed here.

A Merger Must Not Negatively Impact Member Benefits

Under state law, members have a vested right to their benefits, and thus a merger must not negatively impact benefits. In other words, if the Legislature enacts a merger it is important that the merger not reduce the benefits the members would receive.

"Benefits", in this context, generally means the payments of monthly retirement checks calculated as defined in statute.[3]

As drafted, SB 6668 would not impact vested benefits. Sections 1, 3, and 4 of the bill (see **Appendix B**) state that the merger must result in members receiving the same benefits after the merger that they would have received before a merger.

It should be noted, however, that this prohibition does not prevent benefits from being *increased*. Thus, the $5,000 lump sum payment in SB 6668 is not prohibited as a matter of law. The lump sum would also not be a prohibited gift of public funds since the state constitution (Art II, Section 25) specifically allows for payments to retirees. This proviso does reduce the potential savings (see actuarial section below) from a merger, but that is a choice for policy makers, and does not make the payment prohibited under law.

It should also be noted that under state law plan members have a right to an "actuarially sound" retirement system. That said, there is no consistent measure of "actuarial soundness" since the term is not defined in Washington law or actuarial standards of practice. Absent evidence that a merger would result in an actuarially unsound retirement system, this requirement should not prohibit a merger.

The Exclusive Benefit Rule Must be Satisfied

Under federal tax law, contributions set aside for members must be for the exclusive benefit of the plan members. In other words, the Legislature cannot spend money from the retirement plan trust fund on, for example, roads and other infrastructure.

This rule applies both before and after a merger. However, according to the legal analysis, the Internal Revenue Service (IRS) will consider the Exclusive Benefit Rule (EBR) to be satisfied so long as benefits to members and survivors are being paid.[4] Thus, as drafted, counsel believes SB 6668 will satisfy the EBR.

Reversions of Assets are Limited

At the end of the plan's life cycle, any remaining assets revert to the plan sponsor, and can then be spent on things other than retirement benefits. In this context, the plan sponsor is the State of Washington, and the end of a plan's life

[3] For LEOFF 1 and TRS 1 benefit calculations, see Chapter 41.26 RCW and Chapter 41.32 RCW, respectively, or the relevant DRS handbooks.
[4] See **Appendix D.**

cycle means the point in the future when all benefits to retirees and qualified survivors have been addressed (e.g., paid, settled, or immunized) in full.

There are limited circumstances where a reversion of assets can take place prior to the end of the plan's life cycle. According to counsel, those circumstances are not present, and a reversion would not be allowed at this point in the LEOFF 1 plan life cycle.

However, as drafted, counsel believes SB 6668 will not result in a reversion of assets, and thus is not prohibited by this limitation.

Suggestions for Improving SB 6668

If re-introduced in a future legislative session, there are ways that a similar bill can be changed that could improve the state's likelihood of surviving a challenge.

1. Modify the TRS 1 statutes to reflect the merger.

   As drafted, the bill modifies LEOFF 1 statutes (Chapter 41.26 RCW), pension funding statutes (Chapter 41.45 RCW) and the Department of Retirement System (DRS) statutes (Chapter 41.50 RCW). Changes should also be made to the TRS 1 statutes (Chapter 41.32 RCW) sufficient to alert the reader that the merger has taken place.

2. Make the actual merger of assets and liabilities (not necessarily the entire bill) contingent on receipt of both a Private Letter Ruling (PLR) and a Determination Letter (DL) from the IRS.

   As drafted, SB 6668 merges the assets and liabilities at the same time the bill takes effect. This could lead to difficulties if the merger needed to be "unwound" due, for example, to an unfavorable response from the IRS. Counsel has thus suggested that the merger not take effect until favorable responses from the IRS are received.

   In light of this recommendation, stakeholders inquired during public testimony how a bill could be written to account for the fact that the bill's effectiveness must be contingent on an IRS ruling, but an IRS ruling can't be obtained without an enacted bill. In other words, it was sort of a "which came first, the chicken or the egg?" question.

   Here is one example of how it could be structured:

   - The bill could be effective 90 days after session.
   - The actual merger of assets and liabilities would only take effect once DRS receives both a favorable PLR and favorable DL from the IRS.
   - Other aspects of the bill (such as the rate relief provisions) can be effective whenever the legislature chooses.
     - The effective date of each non-merger provision would represent a policy choice for the Legislature.

The Bill Drafting Guide produced by the Office of the Code Reviser/Statute Law Committee contains stock language for contingent effective clauses that should be helpful in crafting this section.

3. Modify the bill such that a new merged system is created, as opposed to a new tier within an existing system.

   Under recently-enacted rules, the IRS will only issue a DL to a new plan. Thus, modifying the bill so that it creates a new merged plan will make the bill eligible for a DL.

4. Modify the bill to further clarify that the members of one plan will not qualify for the benefits of the other.

   As drafted, SB 6668 states that members must receive the same benefits after a merger as they would have before a merger. The bill could be modified to emphasize that in the new merged system (see suggestion number 3) the members of one plan will not be eligible for the benefits of the other.

   In other words, the intent section of the bill could further clarify that

   - TRS 1 benefits will continue to be defined by the TRS statutes.
   - LEOFF 1 benefits will continue to be defined by the LEOFF statutes.

Summary of Fiscal Impacts

Context

At the highest level, the current fiscal conditions of LEOFF 1 and TRS 1 are the result of the Legislature contributing more than needed for one plan, and less than needed for the other. While there are a multitude of reasons and details underlying these contributions, ultimately that is the result.

As it stands now:

- LEOFF 1 has more assets than it is estimated to need.
- TRS 1 has fewer assets than it is estimated to need, and bringing it up to full funding represents a significant ongoing cost for the state.

In light of this, merging TRS 1 with LEOFF 1 will bring a large infusion of assets to TRS 1. Under a pure merger scenario (i.e., a merger of assets and liabilities with neither a rate relief provision nor a lump sum payment), this would lead to quicker amortization of Unfunded Actuarial Accrued Liability (UAAL) and a long-term savings.

Analysis

It is important to note that SB 6668 includes more than just the pure merger of both systems. It also contains a rate-relief provision and a lump sum payment.

At the highest level, SB 6668, as drafted, uses the expected surplus in LEOFF 1 to provide rate relief for TRS 1. This results in a guaranteed short-term savings for the state in the form of smaller contributions being made toward TRS 1.

The bill does this by enacting:

- Fixed rates in the near biennium.
- Minimum rates from there on.

Both of these rates are lower than currently required for TRS.

To reiterate, this is a guaranteed savings in the short term, and an expected savings in the long term. This expected long-term savings is approximately $1.9 billion. However, the actual outcome is very dependent on future economic outcomes.

Under most economic scenarios, the short-term savings becomes a long-term one. The better the economy (in particular, the more interest earned on investments), the larger the long-term savings.

However, it should not be lost in this discussion that there are some economic scenarios that result in a long-term cost. Under pessimistic projections, a merger like SB 6668 results in long-term cost of $3.2 billion. 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 for the plans, but under pessimistic scenarios the impacts of those 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.
- Increasing the minimum UAAL rates would help accommodate the higher risk associated with the added benefit payments.

Summary of Administrative Impacts

Context

DRS is generally neutral on bills and proposals. As plan administrator, DRS is expected to administer the plans as directed by the Legislature, and consistent with IRS regulations and any relevant case law.

Analysis

According to the DRS fiscal note,[5] SB 6668 would result in a one-time cost of $161,010 to pay for things like:

- New communication materials (brochures, mailers, etc.).
- Programming updates.
- Managing the IRS compliance (e.g., PLR and DL).

A merger would also impact the way local governments (who are LEOFF 1 or TRS 1 employers) report their financial situation under Governmental Accounting Standards Board 68 as follows:

- 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.

Goals and Concerns of a Merger

Staff cannot speak for the sponsors of the various merger bills, and will not try to guess at their motivations. However, for the purpose of analysis we can infer some possible viewpoints, as well as goals and concerns for a merger that policymakers may want to consider.

Sample Viewpoints

Staff was unable to find any similar mergers across the nation in the last decade.[6] In light of this, there are several ways a merger of this type could be viewed:

- Uncharted territory.
- Innovative.
- Mainly a technicality since most aspects of the plans are already merged.

Why Might You Want to Merge LEOFF 1 and TRS 1 Similar to SB 6668?

There are at least four reasons why policymakers may want to pursue a merger.

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[5] Reproduced in the **Administrative Analysis** section of this report.
[6] Other mergers took place, but they were either consolidations (i.e., a merger of investments, administration, or governance only), or a merger of a small municipal plan into an existing statewide plan.

1. Immediate Budget Savings/Rate Relief.

A merger such as SB 6668 results in an expected savings of $1.9 billion. This includes a near-term savings for the state General Fund of approximately $338 million over the next two biennia.[7]

While not an explicit requirement of a plan merger, the prior merger bills from 2011 and 2016 have each involved some form of rate relief. In 2011, it was a reduction in the ongoing costs of LEOFF 2. In 2016, it was a reduction to the ongoing costs of TRS 1.

Either would result in an immediate budget savings by reducing contributions. The funds that would normally have been set aside for these plans could instead be used for other state obligations.

2. Quicker Amortization of the TRS 1 UAAL/Improved Funded Status.

A merger such as SB 6668 results in an expected amortization of the TRS 1 UAAL two years earlier.[8]

Quicker amortization of the UAAL is the flip side of rate relief, and aims at maximizing long-term savings. Current projections show that the combined plan would have a higher funded status than the current TRS 1. While it would not be 100 percent funded after a merger, it would be closer to full funding.

3. Managing the Expected Growth of the LEOFF 1 Surplus.

Right now, the LEOFF 1 plan has more assets than needed to pay benefits on an actuarial basis; meaning that if all assumptions are realized the plan will have a surplus remaining once all benefits are paid. Prior to a merger, most economic scenarios result in the surplus continuing to grow. Prior to a merger, these surplus assets are held in the plan trust fund, and cannot be used for other state obligations.

A merger provides one way to manage the expected growth and utilize those assets without a prohibited reversion. In other words, a merger such as SB 6668 would utilize the expected growth of the surplus to pay the combined cost of benefits in the merged plan, which lowers the total amount of contributions required from the state.

4. New Funding Policy for LEOFF 1.

Under current law, it is unclear what the LEOFF 1 funding policy would be under sufficiently poor economic conditions. Right now, no contributions are required because the system is fully funded.[9] If the plan were to fall

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[7] See above, and the State Actuary's Draft Fiscal Note in the **Actuarial Analysis** section of this report.
[8] Ibid.
[9] RCW 41.26.080(2).

out of full funding (i.e., giving rise to an unfunded liability), the current funding policy calls for contributions as follows:[10]

- 6 percent member.
- 6 percent employer.

However, these contributions are collected across the active membership of the plan. In other words, only the active members pay 6 percent of salary, and employers pay an amount equal to 6 percent of each active member's salary. If there are no active members, then no contributions are required under any economic conditions. As of the June 30, 2015, actuarial valuation, there were only 82 remaining active members of LEOFF 1. At the same time, there were 7,507 LEOFF 1 annuitants[11] receiving benefits.

Further complicating this issue is the fact that the state has adopted the goal of fully amortizing any unfunded liability by June 30, 2024.[12] As shown in the 2011 Merger Study, if an unfunded liability were to arise near that date, it may need to be paid very quickly, resulting in a spike in required contributions.

Thus, if the plan were to fall out of full funding, the 6 percent member and 6 percent employer contributions may not be sufficient to fully fund ongoing benefits for the plan.

In light of this, we typically presume for the purposes of analysis that if the plan falls out of full funding the state would once again take responsibility for the payments toward the unfunded liability. This is because the original funding policy for LEOFF 1 called for the 6 percent/6 percent policy above to pay for the ongoing costs, while the unfunded liability would be paid by the state.[13] However, the provision that required the state to pay the unfunded liability was never codified, so if the plan falls out of full funding the only funding policy in law is the 6 percent/6 percent contribution requirement.

By establishing a merged or revised funding policy, a merger could remove this uncertainty. For example, SB 6668 would have established that LEOFF 1 members and employers would never be required to make any future contributions; no matter what the economic situation.[14] Thus, under the bill even if benefits were improved for LEOFF 1, the TRS 1 fund would pay for those improvements.

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[10] RCW 41.26.080(1).
[11] "Annuitants" refers all people receiving benefits from the plan, including retirees and survivors.
[12] RCW 41.45.010(2).
[13] 1969 ex. S. c 209.
[14] SB 6668, 2016. See e.g., Section 8 of the bill.

Why Wouldn't You Want a Merger Similar to SB 6668?

There are at least five reasons why policymakers may not want to pursue a merger.

1. Increased Risks, Including Risk of Potential Underfunding.

The short-term budget savings outlined above will be realized since it is built into the bill. However, the long-term impacts are based on assumptions about future events. This means that the savings may only be temporary, and under some unfavorable economic scenarios, the temporary rate relief could lead to costs for the merged plan.

As noted above, there are potential risks under current law, but the impact of those risks (should they be realized) are increased by a merger.

2. Stakeholder Resistance.

The SCPP received around 1,500 written responses during preparation of this report. Of the responses, over 87 percent were opposed to a merger. For reference:

- Over 53 percent were members or retirees from 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 1/2 members.

The SCPP also received several legal opinions that were solicited by stakeholders; each of which states that there are legal difficulties or problems with the merger (in concept, as drafted, or both).

All the written responses the SCPP received, including the legal analyses, are available verbatim here.

3. Other Uses for the LEOFF 1 Surplus.

Stakeholders have raised the possibility of other uses for the LEOFF 1 surplus besides a merger. For example:

- LEOFF 1 medical benefits.

  Currently, the LEOFF 1 medical benefits are paid entirely by LEOFF employers. Representatives of employers have raised the possibility (for example, at the roundtable discussions) of utilizing the surplus to pay for the ongoing costs of LEOFF 1 medical benefits.

- Immunizing/settling the plan.

  "Immunizing" and "settling" the plan are methods of protecting the plan against future changes. The details of these methods are beyond the scope of this paper, and they may not be the only similar options available.

For purposes of illustration, here are rough descriptions of both:

- Settling a plan generally refers to using plan assets to purchase commercial annuities through an insurance company that will then provide the beneficiary and survivor with a guaranteed lifetime income equivalent to what they would have received if paid directly from the retirement plan. In essence, this transfers the obligation for making benefit payments away from the state.
- Immunizing a plan generally refers to changing the investment policy (i.e., asset allocation) for a plan to safer investments with lower yields, thus protecting the plan from future market volatility.

Again, these are rough descriptions only, and we would encourage any interested policymakers to consult with OSA, DRS, and the State Investment Board before pursuing these, or any similar options.

- Benefit improvements.

  The full realm of possible benefit improvements is too large to describe, but could include something like a higher benefit multiplier.

4. Maintaining the Current Status Quo/Allowing Surplus to Continue Growing.

As noted above, the expected surplus is projected to continue growing, and is expected to grow even more under current law (i.e., without a merger). At the end of a plan's life cycle, the plan assets revert to the plan sponsor (state) and can be used for things other than retirement benefits.

Thus, maintaining the current status quo allows policy makers to wait and see what market conditions actually play out in the future, and whether or not:

- The expected surplus is realized.
- The surplus is larger than expected.

Generally, the more the fund grows now, the more assets will be available at a future date to help pay for other state obligations.

5. Pursue Other Methods for Reaching Same Goals.

Any of the five identified reasons why policy makers might want to pursue a merger could be accomplished by means other than a merger. That said, the implications may be different due to the individual circumstances for each.

For example, a new funding policy could be created for LEOFF 1 that could account for the expected growth of the surplus, provide a method for new contributions in case that the plan could drop out of full funding, or both.

Rate relief can also be accomplished for TRS 1 without a plan merger. However, without the infusion of assets (e.g., from LEOFF 1, or increased contributions from the General Fund), this would result in underfunding of TRS 1. Similarly, the TRS 1 UAAL could be amortized quicker without a merger, but would require additional contributions from the state General Fund.

Other Considerations

Governance

LEOFF 1 and TRS 1 already have the same governance. Both are directly overseen by the Legislature, with input from the Pension Funding Council and the SCPP. That means that a merger would not likely impact governance, and as drafted, neither would SB 6668.

During the roundtable discussions, stakeholders had asked two additional questions about governance. First, they asked if these two plans are governed by local oversight boards. Second, they asked if those boards would be allowed to vote on a proposal.

The answer to both questions is no. There are two types of pension boards in this context that might be considered "local oversight boards", and neither is relevant to a merger of LEOFF 1 and TRS 1:

1. The LEOFF 2 Board.

   The LEOFF 2 Board would only be involved in a merger that directly impacts the LEOFF 2 plan. Under a proposal such as SB 6668 (where LEOFF 1 is merged with TRS 1), the LEOFF 2 Board would not be impacted or involved. The report from the LEOFF 2 Board that is included in this report will discuss the potential impacts of a LEOFF 1/2 merger.

2. LEOFF 1 disability/medical boards.

   The LEOFF 1 disability/medical boards have purview over LEOFF 1 medical benefits only. Under a proposal such as SB 6668 (where section 4 of the bill explicitly states that medical benefits and the disability/medical boards are not impacted), the LEOFF 1 disability/medical boards would not be impacted or involved.

Fiscal Management

Pension funding is only one part of a larger budget, and any funds set aside to pre-fund pension benefits are unavailable to pay for other obligations.

All budgeting requires a balance between income on one side, and on the other side both the short-term costs that must be paid today, and the long-term costs that one reasonably assumes will be needed tomorrow. The full ins and outs of budgeting are well beyond the scope of this paper. However, it can be noted that prefunding of the retirement systems forces lawmakers to choose a balance between setting the money aside for future payments, and using that money to pay for current obligations.

Perhaps the biggest difficulty is the fact that while the existence of a future cost for retirement benefits is known, the actual size of that cost can only be estimated using, for example, the best actuarial methods currently available.

The Legislature has adopted a statutory policy[15] to prefund benefits, but there is a range of opinions on precisely what that should look like. While the State Actuary routinely calculates contribution rates, those rates are based on assumptions. As noted in the certification sections of the actuarial analysis, other approaches and assumptions could also be considered reasonable.

To illustrate, at one extreme we know that pre-paying 100 percent of the estimated future cost is:

- Most costly in the short-term.
- Cheapest in the long-term due to having more contributions available to invest, and the longer time available to earn interest on those contributions.

On the other extreme, waiting until the benefits must be paid to the retiree (no pre-funding, or "pay-go") is:

- Cheapest in the short-term because the member works for approximately 30 years without the employers making a single payment.
- Most costly in the long-term due to little or no ability to invest contributions.

Either way, the cost of benefits must be paid. The earlier this is paid, the more you maximize the time-value of the contributions. This is why we say in pension funding, "pay now or pay more later".

Thus, while any one particular systematic actuarial funding plan may be within the bookends of "actuarial reasonability", it is ultimately a policy decision for lawmakers to strike what they feel is the best balance, and best utilization of public funds.

Impact to Education Funding (*McCleary*)

While the impacts of the *McCleary* case are outside the scope of this paper and staff expertise, it is important to note that under SB 6668, future LEOFF 1 liabilities (should they arise) could possibly be considered an education obligation.

As noted above, the LEOFF 1 plan is currently fully funded. If it were to fall out of full funding and additional contributions were required (either

[15] RCW 41.45.010.

for prefunding or on a "pay-go" basis), it is unclear what the funding policy would be. It is often presumed that because of the prior funding policy, the state would take on at least the bulk of the cost with payments from the general fund, but that is not clear in statute.

Under the bill, any future liability for LEOFF 1 would be the responsibility of the TRS 1 fund. Some have speculated (for example, at the roundtable discussions with stakeholders) that this would require direct contributions from TRS 1 employers (school districts), and may come from local levies. It has also been speculated that the bill would result in constitutional protection for LEOFF 1 funding.[16]

However, it is important to note that the discussion of what costs are considered "basic education" is an ongoing one.[17] It is not yet clear if, or how, a merger would, or could, impact local levies,[18] the state's portion of contributions to education, or both.

As a result, policymakers may want to consult with education staff for more information on the potential impacts.

Contributions to the LEOFF 1 Plan

As noted in the legal analysis section of this report, any remaining assets at the end of a plan's life cycle revert to the plan sponsor, and can then be used for things other than retirement benefits. However, the fact that the Legislature is not required to give those remaining assets to members, beneficiaries, or employers, does not mean that such an arrangement can't be made.

It is important to note that the total plan assets are not treated the same as individual member contributions. Members can withdraw their own contributions under some circumstances, but doing so requires them to forfeit future benefits. However, members who retire are entitled only to the benefits of the plan, and not the actual contributions or interest set aside to pay those benefits.[19]

Some LEOFF 1 stakeholders have stated that their personal contributions alone have paid for their lifetime of benefits after retirement.[20] However, member contributions only make up one portion of the funding equation.

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[16] I.e., if LEOFF 1 benefits are a liability of TRS employers (school districts), and the funding of school districts falls under the constitutional requirement to fund basic education, then the funding of LEOFF 1 benefits may be required under the state constitution.

[17] See e.g., the meetings of the Education Funding Task Force.

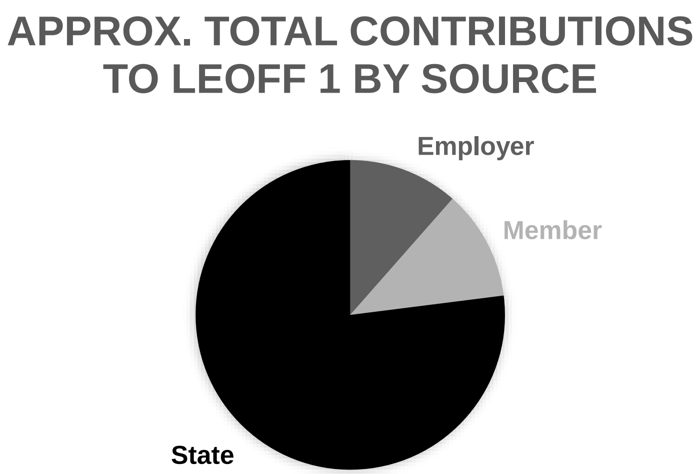
[18] See e.g., the lawsuit filed by the Superintendent for Public Instruction.

[19] See **Appendix D**.

[20] See the responses to the web survey, here.

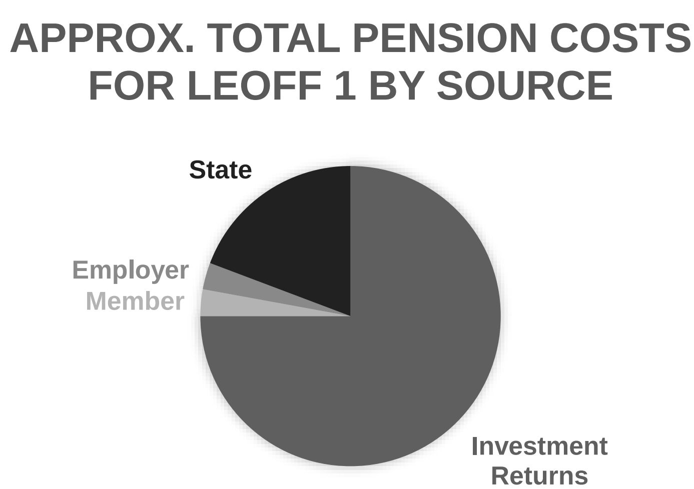
Historical data shows that LEOFF 1 members contributed approximately 11.5 percent of all contributions to the plan, and LEOFF 1 employers paid approximately 11.5 percent.[21] In contrast, the state contributed approximately 77 percent of all contributions toward the plan (see Fig. 1).[22]

Fig 1.



However, contributions are only one part of the equation. In Washington's retirement plans, contributions have historically made up around 25 percent of the total cost of benefit payments for members in the various retirement plans. Investment returns make up the rest (see Fig. 2).

Fig. 2



[21] See the appendix to the May SCPP meeting materials, available here for more details.
[22] Ibid.

Thus, the members' contributions only pay for a portion of each member's average lifetime benefit.

Current analysis shows that after approximately two years of retirement, the system will have paid the retiree all benefits that his or her contributions (and interest on those specific contributions) personally funded.

In other words, if only the member's actual contributions had been made to the system, those contributions plus interest would only pay for approximately two years of benefits. After that, no benefits would have been pre-funded.

Thus, any LEOFF 1 retiree (and any qualified survivor of a retiree) who receives more than two years of benefits is receiving benefits paid for by contributions from the state and employers (plus interest on the combined contributions).

This calculation is known as the "certain period", and is a regular actuarial calculation done periodically for experience study purposes.

A review of certain period calculations for LEOFF 1 since 2005 shows that the certain period has ranged from just below two years, to around 2.4 years. [23] For comparison, as of the June 30, 2015, actuarial valuation, current service retirees have already received, on average, 17 years of benefits.[24]

Other States

Staff was unable to find any similar mergers in other states in the last ten years. While there have been mergers of government plans, they have all been one of the following:

- Small municipal plans merged into a bigger statewide plan.
- Merger of supplemental deferred comp-type plans only.
- Combining of investment functions, governance, or plan administration (i.e., “consolidation” rather than a "merger").

None of these is directly analogous to the merger analyzed here.

Conclusion

LEOFF 1 and TRS 1 can be merged, and a bill like SB 6668 is not prohibited by state law, or federal tax law. That said, counsel has provided several

[23] We did not update the certain period calculations for TRS 1 for this report. However, we last measured it for the 2014 Demographic Experience Study which covers the period of 2007-2012.
[24] Does not include the lifetime benefits for qualified survivors. See 2015 Actuarial Valuation, pages 68 and 69.

suggestions for modifying the bill that they believe will help the bill survive a legal challenge.

A merger such as SB 6668 is expected to have both short and long-term savings. The short-term savings is locked in by the bill, but under sufficiently poor economic conditions the long-term savings could shrink, or become a cost. While the merger will not create new risks for the plan, the outcomes from those same risks as before a merger, if realized, are worsened after a merger.

A merger such as SB 6668 requires one-time costs of approximately $161,000, but DRS reports that the merger can be administered as drafted.

Policymakers may want to pursue a merger 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.

Policymakers 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 a new funding policy for LEOFF 1.
- ❖ Would prefer to use the expected LEOFF 1 surplus for other things, such as LEOFF 1 medical benefits, immunizing the plan, or benefit improvements.