ORSC

The Ohio Retirement Study Council
88 E. Broad St., Suite 1175
Columbus, Ohio 43215
(614)228-1346 Phone
(614)228-0118 Fax
www.orsc.org Website

Voting Members

Senators
Lynn Wachtmann, *Vice-Chair*
Greg DiDonato
Priscilla Mead

Representatives
Kirk Schuring, *Chair*
William Ogg
Michelle Schneider

Governor's Appointees
Robert Barrow
William Bennett
Dale Van Vyven

Non-Voting Members

Executive Directors
Thomas Anderson, *SERS*
Richard Curtis, *HPRS*
Herbert Dyer, *STRS*
William Estabrook, *OP&F*
Laurie Hacking, *PERS*

Director
Aristotle L. Hutras

Analysis

Sub. H.B. 94 - Rep. Carey

May 9, 2001

ORSC Position

Glenn Kacic - Contact Person
(614)228-1346

The bill generally makes appropriations for the operation of the state and education for the biennium beginning July 1, 2001 and ending June 30, 2003. This analysis describes only those provisions of the bill that relate to the Ohio public retirement systems.

The bill would eliminate appropriations to the Public Employees Retirement System (PERS), the State Teachers Retirement System (STRS), the School Employees Retirement System (SERS) and the State Highway Patrol Retirement System (HPRS) for funding various ad hoc increases previously enacted by the legislature prior to 1982; all ad hoc increases subsequently enacted by the legislature since 1982 have been funded by the state retirement systems through regular employee and employer contributions and investment earnings thereon.

The bill would continue the following appropriations to the Ohio Police and Fire Pension Fund (OP&F) for funding various ad hoc increases previously enacted by the legislature prior to 1982, the annual $1.2 million state contribution historically made to OP&F, and the benefits payable under the Ohio Public Safety Officers Death Benefit Fund.[1]

Appropriation Item	Fiscal Year 2002	Fiscal Year 2003
090-524 Police and Fire Disability Pension	$43,000	$40,000
090-534 Police & Fire Ad Hoc Cost of Living	$280,000	$260,000
090-544 Police and Fire State Contribution	$1,200,000	$1,200,000
090-554 Police and Fire Survivor Benefits	$1,550,000	$1,500,000
Police and Fire Death Benefits	$23,000,000	$24,000,000

The bill provides that the appropriations for the Ohio Public Safety Officers Death Benefit Fund shall be disbursed by the Treasurer of State in quarterly payments to the OP&F Board. By the twentieth day of June of each year, the Board shall certify to the Treasurer the amount disbursed in each quarter of the current fiscal year and return to the Treasurer moneys received from this appropriation item, but not disbursed.

The bill would also amend the alternative retirement plan for higher education employees relative to the employer supplemental contributions payable to PERS, STRS or SERS to mitigate any negative fiscal impact resulting from the alternative retirement plan upon the defined benefit plans of these retirement systems. Under the bill, the employer supplemental contribution rate for the alternative retirement plan for higher education shall not exceed the rate established by each retirement system to mitigate any negative fiscal impact resulting from the establishment of their own defined contribution plans upon the defined benefit plans of these retirement systems. Currently, the ORSC actuary is required to determine the employer supplemental contribution rate under the

[1]Created in 1976, the Ohio Public Safety Officers Death Benefit Fund provides benefits to the survivors of various public safety officers who die in the line of duty or from injuries sustained in the line of duty. The Death Benefit Fund is financed by the state, but administered by OP&F. It is a separate benefit program from that of the state retirement systems.

alternative retirement plan for higher education employees for each retirement system; the retirement system's actuary determines the employer supplemental contribution rate under the defined contribution plans recently authorized for PERS, STRS and SERS. The following table shows the current rates under the alternative retirement plan for higher education employees and the rate under the STRS defined contribution plan which becomes effective July 1, 2001:[2]

Retirement System	ARP Supplemental Rate	DC Supplemental Rate
STRS	5.76%	3.50%
SERS	3.10%	Not Available
PERS	0.00%	Not Available

Staff Comments - The bill would eliminate the appropriations to PERS, STRS, SERS and HPRS to fund the cost of previous ad hoc post-retirement increases granted prior to 1982; the cost of all ad hoc increases granted thereafter have been funded by the retirement systems through regular retirement contributions and investment earnings thereon. These subsidies have gradually declined each year as the number of beneficiaries has declined due to mortality, and would have eventually ceased altogether upon the death of the last eligible beneficiary.

By way of background, these subsidies were made at a time when several ad hoc increases were enacted for older retirees and their beneficiaries whose annual benefits were deemed to be less than adequate and when the Ohio retirement systems' funded status was deemed to be less than optimal. In 1969, for example, HPRS had approximately twenty-five cents worth of assets for every one dollar in liabilities, compared to ninety-five cents in 1999. Moreover, PERS became the first Ohio retirement system to become fully funded in 1999, meaning that its assets equalled or exceeded its accrued liabilities. SERS also achieved fully-funded status in 2000, with the other Ohio retirement systems showing continued progress toward this goal. A recent actuarial study prepared by Milliman & Robertson in 1998 confirms that the funded status of the retirement systems has improved significantly, largely due to the major expansion of their investment authority over the last decade and a strong economy in recent years.

The Ohio retirement systems' improved funded status served as a major catalyst for the enactment of several major benefit improvements for each retirement system in the past two years. In OP&F, the benefits for all surviving spouses were increased, along with an annual cost-of-living allowance (COLA). In PERS, STRS and SERS, the benefit formulas were increased, along with ad hoc increases for current retirees and their beneficiaries. In HPRS, the benefit formula was increased for members with at least 20 years of service, along with an increase in the minimum monthly benefit amount for all benefit recipients.

In conjunction with the recently enacted benefit improvements, the PERS board acted to provide a temporary employer contribution rate reduction for calendar year 2000. In SERS, the employer health care surcharge was capped, providing immediate financial relief for school districts with lower-salary employees. In HPRS, the employee contribution rate was reduced by one-half of one

[2]The ARP supplemental contribution rate is 0.00% for PERS due to its fully-funded status at the time the rates were determined by the ORSC actuary for each retirement system. Also, PERS and SERS have not yet established their DC plans and, therefore, no DC supplemental contribution rate has been determined for these retirement systems.

percent; the HPRS board also acted to reduce the employer contribution rate by an equal amount.

As part of its actuarial study in 1998, Milliman & Robertson strongly recommended that the legislature and retirement systems review current funding policies that were designed in large part to amortize their once sizable unfunded liabilities and begin to establish new policies that are designed to address their improved funded status in the decision making process, such as whether to improve benefit levels, reduce contribution levels, or some combination of both. Accordingly, whether the retirement systems should continue to receive these general revenue fund subsidies for pre-1982 ad hoc post-retirement increases is an appropriate and timely issue for legislative review.

The attached actuarial analysis prepared by Milliman & Robertson estimates the financial effect of eliminating the general revenue fund subsidies for pre-1982 ad hoc post-retirement increases on the Ohio retirement systems' funded status, funding period, and ability to finance post-retirement health care benefits. The following table shows the respective decreases in the funded status of each retirement system on account of the recently enacted benefit improvements as well as the proposed elimination of the current subsidies for pre-1982 ad hoc post-retirement increases:

RetirementS ystem	**Funded Status**				
	Prior to Benefit Increases	Decrease due to Benefit Increases	Subsequent to Benefit Increases	Decrease due to Elimination of Pension Subsidy	Subsequent to Elimination of Pension Subsidy
PERS	103.08%	**3.09%**	99.99%	**0.01%**	99.98%
STRS	95.97%	**4.00%**	91.97%	**0.01%**	91.96%
SERS	102.23%	**3.73%**	98.50%	**0.01%**	98.49%
HPRS	96.81%	**2.07%**	94.74%	**0.03%**	94.71%
OP&F	88.16%	**NA**	88.16%	**0.11%**	88.05%

The subsequent table shows the increase in the funding period for each retirement system if the current subsidies for pre-1982 ad hoc post retirement increases were eliminated:

Retirement System	**Current Funding Period**	**Increase in Funding Period**	**Subsequent Funding Period**
PERS	0.0 years	**0.0 years**	0.0 years
STRS	23.1 years	**0.0 years**	23.1 years
SERS	25.0 years	**0.2 years**	25.2 years
HPRS	20.0 years	**0.1 years**	20.1 years
OP&F	26.8 years	**1.6 years**	28.4 years

The actuarial analysis concludes that the current state subsidies can be eliminated for PERS, STRS, SERS and HPRS without violating the maximum 30-year funding period established by S.B. 82 or jeopardizing their ability to continue providing post-retirement health care benefits. However, the

analysis concludes that it is unlikely that OP&F will be able to afford to give up these subsidies for many years without jeopardizing either its ability to continue meeting the maximum 30-year funding period or providing post-retirement health care benefits. Therefore, it would be appropriate to continue the current subsidies for OP&F as provided under the bill.

The bill should be amended to include those sections of PERS, STRS, SERS and HPRS law (i.e., R.C. §§ 145.321, 145.326, 145.3210, 3307.693, 3307.695, 3307.698, 3309.371, 3309.376, 3309.371, 5505.171, and 5505.173) and eliminate the language therein that requires the systems to certify to the Treasurer of State the amount required to be paid in the preceding year and that requires the Treasurer to pay to the systems the amount so certified. The bill should also be amended to conform the language relative to the distribution of appropriated moneys for the Ohio Public Safety Officers Death Benefit Fund to current practice, whereby the money is actually distributed by the Treasurer at the beginning of each fiscal year as opposed to the beginning of each quarter.

In an unrelated amendment to the alternative retirement plan for higher education employees, the bill would provide that the employer supplemental contribution rate shall not exceed the rate established under the DC plans recently authorized for PERS, STRS and SERS. (The STRS DC plan shall become effective on July 1, 2001; the DC plans for PERS and SERS have not yet been established.) Currently, the employer supplemental contribution rate for higher education employees choosing the ARP in lieu of STRS is 5.76%; in lieu of SERS, 3.10%; and in lieu of PERS, 0.00%. The current employer supplemental contribution rate for STRS members choosing the DC plan in lieu of the DB plan will be 3.5%, which is 2.26% less than the current ARP rate. *As competing plans, the lower supplemental contribution under the DC plan than under the ARP provides an arguably unfair incentive for individuals to choose the DC plan over the ARP, since more of the employer contribution will be allocated to the individual's retirement account. Since the very purpose of both the ARP supplemental contribution and the DC supplemental contribution is to mitigate any negative fiscal impact upon the defined benefit plans of PERS, STRS and SERS, it would seem fairer to create an single composite rate covering both employees who join the ARP or DC plan. This alternative would assure that the traditional DB plans of the retirement systems suffer no financial harm as a result of the ARP or DC plan. It would also be consistent with the "cost sharing" approach that is utilized by the retirement systems' actuaries to determine the contribution rates for all members and employers by averaging "lower than average cost" members with "higher than average cost" members. Such approach would greatly simplify administration for both employers and the retirement systems, and would serve to stabilize budgeted costs.*

Fiscal Impact - See the attached actuarial analyses prepared by Milliman & Robertson.

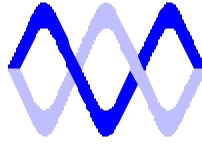
ORSC Position - At its meeting of May 9, 2001 the Ohio Retirement Study Council recommended that the 124th Ohio General Assembly approve those provisions of Sub. H.B. 94 that relate to state retirement systems upon the adoption of the following amendments:

- Include those sections of PERS, STRS, SERS and HPRS law relative to ad hoc increases and eliminate the language therein that requires the systems to certify to the Treasurer of State the amount required to be paid by the state in the preceding year and that requires the Treasurer to pay to the systems the amount so certified;

- Conform the language relative to the distribution of appropriated money for the Ohio Public Safety Officers Death Benefit Fund to current practice, whereby the money is actually distributed by the Treasurer at the beginning of each fiscal year as opposed to the beginning

of each quarter;

- Create a single composite employer supplemental contribution rate covering both individuals who choose an ARP or DC plan, as determined by the retirement system's actuary.



MILLIMAN & ROBERTSON, INC.
Actuaries & Consultants

A Milliman Global Firm

Suite 300, 259 N. Radnor-Chester Road, Radnor, Pennsylvania 19087-5260
Telephone: 610/687-5644
Fax: 610/687-4236

May 7, 2001

Mr. Aristotle L. Hutras
Director
Ohio Retirement Study Council
88 East Broad Street, Suite 1175
Columbus, OH 43215-3580

Re: State Subsidies to Ohio Public Retirement Systems

Dear Aris:

As requested, we have estimated the effect of eliminating the current state subsidies to the Ohio Public Retirement Systems on their:

- Funded status;
- Funding period; and,
- Ability to finance healthcare benefits.

We will address these issues in light of the benefit enhancements enacted during 2000. We will also discuss the effect of unfavorable investment returns from the date of their most recent actuarial valuation and December 31, 2000 on the systems' actuarial status. This letter is a follow-up to our earlier letter of February 19th on this subject.

Background

State subsidies were granted to pay for ad-hoc increases in benefits to retirees in the various Ohio Public Retirement Systems as enacted in the following bills:

- House Bill 377 (102nd General Assembly – 1957),
- House Bill 284 (109th General Assembly – 1971),
- House Bill 204 (113th General Assembly – 1979), and
- House Bill 638 (114th General Assembly – 1981).

In addition, a "state contribution" of $1,200,000 is made annually to the Ohio Police and Fire Pension Fund, "OP&F". This annual contribution has remained unchanged since OP&F's consolidation in 1967. The State also pays a subsidy to OP&F to fund the survivor benefit increases enacted in House Bill 215 (108th General Assembly – 1970), Senate Bill 48 (110th General Assembly – 1974) and House Bill 268 (111th General Assembly – 1976) as modified by House Bill 694 (114th General Assembly – 1981).

We understand that the State contribution to OP&F to fund the benefits payable under the Ohio Public Safety Officers Death Benefit Fund would not be eliminated. Created in 1976, the Death Benefit Fund is a separate program that is financed by the state and simply administered by OP&F. It provides benefits to the survivors of various groups of public safety officers who die in the line of duty.

As described above, the state subsidies payable to the Ohio Public Retirement Systems are primarily for the ad-hoc increases granted to retirees and survivors before 1982. OP&F also receives an annual payment of $1.2 million. The subsidies to fund the ad-hoc increases have been declining as the number of retirees and survivors receiving these increases has been declining.

The following table indicates the actual appropriations to each system during FY 2000 and the budgeted amounts for FY 2001 through 2003. The table also indicates the FY 2000 appropriation as a percentage of system payroll.

System	FY 2000 Actual Appropriation	Percent of System Payroll	FY 2001 Budgeted Amount	FY 2002 House Bill 94*	FY 2003 House Bill 94*
HPRS	$25,000	0.04%	$28,850	$20,960	$20,500
OP&F	3,282,000	0.25	3,215,000	3,073,000	3,000,000
PERS	693,000	0.01	789,100	834,450	718,550
SERS	304,000	0.02	280,600	221,500	200,500
STRS	1,780,000	0.02	1,801,200	1,509,100	1,476,100

* These are the subsidies included in HB 95. They were incorporated into Sub. HB 94. The subsidies for HPRS, PERS, SERS, and STRS were eliminated; only the subsidies for OP&F remain in Sub. HB 94.

It is not clear why the budgeted amount for FY 2001 and the amount in the Budget for FY 2002 for the ad-hoc increases to the Public Employees Retirement System, "PERS", is larger than the amount for FY 2000. The FY 2002 budget amount is also larger than the estimated FY 2001 amount. As indicated above, we believe that these appropriations should be declining over time. The amounts for the other systems' appropriations are generally smaller than the prior year, as we would expect.

Substitute House Bill 94

Substitute House Bill 94 would eliminate the state subsidies to four of the five Ohio Retirement Systems: HPRS, PERS, SERS and STRS. It would continue to provide the state subsidies to OP&F.

Present Value of Subsidies

The consulting actuaries to OP&F, the School Employees Retirement System, "SERS", and the State Teachers Retirement System, "STRS", have calculated the present value of the remaining state subsidies to fund ad hoc increases. We adjusted their figures to reflect the assumption that the State subsidies would only be eliminated for fiscal years 2002 and later; i.e., we assumed that the FY 2001 State subsidies would be paid.

We estimated the present value of the state subsidy appropriations to the Highway Patrol Retirement System, "HPRS", and PERS. In preparing these estimates, we assumed that the appropriations for the ad-hoc colas would continue to decrease based on the annual percentage decline from FY 1992 to FY 2000. We believe that our estimate is probably on the high side.

In preparing these figures, we used the interest rate shown in the last valuation for each System to develop the present values.

The following table shows the estimated present value of future subsidies for each system and the effect of eliminating those subsidies on their funded status. We show two values for OP&F based on eliminating:

1. Only appropriations for the ad-hoc colas; or,
2. Both the ad-hoc cola appropriations and the "State contribution" of $1.2 million.

As requested, we have also shown the effect of the benefit increases enacted in 1999 and 2000 on the funded ratios for comparison purposes. (We did not isolate the effect of SB 118/HB 275 since they were reflected in the January 1, 1999 actuarial valuation of OP&F.)

System	Present Value of Eliminated State Subsidies (in millions)	Funded Ratios				
		Prior to Benefit Inc.	Decr. due to Benefit Inc.	Current	Decr. if State Subsidy Elim.	After Elim. of State Subsidy
HPRS	$0.1**	96.81%	2.07%	94.74%	0.03%	94.71%
OP&F – Ad-hoc Appropriations only	7.1	88.16	0.00	88.16	0.11	88.05
OP&F – both State Contribution & Ad-hoc Appropriations	20.0	88.16	0.00	88.16	0.28	87.88
PERS*	3.6**	103.08	3.09	99.99	0.01	99.98
SERS	0.6	102.23	3.73	98.50	0.01	98.49
STRS	4.5	95.97	4.00	91.97	0.01	91.96

* All divisions combined. Since we do not have information that would allow us to allocate the state subsidies among the three divisions of PERS, we have shown all PERS divisions combined.
** Estimated by M&R.

Effect on Funded Status

Retirement systems typically report their funded ratio to indicate their funded status. The funded ratio is the ratio of:

$$\frac{\text{actuarial value of assets}}{\text{actuarial accrued liabilities.}}$$

SERS and STRS currently include the value of future state subsidies in the actuarial value of assets for basic benefits. HPRS, OP&F and PERS do not. Therefore eliminating the future state subsidies would not affect the reported funded ratios for HPRS, OP&F or PERS. In the table above, we have prepared estimated funded ratios for HPRS, OP&F or PERS as if they included the present value of future state subsidies in the actuarial value of assets. This was done so that we could compare all five systems on a comparable basis.

Effect on Funding Periods

The remaining funding periods for the five systems are shown below on two estimated bases. The first assumes that the state subsidies will continue; the second assumes that they will be eliminated effective FY 2002. We also show the increase in the funding period that would result from such a change.

System	Current Funding Period (in years)	Increase in Funding Period (in years)	Extended Funding Period (in years)
HPRS	20.0 years*	0.1 years	20.1 years
OP&F – Ad-hoc Appropriations	26.8	1.6	28.4
OP&F – State Contribution & Ad-hoc Appropriations	26.8	2.6	29.4
PERS	0.0*	0.0	0.0
SERS	25.0	0.2	25.2
STRS	23.1	0.0	23.1

* Estimated as if the present value of future subsidies were included in the value of assets.

As indicated in the above table, the funding period would be extended for less than one year for most of the Systems if these state appropriations were eliminated. OP&F would be affected the most as the funding period would increase by 1.6 years if the ad-hoc cola appropriations were eliminated and by 2.6 years if the State contribution was also eliminated. Since each of the extended funding periods is less than 30 years (although OP&F would barely fall under that limit if both the Adhoc and State contributions were eliminated), each system would continue to satisfy the requirements of Senate Bill 82. (SB 82 requires that the funding period for amortizing any UAL for basic benefits be 30 years or less.)

Since OP&F applies these subsidies to reduce the normal cost, we eliminated this source of offset to the normal cost effective January 1, 2002. Because the state subsidies are expected to decrease over time rather than grow with OP&F payroll, this method of estimating the effect on the funding period serves to overstate the effect of eliminating the state subsidies.

As indicated previously, HPRS and PERS do not include the value of future state subsidies in the actuarial value of assets (as do SERS and STRS) or as an offset to the normal cost (as does OP&F). Therefore eliminating the future state subsidies would not affect the reported funding period for HPRS or PERS. In the table above, we have prepared estimated funding periods for HPRS and PERS as if they included the present value of future state subsidies in the actuarial value of assets. This was done so that we could compare all five systems.

Effect of Investment Returns since most recent Actuarial Valuation

The year 2000 produced unfavorable investment returns for all five of the Ohio Retirement Systems, as indicated in the table below.

	Returns January through June, 2000	Returns July through December, 2000	Total Year
HPRS	1.78%	(2.04%)	(0.29%)
OP&F	1.18	(2.31)	(1.16)
PERS	1.23	(2.03)	(0.83)
SERS	3.06	(4.03)	(1.09)
STRS	1.10	(3.50)	(2.45)

The returns shown above are measured based on market values of investments while the systems report their actuarial status based on actuarial asset values which are intended to smooth out the more volatile market values. We summarized in the table below the relationship between market values and actuarial values as of the most recent actuarial valuation for each system and indicated the shortfall from the actuarial investment return assumption to provide a rough indication of the impact of 2000's unfavorable investment returns. (Amounts shown are in millions.)

	Valuation Interest Rate	Valuation Date	Excess of MV over Actuarial Value of Assets at most recent valuation	Estimated shortfall in investment returns since last valuation	Estimated Excess of MV over Actuarial Value of Assets at December 31, 2000
HPRS	7.75%	January, 2000	($6.7)	$43.9	($50.6)
OP&F	8.25	January, 2000	1,112.9	756.8	356.1
PERS	7.75	January, 2000	4,029.0	3,723.3	305.7
SERS	8.25	July, 2000	561.4	1,039.6	(478.2)
STRS	7.75	July, 2000	3,315.1	5,886.6	(2,571.5)

As indicated above, all of the systems, except HPRS, had assets as of their last actuarial valuation that, when valued at market, exceeded their actuarial value. Since the actuarial value of assets is assumed to grow at the actuarial investment return assumption, the shortfall shown above is the estimated decrease in the buffer between market and actuarial assets values since the most recent valuation. These estimates indicate that actuarial losses due to adverse investment experience may have eliminated the buffer for SERS and STRS.

But, of course, the systems all report their actuarial status based on the actuarial value of assets, not their market value. The exact actuarial value of assets for HPRS, OP&F and PERS as of January 1, 2001 is not available yet. SERS and STRS will not calculate the actuarial value of assets until July 1, 2001, the date of their next actuarial valuation. When those figures are available, they will reflect some, but not all, of the shortfall in investment returns since the last

actuarial valuation in the actuarial value of assets because the smoothing mechanisms used in determining the actuarial value of assets. Hence the figures shown above probably overstate the effect of the last year's unfavorable investment results on their actuarial status that will be reported in the next actuarial valuation.

Effect on ability to support healthcare benefits

Because the five Ohio Retirement Systems finance health care costs on a modified pay-as-you-go basis, it is necessary to project the pay-as-you-go costs in order to determine whether they can be expected to encounter difficulty financing health care benefits. To estimate the ability of current contribution rates to support health care benefits, we have typically provided to the Council projections of the Healthcare Fund over the period of time required to amortize all unfunded actuarial liabilities. It seems reasonable to continue this approach to determine the effect on the ability of the systems to fund healthcare benefits if the State subsidies are eliminated.

In the recent past, we have prepared rough projections reflecting an assumed growth in health care costs at three alternative rates - the rate of payroll growth plus 0%, 1% and 2% per annum. Health care inflation at a rate as low as the rate of payroll growth is a quite optimistic assumption. But we believe this is a reasonable baseline for these projections because the Boards have the ability to manage the growth in net health care costs by increasing retiree premiums and/or offering lower cost health care options to retired members. To place a frame of reference around the baseline projections, we also projected the growth in the Healthcare Fund under alternative healthcare inflation assumptions 1% and 2% higher than the baseline projection. These were intended to provide an indication of the margin for adverse experience.

PERS, SERS and STRS

Last year we presented such projections in conjunction with our review of proposed legislation to improve benefits under PERS, SERS and STRS. Since eliminating the State subsidies would only increase the funding period for PERS, SERS and STRS by 0.0 years, 0.2 years and 0.0 years respectively, we have not updated those projections. This seems unnecessary because the increases in the funding periods would be insignificant.

HPRS

We did not prepare a projection for HPRS because the increase in their funding period is also insignificant (only 0.1 year) and the baseline projection shown in the January 1, 2000 HPRS actuarial valuation indicates that the healthcare fund balance will grow for the next century if healthcare costs are managed to grow at the rate of payroll growth.

OP&F

Watson Wyatt, the consulting actuary to OP&F, prepared a "Report on the Solvency of the Health Care Stabilization Fund" of OP&F dated November 1, 2000. That report projected the Health Care Stabilization Fund, "HCSF", based on different, and somewhat higher, health cost inflation rates than we have used for the projections we prepared for the Council for the other four systems. We have not prepared alternative projections for OP&F because the Report indicated that the HCSF would be exhausted in 2015 in spite of:

1. increases in the portion of the contribution rate that will be allocated to the HCSF; and,
2. increases in the member premium schedule that will go into effect July 1, 2001.

Since 2015 is well before OP&F's Unfunded Actuarial Accrued Liabilities are expected to be fully amortized, it is clear that OP&F would be adversely affected by eliminating the state subsidies. If the subsidies were eliminated, OP&F may not be able to satisfy the requirements of SB 82, which requires a 30 year amortization period for a UAL due to basic benefits, and continue the current healthcare benefits without making benefit reductions or member premium increases beyond those already planned.

It is worth noting that Watson Wyatt indicated that the healthcare trend assumptions used for that report were the Baseline + 1% Trend assumptions from their 1998 Forecast Study. Their report further indicates that "Actual 1999 cost was considerably higher than expected in the Forecast under the Baseline Trend assumptions… Most of the increase is due to the increased cost of prescription drugs. Because of this increase we have switched to the Baseline Trend + 1% trend rate assumption. But even these changed rates may prove to be too low."

The Report indicates that the OP&F Board will be challenged to manage the growth in health care costs. In order to provide a frame of reference for the magnitude of the challenge facing the Board, we estimated that the member premiums would have to gradually increase to 70% of total health insurance costs by 2027, the last year of the Watson Wyatt projection, to maintain a positive balance in the HCSF. Member premiums were 5.14% of the total cost of the health insurance benefits in 2000.

A revised member premium schedule is scheduled to become effective July 1, 2001. It will increase the member premiums to 6.0% of total costs.

Of course, the OP&F Board has other options, such as reducing benefits (increasing deductibles and/or co-pays) and allocating a larger portion of the total contributions to the HCSF. As noted in the Watson Wyatt study, "allocating additional assets to the HCSF will decrease pension assets, causing the unfunded liability to increase." This could jeopardize the ability of the OP&F Board to meet the 30-year funding period requirement of SB 82.

Based on these projections, we believe that it is unlikely that OP&F will be able to afford to give up the state subsidies for many years. We believe that the current state subsidies can be

eliminated for PERS, STRS, SERS, and HPRS without violating the requirements of SB 82 or jeopardizing their ability to continue to provide health insurance. However, it would be appropriate to continue the current subsidies to OP&F as is provided by Sub. H.B. 94.

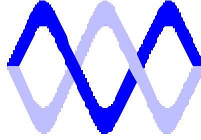
Please let us know if you have any questions.

Sincerely,

Alan H. Perry

William A. Reimert

WAR:AHP:kaw\ORC02
g:\corr01\orc\ltr05_statesubsidy.doc



MILLIMAN & ROBERTSON, INC.
Actuaries & Consultants

A Milliman Global Firm

Suite 300, 259 N. Radnor-Chester Road, Radnor, Pennsylvania 19087-5260
Telephone: 610/687-5644
Fax: 610/687-4236

May 7, 2001

Mr. Aristotle L. Hutras
Director
Ohio Retirement Study Council
88 East Broad Street, Suite 1175
Columbus, OH 43215-3580

Re: Substitute House Bill No. 94

Dear Aris:

As requested, we have reviewed the portion of Substitute House Bill 94 that would amend §3305.06 of the Revised Code to limit the Supplemental Contribution payable to the Ohio Retirement System on account of employees who elect to join an Alternative Retirement Plan, "ARP". We have summarized our analysis below.

Background

H.B. 586

H.B. 586, 121st G.A., allowed academic and administrative employees of public institutions of higher education to elect coverage in an Alternative Retirement Plan instead of becoming members of the Public Employees Retirement System, "PERS", the School Employees Retirement System, "SERS", or the State Teachers Retirement System, "STRS". This act required employers of members who elected to join an ARP to make a Supplemental Contribution to the Ohio Retirement System in which they would have been a member absent their election to join the ARP.

Employers were required to make a Supplemental Contribution initially equal to 6% of the electing employee's salary to mitigate any negative financial impact of the ARP on PERS, SERS and STRS. This rate was re-determined one year after the ARP was established based on the members who elected to join the ARP. It is to be re-determined every three years and continue until the Unfunded Actuarial Liability, "UAL", of the Retirement System, excluding health care benefits and benefit increases provided after March 31, 1997, becomes fully funded.

H.B. 628, S.B. 270, and S.B. 190

H.B. 628, S.B. 270, and S.B. 190, 122nd G.A., allowed the PERS, SERS and STRS Boards, respectively, to establish defined contribution options, "DC option", for their members. These acts required employers of members who select a DC option to make a Supplemental Contribution to the defined benefit plan in which they would have been a member absent their election to select the DC option. The Supplemental Contribution Rates are intended to mitigate the negative financial impact, if any, on the defined benefit plan of the systems. The Supplemental Contribution Rates will continue until the UAL for all benefits, except health care benefits and benefit increases provided to members and former members after 2000, becomes fully funded.

STRS Plan

The STRS Board has announced that it will offer a DC option effective July 1, 2001. Employers will be required to make a Supplemental Contribution initially equal to 3.5% of the electing employee's salary to mitigate any negative financial impact of the DC option on the defined benefit plan of STRS.

PERS and SERS have not announced the formation of DC options yet.

PERS fully funded status as of December 31, 1998

Since PERS became fully funded as of December 31, 1998, the Supplemental Contribution has ceased with respect to employees who joined an ARP in lieu of becoming a member of PERS. (Note that PERS had a UAL as of December 31, 1999 as a result of increases in benefits enacted in 2000. The Supplemental Contributions to PERS have not resumed because H.B. 586 did not provide for such a resumption.)

The Supplemental Contributions continue to be made to SERS and STRS since they have had UALs since the enactment of H.B. 586.

Purpose of amendment contained in Sub. H.B. 94

Sub. H.B. 94 would reduce the Supplemental Contribution Rate for ARP members to the lesser of:

- the Supplemental Contribution Rate for ARP members established at the most recent 3-year actuarial review; and,
- the Supplemental Contribution Rate attributable to employees who select a DC option.

This provision would apply to DC options offered by PERS, SERS, and STRS.

Determination of Supplemental Contribution Rate under current law

H.B. 586, 121st G.A., mandated that the Supplemental Contribution Rate "mitigate any negative financial impact of the Alternative Retirement Program on the State Retirement System". In preparing the initial 3-year report, dated March 6, 2000, we used the method utilized to estimate the magnitude of the Supplemental Contribution Rate during 1994 through 1996 while H.B. 586 was under consideration by the legislature to calculate this rate.

As we indicated at that time, there are three primary reasons why a Supplemental Contribution to the Ohio Retirement Systems is needed. These reasons apply to both ARPs and DC options.

1. The first reason is that the existing unfunded actuarial liabilities of the systems must be amortized. Each system relies on contributions on behalf of all employees (covering both current employees and future hires) in the groups currently covered by the Retirement Systems to amortize these obligations. To the extent that an ARP decreases the number of employees joining the Retirement System in the future or allows current members to transfer out, the financing base for amortizing these unfunded actuarial liabilities will be eroded.

2. The second reason is that employees who are most likely to join the ARP are those who expect to receive benefits from the Ohio Retirement Systems with a lower value than the benefits provided by the ARP. Those members of the Retirement System who expect the ARP will provide benefits with a value lower than the Retirement System will more likely choose to stay in the Retirement System. To the extent that this occurs, this also will serve to increase system costs.

3. A third reason is that University and College employees eligible to join an ARP receive compensation higher than the average compensation provided to other members of the Retirement Systems. Employer contributions allocated to fund health insurance benefits for retired members are expressed as a percentage of pay in each of the three Retirement Systems. But the cost of health insurance does not vary in proportion to earnings. Thus, if the employees with higher than average earnings transfer to an ARP, contributions to finance health insurance will decrease by more than the cost of providing health insurance to retirees.

Reduction in Supplemental Contribution if Sub. H.B. 94 is enacted

The Supplemental Contribution Rate for STRS members who select a DC option will be 3.50%. The Supplemental Contribution Rate currently applicable to employees eligible to join STRS who elected to join an ARP is 5.76%. Thus the adoption of this provision in Sub. H.B. 94 would reduce the Supplemental Contribution Rate payable to STRS by 2.26%.

Since SERS has not announced a DC option to be offered to members of SERS, we cannot indicate the effect of this provision on SERS. (As indicated above, there are no Supplemental Contributions to PERS for ARP members because the UAL was fully funded as of December 31, 1998 and there are no provisions for them to resume.)

The reduction from 5.76% to 3.50% occurs because the Supplemental Contribution Rate reflects:

1. the need of the Systems to continue to fund their UALs; and,
2. the extent to which the employees who join an ARP were subsidizing the cost of benefits to other members.

The contribution rates that employer's make to the Retirement Systems are based on an actuarial valuation that determines an average contribution rate that applies to all employers. Such a "cost sharing" approach greatly simplifies administration for both employers and the systems and serves to stabilize budgeted costs.

As indicated above, the employees who are most likely to join the ARP or DC option are those who expect to receive lower benefits from the defined benefit plans than the ARP or DC option. Offering an ARP or DC option allows these "lower than average cost" members to leave the defined benefit plan. As a direct result, the average cost for the remaining members increases.

As discussed previously, H.B. 586 directed that the Supplemental Contribution Rate should mitigate any negative financial impact of the ARP. Hence the Supplemental Contribution Rate reflected both the need of the systems to continue to receive:

1. support toward funding their UAL; and,
2. the subsidy provided by the "lower than average cost" members who choose to leave the system.

Possible Public Policy Issues

Is the "lower of my cost or someone else's cost" fair?

Effectively, Sub. H.B. 94 would limit the Supplemental Contribution Rate payable on behalf of employees who join an ARP to the lesser of the rate necessary to mitigate the negative financial effect, if any, on SERS or STRS to the lesser of the rate determined for:

1. themselves; or,
2. other STRS members who select a DC option.

Effectively, employers of employees who join an ARP would contribute the lower of the cost to STRS of having higher education employees join an ARP or the cost of allowing all STRS members to select a DC option. It is not clear why higher education employers should receive such "heads I win, tails you lose" treatment.

It would seem fairer to either:

1. Allow higher education employees who join an ARP to stand on their own whether they produce a higher or lower cost than STRS members who select a DC option; or
2. Create a single composite rate covering both employees who join an ARP and STRS members who select a DC option.

Either of these alternatives would assure that STRS suffered no financial effects due to the ARP and DC options. The provision in Sub. H.B. 94 would create a negative financial effect on STRS whenever the Supplemental Contribution Rate for the STRS members who select a DC option is less than the Supplemental Contribution Rate applicable to ARP members only.

Please let us know if you have any questions.

Sincerely,

Alan H. Perry

William A. Reimert

AHP:WAR:war\ORC94
g:\corr01\orc\ltr05_supplementalcontrib.doc