# THE LEOFF 1 RETIREMENT SYSTEM
## COALITION FINDINGS January 17, 2003

A review of public documents was made to understand the condition of the LEOFF 1 Retirement System. The LEOFF 1 system is
“closed” to new members and only has investment returns to supply the necessary funds for benefit payments.

The Washington State Office of Financial Management Comprehensive Annual Financial Report (OFM CAFR, pg. 4) of 1998 suggests that the rosy financial outlook would be darkening over the next three years. This concern over the future finally came to pass when the word “recession” was used to describe what was happening in the fiscal year 2001 Comprehensive Annual Financial Report (OFM CAFR, pg. 5) in the paragraph entitled of Economic Outlook.

The State Legislature wanted to”“REDEFINE” a closed pension system so that the”“SURPLUS” monies could be shared. There is a difference of opinion about the existence of such a surplus. The Legislature changed the economic presumptions for the retirement systems. An 8% rate of return, 4.5% annual salary increase, and a 3.5% CPI was presumed. These new presumptions replaced the 7”Ω% rate of return, 4% salary increase, and planned asset “smoothing” over a 4 year period rather than the previous three year averaging.

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The State Investment Board asked Buck Consultants to study pension funding. The State of Washington set the parameters for this company to study. The firm developed three possible scenarios. There was a High Return, Expected Return, and a low return funding plans developed with the state’s information. The CTF balance at the present time indicates that the LOW RETURN scenario was the closest to what is happening now.

In the low return scenario of the Buck study there is a loss of principal each year through the year 2005. In 2005 it becomes necessary to reintroduce contributions. These contributions will be required to continue past the projection date of 2019. This date was one of the parameters for the study.

Disregarding predictions of an economic downturn in the various CAFRs mentioned in the second paragraph, the legislature actually increased the projected investment return estimates and increased the number of years to use for averaging income. These new projections were then put into statute. The State Investment Board and an independent expert hired by the Office of State Actuary have expressed caution about these assumptions.

A series of events took place in August 2002. There was testimony before the Joint Committee on Pension Policy (JCCP) that the days of double-digit returns were past and losses were occurring in the State's retirement portfolios. Expected returns for the next three to five years would be in the 5-Ω% range. In addition the Commingled Trust Fund (CTF) had decreased from a high of $46.5 billion in the year 2000 to a balance of $39.2 billion as of June 30, 2002. In addition the CTF had declined an additional $2 billion from July 1, 2002 to August 13, 2002. This was the day prior to the JCCP presentation. The presentation also stated that $1.7 billion of this loss was due to a decline in investment performance. The LEOFF 1 pension plan is part of the CTF and its balance was $4.4 billion dollars on June 30, 2002. It declined to $4.250 billion by August of 2002 when the Pension Funding Council presentation was given.

On August 20, 2002, the Pension Funding Council briefed the JCCP. During that meeting a chart indicated that the LEOFF 1 system had $4.578 billion in market assets. This indicated a $300 million
"surplus". The actual August figure for the LEOFF 1 system was $4.250 billion in market assets.

A simple spreadsheet was developed to test the theory of a surplus in the LEOFF 1 Retirement plan. The 09/30/02, LEOFF 1 portion of the CTF was used as the amount available for investment through the year 2039. It should be noted that at the end of 2039 there would still be about 1989 retirees/survivors, which are entitled to benefits. Not considering the retirees/survivors still alive there will be a $166 million dollar deficit using the projected 8% rate of return and 3.5% CPI criteria in statute. The spreadsheet is attached.

The Pension Funding Council continued its presentation using old information. A graph was used that showed the year 2000 as having the highest balance of the Commingled Trust Fund (CTF). The balance was shown as $46.5 billion. At the time of presentation the CTF balance was actually about $37.5 billion. In the final summary a chart was displayed. This chart showed the CTF balance of $45.038 billion with the LEOFF 1 portion at $5.359 billion. These year old figures were used to show that no contribution reinstatement was necessary. These figures also relied on an 8% rate of return, and income averaging over four years rather than the previous three years.

The final indication of information contrary to the Legislature's actions occurred when the Office of State Actuary (OSA) gave a fiscal note presentation to the JCCP on September 18, 2002. This was a presentation to show what impact Initiative I-709 would have on contribution rates and liabilities of the LEOFF 2 retirement plan. Consulting actuary Norman S. Losk, F.S.A. of Gabriel, Roeder, Smith & Company summarizes the results of his study.

"In discussing the future with investment professionals, a consensus view seems to be that the future returns from equities are expected to be lower in the next decade than in recent decades. Thus, while it would be reasonable to use an effective return rate assumption of 3%-3.5% based on our historical reviews, I recommend an effective rate assumption of 4%. This assumption reflects the expectations that:"

"Future returns will not be as high as in the recent past, and in years in which losses occur, those losses will not be as deep as in recent years."

The outside consultant's remarks were presented on September 18, 2002, but had been forwarded to the Office of Financial Management in a letter dated 08/08/02. It was received on 08/12/02 according to the date stamp. Even as the JCCP received testimony about a recommended 4% annual rate of return, they had a presumption of an 8% rate of return in statute for the pension funds.

There is a portion of the Buck Consultants report that needs definition and explanation. The Buck report has a column that has a heading of "benefits and transfers". In both the OFM CAFR 2001 pg. 76 and the DRS CAFR 2001 pg. 38, there is a Note with information that is worth quoting. The following is a quote from that note. ""Although some assets of the plans are commingled for investment purposes, each plan's assets may be used only for the payment of benefits to the members of that plan in accordance with the terms of the plan."

Over the past four years more than $1.6 million dollars have been transferred out of the LEOFF 1 system than have transferred into the system. Keep in mind that the LEOFF 1 system is a closed system with investments as the only source of income. We are not able to track just where these transfers have gone. Terms used to describe the transactions have been "transfers to other pension plans: and "transfers to other plans". "Transfers to other plans" was used in the 1999 DRS CAFR pg.36 to describe a transfer from the LEOFF 1 system. In the OFM CAFR pg. 42 for the same year and presumed to be the same transaction there is a $1,935,000 transfers that is identified as a transfer to other pension plans from the LEOFF 1 system. This is one of many examples which makes it difficult to track transfers. In the 2001 DRS CAFR on pg. 33 there is a transfer from the PERS 2 plan to the SERS 2/3 plan that is more obvious. The sum of 1.9 billion was involved.

There are nine plans listed as members of the CTF (Commingled Trust Fund). Two of the plans did not have an administrative expense in 1998 (WSP AND Volunteer Fire Fighters). In 1999, the Volunteer Fire Fighters had an administrative expense, but not the Washington State Patrol. These figures can be found in the OFM CAFR for 1998 and 1999. This gives the impression of unequal treatment in what is purported to be a combined fund with the benefit and risk shared by all.

The actual and total number of LEOFF 1 members is in doubt. There are two Department of Retirement Systems (DRS) publications that are either sent to or available to the public. One is the Comprehensive Annual Financial Report (CAFR) for a given fiscal year. The other is a much smaller Summary that is sent out to plan participants. The total number of active members and inactive and retired members by system and plan in these two documents do not agree. There are 96 more in the 1999 DRS CAFR Summary than there are in the comprehensive version. The 2000 DRS CAFR Summary has 96 more individuals than the comprehensive report for that year. The 2001 DRS CAFR Summary has 92 more individuals than the comprehensive report for that year.

The Office of State Actuary (OSA) has stated that the individuals involved may be individuals that have contributed to the system, but did not become vested. These individuals would be entitled to a return of contributions only. They have not been reported previously, but are used in the actuary's calculations. There would be no accrual of interest for the individuals on their contributions (this is for non-vested members). State of Washington 2001 Combined Actuarial Valuation dated 12/2002 has been received. The Office of State Actuary has put out this publication with information 15 months old (September 30,2001). On page 20 it indicates that there are a total of 9,402 individuals in the LEOff 1 system. This contradicts the OFM CAFR of 2001, which lists the total of 9,310.

The retirement systems are on a calendar year basis (except for the Teachers Retirement System). In order to be able to make calendar year/fiscal year comparisons two formulas were used. This enables a person to compare calendar year total deductions and calendar year benefits to find out what the total deductions were for a given calendar year. This also enables one to work in a fiscal year base. A copy of the formulas and calculations using these formulas are attached.

For the LEOFF 1 system the following calendar year amounts were calculated for years 1998, 1999, and 2000. The figures were located in state publications. The following was the result.

| YEAR | TOTAL DEDUCTIONS | DIFFERENCE | BENEFITS/REFUNDS |
|---|---|---|---|
| 1998 | $208,540,707.42 | $2,929,219.42 | $205,611,488.00 |
| 1999 | $222,414,867.75 | $3,800,721.75 | $218,614,146.00 |
| 2000 | $232,736,702.59 | $ 340,370.59 | $232,396,332.00 |

The deduction figures come from the DRS CAFR for the given year. The benefits figure comes from the£Schedule of Benefit Expenses and Refunds by Type: LEOFF PLAN 1. The figures can be found on page 146 of the 2001 DRS CAFR. A copy of this page is also included in this report.

The following are figures taken from DRS CAFR reports for the years 1990-2002. This was to determine if funds transferred out of the system were followed by funds that were transferred back into the LEOFF 1 Retirement System.

| YEAR | AMOUNT INTO THE SYSTEM | AMOUNT TRANSFERRED OUT OF THE SYSTEM | |
|---|---|---|---|
| 1990 | $2,230,254.63 | $ 91,200.91 | pg.62 |
| 1991 | $ 365.50 | $ 279,819.66 | pg.52 |
| 1992 | $ 37,038.00 | $ 378,233.00 | pg.60 |
| 1993 | No transfers into | $ 411,462.00 | pg.62 |
| 1994 | No transfers into | $ 369,283.00 | pg.64 |
| | See page 62 of the DRS CAFR 1994 also | | |
| 1995 | No transfers into | $ 615,340.00 | pg.66 |
| 1996 | $ 187,551.00 | No transfer out | pg.70 |

1997 No transfers into or out of the fund, but the state General fund is credited with a 66.75 Million-dollar contribution, which is doubtful at best. Pg.59

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|---|---|---|---|
| 1998 | No transfers into | $ 412,707.00 | pg.35 |
| 1999 | $ 376,034.00 | $1,982,672.00 | pg.36 |
| 2000 | $ 117,226.00 | $ 371,674.00 | pg.32 |

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|---|---|---|---|---|
| 2001 | $ 255,321.00 | | $ 203,019.00 | pg.34 |
| 2002 | $ 163,362.00 | | $ 134,756.00 | pg.40 |
| | | DIFFERENCE | | |
| TOTAL | $ 3,367,152.13 | (1,883,014.44) | $5,250,166.57 | |
| | | Loss to the LEOFF 1 system | | |

An average of $156,917.00 per year is being transferred out of the system each year(over the last twelve years). Market returns of only 5-1/2% are predicted for the near future. In this economic climate the LEOFF 1 system will not generate enough return on investment to enable every retiree/survivor to have the benefits due them to or past 2039.

At this time, by statute, the state is required to make up the deficit for the survivors and retirees. Any changes, like the bills that have been introduced, will eliminate this requirement and put these retirees/survivors in jeopardy. The number of retirees/survivors at that time will be about 2,000 persons.

WPK 02/24/03
LEOFF 1 Coalition