Groundwork Report for Medical Benefits Study

Law Enforcement Officers and Firefighters Pension Plan 1

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Jointly prepared by

Washington State Department of Retirement Systems

and

Washington State Health Care Authority

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Executive Summary

Local governments are facing a significant challenge determining how to address the cost of healthcare obligations for Law Enforcement Officers' and Firefighters' (LEOFF) Plan 1 retirees. The Governor directed the Department of Retirement Systems (DRS) and the Health Care Authority (HCA) to establish the groundwork for a comprehensive study of this issue.

Background

LEOFF Plan 1 retirees receive full healthcare coverage provided by their employers. The medical benefits for LEOFF Plan 1 disability retirees, which represents over 50% of the total number of retired Plan 1 members, are also paid by the employer and governed by local disability boards. Many members retire in their fifties due to the nature of their work. The plan was closed to new members in 1977, nearly thirty years ago, so most LEOFF Plan 1 members are already retired.

LEOFF employers have historically paid their retirees' medical costs when they occurred, and recorded them as current expenses. New government accounting standards require that non-pension retiree benefits, such as healthcare, be recorded as an expense over the working life of the employee when they are earned rather than in retirement when they are paid. The expense becomes an unfunded liability if the funds are not set aside to cover those benefits. Unfunded liabilities can impact a local government's financial position and bond rating. Current estimates of this liability, statewide, are between $750M and $1.25B.

Approach for this Report

The purpose of this report is to lay the groundwork for a future study. The report draws no conclusions. The approach of this report is to accurately characterize the problem and raise all of the collective questions, without bias, that stakeholders have expressed throughout the years.

This document:

- Describes the obligations cities and counties have to pay for LEOFF Plan 1 retiree medical costs.
- Provides historical information about LEOFF Plan 1 and related medical costs.
- Provides an overview of previous studies and recent legislative proposals for addressing the liabilities.
- Outlines a range of potential, but not exhaustive, solutions to be considered in a future study.
- Lists questions that a comprehensive study must ensure are answered in a way that all stakeholders have a common understanding of the answer.
- Suggests an interest-based approach for a formal study of this issue.

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The process used to develop this report was to 1) conduct research of legislative, legal, and other actions related to LEOFF Plan 1; 2) research potential solutions being considered in others states facing a similar situation; 3) develop a tentative framework for a formal study; and 4) meet with stakeholders to obtain and incorporate their input.

Recommendations for Future Study

DRS and HCA offer three recommendations to assist local governments in their search for ways to address their LEOFF Plan 1 Medical obligation in the most efficient way possible.

Recommendation 1 – The first recommendation is to create an interest-based process that brings all stakeholders together. An interest-based approach is suggested because of the lack of success a lengthy position-based approach has produced. The interests of the stakeholders overlap, and there may be more commonality than is currently recognized. Some stakeholders agree that this is the best remaining approach to a previously insoluble problem; others have concern about looking at solutions broader than funding sources.

A panel from DRS, HCA, and the Office of Financial Management (OFM), and LEOFF Plan 1 employers and active/retired members could be appointed to deliver recommendations for local government employers to efficiently address their retiree medical obligation. The Office of the State Actuary (OSA) will participate as expert, independent support. OSA received funding in the 2007-2009 biennial budget to quantify the liability. DRS will provide financial and staff support to this study. If further funds are required, they will be requested in the 2008 supplemental budget.

Properly conducted, DRS and HCA believe this approach is consistent with the Governor's directive and has the potential to achieve success through exploration of a broad range of possibilities, including mechanisms emphasizing efficiencies and changes to the cost structure of the current system.

DRS and HCA recognize the introduction of an interest-based approach can create anxiety. Stakeholders often fear they will "lose" when they are asked to relinquish the position in favor of achieving their interest, even if it improves their circumstances. Some, not all, member/retiree stakeholders have stated an unwillingness to participate in a full discussion.

Recommendation 2 - A related approach to an interest-based process is to convene and fund a task force of DRS, HCA and employer stakeholders, conferring with member/retiree stakeholders on issues directly affecting them. This approach would allow exploration of a broad range of alternatives and efficiencies, but still involve all stakeholders in issues they have stated a willingness to discuss. With the approach of the GASB 2008 deadlines, and an unwillingness of some stakeholder to discuss all issues, this may be a viable alternative for creating a final effort that can succeed.

Recommendation 3 - A third option is to outsource a study of the issue to a third party independent of the state, employees and employers. The independent third party could be a human resource or similar consulting firm. The strength of this approach is that funding

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retirement medical benefits is a national issue. It is not specific to Washington State. A significant amount of knowledge and research is being done for governments around the country. Washington State could benefit from this the knowledge gained by someone working in multiple situations. This approach could be structured to create an unbiased, independent report and solution for consideration.

DRS and HCA recommend one of these three approaches to assisting employers in addressing this liability that is of critical importance to LEOFF Plan 1 members and retirees. We further recommend that no state funding be considered for use in addressing this liability.

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Full Report

Statement of the Problem

LEOFF Plan 1 members are eligible for post-retirement benefits such as health care in addition to their pension. New accounting standards require that the liability for these benefits be accrued on their employer's financial statements by 2008. Further, the liability must be accrued during the working life of the employee.

Nearly all LEOFF Plan 1 members are retired. Their full retiree health care liability must be recorded by employers in their 2008 financial statements. Changing to this accrual basis from the current pay-as-you-go basis may jeopardize the financial viability and/or bond ratings of many local governments within the state. But this is only part of the problem. Ballpark estimates of the state-wide liability range from $750K to $1.25B. Finding financial resources to pre-fund and thereby reduce the liability may be an even greater challenge.

Not a New Problem

This is not a newly recognized problem triggered by recent accounting standards. Debate and efforts to address this medical liability have been occurring for years. These efforts have been stymied for a number of reasons, primarily because stakeholders disapproved of prior actions or disagreed on funding options. A very high lack of trust between LEOFF Plan 1 members and employers now exists, making it very difficult to create, or even discuss, a logical solution in which everyone benefits.

In a recent attempt to find a solution for this problem, the 2006 Legislature passed Substitute House Bill 2688, in which the Governor was to establish a joint executive task force on funding medical benefits for members of LEOFF Plan 1. The bill stated the intention of the Legislature was to create a funding vehicle to assist employers in providing postretirement medical benefits for members of LEOFF Plan 1 and to evaluate the June 30, 2000 suspension of employer and member contributions in the plan.

The Governor vetoed this section of the bill, recognizing:

> "Local governments face challenges in providing health care benefits for retired members of the Law Enforcement Officers' and Firefighters' Retirement System Plan 1 (LEOFF Plan 1). The cost of these benefits can be significant, especially for smaller jurisdictions. It is sensible for the state to assist local governments in their search for ways to address this obligation in the most efficient way possible. However, a thorough and careful review of options will take longer than provided in the bill, and will need to include a broader range of possibilities. The bill also charges a task force to study the use of excess pension assets to provide health coverage. Notwithstanding potential legal barriers to this use of pension assets, the current financial situation of the LEOFF 1 pension plan clearly does not support this option.
>
> While I am vetoing Section 2 (of Substitute HB 2688), I am directing the Department of Retirement Systems and the Health Care Authority to lay the groundwork for study of

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this issue, and to consult plan members and representatives of local governments in their work."

~ Governor Christine Gregoire, March 30, 2006, Veto message on SHB 2688

Laying the Groundwork for a Future Study

The Department of Retirement Systems (DRS) and the Health Care Authority (HCA) are responding to the Governor's veto request by:

- Performing an environmental scan of the history, laws, and prior activities relating to the issue
- Identifying areas of fact to be clarified and documented
- Identifying a broader range of possibilities to assist in funding than has been previously considered
- Meeting with diverse stakeholders from employee and employer groups
- Identifying a framework for the actual study of the issue and recommendations for solutions

Framework of this Report

The approach for this report is to lay the groundwork for a future study by characterizing the problem, reflecting stakeholder concerns and questions, and framing a potential, but not exhaustive, set of solutions. An important distinction is that this report draws no conclusions nor supports any potential solution. It is intended to create a more uniform understanding among stakeholders of a very complex problem so that a future study has a greater chance of achieving successful results. The report lays the framework for the conduct of the future study.

This report was developed and is structured by the history of the problem and commonly identified potential solutions. The history includes information about legal and accounting requirements as well as information specific to LEOFF Plan 1. This document describes the obligations cities and counties have to pay for the medical costs for their LEOFF Plan 1 retirees. It is intended to be accurate for the purpose of characterizing and simplifying the problem. It is not intended to be an historical record.

The potential solutions are intended to be comprehensive and unbiased but not exhaustive:

- Recording the liability and continuing pay-as-you-go funding
- Pre-funding the liability using one or a combination of several sources
- Reducing healthcare liability costs
- Reducing administrative costs

A common understanding of the legal aspects of actions that a future study may consider is critical for the success of that effort. Inconsistent understanding and interpretation of these

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legal aspects have contributed to the significant disagreements and misunderstandings between stakeholders.

This report lists many of the questions that must be answered in order to create a common understanding, dispel unnecessary misunderstandings, and concentrate on solutions agreeable to stakeholders. These questions are raised, and specifically not answered, in this report. For example, stakeholders agree that medical benefits are most likely a contractual right. The future study is an ideal vehicle to obtain a legal opinion to eliminate it permanently as a source of friction. Raising the question is intended to eliminate it from detracting from the solution and to move the discussion to productive areas, not to suggest the benefit be eliminated.

These questions can be identified throughout the report as "Proposed Study Questions", and are listed in total in an index at the end of this document.

Section 2 - Environmental Scan

History of LEOFF Plan 1 Pension and Medical Benefits

LEOFF Plan 1 is a defined benefit pension plan that was created in 1970 when state, city, county and other local government pension plans covering police and fire fighting personnel were consolidated under RCW 41.26.040. Healthcare benefits for LEOFF Plan 1 members and retirees were also enhanced and codified in 1970.

The LEOFF Plan 1 was closed to new members in 1977. There are currently 249 LEOFF Plan 1 employers covering 7,447 active, terminated and vested, and retired LEOFF Plan 1 members eligible for health benefits under RCW 41.26.150. Only 7 members remain who may or may not achieve eligibility for retiree health care benefits.[1] (See Appendix A Summary Table 3 for distribution).

Current Funding Status of the LEOFF Plan 1

The LEOFF Plan 1 is considered fully funded under current actuarial assumptions, and is projected to remain so unless new benefits are added that increase the projected liability or assets decline significantly in value. The most recent pension valuation by Office of the State Actuary (OSA) as of September 30, 2005 indicates a funding level of 114% based on the actuarial valuation of assets of $4,800 million and the present value of credited projected liabilities of $4,223 million, for a surplus of $577 million.

LEOFF Plan 1 pension plan benefits have been pre-funded in part by state, employer and employee contributions based on rates determined by the OSA and applied to the member salaries throughout their employment. Contributions to the plan were suspended in 2000.

Pension contributions are invested and managed by the Washington State Investment Board

[1] Beneficiaries of deceased members are not eligible for these medical benefits, and are not included in the data.

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(WSIB). Investment returns on these contributions complete the funding and provide between 75% and 80% of the final retirement benefit. The ratio of pre-funded assets to the estimated liability determines the funding level at any given point in time.

Proposed Study Question:

1. ***Does a single agreed upon definition of fully funded exist for Washington State plans?***

Medical Benefits Management – Employer and Disability Board Roles

Employers are required to pay for LEOFF Plan 1 medical benefits under RCW 41.26.150. They may provide them singly or jointly with other employers through contracts with regularly constituted insurance carriers, with health maintenance organizations, or with health care service contractors.

Certain aspects of LEOFF Plan 1 are overseen by local disability boards whose authority is specified in RCW 41.26.150. These boards perform the functions of (1) determining duty and non-duty disability for the purpose of leave or retirement, and (2) designating the medical services available to any sick or disabled LEOFF Plan 1 members and retirees. The disability boards represent the various political sub-divisions in the state, including first-class cities, other cities, and counties. The 2001 study indicates there were 80 autonomous disability boards; 20 for first-class cities, 21 for other cities, and 39 for counties.

Separation of responsibilities between disability boards and employers can be a source of friction for employers, members, and retirees. Members and retirees are concerned about unfair denial of legitimate claims, while employers are concerned that boards have the ability to expand coverage and increase costs.

New GASB Rules

The State of Washington and its local governments are subject to Government Accounting Standards Board (GASB) standards. Two GASB statements now require government employers to accrue and record the liability and expense for retiree health care benefits on an actuarial basis over the working life of the employee. This requirement creates consistency with other retirement benefit accounting principles by recording the expense when earned rather than when received by the employee.

The new accounting rules apply specifically to "other post-employment benefits" (OPEB), which include medical, prescription drug, dental, vision, life and long-term care benefits for retirees. The two GASB standards that formalize these rules are Statement 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* and Statement 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.[2]

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[2] Reporting under GASB standards is not legally required, but is required for audit purposes and therefore is the

Fire districts, cities and counties currently or previously employing LEOFF Plan 1 members now have to accrue a cost based on an Annual Required Contribution (ARC) calculation for OPEB benefits. The ARC is an amount that covers the current costs of benefits as they are earned (normal costs) during employment and an amount that amortizes the unfunded actuarial accrued liability (UAAL) for prior service. Because 92% of LEOFF Plan 1 members are retired, and the remaining 8% are near retirement, the majority of each year's accrual and cost will be for UAAL (prior service).

Proposed Study Question:

2. Can employers in a closed plan accrue the UAAL over 30 years, or does the entire accrual need to be recorded by 2008?

Impact of New GASB Rules

Nearly all LEOFF Plan 1 members are retired. Their full retiree health care liability must be recorded by employers in 2008. Changing to this accrual basis from the current pay-as-you-go basis may jeopardize the financial viability and/or bond ratings of many local governments within the state. But this is only part of the problem. Ballpark estimates of the state-wide liability range from $750K to $1.25B. Reducing this liability requires pre-funding, which may be the greater challenge.

Estimated Healthcare Liability and Funding Status

Post-retirement healthcare liability is actuarially estimated using assumptions such as member health profiles, life expectancies, interest rates and other assumptions in a manner similar to estimating pension benefit liability. GASB Statement 45 requires OPEB actuarial valuations at least biennially for employers with 200 or more plan members, and at least triennially for employers with fewer than 200 plan members. Employers with fewer than 100 plan members may use an alternative measurement method based on default values provided in the Statement.

An updated post-employment health care cost valuation will be necessary to identify the total liabilities being faced by city and county government employers today. The Office of the State Actuary (OSA) received $25,000 in the 2007-2009 budget to assist in the performance of an actuarial study of local government liabilities for LEOFF Plan 1 post-retirement medical benefits.

The most recent completed actuarial medical valuation was performed by the OSA as of January 1, 1999 as part of the 2001 Medical Benefits Study. As of January 1, 1999, the accrued liability was estimated to be between $700 million and $1.26 billion.

Actuarial estimates are highly sensitive to the assumptions adopted which can change over

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basis on which governmental entities prepare their financial statements for public disclosure.

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time. Projections based on the 1999 estimate should therefore be avoided.

Choice of Assumptions Affects Funding Levels

Funding levels are based on actuarial assumptions, such as the interest rate used in the funding formula. The choice of assumptions can have a powerful effect on the range of the liability. To demonstrate the sensitivity of changes in the assumptions, the liabilities in the 1999 estimate were also valued using three alternatives: 1) an alternative interest rate; 2) an alternative that employers reimburse members for Medicare premiums; and 3) an alternative that neither members nor employers participate in the optional Medicare Part B program which is subsidized by the federal government. (The Medicare Part D drug benefit program had not yet been enacted).

Sensitivity to Interest Rate Changes

If the interest rate was lowered from 7.5% to 5.5%, the 1999 accrued liability would increase from $700 million to $932 million.

Sensitivity to Different Choices under Medicare

The 2001 study assumed that members over age 65 had the optional Medicare Part B coverage. If all of the employers pay the Medicare Part B premiums for the members, the 1999 accrued liability would increase from $700 million to $761 million.[3] However, the value of Medicare Part B benefits greatly exceeds the premiums. If no Medicare Part B premiums were paid, the 1999 accrued liability would increase from $700 million to $1.26 billion.[4]

Proposed Study Questions:

3. What assumptions should be adopted for an actuarial study?

4. What is the healthcare liability today?

5. Who will pay the costs of the required on-going actuarial evaluations?

LEOFF Plan 1 Medical Benefits (OPEB) Funding Source and Status

It is safe to assume that few local governments have pre-funded their LEOFF Plan 1 post-retirement health care benefits. These benefits have generally been paid on a pay-as-you-go basis, creating a large unfunded OPEB liability.

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[3] Under RCW 41.26.150 (5), "Any employer … may, at its discretion, elect to reimburse a retired former employee under this chapter for premiums the retired former employee has paid for medical insurance that supplements Medicare, including premiums the retired former employee paid for Medicare part B coverage."

[4] Medicare is an important source of medical benefits for the over-age-65 population. Medicare Part B benefits, while requiring an optional additional premium, are subsidized by the federal government.

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Proposed Study Question:

6. Of the 249 LEOFF Plan 1 employers, have any pre-funded their OPEB liability? At what level have the liabilities been funded, and how?

Stakeholders

The primary stakeholders are the LEOFF Plan 1 employers, active members, and retirees because they fund and receive these benefits. The State of Washington has a secondary interest in assisting "local governments in their search for ways to address this obligation in the most efficient way possible"[5] because of the impact this liability may have on the financial viability of the state's local governments as well as individual retirees if left unaddressed.

Members and retirees are represented by numerous associations. Members and retirees often belong to several of these organizations at any given time. Employer organizations are more limited, created in alignment with their government jurisdiction.

There is a significant level of distrust that makes discussing a broader range of possibilities challenging, much less enacting assistance for this liability. Employers are more willing, while member and retiree groups and/or their representatives vary greatly in their willingness to participate in this type of discussion. The depth of this lack of trust was demonstrated in the development of this report, which simply lays the groundwork for a future study. Some member/retiree stakeholders published statements about the comment draft of this report. This creates further distrust among all stakeholders.

This distrust is evident throughout the history of efforts to address this issue. Years of attempts to resolve funding have resulted in commonly held perceptions or misperceptions, some of which are:

- Employers had a chance to fund this liability and didn't.
- Employers want to discontinue funding these costs.
- Disability Boards can continue to increase the cost and the liability.

Misinformation, rumor, multiple jurisdictions, no overarching limitations, and an extremely complex subject matter also contribute to the distrust. Stakeholders within the member/retiree group have been highly divided at times over solutions. Further, solutions have most frequently been introduced in the legislative process. This position-based type of approach does not work well when stakeholders within a primary group such as the members/retirees do not have a uniform position.

Section 3 - Potential Range of Possibilities

DRS and HCA developed a broader range of potential, not exhaustive, possibilities based on

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[5] Governor Christine Gregoire veto of Section 2, Substitute House Bill No. 2688.

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a premise that everyone should benefit from the change. These approaches are intended to be comprehensive, responsible, and benefit both member/retiree and employer. This report provides a basic level of technical discussion on each option, but does not advocate one over another.

Potential approaches fall into the two primary categories. Options within each category are provided in order to pursue further study. The categories are:

1. Funding
   - Record the liability and continue pay-as-you-go funding
   - Pre-fund the accrued liability
2. Medical Costs
   - Reduce post-employment health care liability
   - Reduce administrative costs

Federal and state laws involving pensions and other benefits are complex and comprehensive primarily due to fiduciary and/or tax implications. The impact of current federal and state laws and regulations are considered throughout the analysis. This includes the impact of the Pension Protection Act (PPA) of 2006.

Category 1: Funding

Option 1: Recording the liability and continuing pay-as-you-go funding

GASB accounting rules require only that government employers calculate and accrue an OPEB liability based on the Annual Required Contribution (ARC)[6] for OPEB benefits. Employers are not required to pre-fund this liability but can continue to fund the costs on a pay-as-you-go basis. This option creates no change in funding, just in recording the liability.

Proposed Study Question:

7. ***What would be the costs of recording the ARC as a liability and continuing with pay-as-you-go funding, in terms of bond ratings, financial risk and volatility, and public perception?***

Option 2 - Pre-funding the Accrued Liability

Pre-funding the LEOFF Plan 1 health care liability helps create security for retirees because the money has been set aside. It begins to reduce the significant liability most employers will experience in recording their ARC and may help avoid bond rating and capacity problems. Further, if it is set aside in a separate trust, it cannot be used for other purposes. Pre-funding can also reduce actual costs over time through investment

[6] Normal cost and UAAL

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earnings on the money set aside, particularly if the money is set aside in a separate trust that can earn higher returns than a general fund.

Pre-funding can occur either by 1) pre-funding 100% of the estimated liability; 2) pre-funding an initial payment and funding the remaining UAAL through annual payments; or 3) funding 100% of the UAAL through annual payments.

Pre-funding requires the identification of both a source of funds and a funding vehicle.

Source of Funds

The most likely sources of funding or pre-funding are 1) the general funds of the employer, i.e. the city or county; 2) excess funds from the LEOFF Plan 1 trust; 3) the state general fund; and 4) new, dedicated revenue sources.

Employer General Funds

Employers could continue to fund retiree healthcare benefits on a pay-as-you-go basis; they could begin to set aside funding to offset the liability that is now required to be recorded, or they could adopt a combination of these two approaches. Employer funding increases place additional demands on the local governments. The ARC becomes the new, higher annual contribution, which includes payments for current retiree healthcare costs and pre-funding of future costs.

Transferring Excess LEOFF 1 Pension Plan Funding

The Internal Revenue Service (IRS) permits pension and annuity plans to pay for sickness, accident, hospitalization and medical expenses of retired employees, their spouse and their dependents, with certain restrictions. The medical expenses must be paid from a separate 401(h) retiree medical account arrangement.

In general, transfers of existing retirement funds to a 401(h) are prohibited, but an exception exists that allows fully-funded plans to make such transfers. The 2006 federal Pension Protection Act allows "excess assets" to be transferred to a 401(h) if the plan's assets exceed 120 percent of the current liability.[7] As of the 2005 OSA valuation, LEOFF Plan 1 has assets that are only 114% of the current liability.

If excess funds were available for transfer, the state legislature would need to amend existing LEOFF Plan 1 statutes to create a 401(h) account. Under current IRS regulations, however, it does not appear that LEOFF Plan 1 has excess funding that can be used to defray the LEOFF Plan 1 health care liabilities.

[7] IRS Code Section 420 permits a "qualified transfer" of excess pension assets of a defined benefit plan to the plan's 401(h) account, subject to several requirements. Under the new "qualified future transfer" of the 2006 Pension Protection Act (PPA), excess pension assets are determined as the excess of plan assets over the greater of (1) accrued liability, or (2) 120% of current liability.

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State General Fund

Legislative action would be required to allocate state general fund assistance for pre-funding LEOFF Plan 1 health care benefits. If the state assumes legal liability for paying LEOFF 1 OPEB costs, the state financial reports would be required to reflect the associated OPEB liability and ARC.

Dedicated Revenue Sources

Across the country, police and fire pension funds receive revenues from a variety of sources, including lotteries, property taxes, hotel/motel taxes, and other public fees. In the state of Washington, the Volunteer Fire Fighters' and Reserve Officers' Relief and Pension Fund receives 40 percent of the state taxes paid on fire insurance premiums. Washington’s first class cities’ retirement plans may use funds received in the form of license fees and fines for city code violations.

There may be other sources of revenue that could be identified to pay for retirees’ health benefits. The state legislature would need to revise the statutes to dedicate other sources of revenue for LEOFF Plan 1 retiree health benefits.

Proposed Study Questions:

8. What funding source or combination of sources are potentially available and would be the most appropriate for the provision of LEOFF Plan 1 retiree health care?

9. If there is an excess in the trust fund, whose money is it - state, member, employer, or all three?

10. Does pre-funding create a demand for increased benefits?

11. Do members believe pre-funding is beneficial?

12. Why are members and employers not contributing to the LEOFF Plan 1 trust fund?

Funding Vehicles

Pre-funding OPEB liabilities can be accomplished by earmarking or reserving funds that remain part of the employer’s general assets or by contributing to a separate trust designated to pay only OPEB liabilities. Under GASB rules, the present value of OPEB liabilities must take into account the expected returns on the assets that will be used to pay the benefits. If the actual contributions are less than the ARC, the cumulative unpaid obligation must also include interest based on that expected rate of return.

Separate trusts may provide an advantage for pre-funding OPEB liabilities because they typically achieve higher returns. A higher return creates a lower liability because a larger portion of the actual cost is covered by earnings from investments. The Washington State Investment Board (WSIB) has an annual average expected return of

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8%, while general funds earn a much lower rate due to their short-term nature.

Possible funding vehicles are as follows (see Appendix C for more information about trusts):

- 401(h) health accounts
- VEBA
- State-law grantor trusts
- Equivalent arrangements

Creating a general fund sub-account reduces the actuarially determined liability to the extent that it exceeds current payments. The primary disadvantage is that general funds usually earn a lower interest rate than a separate trust, producing a higher unfunded liability and ARC. Since a 1% decrease in the discount rate may cause a 15%-20% increase in both the total liability and the ARC, this approach may have a significant impact on current costs.

Proposed Study Questions:

13. ***What other funding vehicles exist?***
14. ***What are the actual costs and benefits associated with the different funding vehicles?***
15. ***Could a single trust account be established to cover all LEOFF Plan 1 employers, or should each employer select their own funding vehicle?***

Category 2 - Healthcare Liability

Options for controlling healthcare liability may include 1) reducing post-retirement health benefits or requiring retiree premiums or cost-sharing, 2) reducing risk through risk pooling and/or coordination of benefits, or 3) reducing administrative costs by consolidating services.

Benefits Level / Retiree Payments

The commonly held opinion is that the LEOFF Plan 1 medical benefits are a contractual right and may not be reduced. A legal opinion could confirm this. If the legal opinion were to hold these benefits are not a contractual right or that retiree contributions could be initiated, a more comprehensive discussion would need to occur.

Proposed Study Questions:

16. ***Are LEOFF Plan 1 medical benefits a contractual right under RCW 41.26.150? If so, is there a more cost-effective way to continue to provide the same level of benefits?***
17. ***Are government employers allowed to eliminate or reduce post-retirement***

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benefits other than pensions?

18. ***Can LEOFF Plan 1 retirees be required to pay premiums or a portion of the medical cost?***

Risk Pooling and Coordination of Benefits

Administration of LEOFF Plan 1 medical benefits through 249 separate employer groups, on a fee-for-service basis or through insurance, as determined by the 80 individual Disability Boards, results in many small, fragmented risk pools. A single risk pool leverages the "law of large numbers" by spreading a known risk across a large population.

The following concepts should be reviewed to determine if they are viable approaches to mitigate local governments' long-term financial exposure, contribute to equitable administration of benefits, and increase predictability of future costs:

- Create a single risk pool for all LEOFF Plan 1 retirees.
- Develop a core set of medical services based on a common definition of "medical necessity." Separate employers or disability boards could elect to provide any additional benefits independently, outside of the single risk pool.
- Administer medical services either through a licensed health insurance carrier(s) or through a self-insurance model utilizing a third party administrator. A third option would be to administer medical services through a combination of these two approaches.
- Utilize coordination of benefits provided to LEOFF Plan 1 members through an insured or self-insured approach with other private or public (e.g. Medicare) coverage.

Proposed Study Question:

19. ***Would risk pooling be a viable option for minimizing risks and reducing cost for employers while improving stability for financing the future medical costs of LEOFF Plan 1 members? Would an insured or self-insured model best meet the needs of employers and LEOFF Plan 1 members?***
20. ***Would federal coordination of benefits laws allow for flexibility in the development of insurance options?***

Consolidating Administration

Administrative costs may be reduced by consolidating the benefit payment processes and providing a governance structure that would work in conjunction with the existing Disability Boards. Consolidated administration might allow for better cost negotiations with insurers and third-party service providers, and would be necessary to efficiently administer medical services and coordinate benefits for LEOFF Plan 1 members.

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Proposed Study Questions:

21. With nearly all LEOFF Plan 1 members retired, would a single board be better able to manage benefits? Would consolidated benefits administration create cost savings and efficiencies that would benefit both the LEOFF Plan 1 members and the government employers?

22. Are there other ideas or issues that should be considered?

Conclusion and Recommendation

DRS and HCA offer three recommendations to assist local governments in their search for ways to address their LEOFF Plan 1 Medical obligation in the most efficient way possible.

Recommendation 1 – Interest Based Process

The first recommendation is to create an interest-based process that brings all stakeholders together. This approach is suggested because of the lack of success a lengthy position-based approach has produced. The interests of the stakeholders overlap, and there may be more commonality than is currently recognized. Employers are primarily concerned about manageable medical and administrative costs, but have a clear interest in the well-being of their employees and retirees. Members and retirees are primarily concerned with maintaining their levels of benefits, but also have a clear interest in the financial well-being of the employers who will pay these benefits.

A panel with representatives from DRS, HCA, Office of Financial Management (OFM), LEOFF Plan 1 employers and LEOFF Plan 1 active and retired members would be appointed to conduct this process. OSA will participate as expert, independent support. The panel would be charged with developing interest-based solutions. Their final report could be presented to the Governor and/or the Legislature depending on the actions required.

OSA received funding in the 2007-2009 budget to quantify the liability. DRS could provide general financial and staff support to this study. If further funds are required, they will be requested in the 2008 budget.

DRS and HCA suggest the future study engage a facilitator skilled in bringing widely disparate views into agreement and abiding by the agreement reached. DRS and HCA further suggest all groups participate in funding the costs of this facilitation so as to eliminate any perception that the payer is biasing the study results. Financial participation would be based on ability to pay, but all participants would have equal ownership.

Joint ownership of this process by participants is critical to the success of the effort. The actual structure must be left to the group responsible for the outcome. In general, however, the following guidelines are likely to be followed:

- The group will jointly identify a neutral facilitator. The optimal approach is to have all members contribute to funding for the facilitator to create ownership and trust. Participation can be determined on an ability to pay.

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- Stakeholders will be asked to determine their interests. Positions and prior solutions are temporarily set aside. Commonalities of interest are determined. Generally, there are more commonalities than differences. Position-based processes focus on the difference, while an interest-based process finds solutions based on commonalities.
- The group will determine which facts are needed and what questions need to be answered to develop mutually beneficial solutions. The group also jointly agrees on how to obtain those facts. This enables all participants to trust the source of information and eliminate debate that can unnecessarily block development of a successful solution.
- The group eliminates issues on which everyone agrees from debate. For example, if a legal opinion confirms these benefits are a contractual right, the discussion can be restricted to other funding options.
- Solutions that achieve the combined interests of the stakeholders are identified.

DRS and HCA recognize the introduction of this approach can create a level of anxiety, similar to parties entering mediation in a legal dispute. Stakeholders often fear they will “lose” when they are asked to relinquish a position in favor of achieving their interest, even if their circumstances are improved. The situation of finding funding for these benefits has a long history of fear and distrust which will need to be carefully handled by a skilled facilitator.

This approach would allow for exploration of a broad range of alternatives, including alternatives that emphasize efficiencies and changes to the cost structure of the current system. In addition, the approach is consistent with the direction specified in the Governor’s veto message on Substitute House Bill 2688 (2006).

Some stakeholders agree that this is the best remaining approach to a previously insoluble problem. Employers in general support this approach. Member/retiree stakeholders are split. Some believe considering broader solutions in an interest-based setting can benefit their members. Others are willing to discuss funding solutions, but not a broader range of efficiency solutions. Further, some stakeholders want these meetings to be conducted in an open public forum, which inhibits the brainstorming nature of an interest-based process and ultimately defeats the opportunity to create innovative solutions.

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Recommendation 2 – Employer Task Force

A related approach to an interest-based process is to convene and fund a task force of DRS, HCA and employer stakeholders, conferring with member/retiree stakeholders on issues directly affecting them. This approach would allow exploration of a broad range of alternatives and efficiencies, but still involve all stakeholders in issues they have stated a willingness to discuss. With the approach of the GASB 2008 deadlines, and an unwillingness of some stakeholder to discuss all issues, this may be a viable alternative for

creating a final effort that can succeed.

Recommendation 3 – Independent Study

A third option is to outsource a study of the issue to a third party independent of the state, employees and employers. The independent third party could be a human resource or similar consulting firm. The strength of this approach is that funding retirement medical benefits is a national issue. It is not specific to Washington State. A significant amount of knowledge and research is being done for governments around the country. Washington State could benefit from this the knowledge gained by someone working in multiple situations. This approach could be structured to create an unbiased, independent report and solution for consideration.

DRS and HCA recommend one of these three approaches to assisting employers in addressing this liability that is of critical importance to LEOFF Plan 1 members and retirees.

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Appendix A – LEOFF Plan 1 Employer and Member Data

Summary Table 1 – Employers by Political Subdivision

LEOFF 1 Employer counts by political subdivision	
Cities	148
Counties	39
Fire Protection Districts	57
Port Districts	5
Total	**249**

Summary Table 2 – Members by Age

LEOFF 1 Membership

Age Range	**Actives**	**Terms**	**Retirees**	**Total**
0-45	0	0	0	0
45-50	8	0	1	9
50-55	182	0	281	463
55-60	294	4	1,314	1,612
60-65	99	1	2,042	2,142
65-70	12	0	1,193	1,205
70-75	1	0	713	714
75-80	0	0	622	622
80-85	0	0	445	445
85+	0	0	235	235
Total Counts	**593**	**5**	**6,864**	**7,447**
Average Age	54	56	66	65

Summary Table 3 – Members by Employer Subdivisions

LEOFF 1 Membership

Employer	**Actives**	**Terms**	**Retirees**	**Total**
Law Enforcement Officers				
First Class Cities	128	1	1,710	1,839
Other Cities	74	0	968	1,042
Sheriff	81	1	1,079	1,161
Total	283	2	3,757	4,042

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Fire fighters				
First Class Cities	167	1	1,995	2,163
Other Cities	85	2	709	796
Fire Districts	53	0	322	375
Port Districts	8	0	63	71
Total	313	3	3,089	3,405
Total Counts	**596**	**5**	**6,864**	**7,447**

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Appendix B – Transfer Availability of LEOFF Plan 1 Excess Funds

IRC 401(h) - Retiree Medical Account

The IRS permits pension and annuity plans to provide for the payment of benefits for sickness, accident, hospitalization and medical expenses of retired employees, their spouses and their dependents under a 401(h) account arrangement. Eligibility and limitations to these accounts is defined in code section 401(h) and include but are not limited to the following:

- Subordination of benefits to the retirement benefits – 25% of contribution limit – fully funded pension plans will not be able to make any contributions to the 401(h) health account
- Separate account – this is for record-keeping purposes only and 401(h) monies may be invested with retirement plan monies
- Employer contributions are reasonable and ascertainable
- Non-diversion requirement – monies may not be used for any other purpose until all medical liabilities are satisfied
- Reversion requirement – after satisfaction of all liabilities, any amount remaining must be returned to the employer
- Coverage – only available for retired employees, their spouses and dependents

IRC 420 - Transfer of Excess Retirement Plan Assets

Code Section 420 is a limited exception to the prohibition on transfers between the retirement portion of the plan and the 401(h) account, providing a means whereby a fully-funded pension plan may fund a 401(h) account. Code Section 420 permits a "qualified transfer" of excess pension assets of a defined benefit plan to the plan's 401(h) account, subject to several requirements.

If existing LEOFF Plan 1 statutes were suitably amended and numerous requirements met, it may be possible to make a Section 420 transfer of "excess pension assets" to a Section 401(h) retiree medical account to pay for medical benefits for retired employees.

Qualified Transfer

A "qualified transfer" is a transfer of "excess pension assets" which contravenes no law (such as laws relating to collective bargaining or state laws that may impose restrictions on a transfer of pension plan assets) and satisfies specified requirements in connection with (1) the use of the transferred assets, (2) the vesting of accrued retirement benefits, and (3) maintenance of minimum health benefit coverage for retirees. Only one transfer per year is permitted, and qualified transfers may only be made through December 31, 2013.

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Excess Pension Assets

For private sector plans subject to IRC 412, excess pension assets are assets in excess of liabilities calculated as the greater of:

(a) the lesser of (i) 150% of the current liability, or (ii) the accrued liability, and

(b) 125% of the current liability

Item (a) (i) "150% of the current liability" is the "current liability full funding limit" for which the applicable percent was updated to 170% for 2003. This was suspended in 2004 under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The sunset provisions of EGTRRA would reinstate this item after 2010, but PPA cancels the sunset provisions (see below).

Under this definition, assets would have to exceed 125% of the current liability before there are any excess pension assets.

The value of plan assets is the lesser of fair market value or actuarial value.

Because governmental plans are not subject to the funding requirements of Code Section 412, the meaning of "excess pension assets" for purposes of governmental retirement plans is not clear.

Use of Pension Assets under PPA

Section 841 of PPA - Use of excess pension assets for future retiree health benefits

The provisions allow for transfers of excess pension assets to retiree medical accounts to fund the expected cost of retiree medical benefits for the current and future years. This is called a "qualified future transfer," and may be used by the plan instead of the "qualified transfer." The new "qualified future transfer" relates to the current and future years, whereas the "qualified transfer" is applicable on a year by year basis. A transfer period between 2 and 10 years must be elected for the "qualified future transfer."

The differences in requirements occur in three areas:

(1) Excess pension assets
Under the new "qualified future transfer" the excess pension assets are determined as the excess of plan assets over the greater of (1) accrued liability, or (2) 120% of current liability.

PPA removes the sunset provision of EGTRRA so the current liability full funding limit (170% in 2003) is permanently removed from the excess pension asset formula.

Notice the substitution of 120% for 125% in the definition to fall in line with changes in the funding rules under PPA.

As before, the value of plan assets is the lesser of fair market value or actuarial value.

If the funded status of the pension plan falls below this defined excess level, the shortfall must be made up immediately by either a transfer of funds from the employers, or from the health benefits account.

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(2) Limitation of amount transferred

The amount transferred is limited to a reasonable estimate of the current retiree health benefits for the transfer period. The technical changes allow for the transfer period being greater than one year. For example, a transfer period of seven years could permit a transfer amount equal to seven years of medical costs.

(3) Minimum cost requirements

PPA also modifies the minimum cost requirement which requires retiree medical benefits to be maintained at a certain level.

Other considerations

- An amendment to the existing LEOFF Plan 1 statutes would be necessary to establish 401(h) medical accounts for LEOFF Plan 1 employers.
- IRS approval through the determination letter process would be required to establish 401(h) accounts and 420 transfers.
- Mandatory or elective employer participation in providing 401(h) accounts would need to be defined for the plan.
- Funding options for the 401(h) accounts would have to be created.
- If excess pension assets are moved to 401(h) accounts in a 420 transfer they cannot be moved back into the pension fund and used for retirement benefits (pre PPA qualified transfer).
- The above analysis is based on general research of current federal law, regulations and private letter rulings.

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Appendix C – Trust Account Arrangements

IRC Section 401(h) Health Accounts in Pension Plans

- Employer and employee contributions could be made to 401(h) accounts. Employee contributions could be made on a pre-tax basis through the employer pick-up provisions subject to IRS approval. Contributions made to the plan would have to be tested against subordination limits.
- Excess pension contributions could be transferred to 401(h) accounts if all requirements for the transfer are met.

VEBA (IRC Section 501(c)(9) Health Trusts)

These trusts are usually referred to as Voluntary Employee Benefit Association (VEBA) Trusts.

- Health Trust - Pension fund is not required
- Benefits are tax free to retirees
- Investment earnings are not subject to tax
- Funding allowed up to OPEB liability
- Irrevocable trust
- Employer and employee trustees
- Needs IRS approval
- Federal law requirements

IRC Section 115 Health Trusts (for Government Agencies)

These are special purpose trusts for government agencies.

- Retiree health benefits may be provided under a Section 115 Health Trust (per IRS private letter ruling)
- Benefits are tax free to retirees
- Investment earnings are not subject to tax
- No limits on contributions to trust
- Revocable, but then not subject to favorable GASB account rules
- Employee representation is not required
- Needs IRS private letter ruling
- Very few federal requirements

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Appendix D – Recent Studies and Legislative Bills

This issue was the subject of intensive reviews in 1994-1995, and again in 1999-2001.

1994-1995 Study

In 1994 the Legislature mandated a study of LEOFF Plan 1 medical benefits. The study was conducted by the Office of the State Actuary (OSA), and completed in 1995. The actuarial valuation of LEOFF Plan 1 medical liabilities was performed as of January 1, 1994 by Milliman & Robertson, Inc.

1999-2001 Study

In 1999 the Legislature directed OSA to conduct "an actuarial study of local government liabilities for law enforcement officers' and firefighters' retirement system medical benefits."

The 2000 Legislature directed (Chapter 1, Section 908, Laws of 2000, 2nd Extraordinary Session): "The joint committee on pension policy shall provide for a study, through the office of the state actuary during the 2000 interim, of the options for providing partial funding of law enforcement officers' and firefighters' retirement system plan 1 retiree medical expenses from the surplus assets of the law enforcement officers' and firefighters' retirement system plan 1 fund. The study shall include a report by the office of the state actuary on local government liabilities, as required by the 1999-2001 operating budget and a review of legal issues, federal tax compliance issues, variations in local government benefits and funding mechanisms, and other relevant issues."

OSA published the completed study in 2001. The actuarial valuation was performed as of January 1, 1999 by Milliman & Robertson, Inc.

2000 Bill

Senate Bill 6792 (SB 6792) would have allocated a portion of the LEOFF Plan 1 surplus for extraordinary medical expenses, subject to certain funding conditions and any legal restrictions. It also called for a review of the long-term options for funding a portion of the LEOFF plan 1 medical expenses from the LEOFF Plan 1 trust fund.

2001 Bill

Second Engrossed Substitute Senate Bill 6166 (2ESSB 6166) would have restated LEOFF Plan 1 to utilize the surplus in the fund, by enhancing the pension plan and establishing a medical risk pool.

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2004 Bill

House Bill 3174 (HB 3174) would have established a LEOFF Plan 1 medical account for catastrophic illnesses funded with 6% member contributions and 6% employer contributions if not needed for the pension plan.

2006 Legislation:

The 2006 legislative session introduced Substitute House Bill 2688 (SHB 2688) which passed both houses. Section 1 of the bill addressed LEOFF Plan 1 pension benefit caps, and Section 2 mandated a study of retiree medical benefit costs. The governor signed the bill into law, with the exception of Section 2. The Governor's directions to Department of Retirement Systems (DRS) and the Health Care Authority (HCA) are outlined in the veto message.

Highlights from the Governor's veto message:

- *"Local governments face challenges in providing health care benefits for retired members of the Law Enforcement Officers' and Firefighters' Retirement System Plan 1 (LEOFF Plan 1)."*

- *"The cost of these benefits can be significant, especially for smaller jurisdictions. It is sensible for the state to assist local governments in their search for ways to address this obligation in the most efficient way possible."*

- *"While I am vetoing Section 2, I am directing the Department of Retirement Systems and the Health Care Authority to lay the groundwork for study of this issue, and to consult plan members and representatives of local governments in their work."*

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Appendix E – Stakeholder List

- Office of Financial Management
- Office of the State Actuary
- House of Representative Appropriations Committee Staff
- Senate Ways and Means Committee Staff
- Local Government employer representatives
- Washington Council of Police and Sheriffs (WACOPS)
- Washington State Council of Firefighters (WSCFF)
- COMPAS
- LEOFF 1 Coalition
- Washington State Law Enforcement Assoc. (WSLEA)
- Washington State Retired Deputy Sheriff's and Police Officers Assoc.
- Washington State Retired Police Officers Assoc.
- Retired Seattle Police Officers
- Retired Fire Fighters of Washington.

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Appendix F – Reference Documents

- RCW 41.26.150 – Requirements for employers to pay for certain medical services
- RCW 41.16.050 – Payments from specified fund
- Chapters 41.16 and 41.18 RCW – Employers' obligation to pay benefits
- Substitute House Bill 2688 – Session Law / Chapter 350, Laws of 2006 (partial veto)
- Governor's veto message
- Final House Bill Report
- 1994 Medical Actuarial Valuation Report prepared by Milliman & Robertson, Inc.
- LEOFF 1 Medical Benefits 1995 study prepared by the Office of the State Actuary
- 1999 Medical Actuarial Valuation Report prepared by Milliman & Robertson, Inc.
- LEOFF 1 Medical Benefits 2001 study prepared by the Office of the State Actuary
- 2004 Pension Actuarial Valuation Report by the Office of the State Actuary
- http://osa.leg.wa.gov/OSA%20PDF%20Publications/ValReports/2005_AVR.pdf
- GASB / OPEB 2005 conference sponsored by the Society of Actuaries
- Pension Protection Act (PPA) of 2006
- Joint Committee on Taxation, Technical Explanation of the Pension Protection Act of 2006

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Appendix G – Glossary

ARC – Annual Required Contribution

DRS – Washington State Department of Retirement Systems

GASB – Governmental Accounting Standards Board

HCA – Washington State Health Care Authority

LEOFF – Law Enforcement Officers and Firefighters

OPEB – Other Post-Employment Benefits (other than pensions)

OSA – Office of the State Actuary

UAAL – Unfunded Actuarial Accrued Liability

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