



The Ohio Retirement Study Council

88 East Broad Street, Suite 1175

Columbus, OH 43215-3506

Phone: (614) 228-1346

Fax: (614) 228-0118

Website: www.orsc.org

Voting Members

Senators

Grace Drake, *Chair*
Leigh Herington
Larry Mumper

Representatives

Dale Van Vyven, *Vice-Chair*
William Ogg
Kirk Schuring

Governor's Appointees

Robert Barrow
William Bennett
William Fawley

Non-Voting Members

Executive Directors

Thomas Anderson, *SERS*
Richard Curtis, *HPRS*
Herbert Dyer, *STRS*
Laurie Hacking, *PERS*
Allen J. Proctor, *OP&F*

Director

Aristotle L. Hutras

Introduction and Overview

June 27, 2000

The Ohio Retirement Study Council (ORSC) was requested to review the pros and cons of merging the School Employees Retirement System (SERS) with the Public Employees Retirement System (PERS). The ORSC asked Milliman & Robertson (M&R) to conduct the review. Due to the fact that most of the participating employers covered by SERS are also participating employers covered by the State Teachers Retirement System (STRS), but not PERS, the review was expanded to include a possible merger of SERS with STRS.

The report is divided into the following five sections:

- **Background** - This first section contains some background information regarding the establishment and governance of the retirement systems.
- **Key Comparisons** - This section summarizes several key comparisons between PERS, STRS and SERS.
- **Effect of Merger on Actuarial Status** - This section discusses the possible effects of a merger on the actuarial status of the affected retirement systems and illustrates the effect of several possible alternatives.
- **Other Considerations** - This section identifies several other issues and questions, including the exclusive benefit rule.
- **Advantages and Challenges** - This section identifies several advantages and challenges associated with merging SERS with PERS or STRS.

The report shows that the pension, disability and survivor benefits between the three retirement systems are generally the same, with some minor differences. These benefits are defined by statute, and become vested once granted to the member.

In contrast, the report shows that the retiree health care benefits provided by the three retirement systems vary. Since 1974, each system has been granted discretionary authority to provide retiree health care benefits within its available resources not otherwise actuarially required to fund the cost of pension, disability and survivor benefits. Retiree health care benefits are neither defined by statute nor deemed a vested right. Accordingly, each system may change the level of retiree health care coverage and/or the cost paid by covered individuals as circumstances warrant.

Am. Sub. S.B. 270, as passed by the Senate this session, would require the SERS board, in consultation with the ORSC, to prepare a plan that eliminates the employer health care surcharge. The employer surcharge was enacted in 1988 to help fund the cost of retiree health care benefits in SERS. The fundamental problem is the disproportionate number of short-hour, part-time employees covered under SERS compared to either PERS or STRS. Therefore, the employer contributions received by SERS to support health care benefits is substantially less and places an obvious burden on its ability to maintain existing health care benefits.

The report raises a number of public policy issues that are germane to any plan(s) that would eliminate the employer surcharge in SERS, and offers various alternatives for legislative consideration. The following issues are summarized to provide some framework for the legislature when considering the various alternatives described in the main body of the report:

Public Policy Issues

- Should short-hour, part-time SERS members be offered the same level of retiree health care coverage as full-time SERS members? (Presently, the SERS board makes no distinction between short-hour, part-time members and full-time members regarding the level of retiree health care coverage since service credit is based upon the number of days worked rather than the number of hours worked in a school year. For example, an SERS member who works four-hours per day receives the same level of coverage as an SERS member who works eight-hours per day, provided each member works 120 days.)
- Should the SERS employer contribution rate when expressed as a percent of payroll vary for each school district based upon the cost of providing retirement and health care benefits to employees of that district? (Presently, the employer contributions as a percentage of payroll vary from school district to school district due to the SERS employer health care surcharge. For example, Delphos City Schools paid 18.43% of payroll for the 1998-1999 school year; by contrast, Butler County School District paid 14.10% of payroll.)
- Should the retirement and health care benefits provided to SERS members be the same as those provided to PERS or STRS members *if* SERS were merged with one of these retirement systems? (See pages 17-25 of the report.)
- Should the same contribution rates be made applicable to SERS members as to other members of PERS or STRS *if* SERS were merged with either PERS or STRS? (See pages 17-25 of the report.)
- Should the cost of providing retirement and health care benefits to SERS members be pooled with other public employer units that are not school districts if the effect of pooling would be to effectively subsidize the cost of SERS members? (If SERS were merged with PERS on a consolidated basis, other public employer units, such as municipal corporations, townships, and counties, would share the cost of providing retirement and health care benefits for SERS members included within the applicable division of PERS.)

**DISCUSSION DOCUMENT FOR
OHIO RETIREMENT STUDY COUNCIL
REGARDING
FEASIBILITY OF MERGING THE
SCHOOL EMPLOYEES RETIREMENT SYSTEM
WITH THE
PUBLIC EMPLOYEES RETIREMENT SYSTEM
OR THE
STATE TEACHERS RETIREMENT SYSTEM**

June 2000

Background

The State of Ohio currently has three statewide retirement systems that provide retirement benefits to public employees involved in duties other than public safety as follows:

- Public Employees Retirement System - PERS
- School Employees Retirement System - SERS
- State Teachers Retirement System - STRS

This Discussion Document will address the feasibility of SERS being merged into either PERS or STRS. The initial request from the ORSC was for M&R to discuss the possible merger of SERS and PERS. Our report will also discuss a possible merger of SERS and STRS due to the fact that the SERS contributing employers are generally also contributing employers of STRS, but not PERS.

Some introductory background material is summarized below with respect to the effective dates and governance of all three systems.

PERS was founded in 1935 to provide retirement benefits to employees of the State of Ohio. In 1938, the System was expanded to include employees of counties, municipalities, health departments, and park and conservancy districts. The System was made optional for elected officials in 1941. PERS also provides coverage for certain law enforcement officers. PERS is divided into three divisions: State, Local Government, and Law Enforcement. PERS is managed by a nine-member Board consisting of five elected employee members, one elected retiree member, the Auditor of State, the Attorney General and the Director of Administrative Services. Elected members serve four-year terms.

SERS was formed in 1937 to provide retirement benefits to public school employees who hold positions that do not require a teaching certificate such as bus drivers, cafeteria workers, janitors, secretaries, teacher aids and certain administrative personnel. A seven-member Board consisting of four-elected employee members, one elected retiree member, the Auditor of State, and the Attorney General governs SERS. Elected board members serve four-year terms.

STRS was founded in 1919 to provide retirement benefits to teachers and faculty members of public boards of education and state-supported colleges and universities. A nine-member Board consisting of five-elected employee members, one elected retiree member, the Auditor of State, the Attorney General and the Superintendent of Public Instruction governs STRS. Elected board members serve four-year terms.

Effective January 1, 1967, 454 individual retirement plans covering local police officers and firefighters were consolidated to create the Ohio Police and Fire Pension Fund, OP&F. Thus, the administrative and legislative tasks in completing a merger have been tackled and successfully met in Ohio.

Key Comparisons

Membership

Recent membership statistics for PERS, SERS, and STRS are summarized below.

	PERS	SERS	STRS
Members as of:	December 31, 1998	June 30, 1999	June 30, 1999
Total Actives	371,563	110,175	170,854
Receiving Benefits	125,418	52,818	95,796
Inactive	192,273	76,077	119,115
Total Members	689,254	239,070	385,765

Very roughly, PERS has 2.9 times the number of members as SERS and STRS has 1.6 times the number of members as SERS.

Participating Employer Units

The participating employer units in SERS and STRS are almost identical, as indicated in the table below (based on data as of June 30, 1999).

	SERS	STRS
Local School Districts	370	371
City School Districts	193	192
County Educational Service Centers	61	63
Exempted Village School Districts	49	49
Vocational and Technical Schools	62	49
Universities and Colleges	2	37
County Boards of Mental Retardation and Developmental Disabilities	0	82
Community Schools	17	16
State of Ohio	0	1
Other	6	0
Total	760	860

There is little overlap between the participating employer units in PERS and the other two systems.

Contribution Rates

Regular Contribution Rates

Contributions are made to each of the three systems by both members and employers at the contribution rates summarized below.

	PERS – State	PERS – Local	SERS	STRS
Member	8.50%	8.50%	9.00%	9.30%
Employer	13.31%	13.55%	14.00%	14.00%

The PERS Board has implemented a temporary reduction in the employer contribution rate for calendar year 2000. The employer contribution rates for the State and Local Government divisions were temporarily reduced by 20% to 10.65% and 10.84%, respectively.

As indicated above, the member and employer contributions to SERS are closer to the rates contributed to STRS, but there is not a significant difference between the contribution rates to SERS and PERS, either.

Employer Health Care Surcharge

In addition to the regular contribution rates shown above, an Employer Health Care Surcharge is paid to SERS. In the year ending June 30, 1999, the surcharge generated additional revenue that when expressed as a percentage of total member payroll equaled 1.5% of payroll. The surcharge is in addition to the regular employer contribution rate of 14% of payroll.

By way of background, the employer surcharge was enacted in HB 290 (eff. 9/9/1988) to help fund the cost of retiree health care benefits in SERS. In its analysis of HB 290, SERS found that “the fundamental problem is the disproportionate number of short-hour, part-time employees in the non-certificated ranks. Most SERS members work less than a calendar year and less than 8 hours per day.”

SERS contribution rates are of similar magnitude to the contribution rates of PERS and STRS but the salary levels of SERS members (1998-1999 average salary = \$16,048) are much lower than the other two non-uniformed systems (1998 PERS average salary = \$25,440 and STRS 1998-1999 average salary = \$41,210). Thus SERS member’s earnings average 63% and 39% of PERS and STRS member’s average earnings, respectively.

The following table shows the minimum compensation amount and the aggregate amount generated for each year since the surcharge became effective:

Year	Minimum Compensation	Aggregate Amount
1989	\$7,710	\$14,010,283
1990	\$8,400	\$15,217,909
1991	\$9,100	\$16,990,015

1992	\$9,900	\$20,900,015
1993	\$9,900	\$17,184,995
1994	\$10,400	\$20,744,932
1995	\$11,200	\$20,244,221
1996	\$11,800	\$24,131,511
1997	\$12,400	\$30,288,515
1998	\$12,400	\$29,336,734
1999	\$12,400	\$26,847,444
Total	N/A	\$235,896,574

Upon the advice of its actuary, the SERS Board determines annually a minimum compensation amount. In FY 2000 this was \$12,400. For each active member whose salary for the prior year is less than that amount, the Board assesses a surcharge to the member's employer. The surcharge is determined by subtracting the member's salary for the prior year from the minimum compensation amount. The difference is multiplied by the employer contribution rate in effect and prorated according to the service credit earned. An illustration of this calculation for a member with a salary of \$9,800 is shown below.

<u>Minimum Compensation</u> \$12,400	minus	<u>Employee's Salary</u> \$9,800	equals	<u>Surcharge Base</u> \$2,600
<u>Surcharge Base</u> \$2,600	times	<u>Employer Rate</u> 14%	equals	<u>Gross Surcharge</u> \$364
<u>Gross Surcharge</u> \$364	times	<u>Service Credit</u> (e.g.) 1 year	equals	<u>Total Surcharge</u> \$364
		Or		
\$364	times	(e.g.) ½ year	equals	\$182

Note that the Health Care Surcharge is based on the total employer contribution rate, 14.00%, rather than the portion of the total rate that is allocated to health care, 8.45%, for FY 2000. It is not clear what the rationale is for charging the full rate rather than the health care portion only. If only the health care portion of the total rate were applied in determining the employer surcharge, the minimum compensation amount would have to be increased to generate the same amount of revenues from the surcharge.

As indicated above, the Employer Health Care Surcharge was instituted to address a fundamental problem for SERS, which is its disproportionate number of low-salary employees. Since pension benefits are generally based on compensation, the cost of pension benefits paid is closely related to the contribution base to support those benefits. But the cost of health care benefits does not vary by the level of compensation while the source of financing for those benefits does.

The average contributions per member received by SERS to finance health care benefits are substantially less than the comparable amounts received by PERS and STRS. This restricts SERS' ability to finance health care benefits. Providing a benefit whose cost is not related to

salary (i.e., health care), yet financing it on the basis of payroll poses a real comparative difficulty for SERS. The surcharge was intended to mitigate this problem.

Because of the surcharge, there is no effective cap on the amount of employer contributions to SERS. Moreover, the surcharge varies from school district to school district depending on the number of employees earning less than the minimum compensation amount; that is, those districts with more low-salary employees pay a higher surcharge amount than those districts with fewer low-salary employees. For example, according to the 1998-99 employer surcharge report, the Delphos City Schools paid an employer surcharge of \$28,455 or 4.43% of payroll. Thus their total employer contributions to SERS were 18.43% of payroll (regular contribution rate + employer surcharge rate = 14.00% + 4.43%). By contrast, Butler County School District paid an employer surcharge of \$1,938 or 0.10% of payroll producing a total contribution rate of 14.10% (= 14.00% + 0.10%).

Am. Sub. SB 270, as passed by the Senate this session, would require the SERS Board, in consultation with the ORSC, to prepare a plan that eliminates the employer surcharge. The plan shall be submitted no later than March 30, 2001 to the President and Minority Leader of the Senate, the Speaker and Minority Leader of the House, the chairpersons of the Senate and House standing committees dealing with education, and the chairpersons of the Senate and House standing committees and subcommittees dealing with retirement.

Neither PERS nor STRS imposes a health care surcharge.

Comparison of Pension Benefits

Public employees in the State of Ohio are not covered by Social Security. Hence retirement system benefits for covered employees replace both the Social Security benefits and pension benefits typically provided to private sector employees.

Traditionally, the general policy in Ohio has been to provide similar benefits to non-uniformed members of all three Systems, but as indicated in the table below some differences do exist. PERS, SERS and STRS provide retirement, disability, survivor benefits, and health care benefits. Each System provides a single benefit structure for all of its members (with the exception of the Law Enforcement division of PERS, which is excluded from the comparison shown below).

The benefits provided by the three systems are summarized below based on the assumption that SB 270 for SERS will be enacted.

Age and Service Benefits¹			
	PERS (non-LE)	SERS	STRS
Normal Retirement Eligibility	5 YOS at age 65 or 30 YOS at any age	Same as PERS	Same as PERS
Normal Retirement Benefits	2.2% x FAS x first 30 YOS; 2.5% x FAS x YOS over 30	Same as PERS	Same as PERS, except that an additional 0.1% is added to the PERS formula for each year of service over 31 years (e.g., 2.6%

			for the 31 st year, 2.7% for the 32 nd year, etc.) and for members with 35 YOS, 2.5% would be applied to the 1 st 30-years.
Early Retirement Eligibility	5 YOS at age 60 or 25 YOS at age 55	Same as PERS	Same as PERS
Early Retirement Benefits	Normal retirement benefit reduced by 25 to 3% from ages 55 to 64	Same as PERS	Same as PERS
Termination Benefits after vesting	After 5/10 YOS, member can choose between (1) lump sum of 133%/167% of member contributions with interest at a rate determined by the Board (max. 6%), or (2) accrued benefit payable at normal retirement.	After 5 YOS, member can choose between (1) lump sum payment of member contributions without interest and without a portion of the employer contributions, or (2) accrued benefit payable at normal retirement.	After 5 YOS, member can choose between (1) lump sum of 150% of member contributions with interest determined by the Board (max 6%, currently 5%), or (2) accrued benefit payable at normal retirement.
Termination Benefits before vesting	Member receives refund of member contributions with interest at a rate determined by the Board (max. 6%)	Member receives refund of member contributions without interest	Prior to 3 YOS, refund of member contributions with 4% interest; between 3 and 5 YOS, interest rate increased to a maximum of 6% (5% currently).
Maximum Benefit	100% of FAS	Same as PERS	Same as PERS

¹ Key to abbreviations: YOS – Years of Service; FAS – Final Average Salary.

Comparison of Postretirement Medical Benefits

As indicated earlier, public employees in the State of Ohio are not covered by Social Security. Hence retirement system health care benefits for covered employees provided by the Retirement Systems substitute for both the Medicare benefits (to the extent members are not eligible for them) and the employer provided retiree health care benefits often provided to private sector employees. (Public employees hired after March 31, 1986 are generally subject to the portion of the FICA tax attributable to Medicare and will be eligible for Medicare benefits.)

Health care coverage is not a statutorily defined or required benefit. Each System provides coverage based on the amount of financing available after funding the pension benefits. Hence there are significant differences in the health care benefits offered by the Systems. These differences affect the level of benefits provided by their health insurance options as well as the premium payments required from retirees to share in the cost of this coverage.

Comparison of Health Care Benefits

In the table below, we have compared the basic level of health care benefits provided by the Systems with respect to the most popular option selected by retirees under each of the Systems – the Aetna US Healthcare Indemnity/PPO Plan. This is intended to illustrate the more generous benefits provided by the PERS and STRS healthcare program relative to the SERS program.

	In network			Out of network		
	PERS	SERS	STRS	PERS	SERS	STRS
Deductible	\$100/\$200	\$275/\$550	\$200 per person	\$150/\$300	\$550/\$1,100	\$200 per person
Annual out-of-pocket maximum	\$500/\$750	\$750/\$1,500	\$800/\$1,200	\$750/\$1,125	\$2,000/\$4,000	\$1,600/\$2,400
Hospital Charges						
Admission	No charge	\$100	\$188	\$100	\$250	\$238
Inpatient	100%	100%	100%	70%	65%	80%
Physician Services						
Office	\$10 co-pay	\$20 co-pay	\$10 co-pay	70% UCR	65% UCR	70% UCR
Other	80%	80%	80%	70% UCR	65% UCR	70% UCR

As illustrated in the above table, the level of benefits provided by this popular optional plan are generally lower under the SERS health care program than under the same option under the PERS and STRS programs.

This difference in the level of benefits provided has a significant effect on the cost of this health insurance option. This can be readily seen from the table below, which summarizes the 1999 premiums for the Aetna US Healthcare Indemnity/PPO Plan option under each of the three systems.

	PERS	SERS	STRS
Monthly Premium for members:			
Not Eligible for Medicare	\$384.54	\$358.00	\$390.00
Eligible for Medicare A&B	166.73	60.33	160.00

Retiree Premium Sharing

SERS

SERS requires members who retired on or after August 1, 1989 with less than 25 years of qualified service to pay a portion of their monthly health care premium. Retirees prior to August 1, 1989 do not pay anything for their health care coverage. The percentage subsidized by the System is based on years of service credit and was graded into the current schedule over the period from August 1, 1989 through August 1, 1993 depending on the member's retirement date. The current schedule for retirements on or after August 1, 1993 is shown below.

Years of Service	Retiree's Share	SERS' Share
10-14	75%	25%
15-19	50	50
20-24	25	75
25+	0	100

SERS members retiring with less than 10 years of service are not eligible for health care benefits. Retirees paid \$2,457,850 in premiums toward the cost of their coverage during 1998-1999.

The 1999 retiree's share is illustrated below for the most popular health care option.

Years of Service	Not Eligible for Medicare		Eligible for Medicare Parts A & B	
	Retiree's Share per month	SERS's Share per month	Retiree's Share per month	SERS's Share per month
10-14	\$268.50	\$89.50	\$45.25	\$15.08
15-19	179.00	179.00	30.17	30.16
20-24	89.50	268.50	15.08	45.25
25+	0.00	358.00	0.00	60.33

In addition, spouses and dependent children pay 70% of their premium for health care coverage.

PERS

PERS does not require retirees to pay any portion of the cost of health care benefits if they elect the base plan. If the retiree elects a higher cost plan, they pay the extra premium. The table below illustrates the 1999 premiums paid by retirees for health coverage for select plans offered by PERS.

Years of Service	Not Eligible for Medicare		Eligible for Medicare Parts A & B	
	Retiree's Share per month	PERS's Share per month	Retiree's Share per month	PERS's Share per month
All	0.00	384.54	0.00	166.73

STRS

STRS requires all retirees to share in the cost of the premiums for health care benefits. If the retiree retires before becoming eligible for service retirement under an early retirement incentive plan, the retiree must pay the full cost of health care benefits until eligible for service retirement without regard to the early retirement incentive credit. The 1999 retiree's share is illustrated below for the most popular health care options.

Years of Service	Not Eligible for Medicare		Eligible for Medicare Parts A & B	
	Retiree's Share per month	STRS's Share per month	Retiree's Share per month	STRS's Share per month
5	\$221	\$169	\$68	\$92
10	188	202	58	102
15	154	236	47	113
20	120	270	37	123
25	86	304	26	134
30	53	337	16	144

Medicare Part B premiums

PERS reimburses the full Medicare Part B premium, currently \$45.50 per month, while **STRS** reimburses up to 90% of the Medicare Part B premium for retirees. Under SB 270, **SERS** would reimburse up to a maximum of \$45.50 of the Medicare Part B premium. The current reimbursement under SERS is \$31.80 per month.

Summary

Although changes would be required in order to merge the Systems if the Legislature wishes to continue to provide all members of a system with the same benefits (with the exception of PERS – LE), the retirement benefits are sufficiently similar so this would not pose an insurmountable barrier to merger.

Assets and Investments

Each of the Systems has a trust fund to accumulate assets in order to pay benefits to its members. Investments of the Systems as of December 31, 1999 are:

	----- Fair Value (Millions of Dollars) ¹ -----					
	PERS	Percent of Total	SERS	Percent of Total	STRS	Percent of Total
Domestic Fixed Income	\$18,796	32.6%	\$1,918	22.1%	\$11,010	19.2%
Domestic Equity	20,223	35.0	4,263	49.0	25,437	44.5
Real Estate	5,783	10.0	847	9.7	5,399	9.4
International Equity	11,827	20.5	1,532	17.6	14,091	24.6
Short-Term	991	1.7	53	0.6	763	1.3
Other	94	0.2	86	1.0	566	1.0
Total	\$57,714	100.0%	\$8,699	100.0%	\$57,266	100.0%

¹ From M&R's report on cumulative performance comparisons as of December 31, 1999.

The table below summarizes investment performance over the 1, 3, and 5 year periods ending December 31, 1999 for PERS, SERS and STRS.

Annual Rates of Investment Returns

As of 12/31/1999	1 year	3 year	5 year
PERS	12.15%	13.31%	13.71%
SERS	16.33	17.07	17.98
STRS	18.87	16.10	16.25

PERS investment returns over the past several years have lagged behind the SERS and STRS investment returns over the same periods. PERS's lower investment returns relative to SERS and STRS are largely attributable to PERS's asset allocation. Both SERS and STRS have allocated significantly less of their investments to fixed income than PERS. As a result, they have greater allocations to domestic and international equities. Historically equities have generated higher, but more volatile, investment returns than fixed income investments such as bonds and mortgages. Over the 5-year period ending December 31, 1999, the returns on U.S. domestic equities have been even more favorable than historical averages. As a result, SERS and STRS have benefited from their relatively higher allocations to equities.

As a result of their higher allocation to equities, over the past 6 years the volatility of the investment returns earned by both SERS and STRS are higher than the volatility of investment returns in PERS. As indicated above, this is what should be expected for Funds with more exposure to the equity markets.

In the event of a merger, the combined system would need to develop an investment policy that is consistent with its liabilities and funding goals. A combined system may also be able to achieve certain economies of scale with respect to investment management expenses.

Administrative Expenses

The administrative expenses as a percent of payroll and per participant are:

	PERS	SERS	STRS
Administrative Expenses	\$21,530,875	\$14,491,266	\$48,967,000
Number of Members	689,254	239,070	385,765
Expenses per Member	\$31.24	\$60.62	\$126.93
Payroll	9,016,586,076	1,768,097,813	7,444,243,000
Expenses as Percent of Payroll	0.24%	0.82%	0.66%

In the event of a merger, it should be possible to achieve significant savings in administrative expenses due to the consolidation of administrative functions into a single organization. Over the long term, these savings should exceed any additional costs associated with the merger.

Liabilities and Funded Status Comparison

Information is available regarding the funded status of the systems based on their Annual Actuarial Valuations.

Bills were recently enacted improving benefits for PERS and STRS. In addition, SB 270 has been introduced to improve SERS benefits. We have shown below the actuarial status of each of the systems as if all of the Bills had been enacted on the most recent actuarial valuation date. Please note that STRS is changing the interest rate to 7.75% in conjunction with the enactment of SB 190. The chart below reflects all of these changes.

	\$ Amounts in Millions			
	PERS¹		SERS	STRS
	State	Local		
Valuation Date	1/1999	1/1999	7/1999	7/1999
Interest Rate	7.75%	7.75%	8.25%	7.75%
Salary Inflation	4.75	4.75	4.25	4.50
Difference	3.00	3.00	4.00	3.25
Accrued Liabilities	\$16,318	\$22,491	\$7,832	\$52,395
Actuarial Value of Assets	16,155	21,909	7,332	46,341
Funded Ratio	99%	97%	94%	88%
Unfunded Accrued Liabilities/(Surplus)	\$163	\$582	\$500	\$6,054

Payroll	3,500	5,240	1,768	7,444
UAL/(Surplus) as % of payroll	5%	11%	28%	81%
Funding Period	4 years	8 years	25.0 years	17.1 years

¹ In preparing the actuarial note for PERS under Package 1B, GRS recognized the \$1.3 billion investment gain scheduled to be reflected in the December 31, 1999 Actuarial Valuation. The Actuarial Value of Assets for PERS includes these gains.

Both PERS and STRS have had actuarial audits completed within the past 5 years. An actuarial audit of SERS is currently in progress and is expected to be completed by mid-July.

The actuarial assumptions used by each of the systems differ somewhat in their degree of conservatism. A rough measure of the conservatism or optimism in the actuarial assumptions can be made by comparing:

1. the absolute level of the interest rate (actually this is the assumed rate of return on system assets); and,
2. the difference between the interest rate and the salary inflation assumptions.

The lower the interest rate, the more conservative the assumptions; the lower the difference between the interest rate and the salary inflation rate, the more conservative the assumptions.

On this rough measure, SERS uses the least conservative assumptions as they use the highest interest rate, 8.25%, and have the greatest difference between the interest rate and salary inflation assumptions, $8.25\% - 4.25\% = 4.00\%$.

STRS and PERS have lower, identical interest rate assumptions. As a result, both of these systems can be considered to use more conservative assumptions than SERS. Because the difference between the STRS interest rate and salary inflation assumptions, $7.75\% - 4.50\% = 3.25\%$, is greater than that difference in these assumptions for PERS, $7.75\% - 4.75\% = 3.00\%$, PERS can be viewed as having the most conservative assumptions based on this simplistic measure.

These two figures provide an incomplete and simplistic picture because they do not reflect other important assumptions such as life expectancy, termination and retirement rates and merit salary growth. But they can serve as a "first order" estimate of the conservatism or optimism in the actuarial figures.

On this basis, PERS' assumptions are slightly more conservative than STRS' with SERS' assumptions being the least conservative. As a result, SERS and STRS appear to be better funded relative to PERS than their funded status would be based on consistent assumptions. Moreover, SERS appears to be better funded relative to both PERS and STRS than would be indicated by consistent assumptions.

To provide the Council with a rough measure of this effect, we have also estimated the impact of using the same interest rate and salary inflation assumption on the funded status of all three

systems. For this purpose, we selected the median interest rate (8.00%) and salary inflation rate (4.50%) used by the public defined benefit pension funds with assets of at least \$7.5 billion. This information was determined from the PENDAT 1997 Survey of State and Local Government Employee Retirement Systems. The chart below adjusts the figures shown above to this common interest rate and salary inflation rate. These figures are shown because they provide a common frame of reference for measuring the relative funded status of the pension benefits provided by each of the systems.

	\$ Amounts in Millions			
	PERS		SERS	STRS
	State	Local		
As of	1/1999	1/1999	7/1999	7/1999
Interest Rate	8.00%	8.00%	8.00%	8.00%
Salary Inflation	4.50	4.50	4.50	4.50
Difference	3.50	3.50	3.50	3.50
Accrued Liabilities	\$15,655	\$21,596	\$8,098	\$50,871
Actuarial Value of Assets, AVA	16,155	21,909	7,332	46,341
Market Value of Assets, MV	16,985	23,009	8,042	50,602
Funded Ratio based on:				
AVA	103%	101%	91%	91%
MV	108	107	99	99
Unfunded Accrued Liabilities/(Surplus) based on				
AVA	(\$500)	(\$313)	\$766	\$4,530
MV	(1,330)	(1,413)	56	269
Payroll	3,500	5,240	1,768	7,444
UAL/(Surplus) as % of payroll				
AVA	(14%)	(6%)	43%	61%
MV	(38)	(27)	3	4
Funding Period				
AVA	N/A	N/A	Infinite ²	10.4 years
MV	N/A	N/A	5.7 years	0.5 years

¹ In preparing the actuarial note for PERS under Package 1B, GRS recognized the \$1.3 billion investment gain scheduled to be reflected in the December 31, 1999 Actuarial Valuation. (\$1.0 billion of the investment gain was allocated to pension benefits with the remaining \$0.3 billion allocated to health care benefits.) The Actuarial Value of Assets for PERS reflects this modification.

² Assumes an employer contribution rate of 7.18% allocated to pension benefits for SERS. If the employer contribution rate allocated to pension benefits were increased to 8.85%, the funding period would be 30 years.

Funded Status of Health Care Benefits

The health care benefits provided by SERS are a significantly greater burden on SERS than on either PERS or STRS due to the relatively low average salaries paid to SERS members. Some comparative data regarding the cost of health care is summarized below for each of these systems based on their most recent Comprehensive Annual Financial Reports - fiscal years ending June 30, 1999 for SERS and STRS and fiscal year ending December 31, 1998 for PERS.

(\$Amounts in millions)

	SERS	PERS	STRS
Benefit payments and administrative expenses	\$126.6	\$442.3	\$300.1
Covered payroll	1,768.1	9,016.6	7,444.3
Benefits + admin as % of payroll	7.2%	4.9%	4.0%
Healthcare Assets	\$188.0	\$10,011.8	\$2,783.4
Assets / (benefits + admin)	1.5 years	22.6 years	9.3 years

As indicated in the above table, the current annual cost of health care benefits is 2.3% to 3.2% of payroll higher in SERS than in PERS and STRS, respectively. To offset this difference, SERS collects the employer surcharge to supplement regular employer contributions. While assets have been accumulated to help fund these benefits, the assets accumulated are only approximately 1.5 years of annual costs in SERS and hence provide modest investment income to help finance these benefits and a limited buffer against adverse experience. In contrast, PERS and STRS have 22.6 years and 9.3 years, respectively.

Prior to 1998, PERS actuarially funded health care benefits and accumulated significant assets towards accrued health benefit liabilities. SERS, however, is using a pay-as-you-go approach with a reserve of 150% of projected health care expenses and has significant unfunded accrued postretirement health benefit liabilities. STRS has been funding for health care benefits at a rate between pay-as-you-go funding and full actuarial funding since the early 1980's.

On a pay-as-you-go basis current taxpayers are in effect paying for benefits earned by retirees who provided public services to a prior generation of taxpayers. This is not inherently a problem if costs are stable and expected to remain level relative to sources of financing. But health care costs have experienced rapid escalation for the past 30+ years, and this trend is generally expected to continue due to forces such as increased longevity and new medical treatments. As indicated earlier, the Boards provide health care benefits to the extent that financial resources are available to provide them. The health care benefits are not guaranteed by statute.

Effect of Merger on Actuarial Status

Structure of Merged Systems

There are two basic ways that SERS could be merged into either PERS or STRS. They are:

1. SERS could be merged as a new Division and its assets and liabilities remain segregated from the assets and liabilities attributable to the current members of PERS and STRS;
or
2. SERS could be merged into either the State or Local Division of PERS or STRS and have its assets and liabilities pooled with the assets covering current members.

If the first option is chosen (create a new separate Division), separate contribution rates could be maintained for SERS members and employers, including the health care surcharge, and existing differences in benefits could be maintained quite easily. From a financial and actuarial perspective, little would change. If the Legislature desires to maintain separate contribution rates for SERS members, this would be the logical option to choose. Of course, it would also be possible to establish separate divisions and eliminate the differences in benefits. For example, the PERS State Government and Local Government Divisions provide identical benefits to their members, but assets are accounted for separately and separate contribution rates are determined.

If the second option were selected (consolidate SERS assets and obligations with one of the existing Divisions of PERS or STRS), it would be possible, but more difficult, to maintain different contribution rates or benefits. Over time, actuarial gains or losses can be expected to develop at differing rates due to the probability that demographic experience among SERS members is likely to differ from experience among current PERS or STRS members. If assets and liabilities are pooled, it will be difficult to measure and track those gains and losses.

Hence if the Legislature desires to maintain separate contribution rates for SERS members and their employers, our recommendation would be to create a separate Division for SERS in either PERS or STRS in the event of a merger. Alternatively, if the Legislature prefers to have a single contribution rate apply to all members of the merged system, the second option – pool assets and liabilities – would be the desirable option.

The pooling option could simplify administration and would create a larger pool within which to average higher and lower cost groups. But the adoption of this approach would create several issues. These issues relate to the possible absorption of surplus assets contributed by one group of members and employers to partially or wholly fund benefit obligations attributable to another group.

Based on the results of the June 1999 actuarial valuation and assuming the enactment of SB 270, SERS has a significant UAL that will take 25 years to fully amortize. As of that same date STRS also had a significant UAL after the enactment of SB 190, which will take 17.1 years to fully amortize. But the two PERS Divisions – State Government and Local Government – will be

close to being fully funded, based on the December 1998 actuarial valuation and the enactment of HB 628 and SB 144. Based on the common set of interest rate and salary inflation assumptions summarized earlier, SERS UAL would be even higher and the two PERS Divisions would be fully funded.

If SERS were merged into PERS by creating a new Division, the existing UAL could continue being tracked and financed by contributions from SERS members and their employers. But if SERS were pooled with one of the existing PERS Divisions, inequities would result to the extent that the merger erodes the funded status of the better-funded system.

Illustrations of four merger scenarios

To illustrate the potential issues, we have estimated the actuarial effect of four of the many possible ways that SERS could be merged into either PERS or STRS. The specific merger scenarios we analyzed were based on the following assumptions:

- In the event of a merger, separate SERS benefits and contribution rates (including the employer surcharge) would be eliminated;
- Member contribution rates would be changed to the member contribution rate applicable to the system into which it is merged (8.5% - PERS and 9.3% - STRS); and,
- The actuarial assumptions currently used by SERS would be retained except the interest and salary inflation rates would be changed to the rates used by the system into which it would be merged.

Alternative Scenario	System SERS merged with	Separate Division or Consolidated Division	Employer Contribution Rate
A	PERS	Separate	14.00%
B	PERS	Consolidated	13.55%
C	STRS	Separate	14.00%
D	STRS	Consolidated	14.00%

We assumed that the regular employer contribution rates would remain 14.00% of payroll under all of the alternatives except in the event that SERS were merged with PERS – Local Government on a consolidated or pooled basis. In this case we assumed the contribution rate applicable to SERS employers would be reduced to 13.55% of payroll to avoid increasing the contribution rates applicable to current PERS – Local Government employers.

If current member contribution rates were adopted for SERS members upon merger into PERS or STRS, SERS members either would see their contribution rates decline by 0.5%, in the event of a merger into PERS, or increase by 0.3%, in the event of a merger into STRS.

We also assumed that the Medicare Part B reimbursement would no longer be included in the basic benefits valuation. Since PERS and STRS include this in their healthcare benefits, we assumed that, in the event of a merger, the healthcare assets would provide the Medicare Part B reimbursement. We did this to provide consistent projections of the alternatives.

Illustration of Effect of a Merger of SERS and PERS – Local Government or STRS

Pension Benefits	----- Millions of \$ -----					
	SERS merged with PERS Local			SERS merged with STRS		
	PERS Local ¹	SERS	Merged System	STRS	SERS	Merged System
Alternative:		A	B		C	D
	Separate Division	Separate Division	Consolidate d Division	Separate Division	Separate Division	Consolidate d Division
Accrued Liabilities	\$22,491	\$8,146	\$30,637	\$52,395	\$8,149	\$60,544
Actuarial Value of Assets	21,326	7,332	28,658	46,341	7,332	53,673
Funded Ratio	95%	90%	94%	88%	90%	89%
Unfunded Accrued Liabilities/(Surplus)	\$1,165	\$814	\$1,979	\$6,054	\$817	\$6,871
Total Normal Cost	16.15%	16.81%	16.32%	15.06%	17.72%	15.59%
Member portion of Normal Cost	8.50	8.50	8.50	9.30	9.30	9.30
Employer portion of Normal Cost	7.65	8.31	7.82	5.76	8.42	6.29
Amortization of UAL over 30 years	1.08	2.23	1.37	4.24	2.31	3.85
Minimum Employer Contribution based on SB 82 allocated to pensions	8.73	10.54	9.19	10.00	10.73	10.14
Total Employer Contribution	13.55	14.00	13.55	14.00	14.00	14.00
Remaining Employer Contribution allocable to either health care benefits or more rapid amortization of UAL	4.82	3.46	4.36	4.00	3.27	3.86
Current allocation to health care benefits	4.30	6.82 ²	N/A	2.00	6.82 ²	N/A

- 1 The Actuarial Value of Assets for PERS Local Government Division does not include the deferred investment gains prior to December 31, 1998 due to be reflected in the December 31, 1999 Actuarial Valuation in order to illustrate all of the alternatives on a consistent basis.
- 2 Excludes the employer surcharge that produced \$26.8 million of additional contributions in FY 1999 which was equivalent to 1.5% of payroll. Also based on the assumption that SB 270 was enacted as of the Actuarial Valuation date of July 1, 1999.

Effect on pension benefits

For each of these alternative scenarios, we estimated restated SERS actuarial liabilities for pension benefits assuming that SERS had been merged into the PERS-Local Government Division effective January 1, 1999 or merged into STRS effective July 1, 1999 which were the dates of the most recent Actuarial Valuation Reports.

These restatements are intended to place the SERS actuarial liabilities on a consistent basis with the actuarial liabilities developed for PERS and STRS respectively. We did so by modifying the economic assumptions applied to SERS members to coincide with the assumptions used by PERS and STRS. We retained the SERS demographic assumptions. This is intended to approximate the results that would be developed by the PERS or STRS actuary if such a merger occurred.

The table on the preceding page illustrates the impact of a merger of SERS with PERS – Local Government or STRS. The minimum employer contribution based on Senate Bill 82 allocated to pensions was determined by an amortization period of 30 years for the UAL. For example, an employer rate allocated to pensions of 9.19% would result in a 30-year funding period for a consolidated division of PERS with Local Government and former SERS members. Thirty years is the maximum funding period length permitted by Senate Bill 82 for PERS, SERS, and STRS.

In preparing this exhibit, we added the PERS- Local Government and SERS actuarial liabilities and asset figures. Technically these figures should not be added since they were calculated as of dates six months apart. But the general magnitude of the effect should be similar to the figures indicated.

Effect on financing Health Care

Because SERS finances health care benefits on a modified pay-as-you-go basis, it is necessary to adjust projected pay-as-you-go costs and contributions from employers and retirees in order to determine whether difficulty could be expected in financing health care benefits subsequent to a merger.

As indicated in the earlier comparison of the level of health care benefits provided by the Systems, the health care program of SERS is significantly less generous than the programs offered by PERS and STRS. The deductibles are higher and some coinsurance levels are lower. Moreover, SERS and STRS require that retirees who worked less than a full career make significant contributions toward the premiums for the health care option selected. Thus providing either the current PERS or STRS retiree health care benefits to SERS retirees would significantly increase costs.

We have estimated that SERS FY 2000 pay-as-you-go costs would increase approximately 30% if the PERS health care program replaced the SERS program and by 0% if the STRS health care program replaced the SERS program. But these figures underestimate the longer-term effect of changing to the PERS or STRS health care programs. The SERS pay-as-you-go costs per retiree are significantly lower for recent retirees than for members who retired prior to July 1989. Members who retired prior to that date receive health care benefits without having to pay a portion of the premium for that coverage. Members retiring currently must pay a portion of the premium unless they have completed 25 or more years of service as indicated in the following table.

Years of Service	Retiree's Share	SERS' Share
10-14	75%	25%
15-19	50	50
20-24	25	75
25+	0	100

Thus as older retirees, who do not contribute toward their health care benefits, die and are replaced by retirees, many of whom make significant contributions toward their premiums, the portion of total health care costs supported by SERS will decline.

A better estimate of the long-term effect of changing SERS retirees to the current PERS or STRS health care programs is the relative increase in costs for new, or recent, retirees from such a change. We estimate that transferring all future SERS retirees to the PERS or STRS health care program would increase costs by 60% and 20% over the longer term.

Because the SERS Board currently has the ability to increase the salary level to which the employer surcharge applies, the Board effectively has an uncapped employer contribution rate. (While the 14% of payroll basic contribution rate is fixed in statute, the surcharge requires employers to contribute additional amounts to the extent employees earn less than the minimum compensation level.) Based on the four scenarios we have analyzed for this study, the employer surcharge would be eliminated. This would effectively re-impose the cap on employer contribution rates.

An issue could arise regarding the continuation of the SERS Health Care Surcharge. In the event of a merger, the surcharge could be continued or eliminated. (The merger scenarios analyzed for this report assume the surcharge would be eliminated.) This option exists whether SERS is merged with PERS or STRS and also whether or not the merger creates a separate division for SERS members. In the event the surcharge is continued, it may be desirable to consider whether the surcharge should be based on only the portion of the employer contribution rate that is allocated to health care benefits or continue to be based on the total employer contribution rate.

To estimate the ability of employer contribution rates to support health care benefits for SERS retirees, we have summarized in the tables below rough 10-year projections of the Healthcare Fund in SERS if SERS members were provided the health care benefits of PERS or STRS. We have also summarized the impact on the PERS – Local Government Divisions and STRS Healthcare Funds if the SERS Healthcare Fund were consolidated into their Healthcare Funds. We have not provided longer-term projections of Healthcare Funds if SERS were merged into the PERS or STRS health care programs because the significant added cost of merging SERS members into those programs would probably require the programs to make some significant modifications within the next decade.

These projections were done assuming that the total employer contribution remaining after providing for a 30-year amortization of any UALs in the merged system would be allocated to healthcare. The projections are based on an interest rate of 7.75% and trend rates of 4.5%, 5.5%, and 6.5%. The SERS current plan projections assume that 6.82% of payroll is allocated to healthcare (that is the portion of the employer contribution rate allocated to health care benefits if SB 270 is enacted) and the employer surcharge contribution continues.

Projection of Healthcare Funds
Assumes Pension Benefits Funded over 30 years
SERS merged into PERS

(\$ Amounts in millions)

	PERS – Local Government Current Plan			SERS as separate PERS division			SERS consolidated with PERS – Local Government		
Fiscal Year	Net Health Benefits	EOY Health- care Assets	Ratio (in years)	Net Health Benefits	EOY Health- care Assets	Ratio (in years)	Net Health Benefits	EOY Health- Care Assets	Ratio (in years)
Healthcare Trend = 4.5%									
2000	\$306	\$7,004	22.9	\$204	\$58	0.3	\$510	\$7,053	13.8
2005	435	9,755	22.4	285	(978)	(3.4)	721	8,704	12.1
2010	678	13,076	19.3	420	(3,014)	(7.2)	1,099	9,882	9.0
Healthcare Trend = 5.5%									
2000	\$312	\$6,995	22.4	\$206	\$56	0.3	\$518	\$7,042	13.6
2005	465	9,631	20.7	302	(1,040)	(3.4)	767	8,519	11.1
2010	761	12,556	16.5	467	(3,297)	(7.1)	1,228	9,079	7.4
Healthcare Trend = 6.5%									
2000	\$318	\$6,986	22.0	\$208	\$54	0.3	\$526	\$7,031	13.4
2005	497	9,503	19.1	320	(1,103)	(3.5)	817	8,328	10.2
2010	852	11,997	14.1	518	(3,598)	(7.0)	1,370	8,219	6.0

Projection of Healthcare Funds
Assumes Pension Benefits Funded over 30 years
SERS merged into STRS

(\$ Amounts in millions)

	STRS Current Plan			SERS as separate STRS division			SERS consolidated with STRS		
Fiscal Year	Net Health Benefits	EOY Health-care Assets	Ratio (in years)	Net Health Benefits	EOY Health-care Assets	Ratio (in years)	Net Health Benefits	EOY Health-Care Assets	Ratio (in years)
Healthcare Trend = 4.5%									
2000	\$269	\$3,029	11.3	\$155	\$104	0.7	\$424	\$3,131	7.4
2005	401	4,409	11.0	220	(589)	(2.7)	621	3,799	6.1
2010	605	5,852	9.7	318	(1,980)	(6.2)	922	3,818	4.1
Healthcare Trend = 5.5%									
2000	\$271	\$3,027	11.2	\$157	\$102	0.7	\$428	\$3,127	7.3
2005	425	4,326	10.2	233	(636)	(2.7)	657	3,668	5.6
2010	671	5,452	8.1	353	(2,195)	(6.2)	1,024	3,202	3.1
Healthcare Trend = 6.5%									
2000	\$274	\$3,024	11.1	\$158	\$101	0.6	\$432	\$3,122	7.2
2005	450	4,239	9.4	246	(685)	(2.8)	696	3,533	5.1
2010	745	5,025	6.8	391	(2,425)	(6.2)	1,136	2,546	2.2

As indicated in the above tables, to project the growth in health care costs we assumed that health cost inflation would be at the rate of 4.5%, 5.5% and 6.5% per annum. A 4.5% rate of health cost inflation is a quite optimistic assumption regarding the rate of future health cost inflation. But we believe this is a reasonable baseline for this projection because the Board of the merged system will 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. 4.5% is the median rate of general wage inflation and payroll growth based on the PENDAT 1997 Survey of State and Local Government Employee Retirement Systems. (We had to select a healthcare inflation assumption since neither PERS nor STRS makes an assumption with respect to this matter in their annual actuarial valuation. There is no need for them to do so.)

To place a frame of reference around this baseline projection, we have also projected the growth in the Healthcare Fund under alternative healthcare inflation assumptions 1% and 2% higher than the 4.5% baseline. These are intended to provide an indication of the margin for adverse experience.

As indicated in the above projections, on a stand-alone basis SERS cannot afford to adopt either the PERS or STRS health care program and drop the employer surcharge. To do so would exhaust the

current Healthcare Fund within a few years. But if SERS was consolidated with the current PERS or STRS Healthcare Fund, the combined fund could support the program for a decade or so, depending on the level of health cost inflation. Consolidating the SERS Healthcare Fund into either the PERS or STRS Healthcare Fund would reduce the level of benefit security with respect to health care benefits for PERS or STRS members and improve benefit security for SERS members.

In addition, a significant issue of equity across employers would be created by such a consolidation involving PERS and SERS that merits careful consideration. (Health care benefits are financed solely through employer contributions and retiree premium sharing.) On a combined basis, the SERS health care costs would in effect be spread to other employer units that are not school districts. Combining SERS and STRS would not create comparable equity issues in that the participating employers for both systems are substantially the same.

Effect of Merger into a Consolidated Division in PERS or STRS on Contributions and Funded Status

PERS – Local Government Division

As indicated in the exhibit on page 18, the alternative scenario that involves consolidating SERS into the PERS – Local Government Division (Alternative B) would reduce the regular employer contribution rate from 14.00% to 13.55% and would eliminate the employer surcharge for SERS members. Based on the current SERS payroll of \$1.8 billion, these changes would reduce the contributions from SERS employers by \$8.0 million and \$26.8 million, respectively, for a total saving to these employers of \$34.8 million. This scenario would reduce member contributions from 9.0% to 8.5%. This would save SERS members \$8.8 million. This would produce a combined savings to SERS members and employers of \$43.6 million.

That exhibit also indicates that such a merger would reduce the maximum employer contribution on PERS – Local Government payroll allocable to either health care benefits or to a more rapid amortization of the UAL than 30-year funding (the minimum rate of funding allowed under SB 82) from 4.82% to 4.36% or \$24.1 million per year (based on the current PERS – Local Government payroll of \$5.2 billion). In effect, contributions attributable to PERS – Local Government payroll would be diverted from funding benefits for existing PERS – Local Government members to funding benefits for former SERS members. Effectively PERS – Local Government contributions would subsidize benefits to SERS members. This is one of the sources of funding to offset the \$43.6 million reduction in SERS member and employer contributions. The balance of the savings in annual contributions (\$43.6 million - \$24.1 million = \$19.5 million) would come from pooling SERS and PERS – Local Government assets and liabilities. Pooling would effectively allocate current PERS – Local Government assets toward funding SERS health care benefits and the current SERS pension UAL.

As indicated in the exhibit of page 18, the consolidation of SERS into the PERS – Local Government Division would slightly reduce the Funded Ratio for pension benefits of the current PERS – Local Government Division from 95% to 94% and improve the Funded Ratio for pension benefits of SERS from 90% to 94%. As indicated in the table on page 21, it would reduce the ratio (in years) of Healthcare Assets to Annual Health Benefits from 22.9 years to 13.8 years for the PERS – Local Government Division and increase that ratio for SERS from 0.3 years to 13.8 years.

STRS

A similar analysis with respect to the alternative scenario that would consolidate SERS with STRS to form a single merged system (Alternative D) indicates that SERS employers would save \$26.8 million from the elimination of the employer surcharge currently paid by SERS employers. Offsetting this saving to SERS employers would be the increase in SERS member contributions due to the increase in their contribution rate from 9.0% to 9.3%. This would increase member contributions by \$5.3 million. This would produce a net savings to SERS members and employers of \$21.5 million.

In addition, such a merger would reduce the maximum employer contribution allocable to either health care benefits or to a more rapid amortization of the UAL than 30-year funding (the minimum rate of funding allowed under SB 82) from STRS payroll from 4.00% to 3.86% or \$10.4 million per year based on the current STRS payroll of \$7.4 billion. Since SERS and STRS employers are substantially identical groups, there is no significant subsidy from one group of employers to another, but the \$10.4 million would represent a reallocation of contributions from STRS payroll to providing benefits to SERS members. The balance of the savings in annual contributions (\$21.5 million - \$10.4 million = \$11.1 million) would come from pooling SERS and STRS assets and liabilities. Pooling would effectively allocate current STRS assets toward funding SERS health care benefits and the current SERS pension UAL.

As indicated in the exhibit of page 18, the consolidation of SERS into the STRS would slightly increase the Funded Ratio for pension benefits of STRS from 88% to 89% and slightly reduce the Funded Ratio for pension benefits of SERS from 90% to 89%. As indicated in the table on page 22, it would reduce the ratio (in years) of Healthcare Assets to Annual Health Benefits from 11.3 years to 7.4 years for STRS and increase that ratio for SERS from 0.3 years to 7.4 years.

The above analysis of the source of the funding to offset the reduction in SERS employer contributions is somewhat oversimplified in that it ignores the effect of the changes in pension benefits caused by the merger as well as the effect of changing the actuarial assumptions for SERS to approximate the assumptions used by PERS and STRS.

Important limitations on actuarial estimates shown in this report

All of the actuarial estimates prepared by M&R that are shown in this report were based on data from several years ago. We believe that the resulting estimates and projections are reasonable estimates of the impact of the possible merger of SERS into either PERS – Local Government or STRS. But the estimates should be reviewed by the systems' actuaries and validated based on more current data prior to the enactment of any legislation.

In preparing the projections of health care costs, we assumed that current SERS retirees would continue to receive coverage based on their current elections (i.e., no coverage, single coverage, or family coverage). In other words, a retiree with single coverage would continue to have single coverage under the new plan. If current retirees are offered an opportunity to reenroll in a new health care program or other changes are made that would affect current election patterns, this assumption should be re-considered.

In addition, we assumed that the Medicare Part B reimbursements would be payable out of the Healthcare Fund instead of the Pension Fund. This change is not necessary, but we prepared the projections on this basis so that Medicare Part B reimbursements to SERS members would be treated the same as those reimbursements to members of PERS and STRS.

Other Considerations

Modification of benefits and/or contribution rates is not necessary

In reviewing the previous estimates and projections, it is important to keep in mind that it would not be necessary to modify the current SERS benefits in the event of a merger. (The current benefits could be continued for SERS members whether SERS is merged as a separate division or is consolidated into another division or system.) Also the contribution rates for SERS members could differ from the contribution rates applicable to other members of the merged system. As indicated earlier, keeping separate rates is most easily done if separate divisions are established, but separate rates could also be maintained even if the current assets and liabilities are consolidated into a single pool. Potential problems if separate benefits or contribution rates are desired could be minimized if SERS were merged with PERS or STRS but treated as a separate division for financing purposes.

Desirability of continuing to provide substantially similar benefits to all systems

As indicated in the earlier comparison of benefits among these three systems, Ohio has followed a tradition of providing substantially similar pension benefits to its public employees. Some differences in pension benefits exist, but they are relatively minor. Merging systems would not conflict with that tradition.

In the area of health care benefits, there is greater divergence in practice among the systems. This is a natural consequence of the fact that the health care benefits are discretionary based on the financial resources available to the Board. As noted earlier, SERS faces an inherently more difficult financing situation than either PERS or STRS because of the relatively low average salaries of its members. As a result, SERS requires retirees to complete more years of service to become eligible for health care benefits than STRS. Also, SERS requires significant retiree contributions toward health care premiums from retirees while PERS requires no contributions from retirees who elect to be covered by the basic plan.

Traditionally, each of the Ohio retirement systems has treated their health care benefits program as governed by section 401(h) of the Internal Revenue Code. SERS has recently decided to abandon the 401(h) account and establish a separate health care fund. One of the reasons leading to this decision was recognition that employer contributions into their current health care plan were approaching the maximum limit under section 401(h) of the IRC. This change will not necessarily require SERS to modify the current health care program it offers to retirees. It does, though, serve as an example of each system's need to monitor and modify when appropriate its health care program in light of changing circumstances.

Portability of Health Care Benefits

There have been issues in the recent past regarding the provision of health care benefits to retirees of one Ohio retirement system whose spouses are retirees of another Ohio system. Similar issues can develop regarding members who move from one system to another. We do not have any data regarding how common it is for members of PERS, SERS or STRS to have a spouse in another system or to move from one to another. But these may be factors the Legislature would wish to consider in deciding with which system to merge. For example, if there is more movement of members between PERS and SERS than between SERS and STRS, there may be some advantages in combining PERS and SERS to minimize potential issues in this area.

In any event, the merger of SERS with either PERS or STRS would reduce the potential for issues arising from spouses covered under different systems, or members transferring between systems.

Coverage of non-teaching school employees in other States

To provide an indication of how other states cover non-teaching school employees, we tabulated information contained in the State and Local Pension Exchange web site. To the extent we could, we supplemented this information by phone calls to the systems and/or their consultants. Generally, non-teaching school employees are included in either the Public Employees' Retirement System or Teachers' Retirement System

The only states, other than Ohio, that have a separate retirement system for non-certified school employees are Missouri and Washington. Missouri covers about 35,000 active members in the Non-Teacher School Employees' Retirement System of Missouri. Washington State recently added a new system for its non-teaching school employees that will be established effective September 2000.

This data is summarized in the table below.

System covering non-teaching school employees:	Number of States
General PERS with teachers and general employees	20
General PERS, but with teachers in a separate system	12
System covering all teaching and non-teaching school employees	8
Separate system covering non-teaching school employees	3

Exclusive Benefit Rule

Evidently questions have been raised whether there is any provision under the qualification rules of the Internal Revenue Code, "Code", or ERISA that might prohibit a merger of SERS into either PERS or STRS, or whether there are any special requirements applicable to a merger under those qualification requirements. We are not aware of any qualification requirement that would prohibit a merger, nor are there any special qualification requirements applicable to a merger.

Section 401(a)(2) of the Code requires that under the trust instrument it is impossible for any assets of a qualified pension plan to be used for purposes other than the exclusive benefit of the employees covered by the plan. Section 1.401-2(a)(3) of the Treasury Regulations provides that:

“ purposes other than for the exclusive benefit of his employees or their beneficiaries” includes all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries.”

Sections 401(a)(12) and 414(l) of the Code contain provisions that govern, *inter alia*, the merger of pension plans. The fact that such provisions exist demonstrates that a merger of plans does not constitute a violation of the exclusive benefit rule of section 401(a)(2). In Private Letter Ruling 199928041, the IRS ruled that the transfer of assets from a governmental qualified pension plan to another governmental plan that was not qualified would cause disqualification of the plan. The basis for the ruling was that such a transfer would constitute an in-service distribution prior to normal retirement age and would thus violate the rule against such distributions by qualified pension plans. No mention was made of section 401(a)(2) of the Code or the exclusive benefit rule. We are familiar with numerous mergers of qualified plans and are unaware of any merger where the IRS ruled that section 401(a)(2) was violated.

Regarding the specific Code provisions governing mergers, section 1.414(l)-1(a) of the Treasury regulations provides that:

Sections 401(a)(12) and 414(l) apply only to plans to which section 411 applies without regard to section 411(e)(2). Thus, for example, these sections do not apply to governmental plans such as SERS, PERS or STRS.

Accordingly, the special rules applicable to mergers do not apply to the proposed merger.

Given that employers participating in SERS will also participate in PERS or STRS after the merger, the exclusive benefit rule will be satisfied because the plan will benefit the employees of the participating employers. See, *e.g.* 26 CFR. §1.401-1(d).

This above analysis should not be interpreted as a legal opinion.

Potential Advantages and Challenges of a Merger of SERS with PERS or STRS

PERS, SERS and STRS have a long history dating back over 60 years. During that period they have each established relationships and service standards with the Legislature, participating employers and members. A merger of these Systems could have certain advantages and create certain challenges.

Potential advantages to be gained by merging Systems include:

- **Reduction in Administrative Costs:** Combining PERS and SERS (or SERS and STRS) could result in reduced costs due to the elimination of staff that perform essentially the same functions for each System. Savings could be achieved in many areas including redundant management, staff, computer systems, and a consolidation of outside consultants.
- **Investment Economies of Scale:** Decreases in investment management fees may be realized due to decreasing marginal fee schedules typically applicable to larger pools of investments.
- **Benefit Consistency – Primary Health Care:** Providing health care benefits to SERS retirees is creating an increasing burden on SERS and limited assets have been accumulated to absorb adverse experience. Without a merger *and* a public policy decision to spread these costs among all employers in the merged system, it may be difficult for SERS to continue the current level of health care benefits if the Board is unsuccessful in limiting the growth in the net costs per retiree.
- **Benefit Consistency – Pensions:** PERS, SERS and STRS have essentially the same benefits. Combining the Systems would make it easier for the Legislature to maintain this benefit consistency, if that is desired, since benefits would be provided in one set of laws, not two.
- **Cost Spreading:** The major idea behind the “System” concept is the ability to spread the costs of financing the benefits among all the participating employers. There are many employers in PERS who probably offer part time and low paying jobs, as is the case with SERS. If they had to stand on their own, the cost of providing health care benefits to these individuals would also be disproportionately high when compared to other PERS members. Combining with PERS or STRS would extend the cost-sharing concept for SERS over a broader group.

Potential challenges include:

- **Amendments to the Law:** The chapters of the law governing the merged systems would need to be carefully reviewed and amended to provide for the cessation of accruals under SERS, the transfer of assets and liabilities to PERS or STRS, and the continuing membership and accrual of benefits under PERS or STRS. In our review, we did not discover any legal obstacles to a merger, but we are not attorneys and hence are unable to offer a legal opinion on this matter.
- **Investment Policy:** As indicated earlier in this report, a single investment policy would need to be established for the consolidated system reflecting the combined assets and liabilities.

Possible reenrollment of current retirees for health care benefits: As indicated earlier, in preparing the projections of health care costs, we assumed that current SERS retirees would continue to receive coverage similar to what they currently have. This may not be a reasonable assumption, especially if all current retirees, even those who had declined coverage in the past, are offered the opportunity to reenroll in the health care program. Such a reenrollment could result in some or many current retirees reenrolling, especially if they were offered the opportunity to receive coverage at no cost, which is an option under the current PERS health care plan for retirees who elect the basic package. Also allowing reenrollments to retirees who have gone without health care coverage for a number of years may encourage retirees whose health has deteriorated in the interim to reenroll. Such retirees may have a higher than average cost associated with them due to possible delays in providing care in the past. The treatment of health care for retirees will involve some complicated policy options. The problems could be identified and affordable options to solve them identified, but that effort is beyond the scope of this feasibility report.

Potential equity issues if relatively low salary employees for school districts are pooled with non-school district employees: As discussed earlier, consolidating PERS and SERS may improve health care benefit security to SERS members. However, a significant issue of equity across employers would merit careful consideration. On a consolidated basis, the SERS health care costs would be spread to other employer units that are not school districts.

This issue could be addressed by maintaining SERS as a separate division within PERS but then the obligations would continue to be funded only by SERS employers and the possible benefits from pooling the cost of health care benefits would not be achieved. A merger on this basis (as a separate division) would not improve health care benefit security for SERS members.

Note that this potential equity among employers issue would disappear if SERS were merged into STRS because the school districts that contribute to SERS are almost identical to the employers contributing to STRS.

Service Credit Calculation: PERS has rules for determining how much service is required in order to receive credit for a full or a partial year that differ from the rules for SERS and STRS. If a member of PERS earns \$250 in a month, he or she receives credit for that month. To get one year of service credit, a member must receive 12 months of service credit. If he or she works fewer months than 12 months in a year, service is credited on a pro-rata basis.

The rules for SERS and STRS reflect the nature of a normal school year. If a member is employed and contributes for 120 or more days during a year, he or she receives credit for a full year of service. If the member works less than 120 days, a fractional year of service credit is granted based on the fraction whose numerator is the number of days worked and the denominator is 180 days. For example, if a member of SERS worked 90 days, he or she would receive credit for 90/180 or one-half year of service.

Thus if SERS were merged into PERS, rules would need to be developed that would be appropriate for SERS members. This would not be an issue if SERS were merged into STRS since both systems use the same rules for determining service credits.

The more difficult challenges relate to the possible merger of the SERS health care benefit program into either the PERS or STRS program. The challenges relating to pension benefits would be significantly easier to resolve, especially if SERS were merged with STRS.

Relative Pros and Cons of merger with PERS vs. STRS

As indicated in the introduction, this report was initiated because of a proposal to combine SERS with PERS. We have expanded this report to include a possible merger of SERS with STRS. Such a merger would present many of the same advantages and challenges as a merger with PERS with some potential additional benefits including:

- The school employer units already participate in STRS. This would decrease the administrative task of setting up new employer units in PERS.
- The plan year and reporting periods are the same so many administrative adjustments would not be required.
- School districts benefit from the services of both teachers and school employees. Combining with STRS would continue to allocate all pension and health care costs attributable to these employees to the school districts. In PERS, some SERS costs would be spread among other public employers.
- The service credit formulas under SERS and STRS are identical. Thus the determination of service credit for SERS employees in STRS does not pose a problem with a merger into STRS. If SERS would be merged in PERS, the service credit issue would need to be addressed.

Summary and Conclusion

The ORSC was requested to review the pros and cons of merging SERS with PERS. This report has identified and discussed the advantages and challenges associated with merging SERS with either PERS or STRS. In addition, it has identified a number of issues for the Legislature and the Council to consider if they move forward to develop a plan for merging SERS with either system. The report has provided some preliminary actuarial analysis with respect to four possible approaches for structuring such a merger. As indicated in the report, there are many other approaches that could also be developed. If a merger were favored, it would be desirable to develop a proposed approach based on guidance from the Council and the Legislature regarding the basic policy issues identified in the Introduction and Overview.

The conclusion of this report is that a merger of SERS with either PERS or STRS would be possible. We have not identified any reason that would prevent the Legislature from implementing such a merger. Whether or not a merger would be desirable depends on the Council's and Legislature's weighing of the relative advantages and disadvantages of the alternatives.

Of course, it is also possible to allow SERS to remain an independent system. That alternative has advantages and disadvantages and it remains a viable approach to managing the retirement benefit program for SERS members.

g:\corr00\orc\final merger report.doc