



**STATE TEACHERS
RETIREMENT SYSTEM
OF OHIO**

**A Report to the
Ohio Retirement
Study Council**

March 2005

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Prepared by the State Teachers Retirement System of Ohio Executive Summary

In November 2004, the Retirement Board received a report from its actuary — Mellon Consultants — for the year ended June 30, 2004. While STRS Ohio had an exceptionally good year regarding investment returns, the system experienced actuarial losses in other areas. Consequently, there were only slight improvements to the funding period and the funded ratio. The report explains that the system will require 42.2 years to retire the unfunded actuarial accrued liability (UAAL), which is above the standard of 30 years in Ohio Revised Code (R.C.) Section 3307.512.

Since not all of a system's liabilities come due at once, the funded ratio is a better barometer for evaluating a pension fund's ability to meet its obligations. The funded ratio is the market-related value of assets compared to liabilities. Although STRS Ohio's funding period is expected to increase before again entering a downward trend, STRS Ohio's funded ratio will consistently stay around 75%. STRS Ohio currently has on hand 76% of the assets needed to pay all benefits accrued to date — even though the liabilities will not actually be payable for many years.

The Retirement Board Has Taken Steps to Ensure the Security of Pension Benefits and Preserve Health Care Coverage for Retirees

- **The Retirement Board increased the required member contribution to the maximum allowed under Ohio law — 10% — beginning July 1, 2003, and has been collecting the maximum 14% of payroll from employers since 1984.**
- **The Retirement Board reduced the employer contribution going into the Health Care Stabilization Fund from 4.5% to 1%, beginning July 1, 2003.** This is the lowest allocation to health care of any of the five Ohio retirement systems.
- **The Retirement Board made the very difficult decision to change the eligibility qualifications for both access and subsidies for health care coverage, effective Jan. 1, 2004.**
- **In October 2003, the Retirement Board made adjustments to the actuarial assumptions based on the five-year actuarial experience review.**
- **In February 2005, the Retirement Board reduced the match from the Employer Trust Fund that can be included in a reemployed retiree's lump-sum payment or monthly annuity benefit to 50% from 100%, based on the 10% employee contribution rate.** This represents an additional \$12–\$14 million annually that will be paid toward the unfunded liability.

These actions, along with the recent upturn in the markets, have helped the funding situation. However, reducing the funding period quickly is particularly challenging for STRS Ohio since demographically, its members have longer service, higher earnings and less turnover than in other Ohio public retirement systems.

Nonetheless, as noted in Milliman USA's Feb. 13, 2004, letter to the ORSC: *Our reports confirmed that all of the retirement systems remain financially secure to pay all mandated pension benefits when they become due well into the future.*

Executive Summary (continued)

STRS Ohio's Plan for Returning to a 30-Year Funding Period

The Retirement Board believes any changes should take into consideration the following policy issues:

- Impact on pension funding and the Health Care Stabilization Fund
- Impact of pension benefit changes on employers
- Competitiveness of public employees in the workforce
- Larger economic impact on the state

In January 2005 the Retirement Board approved an asset/liability study for the system with a target completion date of Aug. 31, 2005. This study will:

- Evaluate the ability of various investment portfolios to meet specified funding objectives (e.g., 30-year funding period for the pension fund);
- Anticipate cash flow requirements to meet system liabilities; and
- Determine an asset allocation policy that will achieve a good risk/return trade-off and meet the system's long-term liabilities.

In short, the study will advise the Retirement Board on an investment asset mix and projected rate of return appropriate for the pension and health care liabilities of the system, while providing a level of risk that the board is comfortable with.

The Retirement Board will also evaluate the actuarial liability incurred by the system for various types of purchased service credit.

In addition, the board will continue to monitor retirement trends. Until this past fiscal year STRS Ohio experienced an annual decline in retirements for three consecutive years. We believe this decline was a result of primarily two factors: increased health care costs in retirement and the incentive of a higher benefit formula with 35 years of service. As of July 2005, the enhanced benefit formula for 35 years of contributing service credit will have been in effect for five years. At its February 2005 meeting, the Retirement Board agreed that this milestone would be an appropriate time for the board's actuary to conduct an extensive analysis to determine the overall cost *or* benefit to the system of providing this enhanced benefit.

Other changes that may be evaluated during the 2005-2006 fiscal year by the Retirement Board include:

- Resetting the portion of employer contributions for Defined Contribution Plan participants that goes toward the unfunded liability.
- Resetting the interest rate for account withdrawals, money purchase benefits and reemployed retiree accounts.
- Seeking legislation to change the early retirement reductions to actuarially cost-neutral amounts.

The members of the Retirement Board understand that as fiduciaries, their first and foremost priority and legal obligation is to protect the system's ability to honor the pension and other benefit promises in state law. The board also realizes that a guaranteed pension benefit without some package of affordable health care coverage is not truly a secure retirement package for present or future retirees. The Retirement Board is committed to working with its membership, the other systems, the Legislature and all of the public sector stakeholders to continue implementing changes to reduce the UAAL to 30 years or less while addressing health care funding.

A Report to the Ohio Retirement Study Council

March 2005

The State Teachers Retirement System of Ohio (STRS Ohio) is subject to the reporting requirements of Ohio Revised Code (R.C.) Section 3307.512, enacted by Senate Bill 82 in 1997. This section of the Revised Code requires the State Teachers Retirement Board to provide the Ohio Retirement Study Council with a report in any year that the funding period for the unfunded actuarial accrued liability (UAAL) of the pension fund exceeds 30 years. The report must also indicate how the board will reduce the amortization period to 30 years or less.

In November 2004, the Retirement Board received a report from its actuary — Mellon Consultants — for the year ended June 30, 2004. While STRS Ohio had an exceptionally good year regarding investment returns, the system experienced actuarial losses in other areas. Consequently, there were only slight improvements to the funding period and the funded ratio.

The report from the actuary explains that the system will require 42.2 years to retire the UAAL. Therefore, this report is being submitted in compliance with the Ohio Revised Code.

Background

Since 1920, the State Teachers Retirement Board has provided pension, survivor and disability benefits to the public teachers of Ohio. Further, STRS Ohio has provided subsidized health care coverage for more than 30 years — one of only seven teacher retirement systems in the non-Social Security states to offer health care coverage to retirees.

Ohio law (R.C. Chapter 3307) requires most teachers in the public schools and institutions of higher education to contribute to STRS Ohio while employed in service to its citizens. It also requires the teachers' employers to contribute, based on the salaries paid. The current contribution rates are capped in statute at 10% of gross earnings for employees and 14% from employers.

The same laws that create and govern STRS Ohio also create an "obligation" to these educators as a result of their participation in STRS Ohio. Financial benefits result if and when a teacher attains eligibility.

STRS Ohio is required to pay the following when eligibility is demonstrated:

- Age/service benefits for defined benefit plan participants (R.C. 3307.58, 3307.59 and 3307.60)
- Annuities to reemployed retirees who are already receiving pensions (R.C. 3307.352)
- Disability benefits (R.C. 3307.62–3307.64)
- Survivor benefits (R.C. 3307.562 and 3307.66)
- Defined contribution plan benefits under terms specified by the plan document (R.C. 3307.81)

Other guaranteed payments/programs are:

- Annual 3% COLA (cost-of-living adjustment) for recipients of defined benefits (R.C. 3307.67)

- Partial reimbursement of Medicare Part B premiums paid by Defined Benefit Plan recipients (At a rate of 2.252% of the 2005 premium per year of service, up to a maximum of 30 years or 90%; minimum payment — \$29.90 per month, maximum payment — \$52.83 per month) (R.C. 3307.39)
- Help with the cost of Medicare Part A equivalent coverage for qualifying benefit recipients and their spouse (R.C. 3307.61)
- \$1,000 lump-sum benefit upon death of a benefit recipient (R.C. 3307.661)
- Refunds in lieu of any other benefit upon withdrawal by members who leave teaching in Ohio and request a refund (R.C. 3307.56 and 3307.563)

Ohio law *does not currently guarantee nor require* the following to be provided by STRS Ohio. However, it instead allows STRS Ohio to offer its participants access to other benefits and act, as it is able, to help members by paying all or part of the following:

- Payment of all/part of health coverage cost for defined benefit plan recipients (R.C. 3307.39)
- Supplemental benefit (R.C. 3307.671)
- Additional retiree-funded lump-sum benefit upon the death of a recipient of an age/service or disability benefit (R.C. 3307.392)
- Excess benefit plan to pay guaranteed benefit excluded by IRC section 415 (R.C. 3307.461)

Ohio law directs the Retirement Board to collect contributions and invest the funds prudently under a plan that a qualified actuary determines will cover the cost of the pension and other benefits earned by the participants for performing the current year of service and pay off any UAAL over a period not to exceed 30 years.

Pension Plans Maintain a Long-Term Perspective Toward Investments and Pension Obligations

Funding a retirement plan is a long-term process similar to a home mortgage for an individual. It is not something that is funded overnight. Not all of a system's liabilities come due at once. They are spread out over decades. The more than 180,000 active members of STRS Ohio will not all be retiring and collecting benefits at the same time.

Industry accounting standards require disclosure of trend data, such as funding periods and funded ratios, which reveal the current funding condition and the direction in which the plan appears to be headed. The funding period is the number of years required to pay off the unfunded accrued liability. A 30-year funding period is a commonly used industry standard.

Since not all of a system's liabilities come due at once, the funded ratio is a better barometer for evaluating a pension fund's ability to meet its obligations. The funded ratio is the market-related value of assets compared to liabilities. Although STRS Ohio's funding period is expected to increase before again entering a downward trend, STRS Ohio's funded ratio will consistently stay around 75%. STRS Ohio currently has on hand 76% of the assets needed to pay all benefits accrued to date — even though the liabilities will not actually be payable for many years. STRS Ohio's current funded ratio of 76% is better than at any time in its history before 1993. (See Appendix A for historical funding information.) Without any changes, the funding period is expected to amortize to 30 years by 2020, as shown in Appendix B. Factors that affect these pro-

jections include investment income, payroll growth, salary increases, retirement experience and mortality rates.

STRS Ohio, like most institutional investors, invests for the long term with a diversified portfolio that provides long-term benefits. **As an example, during the past 20 years (ending on June 30, 2004) STRS Ohio posted a 10.36% annualized rate of return, earning approximately \$18 billion more than its actuarial assumed rate of return.** These excess earnings have:

- offset actuarial losses due to changes in demographic experience, and
- benefited members through enhanced pension calculations, cost-of-living increases, supplemental benefit payments and health care subsidies.

As a further indicator of STRS Ohio's financial soundness, Standard & Poor's affirmed STRS Ohio's "AAA" issuer credit rating in January 2005. This is Standard & Poor's highest possible rating regarding an organization's ability to pay its financial obligations. STRS Ohio has maintained the AAA standard since first asking for a rating in 1999.

The Retirement Board Has Taken Steps to Ensure the Security of Pension Benefits

During the past several years, the State Teachers Retirement Board has taken a number of steps to control its UAAL while preserving health care coverage for its current and future retirees.

- (1) **The Retirement Board increased the required member contribution to the maximum allowed under Ohio law — 10% — beginning July 1, 2003, and has been collecting the maximum 14% of payroll from employers since 1984.** STRS Ohio cannot collect a larger contribution annually from either the teachers or their employers unless the Legislature raises the contribution ceiling.
- (2) **The Retirement Board reduced the employer contribution going into the Health Care Stabilization Fund from 4.5% to 1%, beginning July 1, 2003.** This is the lowest allocation to health care of any Ohio retirement system. If this 1% contribution toward retiree health care was discontinued, STRS Ohio would likely reach a 30-year funding period within five years. However, taking this annual allocation of about \$95 million from the Health Care Stabilization Fund would create additional hardship for retirees in the form of increased out-of-pocket costs, and uncertainty among active members.
- (3) **The Retirement Board made the very difficult decision to change the eligibility qualifications for both access and subsidies for health care coverage, effective Jan. 1, 2004.** A 30-year career teacher is now receiving a subsidy of 75% toward the health care premium, down from 87%. The board made these changes to its health care program to provide a 10-year reserve in the Health Care Stabilization Fund on a rolling basis. These changes, coupled with investment returns on the fund, have extended the life of the fund to 2018. However, to maintain that period of solvency, plan participants will have to pay an increasingly larger amount toward their health care costs. The board remains committed to helping provide affordable health care to retired educators.
- (4) **In October 2003, the Retirement Board made adjustments to the actuarial assumptions based on the five-year actuarial experience review.** Changes were made to assumptions regarding longevity, retirement, disability and teacher salary increases to reflect actual experience. With the advice of the board's investment and actuarial consultants, the annual investment return assumption was raised to 8% from 7.75%. (Note: If STRS Ohio raised this return

assumption to 8.25%, the system would likely have a 30-year funding period.) The net effect of the assumption changes was to reduce the amortization period by 10 years.

- (5) **In February 2005, the Retirement Board reduced the match from the Employer Trust Fund that can be included in a reemployed retiree's lump-sum payment or monthly annuity benefit to 50% from 100%, based on the 10% employee contribution rate.** This change, which will go into effect beginning July 1, 2005, applies to reemployed retirees who are age 65 or older. This will result in 8% of the 14% employer contribution for every member going toward STRS Ohio's unfunded liability, versus the current 3%. On an annual basis, this represents an additional \$12–\$14 million that will be paid toward the unfunded liability.

The Retirement Board was given the authority to make this change through the passage of Amended Substitute House Bill 449. This bill also enables STRS Ohio to retain the 14% employer contribution and accompanying interest for reemployed retirees who elect to withdraw before age 65.

These actions, along with the recent upturn in the markets, have helped the funding situation. However, reducing the funding period quickly is particularly challenging for STRS Ohio since its members have longer service, higher earnings and less turnover than in other Ohio public retirement systems. Cumulative investment gains over the last 10 years have been less than \$1 billion, while experience losses (e.g., mortality, payroll growth) have totaled more than \$3.5 billion.

Nonetheless, as noted in Milliman USA's Feb. 13, 2004, letter to the ORSC: *Our reports confirmed that all of the retirement systems remain financially secure to pay all mandated pension benefits when they become due well into the future.*

Considerations for the Future

Certainly complicating the issue for the Retirement Board is its commitment to helping current and future retirees with the cost of their health care coverage. Today, the Retirement Board helps 108,000 retired teachers and their dependents with their medical costs. It provides access to quality health plans and subsidizes the cost of participating in them for most retirees. STRS Ohio has provided a health care program ever since the Legislature authorized this practice in 1974.

For a number of years, a portion of employer contributions, investment earnings, plan changes and premium contributions from plan participants were adequate to cover rising health care expenses and create a reserve in the Health Care Stabilization Fund for future claims. Wise management of STRS Ohio resources and healthy investment returns also enabled the Retirement Board to allocate an additional \$3 billion to the fund. Without these allocations, STRS Ohio retirees and their dependents would have started paying 100% of their health insurance premium costs in 1990. However, as is currently being experienced all over the country, rising medical and prescription drug costs and increasing utilization are impacting how much public and private employers can help their workers and retirees with health care costs.

Of the 14% of pay STRS Ohio collects from employers, the Retirement Board is today dedicating just 1% to help retirees with the cost of health care. This 1% of teacher payroll will generate about \$95 million in 2005. The estimated gross cost of retired teacher and dependent health care in 2005 is about \$450 million. Money this year from employers to help with the cost of retiree medical care will cover just 21% of the annual outgo. The board again will spend some of the reserve in the Health Care Stabilization Fund this year so that the retired career teachers (those with 30 or more years of service) will pay about 25% of the total premium cost.

As noted earlier, the Retirement Board's legal obligations delineated in the Ohio Revised Code include providing retirees assistance with Medicare Parts A and B. The Legislature instituted these mandatory benefits as an offsetting benefit for retirees who would never collect Medicare benefits through participation in Social Security. Funds must be maintained in the Health Care Stabilization Fund to meet these obligations. In 2004, the Retirement Board froze the reimbursement for Medicare Part B at the 2003 level, further reducing its financial liability. Ohio law requires a minimum payment of \$29.90 per month.

The Retirement Board is continuing to look at a wide range of possibilities to address both the funding of the pension benefit obligation and the health care program. The board realizes that a guaranteed pension benefit without affordable health care coverage is not truly a secure retirement package for present or future retirees. Therefore, any changes must address both issues.

The Board is also aware that funding and management of pension benefits is a long-term obligation. Outside pension experts agree that plan design cannot be reactive to short-term market volatility, but must be done in the context of long-term policy horizons.

In fact, the Milliman USA report of February 2004 noted: *The fact that the UAL grows over the short term does not mean that the retirement system is actuarially unsound. Some amortization schedules will produce increasing UALs over the near term even though the scheduled amortization payments will ultimately fully fund the UAL. Moreover, fluctuations in investment and other actuarial experience should be expected. Such fluctuations will cause the UAL to increase or decrease from year to year.*

STRS Ohio's Plan for Returning to a 30-Year Funding Period

The Retirement Board believes any changes should take into consideration the following policy issues:

- Impact on pension funding and the Health Care Stabilization Fund
- Impact of pension benefit changes on employers
- Competitiveness of public employees in the workforce
- Larger economic impact on the state

As noted in the beginning of this report, STRS Ohio experienced only slight improvements to the funding period and the funded ratio during the 2003–2004 fiscal year. The funding period declined to 42.2 years from 42.3 years; the funded ratio increased to 75.9% from 75.2%.

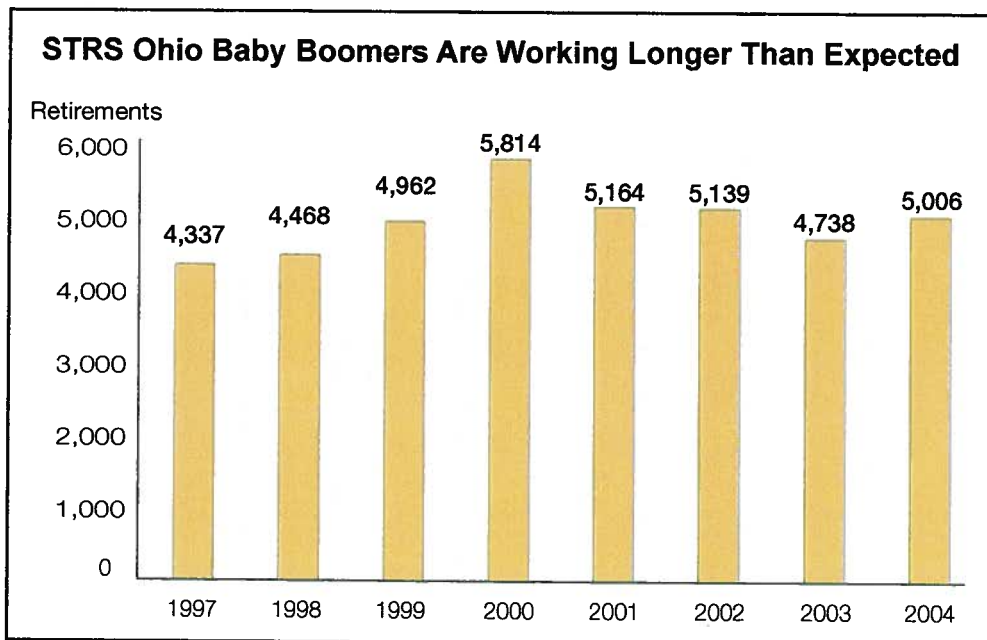
As a result, in January 2005 the Retirement Board approved an asset/liability study for the system with a target completion date of Aug. 31, 2005. Russell Investment Group, the board's investment consultant, will conduct the study. This study will:

- Evaluate the ability of various investment portfolios to meet specified funding objectives (e.g., a 30-year funding period for the pension fund);
- Anticipate cash flow requirements to meet system liabilities; and
- Determine an asset allocation policy that will achieve a good risk/return trade-off and meet the system's long-term liabilities.

In short, the study will advise the Retirement Board on an investment asset mix and projected rate of return appropriate for the pension and health care liabilities of the system, while providing a level of risk that the board is comfortable with.

The Retirement Board will also evaluate the actuarial liability incurred by the system for various types of purchased service credit. One possible option is to make changes through Board Rule and/or statutory changes that would require members to pay 100% of the actuarial liability created by some or all service credit purchases. This discussion will occur this spring.

In addition, the board will continue to monitor retirement trends. As the chart below illustrates, until this past fiscal year STRS Ohio experienced an annual decline in retirements for three consecutive years — in spite of the fact that baby boomers are reaching retirement age. We believe this decline was a result of primarily two factors: increased health care costs in retirement and the incentive of a higher benefit formula with 35 years of service. The slight increase in the number of retirements this past fiscal year can be attributed to the large number of buyout plans that school districts across the state are offering more experienced teachers to balance their budgets in light of education financing challenges. As of July 2005, the enhanced benefit formula for 35 years of contributing service credit will have been in effect for five years. At its February 2005 meeting, the Retirement Board agreed that this milestone would be an appropriate time for the board's actuary to conduct an extensive analysis to determine the overall cost *or* benefit to the system of providing this enhanced benefit.



Other changes that may be evaluated during the 2005-2006 fiscal year by the Retirement Board include:

- Resetting the portion of employer contributions for Defined Contribution Plan participants that goes toward the unfunded liability.
- Resetting the interest rate for account withdrawals, money purchase benefits and reemployed retiree accounts.
- Seeking legislation to change the early retirement reductions to actuarially cost-neutral amounts.

The members of the Retirement Board understand that as fiduciaries, their first and foremost priority and legal obligation is to protect the system's ability to honor the pension and other benefit promises in state law. The Retirement Board is committed to working with its membership, the other systems, the Legislature and all of the public sector stakeholders to continue implementing changes to reduce the UAAL to 30 years or less.

APPENDIX A

STRS Ohio Historical Funding Status

Year Ended June 30	Actuarial Assets	Unfunded Liability	Funding Period	Funded Ratio
1967	\$ 1,204,360,000	\$ 704,671,000	15.6 years	63%
1968	1,360,942,000	936,188,000	15.6	59%
1969	1,523,805,000	970,657,000	14.1	61%
1970	1,710,084,000	1,390,892,000	23.0	55%
1971	1,959,093,000	1,375,086,000	21.6	59%
1972	2,235,741,000	1,445,769,000	22.1	61%
1973	2,526,917,000	1,513,090,000	22.7	63%
1974	2,785,350,000	1,794,728,000	24.7	61%
1975	3,000,635,000	1,939,647,000	24.8	61%
1976	3,240,277,000	2,367,446,000	33.8	58%
1977	3,590,432,000	2,618,608,000	37.1	58%
1978	3,991,494,000	2,947,834,000	44.9	58%
1979	4,474,515,000	3,364,770,000	44.4	57%
1980	4,978,714,000	3,924,712,000	59.7	51%
1981	5,634,905,000	4,669,818,000	50.0	55%
1982	6,344,385,000	5,124,609,000	59.0	55%
1983	7,210,677,000	5,301,141,000	44.0	58%
1984	8,326,788,000	5,772,218,000	41.0	59%
1985	9,469,194,000	6,222,881,000	39.0	60%
1986	10,895,158,000	6,414,042,000	39.5	63%
1987	12,911,072,000	6,380,720,000	35.0	67%
1988	14,613,182,000	6,759,786,000	35.0	68%
1989	16,407,002,000	7,211,686,000	34.5	70%
1990	18,242,453,000	7,640,885,000	34.0	71%
1991	20,094,849,000	8,014,512,000	33.5	72%
1992	22,536,343,000	8,263,895,000	32.5	73%
1993	26,259,447,000	8,229,529,000	31.5	76%
1994	28,543,410,000	8,328,399,000	30.5	77%
1995	31,416,677,000	8,570,498,000	29.3	79%
1996	34,569,651,000	8,197,261,000	28.4	81%
1997	38,743,272,000	7,820,498,000	26.9	83%
1998	43,865,907,000	7,262,181,000	24.2	86%
1999	49,124,802,000	5,638,538,000	16.3	90%
2000	54,712,921,000	4,480,237,000	23.1	92%
2001	57,450,612,000	5,230,628,000	27.5	92%
2002	51,969,345,000	14,256,819,000	39.0	79%
2003	51,697,000,000	17,037,000,000	42.3	75%
2004	55,340,714,000	17,613,627,000	42.2	76%

APPENDIX B

STRS Ohio Projected Funding Status

Year Ended June 30	Actuarial Assets	Unfunded Liability	Funding Period	Funded Ratio
2005	\$ 56,397,323,000	\$ 20,086,046,000	52.0 years	74%
2006	59,420,660,000	20,630,711,000	49.7	74%
2007	63,217,270,000	20,418,365,000	43.7	76%
2008	66,126,938,000	21,086,346,000	42.6	76%
2009	69,007,374,000	21,360,566,000	39.8	76%
2010	71,792,016,000	22,442,490,000	40.3	76%
2011	74,445,831,000	23,164,467,000	39.3	76%
2012	76,944,199,000	23,897,762,000	38.3	76%
2013	79,240,457,000	24,640,720,000	37.3	76%
2014	81,281,571,000	25,391,081,000	36.3	76%
2015	83,006,653,000	26,146,660,000	35.3	76%
2016	84,346,059,000	26,905,336,000	34.3	76%
2017	85,220,715,000	27,664,738,000	33.3	75%
2018	85,541,053,000	28,422,212,000	32.3	75%
2019	85,205,840,000	29,174,779,000	31.3	74%
2020	84,100,875,000	29,919,099,000	30.2	74%