December 2016

SCPP Select Committee on Pension Policy

2016 Merger Study

for LEOFF Plan 1 and TRS Plan 1

Office of the State Actuary

"Supporting financial security for generations."

ACKNOWLEDGMENTS

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To obtain a copy of this report in alternative format call 360.786.6140 or for TDD 711.

ABOUT THIS REPORT

Select Committee on Pension Policy

2016 SCPP Merger Study

About This Report

Study Mandate/Budget Proviso

The 2016 Supplemental Operating Budget[1] requires the SCPP to study:

- A merger of the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1/Teachers' Retirement Systems (TRS) Plan 1 (SB 6668).
- A merger of the LEOFF 1/LEOFF 2 (update of 2011 Merger Study Report).

This includes analysis of implications in the following areas:

- Tax.
- Legal.
- Fiscal/Actuarial.
- Policy.
- Administrative.

The proviso also requires the SCPP to receive stakeholder input. The responses have been compiled, and are available on the SCPP Merger Study webpage.

Report Structure and Process

To meet the requirements of the study proviso, the SCPP requested the assistance of the Attorney General's Office, the Department of Retirement Systems, the LEOFF 2 Board, and the Office of the State Actuary.

The letters sent to the various agencies are in the appendix of this report, and are available on the Merger Study webpage.

The SCPP received the following briefings, all of which are available on the Merger Study webpage:

- May.
  - Initial briefing.
- June.
  - Receive work plan.

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

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- July.
  - Receive preliminary stakeholder input.
- September.
  - Receive final version of compiled stakeholder input.
- October.
  - Receive preparation updates on each section of report.
- November.
  - Receive updates and a draft of the report.
- December.
  - Receive final report.

At the request of stakeholders, a dedicated Merger Study webpage was created within the SCPP website.

Also at the request of stakeholders, previews of SCPP meeting materials were made available in advance of the meetings whenever feasible.

As one means of fulfilling the requirement of soliciting stakeholder input, the SCPP sent a link to a web survey, and invited interested stakeholders to participate via the web, or emails/letters sent to committee staff. The web survey link was sent out on June 28, 2016, and remained open until August 31, 2016.

Altogether, approximately 1,500 responses were received. The responses are compiled on the Merger Study webpage.

The SCPP chair held roundtable meetings with stakeholders on:

- July 27, 2016.
- August 30, 2016.

The discussions at these roundtable meetings also informed the compiled version of stakeholder responses.

Stakeholders also offered testimony at most SCPP Full Committee meetings, and SCPP Executive Committee meetings.

Current Bill Status

At the end of the biennium (June 30, 2016), all bills from the 2015-16 Biennium are considered dead including the merger bill (Senate Bill [SB] 6668). However, similar or identical bills can be introduced beginning on the first day of the 2017 Legislative Session. Bills can also be pre-filed now for introduction next session.

All references to SB 6668 in the attached analysis are based on the *original text* of SB 6668 unless otherwise noted, or the context clearly implies otherwise. However, bills can be amended substantially during session, and it is impossible to speculate on the extent of those amendments in any final enactment.

The bill text, legislative history, staff bill reports, and fiscal notes can be found here.

EXECUTIVE SUMMARY

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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.

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[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.

FEDERAL LEGAL ANALYSIS

IceMiller
LEGAL COUNSEL

MEMORANDUM

Via Electronic Mail

TO: **Anne Hall, Senior Counsel**
Washington State Attorney General's Office

FROM: **Mary Beth Braitman and Robert L. Gauss** MBB
ICE MILLER LLP

DATE: **November 29, 2016**

RE: **Federal Tax Considerations related to a Potential Merger of LEOFF Plan 1 and TRS Plan 1**

This Memorandum follows-up to our telephone conversation on October 27, 2016 and supplements our draft Memorandum dated September 26, 2016 and November 11, 2016 (which considered certain legal questions raised by stakeholders related to a potential merger of LEOFF Plan 1 with TRS Plan 1 (collectively referred to as the “Plans”)). This Memorandum also addresses certain additional questions and/or concerns raised during the SCPP hearing on November 15, 2016.

In particular, this Memorandum will address the federal tax considerations of a merger between two qualified governmental defined benefit plans in accordance with the Internal Revenue Code ("Code") and applicable Treasury Regulations.

I. EXECUTIVE SUMMARY

As will be discussed in greater detail in this Memorandum, under the Code and applicable Treasury Regulations, the term "merger" means the actual merger of assets and liabilities of more than one qualified plan into a single plan where the assets and liabilities are "usable" across the spectrum of merged plans. In order for a merger to be considered "legal" or "valid" for purposes of federal tax law, each participant in the merging plans must receive benefits on a termination basis from the plan immediately after the merger which are equal to or greater than the benefits the participant would have received on a termination basis immediately before the merger. Code §§ 401(a)(12) and 414(l). In this regard, a plan member who has reached normal retirement age or reached other vested status under the merging plans must be vested in his/her accrued benefit as of that date. Finally, in order for a merger to be valid it must comply with the exclusive benefit rule under Code § 401(a)(2). Accordingly, as part of the merger, it must be impossible for any part of the corpus or income of the merged plans to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries before there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the Plans.

Based upon our review of Senate Bill ("SB") 6668, we believe SB 6668 is drafted to comply with the Code requirements for a valid merger. Accordingly, and for the reasons detailed in this Memorandum, the merger contemplated by SB 6668 would not be prohibited under the federal tax laws applicable to qualified governmental pension plans.

In order to confirm that the merger would be approved by the Internal Revenue Service ("IRS"), we normally would strongly recommend that DRS and/or the Plans seek a new determination letter on the new merged plan in order to ensure its qualified status under the Code. Unfortunately, the Plans' ability to obtain a new determination letter will be limited by the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). In particular, we believe that a merger could be structured so that a new plan is created by the two existing plans coming together. If such a structure is decided upon, we believe a determination letter request would be accepted by the IRS. Regardless, we also recommend that the Plans and/or DRS seek a PLR to confirm that the merger does not result in any qualification issues for the merged plans and/or tax consequences to any affected members.

II. CONSIDERED MATERIALS

For purposes of this Memorandum, this will confirm that we have reviewed and considered the following information and legal opinions previously submitted to either the Office of the State Actuary ("OSA") or others regarding the current or previously proposed mergers involving LEOFF 1:

1. 2011 LEOFF Merger Study by the OSA.

2. Letter from Mr. Robert Klausner to Mr. Steven Nelsen dated April 26, 2011.

3. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) dated May 2, 2011.

4. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated June 21, 2011.

5. Ice Miller letter to David Nelson at the Washington State Department of Retirement Systems ("DRS"), Anne Hall at the Washington State Attorney General's Office and Aaron Gutierrez at the OSA dated October 5, 2011.

6. Letter from Mr. J.E. Fischnaller to Mr. Matthew M. Smith dated October 22, 2011.

7. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 12, 2012.

8. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 30, 2012.

9. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck and Mr. Jerry Taylor dated January 31, 2012.

10. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated February 1, 2012.

11. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated June 13, 2013.

12. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated April 23, 2015.

13. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

14. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

15. Letter from Mr. Robert D. Klausner to Mr. Dennis Lawson (President, Washington State Counsel of Firefighters) dated March 4, 2016.

16. The Actuary's Fiscal Note for SB 6668 dated October 27, 2016.

Also, for purposes of our consideration, please know that we have considered DRS's Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2015 (this is the most recent CAFR available). In particular, we have considered:

- LEOFF Plan 1 had an actuarial value of assets in the approximate amount of $5.5 billion, it is stated to have a funding surplus of $1.1 billion and a funded ratio of 127%;

- TRS Plan 1 had an actuarial value of assets in the approximate amount of $6.4 billion and a funded ratio of 69%.[1]

Finally, this will confirm our understanding that the Select Committee on Pension Proposals ("SCPP") has been asked to perform an updated study of a potential merger of LEOFF Plan 1 with TRS Plan 1. In this regard, we understand that OSA, the Attorney General's Office ("AG") and DRS have entered into an agreement to provide resources for the study, and that OSA is handling the actuarial analysis of a potential merger for the study. We also understand that SCPP, OSA, the AG's Office, DRS, each of the Plans and the members of each of the Plans collectively want to understand the requirements and/or restrictions for a potential merger for purposes of federal tax law. Finally, we understand that LEOFF Plan 2 also is considering whether a proposal for a merger of LEOFF Plan 1 and LEOFF Plan 2 should be made.

[1] The data regarding the funding and funded status of each plan was as of June 30, 2014, the most recent actuarial valuation date contained in the CAFR (pg. 160). We also understand that the Actuary's Fiscal Note for SB 6668 has not updated either the surplus analysis for LEOFF Plan 1 or the funded status of LEOFF Plan 1 from the analysis in the 2015 CAFR.

III. BACKGROUND

Before responding to the questions you have forwarded to us, we want to consider the possible meanings of the word "merger." As discussed below, under the 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 "useable" across the spectrum of merged plans. This concept is to be distinguished from a number of other transactions. For example, policy makers may wish to consider forms of joint administration of plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – for example, DRS administers TRS Plan 1 and LEOFF Plan 1 (among a number of other plans) and the Washington State Investment Board handles the investments for each of the Plans. In this consideration each Plan's assets are strictly assets of each individual Plan – they are not "useable" across the spectrum of consolidated plans. For example:

- LEOFF Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1969 session. It covers all full-time, fully compensated, local law enforcement and firefighters who established membership on or before September 30, 1977. The Plan is closed to new members. Based on membership data from the CAFR, there were 120 active members as of June 30, 2014 and 7,607 retired or inactive members. Based upon information provided to us from the AG's Office, we understand there currently are 54 active members and 6,752 retired or inactive members. LEOFF Plan 1 members are eligible for retirement at the age of 50 with five years of service. RCW 41.26.090. Also, members are vested after the completion of 5 years of eligible service. RCW 41.26.170. Based upon information in the CAFR (page 190), for the fiscal year ended June 30, 2015, LEOFF Plan 1 included 19 county and/or municipality employers and 4 other political subdivisions. Finally, LEOFF Plan 1 has certain local disability boards to adjudicate disability claims.

- TRS Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1938 session and covers teachers who established membership before October 1, 1977. RCW 41.32.010(31). Eligibility for membership requires service as a certificated public school employee working in an instructional, administrative or supervisory capacity. The Plan is composed of the State of Washington, component units of the State and individual school districts. Based upon information in the CAFR, for the fiscal year ended June 30, 2015, TRS Plan 1 covered the State of Washington and 34 component units of the State, as well as 208 individual school districts. Also, there were 1,824 active members and 35,962 retired or inactive members. Members are vested after the completion of 5 years of eligible service. RCW 41.32.470. Finally, members are eligible for retirement at any age after 30 years of service, or at the age of 60 with 5 years of service, or at the age of 55 with 25 years of service. RCW 41.32.480; WAC 415-112-500.

Under SB 6668, the assets and liabilities of TRS Plan 1 and LEOFF Plan 1 are proposed to be merged specifically to "improve the actuarial soundness of the teachers' retirement system plan 1 . . ." SB 6668 also stated that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Indeed, under Section 2 of SB 6668, the assets, liabilities and membership of LEOFF Plan 1 are proposed to be merged into TRS Plan 1. As a result, the current assets and liabilities of LEOFF Plan 1 are proposed to become the assets and liabilities of TRS Plan 1. Importantly, Section 3 of SB 6668 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." Further, the merger is proposed to not impact the disability boards established in RCW 41.26.110 for LEOFF Plan 1. In order to entice LEOFF Plan 1 members, Section 6 of SB 6668 establishes that LEOFF Plan 1 members, including inactive vested members, retirees and survivors, shall be eligible to receive a $5,000 lump sum payable on either January 3, 2017 or on the member's retirement date, whichever is later (if there are multiple survivor beneficiaries for a single member, the lump sum shall be divided equally between those survivor beneficiaries).

Finally, the Actuary's Fiscal Note evaluates that the proposed merger potentially results in an expected long-term total employer savings of about $2.1 billion through reduced contribution requirements over the next 25 years for employers of TRS Plan 1 (there are not currently any member or employer contributions required for LEOFF Plan 1 unless the most recent actuarial evaluation report shows the plan has unfunded liabilities). For purposes of the Actuary's Fiscal Note, the Actuary assumed that the LEOFF Plan 1 funding policy would remain in effect. However, the Actuary also discussed the possibility that, under pessimistic projections, remaining LEOFF Plan 1 members and their local employers would be required to contribute 6% of LEOFF Plan 1 salaries if LEOFF Plan 1 drops below its fully-funded status, and that any remaining required contributions would be allocated to the state's general fund.

IV. OVERVIEW OF FEDERAL LAW - MERGER

In this section, we consider the federal tax law requirements for a plan merger – the rules that would apply to any merger of assets and liabilities of two or more governmental plans. (We will not cover the situation where a governmental plan and a nongovernmental plan would merge, as we do not believe that would be pertinent or helpful in the current discussion.)

A. Source of Guidance

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. In general, governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are often subject to pre-ERISA guidance from the Internal Revenue Service ("IRS") on a particular subject (*e.g.*, vesting at normal retirement age). Governmental plans may also follow ERISA provisions by analogy or as a "best practice."

B. Exclusive Benefit Rule

One of the threshold rules in the qualified plan world is the "exclusive benefit" rule. This rule dictates that plan assets cannot be used other than to pay benefits to members and beneficiaries and to pay reasonable administrative expenses. In this regard, Code § 401(a)(2) requires that for a plan to be qualified, it must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries . . ." *See also* Treas. Reg. § 1.401-2(a). Accordingly, the IRS has held that "funds 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. It is important to note that the exclusive benefit rule is incorporated into each of the Plans at WAC 415-02-756.

C. Qualified Plan Status

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. 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.

D. 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 one (or all) of the merged plans had not terminated, but that determination is based on all the facts and circumstances involved in the merger.

E. Participant Elections

In some cases, policy makers may ask if they could give plan participants the option of whether or not to be part of a merger. Pre-ERISA, it was permissible to give participants the option of moving from one plan to another, so long as there was no option to receive a distribution. Rev. Rul. 67-213. However, at the current time, and as to 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 and, as a result, creates a cash or deferred arrangement ("CODA"). Revenue Ruling 2006-43, 2006-35 I.R.B. 329; *see also* PLR

201532036.[2] While we realize there are very few active employees (54 in LEOFF Plan 1 and 1353 in TRS Plan 1), any active employees still would cause problems in terms of the IRS' prohibition on impermissible CODAs. Given the current prohibition and IRS position, we have set this potential approach aside, both because it would not seem to be a useful design in the circumstance and because it would raise issues that would likely significantly impede any resolution.

F. Assets/Liabilities

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of the merger of assets and liabilities/benefits. Code §§ 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 TRS Plan 1, 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 the Legislature to comply with the exclusive benefit rule. We believe it would be difficult for the IRS to make an adverse decision on a merger that satisfied these essential IRS rules.

In this respect, the Code takes a broader position than might be expected. 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) (Emphasis added). This treatment is not limited solely to a merger, but also includes consolidation where the assets may be used for the consolidating plans. 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 and/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 vehicles used for the assets of 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).

In accordance with 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

[2] While Private Letter Rulings ("PLRs") are only binding on the taxpayer to whom they are issued, they are instructive on the IRS' views regarding the issues covered in them.

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: (i) the date of termination upon normal retirement, (ii) the date of plan termination, and (iii) the date or discontinuance of employer contributions to the plan.

Importantly, based upon WAC 415-02-753(3) "the Plan may only be terminated by action of the legislature and employer contributions must be paid in accordance with state law. In the event the legislature took action to terminate a plan, in whole or in part, or discontinue employer contributions to the plan, any applicable state law and constitutional protections would apply to accrued benefits. In such event, pursuant to the state and federal rules, a plan member's accrued benefit under the plan is nonforfeitable to the extent funded."

G. Benefit Changes

To the extent that a merger results in benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law; this would include an analysis of federal and state constitutional protections. From a federal tax law perspective, the accrued benefit of a plan member (at the time of the merger) under the plan must be protected to the extent funded.

H. Plan Terms

A qualified plan must always follow its written terms and conditions, so long as those terms do not violate relevant federal and state law. 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. Separately, the amendment may state whether one or both of the plans are being terminated. Of course, a final analysis of the potential legal issues will depend on the structure of the merger as determined by the Legislature.

I. Taxation

To confirm that the merger of one plan into another does not have a taxation impact on the members, and considering the possibility that the merger could include one overfunded plan with an underfunded plan, we strongly recommend that a PLR be sought from the IRS. The purpose of the PLR would be to confirm that the merger complies with the exclusive benefit rule and the pre-ERISA vesting requirements, and does not result in any adverse tax consequences to the members.

J. On-going Compliance Post Merger

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

K. 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 is not necessarily treated the same as a merger - the treatment depends on whether the plan assets of a consolidating plan are available to fund benefits for any other consolidating plan or not, and, therefore does or does not raise issues with regard to vesting and valuation of benefits on a termination basis. *See* Treas. Reg. § 1.414(l)-1(b)(1)(v).

L. Reversion of Excess Assets

Under ERISA, for an employer to accept a reversion of excess assets, the plan must have always provided for such reversion or have been amended more than five plan years before the termination to permit a reversion. ERISA § 4044(d)(2). As a result, under ERISA, an employer is prohibited from amending a plan in conjunction with a plan termination to give excess assets back to the employer if the plan previously provided for a different allocation of excess assets. Even if an excess asset reversion to the employer is permitted, Code § 4980 imposes a tax of 20% of the amount of any employer reversion from a qualified plan. The 20% excise tax may be increased to 50% of the reversion from a qualified plan if the employer does not establish or maintain a qualified replacement plan or the employer does not provide a pro rata increase in the accrued benefits of all qualified participants. Code § 4980(d). However, the ERISA requirements related to plan amendments and the excise tax on a reversion of qualified plan assets to the employer specifically **do not apply to a governmental plan**. Code § 4980(c)(1)(B). As a matter of interest, the Treasury Regulations do specifically recognize that a merger likely would involve a "lower funded plan." Treas. Reg. § 1.414(l)-1(b)(6). These rules are all part of the federal plan insurance provisions of ERISA and the Pension Benefit Guarantee Corporation, and consequently, the parallels and basics are quite different between governmental plans (not covered by the federal plan insurance program) and nonqualified governmental plans. Therefore, we would not anticipate using these provisions in the governmental settings.

Based upon WAC 415-02-753, without further amendment to the Plans by the Legislature, the Legislature could discontinue employer contributions to the remaining/resulting plan as part of the merger. In response to certain questions raised during the SCPP hearing on November 15, 2016, it is important to note that if a merger involving LEOFF Plan 1 included a reduction in employer contributions in the merged plan for TRS Plan 1 employers, such a reduction in employer contributions would not constitute a reversion of excess assets for purposes of either ERISA Section 4044 or Code Section 4980.

V. CONSIDERATION OF SPECIFIC MERGER POSSIBILITIES

Based upon SB 6668 and our discussions with you, we understand that the proposed merger transaction would be one of the following scenarios (we have shown what we assume are the most likely scenarios):

1. Merger of LEOFF Plan 1 and TRS Plan 1

LEOFF 1 → TRS 1 (merger of assets and liabilities; no change in benefits)

TRS 1 → LEOFF 1 (merger of assets and liabilities; no change in benefits)

LEOFF 1 → TRS 1 (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 plan 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 TRS Plan 1 (or vice versa), because two conditions are met:

1. Both LEOFF Plan 1 and TRS Plan 1 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 current members.

Using Code § 414(l) as a guide, and in accordance with WAC 415-02-753, members 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. This would be true, under the 414(l) model, where the benefits have to be tested as though there had been a plan termination, even though there is not necessarily a plan termination. This testing of benefits would apply if LEOFF Plan 1 is merged into TRS Plan 1 (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' (mandatory) contributions were adjusted. That would be a matter of state law and plan design.

2. Merger of LEOFF 1 and TRS 1 into a New Plan:

LEOFF 1 and TRS 1 → New Plan (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 Plan, 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 members in the new Plan have the same retirement eligibility, *etc*.)

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

From a federal tax law perspective, a plan member 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 all benefits **accrued to date** for members in LEOFF Plan 1 cannot be changed as part of a proposed merger with TRS Plan 1. To the extent that participants in TRS Plan 1 have reached normal retirement age and met the requirements for vesting, those benefits **accrued to date** also cannot be changed. Therefore, any benefit change that is adopted as part of a merger between LEOFF Plan 1 and TRS Plan 1 could only affect new members (of which there would be none), non-vested members (of which there are very few) and/or vested members (which constitutes virtually all of the members) prospectively with regard to future accruals.

If this approach is taken, we believe there is a good chance the new plan could secure a determination letter, even under the IRS' new restricted determination letter program.

3. Consolidation:

LEOFF 1 and TRS 1	→	New 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.

VI. IRS APPROVAL

Finally, if some type of merged or consolidated plan is passed by the Legislature, then we strongly recommend that DRS seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. Unfortunately, based upon the IRS' recent changes to the determination letter program, this would be dependent on whether a new plan is being created or any plan(s) is/are being terminated as part of the merger. In this regard, whether a determination letter can be requested will have to be done in accordance with the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). We do recommend creating a new merged plan consisting of what had been the LEOFF Plan 1 and TRS Plan 1 plans.

If some type of asset transfer is passed by the Legislature, then we also recommend that DRS and/or the Plan(s) seek a PLR to confirm that the transfer does not result in any qualification issues to the merged plans and/or tax consequences to any affected members. This is not affected by the new determination letter changes, and should be done regardless of whether the determination letter process is available or not.

VII. LEGAL QUESTIONS RAISED BY STAKEHOLDERS OF THE POTENTIAL MERGERS

Considering the background information contained in this Memorandum, we received from you certain questions which were raised and submitted to the SCPP by stakeholders of the

Plans being considered for a potential merger (at least LEOFF Plan 1 and TRS Plan 1, if not also stakeholders from LEOFF Plan 2). Those stakeholder questions and answers are being attached to this Memorandum as Appendix A.

VIII. CONSIDERATIONS RELATED TO SB 6668

Based upon our review of SB 6668, Section 2 of the proposal indicates that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Further, Section 3 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." In this regard, we note that the merger proposes to retain the disability boards for LEOFF Plan 1, including any official action of those boards. Therefore, to the extent that the LEOFF Plan 1 disability boards are a vested right in accordance with state law, the vested benefit appears to be preserved as part of the proposed merger. Similarly, we note that SB 6668 does not contemplate a distribution of surplus assets from LEOFF Plan 1 (to the state and/or LEOFF Plan 1 participating employers) as part of the merger. Accordingly, in its current form, SB 6668 does not contain a reversion of excess assets. Finally, we note that under Section 15 of SB 6668, the proposed merger is intended to comply with the Code, including Code § 401(a) (which contains the exclusive benefit rule at Code § 401(a)(2)).

Based upon the analysis of the federal tax considerations related to a merger which we are providing in this Memorandum, we believe that SB 6668 is intended to comply with the Code requirements for a valid merger, including Code §§ 401(a)(2), 401(a)(12) and 414(l). Accordingly, and subject to final approval by the IRS, as drafted, the merger proposed by SB 6668 would not be prohibited under the federal tax laws applicable to qualified governmental pension plans.

IX. CONCLUSION

We hope that this Memorandum provides DRS, OSA and the SCPP with pertinent information regarding the federal tax considerations for a potential merger under SB 6668. We welcome the opportunity to discuss these issues with you at the SCPP meetings on November 15, 2016.

APPENDIX A

Question No. 1: What is the purpose of a merger?

Answer No. 1: As discussed in Section IV, under the Code, the purpose of a merger is generally to merge the assets and liabilities of two or more plans into a single plan. As a result, the assets and liabilities become useable across the spectrum of the merged plan.

Question No. 2: Why merge two different entities?

Answer No. 2: The question is somewhat confusing to us because of the use of the word "entities." Assuming that "entities" means plans, we believe the reason a Legislature could be considering a merger would be to consolidate the assets and liabilities of the Plans. Presumably, the fact that LEOFF Plan 1 is a better funded plan (based on the most recent actuarial analysis) and TRS Plan 1 is a lower funded plan (based on the most recent actuarial analysis) is a factor in the Legislature's consideration.

Question No. 3: Why not merge other plans instead? For example:

(a) All state plans into one with the same benefits?

(b) Legislator's pension plan with the Teachers' Retirement System 1 (TRS 1)?

(c) Public Employees' Retirement System (PERS 1), TRS 1, and the Law Enforcement Officers' and Fire Fighters' Plan 1 (LEOFF 1) into one big plan?

(d) Washington State Patrol Retirement System with TRS 1?

(e) Public Safety Employees' Retirement System with LEOFF 2?

(f) LEOFF 2 with TRS 1?

(g) TRS 1 with TRS 2?

Answer No. 3: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 4: How would a merger benefit:

(a) LEOFF 1 members?

(b) Employers?

Answer No. 4: As discussed in Section IV.F. and G., the merger does not automatically result in enhanced benefits for LEOFF Plan 1 members. Whether enhanced benefits will be provided is a determination for the Legislature. As it relates to participating employers, depending on the actuarial analysis of the merger, the merger could result in a long-term cost savings for the employers.

Question No. 5: Why not wait until all benefits are paid out?

(a) What would happen to the surplus after all remaining members have died?

Answer No. 5: "Why not wait until all benefits are paid out" raises a policy decision for the Legislature. However, if the Legislature waited until all remaining members of LEOFF Plan 1 have passed away and all liabilities under the Plan have been satisfied, in accordance with Code § 401(a)(2) and Treas. Reg. § 1.401-2(a), and WAC 415-02-753 and 756, the remaining assets would be returned to the employers involved in LEOFF Plan 1.

Question No. 6: Will the merger be temporary?

(a) *i.e.*, once TRS 1 is fully funded, will they be unmerged?

(b) Would it be like a loan of funds, with interest?

Answer No. 6: As discussed in Section IV.F., a merger is not temporary nor is it like a loan of funds (with or without interest). Instead, the merger results in combining two (or more) Plans into a single Plan. Whether there would be any future separation of the merged plans would be a future decision for the Legislature.

Question No. 7: Benefit improvements.

(a) Can LEOFF 1 and LEOFF 2 be merged to allow enhanced LEOFF 2 benefits like medical benefits, a higher multiplier, or earlier retirement?

(b) Can any excess funding in LEOFF 1 be used to increase benefits for LEOFF 1 members instead?

Answer No. 7: As discussed in Section IV.G., a merger does not automatically result in enhanced benefits for the members of either plan (the plans) being merged. Whether enhanced benefits will be provided is a determination for the Legislature. As discussed in Section IV.F., as a matter of federal tax law, members in a merged plan must be vested and entitled to benefits calculated on a termination basis from the Plan immediately after the merger which are equal to or greater than the benefits the members would have been entitled to on a termination basis immediately before the merger, consolidation or transfer. *See also* Treas. Reg. § 1.414(l)-1(a)(2). For purposes of federal tax law, assuming compliance with the exclusive benefit rule, members must be vested in their benefits, (not in an allocated account balance based on an actuarial equivalent of their benefits).

Finally, as discussed in Section IV.H., the Legislature would have to pass specific amendments to modify the Plans being merged.

B. Legal

<u>Question No. 8:</u> Is a merger legal?

(a) What legal entities control (e.g., Internal Revenue Service (IRS), State Supreme Court)?

(i) What are their respective roles and jurisdictions?

(b) What case law is relevant, and what does it tell us?

(i) Does it prevent/prohibit a merger?

(ii) Will the *Bakenhus* case apply to the new plan?

(c) What are the terms of the contract that exists between LEOFF 1 members and the state?

(i) i.e., what do members have a right to?

(ii) Benefits?

(iii) Funding plan?

(iv) Cash in the trust fund?

(1) Are LEOFF 1 members vested in the money itself?

(2) i.e., is the money being "stolen" from the trust fund?

(d) What laws need to be changed to complete a merger?

(e) What protections exist for vested rights and financial interests of plan participants?

<u>Answer No. 8:</u> Federal law controls the continuation of the qualified status of the plans involved in a merger. The federal law on mergers focuses on the protection of each member's/survivor's benefit payable from the separate plans and from the merged plan. As a matter of federal tax law, and as discussed in Section IV.F., a merger is a combination of the assets and liabilities of two or more qualified defined benefit plans. Accordingly, based upon the IRS' rules, a merger is legal provided that there is compliance with the exclusive benefit rule and, in accordance with Code § 414(l), the members of the merged plans receive the same benefits after a merger or transfer of assets as they would have received before the merger. This rule must be met in order to retain the qualified status of the funds involved. Consequently, federal law covers the vested rights of the members' and individuals' benefits pre and post-merger.

Whether members have a vested right to certain features or assets (the "contract" between LEOFF/members and the state) under each of the Plans, (as opposed to their individual benefits) would require an analysis of Washington State law which is not being provided as part of this Memorandum. As to the questions about case law, based upon our review of the prior legal opinions from other attorneys which we listed in Section II, we anticipate that the State law analysis would include an analysis of the case *Bakenhus v. City of Seattle*, 48 Wn.2d, 695, 296 P.2d 536 (1956) and its progeny.

Question No. 9: Who are the fiduciaries for each plan?

(a) Is the Legislature a fiduciary to both the plan and the general state?

Answer No. 9: Determining who are the fiduciaries of a qualified plan generally is based upon an analysis of common law trust principles and state law requirements. This primarily is because in accordance with Treas. Reg. § 1.401-1(a)(3)(i), one of the requirements for a qualified plan is that the plan assets must be held in trust. We note that RCW 43.33A.030 vests trusteeship of the Plans' assets in the voting members of the State Investment Board. Also, under RCW 41.50.060 the Director of DRS is responsible for the Plans and, under RCW 41.50.077, the State Treasurer is the custodian of funds of the Plans. ERISA § 3(21) defines a "fiduciary" with respect to a plan as a person to the extent (i) the person exercises any discretionary authority or discretionary control respecting management or dispositions of its assets, (ii) the person renders investment advice for a fee or other compensation or has authority of responsibility to do so, or (iii) the person has any discretionary authority or discretionary responsibility in the administration of the plan. Code § 4975(e)(3) defines "fiduciary" (for purposes of prohibited transactions) in essentially the same manner:.

> (3) Fiduciary.
>
> For purposes of this section, the term "fiduciary" means any person who –
>
> (A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,
>
> (B) lends investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

Based upon these federal definitions, we believe that the IRS would consider DRS, the Washington State Investment Board ("WSIB"), the individual WSIB Board members, the LEOFF 1 Retirement Board, the individual LEOFF 1 Board members, the TRS Plan 1 Retirement Board, the individual TRS Plan 1 Board members, as fiduciaries. In addition, there would be a number of financial and investment related fiduciaries (*e.g.*, registered investment advisors to DRS and WSIB), custodial bank(s), *etc.*) that likely are considered fiduciaries of the Plans.

Question No. 10: Who owns the surplus?

(a) Does case law from Alaska on excess funding show that any surplus belongs to the members?

Answer No. 10: As a matter of federal tax law, unless the plan terms specify otherwise, the employer (or employers) sponsoring the plan generally owns any surplus but only once there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the trust. *See* Treas. Reg. § 1.401-2(b). Plan terms can establish a different structure.

We defer to the Washington state law analysis on whether the Alaska case law would be persuasive to Washington.

Question No. 11: Will there be any direct tax impact on the members?

(a) e.g., will a medically disabled member lose their individual tax exempt status?

Answer No. 11: A merger would not change the tax treatment of any benefits to members of LEOFF Plan 1 (or to the members of another plan with which LEOFF Plan 1 might be merged). So, a LEOFF Plan 1 member who is receiving a service-connected disability benefit which is exempt from federal taxation (whether in whole or in part) would continue to receive the same tax treatment of his/her disability benefit after a merger.

Question No. 12: Are there any other IRS issues?

(a) What would be the impact of an unfavorable opinion by the IRS?

(i) What are the range of outcomes?

(ii) Would the plan members be made whole/held harmless under those scenarios?

(1) If so, how?

(iii) Would the merger be undone?

(1) If so, how?

(b) Does each plan's funded status impact the ability to merge?

Answer No. 12: If the IRS did not approve the merger, the results could range from i) the IRS requiring the Legislature to cease the merger, ii) the IRS requiring the Legislature to make necessary amendments to the merger to address the concern(s) raised by the IRS, to iii) the ultimate penalty by the IRS is disqualification of the underlying plans and/or the merged plan. Disqualification of the underlying plans would be an extreme result, which typically would only be considered if the merger disregarded the exclusive benefit rule or did not provide benefits to participants in the merged plans which were at least equal to or greater than the benefits the members would have received on a termination basis immediately before the merger.

To the extent that any of the involved plans were disqualified by the IRS that would raise an individual taxation issue for the involved members. Whether the affected plan, DRS or the state would reimburse the members or hold them harmless from the potential taxes would depend on legislative action.

Finally, as discussed in Section IV.L., each plan’s funded status does not affect the ability to merge. *See also* Treas. Reg. § 1.414(l)-1(b)(6).

Question No. 13: How will the state pay if it needs to defend a merger in court?

Answer No. 13: Whether or not legal expenses incurred to defend a merger in court are appropriate plan expenses or whether they are settlor expenses which should be paid by the State are questions of both federal law and state law. From the federal law perspective, protection of a plan's qualified status could be argued to be a reasonable and necessary expenditure of the affected plan.

We leave the state law analysis to others. We note that RCW 41.50.255 authorizes the director of DRS to pay from the interest earnings of the trust funds of the Plans lawful obligations of the appropriate [retirement] system for legal expenses which are incurred for the purpose of protecting the appropriate trust fund or are incurred in compliance with statutes governing such funds.

Question No. 14: Can you charge separate rates for the different tiers of benefits within a merged plan?

Answer No. 14: Governmental plans, whether or not merged, are able to have different employee and/or employer contribution rates between tiers in the plan.

Question No. 15: Is a plan trust more like an escrow account to pay benefits or a savings/investment account to accumulate funds?

Answer No. 15: A plan trust is neither an escrow account nor a savings/investment account. Rather, it is a trust under Washington State law, governed in part by federal law, in which employee and employer contributions are held and co-invested for the payment of benefits under the terms of the plan.

Question No. 16: Is there a process for appealing or opposing a merger?

Answer No. 16: This is a question of state law.

Question No. 17: Would employers receive refunds for contributions used for members of another system?

Answer No. 17: As discussed in Section IV.L., the Legislature can decide how to handle any excess assets. *See also* Answer Nos. 10 and 34.

Question No. 18: Are plan members trustees or fiduciaries of their plans?

Answer No. 18: In general, no. However, a plan member may be a trustee or a fiduciary in his/her individual capacity. *See* Answer No. 9.

C. Fiscal/Actuarial

Question No. 19: Historical.

(a) How did gainsharing impact TRS 1?

(i) Is that partly why LEOFF 1 is in such good shape and TRS 1 is not?

(b) What is the funding history for each plan?

(i) Who paid what?

(c) Is LEOFF 1 cost sharing the same as other plans?

(i) *i.e.*, did the state only put in 20 percent of contributions?

(d) What would have happened if there had been no general fund contributions to LEOFF 1?

(i) Or the Prior Act systems (*e.g.*, City of Seattle)?

Answer No. 19: These are historical and actuarial questions which are not being addressed by this Memorandum.

Question No. 20(a): Related to a merger.

(a) What is the financial situation before and after?

(i) What does the "surplus" represent?

(1) Is it the excess of funds needed to pay benefits this month? This year?

(ii) Is the surplus "real" or just projected?

(1) How reasonable is the investment return assumption?

(2) What would it look like under alternate scenarios (*e.g.*, 7 percent or 6 percent)?

(iii) If the surplus disappears, would it be too late to insure the LEOFF 1 benefits?

(1) *E.g.*, ensuring payment under a pay-go scenario versus insuring through plan immunization.

(iv) Would a merger be revenue neutral?

Answer No. 20(a): *See* Answer No. 10. Also, the current funding level of each Plan, and whether each Plan has a funding surplus or funding deficit of plan assets necessary to satisfy the benefits obligations under each Plan, is a matter of actuarial analysis. The actuarial analysis will state the assumptions used as part of the analysis. To the extent that a merged plan would have a deficit of total plan assets, *see* Answer No. 20.c. Finally, we do not understand the question as to whether a merger would be revenue neutral. Rather, whether something is "revenue neutral" to a plan typically means that an increased benefit is offset by an increase in contributions (whether employer or employee). In other words, the increased benefit is considered to be revenue neutral because the plan's net revenues remain unchanged (*i.e.* the cost is offset by the increased contributions).

Question No. 20(b):

(b) How might the funds be used?

(i) Clarify: Usable across the merged plan vs. usable outside either of the retirement plans (other obligations).

(ii) Should it be treated like a reserve for LEOFF 1 only?

(iii) Can money be "skimmed out" of the fund during transfer from LEOFF 1 to TRS 1?

Answer No. 20(b): As discussed in Section IV.F., under a merger, a transfer of assets and liabilities occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumptions of these liabilities by another plan. *See* Treas. Reg. § 1.414(l)-1(b)(3). Further, based upon the pre-ERISA minimum vesting standards, if qualified governmental defined benefit plans are merged, they are required, to the extent funded, to have 100% vesting of benefits accrued to the date of merger. Accordingly, if a merger combined LEOFF Plan 1 and another Plan, but the Plan assets of LEOFF Plan 1 were not available to pay for benefits other than for the original members (and beneficiaries) of LEOFF Plan 1, then a merger will not have occurred, and assets of one plan could not be used for payments to members of another plan. *See* Treas. Reg. §§ 1.414(l)-1(b)(1)(v) and 1.414(l)-1(b)(2). If the assets were combined to pay benefits for both plans, there would be a merger, and the federal laws explained above would apply.

In this regard, the assets of LEOFF Plan 1 are not considered "skimmed out" of the LEOFF Plan 1 trust fund. Rather, the assets of LEOFF Plan 1 and TRS Plan 1 remain in the merged plan and are combined into a single trust to pay benefits to all members and beneficiaries of both plans. Treas. Reg. §1.414(l)-1(b)(2).

Question No. 20(c):

(c) What happens in the event of a deficit?

(i) If the funded status were 87 percent, would that mean I only get 87 percent of my current check amount?

(ii) Before merger?

(iii) After?

(iv) Who pays what?

(v) Who will be paid first? (Overlap with legal/admin analysis)

(vi) Could the state default on the pensions?

Answer No. 20(c): As discussed in Section IV.F., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. It is important to note that we are not aware that the merger concept to be used would provide an immediate liquidation of the trusts, which would raise, at least in part, the concept of a reduced benefit. Instead, we anticipate that the members in pay status would continue to receive their full monthly benefits, unless otherwise legally altered by the legislature. These benefits would be paid by the merged plan. Of course, the ultimate funding level of the merged plan and cost of benefits from the merged plan depends on plan earnings, market value of investments and the actuarial experience of the merged plan, including mortality experience. Finally, this answer is ultimately dependent on the analysis of state law issues regarding vested rights.

<u>Question No. 20(d):</u>

(d) Would there be other costs (*e.g.,* admin)?

<u>Answer No. 20(d)</u>: Certainly, it should be anticipated that a merger would have an increase in administrative costs in the short term. However, it also should be anticipated that there may be savings in administrative costs over a longer term because there could be some cost savings in only administering one plan as opposed to administering two separate plans.

<u>Question No. 20(e):</u>

(e) How would a merger impact financial reporting (GASB) for state and local governments?

<u>Answer No. 20(e)</u>: Based on the actuarial analysis of the merged plan, we would expect that the required financial reporting under GASB 67 (for the merged plan) and the required financial reporting under GASB 68 (for the participating employers in the merged plan) would be different than the financial reporting would have been if the merger did not occur.

<u>Question No. 20(f):</u>

(f) Who is constitutionally liable for future benefit payments?

<u>Answer No. 20(f)</u>: The constitutional obligation for future benefit payments under the merged plan is not a matter of federal tax law. Notwithstanding, *see* Answer No. 20.c.

<u>Question No. 20(g):</u>

(g) Are there other options to address TRS 1 underfunding?

<u>Answer No. 20(g)</u>: Whether there are other options to address underfunding in TRS Plan 1 is not a matter of federal tax law. Rather, it is a policy determination to be made by the Legislature.

D. Benefits

<u>Question No. 21:</u> Will benefits be impacted?

(a) i.e., can they be reduced?

(b) Will benefits be increased in exchange for the merger?

(i) Would LEOFF 1 benefits be given to teachers?

(1) e.g., will TRS 1 members receive health benefits similar to LEOFF 1?

(c) Would LEOFF 1 be paying for TRS 1 benefits?

(d) Will it impact rights for Prior Act City of Seattle or Seattle Police Pension Board (which "interprets the rights" for members)?

(e) Will this include survivor benefits?

(f) Will benefits be interrupted (e.g., are there any administrative issues that might delay issuing checks)?

Answer No. 21: *See* Answer Nos. 20.b. and 20.c.

Question No. 22: Will COLAs be impacted?

(a) Can TRS 1 COLA be reinstated without negative impact to LEOFF 1?

(b) Can LEOFF 1 COLAs be modified so as to not be dependent on date of retirement?

Answer No. 22: As discussed in Answer Nos. 8 and 20.c, as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether COLAs under LEOFF Plan 1 and TRS Plan 1 are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 23: Will medical coverage be impacted?

(a) LEOFF 1

(i) Source of medical benefit payments?

(ii) Disability boards.

(iii) Can it be provided to spouses?

(b) TRS 1 PEBB subsidy?

Answer No. 23: As discussed in Answer Nos. 8 and 20.c., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether medical benefits under LEOFF Plan 1 and TRS Plan 1 are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 24: Will survivor benefits be impacted?

(a) Are reductions for survivor benefits considered contributions to the plan?

Answer No. 24: *See* Answer Nos. 22 and 23.

Question No. 25: Will LEOFF 1 have priority in benefit payments over TRS 1?

Answer No. 25: As discussed in Section IV.F. and Answer No. 8, based upon the IRS' rules, the members of a merged plan receive the same benefits after a merger or transfer of assets as they would have received before the merger. Each member's/survivor's benefits payable from the separate plans are protected and become payable by the merged plan. Therefore, it would not be appropriate for one of the merged Plan's members to have priority in the payment of benefits after a merger.

Question No. 26: Will I still be considered a "retired police officer" as opposed to a general state retiree?

(a) Does this definition have legal implications (*e.g.*, qualifying for certain benefits) or just personal ones?

Answer No. 26: For the reasons discussed in Answer No. 11, and for purposes of federal tax law, whether a member qualifies as a "qualified public safety employee" under the Code will not be affected by a merger.

Question No. 27: Under SB 6668, could members individually refuse the $5,000 lump sum?

Answer No. 27: Based upon our understanding of SB 6668, there is not a provision to specifically allow LEOFF Plan 1 members to individually refuse the lump sum defined benefit which was contemplated under Section 6. If they have an unrestricted right to the benefit, it does present a question of whether federal constructive receipt concepts would apply. We think the better answer would be that the federal constructive receipt concept would not apply and, instead, benefits would only be taxed when received under Code Section 402. Whether LEOFF Plan 1 members would be eligible to disclaim the lump sum defined benefit would be a State law consideration.

E. Governance

Question No. 28: Will governance be impacted?

(a) Will there be equal representation on the LEOFF 2 Board?

(b) Will LEOFF 1 oversee TRS 1 benefits?

(c) Will LEOFF 2 Board control LEOFF 1 benefits?

Answer No. 28: Certainly, governance of the merged plan is something which should be addressed by the Legislature. Notwithstanding, to the extent that LEOFF Plan 2 is not part of the merger, then, presumably, there would not be any change to the governance and/or administration of LEOFF Plan 2.

F. Other General Questions

Question No. 29: Is this a redistribution of the member's income?

Answer No. 29: For the reasons discussed in Answer No. 20.b., no.

Question No. 30: Would a LEOFF1/TRS 1 merger impact LEOFF 2?

Answer No. 30: For the reasons discussed in Answer No. 28, no.

Question No. 31: Would a LEOFF 3 be created for new hires?

Answer No. 31: This question is better directed to the Legislature as it involves a policy issue.

Question No. 32: Can LEOFF 1 members opt out and "take their money out" entirely?

Answer No. 32: Unless the Legislature decided to change the distribution rights of LEOFF Plan 1 members as part of the merger, the members of LEOFF Plan 1 would be limited to the Plan's current provisions related to the distribution of benefits.

Question No. 33: Is lump sum still on the table? If so:

(a) Some feel it should be higher than $5,000.

(b) Why not pay it now, regardless of a merger?

(c) Employers would like a share.

Answer No. 33: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 34: Can any excess be distributed every few years: one-third state, one-third employer, one-third member?

Answer No. 34: As discussed in Section IV.L., generally the Legislature can decide how to handle any excess assets. However, the IRS likely would not approve a reversion of plan assets **before all obligations were liquidated**. For example, if commercial annuities were purchased for all members/survivors pursuant to the respective plan terms, the IRS likely would determine that after the annuities were purchased, then (and only then) could the Legislature provide for a distribution of excess assets. We do note that SB 6668 does not currently contemplate a distribution of excess assets.

Question No. 35: Even if the overall idea is sound, could a mistake in administration jeopardize benefits?

Answer No. 35: As a matter of federal tax law, mistakes in administration are considered operational failures which can be corrected in accordance with Revenue Procedure 2013-12. The IRS' correction procedures are intended to help qualified plans correct their failures and preserve their qualified status.

Question No. 36: Why not just increase the contribution rates for new members of these plans?

Answer No. 36: This question is better directed to the Legislature as it involves a policy issue.

Question No. 37: Will the state be able to make further changes after a merger (*i.e.* slippery slope)?

Answer No. 37: This question is better directed to the Legislature as it involves a policy issue. Notwithstanding, it should be noted that a merger of the Plans does not necessarily preclude the Legislature from making other plan changes. However, all the federal restrictions would still apply. In other words, the exclusive benefit rule must be followed and the members of the merged plans must receive the same benefits after a merger or transfer of assets as they would have received before the merger. *See* Answer No. 8.

Question No. 38: Could recruitment be impacted by a merger?

Answer No. 38: This is not a question of federal tax law.

Question No. 39: How does a merger benefit taxpayers?

Answer No. 39: This question is better directed to the Legislature as it involves a policy issue.

Question No. 40: Will plan members retain their voting rights in plan governance?

Answer No. 40: *See* Answer Nos. 28 and 57.

Question No. 41: Are pension plans governed by local oversight boards, and will those boards be allowed to vote on a proposal?

Answer No. 41: *See* Answer Nos. 28 and 57.

Question No. 42: Can LEOFF 1 members cash out of the retirement system entirely?

Answer No. 42: *See* Answer No. 32.

G. Concerns

Question No. 43: Benefits should be fully funded.

Question No. 44: Funds should be kept separate – TRS with TRS, etc. – and never go back to the general fund.

Question No. 45: A plan should not be merged with a "lesser" plan.

Question No. 46: LEOFF 1 should be administered locally, and not be "some unknown voice in Olympia."

Question No. 47: LEOFF 1 funding was frozen in 2000 without consent of members.

(a) Some members feel employer contributions should have continued up until now.

(b) Some members feel the remaining active members should have been paying over the last 16 years.

Question No. 48: LEOFF 1 system was forced on city and county plan members.

Question No. 49: LEOFF 2 benefits are already substantially higher than LEOFF 1.

Question No. 50: The LEOFF 1 funded status should never drop below 125 percent.

Question No. 51: Transparency in process.

(a) All stakeholders need sufficient notification of any potential changes or discussions.

(b) Members of the plan should be able to vote since it is their plan and not the Legislature's.

Question No. 52: Dual member provisions for members who leave LEOFF 2 should be reviewed.

Question No. 53: There is no guarantee the state will make required contributions.

Question No. 54: Employers have expressed concerns about medical benefits being expanded.

Question No. 55: Local governments are facing high costs for LEOFF 1 medical.

Answer Nos. 43-55: To the extent that Question Nos. 43-55 are questions, they should be directed to the Legislature as they involve individual policy issues/considerations.

Question No. 56: Any payout must be conditional on IRS approval.

Answer No. 56: For the reasons discussed in Section VI, we agree that approval of a merger should be obtained from the IRS before a merger is finalized.

H. Additional Questions

Question No. 57: Will it require a vote of all members and beneficiaries to agree to the merger before a merger can occur?

Answer No. 57: As a matter of federal tax law, unless the respective Plans' terms specifically require it (which we do not see that they do), a vote of all members and beneficiaries is not necessary to agree to a merger before it may occur.

Question No. 58: Has the Legislature reserved its right to change the pension system?

Answer No. 58: Ultimately, this is a question of state law and, therefore, is not being addressed by this Memorandum.

Question No. 59: Is the LEOFF 2 Board a vested right to which members are constitutionally entitled?

Answer No. 59: Whether or not the establishment of the LEOFF Plan 2 Board is a vested right is not a matter of federal tax law. Rather, it is a matter of state law.

Question No. 60: Is a merger of the two plans, where the merger reduces assets, a violation of members' and retirees' constitutional rights?

Answer No. 60: This is a question which is being analyzed separately by the AG's Office. However, it should be noted that a merger itself cannot inherently reduce plan assets.

Question No. 61: Is there a history of mergers in Washington and have there been any legal challenges to mergers in LEOFF 1? How about in 1970 when LEOFF 1 began?

Answer No. 61: This is not a question which is being addressed by this Memorandum.

Question No. 62: Are one or the other of the plans terminated?

Answer No. 62: Whether one of the Plans is being terminated as part of a merger is a determination to be made by the Legislature as a part of the design of the merger. For purposes of federal tax law, and as discussed in Section IV.D., a merger does not require the termination of one of the Plans being consolidated.

Question No. 63: Do the plan terms prevent a merger?

Answer No. 63: As a matter of federal tax law, we do not believe that the Plans' terms prevent a merger.

Question No. 64: If merger is found to be illegal, how do we un-merge? How do you separate the funds? What will happen to the $xxxx that is given to each LEOFF 1 member/retiree/beneficiary – how are you going to get that back?

Answer No. 64: Because we strongly recommend that both a PLR and an updated determination letter (if a new plan is being created or if one or both of the merged plans are being terminated) be obtained from the IRS as part of the merger, the merger would be contingent on receiving these favorable rulings from the IRS. If this is done, there would not be any concern about having to "unwind" a merger based upon an unfavorable ruling by the IRS.

Question No. 65: Can we get the process underway for IRS review of the merger?

Answer No. 65: It is important to note that the IRS will not issue a PLR on a "hypothetical" situation. Accordingly, a piece of "draft" legislation likely would not be considered by the IRS for purposes of a PLR. Similarly, the IRS will not issue a determination letter on a "hypothetical" basis. Rather, the IRS will only consider a determination letter request based upon an action which has been authorized and/or is in process.

STATE LEGAL ANALYSIS

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MEMORANDUM

DATE: December 22, 2016

TO: The Select Committee on Pension Policy
c/o Office of the State Actuary

FROM: Anne Hall, Senior Counsel
Staff Counsel to the SCPP

SUBJECT: **Report by the Attorney General's Office on State Law Analysis of the Merger of LEOFF 1 and TRS 1 pursuant to the provisions of Senate Bill 6668**

The 2016 Legislature directed the Select Committee on Pension Policy (SCPP or Committee) to study Senate Bill 6668 (2016) and to report to the Legislature on the tax, legal, fiscal, policy, and administrative implications of that bill by January 9, 2017. Senate Bill 6668 merges the assets and liabilities of Law Enforcement Officers' and Firefighters' Retirement System Plan 1 (LEOFF Plan 1) and Teachers' Retirement System Plan 1 (TRS Plan 1), and makes a number of other changes and additions to statutes governing LEOFF Plan 1, the Department of Retirement Systems, and the actuarial funding of the state public pension systems.

The SCPP asked counsel assigned to the Committee to analyze Senate Bill 6668 and provide a report to the Committee on the legal implications of that bill. The following report discusses the *state law* implications of Senate Bill 6668 and makes recommendations to the Committee regarding modifications to the bill. In a separate report, the State Actuary's Special Assistant Attorney General, the Ice Miller law firm, analyzes the *federal tax law* implications of Senate Bill 6668.

The state law report is presented in three parts. The first part is a short summary of state pension law and pension rights of members,[1] and a discussion of whether Senate Bill 6668 affects those rights. The second part is an abbreviated legal analysis of the summary and conclusions found in the first part. The third part addresses in more detail the legal analysis governing whether LEOFF Plan 1 and TRS Plan 1 members' constitutionally protected contractual rights may be impaired if Senate Bill 6668 is enacted in its present form. A summary of Senate Bill 6668 is attached as Appendix A.

[1] The term "members" is used to refer to both public pension members and retirees unless a distinction needs to be made in the text.

This report is intended to assist the SCPP in responding to the Legislature's directive to prepare a report on the provisions of Senate Bill 6668. The report is my considered legal judgment as the Committee's assigned counsel. This report is not intended to be a formal opinion by the Attorney General. I understand that the SCPP waives the attorney-client privilege solely as to the contents of this report, and does not waive that privilege as to any underlying research or analysis generated to prepare either the state law or federal law report.

Part 1 – Short Summary of State Law Analysis

- Members of LEOFF Plan 1 and TRS Plan 1 have certain pension rights that are contractual in nature. Those rights can be found in Washington statutes and rules, and in Washington case law that interprets those statutes and rules.

- LEOFF Plan 1 and TRS Plan 1 members have a vested contractual right to a monthly service or disability retirement allowance that was guaranteed to them at the beginning of their service. This retirement benefit cannot be modified except under certain circumstances and to the advantage of the member.

- LEOFF Plan 1 and TRS Plan 1 members' monthly service or disability retirement allowance will not be reduced after a LEOFF Plan 1 and TRS Plan 1 merger under Senate Bill 6668. Therefore, Senate Bill 6668 does not deny LEOFF Plan 1 and TRS Plan 1 members' their vested contractual right to a monthly retirement allowance.

- In the absence of evidence that the merger will create an actuarially unsound pension plan, LEOFF Plan 1 and TRS Plan 1 members' vested contractual right to the systematic funding of their retirement plan to maintain its actuarial soundness is probably not violated by the merger, although this question has never been considered by Washington courts.

- Under state law, TRS Plan 1 employers cannot pay for LEOFF Plan 1 benefits from monies provided by the Legislature for basic education. However, until there is a viable scenario under which TRS Plan 1 employers are required to pay for LEOFF Plan 1 benefits out of funds designated for education, it is difficult to answer the question whether TRS Plan 1 employers will have to pay for LEOFF 1 benefits out of education funds, whatever the funds' source.

- The issue of distribution of a surplus is governed generally by federal law, however, state case law indicates that plan members are not entitled to their pension fund surplus.

- It appears unlikely that counties and cities will need to book any unfunded liability resulting from the LEOFF Plan 1/TRS Plan 1 merger in their financial reporting under GASB. In addition, it does not appear that counties and cities have a legal cause of action against the state because of the merger's impact on counties' and cities' financial requirements under GASB.

- The payment of a lump sum amount to LEOFF Plan 1 retirees, and to future LEOFF Plan 1 members when they retire, is not contrary to state law.

- It is unlikely that Washington courts will find the Alaska case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997) to be persuasive.

Part 2 – Explanation of the State Law Analysis

1. LEOFF Plan 1 and TRS Plan 1 members and retirees have certain vested contractual rights to provisions in the public pension plans.

Members of LEOFF Plan 1 and TRS Plan 1 have a contractual right to a pension that is guaranteed at the time the member begins public service. That pension right may be modified but only for limited purposes. *Lenander v. Dep't of Ret. Sys.,* 186 Wn.2d 393, 415, 377 P.3d 199 (2016). The rights of these members to a pension is defined by the Washington laws that create these rights. *Wash. Educ. Ass'n v. Dep't of Ret. Sys.,* 181 Wn.2d 233, 244-45, 332 P.3d 439 (2014).

LEOFF Plan 1 and TRS Plan 1 have two vested contractual rights that are relevant to the provisions of Senate Bill 6668. The first is the right to a monthly retirement allowance granted to the members when they first began service. This is the right guaranteed by *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956). The second is the right to the systematic funding of the members' retirement plan to maintain the plan's actuarial soundness. *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 625, 62 P.3d 470 (2003).

a) Members and retirees have the right to a monthly retirement allowance. That right not only is not impaired by Senate Bill 6668, but it is guaranteed by Senate Bill 6668.

The *Bakenhus* court held that the monthly retirement benefit promised to a public pension member when the member begins employment is a contractual right. The question here is whether, as a result of the merger, members of LEOFF Plan 1 and TRS Plan 1 will lose the monthly retirement benefit promised to them during employment, or whether their benefit will be reduced as a result of the merger. The answer is no.

Senate Bill 6668 prohibits a modification of members' retirement benefits if that modification is to the member's detriment. Senate Bill 6668 specifically provides that the merger "may not impact benefits for members of these plans." Further, the bill instructs the Department of Retirement Systems to administer the merged plans "in a way that neither reduces, nor grants additional benefits, for members of those plans." Section 3, Senate Bill 6668. *See also* Section 1. Because the merger legislation specifically provides that the benefits the members receive after the merger must be equal to the benefits the member was entitled to before the merger, the members' contractual right to the monthly retirement benefit under *Bakenhus* provided is protected.

b) Members have the right to the systematic funding of their pension plans to maintain the plans' actuarial soundness. That right is not impaired by Senate Bill 6668.

Members have a right to the systematic funding of their pension fund to maintain the fund's actuarial soundness. *Weaver v. Evans,* 80 Wn.2d 461, 495 P.2d 639 (1972), *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 62 P.3d 470 (2003). The question is whether the merger described in Senate Bill 6668 negatively impacts the systematic funding of either TRS Plan 1 or LEOFF Plan 1. The answer is probably no.

In *Charles*, the Washington Supreme Court held that in the absence of proof that a statute or an action of the Legislature impaired the actuarial soundness of a pension plan, members' right to the systematic funding of an actuarially sound system was not violated. Here, there appears to be no evidence upon which a court could find that merging the TRS Plan 1 and LEOFF Plan 1 pension funds under Senate Bill 6668 will render the funds actuarially unsound. The court in *Charles* required proof that something more than the possibility of future harm will occur before finding that legislative action caused a pension fund to become actuarially unsound. On the other hand, the *Weaver* court did not require proof of inability to pay current or future benefits. Washington courts could go either way on this issue but the better reasoning probably is found in *Charles*. If so, in the absence of proof that the merged plan would be actuarially unsound, Senate Bill 6668 cannot be said to violate members' contractual rights.

2. State law does not prohibit two different pension plans from being merged.

As explained above, the terms of members' public pension rights are defined by the language of the statutes creating those rights. After review of the TRS Plan 1 and the LEOFF Plan 1 statutes and other provisions governing public pension plans, there appears to be no state statute that addresses whether either plan may merge with another plan. Given (i) the statutory silence on merger, and (ii) the Legislature's plenary power to design the public pension plans, there is no apparent prohibition under state law to the merger of these two different pension plans.

3. It is difficult to envision a scenario in which TRS Plan 1 employers will be required to pay for LEOFF Plan 1 benefits, and such a scenario seems unlikely to happen.

Questions have arisen regarding whether it is legal under state law for TRS Plan 1 employers to use money generated solely for the purpose of paying education costs to pay for LEOFF Plan 1 benefits. It is difficult to answer this question because there appears to be no scenario under which a TRS Plan 1 employer will be required to pay for benefits of LEOFF Plan 1 members, or will be required to pay down an unfunded liability in LEOFF Plan 1, using money designated solely for education. First, actuarial analysis indicates that there are sufficient funds to pay for all future LEOFF Plan 1 benefits, and second, under a merger, TRS Plan 1 and LEOFF Plan 1 assets and liabilities will be accounted for as a combined fund. It will be impossible under the combined fund to determine what amount each plan may be underfunded. Because contribution rates will be paid to the combined fund without designating which contributions go to which plan, there is no scenario under which TRS Plan 1 employers will pay specifically for LEOFF Plan 1 liabilities.

Nevertheless, basic education funds provided under RCW 28A.150, *et. seq*., must be used solely for the funding of public school education. If there is any scenario which requires the use of basic education funds to pay for LEOFF Plan 1 benefits, that use is probably contrary to law. The state has had a history of contributing to LEOFF Plan 1. In fact, over the history of LEOFF Plan 1, the state has paid approximately 87% of the contributions paid to LEOFF Plan 1. *See* the *2016 Participating Employer Financial Information (PEFI)* at page 114 (http://www.drs.wa.gov/administration/annual-report/pefi/PEFI-2016.pdf). There is nothing in state law that prevents the Legislature from contributing again to the merged TRS Plan 1 and LEOFF Plan 1.

4. LEOFF 1 members do not have a right to the surplus assets of their plan. Generally, distribution of the surplus of LEOFF Plan 1 is controlled by federal law.

There are no Washington statutes that describe the ownership of surplus assets in any of the pension systems. In a defined benefit plan such LEOFF Plan 1, statutory benefits are not proportional to the contributions that employees pay into the plan. *Wash. Fed'n of State Emp. v. State*, 107 Wn. App. 241, 245, 26 P.3d 1003 (2001). The risk for any shortfall falls on the employer. As a result members are entitled to their retirement allowance, but they have no share in the plan's surplus. *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 440-41 (1999).[2]

LEOFF Plan 1 has been determined to be a tax qualified plan under the federal Internal Revenue Code. Because it is a tax qualified plan under federal law, LEOFF Plan 1 must be administered consistent with federal law requirements. Washington rule provides that benefits paid from

[2] *Hughes Aircraft* analyzed claims under the Employee Retirement Income Security Act of 1974 (ERISA), a federal law that is inapplicable to state public pension systems. Nevertheless, ERISA interpretation is sometimes used as guidance for the interpretation or analysis of general pension concepts.

pension plans administered by the Department of Retirement Systems must comply with IRS distribution rules. WAC 415-02-750. IRS distribution rules provide for the distribution of surplus assets to the employers and sponsors of the plan. It is appropriate, then, to defer to Ice Miller's analysis regarding the federal rules on distribution of the LEOFF Plan 1 surplus.

5. LEOFF Plan 1 and TRS Plan 1 members are statutorily entitled to a refund of their contributions but they do not own their contributions and probably do not have a contractual right to the same.

Members question whether they own the contributions they paid into their pension fund over the course of their employment. While the LEOFF Plan 1 and TRS Plan 1 statutes do not address "ownership" of contributions, each plan provides a right to receive an amount equivalent to the member's employee contributions if the member leaves LEOFF Plan 1-covered membership or TRS Plan 1-covered membership. These contributions are paid only if the member has not retired for service or disability and only upon the application of the member. Members will receive their contributions with interest, but will not receive the investment earnings on those contributions. If a member elects to receive the member's contributions, in most instances the member will no longer be eligible for a retirement benefit. *See* RCW 41.26.170 and RCW 41.32.510. There is no statute that provides that LEOFF members are entitled to receive their contributions even though they have retired. Under *Johnson v. City of Tacoma*, No. 74848-3-I, 2016 WL 3190548, *3 (Wash. Ct. App. June 6, 2016) (unpublished)[3] a member has a claim only to a monthly retirement allowance, not to the contributions made during employment. The *Johnson* court notes that a member of the city of Tacoma retirement system no longer "had an ownership interest in his retirement contributions," and could not therefore devise the contributions through his will. *Id.*

The provisions for payment of accumulated contributions, however, poses a different question than the question of who is entitled to, or "owns," a pension fund's surplus assets.

6. Counties and cities have no apparent legal challenge to Senate Bill 6668, if enacted, based on GASB requirements.

In June 2012, the Governmental Accounting Standards Board (GASB) issued new standards for pension accounting and reporting. The new GASB standards require employers to recognize the employers' proportionate share of any unfunded pension liability or surplus in their financial statements. These standards went into effect for fiscal years beginning after June 15, 2014. Public employers who employ or employed LEOFF Plan 1 members have been able to account for, or "book," their proportionate share of the surplus in LEOFF Plan 1. Senate Bill 6668 indicates that the Legislature intends to improve the actuarial soundness of TRS Plan 1 through

[3] *Johnson v. City of Tacoma* is an unpublished case but may be cited as nonbinding authority. GR 14.1. The case analyzed rights under the city of Tacoma public pension plan.

the merger. As a result of this merger there will no longer be a surplus for which LEOFF Plan 1 employers may book their proportionate share of the assets. On the other hand, TRS Plan 1 employers will book a lower amount in liability. It is understood that the reporting by employers under GASB has no direct, and perhaps no indirect, impact on public employers. Nothing in state statute indicates that counties and cities have a legal right to the continued booking of their share of the LEOFF Plan 1 assets, nor is there evidence upon which the counties and cities may claim damages as a result of the merger. Therefore, cities and counties have no apparent claim against the state should Senate Bill 6668 be enacted in its present form.

7. It is permissible under state law to distribute a lump sum payment to LEOFF Plan 1 members and retirees and survivors that is taken from the LEOFF Plan 1 pension fund.

Section 6 of Senate Bill 6668 authorizes a one-time payment of $5000 to each LEOFF Plan 1 "active member, term-vested member, retiree, and survivors" eligible for benefits under LEOFF 1, to be paid out of LEOFF Plan 1 assets. The question has arisen whether it is permissible to distribute a lump sum payment from the pension fund. Article II, section 25 of the Washington Constitution prohibits what is termed a gift of public funds. However this provision does not "prevent increases in pensions after such pensions shall have been granted." Based on this constitutional provision, and case law in support of this provision, there appears to be no prohibition to the distribution of the $5000 lump-sum payment to LEOFF Plan 1 members, retirees, and their survivors.

8. It is unlikely that a Washington court will find the Alaska case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997), to be persuasive.

The SCPP asked whether the case of *Municipality of Anchorage v. Gallion*, 944 P.2d 436 (Alaska 1997) affects how to analyze the issues related to the LEOFF Plan 1/TRS Plan 1 merger. *Gallion* involved an Anchorage police and firefighter retirement system consisting of three tiers of membership (Plan I, II, and III) much like Washington's PERS and TRS. The case did not involve a plan merger. The three tiers had different contribution rates and benefits but the tiers' assets were merged for investment purposes. Anchorage suspended employer and employee contributions to all three tiers because two out of the three funds were overfunded and assets for the three tiers were sufficient to cover liabilities for all three tiers. The *Gallion* court held that the suspension of the contributions reduced the funding status of the plans, which impaired "the inherent integrity" of the two overfunded plans, and that members had a constitutionally protected contractual right to have their plans evaluated separately for actuarial soundness.

There are three reasons a Washington court would not find *Gallion* persuasive to issues relating to the LEOFF Plan 1/TRS Plan 1 merger. First, the *Gallion* court found that maintaining a separation among the plans, rather than merging them, enhanced the integrity of the plans. The court also found that the funding status of the merged plans would be 102% or 99%. The court did not find that the merged plan would *not* be able to pay benefits after the merger. In fact, at a 102% or 99% funded status, it would appear that the plans' liabilities were fully funded. In contrast to *Gallion,* the Washington Supreme Court, in *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 62 P.3d 470 (2003), held that even though the Legislature reduced employer contributions to PERS and TRS, the plaintiffs' general allegations that the lowered contribution rates might reduce earnings on pension assets, or that the lowered rates might reduce benefits, or might curtail the opportunity for future benefit improvements, were insufficient to establish an impairment of a contractually vested right to an actuarially sound system. Unlike *Gallion,* the *Charles* court rejected plaintiff's argument that they need not show a likelihood of harm. Instead, the *Charles* court required proof that the legislative change to the retirement plan would render the plan actuarially unsound. This holding is contrary to *Gallion*, where there was no proof that members' benefits would be affected and there was every indication that the plans were actuarially sound after the suspension of contributions.

Second, the legal analysis used by *Gallion* has not been recognized or used by Washington courts in public pension cases. *Gallion* rested its decision, in part, on *Sheffield v. Alaska Pub. Emp. Ass'n, Inc.*, 732 P.2d 1081 (Alaska 1987), a case involving contractual public pension benefits for Alaskan state public employees. The Washington Supreme Court, when asked to adopt the analysis of *Sheffield,* rejected the invitation and found that the *Sheffield* analysis is "incompatible with our binding precedent." *Lenander v. Dep't of Ret. Sys.,* 186 Wn.2d 393, 417 n 9, 377 P.3d 199 (2016). Just as telling, the Alaska court in *Sheffield* rejected the Washington Supreme Court's analysis of public pension law in *King Cty. Emp. Ass'n v. State Emp. Ret. Bd.,* 54 Wn.2d 1, 336 P.2d 387 (1959), finding that the Washington analysis was not "sufficiently compelling" to overcome Alaska binding precedent. *Sheffield*, 732 P.2d at 1086. Based on the state courts' mutual unwillingness to adopt each other's analysis in public pension cases involving contractual rights, it seems unlikely that Washington courts will find the *Gallion* analysis to be persuasive.

Finally, Washington courts, which have a rich and robust body of public pension case law, generally appear to prefer to rely on Washington courts' own case law rather than the case law from other states.

Part 3 –Analysis of LEOFF 1 and TRS 1 Members' Contractual Rights Under Senate Bill 6668

The Legislature has plenary authority to establish the terms of the public pension systems. The Legislature's power to enact laws "is unrestrained except when expressly or impliedly limited." *Luders v. City of Spokane,* 57 Wn.2d 162, 164, 356 P.2d 331 (1960). The courts have repeatedly said that they will not substitute their judgment for the Legislature's with respect to the structure of public retirement plans. *Wash. Fed'n of State Emp. v. State,* 107 Wn. App. 241, 247, 26 P.3d 1003 (2001), *State Pub. Emp. Bd. v. Cook,* 88 Wn.2d 200, 206, 559 P.2d 991 (1977).

The principal restriction on the Legislature's authority to change retirement benefits is the impairment of contracts clause in article I, section 23 of the Washington Constitution.[4] Members of the Washington state public pension systems, who have met vesting requirements, have certain rights in their pension plan that are contractual in nature. This contractual right was first recognized in the case of *Bakenhus v. City of Seattle,* 48 Wn.2d 695, 296 P.2d 536 (1956), where the Court held that under a contractual analysis, a member of a public pension plan is entitled to the monthly retirement allowance promised to the member when first employed.

In subsequent cases, Washington courts have expanded the list of pension rights that are protected by a contract. In addition to the protection of a promised retirement benefit allowance found in *Bakenhus*, members of a public pension plan have a vested contractual right to a mandatory retirement age that is not reduced during the course of employment, the right to include leave cashouts at the end of employment in the calculation of retirement benefits, the right to a refund of retirement contributions, and the right to the systematic funding of a pension plan to maintain its actuarial soundness. *Ret. Pub. Emp. Council v. Charles,* 148 Wn.2d 602, 624-25, 62 P.3d 470 (2003).

Members' rights are located in the statutes of the public pension plans, related statutes, rules governing the plans, and cases interpreting the statutes and rules. Courts will review those statutes and rules in order to determine the contours of members' benefits. State pension statutes may create contractual rights. *Wash. Educ. Ass'n v. Dep't of Ret. Sys.,* 181 Wn.2d 233, 242, 332 P.3d 439 (2014) (WEA I). In order to determine what pension rights are contractual, courts will look to the language of the statutes creating the claimed rights. *Id.* 244-45.

Over the last 15 years, the Washington Supreme Court has clarified how courts should analyze pension statutes when determining pension contractual rights. The court will address three questions:

1. Does a contractual relationship exist between the parties?
2. Does the legislation substantially impair that contractual relationship?
3. If there is a substantial impairment, was that impairment reasonable and necessary to serve a legitimate public purpose?

Lenander v. Dep't of Ret. Sys., 186 Wn.2d 393, 414, 377 P.3d 199 (2016)(citing *WEA I*, 181 Wn.2d at 243). This is the traditional test used by Washington courts to determine other, non-pension related contractual rights. This traditional test is also applicable to determine contractual

[4] Art. I, § 23 reads: "No bill of attainder, ex post facto law, or law impairing the obligations of contract shall ever be passed."

claims involving pensions. However, in the pension context, the traditional test is also guided by the principles in *Bakenhus,* which require that any changes to a pension benefit must maintain the flexibility and integrity of the pension system, and that comparable new advantages be provided to members.[5] *WEA I*, 181 Wn.2d at 244.

If Senate Bill 6668 is enacted and then legally challenged, Washington courts will undoubtedly use the legal framework described above to determine whether the legislation violates LEOFF Plan 1 members' or TRS Plan 1 members' constitutionally protected contractual rights to their pension benefits. With that understanding, this section of the merger report will discuss the pension benefits that stakeholders suggest will be impaired by Senate Bill 6668, if it is enacted, and provide analysis, under the legal framework used by Washington courts, regarding whether provisions of Senate Bill 6668 may violate specific pension rights of the members under state law.

But, first, two preliminary matters should be addressed. Members' pension rights are found in statute. *WEA I*, 181 Wn.2d at 244-45 ("The respondents contract rights are defined by the language of the statute creating those rights."). Therefore, if members have contractual pension rights, those rights must be found in the language of the statutes.[6] An analysis of Senate Bill 6668 must be done in the context of LEOFF Plan 1 and TRS Plan 1 statutes. This report assumes, therefore, that Senate Bill 6668 does not modify any provisions in either plan other than what is specifically provided for in the bill draft. In other words, it is understood that RCW 41.26 continues to provide the pension terms applicable to LEOFF Plan 1 members post-merger, and that RCW 41.32 continues to provide the pension terms applicable to members of TRS Plan 1 post-merger.

Second, in public pension analysis, courts generally have found that the first element of the traditional contract analysis, listed above, has been met. That element, whether there is an existing contract in which one party has contractual rights and the other has contractual obligations, will be assumed to have been met here without further analysis. Therefore, the analysis begins with the second element: whether any provision in Senate Bill 6668 substantially impairs LEOFF Plan 1 and TRS Plan 1 members' contractual rights.

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[5] *Bakenhus* described its holding as follows: "[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." The employee's "pension rights may be modified prior to retirement, but only for the purpose of keeping the pension system flexible and maintaining its integrity." Any changes that cause a disadvantage to an employee should be accompanied by comparable new advantages. *Bakenhus,* 48 Wn.2d at 701-02.

[6] An exception to the statutory language requirement is found in *Bowles v. Dep't of Ret. Sys.,* 121 Wn.2d 52, 68, 847 P.2d 440 (1993), where the court found that an administrative practice may create a vested right in the future continuation of that practice.

1. Members have a contractual right to the retirement allowance provided for under RCW 41.26 and RCW 41.32, and that right is not impaired by the merger.

Of the pension benefits to which a member has a contractual right, the right to a retirement allowance provided for under statute is a clearly protected pension right. This is the right at issue in the *Bakenhus* case. *Bakenhus* involved the City of Seattle pension fund for police officers. At the beginning of the officers' employment, city ordinances provided future retirement allowances based on the salary attached to the officers' positions. During Bakenhus' employment as a police officer, the city enacted an ordinance that reduced police officers' retirement allowance by approximately one-third. Bakenhus claimed that the reduction of his benefit constituted an impairment of contract under the contracts clause of the Washington Constitution (art. I, section 23). The Washington Supreme Court agreed and found that an employee who accepts a job to which a pension plan is attached has contracted for a retirement allowance based on what was promised at the beginning of the employee's membership, and that the employee is entitled to receive that retirement allowance once the employee vests and retires. *Bakenhus,* 48 Wn.2d at 701.

Section 3 of Senate Bill 6668 provides that the merger of these two plans "may not impact benefits for members of these plans. Specifically, each member of each of these plans is entitled to receive benefits immediately after the merger . . . that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." The Department of Retirement Systems is to administer the merger to ensure that members' benefits are not reduced. *Id.* The intent section of the bill confirms this intent. Section 1, Senate Bill 6668.

The legislation does not define the term "benefits," however, based on *Bakenhus* and subsequent cases, and given the requirements of federal law as described by Ice Miller, it is reasonable to interpret Senate Bill 6668 to intend that members receive the retirement allowance that they were promised pursuant to the statutes in effect for each plan. Because of this language, it is a reasonable interpretation that Senate Bill 6668 protects the retirement allowances of the members of each plan, and that, post-merger, each member has a contractual right to the retirement allowance provided by the members' plan pre-merger.

2. LEOFF Plan 1 members have a contractual right to the disability benefit provided for under RCW 41.26.020, and that right is not impaired by the merger.

The provisions of Senate Bill 6668 do not address LEOFF Plan 1 disability benefits, although Section 2(3) of the bill affirms that all liabilities for LEOFF Plan 1 medical costs, which support disability benefits, remain the responsibility of LEOFF Plan 1 employers, and that the merger "does not impact the disability boards" established under LEOFF Plan 1.[7] Section 4, Senate Bill

[7] These boards grant and deny disability benefits to LEOFF Plan 1 members.

6668. Because the legislation provides that members' benefits will not be reduced because of the merger, and because disability benefits have the same character as a service retirement allowance, which is a *Bakenhus* right, and because federal law forbids the diminution of benefits in a merger, it is a reasonable interpretation of Senate Bill 6668 that LEOFF Plan 1 members' disability benefits are protected under the provisions of Senate Bill 6668, and will not be reduced as a result of the merger.

3. LEOFF Plan 1 and TRS Plan 1 members have a contractual right to the systematic funding of their pension plans to maintain the plans' actuarial soundness, and that right is not impaired as a result by the merger.

LEOFF Plan 1 stakeholders ask whether they have a right to an actuarially sound pension plan and, if so, whether the merger jeopardizes the actuarial soundness of the plan. They note that the LEOFF Plan 1 pension fund is overfunded, that the TRS 1 pension fund is underfunded, and that the resulting merged fund would be underfunded even with the infusion of the surplus assets provided by LEOFF Plan 1.

LEOFF Plan 1 and TRS Plan 1 members have a contractual right "to the systematic funding of the retirement system [here, their respective plans] to maintain [the plans'] actuarial soundness." *Retired Pub. Emp. Council v. Charles*, 148 Wn.2d 602, 625, 62 P.3d 470 (2003). This right has been established in both *Weaver v. Evans,* 80 Wn.2d 461, 478, 495 P.2d 639 (1972) and in *Charles.*

In *Weaver*, an appropriation was made by the Legislature to TRS for the 1969 – 1971 biennium. Toward the end of the biennium the governor sought to reserve some of the appropriation in order to balance the state's budget. There were insufficient funds in the TRS pension fund for benefit payments, therefore the governor advised TRS trustees to pay remaining benefits by transferring funds in the pension reserve account to the TRS pension fund. While it appears that the pension reserve fund had sufficient money to pay for benefits, the *Weaver* court found that by modifying the Legislature's effort to systematically fund TRS in order to make it a financially sound system, the actions of the governor impaired TRS' members contractually protected right to the systematic funding of their system to maintain its actuarial soundness.

In *Charles,* the Legislature implemented an additional contribution rate reduction for employers in both PERS and TRS during the 1999 – 2001 biennium, after reducing those rates at the beginning of the biennium. The plaintiffs challenged the second rate reduction as violating their right to the systematic funding of their plan because the lower rates, they argued, might affect the actuarial soundness of the plan. The *Charles* court found that members' contractual right to the systematic funding of their plan to maintain its actuarial soundness was not impaired where there was no indication that the lower contribution rates would render the plan actuarially unsound. *Charles*, 148 Wn.2d at 484.

Neither the *Weaver* court nor the *Charles* court was specific about whether a member's right is to the "systematic funding" of the pension plan or to the "actuarial soundness" of the plan, or both. The *Weaver* court's focus was on systematic funding as a pension right. The court appeared to view *any* modification of the existing funding system was a per se impairment. The court did not analyze whether the "actuarial soundness" of the plan had been affected. The *Charles* court, on the other hand, focused on the actuarial soundness of the plan as the contractual right belonging to members. Rather than finding a per se impairment, the court looked at the effect the reduction of the contributions would have on the actuarial soundness of the plan. Because there were no facts to demonstrate that the actuarial soundness of the plan would be affected, the court found that plaintiffs did not prove that the system was actuarially unsound.

Note that the term "actuarial soundness" was not defined by either court. Because neither the *Weaver* court nor the *Charles* court explain what is meant by this term, it is unclear whether a comparison of these decisions is comparing apples to oranges. A court, in reviewing a challenge to Senate Bill 6668, might adopt the *Weaver* reasoning and find that the merger would lead to an actuarial unsoundness in LEOFF 1 plan. However, that finding depends on complicated issues regarding whether the LEOFF Plan 1 pension fund can be deemed to be underfunded when it becomes a tier of the TRS 1 pension plan. In addition, an analysis of soundness of the merged plans may very well depend not only the current funded status of the merged plans, but also on the reasonableness of the assumptions and methodology of the funding policy for the merged plans.

On the whole, it seems more likely that a court would follow the *Charles* analysis because it represents a more modern approach to public pensions and funding policy. The State Actuary's fiscal note for Senate Bill 6668 expects the merged plans to be fully funded by 2026. There is no indication that the merged plans could not pay current and future obligations to the LEOFF 1 members and beneficiaries, or that the merger affects the successful operation of the merged plans. *Charles,* 148 Wn.2d at 628. Nevertheless, it cannot be said with legal certainty which direction a court would take in this type of challenge to Senate Bill 6668. This uncertainly represents a risk regarding the merger of these two plans.

4. LEOFF 1 members do not have a contractual right to the LEOFF 1 surplus assets.

The purpose of LEOFF is to provide for an actuarial reserve system for the payment of death, disability, and retirement benefits to law enforcement officers and firefighters and to their beneficiaries. RCW 41.26.020. LEOFF Plan 1 is a defined benefit plan. As a defined benefit plan, LEOFF Plan 1 guarantees members a fixed periodic payment for life. *Wash. Fed'n of State Emp. v. State,* 107 Wn. App. 241, 245 n.5, 26 P.3d 1003 (2001). Because it is a defined benefit plan, the "employer bears the risk of investment and guarantees the distribution of the fixed benefit even if the value of the plan's investments decline." *Johnson v. City of Tacoma*, No. 74848-3-I, 2016 WL 3190548, *3 (Wash. Ct. App. June 6, 2016) (unpublished).

> Given the employer's obligation to make up any shortfall, no [defined benefit] plan member has a claim to any particular asset that composes a part of the plan's general asset pool. Instead, members have a right to a certain defined level of benefits, known as "accrued benefits." . . . [P]lan members generally have a nonforfeitable right only to their "accrued benefits," so that a plan's actual investment experience does not affect their statutory entitlement. Since a decline in the value of a plan's assets does not alter accrued benefits, members similarly have no entitlement to share in the plan's surplus – even if it is partially attributable to the investment growth of their contributions.

Hughes Aircraft Co. v. Jacobson, 525 U.S. 432, 440-41 (1999).[8]

The LEOFF Plan 1 pension fund currently has a surplus. The State Actuary notes that if all assumptions are realized in the future, LEOFF Plan 1 will have assets remaining after all benefits have been paid. October 11, 2016 Fiscal Note by OSA for Senate Bill 6668. The LEOFF Plan 1 surplus is intended to improve the actuarial soundness of TRS Plan 1 after the merger. *See* Section 1, Senate Bill 6668.

There is no provision in LEOFF Plan 1 statutes that addresses the ownership of surplus assets of the plan. Pursuant to RCW 41.26.020, members clearly have a right to a reserve system that pays them a retirement *allowance* but there does not to appear to be any statutory provision that supports members' ownership of the surplus assets. Because members of a defined benefit plan do not share in the decrease or surplus of plan assets, under the reasoning of *Johnson v. City of Tacoma* and *Hughes Aircraft Co. v. Jacobson,* it seems unlikely that a court would find that LEOFF Plan 1 members are entitled to the surplus assets of their plan. Further, Senate Bill 6668 does not appear to intend to distribute the surplus assets but, instead, to use those assets to pay down the TRS Plan 1 unfunded liability.

5. LEOFF Plan 1 members do not have a contractual right to an independent plan, or a separate pension fund, but do have a contractual right to the LEOFF Plan 1 COLA.

LEOFF Plan 1 members ask whether they have a contractual right to LEOFF Plan 1 as an independent plan, and a right to a LEOFF Plan 1 pension fund that is separate from other pension funds. These two questions are subsumed under the broader question of whether state law permits a merger of two different pension plans. The LEOFF 1 members also ask whether they will lose their COLA because of the merger.

[8] As explained in footnote 2, above, *Hughes Aircraft* analyzed claims under the Employee Retirement Income Security Act of 1974 (ERISA), a federal law that is inapplicable to state public pension systems. Nevertheless, ERISA interpretation is sometimes used as guidance for the interpretation or analysis of general public pension concepts. In addition, the *Wash. Fed'n of State Emp. v. State* court and the *Johnson* court relied on *Hughes Aircraft* in their analysis of state and city public pension plans provisions.

Senate Bill 6668 merges the assets and liabilities of a closed law enforcement officers' and firefighters' pension plan with a closed teachers' retirement plan. There is little precedence in Washington public pension history for the merger described in Senate Bill 6668.

In 1969, law enforcement officers and firefighters were transferred into LEOFF Plan 1 from their membership in retirement plans that were administered by local governments. *See* RCW 41.16, 41.18, and 41.20 (the "Prior Acts"). However, unlike Senate Bill 6668, the transfer of Prior Act employees into LEOFF did not require that the Prior Acts become tiers of LEOFF Plan 1, and the transfers of members to LEOFF Plan 1 did not require the merger of the assets and liabilities of the Prior Acts with LEOFF Plan 1. Therefore, the creation of LEOFF Plan 1 does not provide guidance for the merger anticipated in Senate Bill 6668.

In answering the question whether state law will allow a merger of two disparate plans we need to review two basic legal provisions applicable to Washington public pensions. The first is that members' contractual rights are defined by the language of the statute creating those rights. *WEA I*, 181 Wn.2d at 244-45. The second is that the "Legislature has plenary authority to establish the terms of the public pension systems." *Luders v. City of Spokane,* 57 Wn.2d 162, 164, 356 P.2d 331 (1960). The LEOFF Plan 1 and the TRS Plan 1 statutes do not address issues of merger - either by permitting or by prohibiting mergers. While it is always a risk that a Washington court may invalidate a LEOFF Plan 1 and TRS Plan 1 merger, it is not readily apparent upon what grounds a court would invalidate a merger under state law. This is especially true given the Supreme Court's acknowledgment that the Legislature has plenary power to alter or amend retirement plans as long as the amendment passes muster under the Constitution's contracts clause. Further, courts have indicated they will not substitute their judgment for the Legislature's with respect to the structure of public pension plans. *Wash. State Pub. Emp. Bd. v. Cook,* 88 Wn.2d 200, 206-07, 559 P.2d 991 (1977). It is unlikely they would do so here.

In discussions with the SCPP, LEOFF Plan 1 members said they were told that they would have an independent plan and that they would have a separate pension fund. If the Legislature considers Senate Bill 6668, it would be helpful to receive information regarding what members were promised and who made those promises. Under *Bowles v. Dep't of Ret. Sys.,* 121 Wn.2d 52, 847 P.2d 440 (1993), public pension members were entitled to include leave cashouts in the calculation of their retirement benefit based on the Department of Retirement Systems' *practice* of including those cashouts. *Id.* at 68. It is possible under *Bowles* that a court might find that LEOFF Plan 1 members are entitled to an independent plan and a separate pension fund if the court found that the state had a practice in this regard. However, it is difficult to apply *Bowles* here where there is no indication members will suffer a diminution in benefits (unlike in *Bowles)* and there appears to be no other loss to members as a result of the merger. On the other hand, courts have considered the reasonable expectations embodied in a contract. *Tyrpak v. Daniels*, 124 Wn.2d 146, 155 n.1, 874 P.2d 1374 (1994)

Finally, because LEOFF Plan 1 members are statutorily entitled to a COLA described in RCW 41.26.240, and because Senate Bill 6668 requires no diminution of benefits as a result of the merger, LEOFF Plan 1 members are entitled to their continued annual COLA.

In conclusion, the above represents the analysis of the SCPP's assigned counsel as to how Washington courts may analyze a merger described in Senate Bill 6668. While, in general, the conclusion of this report is that the merger appears to meet the requirements protecting the constitutionally protected contractual rights of the affected members, there is always a risk that Washington courts may analyze a merger according to different principles. Nevertheless, the Legislature may wish to adhere closely to the framework developed by Washington courts over the last 15 years regarding the legal analysis of public pension rights of public pension members.

The following are two recommendations regarding revision of the current draft of Senate Bill 6668.

RECOMMENDATIONS

Recommendation #1: Senate Bill 6668 amends the LEOFF Plan 1 statutory provisions to provide for the merger. It is recommended that the legislation amend the TRS Plan 1 statutory provisions to also reflect the merger.

Recommendation #2: Senate Bill 6668 is unclear regarding the Legislature's intent that the benefits provided under each merged plan do not become the benefits of the other plan. In other words, it appears that the Legislature intends, under Senate Bill 6668, that TRS Plan 1 benefits continue to be governed by the provisions of TRS under RCW 41.32, and that LEOFF Plan 1 benefits continue to be governed by the provisions of LEOFF under RCW 41.26. It is recommended that this legislative intent be made clearer.

APPENDIX A

OUTLINE of SB 6668

Section of the Bill	Content of Section
Section 1	Intent Section: • Improve actuarial soundness of TRS 1 • Continue state commitment to maintain actuarial soundness of benefits for LEOFF 1 by merging assets, liabilities, and membership • Merger not to impact benefits of TRS 1 and LEOFF 1 • Merged plan administered to be consistent with plan qualification provisions of Internal Revenue Code
Section 2	• LEOFF 1 merged into TRS 1 • TRS 1 maintains its own liabilities • LEOFF 1 liabilities now liabilities of TRS 1 • LEOFF 1 benefits paid from TRS 1 fund • LEOFF 1 administered as a separate tier of TRS 1 • LEOFF 1 employers retain liability for LEOFF 1 medical benefits • TRS 1 and LEOFF 1 assets are merged
Section 3	• Merger not impact benefits for the members • DRS to administer the merged plan to not impact benefits • DRS must seek determination letter from IRS
Section 4	Merger to not impact disability boards
Section 5	UAAL rate from 9.1.2016 to 8.31.2017 is 4.24%
Section 6	New section added to RCW 41.26: • Assets of LEOFF 1 transferred to TRS 1 and will fund LEOFF 1 lump-sum benefit • LEOFF 1 active, term vested, retired and survivors who are eligible for benefits on effective date of this section are eligible for lump-sum benefit • Lump-sum payment is $5000 payable on 1.3.2017 or member's retirement date, whichever later • Interest shall accumulate on lump-sum benefit if member active or term vested • If member dies before receiving the lump-sum benefit the member's beneficiary receives this benefit • Lump sum payment exempt from judicial process (41.26.053)

	• If sections 1-5 invalid no entitlement to the lump-sum benefit
Section 7	Definition in LEOFF 1 of 'retirement fund' means TRS 1 fund
Section 8	No contribution rate charge to LEOFF 1 employers and members beginning 9.1.2016 (except admin fee)
Section 9	Strikes the provision to fully amortize costs of LEOFF 1 not later than 6.30.2024.
Section 10	• Strikes requirement for PFC to adopt or change basic state contribution rate for LEOFF 1 • Strikes provision to require employer and state contributions to be the level percentages of pay to fully amortize costs of LEOFF 1 • PFC to adopt employer and state contribution rates to fully fund benefits for LEOFF 1 beginning 9.1.2016 • Additional provisions regarding employer contribution rate for TRS 1
Section 11	• Adds 4.24% contribution rate as part of basic employer contribution rate for TRS 1 from 9.1.201 to 8.31.2021 • Minimum contribution rate of 4.24% remains effective until assets equal 100% of actuarial accrued liability
Section 12	DRS to publish annual financial statement for LEOFF 2 (implicitly deleting requirement to publish statement for LEOFF 1)
Section 13	• LEOFF 1 retirement fund closed • LEOFF 1 retirement monies transferred to TRS 1 retirement fund • any monies payable to LEOFF 1 must be paid to TRS 1 retirement fund to finance benefits of TRS 1 and LEOFF 1 beginning 9.1.2016
Section 14	Removes LEOFF 1 retirement fund from a proportionate share of the earnings credited to the Treasury income account
Section 15	• Merger must be administered to comply with 26 USC 401(a) • If IRS determines merger in conflict with 26 USC 401(a), and conflict cannot be resolved, sections 2 and 6-14 are null and void
Section 16	Savings clause
Section 17	Effective date is 9.1.2016

SCPP · 2016 Merger Study

ACTUARIAL ANALYSIS

December 13, 2016

Senator Steve Conway, Chair
Representative Bruce Chandler, Vice Chair
Select Committee on Pension Policy
PO Box 40914
Olympia, Washington 98504

SUBJECT: TRANSMITTAL LETTER FOR ACTUARIAL SECTION OF MERGER STUDY

Pursuant to Section 106 of Chapter 36, Laws of 2016, we transmit the actuarial analysis we prepared in support of the Select Committee on Pension Policy's (SCPP) study of the merger proposed under Senate Bill (SB) 6668. We enclose the following materials for inclusion in the SCPP's report to the Legislature.

- An updated draft actuarial fiscal note for SB 6668.
- The materials the Office of the State Actuary presented to the SCPP during the 2016 Interim concerning actuarial analysis on the merger.
- Responses to actuarial questions the SCPP received from stakeholders during the survey on the merger.

We appreciated the opportunity to assist the SCPP with this study. Please let us know if you have any questions or need further assistance.

Sincerely,

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

cc: Select Committee on Pension Policy Members

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Responses to Actuarial Questions from Stakeholders

Actuarial Questions and Answers

Historical

1. *How did gainsharing impact the Teachers' Retirement System (TRS) Plan 1?*

   Answer: When gainsharing was in effect for TRS 1, it provided increases to the former Plan 1 Uniform Cost of Living Adjustment (COLA). From a funding and actuarial perspective, those past increases lowered the plan's funded status and increased the TRS 1 Unfunded Actuarial Accrued Liability (UAAL).

   a. *Is that partly why the Law Enforcement Officers' and Fire Fighters' (LEOFF) Plan 1 is in such good shape and TRS 1 is not?*

      Answer: No. LEOFF 1's funded status benefitted from below expected inflation. With the benefit of hindsight, we now know this experience gain resulted in LEOFF 1 collecting more in contributions than what was necessary. Those extra contributions also grew with additional investment earnings. No other plan benefitted from this experience to the same degree as LEOFF 1 because LEOFF 1 is the only plan in our state with a fully indexed (Consumer Price Index) post-retirement COLA.

2. *What is the funding history for each plan?*

   Answer: Please find historical funded status for both LEOFF 1 and TRS 1 in the tables below.

Historical Funded Status			
Year	LEOFF 1	Year	LEOFF 1
2015	**125%**	2000	136%
2014	127%	1999	125%
2013	125%	1998	117%
2012	135%	1997	108%
2011	135%	1996	89%
2010	127%	1995	80%
2009	125%	1994	68%
2008	128%	1993	68%
2007	123%	1992	65%
2006	117%	1991	66%
2005	114%	1990	65%
2004	109%	1989	65%
2003	112%	1988	66%
2002	119%	1987	69%
2001	129%	1986	57%

Note: EAN Cost Method used starting in 2014 (PUC previously).

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Historical Funded Status			
Year	**TRS 1**	**Year**	**TRS 1**
2015	**64%**	2000	100%
2014	69%	1999	93%
2013	71%	1998	86%
2012	79%	1997	82%
2011	81%	1996	70%
2010	84%	1995	65%
2009	75%	1994	65%
2008	77%	1993	62%
2007	76%	1992	59%
2006	80%	1991	59%
2005	80%	1990	60%
2004	88%	1989	58%
2003	89%	1988	59%
2002	98%	1987	58%
2001	100%	1986	50%

Note: EAN Cost Method used starting in 2014 (PUC previously).

a. *Who paid what?*

Answer: Please find historical contribution rates on this website: www.drs.wa.gov/employer/EmployerHandbook/chpt6/tables/default.htm

3. *Is LEOFF 1 cost sharing the same as other plans?*

Answer: No. Generally speaking, member contribution rates in the Plans 1 were fixed at 6 percent. Plan 1 employers in Public Employees' Retierement System (PERS) and TRS contribute to the Plan 1 UAAL in addition to the normal cost. When LEOFF 1 had a UAAL, contributions to amortize the UAAL were made exclusively by the state through the General Fund-State budget.

Member contributions in LEOFF 1 ceased. Member contributions in PERS 1 and TRS 1 continue.

Plan 2 members share equally with their employers in the cost of their defined benefits. Plan 3 members do not share in the cost of their defined benefits, but generally receive half the defined benefit of a similarily situated Plan 2 member. The remaining Plan 3 retirement benefit is derived from member contributions (and assoicated investment earnings) to a defined contribution account.

a. *I.e., did the state only put in 20 percent of contributions?*

Answer: No. The state contributes 20 percent of the cost of **LEOFF 2** benefits. When the state made contributions to LEOFF 1, the state was exclusively responsible for amortizing the LEOFF 1 UAAL. Please see the table on the next page for a history of LEOFF 1 contributions by source.

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Total Employee, Employer, and State Contributions to LEOFF 1			
	Employer	Employee	State
(Dollars in Millions)			
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
Total	**$266.4**	**$266.3**	**$1,801.2**

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

4. *What would have happened if there had been no general fund contributions to LEOFF 1?*

   a. *Or the Prior Act systems (e.g., City of Seattle)?*

      Answer: LEOFF 1 would have a significant unfunded liability today without those contributions. However, as noted in the table above, the state contributions to the LEOFF 1 UAAL comprise the majority of past LEOFF contributions.

5. *What is the year-by-year funded status and UAALs rate for TRS 1 since 2000?*

   Answer: Please see the table above for historical funded status.

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6. *What other bills (proposed or enacted) have "utilized the device of pension premium reduction at reduced or would have reduced the obligation of the state to make pension contributions"?*

   Answer: This question is not actuarial in nature.

Related to a Merger

7. *What is the financial situation before and after?*

   Answer: Please see the draft actuarial fiscal note in this study.

   a. *What does the "surplus" represent?*

      i. *Is it the excess of funds needed to pay benefits this month? This year?*

   b. *Is the surplus "real" or just projected?*

      i. *How reasonable is the investment return assumption?*

      ii. *What would it look like under alternate scenarios (e.g., 7 percent or 6 percent)?*

      Answer: These questions were answered during presentations from the Office of the State Actuary (OSA) to the Select Committee on Policy (SCPP) during the 2016 Interim. We have included those materials in the actuarial section of this report.

   c. *If the surplus disappears, would it be too late to insure the LEOFF 1 benefits?*

      i. *E.g., ensuring payment under a pay-go scenario versus insuring through plan immunization.*

      Answer: As of June 30, 2015, LEOFF 1 lacks sufficient assets to completely "immunize" or "settle" plan obligations. The decision to immunize or settle plan obligations is complex and would require analysis outside the scope of this study.

   d. *Would a merger be revenue neutral?*

      Answer: As noted in the draft actuarial fiscal note, the merger proposed under SB 6668 is expected to result in a savings to the state, but could result in a cost under very pessimistic future economic outlooks. Please see the actuarial fiscal note in this report for supporting information.

8. *How might the funds be used?*

   a. *Clarify: Usable across the merged plan vs. usable outside either of the retirement plans (other obligations).*

   b. *Should it be treated like a reserve for LEOFF 1 only?*

   c. *Can money be "skimmed out" of the fund during transfer from LEOFF 1 to TRS 1?*

   Answer: These questions are not actuarial in nature. Some are addressed in the legal and policy sections of this study.

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9. *What happens in the event of a deficit?*
   a. *If the funded status were 87 percent, would that mean I only get 87 percent of my current check amount?*
   b. *Before merger?*
   c. *After?*
   d. *Who pays what?*
   e. *Who will be paid first? (Overlap with legal/admin analysis)*
   f. *Could the state default on the pensions?*

   Answer: These questions are not actuarial in nature. Some are addressed in the legal and policy sections of this study.

10. *Would there be other costs (e.g., admin)?*

    Answer: Yes. Please see the Department of Retirement Systems' (DRS) section on administrative impacts in this report.

11. *How would a merger impact accounting and reporting?*
    a. *How would a merger impact financial reporting (GASB) for state and local governments?*

    Answer: As of this writing, DRS, in consultation with the Office of Financial Management and OSA, is reviewing this question.

12. *Who is constitutionally liable for future benefit payments?*

    Answer: This question is not actuarial in nature.

13. *Are there other options to address TRS 1 underfunding?*

    Answer: Yes.
    a. *What would the impact be if the TRS 1 UAAL rate was reduced without a merger?*

    Answer: If funding to the TRS 1 UAAL is reduced below the level actuarially required to eliminate the UAAL under state funding policy, we would expect the TRS 1 UAAL to persist, potentially increase, and lead to even higher future contribution requirements.

14. *Can the legislature raise taxes to meet pension obligations (pension or general)?*

    Answer: This question is not actuarial in nature.

15. *What is the position of professional actuarial associations about moving a retirement plan from surplus to unfunded?*

    Answer: OSA cannot and does not speak on behalf of professional actuarial associations.

SUMMARY OF RESULTS

BRIEF SUMMARY OF PROPOSAL: This proposal merges the assets and liabilities of TRS Plan 1 and LEOFF Plan 1, and makes other statutory changes to meet this goal. This proposal also provides a one-time, lump-sum bonus of $5,000 per eligible LEOFF 1 member.

COST SUMMARY

Impact on Contribution Rates *(Effective 09/01/2017 - 08/31/2019)*		
Fiscal Year 2018 State Budget	**TRS**	**LEOFF 1**
Employee (Plan 1)	0.00%	0.00%
Total Employer	(2.14%)	0.00%

Budget Impacts			
(Dollars in Millions)	**2017-2019**	**2019-2021**	**25-Year**
General Fund-State	($171.1)	($167.2)	($1,371.9)
Local Government	($69.9)	($68.3)	($560.4)
Total Employer	($241.0)	($235.5)	($1,932.2)

Note: We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

HIGHLIGHTS OF ACTUARIAL ANALYSIS

- 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 will 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 27 years. A very pessimistic or worse outlook occurs in 5 percent of our simulations of future economic outlooks.

- We observed that the proposed merger increases certain risks to the affected systems. See the **How The Risk Measures Changed** section of this draft fiscal note for further information.

See the remainder of this draft fiscal note for additional details on the summary and highlights presented here.

WHAT IS THE PROPOSED CHANGE?

Summary Of Change

This proposal impacts the following systems:

- Teachers' Retirement System Plan 1 (TRS 1).
- Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1).

This proposal merges the assets and liabilities of TRS 1 and LEOFF 1 and makes other statutory changes to meet this goal. LEOFF 1 will be administered as a separate tier of the TRS 1 plan.

The Department of Retirement Systems (DRS) must request a determination letter from the Internal Revenue Service. The merger is null and void if a determination letter indicates the merger is in conflict with Internal Revenue Code, and the conflict cannot be remedied. The results of a determination letter do not impact the changes to Unfunded Actuarial Accrued Liability (UAAL) rates.

This section of the draft actuarial fiscal note only addresses the changes that impact the pricing of the proposal.

Benefits

Pension benefits are not changed. However, eligible members of LEOFF 1 are provided with a one-time, lump-sum bonus of $5,000. This lump-sum bonus is payable on January 3, 2018, for all retired members. For active and terminated-vested members of LEOFF 1 who have not yet retired, this lump-sum bonus is payable with interest at retirement.

Funding Policy

LEOFF 1

No contributions are required for LEOFF 1 members and employers, except for the administrative rate charged by DRS to employers of active members.

TRS 1

The TRS 1 funding policy is largely unchanged (see below for current funding policy), except for the following:

- The assets and liabilities of LEOFF 1 are merged into TRS 1.
- UAAL rates for TRS 1 employers are set at 5.05 percent starting September 1, 2017, and continuing through August 31, 2021.
- A new minimum UAAL rate is set at 5.05 percent beginning September 1, 2021, and continuing until the actuarial value of assets in the merged plan equals 100 percent of the actuarial accrued liability.

Assumed Effective Date: September 1, 2017.

HOW THIS PROPOSAL DIFFERS FROM SB 6668

This proposal is intended to reflect the provisions of SB 6668 (from the 2016 Legislative Session) rolled forward one year. Only the effective dates, and contribution rates (see **Funding Policy** above) are changed from that bill. If a new merger bill is introduced next legislative session, it may not match this proposal precisely. If so, the Office of the State Actuary (OSA) will produce new analysis accordingly. We urge readers to ensure the details of this and any future proposals align before using or relying on this analysis.

What Is The Current Situation?

Both TRS 1 and LEOFF 1 were closed to new members in 1977. The following summary describes only the aspects of current plan provisions necessary to illustrate the impact of the changes described above. Please see the *DRS Handbook* for a full list of plan provisions.

TRS 1

There are two types of contributions to TRS 1: (1) The normal cost, or contributions for the ongoing costs of the plan, and (2) The UAAL, or contributions for past costs.

(1) Members and employers make contributions toward the ongoing cost of the plan. Contribution rates for Plan 1 members are set in statute at 6 percent. Employer contributions are set by the Pension Funding Council (PFC), subject to revision by the Legislature.

(2) A separate UAAL rate is charged to employers in addition to the ongoing contribution rate. The UAAL rate is calculated on a rolling ten-year amortization, as a level percentage of projected system payroll. Beginning September 1, 2015, a minimum 5.75 percent UAAL rate was established, and remains in effect until the actuarial value of assets in TRS 1 equals 100 percent of the actuarial accrued liability.

LEOFF 1

The Legislature has stated its intent to fully amortize the costs of LEOFF 1 by June 30, 2024, and the PFC is directed to adopt biennial "basic rates" for LEOFF 1 that are sufficient to achieve this goal.

Currently, RCW 41.26.080 provides that no member or employer contribution is required for LEOFF 1 unless the most recent actuarial valuation report shows the plan has unfunded liabilities. As of June 30, 2015, the measurement date for the latest actuarial valuation, LEOFF 1 has a surplus of $1.1 billion and a funded status of 125 percent on an actuarial-value basis (i.e., using the actuarial value of assets and the current long-term expected rate of return on investments of

7.7 percent per year to determine the present value of earned pension obligations).

For purposes of this draft fiscal note, we assume the prior funding policy would resume if LEOFF 1 were to come out of its fully-funded state before the year 2024. That is, when the LEOFF 1 UAAL resurfaces under pessimistic outlooks in our analysis, we assume remaining LEOFF 1 members and their local employers would each contribute 6 percent of LEOFF 1 salaries, and the remaining required contributions would be allocated through the state's general fund.

After the year 2024, a LEOFF 1 UAAL can still emerge under some pessimistic outlooks. When this occurs, we assume the UAAL will be amortized, through contributions from the General Fund-State (GF-S) exclusively, over a ten-year rolling period of total LEOFF system salary (LEOFF 1 and LEOFF 2 combined). This assumed funding method is similar to the current funding method for PERS 1 and TRS 1 except we do not assume a minimum contribution rate for LEOFF 1.

Who Is Impacted And How?

This proposal does not change benefits for any members of LEOFF 1 or TRS 1, except for the $5,000 lump-sum bonus for LEOFF 1 members.

Additionally, this proposal does not impact any TRS 1 members through increased or decreased contribution rates because TRS 1 member contribution rates are set in statute at 6 percent of salary. This proposal also stipulates that LEOFF 1 members and employers will not contribute to the merged plan. This provision eliminates the possibility of future LEOFF 1 member or employer contributions.

TRS 1 employers are expected to pay lower UAAL contribution rates over a shorter period of time. However, under pessimistic economic conditions, TRS 1 employers may ultimately pay higher UAAL contribution rates over a longer period of time (compared to current law).

WHY THIS PROPOSAL HAS AN EXPECTED SAVINGS AND WHO RECEIVES IT

Why This Proposal Has An Expected Savings

This proposal has an expected savings because it merges a plan currently in surplus (LEOFF 1) with a plan that is not in surplus (TRS 1). When we apply the existing TRS 1 funding policy to a smaller (combined) unfunded liability, the result is smaller expected contribution requirements.

To help illustrate the impact from the proposal, we begin by displaying the projected UAAL under current law, and then show the impact of the proposed merger. We display an "N/A" once the plan is expected to remain fully funded under each of the scenarios we present as defined below.

In addition to our "Expected" case, we show how the projected UAAL could vary under different economic environments. We used 2,000 simulated economic environments before and after the merger to illustrate a range of possible outcomes. Each simulated economic environment is equally likely to occur under our model.

We categorize these outcomes into four additional scenarios, from "Very Optimistic" to "Very Pessimistic". The likelihood of these scenarios is defined as follows. We observe 5 percent of our simulated outcomes are at the very optimistic level or better. Similarly, we observe 25 percent of our simulated outcomes are at the optimistic level or better. Comparatively, 5 and 25 percent of our simulated outcomes are at the very pessimistic and pessimistic levels or worse, respectively.

Before The Merger (Current Law)

The following table shows that the LEOFF 1 surplus (or negative unfunded liability) is expected to remain under most outcomes. Under current LEOFF 1 funding policy, no contributions are collected when the plan is in surplus and the surplus remains in the fund until the last benefit is paid.

LEOFF 1 UAAL, Before Merger					
(Dollars in Millions)					
Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2015	($1,090)	($1,090)	($1,090)	($1,090)	($1,090)
2018	N/A	N/A	N/A	N/A	($438)
2021	N/A	N/A	N/A	N/A	$286
2024	N/A	N/A	N/A	N/A	$434
2027	N/A	N/A	N/A	N/A	$1,113
2030	N/A	N/A	N/A	N/A	$1,141
2033	N/A	N/A	N/A	N/A	$1,411
2036	N/A	N/A	N/A	N/A	$1,229
2039	N/A	N/A	N/A	N/A	$1,238
2042	N/A	N/A	N/A	N/A	$815
2045	N/A	N/A	N/A	N/A	$671
2048	N/A	N/A	N/A	N/A	$381
2051	N/A	N/A	N/A	N/A	$265

The next table shows that under its current funding policy, if all assumptions are realized ("Expected" column), TRS 1 is expected to be fully amortized at 2028 through future employer contributions and investment returns.

TRS 1 UAAL, Before Merger					
(Dollars in Millions)					
Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2015	$3,187	$3,187	$3,187	$3,187	$3,187
2018	$2,674	$2,861	$3,029	$3,159	$3,338
2021	$834	$1,659	$2,270	$2,732	$3,617
2024	N/A	$268	$1,492	$2,428	$3,900
2027	N/A	N/A	$273	$1,733	$3,612
2030	N/A	N/A	N/A	$671	$2,879
2033	N/A	N/A	N/A	$6	$1,801
2036	N/A	N/A	N/A	N/A	$336
2039	N/A	N/A	N/A	N/A	$97
2042	N/A	N/A	N/A	N/A	N/A
2045	N/A	N/A	N/A	N/A	N/A
2048	N/A	N/A	N/A	N/A	N/A
2051	N/A	N/A	N/A	N/A	N/A

After The Merger

The table below shows that under the merged plan with new funding requirements, the merged plan is expected to be fully funded in 2026.

LEOFF 1 / TRS 1 UAAL, After Merger					
(Dollars in Millions)					
Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2015	$2,097	$2,097	$2,097	$2,097	$2,097
2018	$1,051	$1,420	$1,752	$2,009	$2,384
2021	N/A	$20	$1,250	$2,184	$3,964
2024	N/A	N/A	$385	$2,315	$5,293
2027	N/A	N/A	N/A	$2,091	$5,458
2030	N/A	N/A	N/A	$1,586	$4,983
2033	N/A	N/A	N/A	$814	$4,273
2036	N/A	N/A	N/A	$36	$3,289
2039	N/A	N/A	N/A	N/A	$1,958
2042	N/A	N/A	N/A	N/A	$147
2045	N/A	N/A	N/A	N/A	N/A
2048	N/A	N/A	N/A	N/A	N/A
2051	N/A	N/A	N/A	N/A	N/A

The funding policy of the merged plan will apply the expected LEOFF 1 surplus to the TRS 1 UAAL. This serves to reduce the expected TRS 1 UAAL and lower the associated future contribution requirements of the merged plan if all assumptions are realized.

The fiscal impact of the merger, however, depends heavily on future economic outlooks. Please see the **How The Results Change When The Assumptions Change** section of this draft fiscal note for further information on how the expected costs of this bill can vary from our best-estimate assumptions.

Who Will Receive These Savings?

Based on the funding policy for the merged plan, the expected savings of the merged plan will be realized by TRS employers and state budgets through decreases in the Plan 1 UAAL contribution rates.

As noted above, TRS 1 member rates are set in statute and do not change under this proposal. Under pessimistic outcomes (where the LEOFF 1 UAAL could resurface in the future) LEOFF 1 members and their employers do not make contributions to the merged plan under this proposal.

HOW WE VALUED THESE COSTS

Assumptions We Made

In all areas other than the risk analysis section, we performed what we call "current law" scenario analysis in this draft fiscal note. Under current law scenarios, we assume no future funding shortfalls and no future benefit improvements.

In the **Actuarial Results** section for liability, salary, contribution rate, and budget changes, we applied current law scenarios and made no assumption changes.

For the projections before the merger, we assumed that the state, through GF-S contributions, would fully amortize any future LEOFF 1 unfunded liability not covered by LEOFF 1 members and employers, by 2024.

After the year 2024, a LEOFF 1 UAAL can still emerge under some pessimistic outlooks. When this occurs, we assume the UAAL will be amortized, through contributions from the GF-S exclusively, over a ten-year rolling period of total LEOFF system salary (LEOFF 1 and LEOFF 2 combined). This assumed funding method is similar to the current funding method for PERS 1 and TRS 1 except we do not assume a minimum contribution rate for LEOFF 1.

Based upon historical LEOFF 1 headcounts as shown in the table, we expect approximately 7,300 members and beneficiaries will be eligible for the bonus as of the effective date of the proposal.

LEOFF 1	2015	2014	2013	2012	2011	2010	2009
Counts	7,589	7,727	7,873	8,031	8,183	8,310	8,445

Otherwise, we developed these savings using the same assumptions as disclosed in the *June 30, 2015, Actuarial Valuation Report* (AVR) and as described on the Projections Disclosures webpage of the OSA website.

How We Applied These Assumptions

Using our projection system, we calculated expected liabilities, assets, and benefit payments in LEOFF 1 and TRS 1 using current assumptions and methods. We recorded the expected contributions in each year of the projection. This established the expected contribution requirements before the merger.

Next, we combined projected assets and liabilities for LEOFF 1 and TRS 1. Then we applied the funding policy specified in the proposal to the new assets and liabilities. We recorded the expected contributions in each year of the projection. This established the expected contributions in the merged plan. We then compared the contributions before and after the merger to determine the expected savings under this proposal.

We modeled the LEOFF 1 member bonus as a one-time benefit payment during 2018 in our projection system. This provision, by itself, lowers the assets and increases future UAAL contribution rates under the merger. We ignored any interest adjustment on deferred payments for the few remaining active members because the impact is immaterial to this pricing.

Special Data Needed

We developed these savings using the same assets and data as disclosed in the AVR. In addition, we recognized investment returns of 2.65 percent through June 30, 2016, when estimating projected asset values.

ACTUARIAL RESULTS

How The Liabilities Changed

The proposal does not change benefits for LEOFF 1 or TRS 1, except for the one-time $5,000 lump-sum bonus for LEOFF 1 members. Multiplying the $5,000 lump-sum by 7,300 (expected eligible members) amounts to an assumed total distribution of about $36.5 million, payable on January 3, 2018. Otherwise, this proposal is not expected to impact the present value of future benefits payable under either plan.

How The Present Value of Future Salaries (PVFS) Changed

This proposal will impact the actuarial funding of the affected plans by decreasing the PVFS of the members of LEOFF 1 as shown below. We assume that current law requires any LEOFF 1 UAAL that may emerge to be funded by the state as a contribution rate collected over all LEOFF salaries. The decrease in PVFS resulting from the proposal represents the change in funding policy under the merged plan, where all UAAL contributions will be collected over TRS salaries only.

UAAL Present Value of Future Salaries			
(The Value of the Future Salaries Used to Fund the UAAL)			
(Dollars in Millions)	**Current**	**Increase**	**Total**
TRS	$42,703	$0	$42,703
LEOFF	$11,025	($11,025)	$0
TRS 1 / LEOFF 1 Merged*			**$42,703**

Note: Totals may not agree due to rounding.
**TRS 1 / LEOFF 1 merged plan contribution rates collected over TRS salaries only.*

How Contribution Rates Changed

We show the expected contribution rate differences by year in the table below. Please see **Appendix A** for further details on how the projected contribution rates change under different economic environments.

TRS 1 / LEOFF 1 UAAL Contribution Rates *(If All Assumptions Are Realized)*				
	LEOFF 1	**TRS 1**	**TRS 1 / LEOFF 1 Merged***	**Difference**
Fiscal Year	**Current Law**	**Current Law**	**After Merger**	
2018	0.00%	7.19%	5.05%	(2.14%)
2019	0.00%	7.19%	5.05%	(2.14%)
2020	0.00%	6.94%	5.05%	(1.89%)
2021	0.00%	6.94%	5.05%	(1.89%)
2022	0.00%	5.75%	5.05%	(0.70%)
2023	0.00%	5.75%	5.05%	(0.70%)
2024	0.00%	5.75%	5.05%	(0.70%)
2025	0.00%	5.75%	5.05%	(0.70%)
2026	0.00%	5.75%	0.10%	(5.65%)
2027	0.00%	5.75%	0.00%	(5.75%)
2028	0.00%	3.16%	0.00%	(3.16%)
2029	0.00%	0.00%	0.00%	0.00%
2030	0.00%	0.00%	0.00%	0.00%

**Collected over TRS salaries only.*

How This Impacts Budgets And Employees

We show the expected savings under this proposal in the table below. Please see the **How The Results Change When The Assumptions Change** section of this draft fiscal note for further details on how the projected budget impacts change under different economic environments.

Budget Impacts *(If all Assumptions are Realized)*			
(Dollars in Millions)	**TRS**	**LEOFF**	**Total**
2017-2019			
General Fund	($171.1)	$0.0	($171.1)
Non-General Fund	$0.0	0.0	$0.0
Total State	**($171.1)**	**$0.0**	**($171.1)**
Local Government	($69.9)	0.0	($69.9)
Total Employer	**($241.0)**	**$0.0**	**($241.0)**
Total Employee	**$0.0**	**$0.0**	**$0.0**
2019-2021			
General Fund	($167.2)	$0.0	($167.2)
Non-General Fund	$0.0	0.0	$0.0
Total State	**($167.2)**	**$0.0**	**($167.2)**
Local Government	($68.3)	0.0	($68.3)
Total Employer	**($235.5)**	**$0.0**	**($235.5)**
Total Employee	**$0.0**	**$0.0**	**$0.0**
2017-2042			
General Fund	($1,371.9)	$0.0	($1,371.9)
Non-General Fund	$0.0	0.0	$0.0
Total State	**($1,371.9)**	**$0.0**	**($1,371.9)**
Local Government	($560.4)	0.0	($560.4)
Total Employer	**($1,932.2)**	**$0.0**	**($1,932.2)**
Total Employee	**$0.0**	**$0.0**	**$0.0**

Note: Totals may not agree due to rounding. We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

The analysis of this proposal does not consider any other proposed changes to the systems. The combined effect of several changes to the systems could exceed the sum of each proposed change considered individually.

As with the costs developed in the actuarial valuation, the emerging costs of the systems will vary from those presented in the AVR or this draft fiscal note to the extent that actual experience differs from the actuarial assumptions.

How the Risk Measures Changed

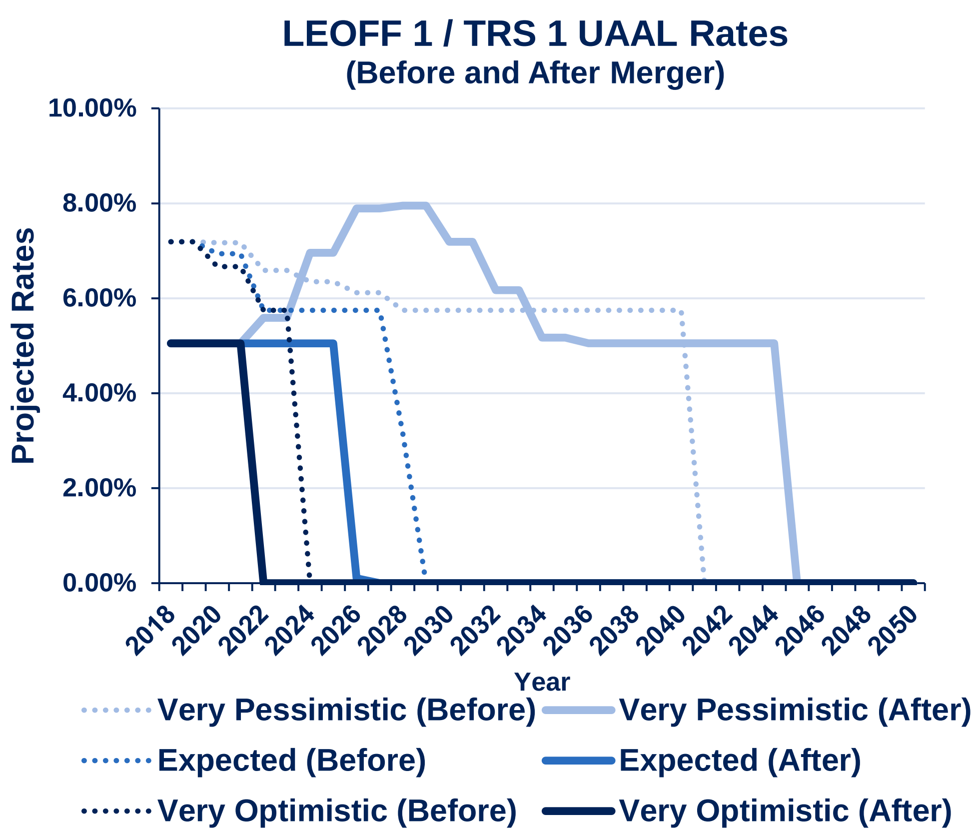
This proposal will affect the risk of the impacted systems. Because the proposal merges two plans and impacts two closed plans only, we needed to develop custom risk measures.

In terms of actuarial funding, we believe the largest risk with the proposed merger is reducing funding to the merged plan based on an expected surplus that may not remain if future experience, primarily inflation and investment returns, does not match expectations. Our risk model allows us to review the likelihood of these outcomes using data, assumptions, and methods specific to the risk assessment.

If the risks noted above were to surface under the proposed merger, you would see increases in future contribution rates and potentially increases in pay-go funding situations. The graphs below demonstrate under what scenarios this risk emerges, when, and for how long.

<u>Projected TRS 1 UAAL Rates</u>

Starting in 2024 and through 2034, we observed increased UAAL contribution rates after the merger under the Very Pessimistic scenario. Under this same scenario, we also observed an extension of UAAL rates from 2041 to 2045 after the merger. These very pessimistic or worse outcomes occur in 5 percent of the simulations in our model.

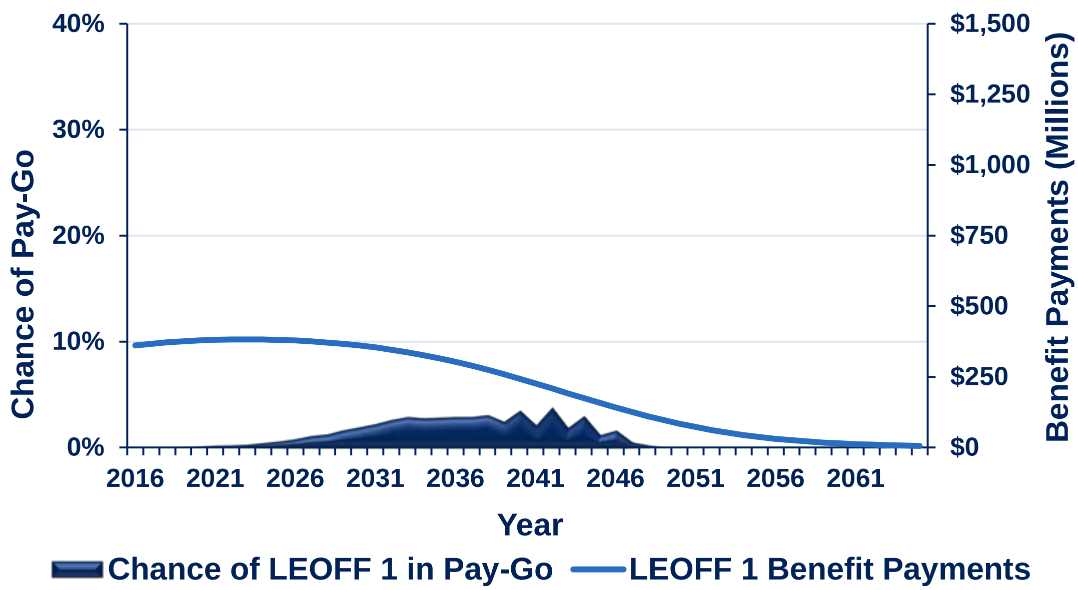


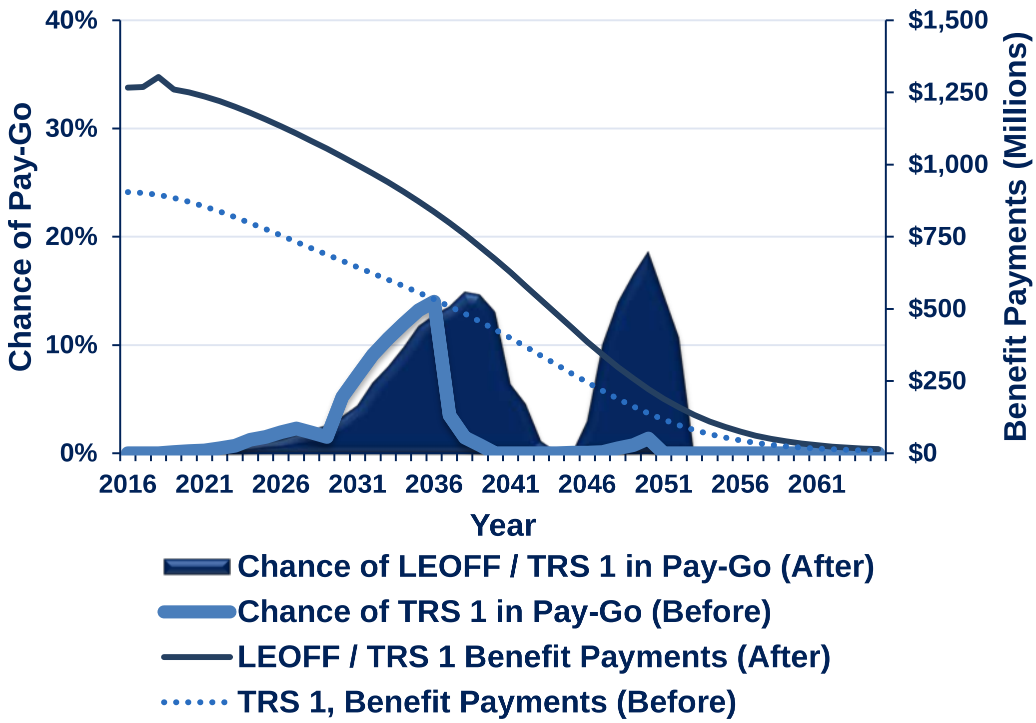
Increased UAAL contribution rates can occur after the merger because the merged plan has higher assets and obligations than TRS 1 before merger. With this larger base of assets and obligations, pessimistic outcomes become more pessimistic than before the merger. Optimistic outcomes become more optimistic after the merger for the same reasons.

Note that these contribution rate graphs are based upon "current law" scenario analysis, which match the tables shown in **Appendix A**.

Pay-Go Risk

When we assume on-going funding to LEOFF 1 after 2024 similar to the funding method for PERS 1 and TRS 1, we observe LEOFF 1 pay-go risk from about 2024 through 2047 with a maximum chance of about 4 percent in the year 2042. At that time, the annual benefit payments for LEOFF 1 are about $210 million under our risk model assuming past practices continue in the areas of funding and benefit enhancements.





After the merger, we observed a shift and increase in pay-go risk. The initial infusion of LEOFF 1 surplus assets insulates the merged plan from some very pessimistic outcomes earlier in the projection resulting in a shift of pay-go risk. When those very pessimistic outcomes continue, the merged plan can face increased pay-go situations near the end of the plan's life due to the higher combined benefit payments from the merger.

Who Would Be Impacted If These Risks Materialize

The risks identified above can surface under current law or under the proposed merger. If the risks materialize under the proposed merger, we anticipate the following impacts from a funding policy perspective:

- **LEOFF 1 Active Members** – These members don't contribute to LEOFF 1 under current law when the plan is fully funded and would not contribute to the merged plan under this proposal.
- **TRS 1 Active Members** – These members contribute 6 percent of pay under current law and under this proposed merger.
- **LEOFF 1 Employers** – Past LEOFF 1 employer funding has come from two sources: (1) local government and (2) the state's general fund. Under current law, however, given the relatively small number of LEOFF 1 active members remaining in the plan, the state's general fund would assume nearly all the responsibility if unfunded

LEOFF 1 costs re-emerge and past funding policy were reinstated. Under this proposed merger, local government would no longer be responsible for funding LEOFF 1 retirement benefits.

- **TRS Employers** – TRS employer funding comes from two sources: (1) local government and (2) state/federal. Under this proposed merger, TRS employers and these funding sources would assume all costs under the merger. As a result, any unfunded LEOFF 1 costs that re-emerge under the merger, if identifiable, could potentially be shared with local government in TRS (school districts).

Risk Management Considerations

If the Legislature decides to pursue this proposal, the following changes to the proposal could reduce some of the risks noted above:

- **Fixed UAAL Rates** – Eliminate or shorten the period of fixed rates under the proposal. This would allow for more responsive and adequate funding should the need arise.
- **Minimum UAAL Rates** – Increase the minimum UAAL rates under the proposal. The current minimum UAAL rate for TRS 1 is 5.75 percent. The proposed minimum UAAL rate for the merged plan is 5.05 percent. Because the merged plan has larger combined benefit payments than TRS 1, the merged plan may require higher minimum rates to accommodate the higher risk associated with the added benefit payments.

As part of this analysis, we changed our standard risk model to accommodate the risk analysis of a merged plan. Specifically, we made the following modifications:

- We applied a $50 million annual pay-go threshold (today's dollars) to the merged plan (we did not combine the threshold we would apply to each plan before the merger).
- We assumed the same Percent of Contributions Made and Benefit Improvements assumptions for the merged plan as we do for TRS 1 before the merger.
- In our standard risk modeling, we assume maximum contribution rates by system. For this analysis, we adjusted this maximum for the merged plan so the merged plan receives contributions from the state-general fund that are no less than what LEOFF 1 and TRS 1 would receive from the state-general fund on a combined basis before a merger.

Otherwise, we developed this risk analysis using the same assumptions, methods, and data as disclosed in the *2016 Risk Assessment Assumptions Study*.

HOW THE RESULTS CHANGE WHEN THE ASSUMPTIONS CHANGE

As mentioned previously, the fiscal impact of the merger depends heavily on future economic outlooks. To determine the sensitivity of the actuarial results to the best-estimate assumptions or methods selected for this pricing, we calculated the budget impact of this proposal under outcomes ranging from Very Optimistic to Very Pessimistic using stochastic analysis.

The table below shows fiscal cost impacts for those outcomes, along with our best-estimate ("Expected") fiscal impact, when we use the methods and assumptions described in the body of this draft fiscal note.

Budget Impacts - Varying Economic Scenarios					
(Dollars in Millions)	**Very Optimistic**	**Optimistic**	**Expected**	**Pessimistic**	**Very Pessimistic**
2017-2019					
General Fund	($171)	($171)	($171)	($171)	($171)
Non-General Fund	$0	$0	$0	$0	$0
Total State	**($171)**	**($171)**	**($171)**	**($171)**	**($171)**
Local Government	($70)	($70)	($70)	($70)	($70)
Total Employer	**($241)**	**($241)**	**($241)**	**($241)**	**($241)**
Total Employee	**$0**	**$0**	**$0**	**$0**	**$0**
2019-2021					
General Fund	($143)	($157)	($167)	($176)	($188)
Non-General Fund	$0	$0	$0	$0	$0
Total State	**($143)**	**($157)**	**($167)**	**($176)**	**($188)**
Local Government	($59)	($64)	($68)	($72)	($77)
Total Employer	**($202)**	**($222)**	**($235)**	**($248)**	**($264)**
Total Employee	**$0**	**$0**	**$0**	**$0**	**$0**
2017-2042					
General Fund	($878)	($1,275)	($1,372)	($36)	$805
Non-General Fund	$0	$0	$0	$0	$0
Total State	**($878)**	**($1,275)**	**($1,372)**	**($36)**	**$805**
Local Government	($358)	($521)	($560)	($15)	$457
Total Employer	**($1,236)**	**($1,796)**	**($1,932)**	**($50)**	**$1,261**
Total Employee	**$0**	**$0**	**$0**	**$0**	**$0**
2017-2044					
General Fund	($878)	($1,275)	($1,372)	($36)	$2,155
Non-General Fund	$0	$0	$0	$0	$0
Total State	**($878)**	**($1,275)**	**($1,372)**	**($36)**	**$2,155**
Local Government	($358)	($521)	($560)	($15)	$1,008
Total Employer	**($1,236)**	**($1,796)**	**($1,932)**	**($50)**	**$3,163**
Total Employee	**$0**	**$0**	**$0**	**$0**	**$0**

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

The savings in the 2017-19 Biennium does not change under varying economic conditions because the contribution rates adopted under current law and this proposal are fixed during that period. The savings in the 2019-21 Biennium, however, increase as economic conditions worsen because current law contribution rates (before the merger) will increase while they remain fixed at 5.05 percent under this proposal (after the merger) through August 31, 2021.

When economic conditions improve over expected conditions, we see that the merger results in a smaller fiscal savings in the long-term. This occurs because the number of years earlier that the TRS 1 UAAL is paid off under the merger declines in comparison to current law funding under these economic conditions.

When economic conditions worsen, we see the savings of the merger decline, ultimately resulting in a long-term cost to the system. This happens in the pessimistic scenarios because under the funding policy stated in the proposal, contribution requirements are lowered on the expectation of a long-term LEOFF 1 surplus and the current surplus becomes an unfunded liability over time. Under this outcome, the merged plan will have to make up the lost contributions plus lost assumed investment earnings.

WHAT THE READER SHOULD KNOW

The Office of the State Actuary ("we") prepared this draft fiscal note based on our understanding of the proposal as of the date shown in the footer. We prepared this draft actuarial fiscal note for the Select Committee on Pension Policy for inclusion in their report to the Legislature on the study of SB 6668. Please do not use this draft fiscal note for other purposes and please replace this draft actuarial fiscal note when an updated version becomes available.

We advise readers of this draft fiscal note to seek professional guidance as to its content and interpretation, and not to rely upon this communication without such guidance. Please read the analysis shown in this draft fiscal note as a whole. Distribution of, or reliance on, only parts of this draft fiscal note could result in its misuse, and may mislead others.

ACTUARY'S CERTIFICATION

The undersigned hereby certifies that:

1. The actuarial cost methods are appropriate for the purposes of this pricing exercise.
2. The actuarial assumptions used are appropriate for the purposes of this pricing exercise.
3. The data on which this draft fiscal note is based are sufficient and reliable for the purposes of this pricing exercise.
4. Use of another set of methods, assumptions, and data may also be reasonable, and might produce different results.
5. The risk analysis summarized in this draft fiscal note involves the interpretation of many factors and the application of professional judgment. We believe that the data, assumptions, and methods used in our risk assessment model are reasonable and appropriate for the purposes of this pricing exercise. The use of another set of data, assumptions, and methods, however, could also be reasonable and could produce materially different results.
6. We prepared this draft fiscal note and provided opinions in accordance with Washington State law and accepted actuarial standards of practice as of the date shown in the footer of this draft fiscal note.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein.

While this draft fiscal note is meant to be complete, the undersigned is available to provide extra advice and explanations as needed.

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

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APPENDIX A – HOW THE CONTRIBUTION RATES CHANGED

State UAAL Contribution Rates, Before Merger - LEOFF 1					
Fiscal Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2018	0.00%	0.00%	0.00%	0.00%	0.00%
2019	0.00%	0.00%	0.00%	0.00%	0.00%
2020	0.00%	0.00%	0.00%	0.00%	0.00%
2021	0.00%	0.00%	0.00%	0.00%	0.00%
2022	0.00%	0.00%	0.00%	0.00%	0.00%
2023	0.00%	0.00%	0.00%	0.00%	0.00%
2024	0.00%	0.00%	0.00%	0.00%	12.42%
2025	0.00%	0.00%	0.00%	0.00%	0.00%

Employer UAAL Contribution Rates, Before Merger - TRS 1					
Fiscal Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2018	7.19%	7.19%	7.19%	7.19%	7.19%
2019	7.19%	7.19%	7.19%	7.19%	7.19%
2020	6.67%	6.83%	6.94%	7.04%	7.17%
2021	6.67%	6.83%	6.94%	7.04%	7.17%
2022	5.75%	5.75%	5.75%	5.82%	6.59%
2023	5.75%	5.75%	5.75%	5.82%	6.59%
2024	0.00%	5.75%	5.75%	5.75%	6.35%
2025	0.00%	5.75%	5.75%	5.75%	6.35%
2026	0.00%	0.00%	5.75%	5.75%	6.12%
2027	0.00%	0.00%	5.75%	5.75%	6.12%
2028	0.00%	0.00%	3.16%	5.75%	5.75%
2029	0.00%	0.00%	0.00%	5.75%	5.75%
2030	0.00%	0.00%	0.00%	5.75%	5.75%
2031	0.00%	0.00%	0.00%	5.75%	5.75%
2032	0.00%	0.00%	0.00%	5.75%	5.75%
2033	0.00%	0.00%	0.00%	5.75%	5.75%
2034	0.00%	0.00%	0.00%	5.75%	5.75%
2035	0.00%	0.00%	0.00%	0.00%	5.75%
2036	0.00%	0.00%	0.00%	0.00%	5.75%
2037	0.00%	0.00%	0.00%	0.00%	5.75%
2038	0.00%	0.00%	0.00%	0.00%	5.75%
2039	0.00%	0.00%	0.00%	0.00%	5.75%
2040	0.00%	0.00%	0.00%	0.00%	5.75%
2041	0.00%	0.00%	0.00%	0.00%	0.00%
2042	0.00%	0.00%	0.00%	0.00%	0.00%

Note: With the exception of the Expected case, we collect the minimum UAAL rate for a full year in any year a UAAL exists.

Employer UAAL Contribution Rates, After Merger - LEOFF 1 / TRS 1					
Fiscal Year	**Very Optimistic**	**Optimistic**	**Expected**	**Pessimistic**	**Very Pessimistic**
2018	5.05%	5.05%	5.05%	5.05%	5.05%
2019	5.05%	5.05%	5.05%	5.05%	5.05%
2020	5.05%	5.05%	5.05%	5.05%	5.05%
2021	5.05%	5.05%	5.05%	5.05%	5.05%
2022	0.00%	5.05%	5.05%	5.05%	5.59%
2023	0.00%	0.00%	5.05%	5.05%	5.59%
2024	0.00%	0.00%	5.05%	5.05%	6.96%
2025	0.00%	0.00%	5.05%	5.05%	6.96%
2026	0.00%	0.00%	0.10%	5.05%	7.89%
2027	0.00%	0.00%	0.00%	5.05%	7.89%
2028	0.00%	0.00%	0.00%	5.05%	7.95%
2029	0.00%	0.00%	0.00%	5.05%	7.95%
2030	0.00%	0.00%	0.00%	5.05%	7.19%
2031	0.00%	0.00%	0.00%	5.05%	7.19%
2032	0.00%	0.00%	0.00%	5.05%	6.17%
2033	0.00%	0.00%	0.00%	5.05%	6.17%
2034	0.00%	0.00%	0.00%	5.05%	5.17%
2035	0.00%	0.00%	0.00%	5.05%	5.17%
2036	0.00%	0.00%	0.00%	5.05%	5.05%
2037	0.00%	0.00%	0.00%	0.00%	5.05%
2038	0.00%	0.00%	0.00%	0.00%	5.05%
2039	0.00%	0.00%	0.00%	0.00%	5.05%
2040	0.00%	0.00%	0.00%	0.00%	5.05%
2041	0.00%	0.00%	0.00%	0.00%	5.05%
2042	0.00%	0.00%	0.00%	0.00%	5.05%
2043	0.00%	0.00%	0.00%	0.00%	5.05%
2044	0.00%	0.00%	0.00%	0.00%	5.05%
2045	0.00%	0.00%	0.00%	0.00%	0.00%
2046	0.00%	0.00%	0.00%	0.00%	0.00%

Note that under a Very Optimistic scenario, the fixed 5.05 percent contribution rate may not be required for all four years as provided under the proposal.

The pattern of contribution rate changes on the next page under the Very Pessimistic scenario can be explained as follows. Initially, contribution rate requirements are fixed and lower than required under current law (years 2018-21). The combination of smaller contributions earlier in the projection and poor economic environments under this scenario lead to higher contribution rate requirements than under current law (years 2024-32).

The contribution rates then gradually decline under the merger back down to the 5.05 percent rate floor, below the 5.75 percent rate floor under current law (years 2033-40). The merged plan UAAL rate floor must then be collected two years longer than our standard 25-year budget impact table (years 2043-44) due to the poor investment returns under this scenario.

Impact on TRS UAAL Rates					
Fiscal Year	Very Optimistic	Optimistic	Expected	Pessimistic	Very Pessimistic
2018	(2.14%)	(2.14%)	(2.14%)	(2.14%)	(2.14%)
2019	(2.14%)	(2.14%)	(2.14%)	(2.14%)	(2.14%)
2020	(1.62%)	(1.78%)	(1.89%)	(1.99%)	(2.12%)
2021	(1.62%)	(1.78%)	(1.89%)	(1.99%)	(2.12%)
2022	(5.75%)	(0.70%)	(0.70%)	(0.77%)	(1.00%)
2023	(5.75%)	(5.75%)	(0.70%)	(0.77%)	(1.00%)
2024	0.00%	(5.75%)	(0.70%)	(0.70%)	0.61%
2025	0.00%	(5.75%)	(0.70%)	(0.70%)	0.61%
2026	0.00%	0.00%	(5.65%)	(0.70%)	1.77%
2027	0.00%	0.00%	(5.75%)	(0.70%)	1.77%
2028	0.00%	0.00%	(3.16%)	(0.70%)	2.20%
2029	0.00%	0.00%	0.00%	(0.70%)	2.20%
2030	0.00%	0.00%	0.00%	(0.70%)	1.44%
2031	0.00%	0.00%	0.00%	(0.70%)	1.44%
2032	0.00%	0.00%	0.00%	(0.70%)	0.42%
2033	0.00%	0.00%	0.00%	(0.70%)	0.42%
2034	0.00%	0.00%	0.00%	(0.70%)	(0.58%)
2035	0.00%	0.00%	0.00%	5.05%	(0.58%)
2036	0.00%	0.00%	0.00%	5.05%	(0.70%)
2037	0.00%	0.00%	0.00%	0.00%	(0.70%)
2038	0.00%	0.00%	0.00%	0.00%	(0.70%)
2039	0.00%	0.00%	0.00%	0.00%	(0.70%)
2040	0.00%	0.00%	0.00%	0.00%	(0.70%)
2041	0.00%	0.00%	0.00%	0.00%	5.05%
2042	0.00%	0.00%	0.00%	0.00%	5.05%
2043	0.00%	0.00%	0.00%	0.00%	5.05%
2044	0.00%	0.00%	0.00%	0.00%	5.05%
2045	0.00%	0.00%	0.00%	0.00%	0.00%
2046	0.00%	0.00%	0.00%	0.00%	0.00%

GLOSSARY OF ACTUARIAL TERMS

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 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.).

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. Under this method, all plan costs (for past and future service credit) are included under the normal cost. Therefore, the method does not produce an unfunded actuarial accrued liability outside the normal cost. It's most common for the normal cost to be determined for the entire group rather than on an individual basis for this method.

Entry Age Normal Cost Method (EANC): The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- Normal cost.
- Amortization of the unfunded actuarial accrued liability.

The normal cost is most commonly 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.

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.

Projected Benefits: Pension benefit amounts that are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

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 that are not covered by plan assets.

Unfunded EAN Liability: The excess, if any, of the Present Value of Benefits calculated under the EAN cost method over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

GLOSSARY OF RISK TERMS

Affordability: Measures the affordability of the pension systems. Affordability risk measures the chance that pension contributions will cross certain thresholds with regards to the General Fund and contribution rates.

"Current Law": Scenarios in which assumptions about legislative behavior are excluded. These scenarios show projections regarding the current state of Washington statutes.

Optimistic: A measurement of the pension system under favorable conditions (above expected investment returns, for example). Optimistic refers to the 75th percentile, where there is a 25 percent chance of the measurement being better and 75 percent chance of the measurement being worse. Very optimistic refers to the 95th percentile.

"Past Practices": Scenarios in which assumptions regarding legislative behavior are introduced. These assumptions include actual contributions below what are actuarially required and improving benefits over time. These scenarios are meant to project past behavior into the future.

Pay-Go: The trust fund runs out of assets, and payments from the General Fund must be made to meet contractual obligations.

Pessimistic: A measurement of the pension system under unfavorable conditions (below expected investment returns, for example). Pessimistic refers to the 25th percentile, where there is a 75 percent chance of the measurement being better and 25 percent chance of the measurement being worse. Very pessimistic refers to the 5th percentile.

Premature Pay-Go: Pay-go payments, measured in today's value, which might be considered "significant" in terms of the potential impact on the General Fund.

Risk: Measures the risk metrics of the pension systems, including the chance that the pension systems will prematurely run out of assets, the amount of potential pay-go contributions, and the chance that the funded status will cross a certain threshold.

Risk Tolerance: The amount of risk an individual or group is willing to accept with regards to the likelihood and severity of unfavorable outcomes.

Select Committee on Pension Policy

Merger Study

Final Survey Results and LEOFF 1 Funding Information

Aaron Gutierrez, MPA, JD
Senior Policy Analyst

Matt Smith, FCA, EA, MAAA
State Actuary

September 20, 2016

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"Supporting financial security for generations."

Today's Presentation

- SCPP asked staff to bring back final survey results
  - Full list in your materials
  - About 40 new additions (depending on how they're counted)
  - Highlights in presentation
- Matt will address LEOFF 1 expected surplus
  - One of the most common questions we've received

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Survey Information

- Survey was intended to focus on LEOFF 1/TRS 1 merger
  - Did not remove LEOFF 1/LEOFF 2 merger comments
- At stakeholders' request, all responses will be posted on the web
- Received over 1,400 web survey responses, plus email, letters, and phone calls
- Compiled list sent to AGO, DRS, and LEOFF 2 Board

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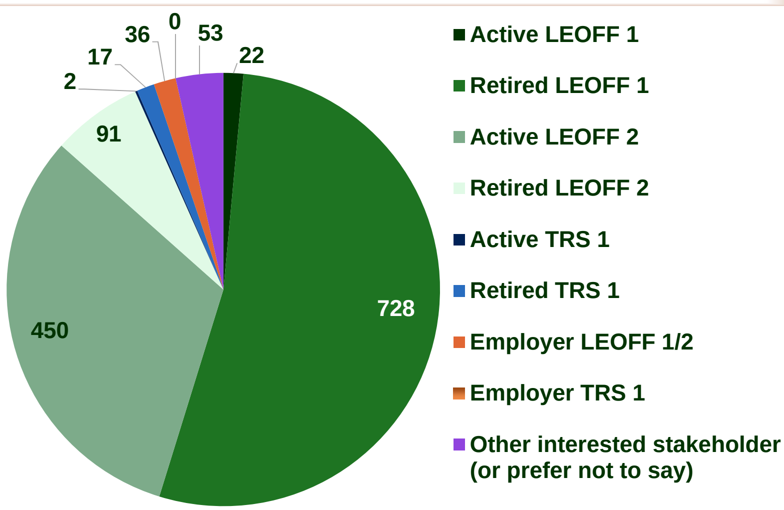
Question 1: Plan Membership and Status (as of August 31, 2016)



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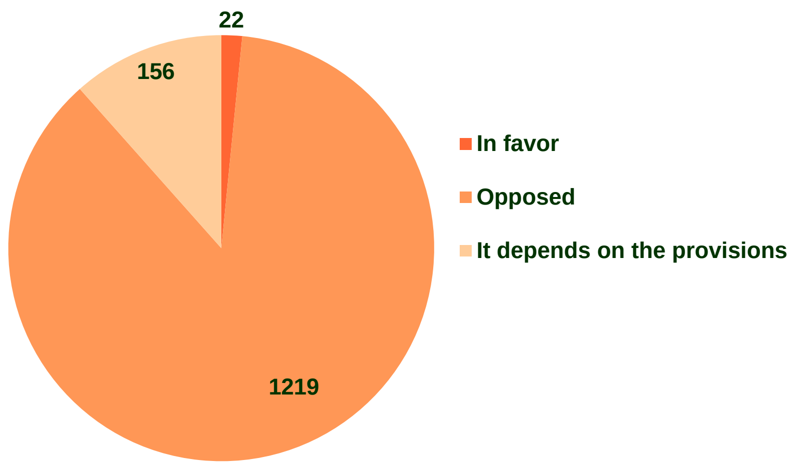
Question 2: For or Against a Merger? (as of August 31, 2016)



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New Questions/Concerns: Highlights

- Most questions/concerns expand on prior questions
- How would a merger impact accounting and reporting?
- Are there other options for addressing TRS 1 underfunding?
- How does McCleary impact the merger analysis?
  - How could a merger impact local levies if a future unfunded liability arises?
- Added section for "Questions for Bill Sponsors"
  - Questions that staff can't address, such as why the sponsor chose to include the $5,000 lump sum in SB 6668

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What Constitutes the LEOFF 1 Surplus?

- A comparison, at a single point in time, of the *Actuarial Value of Assets* to the *Present Value of Future Benefits*
- At June 30, 2015, the LEOFF 1 surplus was $1,090 million ($1.09 billion)
- Let's dig a little deeper

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What Constitutes the LEOFF 1 Surplus?

(Dollars in Millions)	
Actuarial Value of Assets (AVA)	**$5,404**
Present Value of Future Benefits (PVB)	**$4,313**
Surplus/(Deficit) [AVA-PVB]	**$1,090**

At June 30, 2015. Totals don't agree due to rounding.

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What Constitutes the LEOFF 1 Surplus?

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(Dollars in Millions)	
Actuarial Value of Assets (AVA) [a-b]	**$5,404**
Market Value of Assets [a]	$5,610
Deferred Investment Gains/(Losses) [b]	$207
Present Value of Future Benefits (PVB)	**$4,313**
Surplus/(Deficit) [AVA-PVB]	**$1,090**

At June 30, 2015. Totals don't agree due to rounding.

What Constitutes the LEOFF 1 Surplus?

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(Dollars in Millions)	
Actuarial Value of Assets (AVA) [a-b]	**$5,404**
Market Value of Assets [a]	$5,610
Deferred Investment Gains/(Losses) [b]	$207
Present Value of Future Benefits (PVB) [c-d]	**$4,313**
PVB Assuming Zero Real Rate of Return [c]	$7,029
Additional Interest Discount for Assumed Real Rate of Return [d]	$2,716
Surplus/(Deficit) [AVA-PVB]	**$1,090**

At June 30, 2015. Totals don't agree due to rounding. 7.7% nominal rate of return equals 3% for assumed inflation plus 4.7% for the assumed real rate of return.

What Constitutes the LEOFF 1 Surplus?

- At June 30, 2015, the LEOFF 1 surplus was $1,090 million
  - Meaning the actuarial value of assets exceeds the present value of future benefits by $1,090 million
- The entire LEOFF 1 surplus is comprised of assumed future investment income above inflation
- See *2015 Actuarial Valuation Report* for further details and supporting information

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Next Steps

- October
  - Progress updates and/or drafts from AGO, DRS, OSA, LEOFF 2 Board
- November
  - SCPP receives draft report
- December
  - Final action on report
- Report due January 9, 2017

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Appendix: Survey Questions

- Plan membership and status (active, retired, employer)
- If the Legislature proposed a merger of LEOFF 1 and TRS 1, then you would be…
  - In favor, opposed, or it depends on the provisions of the merger
- If the Legislature proposed a plan merger
  - What QUESTIONS would you like answered?
  - What CONCERNS would you like to see addressed?
  - What GENERAL COMMENTS would you have?

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Merger Study – Actuarial Update

Matt Smith, FCA, EA, MAAA
State Actuary

Presentation to Select Committee on Pension Policy

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

October 18, 2016

Today's Update

- Share preliminary results we have thus far
- Response to SCPP member questions from September meeting
- Discuss next steps on actuarial analysis

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Preliminary Results

- Updated fiscal analysis on SB 6668
- Reflects most recent participant data and 2015 AVR
- Asset returns through June 30, 2016
- Assumes following key updates to SB 6668
  - Payment of $5,000 bonus one year later
  - 4.24 percent contribution rate (based on 2014 AVR) replaced with 5.05 percent (based on 2015 AVR)
  - Referred to as SB 6668 (2017) in this presentation
- All other data, assumptions, and methods consistent with actuarial fiscal note from last session (in materials)
- Please see actuarial fiscal note for supporting information and considerations on the use of the analysis

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Comparison Of Budget Impacts

- LEOFF 1 surplus decreased from June 30, 2014, to June 30, 2015, measurement
- Lower surplus leads to lower expected long-term savings from the merger

	Budget Impact	
(Dollars in Millions)	**SB 6668 (2017)**	**SB 6668 (2016)**
2017-2019		
General Fund-State	($171)	($244)
Local Government	($70)	($100)
Total Employer	($241)	($343)
2019-2021		
General Fund-State	($167)	($212)
Local Government	($68)	($86)
Total Employer	($235)	($298)
25-Year		
General Fund-State	($1,372)	($1,477)
Local Government	($560)	($603)
Total Employer	($1,932)	($2,080)

Note: We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

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Response To SCPP Member Questions From September Meeting

- Historical LEOFF 1 funded status
- Impact of different assumed rates of return on LEOFF 1 surplus
- Budget impact of merger under different assumed funding policies
- Response to other questions included in forthcoming draft report or November presentation

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Historical LEOFF 1 Funded Status

Funded Status On An Actuarial Value Basis	
Year	**Funded Status**
2015	**125%**
2013	125%
2011	135%
2009	125%
2007	123%
2005	114%
2003	112%
2001	129%
1999	125%
1997	108%
1996	89%
1994	68%
1992	65%
1990	65%
1988	66%
1986	57%

Note: EAN Cost Method used starting in 2014 (PUC previously). Please see Appendix for full history.

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LEOFF 1 Surplus At Different Assumed Rates Of Return

Funded Status On An Actuarial Value Basis *(Dollars in Millions)*			
Assumed RoR*	**5.0%**	**7.5%**	**7.7%**
Accrued Liability	$5,585	$4,384	$4,307
Valuation Assets	$5,404	$5,404	$5,404
Unfunded Liability	$182	($1,020)	($1,097)
Funded Ratio			
June 30, 2015	**97%**	**123%**	**125%**

**RoR = Rate of Return.*
Note: Totals may not agree due to rounding.

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Budget Impact Of Merger Under Different Assumed Funding Policies

- Budget impact of any merger will depend on the assumed funding policy
- Funding policy determines who pays/saves, when, and how much
- Funding policy can range from a minimum to maximum use of the LEOFF 1 surplus
  - Minimum use would not reduce TRS 1 UAAL rates until UAAL is eliminated
  - Maximum use would eliminate near-term TRS 1 UAAL contributions until surplus was depleted

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Description Of Assumed Funding Policies

	Minimum Use	SB 6668 (2017)	Maximum Use
Employee Rates	6% TRS 1 0% LEOFF 1	6% TRS 1 0% LEOFF 1	6% TRS 1 0% LEOFF 1
Employer UAAL Rates	Same as current law until UAAL=0	5.05% FY 18-21 Variable FY 22+ 5.05% Min FY 22+	0% FY 18-20 Variable FY 21+ 5.75% Min FY 21+
UAAL Payoff Year	2023	2025	2028

- Employer rates under the merger apply to TRS employers only
- Expected UAAL payoff year if all assumptions are realized

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Budget Impact Of Merger Under Different Assumed Funding Policies

Budget Impact			
(Dollars in Millions)	**Minimum Use**	**SB 6668 (2017)**	**Maximum Use**
2017-2019			
General Fund-State	$0	($171)	($575)
Local Government	$0	($70)	($235)
Total Employer	$0	($241)	($810)
2019-2021			
General Fund-State	$0	($167)	($353)
Local Government	$0	($68)	($144)
Total Employer	$0	($235)	($498)
25-Year			
General Fund-State	($1,536)	($1,372)	($940)
Local Government	($627)	($560)	($384)
Total Employer	($2,163)	($1,932)	($1,324)

Note: We use long-term assumptions to produce our short-term budget impacts. Therefore, our short-term budget impacts will likely vary from estimates produced from other short-term budget models.

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How The Results Of The Merger Change Under Different Future Return Scenarios

25-Year Budget Impact By Return Scenario
(Dollars in Millions) TRS - Total Employer

Future Return Scenario	Minimum Use	SB 6668 (2017)	Maximum Use
5.0% RoR*	$359	$1,368	$2,104
6.0% RoR	($1,395)	($156)	$710
7.7% RoR	($2,163)	($1,932)	($1,324)

**RoR = Rate of Return. 7.7% expected.*

- Merger could have a cost when return scenario is lower than expected
- The cost of below expected returns increases
  - As the assumed funding policy approaches the maximum use policy
  - When there are fixed contribution rates under assumed policy

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Next Steps On Actuarial Analysis

- Finalize preliminary analysis presented today
- Present further risk analysis in November
- Present actuarial analysis on LEOFF 1 risks requested by the LEOFF 2 Board
- Complete actuarial section of draft report

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Questions?

Appendix – Full History Of LEOFF 1 Funded Status

Historical Funded Status			
Year	Funded Status	Year	Funded Status
2015	**125%**	2000	136%
2014	127%	1999	125%
2013	125%	1998	117%
2012	135%	1997	108%
2011	135%	1996	89%
2010	127%	1995	80%
2009	125%	1994	68%
2008	128%	1993	68%
2007	123%	1992	65%
2006	117%	1991	66%
2005	114%	1990	65%
2004	109%	1989	65%
2003	112%	1988	66%
2002	119%	1987	69%
2001	129%	1986	57%

Note: EAN Cost Method used starting in 2014 (PUC previously).

Appendix – Data, Assumptions, And Methods Used In Analysis

- Participant and financial data as of June 30, 2015
- In addition, we recognized investment returns of 2.65 percent through June 30, 2016, when estimating projected asset values
- We estimated that approximately 7,300 LEOFF 1 members would be eligible for the $5,000 bonus as of January 1, 2018
- Unless noted otherwise in this presentation, we used the same data, assumptions, and methods as disclosed in our actuarial fiscal note for SB 6668

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Appendix – Expected Contribution Rates

TRS 1 / LEOFF 1 Contribution Rates
(If All Assumptions Are Realized)

Fiscal Year	Current Law LEOFF 1	Current Law TRS 1	TRS 1 / LEOFF 1 Merged* Minimum Use	TRS 1 / LEOFF 1 Merged* SB 6668 (2017)	TRS 1 / LEOFF 1 Merged* Maximum Use
2017	0.00%	6.23%	6.23%	6.23%	6.23%
2018	0.00%	7.19%	7.19%	5.05%	0.00%
2019	0.00%	7.19%	7.19%	5.05%	0.00%
2020	0.00%	6.94%	6.94%	5.05%	0.00%
2021	0.00%	6.94%	6.94%	5.05%	5.75%
2022	0.00%	5.75%	5.75%	5.05%	5.75%
2023	0.00%	5.75%	5.42%	5.05%	5.75%
2024	0.00%	5.75%	0.00%	5.05%	5.75%
2025	0.00%	5.75%	0.00%	5.05%	5.75%
2026	0.00%	5.75%	0.00%	0.10%	5.75%
2027	0.00%	5.75%	0.00%	0.00%	5.75%
2028	0.00%	3.16%	0.00%	0.00%	2.98%
2029	0.00%	0.00%	0.00%	0.00%	0.00%

**Collected over TRS salaries only.*

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Appendix – Expected UAAL

	Projected UAAL				
(Dollars in Millions)	(If All Assumptions Are Realized)				
	Current Law		TRS 1 / LEOFF 1 Merged		
Fiscal Year	LEOFF 1	TRS 1	Minimum Use	SB 6668 (2017)	Maximum Use
2015	($1,090)	$3,187	$2,097	$2,097	$2,097
2016	N/A	$3,364	$1,922	$1,922	$1,922
2017	N/A	$3,210	$1,773	$1,773	$1,773
2018	N/A	$3,029	$1,629	$1,752	$2,041
2019	N/A	$2,803	$1,352	$1,612	$2,227
2020	N/A	$2,556	$1,046	$1,446	$2,426
2021	N/A	$2,270	$694	$1,250	$2,260
2022	N/A	$2,061	$364	$1,012	$2,050
2023	N/A	$1,798	N/A	$720	$1,786
2024	N/A	$1,492	N/A	$385	$1,480
2025	N/A	$1,139	N/A	N/A	$1,126
2026	N/A	$734	N/A	N/A	$720
2027	N/A	$273	N/A	N/A	$258
2028	N/A	N/A	N/A	N/A	N/A

Note: We show N/A upon paying off the unfunded liability.

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Merger Study – Actuarial Update

Matt Smith, FCA, EA, MAAA
State Actuary

Michael Harbour
Senior Actuarial Analyst

Presentation to Select Committee on Pension Policy

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"Supporting financial security for generations."

November 15, 2016

Today's Update

- LEOFF 1 risk analysis requested by LEOFF 2 Board
- Risk analysis on SB 6668 (2017)
- Draft actuarial section of merger study included in materials

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Actuarial Section Of Merger Study

- Transmittal letter
- Draft actuarial fiscal note for SB 6668 (2017)
- OSA presentations to SCPP this interim
- Responses to actuarial questions from stakeholders

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Risk Analysis Requested By LEOFF 2 Board

- Board requested scenario-based risk analysis on LEOFF 1
- Provides an understanding of LEOFF 1 risks before merger
- LEOFF 1 risks assumed by TRS 1 (or LEOFF 2) and vice versa depending on merger

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Sample Of Scenarios Requested By LEOFF 2 Board

- Different investment return and inflation environments
- Varying investment return scenarios
- Impact of providing $5,000 bonus payment

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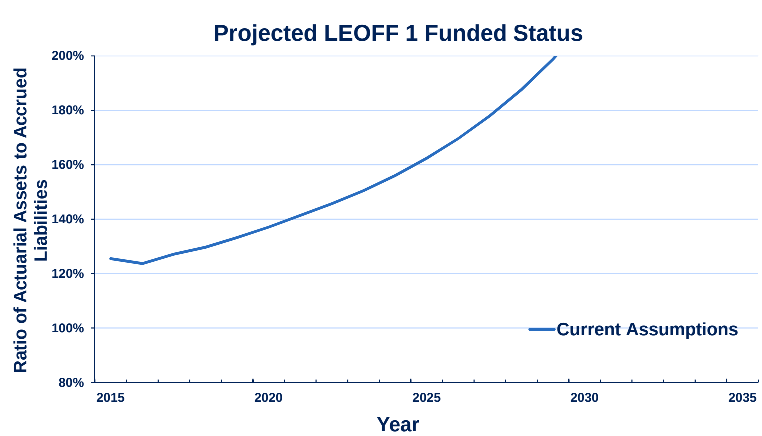
LEOFF 1 Funded Status Expected To Improve

- If fund earns 7.7 percent return each year



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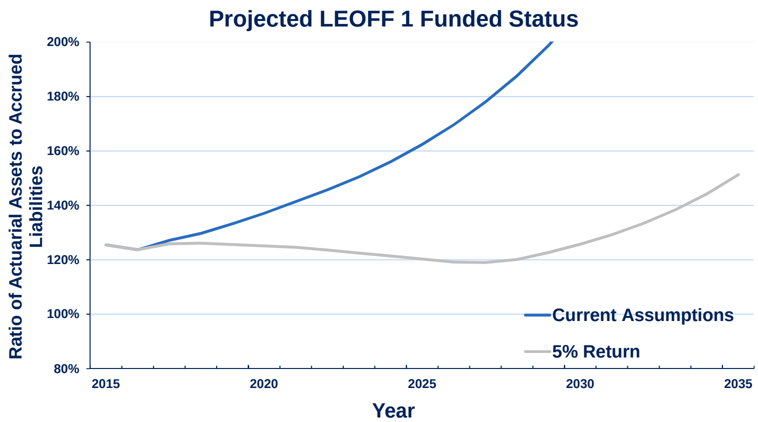
Funded Status Falls With Lower Than Expected Returns

- If fund earns 5.0 percent for next 10 years and 7.7 percent thereafter



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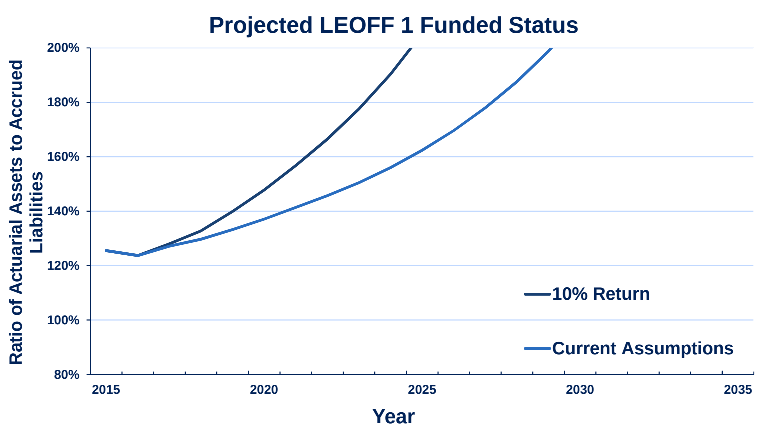
Funded Status Improves With Better Than Expected Returns

- If fund earns 10.0 percent for next 10 years and 7.7 percent thereafter



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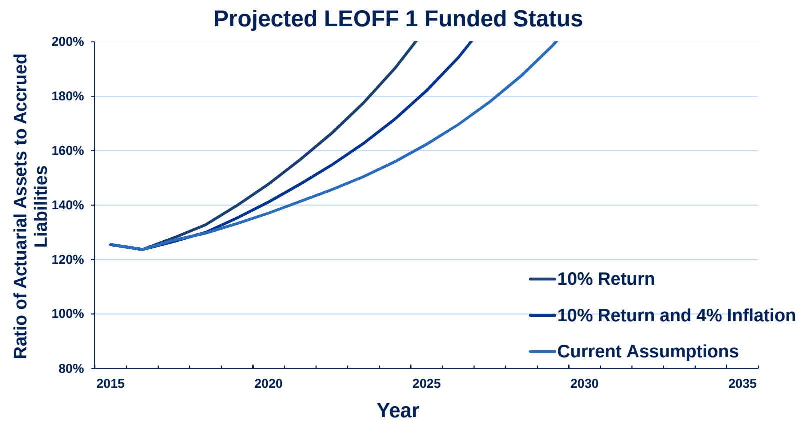
Higher Inflation Dampens Funded Status

- If plan experiences 10.0/4.0 percent return/inflation for next 10 years and 7.7/3.0 return/inflation percent thereafter



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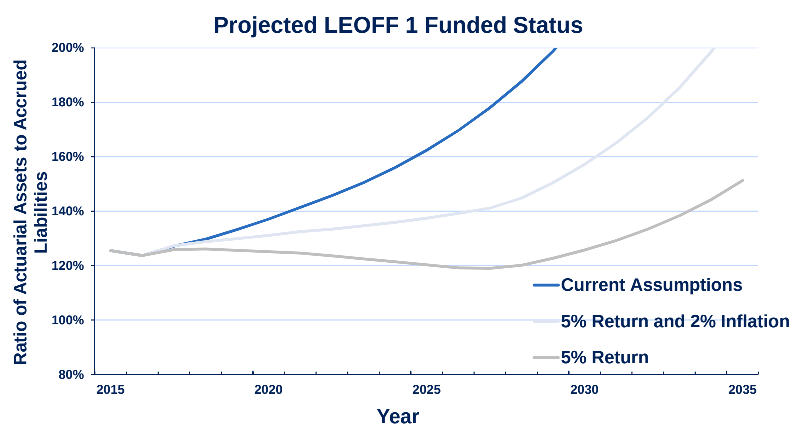
Lower Inflation Improves Funded Status

- If plan experiences 5.0/2.0 percent return/inflation for next 10 years and 7.7/3.0 return/inflation percent thereafter



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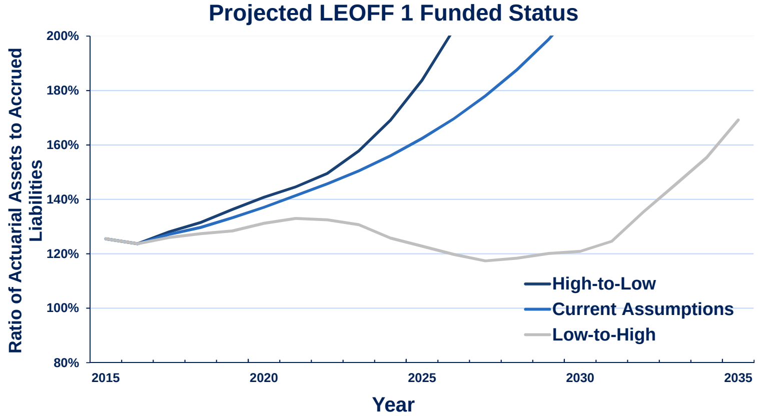
How We Arrive At Expected Return Impacts Funded Status

- Average annual investment return of 7.7 percent, but achieving those returns with different paths (high-to-low and low-to-high)



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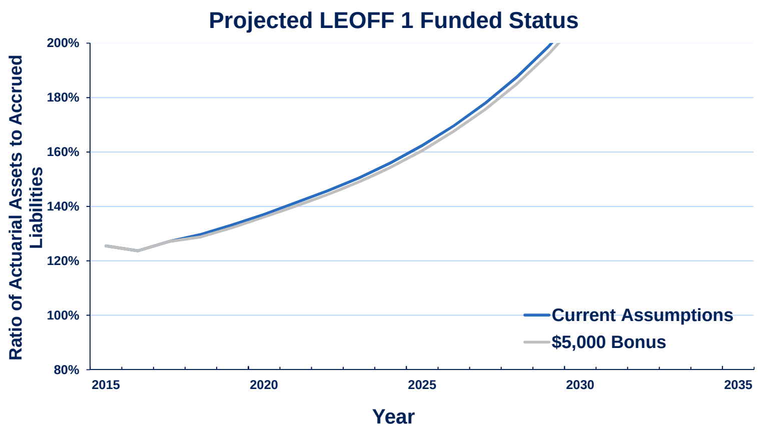
Bonus Payment Lowers Funded Status By About 1 Percent

- Providing $5,000 bonus payment to each LEOFF 1 member consistent with SB 6668 and all experience matches expectations



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Comments On Risk Analysis Requested By LEOFF 2 Board

- LEOFF 1 remains fully funded under all scenarios requested by the Board
- There are other possible scenarios where LEOFF 1 would fall out of full funding
- Next section of presentation addresses those possible scenarios

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What Does Our Risk Analysis Represent?

- Outcomes from scenario-based analysis highly dependent on scenarios selected
- Instead of scenario analysis, we typically perform "stochastic" analysis when analyzing risk
- We simulate 2,000 equally likely future economic environments
- We then record the resulting impacts to retirements systems for the next 50 years
- This allows us to present a fuller range of outcomes and quantify the "likelihood" of a given risk
  - Likelihood equals the number of occurrences observed, for a given risk measurement, divided by total number of simulated outcomes
  - The true or actual likelihood is rarely known

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Risk Analysis On SB 6668 (2017)

- Reminder: SB 6668 (2017) represents SB 6668 from 2016 rolled forward one year and updated for 2015 actuarial valuation results
- Funding policy under SB 6668 would apply expected LEOFF 1 surplus to future contribution requirements of merged plan resulting in an expected long-term total employer savings
- If future experience does not match expectations, primarily inflation and investment returns, certain risks can emerge
  - For instance, you would see an increase in UAAL rates and more pay-go funding situations after the merger than before
- The following graphs demonstrate under what scenarios this risk emerges, when, and for how long
- Please see draft actuarial fiscal note for SB 6668 (2017) for more details and supporting information

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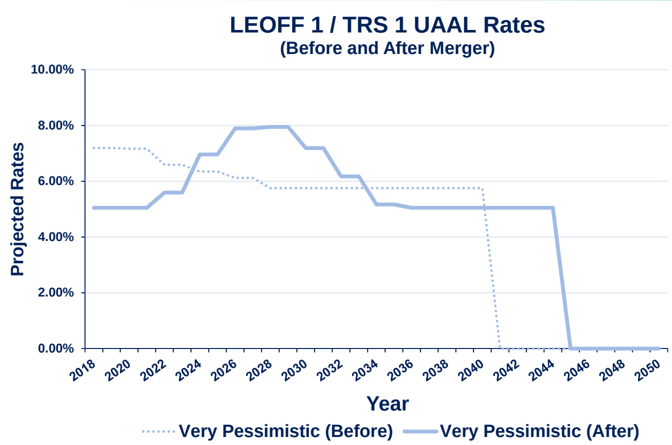
UAAL Rates Increase After Merger Under Very Pessimistic Scenarios



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Pay-Go Risk

- Pay-go risk is the risk a plan's trust fund will exhaust before all benefits have been paid
- If this occurs and significant benefit payments remain, it can represent a significant financial risk for affected employers
- Before a merger, LEOFF 1 has a maximum chance of pay-go of 4 percent in the year 2042 with about $210 million in annual benefit payments at that time
  - Assumes LEOFF 1 receives on-going funding after 2024, if necessary, similar to the funding method for PERS 1 and TRS 1
  - This is an assumption change we made from our prior risk analysis
- Because TRS 1 assumes the assets and liabilities of LEOFF 1 under SB 6668 (2017), the following graphs compare TRS 1 before merger to the merged plan

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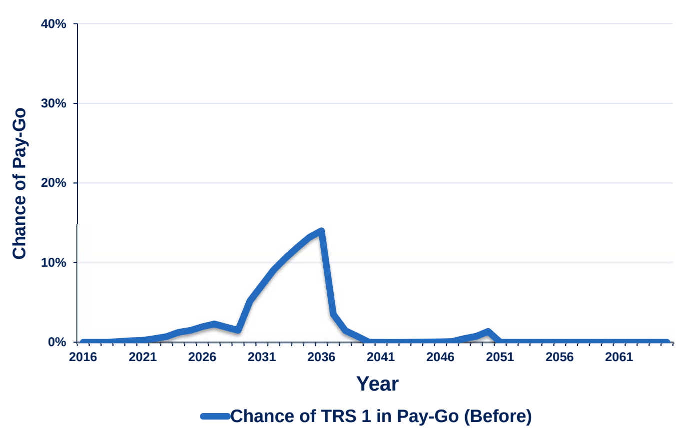
14 Percent Chance Of Pay-Go In TRS 1 Before Merger



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Pay-Go Risk Shifts And Increases After Merger

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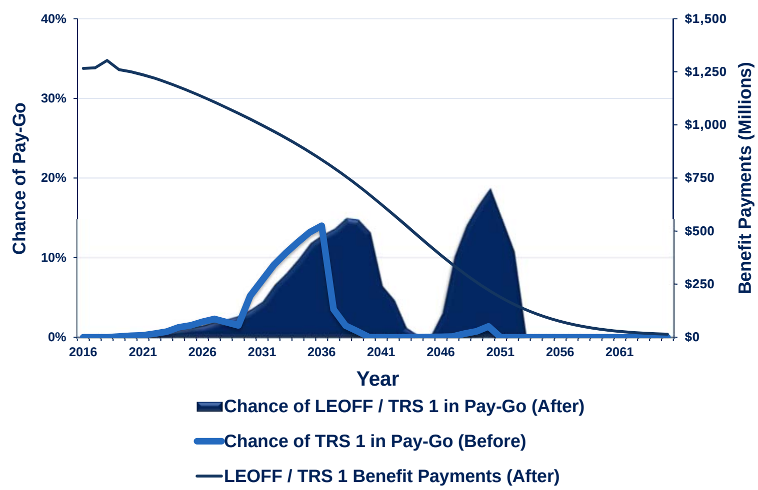
Largest Increase In Pay-Go Occurs Near End of Plan's Life



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Recap On Risk Analysis

- UAAL rates increase after the merger under very pessimistic scenarios
  - Merged plan has higher assets and obligations than before merger
  - With this larger base of assets and obligations, pessimistic/optimistic outcomes become more pessimistic/optimistic than before the merger
  - Very pessimistic or worse outcomes occur in 5 percent of the simulations in our model
- Pay-go risk shifts and increases after the merger
  - Initial infusion of LEOFF 1 surplus assets insulates the merged plan from some very pessimistic outcomes in earlier years of the projection
  - When those very pessimistic outcomes continue, the merged plan can face increased pay-go situations near the end of plan's life due to higher combined benefit payments from the merger
- Results based on the data, assumptions, and methods from our most recent risk measurements
  - Future results may vary from these measurements

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Who Would Be Impacted If These Risks Materialize

- Risks identified with SB 6668 (2017) can surface under current law or under proposed merger
- If these risks materialize under the merger, impacts would vary by affected group

Affected Group	Impact Under Funding Policy
LEOFF 1 Active Members	No contributions required under merger
TRS 1 Active Members	Contribution rate fixed at 6 percent before and after merger
LEOFF 1 Employers	Local government employers no longer responsible for funding LEOFF 1 retirement benefits
TRS Employers/GF-S	Assume all costs of the merged plan

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Risk Management Considerations

- If Legislature decides to pursue SB 6668 (2017), the following changes could reduce some of the risks noted in this presentation

Provision	Possible Change To Reduce Risk
Fixed UAAL Rates	Eliminate or shorten the period of fixed rates under the proposal. This would allow for more responsive and adequate funding should the need arise.
Minimum UAAL Rates	Increase the minimum UAAL rates under the proposal. The current minimum UAAL rate for TRS 1 is 5.75%. The minimum UAAL rate for the merged plan is 5.05%. Because the merged plan has larger combined benefit payments than TRS 1, the merged plan may require higher minimum rates to accommodate the higher risk associated with the added benefit payments.

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Questions?

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Appendix – Varying Investment Return Scenarios For LEOFF 1

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Low-to-High and High-to-Low Returns		
FY	Low-to-High	High-to-Low
2017	6.88%	9.32%
2018	0.93%	7.41%
2019	7.35%	9.47%
2020	11.37%	5.58%
2021	(2.68%)	7.82%
2022	2.49%	11.60%
2023	0.65%	12.16%
2024	(1.51%)	10.34%
2025	19.62%	13.28%
2026	6.12%	20.71%
2027	9.45%	(3.47%)
2028	12.62%	11.81%
2029	4.71%	23.88%
2030	5.49%	1.49%
2031	17.59%	3.50%
2032	20.48%	(7.61%)
2033	4.92%	1.49%
2034	6.29%	7.70%
2035	10.68%	3.00%
2036	14.35%	8.99%
First 10 Years	4.93%	10.70%
Next 10 Years	10.53%	4.76%
All 20 Years	7.70%	7.69%

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SCPP • 2016 MERGER STUDY

ADMINISTRATIVE ANALYSIS

STATE OF WASHINGTON

DEPARTMENT OF RETIREMENT SYSTEMS

PO Box 48380 • Olympia, WA 98504-8380 • 360.664.7000 • 800.547.6657 • *www.drs.wa.gov*

DATE:	November 28, 2016
TO:	Select Committee on Pension Policy
FROM:	Department of Retirement Systems
SUBJECT:	LEOFF 1/TRS 1 Merger Study - Administrative Impacts of SB 6668

The Select Committee on Pension Policy (SCPP) was tasked by the legislature to create a report on the potential impacts of SB 6668, *Merging the assets, liabilities, and membership of the law enforcement officers' and firefighters' retirement system plan 1 with the teachers' retirement system plan 1 and establishing a funding policy for the merged plan.* The SCPP requested that the Department of Retirement Systems (DRS) report to the SCPP on the administrative impacts of SB 6668.

During the 2016 legislative session DRS completed a Fiscal Note which addressed the administrative impacts of SB 6668. DRS is submitting this Fiscal Note to the SCPP to be included in its report to the legislature.

There was one administrative issue raised by the SCPP that was not addressed in the DRS Fiscal Note. This question relates to the potential impact of SB 6668 on the financial reporting requirements of Governmental Accounting Standards Board[i] Statement 68 (GASB 68).

GASB 68 establishes accounting and financial reporting requirements for government employers that prepare financial statements compliant with Generally Accepted Accounting Principles[ii] (GAAP). GASB 68 requires that cost-sharing governments report a net pension liability (or asset), pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective amounts for all the governments in the plan. Pension liabilities or assets result from the difference between contributions required and contributions made.

In response to GASB's adoption of Statement 68, DRS has followed authoritative guidance from the American Institute of Certified Public Accountants[iii]. DRS does not prepare employer financial statements. It does, however, publish a Comprehensive Annual Financial Report (CAFR) that includes financial reporting for pension plans that are administered by DRS. DRS also publishes a Participating Employer Financial Information (PEFI) report that includes employer allocation percentages and additional information needed by employers to meet the requirements of GASB 68.

To respond to SCPP's inquiry regarding GASB 68, DRS reviewed its existing procedures and reached out to our employer partners regarding impacts of employer financial reporting should TRS 1 and LEOFF 1 merge into one plan (TRS 1). DRS has concluded that if LEOFF 1 is merged with TRS 1, DRS would continue to allocate employer proportionate shares of the TRS 1 net pension liability based on employer contribution transmittals processed by DRS during the fiscal year. Continuing this approach would have the following impacts under a LEOFF 1 merger with TRS 1:

- Local governments who are LEOFF 1 employers (mainly cities and counties) would no longer have a LEOFF 1 asset to report in their financial statements. LEOFF 1 employers would not be required to include TRS 1 liabilities in their statements.
- Local governments who are TRS 1 employers (mostly school districts) would continue to include a liability for TRS 1 in their financial reporting. However, the liability would be reduced because of the merged LEOFF 1 asset.
- The state would no longer have a LEOFF 1 asset to report in its financial statement. The TRS 1 liability reported by the state would be reduced, but the reduction would be relatively small because there are fewer state government TRS 1 employers.

We hope this information is of assistance to you. If you have questions, please contact me directly.

Sincerely,

Jacob White
Legal and Legislative Services Director
Department of Retirement Systems
360-664-7219
jacob.white@drs.wa.gov

Enclosure

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[i] GASB – Governmental Accounting Standards Board: Established in 1984, the GASB is the independent, private-sector organization based in Norwalk, Connecticut, that establishes accounting and financial reporting standards for U.S. state and local governments that follow Generally Accepted Accounting Principles

ii GAAP - Generally Accepted Accounting Principles are the generally accepted accounting principles adopted by the U.S. Securities and Exchange Commission.

iii AICPA - The American Institute of CPAs is the world's largest member association representing the accounting profession. AICPA sets ethical standards for the profession and U.S. auditing standards for private companies, nonprofit organizations, federal, state and local governments.

Individual State Agency Fiscal Note

Bill Number: 6668 SB	Title: LEOFF 1 & TRS 1 merge	Agency: 124-Department of Retirement Systems

Part I: Estimates

☐ **No Fiscal Impact**

Estimated Cash Receipts to:

NONE

Estimated Expenditures from:

	FY 2016	FY 2017	2015-17	2017-19	2019-21
FTE Staff Years	0.3	0.2	0.3	0.0	0.0
Account					
Department of Retirement Systems Expense Account-State 600-1	93,572	67,448	161,020	0	0
Total $	93,572	67,448	161,020	0	0

Estimated Capital Budget Impact:

NONE

The cash receipts and expenditure estimates on this page represent the most likely fiscal impact. Factors impacting the precision of these estimates, and alternate ranges (if appropriate), are explained in Part II.

Check applicable boxes and follow corresponding instructions:

☒ If fiscal impact is greater than $50,000 per fiscal year in the current biennium or in subsequent biennia, complete entire fiscal note form Parts I-V.

☐ If fiscal impact is less than $50,000 per fiscal year in the current biennium or in subsequent biennia, complete this page only (Part I).

☐ Capital budget impact, complete Part IV.

☒ Requires new rule making, complete Part V.

Legislative Contact:	Steve Jones	Phone: (360)786-7440	Date: 02/24/2016
Agency Preparation:	Mike Ricchio	Phone: 360-664-7227	Date: 02/29/2016
Agency Approval:	Marcie Frost	Phone: 360-664-7312	Date: 02/29/2016
OFM Review:	Jane Sakson	Phone: 360-902-0549	Date: 02/29/2016

Part II: Narrative Explanation

II. A - Brief Description Of What The Measure Does That Has Fiscal Impact

Briefly describe by section number, the significant provisions of the bill, and any related workload or policy assumptions, that have revenue or expenditure impact on the responding agency.

This bill merges the assets, liabilities, and membership of Plan 1 of the Law Enforcement Officers' and Firefighters' (LEOFF) Retirement System with Plan 1 of the Teachers' Retirement System (TRS), and establishes a funding policy for the merged plan. It also provides a one-time, lump-sum defined benefit payment of $5,000 to all retired LEOFF Plan 1 members, payable on January 3, 2017. Active or "term-vested" members will receive the lump-sum benefit payment, with interest, on their retirement date. The bill takes effect on September 1, 2016.

II. B - Cash receipts Impact

Briefly describe and quantify the cash receipts impact of the legislation on the responding agency, identifying the cash receipts provisions by section number and when appropriate the detail of the revenue sources. Briefly describe the factual basis of the assumptions and the method by which the cash receipts impact is derived. Explain how workload assumptions translate into estimates. Distinguish between one time and ongoing functions.

No impact.

II. C - Expenditures

Briefly describe the agency expenditures necessary to implement this legislation (or savings resulting from this legislation), identifying by section number the provisions of the legislation that result in the expenditures (or savings). Briefly describe the factual basis of the assumptions and the method by which the expenditure impact is derived. Explain how workload assumptions translate into cost estimates. Distinguish between one time and ongoing functions.

ADMINISTRATIVE ASSUMPTIONS

- Approximately 7,500 current retirees/survivors will receive the one-time $5,000 payment on January 3, 2017. Persons assigned a portion of a retiree's benefit will not receive a payment.
- There are approximately 120 non-retired LEOFF 1 members who will have the $5,000 credited to their member account and, upon retirement, will receive the payment plus interest.
- No changes are needed to the agency's integrated mainframe systems, other than creating a separate code to hold and distribute the $5,000 payment. The associated accounts will be set with a special circumstances flag. Interest will accrue on the active/inactive accounts at a rate that is consistent with LEOFF Plan 1.
- Any active/inactive member that does not meet the criteria to receive the $5,000 payment will have the payment plus interest removed from their account manually by a Retirement Specialist.
- The $5,000 payment will be paid by the same method that the retiree currently receives their monthly benefit by, using current IRS withholding.
- The $5,000 payment cannot be rolled into purchasing an annuity from DRS.
- This $5,000 payment is an additional no-basis retirement benefit payment.
- All impacted LEOFF retirees/survivors will receive separate 1099's for payments made under the LEOFF plan for the period prior to and after the merging of the plans. (Each retirement system has a different tax identification number.)
- Any 1099 corrections prior to September 1, 2016, will always use the prior LEOFF 1 tax identification number.
- If a LEOFF 1 member dies after the effective date of this legislation (September 1, 2016) and before the payment date (January 3, 2017), the payment will be made to the beneficiaries of the member.
- Online account access (OAA) will display the $5,000 payment when an eligible member is applying for retirement, and will show it under "benefit summary" for retirees/survivors.
- The LEOFF 1 fund will remain open until all warrants have cleared, the cash balance is zero and all transactions are finalized.

The assumptions above were used in developing the following workload impacts and cost estimates.

BENEFITS/CUSTOMER SERVICE

Retirement Specialists (RSs) will support modifications of DRS' automated systems, help update member communication materials, update internal procedures, update internal reference materials, and provide training on the changes to existing procedures.

Retirement Specialist 3 – 92 hours (salaries/benefits) = $3,259

FISCAL SERVICES

Teams within Fiscal Services will need to develop business requirements and perform user acceptance testing with the Department of Enterprise Services. They will need to test AFRS interface updates and enter AFRS coding updates, updates to cash processes, reclamations/returns, and cash-flow activities, and updates to reconciliation processes. Time will also be required to perform disbursement and tax (1099) testing, as well as processing returned warrants/EFTs until all LEOFF 1 transactions have cleared.

Contracted programming, testing and verification – 40 hours @ $95 per hour = $3,800
Management Analyst 5 - 120 hours (FY 17 salaries/benefits) = $5,643
Fiscal Analyst 5 - 380 hours (FY 17 salaries/benefits) = $16,015

Total Estimated Fiscal Support Costs = $25,458

MEMBER COMMUNICATIONS

The Communications Team will develop an informational letter for 7,500 affected LEOFF Plan 1 retirees regarding the lump-sum benefit. They will also review agency publications and online materials, and make appropriate adjustments.

Communications Consultant 5 – 40 hours (salaries/benefits) = $1,880
Envelopes, printing and postage = $1,696

Total Estimated Member Communications Costs = $3,576

PLAN QUALIFICATION

DRS will request a determination letter from the Internal Revenue Service (IRS) for the plan qualification status from a merger of LEOFF 1 and TRS 1. Special tax counsel familiar with IRS plan qualification issues would be contracted, through the state's Attorney General's Office, for this effort. This process of obtaining a determination is estimated to take approximately six months.

Project Management – 220 hours (salaries/benefits) = $11,898
One-time cost for tax counsel to lead plan determination effort = $50,000

Total Estimated Plan Qualification Costs = $61,898

AUTOMATED SYSTEMS

Modifications will be required to our Member Information System to updated fund codes, update the Annual Tax Reporting processing and process the $5,000 payments to members, retirees and survivors. Modifications will be required to our Online Account Access to display the $5,000 payment information to retirees and survivors. Analysis of our AFRS interfaces will be required. Business requirements will be created and User Acceptance Testing will be performed to support these changes.

Contracted Programmer - 482 hours @ $95 per hour = $45,790
Info Tech Specialist 4 – 320 hours (salaries/benefits) = $15,039
WaTech cost* of $500 per week for 12 weeks = $ 6,000

Total Estimated Automated Systems Costs = $66,829

*cost for mainframe computer processing time and resources at WaTech

ESTIMATED TOTAL COST TO IMPLEMENT THIS BILL: $161,020

Part III: Expenditure Detail

III. A - Expenditures by Object Or Purpose

	FY 2016	FY 2017	2015-17	2017-19	2019-21
FTE Staff Years	0.3	0.2	0.3		
A-Salaries and Wages	24,113	15,965	40,078		
B-Employee Benefits	7,963	5,693	13,656		
C-Professional Service Contracts	50,000		50,000		
E-Goods and Other Services	11,496	45,790	57,286		
G-Travel					
J-Capital Outlays					
M-Inter Agency/Fund Transfers					
N-Grants, Benefits & Client Services					
P-Debt Service					
S-Interagency Reimbursements					
T-Intra-Agency Reimbursements					
9-					
Total:	$93,572	$67,448	$161,020	$0	$0

III. B - Detail: *List FTEs by classification and corresponding annual compensation. Totals need to agree with total FTEs in Part I and Part IIIA*

Job Classification	Salary	FY 2016	FY 2017	2015-17	2017-19	2019-21
Communications Consultant 5	73,644	0.0		0.0		
Fiscal Analyst 5	64,620		0.2	0.1		
Info Tech Specialist 4	73,644	0.2		0.1		
Management Analyst 5	73,140		0.1	0.0		
Project Manager	86,004	0.1		0.1		
Retirement Specialist 3	53,424	0.0		0.0		
Total FTE's	424,476	0.3	0.2	0.3		0.0

Part IV: Capital Budget Impact

No impact.

Part V: New Rule Making Required

Identify provisions of the measure that require the agency to adopt new administrative rules or repeal/revise existing rules.

New rules may be required to clarify portions of the merger.

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

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[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.

Select Committee on Pension Policy

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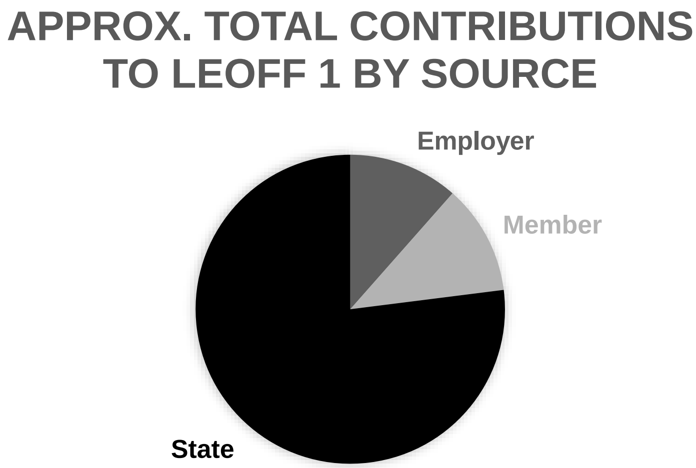
16 I.e., if LEOFF 1 benefits are a liability of TRS employers (school districts), and the funding of school districts falls under the constitutional requirement to fund basic education, then the funding of LEOFF 1 benefits may be required under the state constitution.
17 See e.g., the meetings of the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

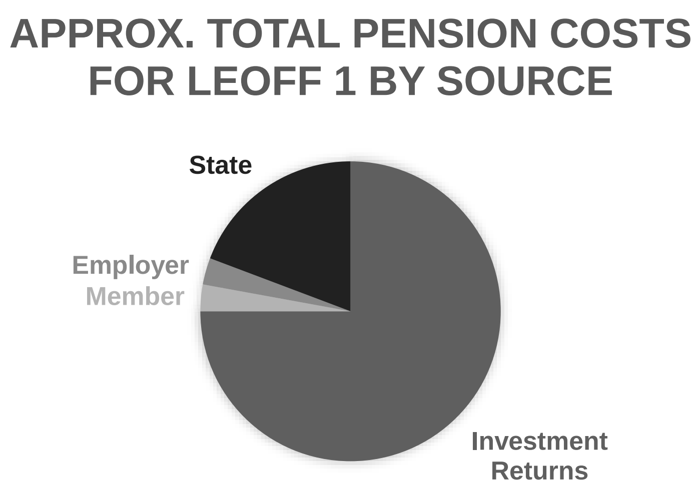
Historical data shows that LEOFF 1 members contributed approximately 11.5 percent of all contributions to the plan, and LEOFF 1 employers paid approximately 11.5 percent.[21] In contrast, the state contributed approximately 77 percent of all contributions toward the plan (see Fig. 1).[22]

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.

SCPP · 2016 MERGER STUDY

LEOFF 1/LEOFF 2 MERGER ANALYSIS

December 7, 2016

LEOFF 1/LEOFF 2 Merger Study

FINAL REPORT
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ISSUE STATEMENT

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

OVERVIEW

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

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

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

There have been several legislative proposals since 2010 to merge State public pension plans, including the Law Enforcement Officers' and Fire Fighters' Plan 2 (LEOFF Plan 2), in order to save the State money by reducing State contributions to the new plan. The debate over these proposals has raised questions of whether the proposals are legal under state or federal law; how the merger impacts the State budget; and how the merger affects member benefits, plan governance and plan funding.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2016 3rd sp.s. c 4 s 106) for the SCPP to work with the LEOFF Plan 2 Board, DRS, and OSA to study the legal, financial and policy issues raised by merging the LEOFF Plan 1 Retirement Fund with either the LEOFF Plan 2 Retirement Fund or the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

This report will provide an explanation of the issues raised by a merger of the LEOFF Plan 1 and LEOFF Plan 2 retirement funds. The analysis of these issues will not be specific to any past legislative proposal. Rather, the goal of this report is to increase understanding of the general principles that would apply to any merger of these plans.

BACKGROUND & POLICY ISSUES

Benefit Administration and Investment of the Retirement Funds

The Law Enforcement Officers' and Fire Fighters' (LEOFF) Retirement System was created in 1970 by merging a number of separate city and county retirement plans into one state-wide plan. The LEOFF Retirement fund was established to pay for the liabilities of this new retirement system. The administration of the LEOFF Retirement System and the investment of fund assets was initially the responsibility of the Public Employees' Retirement System (PERS) Board.

The responsibility for administering the LEOFF Retirement System benefits was transferred from the PERS Board to the newly-created Department of Retirement Systems (DRS) in 1977. DRS continues to administer LEOFF member benefits to this day. On October 1, 1977, the original LEOFF system (Plan 1) was closed to new members and a new tier of benefits, LEOFF Plan 2, was established for all new LEOFF members. LEOFF Plan 2 currently remains open. The PERS Board continued to invest the LEOFF Retirement Systems fund, which included assets and liabilities of both LEOFF Plan 1 and LEOFF Plan 2, until 1981 when the Board was abolished and investment authority for the fund was transferred to the newly-created Washington State Investment Board (WSIB) where it remains today.

The Pension Funding Act of 1989 (c. 272, laws of 1989) split the assets and liabilities of the LEOFF Retirement System into separate funds for LEOFF Plan 1 and LEOFF Plan 2. Both funds are commingled for investment purposes as part of the Commingled Trust Fund managed by the SIB but assets and liabilities are accounted for separately.

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

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

LEOFF 1 Contributions

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

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

[1] RCW 41.33A.110

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

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

LEOFF 2 Contributions

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

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

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

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

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

Funding Policies

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

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[2] RCW 41.26.725(1)
[3] RCW 41.26.725 and RCW 41.45.0604
[4] RCW 41.45.010(1)
[5] RCW 41.45.010(4)
[6] RCW 41.45.010(5)
[7] RCW 41.45.070

Actuarial Funding Method

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

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

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

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

Long-Term Economic Assumptions

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

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

Demographic Assumptions

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

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

[8] RCW 41.45.010(2)
[9] 2009 LEOFF Actuarial Valuation Report, Office of the State Actuary p. 36

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

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

Actuarial Value of Assets v. Market Value of Assets ("Smoothing")

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

Asset Value Corridor

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

The Funded Status of LEOFF 1 and LEOFF 2

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

Governance

LEOFF Plan 2

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

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[10] RCW 41.45.090
[11] RCW 41.26.720
[12] RCW 41.45.035(3)(a)

LEOFF Plan 1

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

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

Legislative History

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

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

House Bill 2350/Senate Bill 6563 in 2012 proposed merging LEOFF Plan 1 with LEOFF Plan 2 and reducing the State contribution to the merged plan. That bill was recommended by the LEOFF Plan 2 Retirement Board did not pass the legislature.

Senate Bill 6668 in 2016 proposed merging LEOFF Plan 1 with the Teachers' Retirement System (TRS) Plan 1 and reducing the State contributions to pay the unfunded liability in the merged plan.

The Supplemental Operating Budget passed by the Legislature in 2016 included a proviso (2ESHB 2376, sec. 106) for the SCPP to work with the LEOFF Plan 2 Board, DRS, and OSA to study the legal, financial and policy issues raised by merging the LEOFF Plan 1 Retirement Fund with the LEOFF Plan 2 Retirement Fund or the Teachers' Retirement System (TRS) Plan 1 Retirement Fund.

Senate Bill 6166 in 2001 proposed terminating LEOFF Plan 1 and using some of the assets of the fund for state purposes as well as for the cost to "restate" the plan and pay for a one-time payment to LEOFF Plan 1 beneficiaries. The bill did not pass the legislature.

Legal Framework

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

There is a body of state case law across the country regarding plan mergers which may be illustrative of potential issues in evaluating a merger but there is no similar case law in Washington. Additionally, there is a significant body of Washington case law defining members' rights to retirement benefits and to have their retirement plan funded on a sound actuarial basis.

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[13] RCW 41.04.281
[14] RCW 41.04.278(2)(a)

POLICY ISSUES

What is a "merger" of LEOFF Plan 2 with LEOFF Plan 1?

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

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

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

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

How much is the surplus in LEOFF Plan 1?

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

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

Today's Value: The current Actuarial Valuation Report (AVR) prepared by the Office of the State Actuary (OSA) is based on asset and liability information as of June 30, 2015. The Washington State Investment Board (WSIB) updates the market value of plan assets monthly. OSA prepares annual projections of liabilities and actuarial value of assets for LEOFF Plan 1. The most recent investment report from the WSIB (July 2016) indicated a market value for LEOFF Plan 1 of $5.387 billion which is lower than the actuarial value of assets in the 2015 AVR.

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

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

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

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

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

Who does the LEOFF Plan 1 surplus belong to?

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

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

How does a merger affect LEOFF Plan 2 benefits?

A merger does not require that all members of the new plan receive the same benefits. Typically, the new plan continues the same benefits previously provided to members and beneficiaries as separate tiers of benefits.

State law prohibits a merger from reducing benefits provided to members. Benefits can be increased in the same piece of legislation that merges plans but any benefit increase is separate and distinct from the merger itself.

How would a LEOFF 2/LEOFF 1 merger impact the State budget?

LEOFF Plan 2 receives 20% of the cost of the plan from the State as an appropriation from the General Fund. That appropriation will be approximately $130 million in the 2015-17 biennium. The required biennial appropriation for 2017-19 has yet to be determined but is likely to increase due to projected growth in the LEOFF Plan 2 membership and salary base. LEOFF Plan 1 also has received a portion of its funding from the State in the past but no contributions have been required since 2001.

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

What legal issues are raised by a LEOFF 2/LEOFF 1 merger?
A merger of public retirement plans raises questions of both federal and state law. Public pension plans must be qualified under federal law in order for members and plan sponsors to receive favorable tax treatment for their contributions and earnings. So, when a merger creates a new plan, that new plan must be reviewed by the Internal Revenue Service to determine if it is qualified. The Internal Revenue Service recently issued notice that they will cease doing plan determination letters for existing plans. However, they will continue to issue plan qualification determinations for new plans including a new plan created by a merger. The current estimated turnaround time for a determination is six months.

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

One of the key requirements for a retirement plan to be qualified is that assets must be held in trust for the exclusive benefit of the plan beneficiaries. Some of the additional criteria used to evaluate a proposed merger include: are the plans open or closed to new members; do the plans have similar employers; are the plans over-funded or under-funded; and, are the plans demographics compatible?

A copy of the advice received from Ice Miller can be found in Appendix A.

Washington case law on pensions is based on the principle that pension benefits are part of a contract between the employer and employee which cannot be diminished by state law (*Bakenhus*). So, a merger cannot reduce benefits. Similarly, the courts have held that the funding which underlies the benefit promise is also subject to protection (*Weaver*). So, a merger that diminishes current or future plan funding needs to be evaluated according to these protections.

The State Attorney General's Office is responsible for this evaluation. The firm of K&L Gates has been used as a Special Assistant Attorney General to provide advice related to plan mergers to the LEOFF Plan 2 Retirement Board. A copy of the advice received from K&L Gates can be found in Appendix B.

How would a LEOFF 2/LEOFF 1 merger affect plan governance?
The Pension Funding Council adopts contribution rates for LEOFF Plan 1. The Select Committee on Pension Policy studies policy issues related to LEOFF Plan 1 benefits and recommends any changes to the Legislature. A merger would not require any changes.

The LEOFF Plan 2 Retirement Board adopts contribution rates for LEOFF Plan 2, studies policy issues related to the plan and recommends any changes to the Legislature. A merger would not require any changes.

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

Some state courts have held that the right of plan members to have their plan governed by an independent board of trustees who owe a fiduciary duty to the plan, such as the LEOFF Plan 2 Retirement Board, is a benefit of the plan subject to the same legal protections as other plan benefits. That question has not been decided by Washington courts.

Mergers in the private sector are typically arm's length transactions between two different plans with separate governing bodies and separate plan sponsors. The trustees of each plan have a fiduciary responsibility to ensure that a proposed merger is in the best interest of their plan's members and negotiate the terms of the merger accordingly. But, there are no governing boards for any of the state-administered public pension plans in Washington other than LEOFF Plan 2. The terms of any merger of LEOFF Plan 2 and LEOFF Plan 1 would be established by the State Legislature in legislation.

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

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

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

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

No State, member or employer contributions for LEOFF Plan 1 have been required since 2001 because of the positive funding status of the plan. Contributions to LEOFF Plan 1 could be reinstated if the plan's funding status decreased due to adverse investment or actuarial experience. Any potential future member contributions would not be significant due to the low number of members currently active in the plan so the responsibility for any potential future funding requirements would fall on LEOFF employers and the State.

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

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

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

A merger that included keeping the new fund in the CTF would mean no change in investment policy. A merger of two plans within the CTF into a new plan that remains in the CTF would not require any sale of assets that could create transactions costs for the new plan or other plans in the CTF.

Commingled Investment

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

Since LEOFF 2 is an open and ongoing plan, merging LEOFF 1 with LEOFF 2 would affect analysis of this issue.

What is a plan termination and how does it apply to a plan merger?

One question that often arises when discussing merger is what happens to any remaining assets in a fund when it closes? Federal case law has said that when a private plan is terminated and all the liabilities to beneficiaries have been satisfied, any remaining assets revert to the plan sponsor (*Hughes Aircraft*). It is unclear how that holding would be applied in the context of a public plan termination. Both LEOFF employers and the State contributed to LEOFF Plan 1 so both would have a sponsorship claim to any remaining assets. The State Senate proposed a termination of LEOFF Plan 1 in 2001 which included annuitizing existing LEOFF 1 liabilities and a distribution of surplus assets to the State, LEOFF 1 employers and a payment to LEOFF 1 beneficiaries.

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

The principle that surplus assets in a terminated plan belong to the plan sponsor has sometimes been misapplied to discussions of a plan merger stated as a principle that all surplus assets in a fund belong to the fund sponsor(s). But, that is not accurate for several reasons. First, a plan “termination” is a separate process under federal law from merger and different legal requirements apply. A merger does not allow for fund assets to be distributed to the plan sponsors. Second, as long as a plan has beneficiaries, all assets in the plan are held in trust for the exclusive benefit of the plan’s beneficiaries. The possible disposition of any potential remaining assets if the plan is terminated in the future does not alter the legal status of those assets while the plan is active.

What is the history of plan mergers in Washington?

Plan mergers are more common in the context of private sector Taft-Hartley pension plans but there have been several mergers of public pension plans in the State of Washington. The Law Enforcement Officers’ and Fire Fighters’ (LEOFF) Retirement System was originally created in 1970 by merging some of the assets and most of the liabilities of the police pension plan of ten first-class cities with the fireman’s pension fund of 42 separate systems throughout the State. The prior plan sponsors were allowed to keep some assets to cover medical expenses. The prior plan sponsors remained liable for any retirement benefits beyond those provided in LEOFF Plan 1.

In 1972, the Statewide City Employers’ Retirement System was merged into the Public Employers’ Retirement System (PERS).

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

There is a statutory funding policy to fully amortize any unfunded liability which may emerge in LEOFF 1 no later than June 30, 2024.[15] If an unfunded liability emerges in LEOFF 1, this policy requirement could significantly impact funding requirements for LEOFF members, employers and the State in a merged plan. There is no funding policy for LEOFF 1 after June 30, 2024 so it is unclear what would be done if an unfunded liability emerges after that date.

LEOFF 1 Supplemental Rate

When an unfunded liability emerged in both PERS Plan 1 and TRS Plan 1, the State adopted a supplemental rate to cover this cost which is charged to employers as a percentage of salary of all PERS

[15] RCW 41.45.010(2)

or TRS employees, not just those in Plan 1. If an unfunded liability were to emerge in LEOFF Plan 1, the State could adopt a similar supplemental rate to cover that cost. The additional cost to LEOFF employers would likely be shared with LEOFF 2 members indirectly through the bargaining process since less money would be available for salaries, equipment and other expenses.

Financial Efficiencies

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

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

Risk Transfer/Sharing

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

LEOFF 2 Board Request for State Actuary Study

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

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

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

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

A. How does that likelihood change using a 7.5% earnings assumption?
B. How does that likelihood change using different economic scenarios?
C. How does that likelihood change if the CTF earns 5% on average for the next 10 years?
D. How does that likelihood change if LEOFF 1 annuitants receive $5000 each as an additional benefit?
E. What are the greatest risks to a LEOFF Plan 1 UAAL reemerging?
F. What are the consequences of a LEOFF Plan 1 UAAL reemerging? (State payments as a percentage of LEOFF 2 salary base? Employer payments?)

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

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

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

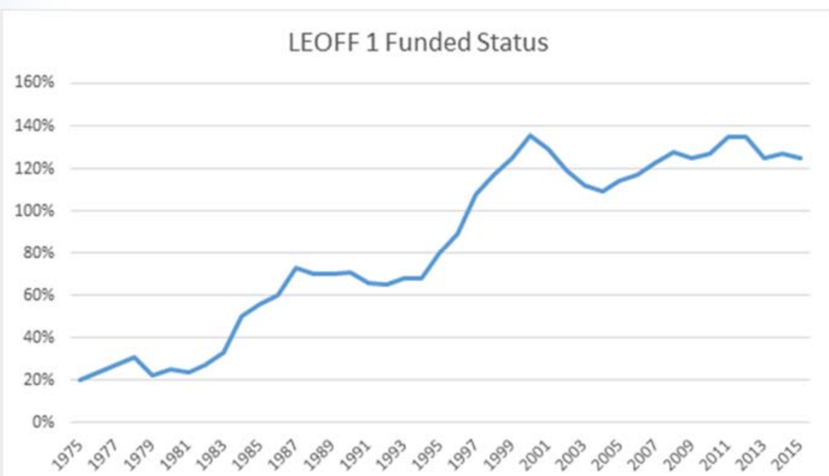
Is there a way to estimate the monthly changes to the LEOFF 1 “surplus” using the most recent monthly fund market value from the State Investment Board and an estimate of how much LEOFF 1 liabilities have changed since the most recent valuation? For instance, can you estimate the projected change in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

One other scenario that needs analysis is the impact of a rate holiday. Can you show the impact to funding ratio and contribution rates of a 0% state rate for 4 years on the merged plan? For instance, 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 have on the likelihood of future rate increases becoming necessary?

A copy of the analysis received from OSA can be found in Appendix C.

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

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



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

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

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

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

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

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

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

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

SUPPORTING INFORMATION

Merger Study Budget Proviso (2016 3rd sp.s. c 4 s 106)

During the 2016 legislative interim, the select committee on pension policy shall study Senate Bill No. 6668 (LEOFF 1 & TRS 1 merger) and report on the tax, legal, fiscal, policy, and administrative implications. In conducting the study, the select committee on pension policy shall also update its 2011 study of law enforcement officers' and firefighters' retirement system plans 1 and 2. In preparing this study, the department of retirement systems, the attorney general's office, the law enforcement officers' and firefighters' retirement system plan 2 board, and the office of the state actuary shall provide the select committee on pension policy with any information or assistance the committee requests. The committee shall also receive stakeholder input on the bill as part of its deliberation. The select committee on pension policy shall submit this report to the legislature by January 9, 2017.

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[16] Comparison of Public Employee Retirement Systems in the State of Washington, Institute of Governmental Research in cooperation with public pension commission, December 1970.

APPENDIX

Appendix A – Ice Miller Memo: Federal Tax Considerations and Questions Raised by Stakeholders related to a Potential Merger of LEOFF 1 / LEOFF 2

Appendix B – K&L Gates Memo

Appendix C – OSA Analysis: LEOFF 2 Board Request For Analysis of LEOFF 1 Risks

IceMiller
LEGAL COUNSEL

MEMORANDUM

Via Electronic Mail

TO: **Steven N. Nelsen, Executive Director**
Washington LEOFF Plan 2 Retirement Board

FROM: **Mary Beth Braitman and Robert L. Gauss**
ICE MILLER LLP

MBB

CC: **Tor Jernudd**
Washington State Office of the Attorney General

DATE: **November 28, 2016**

RE: **Federal Tax Considerations and Questions Raised by Stakeholders related to a Potential Merger of LEOFF 1 / LEOFF 2**

This Memorandum follows-up to our meeting on October 24, 2016 and our discussions at the recent Select Committee on Pension Proposals ("SCPP") hearing.

In particular, this Memorandum will address the federal tax considerations of a potential merger between LEOFF Plan 1 and LEOFF Plan 2 (collectively referred to as the "Plans"). In this regard, this Memorandum will address the federal tax considerations of a merger between two qualified governmental defined benefit plans in accordance with the Internal Revenue Code ("Code") and applicable Treasury Regulations. Last, this Memorandum addresses certain legal questions which were submitted to the SCPP by stakeholders related to a potential merger involving LEOFF Plan 1.

I. EXECUTIVE SUMMARY

As will be discussed in greater detail in this Memorandum, under the Code and applicable Treasury Regulations, the term "merger" means the actual merger of assets and liabilities of more than one qualified plan into a single plan where the assets and liabilities are "usable" across the spectrum of merged plans. In order for a merger to be considered "legal" or "valid" for purposes of federal tax law, each participant in the merging plans must receive benefits on a termination basis from the plan immediately after the merger which are equal to or greater than the benefits the participant would have received on a termination basis immediately before the merger. Code §§ 401(a)(12) and 414(l). In this regard, a plan member who has reached normal retirement age or reached other vested status under the merging plans must be vested in his/her accrued benefit as of that date. Finally, in order for a merger to be valid it must comply with the exclusive benefit rule under Code § 401(a)(2). Accordingly, as part of the merger, it must be impossible for any part of the corpus or income of the merged plans to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries before there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the Plans. Although there is not a current legislative proposal for the merger of LEOFF Plan 1 and LEOFF Plan 2, based upon our review of Senate Bill ("SB") 6668, we believe that if such a proposal contains the same features as in SB 6668, then it would be drafted to comply with the Code requirements for a valid merger.

In order to confirm that the merger would be approved by the Internal Revenue Service ("IRS"), we would normally strongly recommend that DRS and/or the Plans seek a new determination letter on the new merged plan in order to ensure its qualified status under the Code. Unfortunately, the Plans' ability to obtain a new determination letter will be limited by the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37). There may be a way to structure the merger – *i.e.* a new plan created by the two existing plans coming together – which would allow a determination letter request to be submitted. We would intend to discuss this with you in more detail if this proceeded. Regardless, we also recommend that the Plans and/or DRS seek a PLR to confirm that the merger does not result in any tax consequences for any affected members.

II. CONSIDERED MATERIALS

For purposes of this Memorandum, this will confirm that we have reviewed and considered the following information and legal opinions previously submitted to either the Office of the State Actuary ("OSA") or others regarding previously proposed mergers involving LEOFF 1:

1. 2011 LEOFF Merger Study by the OSA.

2. Letter from Mr. Robert Klausner to Mr. Steven Nelsen dated April 26, 2011.

3. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) dated May 2, 2011.

4. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated June 21, 2011.

5. Ice Miller letter to David Nelson at the Washington State Department of Retirement Systems ("DRS"), Anne Hall at the Washington State Attorney General's Office and Aaron Gutierrez at the OSA dated October 5, 2011.

6. Letter from Mr. J.E. Fischnaller to Mr. Matthew M. Smith dated October 22, 2011.

7. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 12, 2012.

8. Letter from Mr. J.E. Fischnaller to the LEOFF 1 Coalition Board dated January 30, 2012.

9. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck and Mr. Jerry Taylor dated January 31, 2012.

10. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck (President of the Retired Firefighters of Washington) and Mr. Jerry Taylor (President of Retired Seattle Police Officers' Association) dated February 1, 2012.

11. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated June 13, 2013.

12. Letter from Ice Miller LLP to Mr. Aaron Gutierrez (OSA) dated April 23, 2015.

13. Memorandum from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

14. Letter from Mr. Phil Talmadge to Mr. Dick Warbrouck dated February 29, 2016.

15. Letter from Mr. Robert D. Klausner to Mr. Dennis Lawson (President, Washington State Counsel of Firefighters) dated March 4, 2016.

16. The Actuary's Fiscal Note for SB 6668 dated October 27, 2016.

Also, for purposes of our consideration, please know that we have considered DRS's Comprehensive Annual Financial Report ("CAFR") for the year ended June 30, 2015 (this is the most recent CAFR available). In particular, we have considered:

- LEOFF Plan 1 had an actuarial value of assets in the approximate amount of $5.5 billion, it is stated to have a funding surplus of $1.1 billion and a funded ratio of 127%; and

- LEOFF Plan 2 had an actuarial value of assets in the approximate amount of $8.64 billion and a funded ratio of 107%[1].

Finally, this will confirm our understanding that the SCPP has been asked to perform an updated study of a potential merger of LEOFF Plan 1. In this regard, we understand that the possible scenarios for a merger with LEOFF Plan 1 involve either TRS Plan 1 or LEOFF Plan 2. However, based upon SB 6668, the contemplated merger is between LEOFF Plan 1 and TRS Plan 1. Notwithstanding, we also understand that LEOFF Plan 2 is updating the 2011 LEOFF Merger Study for consideration by the SCPP. Finally, we understand that SCPP, OSA, the AG's Office, DRS, each of the Plans and the members of each of the Plans collectively want to understand the requirements and/or restrictions for a potential merger for purposes of federal tax law.

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[1] The data regarding the funding and funded status of each plan was as of June 30, 2014, the most recent actuarial valuation date contained in the CAFR (pg. 160). We also understand that the Actuary's Fiscal Note for SB 6668 has not updated either the surplus analysis for LEOFF Plan 1 or the funded status of LEOFF Plan 1 from the analysis in the 2015 CAFR.

III. BACKGROUND

Before responding to the questions submitted to the SCPP, we want to consider the possible meanings of the word "merger." As discussed below, under the 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 "useable" across the spectrum of merged plans. This concept is to be distinguished from a number of other transactions. For example, policy makers may wish to consider forms of joint administration of plans, which we have referred to as "consolidation." We are aware that substantial consolidation already exists – for example, DRS administers LEOFF Plan 1, PERS and TRS (among a number of other plans) and the Washington State Investment Board handles the investments for each of the Plans. In this regard, each Plan's assets are strictly assets of each individual Plan – they are not "useable" across the spectrum of consolidated plans. For example:

- LEOFF Plan 1 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1969 session. It covers all full-time, fully compensated, local law enforcement and firefighters who established membership on or before September 30, 1977. The Plan is closed to new members. Based on membership data from the CAFR, there were 120 active members as of June 30, 2014 and 7,607 retired or inactive members. Based upon information from the OSA's 2015 Actuarial Valuation Report, there were 82 active members and 7,507 annuitants as of June 30, 2015. Based upon information provided to us, we understand there currently are 54 active members and 6,752 retired or inactive members in LEOFF Plan 1. LEOFF Plan 1 members are eligible for retirement at the age of 50 with five years of service. RCW 41.26.090. Also, members are vested after the completion of 5 years of eligible service. RCW 41.26.170. Based upon information in the CAFR (page 190), for the fiscal year ended June 30, 2015, LEOFF Plan 1 included 19 county and/or municipality employers and 4 other political subdivisions. Finally, LEOFF Plan 1 has certain local disability boards to adjudicate disability claims.

- LEOFF Plan 2 is a cost-sharing multiple-employer defined benefit plan which was established by the Washington State Legislature during the 1977 session and became effective October 1, 1977. LEOFF Plan 2 covers persons who first became members of the System on and after October 1, 1977. LEOFF Plan 2 is governed by the LEOFF Plan 2 Retirement Board, which is the policy-making board that studies pension issues, acts as fiduciary for LEOFF Plan 2, sets contribution rates and recommends pension policy to the legislature for LEOFF Plan 2 members. (RCW 41.26.705-735). Based upon the CAFR, as of June 30, 2014, LEOFF Plan 2 had 16,773 active members and 3,984 retired or inactive members. Members of LEOFF Plan 2 are all full-time, fully compensated, local law enforcement commissioned officers, firefighters, and, as of July 24, 2005, emergency medical technicians. Members are vested after the completion of 5 years of eligible service. RCW 41.26.530. Additionally, members are eligible for retirement at the age of 53 with 5 years of service. RCW 41.26.430. Based upon information in the CAFR, for the fiscal year ended June 30, 2015, LEOFF Plan 2 covered the State of Washington, 195 county and/or municipality employers and 157 other political subdivisions.

Under SB 6668, the assets and liabilities of TRS Plan 1 and LEOFF Plan 1 are proposed to be merged specifically to "improve the actuarial soundness of the teachers' retirement system plan 1 . . ." SB 6668 also stated that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Indeed, under Section 2 of SB 6668, the assets, liabilities and membership of LEOFF Plan 1 are proposed to be merged into TRS Plan 1. As a result, the current assets and liabilities of LEOFF Plan 1 are proposed to become the assets and liabilities of TRS Plan 1. Importantly, Section 3 of SB 6668 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." Further, the merger is proposed to not impact the disability board established in RCW 41.26.110 for LEOFF Plan 1. In order to entice LEOFF Plan 1 members, Section 6 of SB 6668 establishes that LEOFF Plan 1 members, including inactive vested members, retirees and survivors, shall be eligible to receive a $5,000 lump sum payable on either January 3, 2017 or on the member's retirement date, whichever is later (if there are multiple survivor beneficiaries for a single member, the lump sum shall be divided equally between those survivor beneficiaries).

Finally, the Actuary's Fiscal Note evaluates that the proposed merger under SB 6668 potentially results in an expected long-term total employer savings of about $2.1 billion through reduced contribution requirements over the next 25 years for employers of TRS Plan 1 (there are not currently any member or employer contributions required for LEOFF Plan 1 unless the most recent actuarial evaluation report shows the plan has unfunded liabilities). For purposes of the Actuary's Fiscal Note, the Actuary assumed that the LEOFF Plan 1 funding policy would remain in effect. However, the Actuary also discussed the possibility that, under pessimistic projections, remaining LEOFF Plan 1 members and their local employers would be required to contribute 6% of LEOFF Plan 1 salaries if LEOFF Plan 1 drops below its fully-funded status. Importantly, we understand that LEOFF Plan 2 is having the OSA conduct an updated fiscal analysis of the 2011 LEOFF Merger Study in order to report to the SCPP the potential savings from a LEOFF Plan 1 and LEOFF Plan 2 merger.

IV. OVERVIEW OF FEDERAL LAW - MERGER

In this section, we consider the federal tax law requirements for a plan merger – the rules that would apply to any merger of assets and liabilities of two or more governmental defined benefit plans. (We will not cover the situation where a governmental plan and a nongovernmental plan would merge, as we do not believe that would be pertinent or helpful in the current discussion.)

A. Source of Guidance

Governmental pension plans are subject to certain specific provisions of the Code and related Treasury Regulations. In general, governmental pension plans are not subject to the Employee Retirement Income Security Act of 1974 ("ERISA"). In lieu of ERISA provisions, governmental plans are often subject to pre-ERISA guidance from the Internal Revenue Service ("IRS") on a particular subject (*e.g.*, vesting at normal retirement age). Governmental plans may also follow ERISA provisions by analogy or as a "best practice."

B. Exclusive Benefit Rule

One of the threshold rules in the qualified plan world is the "exclusive benefit" rule. This rule dictates that plan assets cannot be used other than to pay benefits to members and beneficiaries and to pay reasonable administrative expenses. In this regard, Code § 401(a)(2) requires that for a plan to be qualified, it must be "impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries . . ." *See also* Treas. Reg. § 1.401-2(a). Accordingly, the IRS has held that "funds 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. It is important to note that the exclusive benefit rule is incorporated into each of the Plans at WAC 415-02-756.

C. Qualified Plan Status

Pre-ERISA guidance provides that only qualified plans under Code Section 401(a) may be merged. Revenue Ruling 67-213. 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.

D. 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 one (or all) of the merged plans had not terminated, but that determination is based on all the facts and circumstances involved in the merger.

E. Participant Elections

In some cases, policy makers may ask if they could give plan participants the option of whether or not to be part of a merger. Pre-ERISA, it was permissible to give participants the option of moving from one plan to another, so long as there was no option to receive a distribution. Rev. Rul. 67-213. However, at the current time, and as to a governmental plan, giving existing employees a choice among plans currently will not be approved by the IRS if the choice impacts the employees' pre-tax contributions and, as a result, creates a cash or deferred arrangement ("CODA"). Revenue Ruling 2006-43, 2006-35 I.R.B. 329; *see also* PLR 201532036.[2] While we recognize there are very few active employees (54) in LEOFF Plan 1, any active employees still would cause problems in terms of the IRS' prohibition on impermissible CODAs. Given the current prohibition in the IRS' position, we have set this potential approach aside, both because it would not seem to be a useful design in the circumstance and because it would raise issues that would likely significantly impede any resolution.

F. Assets/Liabilities

Pre-ERISA guidance applicable to governmental plans does not provide any specific guidance with respect to the treatment of the merger of assets and liabilities/benefits. Code §§ 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 the Legislature to comply with the exclusive benefit rule. We believe it would be difficult for the IRS to make an adverse decision on a merger that satisfied these essential IRS rules.

In this respect, the Code takes a broader position than might be expected. 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) (Emphasis added). This treatment is not limited solely to a merger, but also includes consolidation where the assets may be used for the consolidating plans. 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 and/or the assumption of

[2] While Private Letter Rulings ("PLRs") are only binding on the taxpayer to whom they are issued, they are instructive on the IRS' views regarding the issues covered in them.

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 vehicles used for the assets of 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(1)-1(b)(3).

In accordance with 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: (i) the date of termination upon normal retirement, (ii) the date of plan termination, and (iii) the date or discontinuance of employer contributions to the plan.

Importantly, based upon WAC 415-02-753(3) "[t]he Plan may only be terminated by action of the legislature and employer contributions must be paid in accordance with state law. In the event the legislature took action to terminate a plan, in whole or in part, or discontinue employer contributions to the plan, any applicable state law and constitutional protections would apply to accrued benefits. In such event, pursuant to the state and federal rules, a plan member's accrued benefit under the plan is nonforfeitable to the extent funded."

G. Benefit Changes

To the extent that a merger results in benefit changes post-merger, there would have to be a state law analysis with respect to pension protections under state law; this would include an analysis of federal and state constitutional protections. From a federal tax law perspective, the accrued benefit of a plan member (at the time of the merger) under the plan must be protected to the extent funded.

H. Plan Terms

A qualified plan must always follow its written terms and conditions, so long as those terms do not violate relevant federal and state law. 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. Separately, the amendment may state whether one or both of the plans are being terminated. Of course, a final analysis of the potential legal issues will depend on the structure of the merger as determined by the Legislature.

I. Taxation

To confirm that the merger of one plan into another does not have a taxation impact on the members, and considering the possibility that the merger could include one overfunded plan with an underfunded plan, we strongly recommend that a PLR be sought from the IRS. The purpose of the PLR would be to confirm that the merger complies with the exclusive benefit rule and the pre-ERISA vesting requirements, and does not result in any adverse tax consequences to the members.

J. On-going Compliance Post Merger

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

K. 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 is not necessarily treated the same as a merger - the treatment depends on whether the plan assets of a consolidating plan are available to fund benefits for any other consolidating plan or not, and, therefore does or does not raise issues with regard to vesting and valuation of benefits on a termination basis. *See* Treas. Reg. § 1.414(l)-1(b)(1)(v).

L. Reversion of Excess Assets

Under ERISA, for an employer to accept a reversion of excess assets, the plan must have always provided for such reversion or have been amended more than five plan years before the termination to permit a reversion. ERISA § 4044(d)(2). As a result, under ERISA, an employer is prohibited from amending a plan in conjunction with a plan termination to give excess assets back to the employer if the plan previously provided for a different allocation of excess assets. Even if an excess asset reversion to the employer is permitted, Code § 4980 imposes a tax of 20% of the amount of any employer reversion from a qualified plan. The 20% excise tax may be increased to 50% of the reversion from a qualified plan if the employer does not establish or maintain a qualified replacement plan or the employer does not provide a pro rata increase in the accrued benefits of all qualified participants. Code § 4980(d). However, the ERISA requirements related to plan amendments and the excise tax on a reversion of qualified plan assets to the employer specifically **do not apply to a governmental plan**. Code § 4980(c)(1)(B). As a matter of interest, the Treasury Regulations specifically recognize that a merger likely would involve a "lower funded plan." Treas. Reg. § 1.414(l)-1(b)(6). These rules are all part of the federal plan insurance provisions of ERISA and the Pension Benefit Guarantee Corporation, and consequently, the parallels and basics are quite different between governmental plans (not covered by the federal plan insurance program) and nonqualified governmental plans. Therefore, we would not anticipate using these provisions in the governmental settings.

Based upon WAC 415-02-753, without further amendment to the Plans by the Legislature, the Legislature could discontinue or modify employer contributions to the remaining/resulting plan as part of the merger. Based upon certain questions raised during the SCPP hearing on November 15, 2016, it is important to note that if a merger involving LEOFF

Plan 1 included a reduction in employer contributions in the merged plan, such a reduction in employer contributions would not constitute a reversion of excess assets for purposes of either ERISA § 4044 or Code § 4980.

V. CONSIDERATION OF SPECIFIC MERGER POSSIBILITIES

Based upon our discussions with you, we understand that the possible merger transaction for purposes of the update to the 2011 LEOFF Merger Study would include one of the following scenarios (we have shown what we assume are the most likely scenarios):

1. Merger of LEOFF Plan 1 and LEOFF Plan 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 plan 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 LEOFF 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 current active members.

Using Code § 414(l) as a guide, and in accordance with WAC 415-02-753, members 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. This would be true under the 414(*l*) model, where the benefits have to be tested as though there had been a plan termination, even though there is not necessarily a plan 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' (mandatory) contributions were adjusted. That would be a matter of state law and plan design.

2. Merger of LEOFF Plan 1 and LEOFF Plan 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 LEOFF Plan 2 separately is considering whether benefits can be changed as part of the merger from a state law perspective, including an analysis of vested rights.

From a federal tax law perspective, a plan member 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 all benefits <u>accrued to date</u> for participants in LEOFF Plan 1 cannot be changed as part of a proposed merger. To the extent that participants in LEOFF Plan 2 have reached normal retirement age and met the requirements for vesting, those benefits <u>accrued to date</u> also cannot be changed. Therefore, any benefit change that is adopted as part of a merger could only affect new members (of which there would be none), non-vested members (of which there are very few) and/or vested members (which constitutes virtually all of the members) prospectively with regard to future accruals.

If this approach is taken, we believe there is a good chance the new plan could secure a determination letter, even under the IRS' new restricted determination letter program.

3. 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.

VI. <u>IRS APPROVAL</u>

Finally, if some type of merged or consolidated plan is passed by the Legislature, then we strongly recommend that the Plans and/or DRS seek a new determination letter on the new structure in order to ensure the qualified status of the new structure under the Code. Of course, this would be dependent on whether a new plan is being created or any plan(s) is/are being terminated as part of the merger. Also, whether a determination letter can be requested will have to be determined in accordance with the IRS' new procedures for determination letters for individually designed plans (*see* Revenue Procedure 2016-37).

If some type of asset transfer is passed by the Legislature, then we also recommend that the Plans and/or DRS seek a PLR to confirm that the transfer does not result in any tax consequences to any affected members. This is not affected by the new determination letter changes, and should be done regardless of whether the determination letter process is available or not.

VII. LEGAL QUESTIONS RAISED BY STAKEHOLDERS OF THE POTENTIAL MERGERS

Considering the background information contained in this Memorandum, we have answered certain questions which were raised and submitted to the SCPP by stakeholders of the Plans being considered for a potential merger (at least LEOFF Plan 1 and TRS Plan 1, if not also stakeholders from LEOFF Plan 2). Those stakeholder questions and answers are being attached to this Memorandum as Appendix A.

VIII. CONSIDERATIONS RELATED TO SB 6668

We certainly understand that SB 6668 proposes a merger between LEOFF Plan 1 and TRS Plan 1. Additionally, we understand that there currently is not a legislative proposal for the merger of LEOFF Plan 1 with LEOFF Plan 2. However, if a proposed merger of LEOFF Plan 1 and LEOFF Plan 2 contains certain features which are included in SB 6668, then we believe the proposed merger would be intended to comply with the Code's requirements for merger. In particular, Section 2 of SB 6668 states that the Legislature intends that the merger of assets, liabilities and membership will be accomplished in a way which does not impact benefits provided to members of either plan. Further, Section 3 states that "each member of each of these plans is entitled to receive benefits immediately after the merger on the effective date of this section that are equal to the benefits the member would have been entitled to receive immediately before the merger in accordance with plan terms." In this regard, we note that the merger proposes to retain the disability board for LEOFF Plan 1, including any official action of those boards. Therefore, to the extent that the LEOFF Plan 1 disability board structure is a vested right in accordance with state law, the vested benefit appears to be preserved as part of the proposed merger. Similarly, we note that SB 6668 does not contemplate a distribution of surplus assets from LEOFF Plan 1 (to the state and/or LEOFF Plan 1 participating employers) as part of the merger. Accordingly, in its current form, SB 6668 does not contain a reversion of excess assets. Finally, we note that under Section 15 of SB 6668, the proposed merger is intended to comply with the Code, including Code § 401(a) (which contains the exclusive benefit rule at Code § 401(a)(2)).

Based upon the analysis of the federal tax considerations related to a merger which we are providing in this Memorandum, if a merger of LEOFF Plan 1 and LEOFF Plan 2 contained the same requirements as contained in SB 6668, then we believe the merger would be intended to comply with the Code requirements for a valid merger, including Code §§ 401(a)(2), 401(a)(12) and 414(l).

IX. CONCLUSION

We hope that this Memorandum provides LEOFF Plan 2 with pertinent information regarding the federal tax considerations for its update of the 2011 LEOFF Merger Study. Of course, if you have any questions or comments regarding our analysis, or if there is any additional information (or proposed legislation) you would like us to consider, please do not hesitate to let us know.

APPENDIX A

A. Goals

Question No. 1: What is the purpose of a merger?

Answer No. 1: As discussed in Section IV (especially Section IV.F.), under the Code, the purpose of a merger generally is to merge the assets and liabilities of two or more plans into a single plan. As a result, the assets and liabilities become useable across the spectrum of the merged plan.

Question No. 2: Why merge two different entities?

Answer No. 2: The question is somewhat confusing to us because of the use of the word "entities." Assuming that "entities" means plans, we believe the reason a Legislature could be considering a merger would be to consolidate the assets and liabilities of the Plans. Presumably, the fact that LEOFF Plan 1 is a better-funded plan (based on the most recent actuarial analysis) is a factor in the Legislature's consideration.

Question No. 3: Why not merge other plans instead? For example:

(a) All state plans into one with the same benefits?

(b) Legislator's pension plan with the Teachers' Retirement System 1 (TRS 1)?

(c) Public Employees' Retirement System (PERS 1), TRS 1, and the Law Enforcement Officers' and Fire Fighters' Plan 1 (LEOFF 1) into one big plan?

(d) Washington State Patrol Retirement System with TRS 1?

(e) Public Safety Employees' Retirement System with LEOFF 2?

(f) LEOFF 2 with TRS 1?

(g) TRS 1 with TRS 2?

Answer No. 3: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 4: How would a merger benefit:

(a) LEOFF 1 members?

(b) Employers?

Answer No. 4: As discussed in Section IV.F. and G., the merger does not automatically result in enhanced benefits for LEOFF Plan 1 members. Whether enhanced benefits will be provided is a determination for the Legislature. As it relates to participating employers, depending on the actuarial analysis of the merger, the merger could result in a long-term cost savings for the employers.

Question No. 5: Why not wait until all benefits are paid out?

(a) What would happen to the surplus after all remaining members have died?

Answer No. 5: Why not wait until all benefits are paid out raises a policy decision for the Legislature. However, if the Legislature waited until all remaining members of LEOFF Plan 1 have passed away and all liabilities under the Plan have been satisfied, in accordance with Code § 401(a)(2) and Treas. Reg. § 1.401-2(a), and WAC 415-02-753 and 756, the remaining assets would be returned to the employers involved in LEOFF Plan 1.

Question No. 6: Will the merger be temporary?

(a) *i.e.*, once TRS 1 is fully funded, will they be unmerged?

(b) Would it be like a loan of funds, with interest?

Answer No. 6: As discussed in Section IV.F., a merger is not temporary nor is it like a loan of funds (with or without interest). Instead, the merger results in combining two (or more) Plans into a single Plan. Whether there would be any future separation of the merged plans would be a future decision for the Legislature.

Question No. 7: Benefit improvements.

(a) Can LEOFF 1 and LEOFF 2 be merged to allow enhanced LEOFF 2 benefits like medical benefits, a higher multiplier, or earlier retirement?

(b) Can any excess funding in LEOFF 1 be used to increase benefits for LEOFF 1 members instead?

Answer No. 7: As discussed in Section IV.G., a merger does not automatically result in enhanced benefits for the members of either plan (the plans) being merged. Whether enhanced benefits will be provided is a determination for the Legislature. As discussed in Section IV.F., as a matter of federal tax law, members in a merged plan must be vested and entitled to benefits calculated on a termination basis from the Plan immediately after the merger which are equal to or greater than the benefits the members would have been entitled to on a termination basis immediately before the merger, consolidation or transfer. *See also* Treas. Reg. § 1.414(l)-1(a)(2).

For purposes of federal tax law, assuming compliance with the exclusive benefit rule, members must be vested in their benefits, (not in an allocated account balance based on an actuarial equivalent of their benefits). Finally, as discussed in Section IV.H., the Legislature would have to pass specific amendments to modify the Plans being merged.

B. Legal

Question No. 8: Is a merger legal?

(a) What legal entities control (*e.g.*, Internal Revenue Service (IRS), State Supreme Court)?

(i) What are their respective roles and jurisdictions?

(b) What case law is relevant, and what does it tell us?

(i) Does it prevent/prohibit a merger?

(ii) Will the *Bakenhus* case apply to the new plan?

(c) What are the terms of the contract that exists between LEOFF 1 members and the state?

(i) *i.e.*, what do members have a right to?

(ii) Benefits?

(iii) Funding plan?

(iv) Cash in the trust fund?

(1) Are LEOFF 1 members vested in the money itself?

(2) *i.e.*, is the money being "stolen" from the trust fund?

(d) What laws need to be changed to complete a merger?

(e) What protections exist for vested rights and financial interests of plan participants?

Answer No. 8: Federal law controls the continuation of the qualified status of the plans involved in a merger. The federal law on mergers focuses on the protection of each member’s/survivor's benefit payable from the separate plans and from the merged plan. As a matter of federal tax law, and as discussed in Section IV.F., a merger is a combination of the assets and liabilities of two or more qualified defined benefit plans. Accordingly, based upon the IRS' rules, a merger is legal provided that there is compliance with the exclusive benefit rule and, in accordance with Code § 414(l), the members of the merged plans receive the same benefits after a merger or transfer of assets as they would have received before the merger. This rule must be met in order to retain the qualified status of the funds involved. Consequently, federal law covers the vested rights of the members' and individuals' benefits pre and post-merger.

Whether members have a vested right to certain features or assets (the "contract" between LEOFF/members and the state) under each of the Plans, (as opposed to their individual benefits) would require an analysis of Washington State law which is not being provided as part of this Memorandum. As to the questions about case law, based upon our review of the prior legal opinions from other attorneys which we listed in Section II, we anticipate that the State law analysis would include an analysis of the case *Bakenhus v. City of Seattle*, 48 Wn.2d, 695, 296 P.2d 536 (1956) and its progeny.

Question No. 9: Who are the fiduciaries for each plan?

(a) Is the Legislature a fiduciary to both the plan and the general state?

Answer No. 9: Determining who are the fiduciaries of a qualified plan generally is based upon an analysis of common law trust principles and state law requirements. This primarily is because in accordance with Treas. Reg. § 1.401-1(a)(3)(i), one of the requirements for a qualified plan is that the plan assets must be held in trust. We note that RCW 43.33A.030 vests trusteeship of the Plans' assets in the voting members of the State Investment Board. Also, under RCW 41.50.060 the Director of DRS is responsible for the Plans and, under RCW 41.50.077, the State Treasurer is the custodian of funds of the Plans. ERISA § 3(21) defines a "fiduciary" with respect to a plan as a person to the extent (i) the person exercises any discretionary authority or discretionary control respecting management or dispositions of its assets, (ii) the person renders investment advice for a fee or other compensation or has authority of responsibility to do so, or (iii) the person has any discretionary authority or discretionary responsibility in the administration of the plan. Code § 4975(e)(3) defines "fiduciary" (for purposes of prohibited transactions) in essentially the same manner:

(3) Fiduciary.

For purposes of this section, the term "fiduciary" means any person who –

(A) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets,

(B) lends investment advice for a fee or other compensation, direct or indirect, with respect to any monies or other property of such plan, or has any authority or responsibility to do so, or

(C) has any discretionary authority or discretionary responsibility in the administration of such plan.

Based upon these federal definitions, we believe that the IRS would consider DRS, the Washington State Investment Board ("WSIB"), the individual WSIB Board members, the LEOFF 2 Retirement Board, and the individual LEOFF 2 Board members, as fiduciaries. In addition, there would be a number of financial and investment related fiduciaries (*e.g.*, registered investment advisors to DRS and WSIB), custodial bank(s), *etc.*) likely are considered fiduciaries of the Plans for purposes of state law.

Question No. 10: Who owns the surplus?

(a) Does case law from Alaska on excess funding show that any surplus belongs to the members?

Answer No. 10: As a matter of federal tax law, unless the plan terms specify otherwise, the employer (or employers) sponsoring the plan generally owns any surplus but only once there has been a complete satisfaction of all liabilities with respect to employees and their beneficiaries under the trust. *See* Treas. Reg. § 1.401-2(b). Plan terms can establish a different structure.

We defer to the Washington state law analysis on whether the Alaska case law would be persuasive to Washington.

Question No. 11: Will there be any direct tax impact on the members?

(a) *e.g.*, will a medically disabled member lose their individual tax exempt status?

Answer No. 11: A merger would not change the tax treatment of any benefits to members of LEOFF Plan 1 (or to the members of another plan with which LEOFF Plan 1 might be merged). So, a LEOFF Plan 1 member who is receiving a service-connected disability benefit which is exempt from federal taxation (whether in whole or in part) would continue to receive the same tax treatment of his/her disability benefit after a merger.

Question No. 12: Are there any other IRS issues?

(a) What would be the impact of an unfavorable opinion by the IRS?

(i) What are the range of outcomes?

(ii) Would the plan members be made whole/held harmless under those scenarios?

(1) If so, how?

(iii) Would the merger be undone?

(1) If so, how?

(b) Does each plan's funded status impact the ability to merge?

Answer No. 12: If the IRS did not approve the merger, the results could range from i) the IRS requiring the Legislature to cease the merger, ii) the IRS requiring the Legislature to make necessary amendments to the merger to address the concern(s) raised by the IRS, to iii) the ultimate penalty by the IRS is disqualification of the underlying plans and/or the merged plan. Disqualification of the underlying plans would be an extreme result, which typically would only be considered if the merger disregarded the exclusive benefit rule or did not provide benefits to participants in the merged plans which were at least equal to or greater than the benefits the members would have received on a termination basis immediately before the merger.

To the extent that any of the involved plans were disqualified by the IRS that would raise an individual taxation issue for the involved members. Whether the affected plan, DRS or the state would reimburse the members or hold them harmless from the potential taxes would depend on legislative action.

Finally, as discussed in Section IV.L., each plan’s funded status does not affect the ability to merge. *See also* Treas. Reg. § 1.414(l)-1(b)(6).

Question No. 13: How will the state pay if it needs to defend a merger in court?

Answer No. 13: Whether or not legal expenses incurred to defend a merger in court are appropriate plan expenses or whether they are settlor expenses which should be paid by the State are questions of both federal law and state law. From the federal law perspective, protection of a plan's qualified status could be argued to be a reasonable and necessary expenditure of the affected plan.

We leave the state law analysis to others. We note that RCW 41.50.255 authorizes the director of DRS to pay from the interest earnings of the trust funds of the Plans lawful obligations of the appropriate [retirement] system for legal expenses which are incurred for the purpose of protecting the appropriate trust fund or are incurred in compliance with statutes governing such funds.

Question No. 14: Can you charge separate rates for the different tiers of benefits within a merged plan?

Answer No. 14: Governmental plans, whether or not merged, are able to have different employee and/or employer contribution rates between tiers in the plan.

Question No. 15: Is a plan trust more like an escrow account to pay benefits or a savings/investment account to accumulate funds?

Answer No. 15: A plan trust is neither an escrow account nor a savings/investment account. Rather, it is a trust under Washington State law, governed in part by federal law, in which employee and employer contributions are held and co-invested for the payment of benefits under the terms of the plan.

Question No. 16: Is there a process for appealing or opposing a merger?

Answer No. 16: This is a question of state law.

Question No. 17: Would employers receive refunds for contributions used for members of another system?

Answer No. 17: As discussed in Section IV.L., the Legislature can decide how to handle any excess assets. *See also* Answer Nos. 10 and 34.

Question No. 18: Are plan members trustees or fiduciaries of their plans?

Answer No. 18: In general, no. However, a plan member may be a trustee or a fiduciary in his/her individual capacity. *See* Answer No. 9.

C. Fiscal/Actuarial

Question No. 19: Historical.

(a) How did gainsharing impact TRS 1?

(i) Is that partly why LEOFF 1 is in such good shape and TRS 1 is not?

(b) What is the funding history for each plan?

(i) Who paid what?

(c) Is LEOFF 1 cost sharing the same as other plans?

(i) *i.e.*, did the state only put in 20 percent of contributions?

(d) What would have happened if there had been no general fund contributions to LEOFF 1?

(i) Or the Prior Act systems (*e.g.*, City of Seattle)?

Answer No. 19: These are historical and actuarial questions which are not being addressed by this Memorandum.

Question No. 20(a): Related to a merger.

(a) What is the financial situation before and after?

(i) What does the "surplus" represent?

(1) Is it the excess of funds needed to pay benefits this month? This year?

(ii) Is the surplus "real" or just projected?

(1) How reasonable is the investment return assumption?

(2) What would it look like under alternate scenarios (*e.g.*, 7 percent or 6 percent)?

(iii) If the surplus disappears, would it be too late to insure the LEOFF 1 benefits?

(1) *e.g.*, ensuring payment under a pay-go scenario versus insuring through plan immunization.

(iv) Would a merger be revenue neutral?

Answer No. 20(a): *See* Answer No. 10. Also, the current funding level of each Plan, and whether each Plan has a funding surplus or funding deficit of plan assets necessary to satisfy the benefits obligations under each Plan, is a matter of actuarial analysis. The actuarial analysis will state the assumptions used as part of the analysis. To the extent that a merged plan would have a deficit of total plan assets, *see* Answer No. 20.c. Finally, we do not understand the question as to whether a merger would be revenue neutral. Rather, whether something is "revenue neutral" to a plan typically means that an increased benefit is offset by an increase in contributions (whether employer or employee). In other words, the increased benefit is considered to be revenue neutral because the plan's net revenues remain unchanged (*i.e.* the cost is offset by the increased contributions).

Question No. 20(b):

(b) How might the funds be used?

(i) Clarify: Usable across the merged plan vs. usable outside either of the retirement plans (other obligations).

(ii) Should it be treated like a reserve for LEOFF 1 only?

(iii) Can money be "skimmed out" of the fund during transfer from LEOFF 1 to TRS 1?

Answer No. 20(b): As discussed in Section IV.F., under a merger, a transfer of assets and liabilities occurs when there is a diminution of assets or liabilities with respect to one plan and the acquisition of these assets or the assumptions of these liabilities by another plan. *See* Treas. Reg. § 1.414(l)-1(b)(3). Further, based upon the pre-ERISA minimum vesting standards, if qualified governmental defined benefit plans are merged, they are required, to the extent funded, to have 100% vesting of benefits accrued to the date of merger. Accordingly, if a merger combined LEOFF Plan 1 and another Plan, but the Plan assets of LEOFF Plan 1 were not available to pay for benefits other than for the original members (and beneficiaries) of LEOFF Plan 1, then a merger will not have occurred, and assets of one plan could not be used for payments to members of another plan. *See* Treas. Reg. §§ 1.414(l)-1(b)(1)(v) and 1.414(l)-1(b)(2). If the assets were combined to pay benefits for both plans, there would be a merger, and the federal laws explained above would apply.

In this regard, the assets of LEOFF Plan 1 are not considered “skimmed out” of the LEOFF Plan 1 trust fund. Rather, the assets of LEOFF Plan 1, TRS Plan 1 and/or LEOFF Plan 2 remain in the merged plan and are combined into a single trust to pay benefits to all members and beneficiaries of both plans. Treas. Reg. §1.414(l)-1(b)(2).

Question No. 20(c):

(c) What happens in the event of a deficit?

(i) If the funded status were 87 percent, would that mean I only get 87 percent of my current check amount?

(ii) Before merger?

(iii) After?

(iv) Who pays what?

(v) Who will be paid first? (Overlap with legal/admin analysis)

(vi) Could the state default on the pensions?

Answer No. 20(c): As discussed in Section IV.F., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. It is important to note that we are not aware that the merger concept to be used would provide an immediate liquidation of the trusts, which would raise, at least in part, the concept of a reduced benefit. Instead, we anticipate that the members in pay status would continue to receive their full monthly benefits, unless otherwise legally altered by the legislature. These benefits would be paid by the merged plan. Of course, the ultimate funding level of the merged plan and cost of benefits from the merged plan depends on plan earnings, market value of investments and the actuarial experience of the merged plan, including mortality experience. Finally, this answer is ultimately dependent on the analysis of state law issues regarding vested rights.

Question No. 20(d):

(d) Would there be other costs (*e.g.,* admin)?

Answer No. 20(d): Certainly, it should be anticipated that a merger would have an increase in administrative costs in the short term. However, it also should be anticipated that there may be savings in administrative costs over a longer term because there could be some cost savings in only administering one plan as opposed to administering two separate plans.

Question No. 20(e):

(e) How would a merger impact financial reporting (GASB) for state and local governments?

Answer No. 20(e): Based on the actuarial analysis of the merged plan, we would expect that the required financial reporting under GASB 67 (for the merged plan) and the required financial reporting under GASB 68 (for the participating employers in the merged plan) would be different than the financial reporting would have been if the merger did not occur.

Question No. 20(f):

(f) Who is constitutionally liable for future benefit payments?

Answer No. 20(f): The constitutional obligation for future benefit payments under the merged plan is not a matter of federal tax law. Notwithstanding, *see* Answer No. 20.c.

<u>Question No. 20(g):</u>

(g) Are there other options to address TRS 1 underfunding?

<u>Answer No. 20(g)</u>: Whether there are other options to address underfunding in TRS Plan 1 is not a matter of federal tax law. Rather, it is a policy determination to be made by the Legislature.

D. Benefits

<u>Question No. 21:</u> Will benefits be impacted?

(a) *i.e.*, can they be reduced?

(b) Will benefits be increased in exchange for the merger?

(i) Would LEOFF 1 benefits be given to teachers?

(1) *e.g.*, will TRS 1 members receive health benefits similar to LEOFF 1?

(c) Would LEOFF 1 be paying for TRS 1 benefits?

(d) Will it impact rights for Prior Act City of Seattle or Seattle Police Pension Board (which "interprets the rights" for members)?

(e) Will this include survivor benefits?

(f) Will benefits be interrupted (*e.g.*, are there any administrative issues that might delay issuing checks)?

<u>Answer No. 21:</u> *See* Answer Nos. 20.b. and 20.c.

<u>Question No. 22:</u> Will COLAs be impacted?

(a) Can TRS 1 COLA be reinstated without negative impact to LEOFF 1?

(b) Can LEOFF 1 COLAs be modified so as to not be dependent on date of retirement?

<u>Answer No. 22:</u> As discussed in Answer Nos. 8 and 20.c, as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether COLAs under LEOFF Plan 1 and LEOFF Plan 2 (or TRS Plan 1) are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 23: Will medical coverage be impacted?

(a) LEOFF 1

(i) Source of medical benefit payments?

(ii) Disability boards.

(iii) Can it be provided to spouses?

(b) TRS 1 PEBB subsidy?

Answer No. 23: As discussed in Answer Nos. 8 and 20.c., as part of a merger, each member must be entitled to benefits on a termination basis from the Plan immediately after the merger or transfer which are equal to or greater than the benefits the member would have been entitled to on a termination basis immediately before the merger or transfer. Whether medical benefits under LEOFF Plan 1 and LEOFF Plan 2 (or TRS Plan 1) are vested rights requires an analysis under Washington State law which is not being provided as part of this Memorandum.

Question No. 24: Will survivor benefits be impacted?

(a) Are reductions for survivor benefits considered contributions to the plan?

Answer No. 24: *See* Answer Nos. 22 and 23.

Question No. 25: Will LEOFF 1 have priority in benefit payments over TRS 1?

Answer No. 25: As discussed in Section IV.F. and Answer No. 8, based upon the IRS' rules, the members of a merged plan receive the same benefits after a merger or transfer of assets as they would have received before the merger. Each member's/survivor's benefits payable from the separate plans are protected and become payable by the merged plan. Therefore, it would not be appropriate for one of the merged Plan's members to have priority in the payment of benefits after a merger.

Question No. 26: Will I still be considered a "retired police officer" as opposed to a general state retiree?

(a) Does this definition have legal implications (*e.g.*, qualifying for certain benefits) or just personal ones?

Answer No. 26: For the reasons discussed in Answer No. 11, and for purposes of federal tax law, whether a member qualifies as a "qualified public safety employee" under the Code will not be affected by a merger.

Question No. 27: Under SB 6668, could members individually refuse the $5,000 lump sum?

Answer No. 27: Based upon our understanding of SB 6668, there is not a provision to specifically allow LEOFF Plan 1 members to individually refuse the lump sum defined benefit which was contemplated under Section 6. If they have an unrestricted right to the benefit, it does present a question of whether federal constructive receipt concepts would apply. We think the better answer would be that the federal constructive receipt concept would not apply and, instead, benefits would only be taxed when received under Code Section 402. Whether LEOFF Plan 1 members would be eligible to disclaim the lump sum defined benefit would be a State law consideration.

E. Governance

Question No. 28: Will governance be impacted?

(a) Will there be equal representation on the LEOFF 2 Board?

(b) Will LEOFF 1 oversee TRS 1 benefits?

(c) Will LEOFF 2 Board control LEOFF 1 benefits?

Answer No. 28: Certainly, governance of the merged plan is something which should be addressed by the Legislature. Notwithstanding, to the extent that either LEOFF Plan 2 or TRS Plan 1 is not part of the merger, then, presumably, there would not be any change to the governance and/or administration of LEOFF Plan 2 or TRS Plan 1.

F. Other General Questions

Question No. 29: Is this a redistribution of the member's income?

Answer No. 29: For the reasons discussed in Answer No. 20.b., no.

Question No. 30: Would a LEOFF1/TRS 1 merger impact LEOFF 2?

Answer No. 30: For the reasons discussed in Answer No. 28, no.

Question No. 31: Would a LEOFF 3 be created for new hires?

Answer No. 31: This question is better directed to the Legislature as it involves a policy issue.

Question No. 32: Can LEOFF 1 members opt out and "take their money out" entirely?

Answer No. 32: Unless the Legislature decided to change the distribution rights of LEOFF Plan 1 members as part of the merger, the members of LEOFF Plan 1 would be limited to the Plan's current provisions related to the distribution of benefits.

Question No. 33: Is lump sum still on the table? If so:

(a) Some feel it should be higher than $5,000.

(b) Why not pay it now, regardless of a merger?

(c) Employers would like a share.

Answer No. 33: These questions are better directed to the Legislature as they involve policy decisions.

Question No. 34: Can any excess be distributed every few years: one-third state, one-third employer, one-third member?

Answer No. 34: As discussed in Section IV.L., generally the Legislature can decide how to handle any excess assets. However, the IRS likely would not approve a reversion of plan assets before all obligations were liquidated. For example, if commercial annuities were purchased for all members/survivors pursuant to the respective plan terms, the IRS likely would determine that after the annuities were purchased, then (and only then) could the Legislature provide for a distribution of excess assets. We do note that SB 6668 does not currently contemplate a distribution of excess assets.

Question No. 35: Even if the overall idea is sound, could a mistake in administration jeopardize benefits?

Answer No. 35: As a matter of federal tax law, mistakes in administration are considered operational failures which can be corrected in accordance with Revenue Procedure 2013-12 (which recently was amended by Revenue Procedure 2016-51 effective January 1, 2017). The IRS' correction procedures are intended to help qualified plans correct their failures and preserve their qualified status.

Question No. 36: Why not just increase the contribution rates for new members of these plans?

Answer No. 36: This question is better directed to the Legislature as it involves a policy issue.

Question No. 37: Will the state be able to make further changes after a merger (*i.e.* slippery slope)?

Answer No. 37: This question is better directed to the Legislature as it involves a policy issue. Notwithstanding, it should be noted that a merger of the Plans does not necessarily preclude the Legislature from making other plan changes. However, all the federal restrictions would still apply. In other words, the exclusive benefit rule must be followed and the members of the merged plans must receive the same benefits after a merger or transfer of assets as they would have received before the merger. *See* Answer No. 8.

Question No. 38: Could recruitment be impacted by a merger?

Answer No. 38: This is not a question of federal tax law.

Question No. 39: How does a merger benefit taxpayers?

Answer No. 39: This question is better directed to the Legislature as it involves a policy issue.

Question No. 40: Will plan members retain their voting rights in plan governance?

Answer No. 40: *See* Answer Nos. 28 and 57.

Question No. 41: Are pension plans governed by local oversight boards, and will those boards be allowed to vote on a proposal?

Answer No. 41: *See* Answer Nos. 28 and 57.

Question No. 42: Can LEOFF 1 members cash out of the retirement system entirely?

Answer No. 42: *See* Answer No. 32.

G. Concerns

Question No. 43: Benefits should be fully funded.

Question No. 44: Funds should be kept separate – TRS with TRS, *etc.* – and never go back to the general fund.

Question No. 45: A plan should not be merged with a "lesser" plan.

Question No. 46: LEOFF 1 should be administered locally, and not be "some unknown voice in Olympia."

Question No. 47: LEOFF 1 funding was frozen in 2000 without consent of members.

(a) Some members feel employer contributions should have continued up until now.

(b) Some members feel the remaining active members should have been paying over the last 16 years.

Question No. 48: LEOFF 1 system was forced on city and county plan members.

Question No. 49: LEOFF 2 benefits are already substantially higher than LEOFF 1.

Question No. 50: The LEOFF 1 funded status should never drop below 125 percent.

Question No. 51: Transparency in process.

(a) All stakeholders need sufficient notification of any potential changes or discussions.

(b) Members of the plan should be able to vote since it is their plan and not the Legislature's.

Question No. 52: Dual member provisions for members who leave LEOFF 2 should be reviewed.

Question No. 53: There is no guarantee the state will make required contributions.

Question No. 54: Employers have expressed concerns about medical benefits being expanded.

Question No. 55: Local governments are facing high costs for LEOFF 1 medical.

Answer Nos. 43-55: To the extent that Question Nos. 43-55 are questions, they should be directed to the Legislature as they involve individual policy issues/considerations.

Question No. 56: Any payout must be conditional on IRS approval.

Answer No. 56: For the reasons discussed in Section VI, we agree that approval of a merger should be obtained from the IRS before a merger is finalized.

H. Additional Questions

Question No. 57: Will it require a vote of all members and beneficiaries to agree to the merger before a merger can occur.

<u>Answer No. 57:</u> As a matter of federal tax law, unless the respective Plans' terms specifically require it (which we do not see that they do), a vote of all members and beneficiaries is not necessary to agree to a merger before it may occur.

<u>Question No. 58:</u> Has the Legislature reserved its right to change the pension system?

<u>Answer No. 58:</u> Ultimately, this is a question of state law, and, therefore, is not being addressed by this Memorandum.

<u>Question No. 59:</u> Is the LEOFF 2 Board a vested right to which members are constitutionally entitled?

<u>Answer No. 59:</u> Whether or not the establishment of the LEOFF Plan 2 Board is a vested right is not a matter of federal tax law. Rather, it is a matter of state law.

<u>Question No. 60:</u> Is a merger of the two plans, where the merger reduces assets, a violation of members' and retirees' constitutional rights?

<u>Answer No. 60:</u> This is a question which is being analyzed separately by the AG's Office. However, it should be noted that a merger itself cannot inherently reduce plan assets.

<u>Question No. 61:</u> Is there a history of mergers in Washington and have there been any legal challenges to mergers in LEOFF 1? How about in 1970 when LEOFF 1 began?

<u>Answer No. 61:</u> This is not a question which is being addressed by this Memorandum.

<u>Question No. 62:</u> Are one or the other of the plans terminated?

<u>Answer No. 62:</u> Whether one of the Plans is being terminated as part of a merger is a determination to be made by the Legislature as a part of the design of the merger. For purposes of federal tax law, and as discussed in Section IV.D., a merger does not require the termination of one of the Plans being consolidated.

<u>Question No. 63:</u> Do the plan terms prevent a merger?

<u>Answer No. 63:</u> As a matter of federal tax law, we do not believe that the Plans' terms prevent a merger.

<u>Question No. 64:</u> If merger is found to be illegal, how do we un-merge? How do you separate the funds? What will happen to the $xxxx that is given to each LEOFF 1 member/retiree/beneficiary – how are you going to get that back?

Answer No. 64: Because we strongly recommend that both a PLR and an updated determination letter (if a new plan is being created or if one or both of the merged plans are being terminated) be obtained from the IRS as part of the merger, the merger would be contingent on receiving these favorable rulings from the IRS. If this is done, there would not be any concern about having to "unwind" a merger based upon an unfavorable ruling by the IRS.

Question No. 65: Can we get the process underway for IRS review of the merger?

Answer No. 65: It is important to note that the IRS will not issue a PLR on a "hypothetical" situation. Accordingly, a piece of "draft" legislation likely would not be considered by the IRS for purposes of a PLR. Similarly, the IRS will not issue a determination letter on a "hypothetical" basis. Rather, the IRS will only consider a determination letter request based upon an action which has been authorized and/or is in process.

K&L GATES

Appendix B

December 5, 2016

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Re: Proposed Merger

Dear Mr. Nelson and Mr. Jernudd:

The Law Enforcement Officers and Firefighters Retirement System Plan 1 ("LEOFF 1") and the Law Enforcement Officers and Firefighters Retirement System Plan 2 ("LEOFF 2") are defined benefit pension plans. LEOFF 2 is governed by a Board of Trustees ("LEOFF 2 Board"). It is our understanding that the LEOFF 2 Board has been asked to review the legal issues raised by a merger of LEOFF 1 and LEOFF 2. Our firm has been asked to provide analysis and advice on a proposed merger of LEOFF 1 and 2.

This memorandum will address whether the Contracts Clause of the Washington Constitution would limit, preclude or affect the merger of these two public pension plans in Washington. As part of this analysis, we will address the following:

- Whether the funded status of the plans, both before and after merger, would impact these issues;
- Whether the open or closed status of the plans, both before and after merger, would impact these issues;
- Whether a reduction in the aggregate amount of State contributions after merger would impact these issues;

- Whether a change in the character of employer sponsors for the merged plan would impact these issues;
- Whether a change in plan governance for the merging plans would impact these issues;
- Whether the legislature may repeal or reduce the current LEOFF 1 Cost Of Living Adjustment;
- Whether the legislature may impose employee contributions on active LEOFF 1 members; and
- Whether there are Washington state law fiduciary issues when the legislature approves the merger of two public pension plans

We understand that there is no bill language covering or describing the proposal. For purposes of our analysis, therefore, we make several assumptions. First, we assume that the proposed merger will combine the assets and liabilities of LEOFF 1 and LEOFF 2 into a single pension plan. Thus, all assets of the new plan will be available to pay all liabilities of the same plan. Second, we assume that the combined assets of the new plan will continue to be invested by the Washington State Investment Board on a commingled basis consistent with current law. Third, we assume that the existing benefit levels and formulas for all LEOFF 1 and LEOFF 2 members will remain the same after the merger. Fourth, we assume that merger legislation will authorize the State of Washington to make a reduced contribution to LEOFF 2 for two years after the merger. Fifth, we assume that the new plan will satisfy the requirements of the Internal Revenue Code for tax-qualified employee benefit plans. Finally, we assume that there are no collective bargaining agreements or memoranda of understanding that bear on the issues analyzed here.

I. Background

In 1969, the Washington Legislature enacted a comprehensive benefits plan for police officers and firefighters in the state. Laws of 1969, 1st Ex. Sess., ch. 209. The "Washington Law Enforcement Officers' and Fire Fighters' Retirement System Act" created this new plan, known as LEOFF, which was administered by the state Department of Retirement Systems. *McAllister* v. *City of Bellevue Firemen's Pension Bd.*, 166 Wn.2d 623, 627 (2009). In 1977, the Legislature amended LEOFF to create two classes of members. Laws of 1977, 1st Ex. Sess., ch. 294, §§ 1-2. Police officers and fire fighters employed on or before September 30, 1977 constituted one class and those employed after that date constituted another. In a subsequent amendment, the Legislature designated the former class as LEOFF 1 and the latter class as LEOFF 2. RCW 41.26.030(21), (22); see *Adams* v. *City of Seattle*, 173 Wn. App. 398, 400 fn. 4. LEOFF 2 is a "less generous retirement system" than LEOFF 1. *City of Pasco* v. *Dep't of Ret. Systems*, 110 Wn. App. 582, 587 fn. 6.

In 2002, the citizens of Washington passed Initiative Measure 790, making substantial changes in the governance of LEOFF 2. The express intent of the measure was to establish a board of trustees endowed with fiduciary duties and responsible for administration of specified pension management functions. Laws of 2003, ch. 2, § 2, codified at RCW 41.26.705. Among other duties, the LEOFF 2 Board is responsible for the actuarial functions of the plan and establishes employee, employer and State of Washington contributions to the plan consistent with the statutory ratio. RCW 41.26.725(1) ("The board of trustees shall establish contributions as set forth in this section.") and RCW 41.26.720 (board shall "adopt actuarial tables, assumptions, and cost methodologies"; provide for design and implementation of increased benefits; recommend changes in benefits to legislature; and retain professional advisors).

The Washington Legislature enacted a statute that suspends employer and employee contributions to LEOFF 1 unless "the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 has not received any employer or employee contributions since 2000. See Comprehensive Annual Financial Report, Funds for the State of Washington for Year Ended June 30, 2016 ("CAFR") at 77. As of June 30, 2016, the actuarial value of assets in LEOFF 1 exceeded estimated pension liabilities by approximately $1 billion and the plan is approximately 123.7% funded on an actuarial basis. Id. at p. 64. As of the same date, LEOFF 2 is approximately 106% funded on an actuarial basis. Id. at p. 67.

Washington courts will generally defer to the legislative branch on plan design issues: "[w]e will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." *Washington Federation of State Emps.* v. *State*, 107 Wn.App. 241, 246 (2001). Nevertheless, the Contracts Clause of the Washington State Constitution restricts the power of the legislature to make changes in pension funding and benefits.

II. Overview of the Contracts Clause

Article I, section 23 of the Washington Constitution provides that "no … law impairing the obligations of contracts shall ever be passed." The Washington Supreme Court has repeatedly held that this protection "echoes" the parallel federal Contracts Clause of the United States Constitution. *Washington Educ. Ass'n* v. *Dep't. of Retirement Systems*, 181 Wn.2d 233, 242 (2014). Thus, the state and federal Contracts Clauses are given the same effect. *Ibid.* Under these provisions, the State's attempts to impair its own contracts are given a more "stringent" review by the courts in Washington. *Ibid.*

The Washington Supreme Court has long recognized that state pension statutes can create enforceable contract rights. *Washington Educ. Ass'n*, 181 Wn.2d at 242. In *Bakenhus* v. *City of Seattle*, 48 Wn.2d 695 (1956), the Court reviewed the contract rights of a police officer whose monthly pension benefit was reduced by a city ordinance enacted after he first became employed and prior to his retirement. The court ruled that the ordinance violated the officer's contract rights to a higher pension, reasoning that "pensions are 'deferred compensation for services rendered' and therefore create a contract that can be modified only to ensure the continued flexibility and integrity of the system." *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 698. Changes in the pension plan must be for the purpose of ensuring "continued flexibility and integrity" of the plan. *Lenander* v. *Dep't of Ret. Systems*, -- Wn.2d -- [2016 Wash. LEXIS 903, *1, *26] (2016) And "[m]odifications that have an adverse effect on employees must be accompanied by 'comparable new advantages.'" *Washington Educ. Ass'n.*, 181 Wn.2d at 243, quoting *Bakenhus*, 48 Wn.2d at 702. These principles have historically formed the Contracts Clause analysis for public pension rights in Washington.

In 2014, the Washington Supreme Court reviewed these principles in *Washington Education Association* v. *Washington Department of Retirement Systems*. Noting that the *Bakenhus* test is a part of an "overarching" framework applied to all public contracts, the Court held that these contracts are analyzed using a three-part test: "(1) whether a contractual relationship exists, (2) whether the legislation substantially impairs the contractual relationship, and (3) if there is substantial impairment, whether the impairment is reasonable and necessary to serve a legitimate public purpose." *Washington Educ. Ass'n.*, 181 Wn.2d at 243-244; accord, *Lenander,* 2016 Wash. LEXIS at *25-26; see also *Retired Pub. Emps. Council of Wash.* v. *Charles*, 148 Wn.2d 602, 624 (2003). The *Bakenhus* requirements of "flexibility, integrity, and comparable new advantages" remain important, "focus[ing]" the analysis in the specific context of pension contract rights. *Washington Educ. Ass'n.*, 181 Wn.2d at p. 244; see also, *Lenander*, 2016 Wash. LEXIS at *26-27 ("While the three-prong contract impairment test forms the backbone of the analysis in pension cases, the analysis of substantial impairment is guided by the principles set forth in *Bakenhus* and its progeny.") (internal quotations omitted).

III. Contracts Clause Issues When Two Plans Merge

The "merger" of two public pension plans raises substantial Contracts Clause issues. Combining assets and liabilities of two separate plans will change the funded status of the plans unless the two plans have exactly the same funded status and the same benefit/ liability structures and durations prior to the merger. This change could also affect the method and security of funding for future benefits, the level of employee contributions, and the governance of the plans.

A. Funding Rights

Under Washington law, the terms and limitations of pension contract rights "are defined by the language of the statutes creating those rights." *Lenander*, 2016 Wash. LEXIS at *27. In *Weaver* v. *Evans*, 80 Wn.2d 461 (1972), the Washington Supreme Court applied the vested contract rights analysis to actions affecting the funding of a public pension plan.

The *Weaver* Court reviewed the constitutionality of the Governor's action "curtailing" a substantial portion of the State's contributions to Washington State Teachers' Retirement System (TRS). The Court first examined the origins and evolution of the TRS plan. The Court found that the legislature had through the years "evinced a growing concern with maintaining the actuarial soundness of the retirement system … and determined upon a systematic amortization of the unfunded liabilities … and a systematic computation and funding of current and future liabilities …." *Id.* at 472. The *Weaver* court held:

> [W]here, as here, the legislature has over a span of years indicated a deep concern with the actuarial soundness of the retirement system, and that concern has culminated in the express adoption of a systematic method of funding to ultimately attain the desired soundness, *then the principle of systematic funding so adopted becomes one of the vested contractual pension rights flowing to members of the system.* This being so, it follows under *Bakenhus* that such a vested contractual right cannot be unilaterally modified except for the purpose of keeping the retirement system flexible and maintaining its integrity, which modification must in turn be reasonable and bear some material relation to the theory of a pension system and its successful operation, *else the vested contractual right becomes unconstitutionally impaired.*

Weaver, 80 Wn.2d at 478 (emphasis added). The Court concluded that the actions taken by the Governor violated the "vested contractual rights to a retirement system actuarially designed through systematic funding to meet present and future pension liabilities." *Ibid.*; followed by *Charles*, 148 Wn.2d at 625 (members of two state pension plans have "vested contractual rights to the systematic funding of the retirement system to maintain actuarial soundness").

When the Legislature established the original LEOFF plan in 1969, its purpose was "to provide for an *actuarial reserve system* for the payment of death, disability, and retirement benefits to law enforcement officers and firefighters …." RCW 41.26.020 (emphasis added); see *Pasco*, 110 Wn. App. At 587 fn. 5. The legislation defined "actuarial reserve" as follows:

> a method of financing a pension or retirement plan wherein *reserves are accumulated* as the liabilities for benefit payments are incurred *in order that sufficient funds will be available on the date of retirement of each member to pay the member's future benefits* during the period of retirement.

RCW 41.26.030 (emphasis added). When the Legislature created LEOFF 2 in 1977, these provisions were made expressly applicable to the old LEOFF plan (now LEOFF 1) as well as the new LEOFF 2. RCW 41.26.005.

In 1989, the Legislature expressed its intent "to provide a dependable and systematic process for funding the benefits provided to members and retirees of … the law enforcement officers' and firefighters' retirement systems …." RCW 41.45.010; see Laws of 1989, ch. 273, § 1 (adding actuarial funding provisions). The legislature established goals of fully funding LEOFF 2 and fully amortizing the total costs of LEOFF 1 not later than June 30, 2024. RCW 41.45.010(1) and (2).

Consistent with *Weaver*, these provisions establish the legislature's intent to create actuarially sound plans. Like members of TRS, the members of LEOFF 1 and LEOFF 2 have a contractual right to a retirement plan that is systematically funded on the basis of sound actuarial principles.

B. Substantial Impairment

Substantial impairment is measured by the implied consent and comparable new advantages analysis established by the *Bakenhus* decision. *Lenander*, 2016 Wash. LEXIS at *33. "A contract is impaired by a statute which alters its terms, imposes new conditions or lessens its value." *Ibid.* (internal quotations and citations omitted). Changes in pension contract terms must be for "the sole purpose of ensuring the continued flexibility and integrity of the pension system[] [and] … [a]ny modifications that have the effect of reducing a pension benefit or have an adverse effect on members must be counterbalanced by a corresponding increase or additional benefit." *Id.* at *26. A modification of a pension contract will not result in substantial impairment "if the overall result of the change is favorable to employees." *Washington Educ. Ass'n.*, 181 Wn.2d at 250. And whether a modification is favorable "is a fact-specific question that must be measured by the totality of the circumstances." *Ibid.*

LEOFF 1 members have a contract right to a retirement plan that is systematically funded on an actuarially sound basis. After merger, the general system of funding the retirement benefits of these members will not be affected. The new plan will, however, have a funded status that is lower than the current funded status of LEOFF 1. As a result, there will be fewer assets available to pay the future benefits of LEOFF 1 members. Compare CAFR at 64 (LEOFF 1 is 123.7% funded) with *id.* at 67 (LEOFF 2 is 106% funded). There is a risk that a court could consider this action a reduction in the value of the LEOFF 1 contract.

In addition, we assume that legislation authorizing the merger will allow the State of Washington to avoid making an actuarially determined contribution to fund LEOFF 2 benefits for at least two years after the merger. Even though the funded status and therefore security of these benefits will likely increase as a result of the merger through the transfer of "suplus" assets[1] from LEOFF 1, there is a risk that a court could consider this action a reduction in the value of the LEOFF 2 contract.

We believe that analysis of these risks is impacted by several factors.

C. Funded Status of the Plans

Consistent with actuarial standards of practice, the goal of a sound plan is 100% funded status. See., e.g., American Academy of Actuaries Issue Brief (July 2012) at 1, available at https://www.actuary.org/files/80_Percent_Funding_IB_071912.pdf ("Pension plans should have a strategy in place to attain or maintain a funded status of 100% or greater over a reasonable

[1] Surplus assets are the assets excess in value of the actuarial liabilities of the plan.

period of time."). Based on information set forth in CAFR, the new plan will remain over 100% funded.

The merger will reduce the amount of assets available to pay the future benefits of the former LEOFF 1 members. We have found no case from Washington that directly addresses whether a change in funded status through a merger of two separate plans is a "substantial impairment" of vested contractual pension rights to an "actuarially sound" plan. We have also found no Washington cases that directly considered the use of "surplus" plan assets. Cases from other jurisdictions which have considered similar changes in plan design nevertheless shed some light on these issues.

In *Koster* v. *City of Davenport*, 183 F.3d 762 (8th Cir. 1999), the Court of Appeals for the Eighth Circuit considered a constitutional challenge to a merger of local public pensions in Iowa into the statewide plan. At the time the plans were merged, each of the cities' plans was overfunded. The merger law included a provision allowing each city to use "excess" funds in the city plan to offset the city's future contributions to the statewide plan. *Id.* at 765. Reviewing the challenge under the federal Contracts Clause, the *Koster* court held that there was no substantial impairment of any contract right to an actuarially sound pension plan. Central to the court's reasoning was the funded status of the plans.

> The [challenged] statute required the plan's actuary to first determine that the assets transferred from each separate plan to the statewide plan *were more than adequate to meet the plan's accrued liabilities* before allowing the city to offset its future contributions. [Citation omitted.] Thus, the statute does not infringe on the members' rights to receive predefined benefits upon retirement and provides measures to ensure that the statewide fund remains sound.

Id. at 768 (emphasis added) (internal citation omitted). The court concluded that any impairment was not substantial because it does not "compromise the soundness of the plan." *Ibid.*

State courts in West Virginia, North Dakota, and California have reached similar conclusions.

In *Dadisman* v. *Caperton*, 186 W.Va. 627 (1991), the West Virginia Supreme Court of Appeals rejected a constitutional challenge to a statute that merged two pension "divisions." From an actuarial standpoint, the "state" division had an unfunded liability while the "non-state" division had a large surplus "which more than offset[] the state unfunded amount." *Id.* at 633. In a prior proceeding, the court had ordered the state pension plan trustees to engage an independent actuary to determine whether underfunding had rendered the plan "actuarially unsound." Two actuaries were consulted and, ultimately, both opined that the system was actuarially sound at the time of the merger, "whether the System is viewed as a whole or the former state division of the System is viewed separately." *Id.* at 632. Plaintiffs nevertheless claimed unconstitutional impairment because members of the non-state plan were "deprived" of the surplus held for the benefit of the members of that plan. The *Dadisman* court rejected these claims and ruled that the legislation was valid because (1) the assets of both divisions were "owned" by the retirement system as a whole, and (2) the system as a whole, or each division separately, has "at all times ... continued to be actuarially sound." *Ibid.*

Similarly, the North Dakota Supreme Court determined that a merger of underfunded and overfunded pension plans did not violate rights of overfunded plan members because the members were not entitled to "surplus" assets and the employer was not required to continue funding to preserve a surplus. *Klug* v. *City of Minot*, 795 NW2d 906, 912 (North Dakota 2011); see also *Claypool* v. *Wilson*, 4 Cal.App.4th 646 (1992) (no substantial impairment when funds in special account were used to offset employer contributions but plan actuary had determined these funds were not necessary to the actuarial soundness of the plan).

Under the reasoning of these cases, plan assets in excess of actuarial liabilities may not be essential to the actuarial soundness of the plan. Each of the courts in these cases evaluated the consequences of the merger and, relying on the opinions of actuaries, concluded that the change in funded status did not jeopardize the actuarial soundness of the combined plan after the merger, provided that, in the opinion of responsible actuaries, the funding of benefits provided by the new plan remained sound.

The opinions in these cases supports the view that a reduction in the amount of funds available to pay the benefits of LEOFF 1 members would not substantially impair their vested contract rights, provided that new plan remained actuarially sound. The *Koster* and *Claypool* decisions also support the view that "surplus" assets in an over-funded plan may be used to offset contributions otherwise required to maintain the soundness of the plan, again provided that the plan remains actuarially sound. It appears that the funded status of the newly merged plan, post merger, would be well over 100%, which would seem to support a finding of actuarial soundness. However, a case from Alaska might cast some doubt on these conclusions.

In *Municipality of Anchorage* v. *Gallion*, 944 P.2d 436 (Alaska 1997), the court reviewed the constitutionality of an ordinance permitting the city to use surplus assets in two plans to fund the liabilities of a third plan. Each plan had a different funded level prior to this consolidation of assets and liabilities: the first two plans were funded at levels of 135% and 112%, while the third plan was funded at 89%. *Id.* at 438-439. Even though the three plans were approximately 100% funded in the aggregate after the consolidation,[2] the *Gallion* court held that the ordinance impaired the pension rights of members of the better funded pension plans.

The Alaska Constitution "protects 'accrued benefits' of public employee retirement systems from diminution or impairment." *Id.* at 440, quoting Alaska Const., art. XII, § 7. The *Gallion*

[2] The actuarial calculations revealed that the funding for the new plan was either 102% or 99%, depending upon the assumptions used. *Id.* at 444.

court first noted that the separate treatment of each plan's funding was an essential part of the funding scheme of the plans. Members in the first two plans "reasonably could have expected that the product of their contributions would be used for their ultimate benefit[] [and] [c]ertainly they could not have expected that any surplus would be used for the benefit of non-plan members." *Id.* at 443. Because the funding level of the new plan was reduced from the pre-consolidation levels of Plans I and II, the court held that the ordinance "clearly impaired the inherent integrity of Plans I and II." *Id.* at 444. The court held:

> We conclude that [the ordinance] unconstitutionally impairs the vested right of members of Plans I and II to have the actuarial soundness of those plans *evaluated and maintained separately without being affected by the soundness of the other plans*. That failure impairs the ability of Plans I and II to withstand future contingencies, such as increases in plan obligations, declines in investment revenue and inability by [the city of Anchorage] to fund any shortfall. It is therefore unconstitutional.

Id. at 444 (emphasis added); compare *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1993) (legislative change in actuarial valuation method which created an actuarial "surplus" and allowed employers to "offset" contributions was unconstitutional impairment of right to independent trustee's exercise of discretion over setting contribution rates).

It is not clear whether Washington courts would adopt the *Gallion* analysis. Unlike the Washington Constitution, the Alaska Constitution contains a specific provision protecting pension rights. In a line of pension cases involving the alleged impairment of pension contract rights, the Alaska courts have rejected the reasoning of one Washington court. See *Sheffield* v. *Alaska Pub. Employees' Ass'n.*, 732 P.2d 1083, 1086-1087 (Alaska 1987) (rejecting reasoning of *King County Employees' Ass'n* v. *State Employees' Retirement Bd.*, 54 Wn.2d 1 (1959). And, in a recent case, the Washington Supreme Court acknowledged the difference in case law between the two jurisdictions. *Lenander*, 2016 Wash. LEXIS at *31-*32 fn. 9 (rationale in *Sheffield* is "incompatible" with precedent in *King County Employees' Ass'n* and is rejected).

In contrast, at least one Washington court has cited the *Koster* decision with approval in the context of a challenge to the standing of retirement plan members to file suit. See *Charles*, 148 Wn.2d at 478-479, citing *Koster*, *supra*, 183 F.3d at 767 (defined benefit plan does not entitle its members "to any use of the contributions other than to ensure the ... entitlements [to a predetermined pension and an actuarially sound plan] are met").

If the Washington courts nevertheless applied the reasoning of the *Gallion* case, there is a substantial risk that the LEOFF 1 and 2 merger would be held unconstitutional. The Alaska Supreme Court was concerned with the structure of the plans and pre-ordinance authorization for consolidation of the assets and liabilities of the plans. We have found no Washington statute that specifically authorizes a merger or consolidation of the LEOFF 1 and 2 plans. Similarly, we have not found any statute or plan materials that notify LEOFF 1 members of such a merger. It is also clear that the separate structure of LEOFF 1 and 2 would not be maintained and the percentage of assets to liabilities for the LEOFF 1 benefits would be lowered. For the same reasons, the *Gallion* court held that the consolidation ordinance under its consideration was invalid.

Finally, Washington courts may look to federal law in evaluating whether a merger of LEOFF 1 and LEOFF 2 retirement plans would impair the vested rights of plan participants. Private pension plans are governed by the Employee Retirement Income Security Act, 29 U.S.C. §§ 1001 *et seq.* ("ERISA"). Section 1058 of ERISA and Internal Revenue Code section 414(l) each provide essentially similar rules concerning the merger of pension plans and requires that in the case of a merger, each participant in the newly formed plan "would (if the plan then terminated) receive a benefit immediately after the merger, consolidation, or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation, or transfer (if the plan had then terminated)." 29 U.S.C. § 1058. The Internal Revenue Service has issued regulatory guidance under section 414(l), which we understand will be addressed in a different memorandum.[3] The Code of Federal Regulations, 26 CFR 1.414(l)-1 provides that, for defined benefit plans, "if the sum of the assets of all plans is not less than the sum of the present values of the accrued benefit (whether or not vested) of all plans, the requirements of section 414(l) will be satisfied merely by combining the assets and preserving each participants accrued benefits." 26 CFR 1.414(1)-1(e). Both the ERISA statute and regulation governing plan mergers focus on the preservation of accrued benefits, and do not speak to a plan participant's entitlement to plan surplus that exists prior to merger. Since the LEOFF 1 and LEOFF 2 plans are both overfunded, it appears that the application of this law, by analogy, would not support an argument that the merger of LEOFF 1 and 2 pensions is impermissible.

Nevertheless, private plan participants have challenged plan mergers and amendments on the basis that they are entitled to the surplus assets of the over-funded pension plan in which they were a participant, or the basis that the merger or amendment impermissibly reduces the funded status of their pension plan. The federal courts, however, have generally rejected such challenges.

In *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432 (1999), the Supreme Court considered changes in the design of a defined benefit plan holding assets whose value substantially exceeded the actuarial value of the accrued liabilities. Under the plan amendments, early retirees were provided significant additional benefits while new employees were placed in a new "non-contributory" benefit structure. *Id.* at 435-436. Existing members were allowed to choose between the original benefit structure or the new one. Certain members filed suit claiming inter alia that the plan's surplus assets could not be used to fund the new non-contributory benefit

[3] The United States Department of Labor has not issued any regulations under ERISA section 1058.

structure. The Supreme Court rejected this claim, reasoning that "[t]he structure of a defined benefit plan reflects the risk borne by the employer. Given the employer's obligation to make up any shortfall, no plan member has claim to any particular asset that composes a part of the plan's general asset pool." *Id.* at 440. Thus, the Court concluded, the employer "could not have violated ERISA's vesting requirements by using assets from the surplus attributable to the employees' contributions to fund the noncontributory structure." *Id.* at 441. Similar conclusions have been reached by other federal courts. See *Systems Council EM-3 v. AT&T Corp.*, 159 F.3d 1376 (D.C.Cir. 1998) (participant in spun-off plan not entitled to residual assets that would be available upon termination of plan); *Brillinger v. General Elec. Co.*, 130 F.3d 61 (2d Cir. 1997) ("We therefore hold that the participants in the RCA plan were not entitled to have their benefits increased at the time of the merger with the GE plan, to take into account the existence of the RCA plan's residual assets.").

Governmental plans, like LEOFF 1 and 2, are of course exempt from ERISA. Nevertheless, the *Jacobson* case has been followed in two public pension cases in Washington. In *Johnson* v. *City of Tacoma*, 2016 Wash. App. Lexis 1326, *1 (June 6, 2016),[4] the Washington Court of Appeals considered a claim on employee contributions credited to the account of a member. Citing *Jacobson* with approval, the court observed that "[e]mployees who participate in a defined-benefit plan do not share in any decrease or surplus in the value of plan assets." *Id.* at *9; see *Washington Federation of State Emps.* v. *State*, 107 Wn. App. 241, 245 fn.5 (2001) (citing *Jacobson* with approval).[5]

Under this reasoning, LEOFF 1 plan members have no vested or contractual rights to the actuarial surplus of the LEOFF 1 plan and this surplus could be used to fund the benefits of LEOFF 2 plan members post merger without impairing the vested rights of LEOFF 1 members. It remains unclear whether another Washington court would apply this reasoning to the proposed merger.

We recommend that the Board consult with OAS and request the State Actuary to conduct an appropriate study to measure the actuarial impacts of a merger (including authorization for the State to skip its contributions for one or two years after the merger) and issue an opinion on the soundness of the new plan after merger. The results of this study will be critical to evaluating the impacts of the merger on the contract rights of LEOFF 1 and 2 members.

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[4] The opinion in *Johnson* is not published in the official Washington Appellate Reports. Under Washington law, it may be cited as non-binding authority and may be given such persuasive authority as a court deems appropriate. Wash. State Court Rules, GR 14-1.

[5] This reading is reinforced by statute as well. See RCW 41.26.080(d) (Payment of salary and compensation to LEOFF 1 members less contributions "shall be a complete discharge of all claims and demands whatsoever for the services rendered ..., except his or her claim to the benefits" provided to these members).

D. Open and Closed Status

We understand that LEOFF 1 is a closed plan and therefore not accepting any new entrants. In addition, it is a very mature plan. As of June 2016, there were 62 active members and 7,431 retired members and beneficiaries receiving benefits.[6] CAFR at 46.

In contrast, LEOFF 2 is an open plan still accepting new entrants. It is also a younger plan, with 17,321 active members (both vested and non-vested) and 4,508 retired members and beneficiaries receiving benefits.[7]

Pursuant to statute, the assets of both plans are currently managed and invested by the Washington State Investment Board ("WSIB"). RCW 43.33A.10; RCW 41.26.735 (LEOFF 2). Along with the assets of other Washington pension funds, the assets of LEOFF 1 and LEOFF 2 are commingled for investment purposes in the Commingled Trust Fund ("CTF"). CAFR at 64, 66; see RCW 43.33A.170 (WSIB may establish commingled trust funds for any combination of funds under its jurisdiction). Assets in the CTF are currently allocated to different classes pursuant to the Retirement CTF Asset Allocation policy. WSIB Policy No. 2.10-050 (Feb. 18, 2016). The WSIB believes that "[t]he selection of asset classes, the amount invested in each, and the correlation of those asset classes are the greatest source of return and risk to the CTF[,]" and therefore to LEOFF 1 and LEOFF 2. *Ibid.* The WSIB aggregates the liabilities of all the pension funds in the CTF as part of its evaluation of the appropriate asset mix. *Ibid.* The current target allocations for each class of assets are as follows:

- 20% Fixed Income
- 5% Tangible Assets
- 15% Real Estate
- 37% Public Equity
- 23% Private Equity
- 0% Innovation Portfolio
- 0% Cash

Ibid.[8] The Washington Legislature set the target rate of investment return at 7.70% per year, beginning July 1, 2017, for all assets in the CTF, except for those of LEOFF 2. RCW 41.45.035(3)(c).

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[6] There was also one terminated member not yet receiving benefits.
[7] In addition, there were 839 terminated members not yet receiving benefits.

[8] These are target allocations. Under the policy, the actual allocation of each class of the CTF may fluctuate between 2 and 5 %, plus or minus, of the target.

This target allocation might not be ideal for a closed, mature plan. It is designed to generate relatively higher investment returns but with higher risk and therefore more volatility. As the Washington Office of the State Actuary ("OSA") explains:

> In deciding the trade-off between risk and return, WSIB can take advantage of the long time horizon of the pension financing plan. [¶] The long time horizon for investing means that as a general matter, WSIB does not need to match pension liabilities with the short term ups and downs in the market. Instead, *WSIB can take more investment risk and seek higher expected returns* over the long term.

Office of the State Actuary's 2010 Risk Assessment (August 31, 2010) at 10 (emphasis added). Because LEOFF 1 is a closed plan and relatively mature, the duration of its liabilities is shorter than, and its cash flow needs are greater than, most of the other plans whose assets are managed by WSIB. Declines in asset values through investment losses will not be immediately replaced by incoming contributions of active members. Large investment losses could also cause the sale or liquidation of assets because of the need for cash to pay out benefits. The ability of plans like LEOFF 1 to absorb large investment losses is likely to be lower than that of an open and less mature plan. Thus, the current funding structure and target investment allocation may increase the risk of underfunding and, possibly, insolvency. (See, e.g., Office of the State Actuary 2011 LEOFF Merger Study at 20-22 (lack of ongoing funding policy requires new unfunded liabilities to be paid on a non prefunded or "pay as you go" basis and 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 is merged with LEOFF 2, the resulting new plan will be an open plan with approximately 17,383 active members and 11,939 retired members and beneficiaries. It will also be less mature and will likely have, in the aggregate, longer duration liabilities. For these reasons, the asset allocation adopted by the WSIB might be better suited to reducing the long-term risks of under funding or insolvency. Under the Contracts Clause analysis, public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at *26-27, citing *Bakenhus*, 48 Wn.2d at 701. Mitigating these risks to ensure the integrity of the system likely satisfies this requirement. It is also possible that a reduction in funding risk could be considered a "comparable new advantage" to LEOFF 1 members. See *Bakenhus*, 48 Wn.2d at 702.

We recommend that OSA review the change in funding and analyze the "pay-go" risks for LEOFF 1 benefits as part of its actuarial study. This review should include an analysis of these risks both pre and post merger of the two plans.

E. Reduction In Aggregate State Contributions

Under current law, funding of LEOFF 1 is based upon statute. RCW 41.26.080 provides that every member shall make an employee contribution of 6% of the member's basic salary and every employer shall make a similar 6% employer contribution for every employee in the plan. However, no employer or member contribution is required "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.80(2).

Remaining liabilities of LEOFF 1 are funded by the State of Washington ("State"). RCW 41.26.80(1)(c); and RCW 41.45.010, et seq. The OSA provides preliminary actuarial valuation results to the Pension Funding Council, which in turn adopts a LEOFF 1 contribution rate for the State. This rate is recommended to the Legislature for final approval. RCW 41.45.060(1)-(3). Because LEOFF 1 has been overfunded, we understand the State has not made a contribution to LEOFF 1 for many years.

The funding of LEOFF 2 is also set forth in statute. RCW 41.26.725(1) provides that the LEOFF 2 Board has the duty to establish the rates of contribution for employers and employees according to the funding ratio set by statute. For the year 2015, the State contributed 3.15% of payroll, employers contributed 4.73% of payroll and employees contributed 7.88% of pay. Law Enforcement Officers' and Firefighters' Plan 2 Actuarial Valuation Report 2015 ("Valuation Report") at 5. Collectively, the State and participating employers contributed $147 million to LEOFF 2 in 2015. Valuation Report at 17.

After a merger of LEOFF 1 and 2, it is likely that aggregate contributions by employees, employers and the State will be reduced from their prior levels. The assets and liabilities of both plans will be combined and the funded status of the new plan will be higher than the funded status of the former LEOFF 2. As a general matter, a higher funded status will reduce the amount of contributions needed to fund current and future pension liabilities. Provided that future rate-setting for the new plan follows the existing rules for LEOFF 2, and members, employers, and the State continue to make required contributions, a change in the aggregate amount of State and employer contributions should be consistent with the "actuarial soundness" requirements of the Contracts Clause. See *Washington Federation of State Emps.* v. *State*, 107 Wn.App. at 245 fn. 5 (sponsor of overfunded pension plan may reduce or suspend its contributions) (dicta).

However, if the State enacts a statute allowing it to reduce or avoid making otherwise required contributions after a merger, this action would raise an additional risk of a Contracts Clause violation. The Washington Supreme Court in *Weaver* declared the Governor's action "curtailing" a substantial portion of the State's contributions to the Teachers' Retirement System an unconstitutional impairment of contract. The court concluded that this diversion of contributions violated the vested contractual rights to an actuarially sound retirement system. Under the *Koster* and *Jacobson* decisions as explained above, a Washington court could adopt the view that LEOFF 1 members do not have an interest in the surplus assets of their plan. The legislature would therefore remain free to use these assets to help fund LEOFF 2 benefits, provided that the soundness of the plan is not jeopardized. A contrary view was expressed in the *Gallion* case and a Washington court following it could conclude that these assets are not a State contribution and their use to pay an otherwise required contribution impairs the contract rights of LEOFF members.

F. Character of Employer Plan Sponsors

The members of both LEOFF plans have a vested contract right to an actuarially sound pension plan. For these defined benefit plans, "[t]he employer bears the risk of investment and guarantees the distribution of the fixed benefit even if the value of plan's investments decline." *Johnson*, 2016 Wash. App. LEXIS at *8-9. Thus, the employers in the LEOFF plans are ultimately responsible for the payment of benefits to the LEOFF members. Post merger, there will be a difference in the employer sponsors responsible for the actuarial soundness of the benefits provided by the LEOFF 1 and 2 plans. It does not appear that this difference will materially affect the soundness of the new plan.

LEOFF 1 currently has 64 active employee members employed by 29 different employer sponsors. CAFR at p. 194. The City of Seattle is the primary sponsor, accounting for 37.5% of all member participants. The remaining active members are employed by a variety of cities, counties, and special districts including the City of Bellevue, King County, and the City of Pasco. Other than Seattle, no single employer accounts for more than 5% of the active membership. *Ibid.*

LEOFF 2 currently has 17,470 active members employed by 369 different employers. CAFR at 195. As with LEOFF 1, Seattle has the largest number of active employees but the percentage is much lower -- 13.4%. The remainder of employers includes cities, counties, and special districts in Washington.[9] *Ibid.*

Based upon this composition of employers, there does not seem to be a substantial change in the risk of plan funding. From the standpoint of LEOFF 1 members, the addition of more than 200 employers with active members responsible for maintaining the actuarial soundness of the new plan seems to be a favorable change. And in any event, unless this change at least "likely" harms the actuarial soundness of the system, there can be no showing that the vested contract rights of the members have been impaired. *Charles*, 148 Wn.2d at 627.

G. Change in Plan Governance

Under Washington law, the LEOFF 2 Board is clearly a fiduciary to the members of the LEOFF 2 plan, responsible for adopting actuarial standards and setting contribution rates that "will

[9] The State of Washington is also a sponsor, accounting for about 1.4% of active employees.

guaranty the viability of the plan." RCW 41.26.705. Under current law, the State "shall make" contributions to LEOFF 2 based on rates established by statute, "regardless of the level of appropriation provided in the biennial budget." RCW 41.45.050(2) and (3). Because the legislature of course may generally amend statutes, it is possible that it could modify these rules and alter contribution rates set by the Board. We understand, however, that the legislature has not exercised this authority since the creation of the LEOFF 2 Board.

The Contracts Clause may limit the legislature's authority in this area. In *McDermott* v. *Regan*, 191 A.D.2d 47 (N.Y. App. Div. 1991), the court considered a challenge to a new statute compelling the trustee of the New York State Employees' Retirement System and the New York State and Local Police and Fire System to use certain actuarial methods of calculating pension liabilities and calculating employer contribution rates. Using the new method, the funds had an actuarial surplus of about $9 billion. The legislation further authorized the contributing employers to offset their contributions against a share of this "surplus." The end result of these changes was a reduction in employer contributions and a faster depletion of the surplus. This change "essentially shift[ed] the burden of funding the retirement systems from the present to the future [and] was admittedly imposed upon the [trustee] in an attempt to ease the State's budgetary problems." *Id.* at 49. The court held the legislation an unconstitutional impairment of the members' contract rights.

> The imposition of a particular funding method, as opposed to the mere setting of guidelines for selection of a method, vitiates the members' right to have the benefit of the [trustee's] discretion in fixing the amount of contributions needed for the continued stability and security of the systems.

Id. at 51. The court further reasoned that the legislation not only imposed a dramatically different funding method on the trustee, it dictated the depletion of surplus funds, "a further usurpation of the [trustee's] authority to manage the accounts of the fund." *Ibid.* The *McDermott* court concluded that the additional changes in the actuarial valuations "strip[ped] the systems' members of their right to the [trustee's] independent judgment, and therefore they too are unconstitutional." *Ibid.*

It is unclear whether a Washington court would follow *McDermott* and hold unconstitutional a legislatively imposed reduction in the contribution rates set by the LEOFF 2 Board. Nevertheless, the fiduciary authority and responsibility of the LEOFF 2 Board to make actuarial valuations and set contribution rates independent of the State legislature or any State agencies is likely considered a valuable aspect of LEOFF 2 plan governance.

As Initiative 790 noted, the then existing LEOFF 2 plan was "subject to policymaking by the legislature's joint committee on pension policy with ratification by the members of the legislature …." Laws of 2003, ch. 2, § 1 (codified at RCW 41.26.700). The initiative created a new plan governance that was intended, in the words of the initiative, "to give management of the retirement program to the people whose lives are directly affected by it ...." *Ibid.* The initiative created a new board -- the LEOFF 2 Board -- with authority to manage certain aspects of the system. The 11 member board is composed of three fire fighters, three police officers, three employer representatives and two legislators. At least one Board member must be a retired participant of LEOFF 2. RCW 41.26.715. Although members are appointed by the Governor, the Board has independent pension management authority. This includes authority over actuarial standards, providing for additional benefits under certain conditions, providing effective monitoring of the plan, establishing contribution rates, and authority to retain professional and technical advisors. RCW 41.26.705. The LEOFF 2 Board must "[e]xercise fiduciary responsibility in the oversight of those pension management functions" assigned to it and thus owes duties of loyalty and prudence solely to the plan members and their beneficiaries. RCW 41.26.705(3).

Unlike LEOFF 2, there is no board or other body or official that has fiduciary oversight for LEOFF 1. OSA performs an advisory role. See RCW 44.44.040. The Washington Department of Retirement Services ("DRS") is only responsible for administering the system. RCW 41.50. Neither the Washington Legislature, OSA, nor DRS is expressly a fiduciary. In *Retired Public Employees Council of Washington* v. *Charles*, the Washington Supreme Court considered whether the Public Employees Retirement System I and the Teacher's System I are considered trust funds and whether the DRS Director is a trustee or other fiduciary of the two plans. *Charles*, 148 Wn.2d at 612. Relying on a number of prior decisions, the court held that "this State's case law, recent case law in particular, has refused to characterize the retirement funds as trusts." *Id.* at 622. The court concluded that if the retirement funds are not trusts, then the DRS Director may not be considered a trustee. *Ibid.* Thus, there is no fiduciary responsibility for administration of LEOFF 1.

If the newly merged plan were governed by the current LEOFF 2 Board having the same fiduciary responsibilities and the same composition, this change in governance could well be considered a change enhancing the integrity of the system. As explained above, under Washington law public pension contract modifications "must be made for the sole purpose of ensuring the continued flexibility and integrity of the pension system." *Lenander*, 2016 Wash. LEXIS at 26-27. Merging LEOFF 1 into LEOFF 2 and placing the new system under the governance regime of LEOFF 2 would seem to clearly enhance the system's integrity. As with the change in the maturity and closed status of LEOFF 1, this modification likely satisfies the requirement that pension plan modifications must be for the purpose of ensuring the continued flexibility and integrity of the system. In addition, it might well be considered an additional benefit for LEOFF 1 members which was conferred on them by the merger of LEOFF 1 and 2.

H. LEOFF 1 Cost Of Living Adjustments

A mandatory cost of living adjustment ("COLA") to a public pension benefit can be part of the vested contractual rights of the member. Effective April 1, 1971, the Washington Legislature granted LEOFF members an annual COLA based upon percentage increases in the consumer price index. See Laws of 1970, 1st Ex. Sess., ch. 6, §16, codified at RCW 41.26.240. In 1974, the legislature made slight changes to the calculation of the allowance based, LAWS 1974, 1st Ex. Sess., ch. 120, § 13. Since then, this statutory COLA has consistently been paid each year to LEOFF 1 members.

A legislative reduction or elimination of the current COLA provided to LEOFF 1 members would likely impair their contractual pension rights.

In *Washington Education Association,* the Washington Supreme Court considered several legislative changes to COLAs provided to the PERS and TRS Plan 1 members. *Wash. Educ. Ass'n.*, 181 Wn.2d at 236. In 1972, the legislature enacted a statute providing for a COLA, "'provided that the [DRS] finds, in its sole discretion,'" that system assets were sufficient to fund the COLA. *Id.* at 236, quoting former RCW 41.32.499 and former RCW 41.40.195. Under this statutory scheme, COLAs were never granted to TRS 1 members and were granted only through 1980 to PERS 1 members. Thus, for 15 years prior to the adoption of a new COLA scheme, DRS never exercised its discretion to grant a COLA under the 1973 enactment. *Id.* at 238. In 1995, the legislature adopted a new uniform cost of living adjustments ("UCOLA") for these members (and others). Under this new scheme, the legislature repealed the 1973 COLA and replaced it with a different benefit. "To prevent a perpetual obligation to increase the COLA amount each year, the legislature included a clause that reserved its right to modify or repeal the UCOLA scheme in the future and specified that it was not creating any contract rights." *Id.* at 239, citing former RCW 41.32.489(6) and former RCW 41.40.197(6). In 2011, the legislature repealed the UCOLA statutes, eliminating a COLA for TRS and PERS 1 members who had not yet retired at the time of the repeal. These members filed suit, bringing unconstitutional impairment claims. Id. at 240-241.

The *Washington Education Association* court first considered the 2011 repeal of the UCOLA statutes. Assuming that COLAs could be considered a part of the members' contract rights, the court rejected this claim because there was no substantial impairment. The authority to repeal the UCOLA was expressly reserved in the original legislation and "the legislature could not have been more explicit in reserving the power to amend the UCOLA statute and disclaiming any grant of contractual rights." *Wash. Educ. Ass'n.*, 181 Wn.2d at at 247. Thus, the court held, no vested contractual rights were violated.

The court also considered the claim that the 1995 legislation establishing UCOLA and repealing the 1973 COLA was an unconstitutional impairment. This claim was rejected as well. The court noted that even when modifications are detrimental to plan members there is no contract impairment "so long as those disadvantageous modifications were accompanied by comparable new advantages." *Id.* at 249, citing *Bakenhus*, 48 Wn.2d at 701-703. Whether an alteration is favorable to the members "is a fact-specific question that must be measured by the totality of the circumstances." *Id.* at 250. Turning to the repeal of the 1973 COLA in 1995, the court held that the affected members received comparable new advantages through enactment of the UCOLA benefit. Because the 1973 COLA was discretionary and contingent upon adequate funding, the UCOLA system represented a "substantial improvement" over the former COLA provisions.

> Notwithstanding the reservation clause, UCOLA provided a guaranteed right to an annual COLA of increasing amounts for as long as the program remained in effect. In contrast, the 1973 COLA … merely assured employees that the DRS would *consider* whether a COLA was practicable based on current funding levels. … Although the UCOLA statute reserved the legislature's right to change or terminate the program, such reservation clauses are enforceable and even the creation of an undefined automated COLA system constitutes an added favorable benefit ….

Id. at 250 (italics in original). Thus, the court held, replacement of the 1973 COLA by the UCOLA did not impair any existing contract rights.

We have found no legislative reservation of rights to modify or eliminate the LEOFF 1 COLA. Since 1971, the LEOFF COLA statute has provided that every eligible retirement allowance "shall be adjusted" to reflect changes in the consumer price index. Further, we understand that each LEOFF 1 member has received this annual adjustment since enactment of the statute. Unlike the 1973 COLA and the UCOLA considered in *Washington Education Association*, the legislature did not make the award of a COLA in any year discretionary and did not expressly reserve the right to modify or repeal the LEOFF COLA. Thus, this benefit would likely be considered a vested contractual right by Washington courts subject to impairment if the legislature reduced or eliminated it.

Under the reasoning of this case, however, it is possible that a court could consider the governance and demographic changes addressed in sections D. and G., supra, as an added favorable benefit and thus find no impairment. New benefits typically must be "comparable" to the detriment suffered to avoid a finding of impairment. See *id.* at 447; see also, e.g., *Bowles*, 121 Wn.2d at 65 ("modifications *reducing pension levels* must be counterbalanced with *increases in pension levels*") (emphasis added); *Wash. Fed'n of State Employees Council 28* v. *State*, 98 Wn.2d 677, 689 (1983) (legislative change eliminating a pension benefit "without giving … employees a *comparable benefit substitute*" held unconstitutional) (italics added); *Vallet* v. *Seattle*, 77 Wn.2d 12, 21-22 (1969) (sliding scale escalator clause for pension allowance over a period of years "outweighed" a higher but fixed pension benefit). In *Washington Education Association*, the Washington Supreme Court explained this analysis further:

> [M]odification of a pension contract will not substantially impair an existing contract if the *overall result of the change is favorable to employees*. Whether an alteration is favorable to employees is a fact-specific question that must be measured by the totality of the circumstances.

Wash. Educ. Ass'n., 181 Wn.2d at 250 (emphasis added).

It is difficult to compare the loss of an annual COLA with the benefit of added fiduciary oversight, better governance, and a possible increase in the benefit security of the new plan. The former entails a direct reduction in the dollar amount of each member's benefit while the latter enhances the future security of benefit payments. Despite these differences, a Washington court might view the totality of these changes as an added benefit that outweighs the loss of a COLA. Nevertheless, elimination or reduction of the LEOFF 1 COLA remains a substantial risk under *Bakenhus* and its progeny.

I. LEOFF 1 Member Contributions

LEOFF 1 members are not obligated to pay any employee contributions, "unless the most recent valuation study for [LEOFF 1] indicates the plan has unfunded liabilities." RCW 41.26.080(2). We understand that LEOFF 1 members have not paid any employee contributions to the plan since at least 2000.

Under *Bakenhus* and its progeny, "modifications reducing pension levels must be counterbalanced with increases in pension levels." *Bowles* v. *Wash. Dept. of Ret. Sys.*, 121 Wn.2d 52, 65 (1993), following *Bakenhus*, 48 Wn.2d at 701. In *Allen* v. *City of Long Beach*, 45 Cal.2d 128, 131-133 (1955), the California Supreme Court held that an increase in the amount of an employee's contribution without a corresponding increase in benefit payments was an unconstitutional impairment of the employee's contract rights. In its opinion, the *Bakenhus* court noted this result and relied on the *Allen* decision for its conclusion that a decrease in a pensioner's benefit made without a corresponding benefit was also unconstitutional. *Bakenhus*, 48 Wn.2d at 701-702. If any existing active member of LEOFF 1 is required to pay employee contributions after the merger, it is likely this change would be held unconstitutional, unless this change were accompanied by a corresponding benefit to these members. Even a higher likelihood of payment could be grounds for a constitutional challenge. See *Charles*, 148 Wn.2d at 627 (impairment claim must at least demonstrate "likely" harm to member). Under more recent case law, a Washington court might possibly be inclined to find the "overall result" of the merger favorable to members. See section H., *supra*. However, changes that impose employee contributions on LEOFF 1 active members retain a substantial risk of contract impairment.

IV. Fiduciary Issues In Plan Mergers

The proposed merger would be effected through statutory changes enacted by the Washington Legislature. A pension plan merger is a change in plan design. In Washington, "the legislature has the authority under its police power to establish a retirement system for public employees ...." *Wash. Fed. Of State Emps.* v. *State*, 107 Wn.App. at 247 (internal quotations and citation omitted). Retirement plan design issues, such as a "lack of an independent trustee," a need for a "review and clarification" of fiduciary duties, and a need for a retirement trust "are matters for legislative, not judicial, action[.]" Id. at 246-247. Thus, "[t]he courts have repeatedly said we will not substitute our judgment for the Legislature's with respect to the structure of public retirement plans." Id. at 247. Legislative exercise of the police power is not a fiduciary function and it is unlikely that a Washington court would require to act as a fiduciary in enacting pension plan merger legislation.

This conclusion is consistent with federal law governing non-governmental plans. Under ERISA, an employer's decision to change the plan design generally does not implicate fiduciary duties. *Jacobson*, 525 U.S. at 444-445. Plan design changes are typically "trustor" or employer functions and plan sponsors who alter plan terms "do not fall into the category of fiduciaries." Id. at 445 (internal quotations omitted).[10] Under this reasoning, the Washington Legislature's actions in re-designing the LEOFF 1 and 2 plans should not be subject to fiduciary principles. As explained above, Washington courts have cited the *Jacobson* case with approval, albeit in different contexts.[11]

V. Conclusion

The Contracts Clause in the Washington Constitution provides members of LEOFF 1 and 2 with vested contract rights to an actuarially sound plan for providing their retirement benefits. Legislation merging these plans will make changes that could affect these rights. Washington courts may review changes in plan funding, plan status, contributions, plan governance, and benefits in addressing any constitutional challenge to a merger. Evaluation of these factors will shape a judicial decision whether the legislation unconstitutionally impairs the members' contract rights.

Peter Mixon

Brian Peterson

cc: David Morse

[10] The Supreme Court recognized a potential exception for "sham transactions" -- a transaction "meant to disguise an otherwise unlawful transfer of assets to a party in interest[.] Id. at 445 (internal quotations omitted). Unless the merger legislation violated the vested contract or other constitutional rights of plan members, it is difficult to envision the merger plan being categorized as a sham under the circumstances presented here.

[11] See text accompanying footnotes 4 through 5, supra.

Office of the State Actuary

"Supporting financial security for generations."

November 30, 2016

Mr. Steve Nelsen
Executive Director
LEOFF 2 Retirement Board
PO Box 40918
Olympia, Washington 98504-0918

SUBJECT: LEOFF 2 BOARD REQUEST FOR ANALYSIS OF LEOFF 1 RISKS

Dear Steve:

At your request, we have performed analysis on the risks inherent in the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1). Specifically, you asked us to analyze the following:

- Impact to LEOFF 1 under varying investment return scenarios.
- Impact of LEOFF 1 annuitants receiving a one-time $5,000 bonus.
- Plan merger of LEOFF Plans 1 and 2.

The key results from our analysis are presented in the body of this communication along with our written responses to other questions you asked. We document the data, assumptions, and methods we used to perform this analysis in **Appendix A**. **Appendices B-D** provide additional information for the requested scenarios including tables and graphs of the projected surplus and funded status. **Appendix E** contains plan merger analysis and **Appendix F** contains projected benefit payments.

Summary of Analysis

Impact to LEOFF 1 Under Varying Investment Return Scenarios

We calculated the projected funded status and surplus for LEOFF 1 assuming: (i) the long-term Rate of Return (ROR) assumption is reduced from 7.7 percent to 7.5 percent; (ii) the fund earns actual investment returns of 5 percent (and 10 percent) for 10 years followed by 7.7 percent; and (iii) the fund earns average actual investment returns of 7.7 percent that follow two different paths – low/high returns for the first ten years, followed by high/low returns for the next ten years.

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The funded status measure compares actuarial assets to the present value of accrued (earned) benefits. With each of these scenarios, neither the current assets nor the stream of future benefit payments are changing. What changes is the amount of future earnings we expect on the assets. When the amount of earnings changes, it means more (or less) money is needed today to pay for the same stream of benefits in the future.

Under each scenario described above, the projected funded status of LEOFF 1 remains above 100 percent. Please see **Appendices B and D** for additional information.

The requested analysis did not include any impact from the inflation assumption. We believe that it would be reasonable to assume inflation is correlated with investment returns. As an example, a period of higher than expected investment returns could be the result of higher than expected inflation. Inflation that is lower (or higher) than expected would improve (or worsen) the funded status of the plan. To show the impact inflation can have on the results, we added two scenarios to the third graph in **Appendix B** where actual inflation is correlated to the investment return.

Based on our analysis, it would take a larger investment shock or a much longer low investment return environment to take LEOFF 1 out of a fully funded position. For example, if the commingled trust fund experienced an immediate shock of -6 percent for two years, followed by 7.7 percent thereafter, the funded status for LEOFF 1 would drop below 100 percent. Alternatively, if the long-term ROR assumption was lowered to 5 percent instead of the assumed 7.7 percent, or the assets earned an average of 4 percent for the next ten years followed by 7.7 percent thereafter, LEOFF 1 would fall below 100 percent funded. In addition, the plan merger analysis will include investment shocks since we analyze 2,000 simulations of different economic environments (stochastic analysis), among other assumptions. Please see those results in **Appendix E**.

Impact of LEOFF 1 Annuitants Receiving a One-Time $5,000 Bonus

We estimate this bonus would add approximately $36.5 million to the expected liabilities in Fiscal Year (FY) 2018. This bonus would lower the funded status in FY 2018 by approximately 1 percent. Please see **Appendix C and D** for additional information.

Plan Merger of LEOFF Plans 1 and 2

We analyzed the impact to LEOFF when we merge LEOFF plans 1 and 2 based on the merger definition you provided. The defined merger includes a long-term ROR assumption of 7.5 percent and a two-biennia state contribution rate holiday. We also considered two different merged plan scenarios; (i) updating the merged plan based on our *2011 LEOFF Merger Study*; and (ii) the merged plans with a 7.5 percent ROR assumption and no state contribution rate holiday. Ultimately, we did not observe a significant change in the LEOFF 2 risk measures under any of the merged plan scenarios.

The four-year state contribution rate holiday provides a savings for the state of approximately $300 million but did not materially impact the results. We compared the expected funded status when we merged LEOFF plans 1 and 2 with (and without) the contribution rate holiday. The funded status decreased from 112.8 percent to 110.9 percent in the year following the four-year state contribution rate holiday (FY 2022).

Please see **Appendix E** for additional information.

Miscellaneous Questions

In your letter dated September 9, 2016, there were several questions that require a written answer versus actuarial analysis. These questions and our answers follow.

What are the greatest risks of a LEOFF 1 Unfunded Actuarial Accrued Liability (UAAL) emerging, and what are the budgetary impacts if that occurs?

As of June 30, 2015, LEOFF 1 has a funded status of 125 percent; however, a LEOFF 1 UAAL could emerge in the future. The financial measures of a retirement plan rely on assumptions about unknown future events so many risks exist. Some of these risks include members outliving their expected benefit payments, benefit improvements occur without sufficient funding, investments earn less than expected, and inflation is higher than expected. Since the Legislature has adopted mortality improvement assumptions and has authority to manage benefit improvements, we believe the greatest risks LEOFF 1 faces are economic in nature. For example, significant negative investment earnings, long periods of lower than expected investment earnings, or long periods of high inflation would negatively impact the assets and future obligations of the plan. In addition, the combination of low investment returns and a high inflation environment would also put the plan's funded status at risk of dropping below 100 percent. Since LEOFF 1 annuitants receive fully indexed Cost-of-Living Adjustments (COLAs), high inflation or long periods of inflation that exceed the 3 percent assumed rate, will increase the future benefit payment streams above our current projections.

If a UAAL emerged, RCW 41.26.080 states that employees (and their employers) would contribute 6 percent of their salary annually until the plan no longer has unfunded liabilities. In addition, the funding goal in statute states that any LEOFF 1 UAAL be amortized by June 30, 2024, over all plan payroll. LEOFF 1 members (and their employers) are not currently required to contribute to LEOFF 1 while the plan remains in surplus.

Do LEOFF 1 liabilities reflect the Office of the State Actuary's (OSA's) recommended mortality assumption?

Yes, the liabilities calculated in the most recent Actuarial Valuation Report (AVR) and the analysis contained in this communication reflect an assumption for mortality improvement based on 100 percent of Scale BB.

What are the LEOFF 1 projected benefit payments?

Please see **Appendix F** for the expected benefit payments for LEOFF 1, by year. The expected benefit payments assume an annual 3 percent COLA.

Does OSA use the most-up-to-date data to perform analysis?

OSA uses data consistent with the most recent AVR. The data is prepared by the plan administrator, the Department of Retirement Systems, and reviewed by OSA for reasonableness for the purpose of performing an annual actuarial valuation. Our most recent AVR measurement date is June 30, 2015. All data and assets are based on that measurement date, however, our projections model includes the most recent investment returns as of June 30, 2016.

Can OSA provide monthly changes to the LEOFF 1 surplus?

Plan surplus or funded status is calculated at a measurement date using both the actuarial assets and plan liabilities valued at that same date. While the assets may be reported monthly by the Washington State Investment Board (WSIB), plan liabilities are not calculated that frequently. In addition, the assets used to determine the plan's surplus or funded status are not market value assets, as reported by WSIB, but rather actuarial assets. Actuarial assets are determined using an asset smoothing method that defers recognition of the annual investment gain or loss over a defined period of time. This asset smoothing method is defined in statute.

This analysis, like most actuarial analysis, will quickly become outdated. Some examples of why this analysis can become outdated include the following: material changes to benefit provisions, changes to actuarial assumptions or methods, and the inclusion of more recent participant or asset data. We recommend updating this analysis after the 2017 Legislative Session.

We prepared this analysis for the LEOFF 2 Board to understand the risks inherent in LEOFF 1. We advise readers of this analysis to seek professional guidance as to its content and interpretation and not rely upon the communication without such guidance. Please read the analysis shown in the letter and attached appendices as a whole. Distribution of, or reliance on, only parts of this analysis could result in misuse and may mislead others.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein. Matt Smith was the supervising actuary for the actuarial analysis contained in this communication. We are both available to answer any additional questions that arise.

Sincerely,

Lisa Won, ASA, FCA, MAAA
Deputy State Actuary

cc: Kelly Fox, Chair
LEOFF Plan 2 Retirement Board
Matthew M. Smith, FCA, EA, MAAA
State Actuary
Mitch DeCamp
Actuarial Analyst

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APPENDIX A – DATA, ASSUMPTIONS, AND METHODS WE USED

Data We Used

This analysis is based on the data as disclosed in the *June 30, 2015, AVR* along with future new member data as disclosed in our New Entrant profiles on our projections webpage.

Assumptions We Used

Demographic Assumptions: All current members are expected to decrement (or leave) the retirement systems via termination, disability, retirement, or mortality. As members leave the retirement systems, they are replaced by new entrants. Demographic assumptions for our projections model are needed to develop new entrants into LEOFF 2 over the next 50 years.

Economic Assumptions: For purposes of determining the present value of future salaries and benefits when determining projected contribution requirements, we assumed a 7.7 percent ROR for LEOFF 1 (7.5 percent for LEOFF 2) for all future years beginning July 1, 2016. For purposes of projecting the growth of invested assets, we used actual asset returns through June 30, 2016 (2.65 percent for FY 2016).

Unless noted otherwise, all analysis was developed using deterministic projections. Deterministic projection assumptions will match our long-term expectations for each assumption and assume full funding with no benefit improvements.

Please see the AVR and our projections webpage for additional detail on assumptions used to develop the analysis in this communication.

Methods We Used

With the data and assumptions noted above as inputs, we used our valuation software to project the outputs (i.e., projected salaries, benefit payments, etc.) necessary to project the next 50 AVRs. We then applied the current funding and asset smoothing methods set in statute to these outputs to determine projected asset values, contribution rates, and the associated contribution requirements.

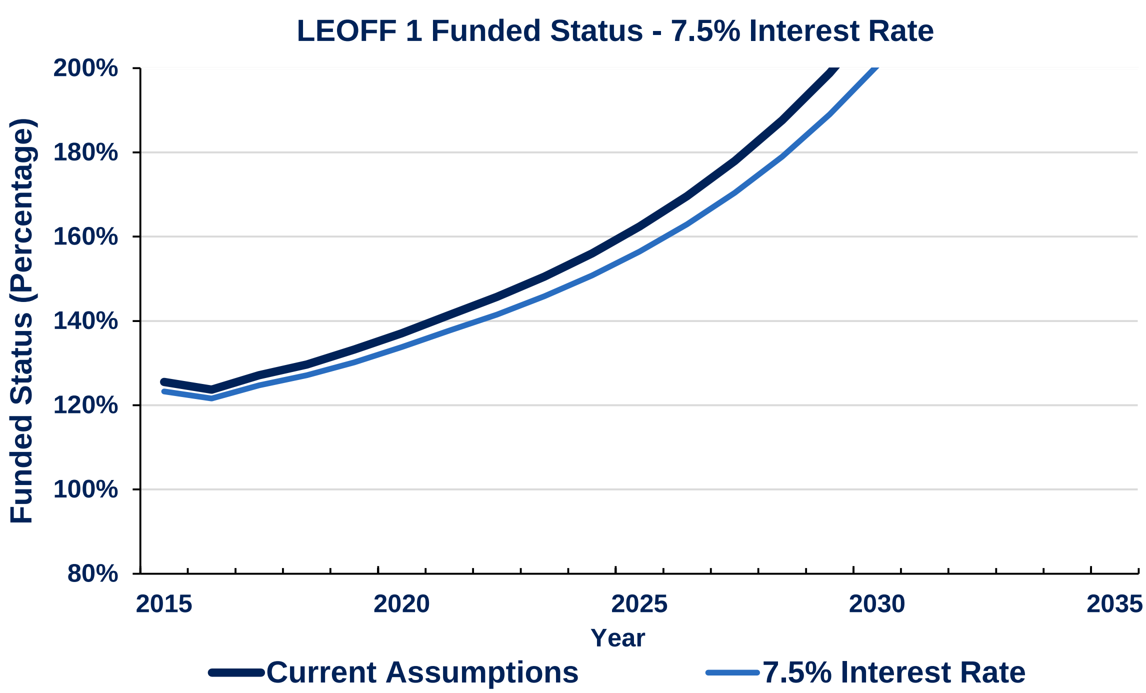
APPENDIX B - IMPACT TO LEOFF 1 UNDER VARYING INVESTMENT RETURN SCENARIOS

Unless noted otherwise, all data, assumptions, and methods are consistent with **Appendix A**.

Impact to LEOFF 1 Assuming 7.5 Percent Long-Term ROR Assumption

To perform this analysis, we assumed all future benefit payments were discounted using a 7.5 percent interest rate assumption. We also assumed the future investment return will be 7.5 percent for all fiscal years following June 30, 2016.

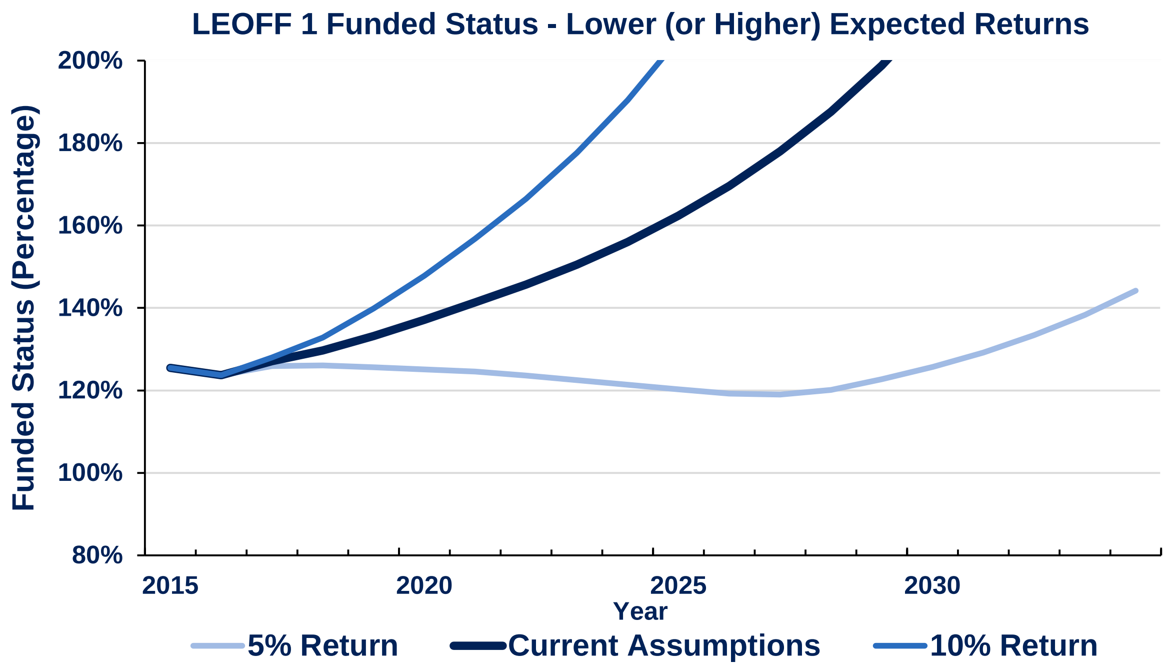
We observe a lower funded status under this scenario; however, LEOFF Plan 1 is more mature relative to other Washington State retirement plans and less impacted by a reduced interest rate assumption. The graph below summarizes the change in funded status under this scenario.



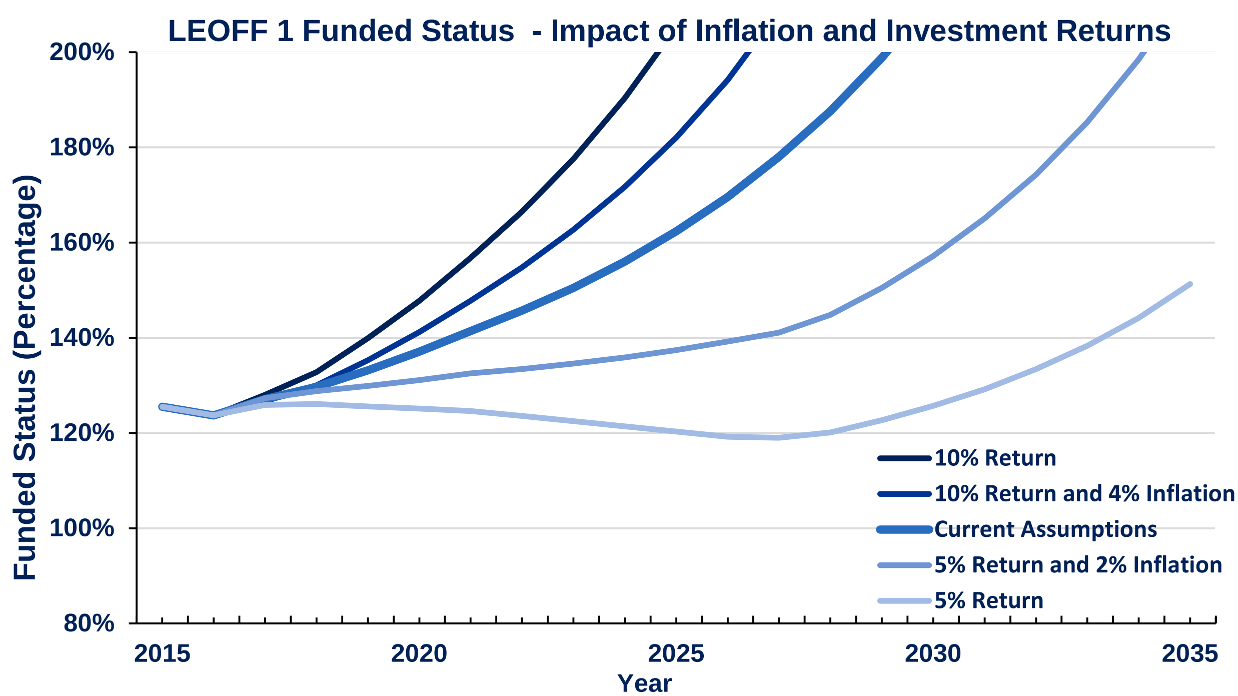
Impact to LEOFF 1 Assuming an Actual ROR Lower (or Higher) Than Expected Over the Next Ten Years

To perform this analysis, we assumed the actual future investment return will be 5 percent (or 10 percent) for the next ten years (FY 2017-2026). Following FY 2026, we assumed actual returns equal the assumed investment return of 7.7 percent.

Under both scenarios, we continue to observe a funded status above 100 percent. The graph on the next page summarizes the change in funded status under these two scenarios.



The analysis above did not consider the impact to inflation. We believe it would be reasonable to assume inflation is correlated with investment returns. The graph below models actual future inflation of 2 percent (or 4 percent) for FY 2017-2026. Following FY 2026, we assumed actual inflation equals the inflation assumption rate of 3 percent. In each scenario, the funded status for LEOFF 1 does not fall below 100 percent.



Impact to LEOFF 1 Under Low to High Returns and High to Low Returns

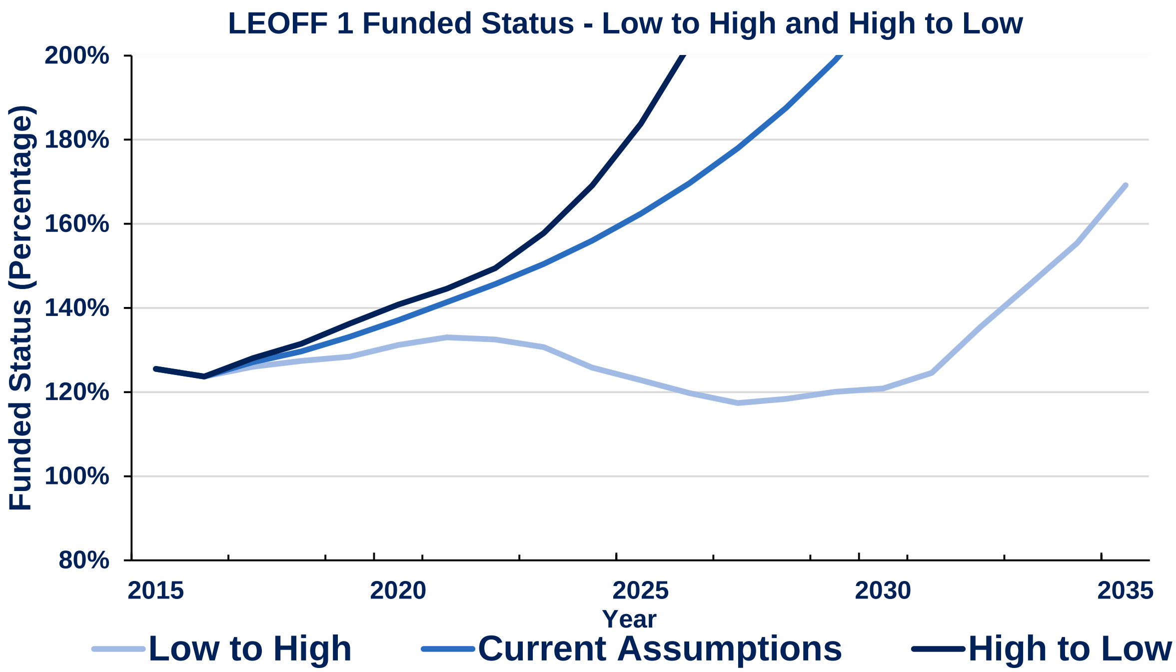
In these two scenarios, we assumed a "low to high" investment return scenario and a "high to low" investment return scenario. Each scenario randomly simulated returns over the next twenty years. In general, the "low" period of returns averaged an approximate 5 percent return and the "high" period of returns averaged an approximate 11 percent return.

The analysis of these scenarios does not consider any impact on inflation.

The investment returns, under each scenario, are displayed in the table below. Following FY 2036, we assumed actual investment returns equal the investment return assumption of 7.7 percent.

Low to High and High to Low Returns		
FY	Low to High	High to Low
2017	6.88%	9.32%
2018	0.93%	7.41%
2019	7.35%	9.47%
2020	11.37%	5.58%
2021	(2.68%)	7.82%
2022	2.49%	11.60%
2023	0.65%	12.16%
2024	(1.51%)	10.34%
2025	19.62%	13.28%
2026	6.12%	20.71%
2027	9.45%	(3.47%)
2028	12.62%	11.81%
2029	4.71%	23.88%
2030	5.49%	1.49%
2031	17.59%	3.50%
2032	20.48%	(7.61%)
2033	4.92%	1.49%
2034	6.29%	7.70%
2035	10.68%	3.00%
2036	14.35%	8.99%
First 10 Years	4.93%	10.70%
Next 10 Years	10.53%	4.76%
All 20 Years	7.70%	7.69%

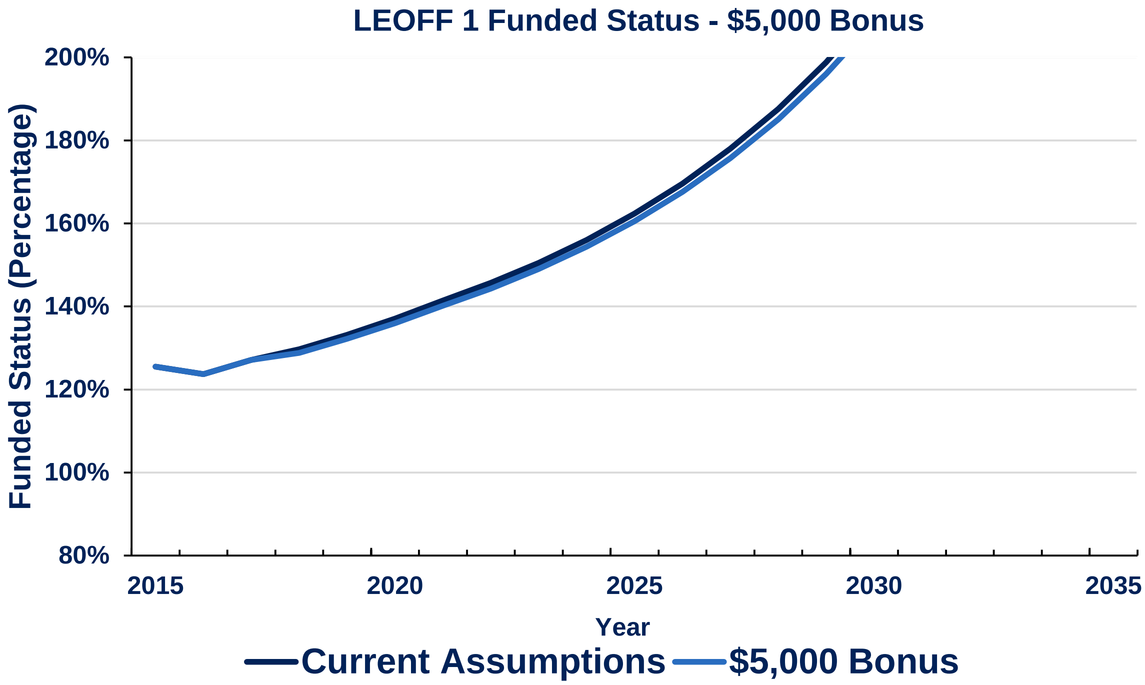
Under both scenarios, we continue to observe a funded status above 100 percent. The graph on the next page summarizes the change in funded status under these two scenarios.


LEOFF 1 Funded Status - Low to High and High to Low
Funded Status (Percentage)
200%
180%
160%
140%
120%
100%
80%
2015
2020
2025
2030
2035
Year
Low to High
Current Assumptions
High to Low

APPENDIX C – IMPACT OF LEOFF 1 ANNUITANTS RECEIVING A ONE-TIME $5,000 BONUS

To perform this analysis, we had to make an estimate of the number of annuitants who would receive a one-time $5,000 bonus as well as when the members would receive the bonus. We assumed 7,300 annuitants would receive this bonus based on the downward trend in number of annuitants in LEOFF 1. FY 2018 was determined to be appropriate since an annuitant bonus would occur after the 2017 Legislative session. Overall, the total expected benefit increase was $36.5 million ($5,000 * 7,300 = $36.5 million).

The graph below summarizes the change in funded status under this scenario.



Unless noted otherwise, all data, assumptions and methods are consistent with **Appendix A**.

APPENDIX D – SURPLUS UNDER VARYING SCENARIOS

Surplus is another way to look at the impact of various scenarios presented in this communication. The table below will display how the annual surplus will change under each scenario.

(Dollars in Millions)	LEOFF 1 Projected Surplus								
	Long-Term ROR Assumption		Actual Experience**						
Scenario	Current (7.7%)	New (7.5%)	5% ROR	10% ROR	5% ROR, 2% Inflation	10% ROR, 4% Inflation	High to Low ROR	Low to High ROR	$5,000 One-Time Payment
2015	$ (1,090)	$ (1,013)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)	$ (1,090)
2016	$ (1,007)	$ (932)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)	$ (1,007)
2017	$ (1,138)	$ (1,055)	$ (1,091)	$ (1,180)	$ (1,135)	$ (1,133)	$ (1,180)	$ (1,095)	$ (1,138)
2018	$ (1,232)	$ (1,142)	$ (1,082)	$ (1,308)	$ (1,174)	$ (1,270)	$ (1,308)	$ (1,136)	$ (1,195)
2019	$ (1,355)	$ (1,255)	$ (1,044)	$ (1,484)	$ (1,186)	$ (1,483)	$ (1,484)	$ (1,161)	$ (1,314)
2020	$ (1,485)	$ (1,374)	$ (1,006)	$ (1,636)	$ (1,199)	$ (1,716)	$ (1,636)	$ (1,251)	$ (1,441)
2021	$ (1,623)	$ (1,502)	$ (966)	$ (1,748)	$ (1,214)	$ (1,969)	$ (1,748)	$ (1,295)	$ (1,576)
2022	$ (1,748)	$ (1,614)	$ (903)	$ (1,893)	$ (1,207)	*	$ (1,893)	$ (1,244)	$ (1,697)
2023	$ (1,882)	$ (1,735)	$ (840)	*	$ (1,203)	*	*	$ (1,143)	$ (1,828)
2024	*	$ (1,865)	$ (776)	*	$ (1,200)	*	*	$ (933)	$ (1,968)
2025	*	*	$ (711)	*	$ (1,200)	*	*	$ (799)	*
2026	*	*	$ (647)	*	$ (1,202)	*	*	$ (667)	*
2027	*	*	$ (617)	*	$ (1,210)	*	*	$ (565)	*
2028	*	*	$ (626)	*	$ (1,264)	*	*	$ (574)	*
2029	*	*	$ (674)	*	$ (1,361)	*	*	$ (596)	*
2030	*	*	$ (726)	*	$ (1,466)	*	*	$ (589)	*
2031	*	*	$ (782)	*	$ (1,578)	*	*	$ (658)	*
2032	*	*	$ (842)	*	$ (1,700)	*	*	$ (893)	*
2033	*	*	$ (907)	*	$ (1,831)	*	*	$ (1,071)	*
2034	*	*	$ (977)	*	$ (1,972)	*	*	$ (1,224)	*
2035	*	*	$ (1,052)	*	*	*	*	$ (1,418)	*
2036	*	*	$ (1,133)	*	*	*	*	$ (1,728)	*
2037	*	*	$ (1,221)	*	*	*	*	*	*
2038	*	*	$ (1,315)	*	*	*	*	*	*
2039	*	*	$ (1,416)	*	*	*	*	*	*
2040	*	-	$ (1,525)	*	*	*	*	*	*

Note: Negative values indicate a surplus. ROR = Rate of Return.
**Surplus in excess of $2 billion.*
***Actual experience equals the long-term assumptions from years eleven (or twenty-one) and beyond, depending on the scenario. Funding is based on the current ROR assumption of 7.7% for the entire period.*

Please see **Appendices A-C** for underlying assumptions.

APPENDIX E – ANALYZE THE MERGING OF LEOFF PLANS 1 AND 2

Unless noted otherwise, the analysis within this appendix will focus on the merger of LEOFF Plans 1 and 2 based on the parameters you provided to us. The defined "LEOFF 1/LEOFF 2 Merger" includes merging the assets and liabilities of both plans, using a long-term ROR assumption of 7.5 percent, and providing for a two-biennia state contribution rate holiday.

Assumptions

This merger analysis follows our "Past Practices" stochastic assumptions including future funding shortfalls and annual benefit improvements. Our stochastic analysis produces 2,000 randomly simulated future economic environments and we summarize the outcomes to quantify the 'likelihood' of a given risk. Please see our projections page of our website for additional information on our stochastic assumptions.

We assumed the benefit structure in each plan would remain unchanged and there would be no change to the current governance structure. We further assumed that future benefit improvements, for all LEOFF members, would occur at the same rate as those for LEOFF 2.

We assumed a funding policy consistent with LEOFF 2 and contribution rates would be determined using the combined assets and liabilities but collected over LEOFF 2 payroll only.

We assumed pay-go has occurred when the amount of annual pay-go exceeds $50 million in present value dollars.

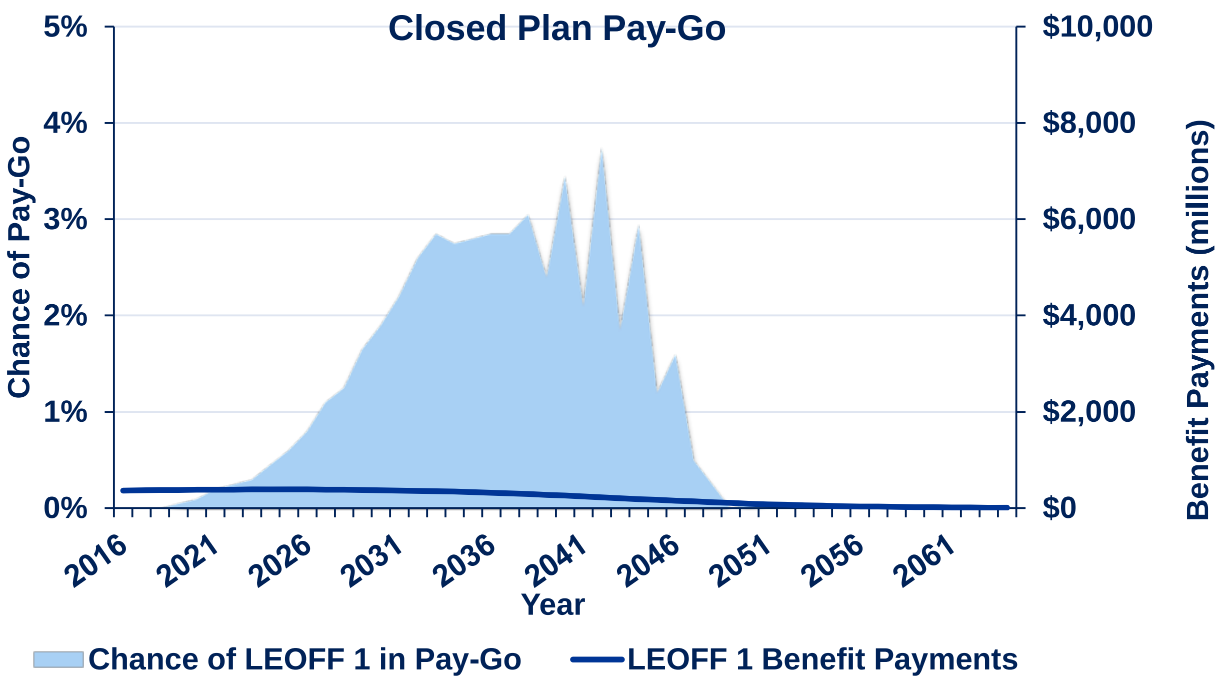
Lastly, we assumed no state contributions will be made for fiscal year 2018 through fiscal year 2021 (four-year state contribution rate holiday).

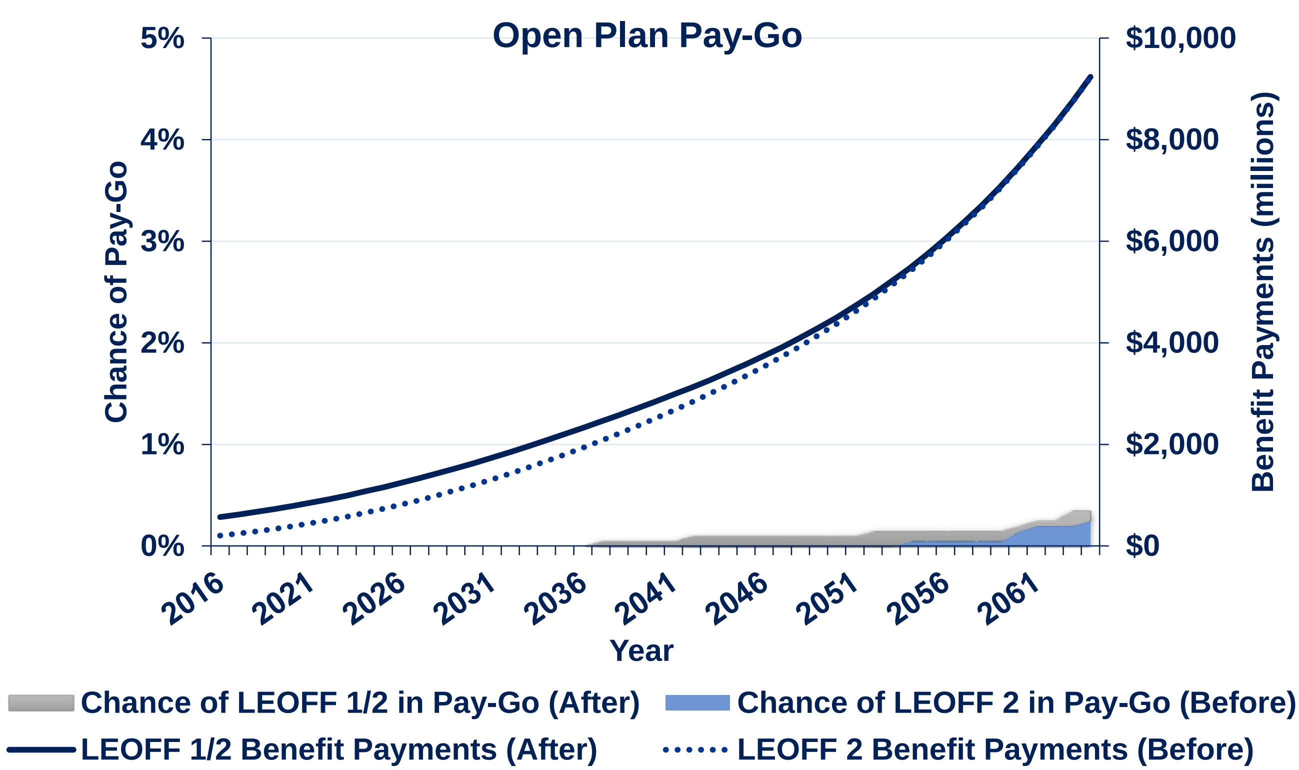
Analysis

Based on our stochastic analysis, the merger of LEOFF 1 and LEOFF 2 would remove the likelihood of pay-go occurrences prior to fiscal year 2037. Beginning in fiscal year 2037 we observe the likelihood of pay-go in the merged plan equal to or greater than our expectations for LEOFF 2 on its own. However, we do not expect the likelihood of pay-go in the merged plan to exceed 0.35 percent in any given year.

The two graphs on the next page display the likelihood of pay-go for LEOFF 1, LEOFF 2, and the merged plan (LEOFF 1/2). In addition to the likelihood of pay-go, we present the expected annual benefit payments to be paid from the plans.

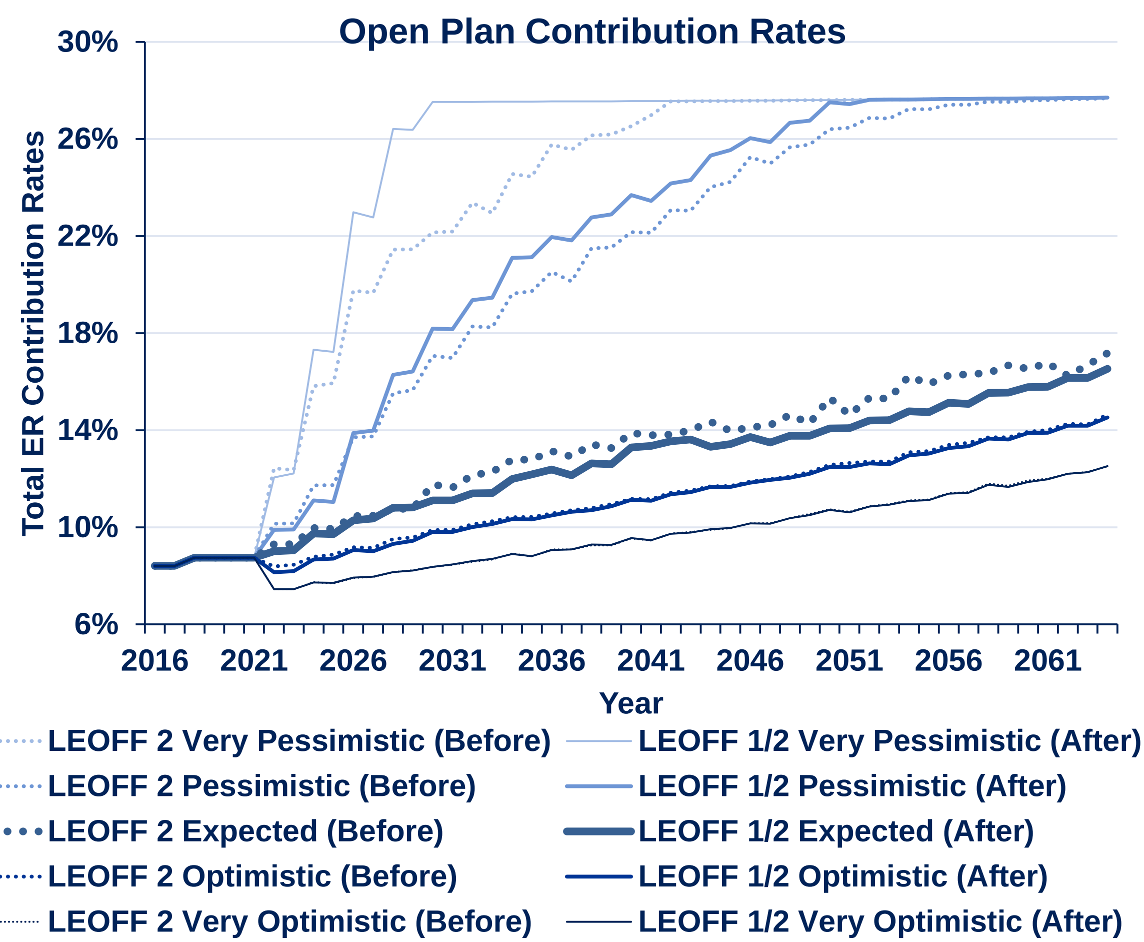
The results presented here could be different under a different set of assumptions. For instance, we would not expect pay-go to occur either for LEOFF 2 or the merged plans if we assumed "Current Law" projections. Under Current Law, we assume no future funding shortfalls or benefit improvements.


Closed Plan Pay-Go
5%
4%
3%
2%
1%
0%
Chance of Pay-Go
$10,000
$8,000
$6,000
$4,000
$2,000
$0
Benefit Payments (millions)
2016
2021
2026
2031
2036
2041
2046
2051
2056
2061
Year
Chance of LEOFF 1 in Pay-Go
LEOFF 1 Benefit Payments


Open Plan Pay-Go
5%
4%
3%
2%
1%
0%
Chance of Pay-Go
$10,000
$8,000
$6,000
$4,000
$2,000
$0
Benefit Payments (millions)
2016
2021
2026
2031
2036
2041
2046
2051
2056
2061
Year
Chance of LEOFF 1/2 in Pay-Go (After)
Chance of LEOFF 2 in Pay-Go (Before)
LEOFF 1/2 Benefit Payments (After)
LEOFF 2 Benefit Payments (Before)

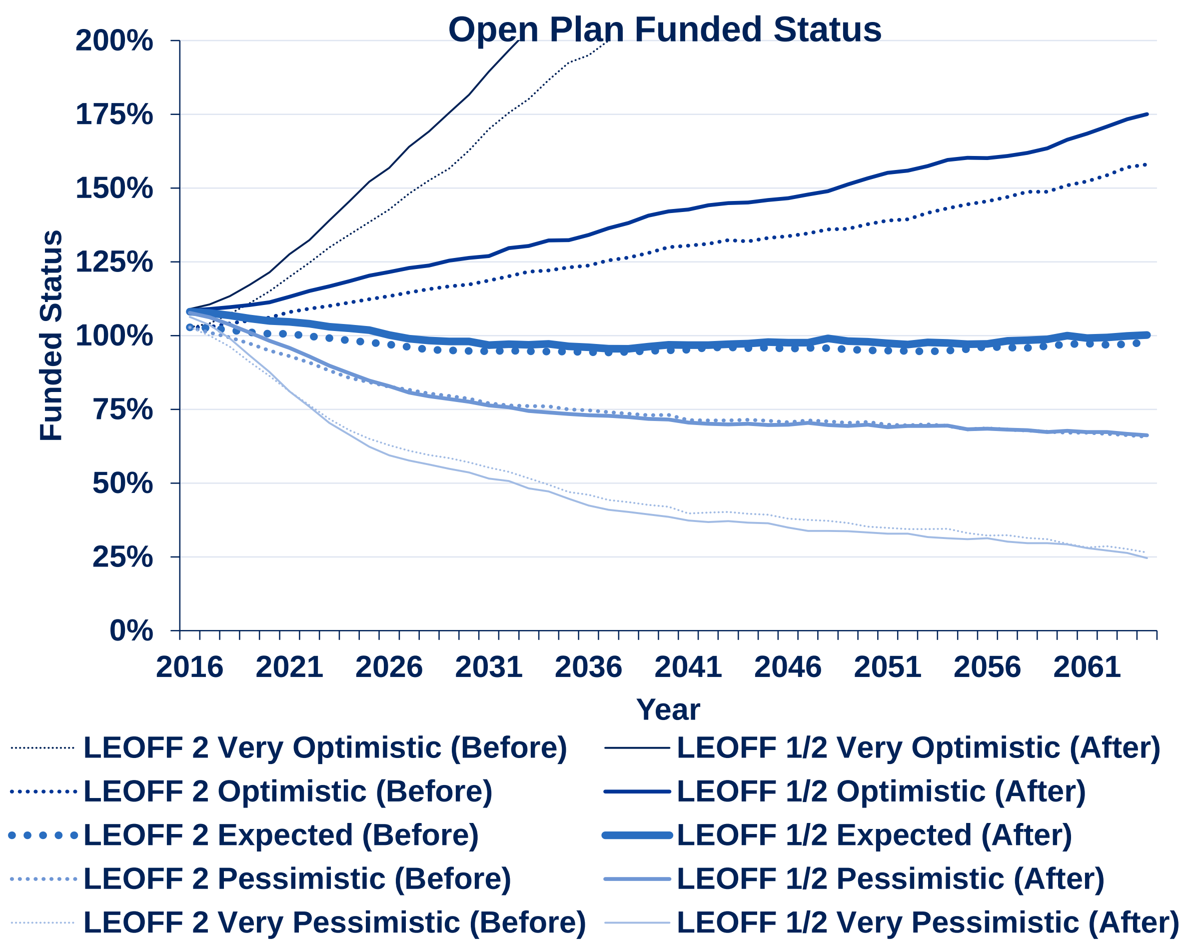
The graph below displays the projected contribution rates under varying percentiles including very optimistic (5th percentile), optimistic (25th percentile), expected (50th percentile), pessimistic (75th percentile), and very pessimistic (95th percentile). Please note that we expect contribution rates to increase under all scenarios as a result of the benefit improvement assumption used in our Past Practices stochastic analysis.

- Optimistic Scenarios: The contribution rates are similar between LEOFF 2 and the merged plan because they are at (or near) the rate floor under strong economic environments. The rate floor is calculated under the Entry Age Normal Cost method which is not impacted by LEOFF 1 assets added under the merger.
- Expected Scenario: The contribution rates improve (decrease) under the merged plan as a result of the addition of LEOFF 1 surplus assets.
- Pessimistic Scenarios: The contribution rates worsen (increase) under the merged plan when economic environments are poor due to the larger combined LEOFF 1 and LEOFF 2 liabilities impacted by poor conditions. The contribution rates ultimately hit the assumed system maximum rate under both pessimistic scenarios.



The graph below displays the projected funded status under varying percentiles including very pessimistic (5th percentile), pessimistic (25th percentile), expected (50th percentile), optimistic (75th percentile), and very optimistic (95th percentile).

- ❖ Optimistic Scenarios: Since the merged plan starts with additional surplus assets, the projected funded status grows larger in the merged plan than in LEOFF 2 under strong economic environments.
- ❖ Expected Scenario: The inclusion of LEOFF 1 surplus assets provide the merged plan with a higher funded status than LEOFF 2. Both LEOFF 2 and the merged plan are projected to fall below 100% funded status as a result of assumed future benefit improvements.
- ❖ Pessimistic Scenarios: Contribution rates reach the assumed system maximum faster under the merged plan so funding shortfalls occur more and the merged plan has a lower funded status than LEOFF 2.



We also considered the impact of the merged LEOFF plans under two other sets of assumptions and methods.

Updated 2011 Merger Study

The underlying assumptions and funding policy are consistent with our LEOFF 1/LEOFF 2 Merger scenario; however, we assumed an 80 percent Entry Age Normal Cost rate floor and contributions would be collected over LEOFF 1 and LEOFF 2 payroll. Additionally, we assumed no state contribution rate holiday.

Plan Merger under L2 Funding Policy without State Holiday

The underlying assumptions and funding policy are consistent with our LEOFF 1/LEOFF 2 Merger scenario; however, we assumed no state contribution rate holiday.

We did not observe a significant change in the chance of pay-go under either scenario from our LEOFF 1/LEOFF 2 Merger analysis. At most, we observed a 0.05 percent change in annual pay-go likelihood.

APPENDIX F – EXPECTED BENEFIT PAYMENTS

The projected annual benefit payments are summarized in the table below.

Fully Projected Benefit Payments											
(Dollars in Millions)					LEOFF - Plan 1						
Year	Future Value	Present Value	Year	Future Value	Present Value	Year	Future Value	Present Value	Year	Future Value	Present Value
2015	$362	$349	2040	$227	$34	2065	$4	$0	2090	$0	$0
2016	367	329	2041	210	29	2066	4	0	2091	0	0
2017	372	309	2042	192	25	2067	3	0	2092	0	0
2018	376	290	2043	175	21	2068	2	0	2093	0	0
2019	379	271	2044	158	18	2069	2	0	2094	0	0
2020	381	253	2045	141	15	2070	2	0	2095	0	0
2021	382	236	2046	126	12	2071	1	0	2096	0	0
2022	382	219	2047	111	10	2072	1	0	2097	0	0
2023	382	203	2048	97	8	2073	1	0	2098	0	0
2024	381	188	2049	84	6	2074	1	0	2099	0	0
2025	379	174	2050	72	5	2075	1	0	2100	0	0
2026	376	160	2051	62	4	2076	1	0	2101	0	0
2027	372	147	2052	52	3	2077	1	0	2102	0	0
2028	367	135	2053	44	3	2078	0	0	2103	0	0
2029	361	123	2054	37	2	2079	0	0	2104	0	0
2030	354	112	2055	31	2	2080	0	0	2105	0	0
2031	346	102	2056	26	1	2081	0	0	2106	0	0
2032	337	92	2057	21	1	2082	0	0	2107	0	0
2033	327	83	2058	17	1	2083	0	0	2108	0	0
2034	316	74	2059	14	1	2084	0	0	2109	0	0
2035	303	66	2060	12	0	2085	0	0	2110	0	0
2036	290	59	2061	10	0	2086	0	0	2111	0	0
2037	275	52	2062	8	0	2087	0	0	2112	0	0
2038	260	45	2063	7	0	2088	0	0	2113	0	0
2039	$244	$40	2064	$5	$0	2089	$0	$0	2114	$0	$0
									Total	**$10,633**	**$4,313**

Please see **Appendix A** for assumptions used to develop this table.

SCPP • 2016 Merger Study

APPENDICES

Select Committee on Pension Policy

Appendix A

Prior Bills Related to LEOFF 1 Surplus

Since 2000, there have been several bills that addressed the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 expected surplus.

2000:

The 2000 Supplemental Operating Budget[1] modified the LEOFF 1 funding policy to state that no contributions were required from June 30, 2000, onward, unless the most recent valuation study showed that LEOFF 1 had unfunded liabilities.[2] As a result, no contributions have been made to the plan since 2000.

2001:

A bill was introduced that would close and restate the LEOFF 1 plan.[3] This bill would have distributed the surplus in three portions:

- Members.
- Local governments (for LEOFF 1 medical benefits).
- A new reserve fund to ensure actuarial soundness of LEOFF 1.

This bill did not pass.

2011:

Multiple bills were introduced that would have merged LEOFF 1 and LEOFF 2:

---

[1] EHB 2487 (Chapter 1, Laws of 2000 2nd Sp.S, Section 907).
[2] This provision was modified in 2007 (SSB 5174, Chapter 492, Laws of 2007, Section 8) to read as follows: No employer or member contribution is required after June 30, 2000, unless the most recent valuation study for law enforcement officers' and fire fighters' retirement system plan 1 indicates the plan has unfunded liabilities. The legislature clarifies the enactment of section 907, chapter 1, Laws of 2000 2nd sp. sess. and affirms the suspension of employer and member contributions to plan 1 of the law enforcement officers' and fire fighters' retirement system, effective June 30, 2000, as provided in this subsection. The legislature intends this 2007 amendment of this subsection to be curative, remedial, and retrospectively applicable to June 30, 2000.
[3] SB 6166, 2001.

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- HB 2097[4].
- HB 2350[5].
- SB 6563[6].

The bills were largely identical, but please see the actual bills or staff bill reports for details. In general, the bills would have merged the assets and liabilities of the LEOFF 1 and LEOFF 2 plans. In other words, this would have allowed the LEOFF 1 surplus to be used to fund both LEOFF 1 and LEOFF 2 benefits. The bills would also have temporarily reduced the state contributions required for LEOFF 2.

While none of these bills passed, the Legislature included a budget proviso in the 2011-13 Operating Budget that required the Office of the State Actuary (OSA) to study a merger of LEOFF 1 and LEOFF 2.[7]

The resulting *2011 OSA Merger LEOFF Merger Study* is available on OSA website.

2016:

A bill was introduced to merge LEOFF 1 and the Teachers' Retirement System (TRS) Plan 1.[8] This bill would have merged the assets and liabilities of the LEOFF 1 and TRS 1 plans. In other words, this would have allowed the LEOFF 1 surplus to be used to fund both LEOFF 1 and TRS 1 benefits. The bill would also have temporarily reduced the state contributions required for TRS 1, and provided a one-time payment to LEOFF 1 members. The bill also utilized the LEOFF 1 surplus to reduce rates for TRS 1.

While this bill did not pass, the Legislature included a budget proviso in the 2016 Supplemental Operating Budget that required the SCPP to study a merger of LEOFF 1 and TRS 1,[9] and update the 2011 OSA LEOFF Merger Study.

See below for a section-by-section explanation of the bill.

[4] HB 2097, 2011.
[5] HB 2350, 2011.
[6] SB 6563, 2011.
[7] 2ESHB 1087 (Chapter 50, Laws of 2011, Section 104).
[8] SB 6668, 2016.
[9] 2ESHB 2376, (Chapter 36, Laws of 2016, Section 106).

Select Committee on Pension Policy

Appendix B

Bill Sectional: Senate Bill 6668 (2016)

When two retirement plans are merged, then assets of both plans can be used across the two plans. Other than that, little about a merger is prescribed. Theoretically, a merger of two retirement plans can involve impacts to governance, funding policy, benefits, and other aspects of each plan.

Thus, it is impossible to outline everything that *could* take place in a successful merger bill. It is also impossible to predict exactly what *would* take place in such a merger bill.

We can instead clarify with a reasonable amount of certainty what Senate Bill 6668 would have done as drafted. Technically this bill is dead because all bills die at the end of the biennial legislative cycle. However, a nearly identical or reasonably similar bill could be introduced at the beginning of the next cycle, and thus a clear understanding of the bill's provisions may prove helpful.

Section 1 -- Intent

This section states the Legislature's intent in merging the two systems. The following text is reproduced verbatim:

The legislature intends to improve the actuarial soundness of the teachers' retirement system plan 1 while also continuing the state commitment to maintain the actuarial soundness of benefits promised to members of the law enforcement officers' and firefighters' retirement system plan 1 by merging the assets, liabilities, and membership of the law enforcement officers' and firefighters' retirement system plan 1 into the teachers' retirement system plan 1. The legislature further intends that this merger of assets, liabilities, and membership, and any administrative changes necessary to implement the merger, be accomplished in a way that does not impact benefits provided to members of either the teachers' retirement system plan 1 or the law enforcement officers' and firefighters' retirement system plan 1.

The legislature further intends that the merger of assets, liabilities, and membership of the teachers' retirement system plan 1 and the law enforcement officers' and firefighters' retirement system plan 1 be administered in a way consistent with plan qualification requirements in the federal internal revenue code.

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Select Committee on Pension Policy

Section 2 -- Merger

This section merges the assets, liabilities, and membership of the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 and Teachers' Retirement System (TRS) Plan 1 systems. It further states that:

- The LEOFF 1 plan will be administered as a separate tier of the TRS 1 plan.
- All assets of TRS 1 and LEOFF 1 are merged.
- All liabilities of TRS 1 remain liabilities of the TRS 1 plan after the merger.
    - All benefits for TRS 1 are paid by the merged TRS 1 plan.
- All liabilities of LEOFF 1 become liabilities of the TRS 1 plan after the merger.
    - All pension benefits for LEOFF 1 are paid by the merged TRS 1 plan.
    - This does not include medical benefits for LEOFF 1. All LEOFF 1 medical/disability liabilities remain liabilities of LEOFF 1 employers.

Section 3 -- No Impact to Pension Benefits

This section states that the merger may not impact the benefits of either TRS 1 or LEOFF 1. It further specifies that members of both plans are entitled to the same benefits immediately after the merger as they were before the merger.

The Department of Retirement Systems (DRS) is explicitly instructed to administer the merger in such a way that ensures member benefits are neither increased nor decreased by the merger.

DRS is further instructed to submit a request for a determination letter from the Internal Revenue Service (IRS).

Section 4 -- No Impact to Medical Benefits

This section explicitly states that the merger does not impact the LEOFF 1 disability/medical boards or any official action of those boards.

Section 5 -- TRS 1 UAAL Rate

The contribution rate intended to fund the Unfunded Actuarial Accrued Liability (UAAL) of TRS 1 is set at 4.24 percent from September 1, 2016, to August 31, 2017.

Section 6 -- Lump Sum Benefit

Prior to merging, this section would have disbursed a portion of the funds in the LEOFF 1 retirement account to LEOFF 1 members only.
Specifically, this section required that on January 3, 2017, or the member's retirement date, the sum of $5,000 would be paid to the following LEOFF 1 beneficiaries:

- Active members.
- Term-vested members.
- Retirees.
- Eligible survivors.

For active and term-vested members, the lump sum would not be paid until retirement, but interest would accrue on this payment until that time. If the member died prior to retirement, the distribution would be made according to the member's beneficiary designation.

This lump-sum payment would have been subject to the provisions of RCW 41.26.053, which provides that pensions are not generally subject to taxes and judicial processes, except as listed in the statute.

This section also contains a refund clause, meaning that if certain sections of the bill were held invalid then members do not have a right to the lump sum benefit, and it must be repaid if the member had already received it.

Section 7 -- Technical Change

This section clarifies that once the merger goes into effect, references to "retirement fund" in the LEOFF 1 statutes will refer to the TRS 1 retirement fund.

Section 8 -- Funding Policy: Contributions

This section clarifies that after the merger no contributions can be required from the LEOFF 1 *members or employers*, except for the administrative rate charged to employers under RCW 41.50.110.

Section 9 -- Funding Policy: Funding Goal

This section strikes the statutory goal of amortizing any UAAL existing in LEOFF 1 by June 30, 2024.

Section 10 -- Funding Policy: Pension Funding Council and Contribution Rates

This section modifies instructions to the Pension Funding Council (PFC) as follows:

- For LEOFF 1:
  - The PFC no longer adopts a basic contribution rate.[1]
  - The requirement that the basic contribution rate fully amortize any UAAL existing in LEOFF 1 by June 30, 2024, is removed as well.[2]
- For TRS 1:
  - The basic contribution rate adopted by the PFC must be sufficient to fully fund the merged plan.[3]

This section would also revise the way basic employer contribution rates for TRS 1 are calculated.[4] Specifically:

- The calculation must use projected future salary and system growth in TRS 1, but not in LEOFF 1.
- The calculation must include the amount required to amortize the cost of any benefit improvements for LEOFF 1 effective after the merger.
  - Any benefit improvements for LEOFF 1 must be amortized over a fixed ten-year period using projected future salary and system growth in TRS 1, but not in LEOFF 1.
  - This amount is collected in addition to the normal contribution rates, and is not subject to any minimum or maximum rates.

Section 11 -- TRS 1 Funding Policy

Subsection 6 of this section would have reduced the current TRS 1 UAAL rate by establishing a lower fixed rate in the short term, and then a minimum rate in the future. More specifically:

- From September 1, 2016, through August 31, 2021, a fixed UAAL contribution rate of 4.24 percent is established. This rate

[1] Subsection 2(a).
[2] Subsection 3(a).
[3] Revised subsection 3(b).
[4] Subsection 8.

excludes the cost of any benefit improvements enacted after June 30, 2016.

- ◊ The current rate is 5.75 percent, and excludes the cost of benefit improvements enacted after June 30, 2009.

❖ Beginning September 1, 2021, a minimum UAAL contribution rate of 4.24 percent is established.

Subsection 3 of this section also states that the maximum employer contribution rate cap for TRS 1 UAAL that already ended under current law would exclude the cost of any benefit improvements for either TRS 1 or LEOFF 1 effective after June 30, 2009.

Section 12 -- Clarification

This section clarifies that one statutory reference to the LEOFF system refers to the LEOFF 2 plan only. This is the section that requires the director of the Department of Retirement Systems to prepare, among other things, a financial statement on the condition of the LEOFF system.

Section 13 -- Trust Accounts

Pursuant to a merger of assets, this section closes the LEOFF 1 account, and transfers all funds to the TRS 1 account. In the future, any and all moneys payable to the LEOFF 1 account (such as interest, see Section 14) would be paid to the merged TRS 1 account instead.

This section also states that after a merger the TRS 1 account consists of moneys paid to finance both the TRS 1 benefits and the LEOFF 1 benefits.

Section 14 -- Treasury Accounts

This section strikes the LEOFF 1 trust account from the list of accounts managed by the State Treasurer (OST). Currently, OST determines what portion of the Treasury Income Account each account should receive.[5]

Pursuant to a merger of assets with the TRS 1 account (Section 2) and the closure of the LEOFF 1 account (Section 13), the reference to the LEOFF 1 account is stricken.

[5] This is different from "regular interest" credited to retirement accounts which is determined by the director of DRS. See e.g. RCW 41.50.033 and RCW 41.40.010(31).

Section 15 -- Administration Consistent with IRS Rules; Null and Void Clause

This section states that the bill must be administered consistent with IRS rules. If there are any parts of the bill that are unclear, it must be interpreted in a way that favors IRS compliance.

Also, if the IRS issues a determination letter stating that Section 2 is in conflict with IRS rules and the conflict cannot be addressed through administrative action or statutory change, then Sections 2, and 6-14 are null and void.

Section 16 -- Severability Clause

This section states that if any provision of the bill is held invalid (e.g., is struck down by the court), then the rest of the bill is unaffected. The same applies if the bill is held invalid as it applies to any particular person.

Section 17 -- Effective Date

The act takes effect September 1, 2016.

Select Committee on Pension Policy

Appendix C

Agency Request Letters

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Select Committee on Pension Policy

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August 9, 2016

Ms. Anne Hall
Senior Counsel
Washington State Attorney General
P.O. Box 40108
Olympia, WA 98504

Dear Ms. Hall:

Consistent with the adoption of the 2016 Merger Study work plan at their June meeting, the Select Committee on Pension Policy (SCPP) formally requests the assistance of the Attorney General's Office (AGO) in completing the 2016 Merger Study, as required under Section 106 of Chapter 36, Laws of 2016. I believe the following information is consistent with our prior discussions, but please contact me if you have questions or concerns with any item.

Specifically, the SCPP is requesting that the AGO analyze the legal implications of a merger of the Law Enforcement Officers' and Fire Fighters' Plan 1 and the Teachers' Retirement System Plan 1, including any impacts at both the state and federal level, and report back to the SCPP as outlined below.

As you are aware, SCPP staff is conducting a stakeholder survey to help inform the analysis. We have shared a preliminary compilation of the results with you, and will forward a final version when complete (approximately mid-September). We encourage you to answer as many of the questions that relate to your area of expertise as time and resources allow.

In order to meet the required deadline of January 9, 2017, the SCPP asks that, at a minimum, you provide the following:

- A presentation updating the SCPP on your analysis at the SCPP meeting on October 18.

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

- A presentation of a preliminary draft of your full report at the SCPP meeting on November 15.
- A presentation of a final draft at the SCPP meeting on December 13.

Please contact SCPP staff if you have any questions or concerns with this request, the survey, or coordination with the SCPP.

Thank you for your assistance,

Aaron Gutierrez, MPA, JD
Staff Coordinator
Select Committee on Pension Policy

cc: Senator Steve Conway, Chair
  Select Committee on Pension Policy
 Representative Bruce Chandler, Vice Chair
  Select Committee on Pension Policy
 Matt Smith, FCA, EA, MAAA
  State Actuary

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Select Committee on Pension Policy

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August 9, 2016

Mr. Steve Nelsen
Executive Director
LEOFF 2 Board
P.O. Box 40918
Olympia, WA 98504-0918

Dear Mr. Nelsen:

Consistent with the adoption of the 2016 Merger Study work plan at their June meeting, the Select Committee on Pension Policy (SCPP) formally requests the Law Enforcement Officers' and Fire Fighters' (LEOFF) Plan 2 Board's assistance in completing the 2016 Merger Study, as required under Section 106 of Chapter 36, Laws of 2016. I believe the following information is consistent with our prior discussions, but please contact me if you have questions or concerns with any item.

Specifically, the SCPP is requesting that the LEOFF 2 Board update OSA's 2011 Merger Study, which focused on a hypothetical merger of LEOFF 1 and LEOFF 2.

As you are aware, SCPP staff is conducting a stakeholder survey to help inform the analysis. We have shared a preliminary compilation of the results with you, and will forward a final version when complete (approximately mid-September). While the survey is predominantly geared toward the LEOFF 1/Teachers' Retirement System Plan 1 portion of the study, there are many LEOFF 2 questions, and a great many more that overlap between the two analyses. We encourage you to answer as many of the questions that relate to your area of expertise as time and resources allow.

In order to meet the required deadline of January 9, 2017, the SCPP asks that, at a minimum, you provide the following:

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

- ❖ A presentation updating the SCPP on your analysis at the SCPP meeting on October 18.
- ❖ A presentation of a preliminary draft of your full report at the SCPP meeting on November 15.
- ❖ A presentation of a final draft at the SCPP meeting on December 13.

Please contact SCPP staff if you have any questions or concerns with this request, the survey, or coordination with the SCPP.

Thank you for your assistance,

Aaron Gutierrez, MPA, JD
Staff Coordinator
Select Committee on Pension Policy

cc: Kelly Fox, Chair
LEOFF 2 Board
Senator Steve Conway, Chair
Select Committee on Pension Policy
Representative Bruce Chandler, Vice Chair
Select Committee on Pension Policy
Matt Smith, FCA, EA, MAAA
State Actuary

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P.O. Box 40914
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Select Committee on Pension Policy

August 9, 2016

Mr. Jacob White
Legal and Legislative Services Manger
Department of Retirement Systems
P.O. Box 48380
Olympia, WA 98504-8380

Dear Mr. White:

Consistent with the adoption of the 2016 Merger Study work plan at their June meeting, the Select Committee on Pension Policy (SCPP) formally requests the assistance of the Department of Retirement Systems (DRS) in completing the 2016 Merger Study, as required under Section 106 of Chapter 36, Laws of 2016. I believe the following information is consistent with our prior discussions, but please contact me if you have questions or concerns with any item.

Specifically, the SCPP is requesting that DRS analyze the administrative implications of a merger of the Law Enforcement Officers' and Fire Fighters' Plan 1 and the Teachers' Retirement System Plan 1, including any impacts at both the state and federal level, and report back to the SCPP as outlined below. We understand there may be some overlap with the legal analysis (e.g., the tax implications), and we encourage you to communicate with the Attorney General's Office if there is any concern of duplicating analysis.

As you are aware, SCPP staff is conducting a stakeholder survey to help inform the analysis. We have shared a preliminary compilation of the results with you, and will forward a final version when complete (approximately mid-September). We encourage you to answer as many of the questions that relate to your area of expertise as time and resources allow.

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- A presentation updating the SCPP on your analysis at the SCPP meeting on October 18.
- A presentation of a preliminary draft of your full report at the SCPP meeting on November 15.
- A presentation of a final draft at the SCPP meeting on December 13.

Please contact SCPP staff if you have any questions or concerns with this request, the survey, or coordination with the SCPP.

Thank you for your assistance,

Aaron Gutierrez, MPA, JD
Staff Coordinator
Select Committee on Pension Policy

cc: Senator Steve Conway, Chair
Select Committee on Pension Policy
Representative Bruce Chandler, Vice Chair
Select Committee on Pension Policy
Matt Smith, FCA, EA, MAAA
State Actuary

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Select Committee on Pension Policy

Appendix D

This document is solely an SCPP staff summary of the high-level takeaways from the legal analysis that is reprinted verbatim in other sections of this report. It was reviewed by the Assistant Attorney General and Ice Miller, but **no additional information was provided**.

We provide it here for the purposes of transparency and supplemental documentation only. In case of any conflict between this summary document and the legal analysis in the preceding sections of the report, those sections should be considered a more accurate reflection of the Assistant Attorney General's and Ice Miller's professional opinions than this document.

1. There is no apparent legal barrier to merging the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 1 and the Teachers' Retirement System (TRS) Plan 1, however any legislation comes with the risk that a court may strike it down.
   a. The merger described in Senate Bill (SB) 6668 is probably not prohibited under state or federal law.
   b. The Washington State Legislature has general authority to create and modify retirement plans, subject to restrictions in state law.
2. A "merger" is a merger of assets and liabilities of more than one tax-qualified plan.
   a. Assets must be usable across the combined plan.
   b. Can be contrasted with a "consolidation"; Washington plans are already consolidated for certain purposes.
3. If a bill was introduced that had the same provisions as SB 6668, the merger provided under that bill probably would not be prohibited under state or federal law. There are some suggested changes that can be made to the bill, such as:
   a. Modify TRS statutes to show merger of the two plans
      i. The prior bill only modified LEOFF 1 statutes (RCW 41.26), funding policy statutes (RCW 41.45), and the DRS statutes (RCW 41.50).
      ii. Specifically, there should be some adjustments in RCW 41.32 that put the reader on notice that the merger has occurred, and that the LEOFF 1 plan is

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now a tier of the TRS 1 plan, but that each plan retains the benefits provided in that original plan.

b. A better structure would be if both LEOFF 1 and TRS 1 are merged into a new plan so that a Determination Letter (DL) can be sought from the IRS based upon its recent changes to the DL program.

c. Make the actual merger of assets and liabilities contingent on favorable Private Letter Ruling (PLR) and DL.

    i. In other words:

        1. The bill is effective, for example, 90 days after session.

        2. The actual merger is only effective once DRS receives both the PLR and a favorable DL from the IRS.

    ii. That said, other aspects of the bill (such as the rate relief provisions) can be effective whenever the Legislature chooses.

        1. The decision of whether or not to make rate relief contingent on a PLR/DL is a policy choice; not a legal concern.

4. As currently drafted, a court would probably find that SB 6668 does not impact members' vested benefits to a monthly retirement allowance.

    a. The bill contains explicit statements to this effect (specifically, that each participant in the merging plan will receive benefits after the merger which are equal to or greater than the retirement benefits the participant would have received on a termination basis immediately before the merger).

    b. Members have a vested right to certain benefits as defined by their plan.

        i. "Benefits" can mean the monthly benefit allowance after retirement as calculated by the formula in statute. It can also mean statutory disability, death and survivor benefits. It can also mean other rights that have been described by Washington courts.

        ii. So long as members (including survivors) receive the promised monthly benefit payments, the courts will likely not object to a merger for this reason based on a constitutional contractual right analysis.

5. At the state level, members have a right to the systematic funding of a public pension plan to maintain its actuarial soundness.

    a. There is no consistent measure of the term "actuarial soundness" because the term is not defined in statute, or in case law, or in actuarial standards of practice.

b. Absent evidence that a merger makes a plan actuarially <u>un</u>sound, the courts will likely not object to a merger for this reason.

6. No Washington court has considered the legality of a merger of pension plans such as provided for in SB 6668. Given the lack of precedent it is always possible that a court might find fault with this merger.

7. The liabilities of the plans and the funding level of the plans should be considered separately.

   a. At the federal level, the funded status of both plans is irrelevant for the purposes of a merger.

   b. For the purpose of federal tax law, plan "liabilities" means the benefits that are owed under the plans (including retirement benefits as calculated above, as well as disability and death benefits under the plans).

   c. These benefits do not increase or decrease with the funded level.

8. As currently drafted, SB 6668 is intended to satisfy the Exclusive Benefit Rule (EBR).

   a. Under tax law, the EBR must be satisfied, both before and after a merger.

   b. The IRS will consider the EBR satisfied so long as benefits are being paid such that each participant in the merging plan will receive retirement benefits after the merger which are equal to or greater than the retirement benefits the participant would have received on a termination basis immediately before the merger.

9. As currently drafted, SB 6668 does not result in a prohibited reversion of assets.

   a. A reversion of assets occurs when a party is entitled to remove assets from the trust and the assets are returned to either the plan sponsor or participating employers.

      i. For example, if the legislature wanted to remove assets from the pension trust to help pay for roads.

   b. When all total liabilities of a plan are satisfied, any remaining assets revert to the plan sponsor and/or participating employer(s) based upon the terms of the plan.

      i. In that sense, the plan sponsor and/or participating employer(s) "own(s)" the expected surplus.

         1. State is the plan sponsor.

      ii. Since total liabilities have not been satisfied (i.e., an expected surplus based on assumptions is not the same as having all liabilities finally paid and remaining assets physically on hand), a reversion of LEOFF 1 assets may not take place at this time.

c. Because no money is being taken out for non-benefit purposes, the merger of assets and liabilities in SB 6668 does not meet the definition of a reversion, and is therefore not prohibited (see Ice Miller's discussion in Sections IV.L. and VIII of their letter and their answer to Question No. 34 in the Appendix to their letter).

10. The $5,000 lump sum payout is permissible under state and federal law, and is therefore a policy choice for lawmakers.

    a. It is not a prohibited gift of public funds under Art. II, Section 25 of the Washington Constitution.

    b. Art. II, Section 25 expressly provides an exception for increases in payments to retirees.

11. Retirement plans with dissimilar employers can be merged.

    a. The Public Employees' Retirement System, for example, combines many different types of employers.

    b. The fact that in a pension plan one employer is a utilities district and the other is a city is irrelevant under state and federal law so long as all participating employers are the state or political subdivisions of the state, including agencies or instrumentalities of the state or its political subdivisions.

    c. As noted above, the plan sponsor is the state.

12. The Alaska case of *Anchorage v. Gallion* is <u>un</u>likely to be persuasive to Washington courts.

    a. Under federal law this case is irrelevant to a federal tax law analysis.

    b. Under state law:

        i. Its holding diverges from the holding by the Washington Supreme Court in *RPEC v. Charles*.

        ii. The *Anchorage v. Gallion* court based it's holding on a previous Alaska case, *Sheffield v. Alaska Public Employees' Ass'n*.

        iii. The Washington Supreme Court has recently expressly rejected the Alaska court's reasoning in the Sheffield case. Washington courts tend to rely primarily on their own case law.

SCPP Select Committee on Pension Policy

2016 Merger Study

for LEOFF Plan 1 and TRS Plan 1

December 2016