Washington State
House of Representatives
Office of Program Research

BILL ANALYSIS

Appropriations Committee

HB 1072

Brief Description: *Establishing a law enforcement officers' and fire fighters' health and welfare risk assumption program.*

Sponsors: *Representatives H. Sommers, Lambert, Doumit, Alexander, Van Luven, Ogden, Edmonds, Haigh, Kagi and Marine; by request of Joint Committee on Pension Policy.*

Brief Summary of Bill

- *Creates a local government risk pool and risk assumption program to reduce medical costs for LEOFF 1 employers.*
- *Permits certain surplus assets in the LEOFF 1 fund to be used to assist local government in providing medical benefits and long-term care for LEOFF 1 retirees.*
- *Establishes accounts, processes, and oversight for the risk pool, risk assumption program, and fund transfers, subject to the Internal Revenue Code and legislative appropriation.*

Hearing Date: *2/15/01*

Staff: *Andrea Hardy (786-7349).*

Background:

LEOFF 1 Pension Benefits and Funding Status

The Law Enforcement Officers and Fire Fighters Retirement System plan 1 (LEOFF 1) covers persons who were employed as full time, fully compensated law enforcement officers or fire fighters in Washington prior to 1977. LEOFF 1 provides pension benefits for service and disability retirement, and survivor benefits. These benefits have an automatic annual cost of living adjustment (COLA) equal to the change in the Consumer Price Index (CPI) for the Seattle

area. There are about 1,500 active LEOFF 1 members, and about 7,800 LEOFF 1 retirees. As of the end of 1999, the average age and service of the LEOFF 1 active members was 51 years old with 26 years of service. Average salary for an active LEOFF 1 member was $60,683. Also, as of the end of 1999, LEOFF 1 retirees were an average age of 63 with 22 years of service, with an average annual benefit of $29,040.
The state has the primary responsibility for funding LEOFF 1 pension and survivor benefits. The member and employer both contribute 6 percent of pay for each active member, and the state pays the remaining portion of the required funding. In some years during the 1980s, the state contribution level exceeded 70 percent of the reported LEOFF 1 compensation. The Office of the State Actuary (OSA) has estimated that about 78 percent of the total contributions made to the LEOFF 1 fund since 1970 were paid by the state, with the members and employers each providing about 11 percent. The actuarial valuation studies done of LEOFF 1 since the end of 1997 indicate that all benefits earned by LEOFF 1 members are more than 100% funded, and the amount of the surplus assets in the fund has grown from about $300 million since 1997 to over $1 billion in 1999.

High investment returns accompanied by lower than expected inflation have played a major part in the development of the surplus in LEOFF 1. As a result of the surplus, the state contribution to LEOFF 1 has been zero since 1999, and the Legislature suspended further member and employer contributions while the plan has a surplus.

LEOFF 1 Retiree Medical Benefits
When LEOFF 1 was established in 1970, the law provided that all necessary medical services for LEOFF 1 members and retirees not payable from some other source would be paid by the LEOFF 1 employers. The term "medical services" was defined broadly, and it specifically includes "nursing home confinement." Local disability boards were created and given the authority to determine what medical services were necessary in a given case. Each city with a population of less than 20,000 is currently serviced by its county disability board. These cities are unlikely to have many LEOFF 1 active members or retirees. When a city reaches a population of 20,000 it is required to create its own disability board.

Most of the individual cities, counties, and fire districts that have the responsibility to pay for LEOFF 1 retiree medical services have not pre-funded those benefits. Many employers have used self-insurance or have purchased health insurance to cover these costs. According to two studies conducted by the OSA, the cost of LEOFF 1 retiree medical coverage has not posed a problem for most employers. One major reason is that the average LEOFF 1 retiree is age 63. As the group ages, the medical costs are certain to increase. The risk of very high claims for any one employer is usually offset by purchasing medical insurance, which allows risk to be spread across a larger pool of employers. Since most employers have not pre-funded their LEOFF 1 retiree medical liabilities, they do not have the benefit of surplus investment returns to help pay those liabilities.

The medically necessary long-term-care costs covered by LEOFF Plan 1 differ from other medical costs in several respects. Few LEOFF 1 retirees will have long-term-care costs, *but the costs can be very high, and it is hard for the local governments to find adequate long-term care insurance policies.*

The latest actuarial review of the LEOFF 1 medical benefits estimated that the present value of local government liabilities for retirees was at least $708 million. This assumes that all retirees will be covered by Medicare and that the local governments are not paying the Medicare Part B premium. The liability is well over $800 million when individual local government Medicare differences are included. This benefit is almost completely unfunded.

In summary, the LEOFF 1 pension and survivor benefits have been pre-funded and there are substantial surplus assets. By contrast, the LEOFF 1 retiree medical benefits have not been pre-
funded, and present substantial unfunded liabilities.

Joint Committee on Pension Policy Review

In the 1999-2001 biennial operating budget, the Legislature directed OSA to conduct a study of the LEOFF 1 retiree medical liabilities. Additionally, the 2000 supplemental budget directed the Joint Committee on Pension Policy (JCPP) to add to the OSA study a review of options for funding a portion of LEOFF 1 retiree medical expenses from LEOFF 1 surplus assets. The JCPP study included a review of legal issues, federal tax compliance issues, variations in local government LEOFF 1 retiree benefits and funding mechanisms, and other relevant issues. In conducting the study, the JCPP solicited information from organizations that represent LEOFF 1 employers and retirees during six public meetings held between June and December. This bill was proposed by the JCPP for the 2001 session as the result of its 2000 interim study and meetings.

Federal Tax Issues

The Internal Revenue Service (IRS) requires pension plans to meet certain criteria in order to qualify for tax-deferred treatment. Employee and employer contributions to an IRS qualified plan are not included in current taxable income. The federal tax code provides mechanisms for qualified pension plans to use surplus pension assets for the payment of medical services and insurance for retired members. A medical account may be established under section 401(h) of the tax code for the payment of medical benefits, and surplus assets in a qualified pension fund may be transferred to the 401(h) account, pursuant to code section 420 and IRS oversight, to pay for qualified medical benefits. The IRS imposes many limitations on a plan's ability to use pension assets to fund retiree medical expenses, in part to ensure that the pension system funding status is not put at risk.

Department of General Administration - Office of Risk Management

The Department of General Administration has an Office of Risk Management, and a risk manager, who have oversight and regulatory authority over local government risk programs for property and liability plans, and for health and welfare plans. The state risk manager also sits on the Health and Welfare Board, which advises local governments on health benefits.

The Department of Community, Trade and Economic Development

The Department of Community, Trade and Economic Development (DCTED) is a state agency that has responsibility for distributing many forms of the state assistance to local *governments.*

Summary of Bill:

Creation of the Risk Pool and Risk Assumption Program
The bill provides for the creation of a LEOFF 1 retiree health insurance risk pool and medical account to help reimburse employers for certain retiree medical costs, including long-term care. Funding for the risk pool account is provided from three sources: employer premiums, funds that are transferred from the LEOFF 1 Medical Account, and investment earnings.

A risk assumption program is created that permits cities, towns, counties, and fire districts that are LEOFF 1 employers to voluntarily join the risk pool for the purpose of sharing their uninsured medical costs for long-term care and major medical services for LEOFF 1 retirees. Costs may be pooled only if they are incurred for long-term care and major medical services that have been approved by city and county LEOFF 1 disability boards and that are required under LEOFF 1.

Cities that reach a population of 20,000 or more after January 1, 2002 will no longer form their own disability boards, but instead will continue to use the county disability board to review LEOFF 1 medical service claims.

Contingent on legislative approval, the state operating budget will transfer surplus funds from the LEOFF 1 retirement fund to the medical account and to authorize payments from the medical account to the risk pool. A board composed of employees, employers, and the state would manage the risk pool.

Risk Pool Operation
The Department of General Administration's state risk manager, in consultation with the statutory Health and Welfare Advisory Board shall adopt rules to govern the operation of the risk pool, including the standards for management, operation, solvency, an annual report, and the necessity of actuarial analyses and claims audits. The Health and Welfare Advisory Board advises local governments on self-insured benefits programs. The risk pool must operate in a manner that is consistent with a management and operations plan that has been approved by the state risk manager. The risk pool will pay an investigation fee that covers the cost of the initial review and approval of the risk pool, and it must also pay for the cost of subsequent reviews or investigations.

Creation and Duties of the Executive Board
An executive board is created to adopt rules regarding employer participation and withdrawal from the risk pool. The board is composed of nine members appointed by the Governor. The chair must be familiar with risk pool operation and medical matters, and may not be a law enforcement officer or firefighter. The remainder of the board membership consists of two members representing counties, two members representing cities and towns, two members representing fire protection districts, one member representing law enforcement officers, and one member representing fire fighters.

The duties of the board include the following:

1) *establish the basis for membership in the risk pool;*
2) *define the benefits to be reimbursed by the risk pool;*
3) *authorize distributions from the risk pool account consistent with the rules of the IRS;*
4) *determine, with the help of the OSA, the employer premium payments to the risk pool, which must include the administrative expenses of the DCTED;*
5) *authorize reimbursements for LEOFF 1 medical and long-term care costs that are not covered by standard medical insurance policies, in a manner consistent with the requirements of the federal tax code; and*
6) *purchase reinsurance as the board deems necessary.*

LEOFF 1 Medical Account Established
The LEOFF 1 Medical Account is established, pursuant to IRC section 401(h), as a sub-account within the LEOFF 1 retirement account. The LEOFF 1 Medical Benefits Risk Pool Account is also established with the State Treasurer. Only those funds in the account that are necessary for the administration of the risk pool by the DCTED are subject to legislative appropriation.

Specific uses of Medical Account
Medical account funds may be used solely for reimbursement of medical and long-term care expenses, insurance premiums, Medicare part B premiums; costs incurred by the executive board, state risk manager, and OSA; and accounting and management of the funds by an employer. In accordance with federal requirements, any amounts transferred from the LEOFF 1 fund to the medical account that are not used for payment of LEOFF 1 retiree medical and long-term care costs by the end of the calendar year must be returned to the LEOFF 1 fund.

Actuary to Identify Amounts
By September 30, 2001 and every two years thereafter, the OSA must identify the following amounts, consistent with IRS rules: (1) a valuation of the assets in the LEOFF 1 fund that are in excess of those needed for actuarial full funding of the plan, and do not exceed the anticipated cost of LEOFF 1 retiree medical expenses for the ensuing biennium; (2) the maximum allowable transfer from the LEOFF 1 fund to the medical account; (3) the maximum allowable transfer from the medical account to the risk pool account; and (4) the maximum allowable per person reimbursement to employers for LEOFF 1 medical costs. The OSA shall immediately transmit the information regarding the above values to the Office of Financial Management (OFM), the legislative fiscal committees, and the LEOFF 1 risk pool executive board.

Legislature to Transfer Funds to Medical Account
Until December 31, 2005 or such later date as permitted by the federal tax code, one time each fiscal year the Legislature may transfer to the medical account all or a portion of the excess funds of the LEOFF 1 surplus, so long as that amount does not exceed the anticipated cost of LEOFF 1 retiree medical care benefits. The amount of the transfer is determined by the OSA and must be consistent with the federal tax code and IRS rules. The OSA will also determine the maximum allowable transfer from the medical account to the risk pool, and the maximum allowable per-person reimbursement for LEOFF 1 employers' retiree medical costs. Transfers can only be made once each fiscal year.

Director of the DCTED to Allot Funds
The director of the DCTED is given the authority to allot funds that are transferred by the Legislature from the LEOFF 1 medical account to the risk pool account and to reimburse employer medical expenses. The director must also appoint staff to operate the risk pool, contract for services to support the operation of the risk pool, provide staff support to the executive board, and adopt rules pertaining to the risk pool operation.

Appropriation: *None.*

Fiscal Note: *Available.*

Effective Date: *Ninety days after adjournment of session in which bill is passed, except sections 1 through 19, and 21 through 24, which take effect July 1, 2001, and section 20, which takes effect March 1, 2002.*