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March 8, 2004

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

Re: House Bill No. 337

Dear Aris:

As requested, we have reviewed House Bill No. 337, which would expand eligibility to participate in an Alternative Retirement Plan, "ARP", to all full-time employees of public institutions of higher education and modify the amounts to be credited to their ARP accounts.

## Understanding of the Bill

### Eligible Employees

We understand that HB 337 would allow current members of the Public Employees' Retirement System, "PERS", the School Employees' Retirement System, "SERS', and the State Teachers Retirement System, STRS", who are full-time employees of public institutions of higher education to elect to transfer their participation from the retirement system to an ARP sponsored by their current employer. This would be a one-time opportunity and eligible members would have to make an irrevocable election to transfer within 120 days of the effective date of HB 337. (Note: this would actually be a second opportunity to transfer to an ARP for members who had less than 5 years of service as of April 1, 1998 and a second opportunity to join an ARP for members who did not elect to join an ARP when they became employed subsequent to April 1, 1998.)

We understand that this would include members of PERS and STRS who are members of these systems' DC and Combined options as well as members of their DB option.

Moreover, future hires as full-time employees of public institutions of higher education will be able to elect to join an ARP if they so elect within 120 days of commencement of employment.

Treatment of Employee and Employer Contributions

For employees who elect to join an ARP under HB 337 and who are currently members of PERS, SERS or STRS, employee and employer contributions made to the retirement system for the period beginning on the employee's starting day of employment and ending on the day before the day on which contributions commence under an ARP would be transferred to their ARP, except for employer contributions allocated by the retirement system to fund Unfunded Actuarial Accrued Liabilities, "UAL", prior to the time when the UAL became fully funded.

In the case of PERS, no portion of the employer contributions made subsequent to January 1, 1999 would be treated as being allocated to UALs because the December 31, 1998 Actuarial Valuation of PERS indicated that the UAL was fully amortized as of that date. Similarly, in the case of SERS, no portion of the employer contributions would be treated as being allocated to UALs subsequent to July 1, 2000 because the June 20, 2000 Actuarial Valuation of SERS indicated that the UAL was fully amortized as of that date.

The following table summarizes the historical Supplemental Contribution Rates that were payable under section 3305.06 of the Revised Code. Effective September 5, 2001, section 3305.061 of the Revised Code limited the Supplemental Contribution Rate on behalf of ARP members to not more than the rate transferred to mitigate the negative financial impact on the system for members who participate in the systems' defined contribution plan.

History of Supplemental Contribution Rates

| | PERS | SERS | STRS |
|---|---|---|---|
| Prior to 12/31/98 | 6.00% | 6.00% | 6.00% |
| From 1/1/99 through 6/30/99 | 0.00 | 6.00 | 6.00 |
| From 7/1/99 through 6/30/00 | 0.00 | 3.10 | 5.76 |
| From 7/1/00 through 9/30/01 | 0.00 | 0.00 | 5.76 |
| From 10/1/01 | 0.00 | 0.00 | 3.50 |

It appears that the employer contributions to be transferred would include all employer contributions made to the retirement system prior to the election to join an ARP, whether from the current higher education employer or a prior employer, without regard to whether the prior employer was an institution of higher education or whether that prior employer offered an ARP.

Since HB 337 is silent regarding the transfer of interest on the contributions, we assume that only the amount of the contributions would be transferred without interest.

All future employee and employer contributions would be made to the ARP less the Supplemental Contributions due under 3305.06 of the Revised Code, as long as the employee remains with the current employer. Since no supplemental contributions are

payable to PERS or SERS because their UALs became fully amortized as of December 31, 1998 and June 30, 2000, respectively, employees otherwise eligible for membership in these systems would be credited with their full employee and employer contributions in their ARP account.

## Discussion of the Bill

There are several aspects of HB 337 that may merit consideration by the ORSC. They are:

1. Should supplemental contributions resume if UALs become fully amortized for a temporary period, such as during the market peaks of 1999-2000, and then reemerge due to subsequent actuarial losses, such as due to the 2000-2003 market declines?
2. Should the supplemental contribution rate mitigate the effect of the ARP on the Retirement Systems' abilities to fund discretionary healthcare benefits?
3. Should the supplemental contribution rate ignore UALs caused by benefit increases subsequent to March 31, 1997?

### Background

As we have indicated in prior reports regarding the supplemental contribution rate, there are three primary reasons why a supplemental contribution to the Ohio Retirement Systems is needed. The first reason is that the existing unfunded actuarial liabilities of the systems must be amortized. Each system relies on contributions on behalf of all employees (covering both current employees and future hires) in the groups currently covered by the Retirement Systems to amortize these obligations.

For example, in 2000 and 2001 legislation was enacted to increase the benefits provided to members of PERS, SERS, and STRS. In its consideration of that legislation, the ORSC received cost estimates based, in part, on the assumption that the current members of the retirement systems would continue to be covered by those systems. To the extent that an ARP allows some of those members to transfer out, the financing base for amortizing the increased unfunded actuarial liabilities from those benefit increases will be eroded.

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

A third reason is that University and College employees eligible to join an ARP generally receive compensation higher than the average compensation provided to other members of the Retirement Systems. Employer contributions allocated to fund health

insurance benefits for retired members are expressed as a percentage of pay in each of the three Retirement Systems. But the cost of health insurance does not vary in proportion to earnings. Thus, if the employees with higher than average earnings transfer to an ARP, contributions to finance health insurance will decrease disproportionately.

<u>Should supplemental contributions resume if UALs reemerge due to subsequent actuarial losses?</u>

The most recent actuarial reports of PERS and SERS indicate that both systems have significant UALs due to the 2000-2003 market declines. But Section 3305.06 of the Revised Code states that the supplemental contribution should cease when the system's actuarial report indicates that its UALs have been fully amortized. Since both systems had fully amortized their UALs prior to the market decline, supplemental contributions to them have ceased. The statute does not address what is to happen in such circumstances and Section 3305.06 has been interpreted to mean that once an actuarial report indicates that the UALs have been fully amortized, the supplemental contributions to it cease permanently.

This is an important issue beyond the context of funding the retirement systems' UALs. When an employee decides whether to join an ARP or the retirement system, he or she should base that decision on an analysis of what benefits they will receive from each. If the supplemental contribution rates can vary significantly from year to year, employees will have a difficult time estimating the benefits they will receive from an ARP. Thus it is desirable from the perspective of employees facing this choice to have a clear understanding of what portion of the employer contributions on behalf of them will be directed to the retirement system as a supplemental contribution instead of being allocated to their ARP account. From their perspective, it would be desirable to have (a) the magnitude of the supplemental contribution rate as well as (b) the time period over which it will be payable be relatively stable, or even fixed, rather than subject to significant fluctuations.

In our prior reports on the supplemental contributions, we have discussed this issue along with a related issue regarding whether supplemental contributions should cover the cost of benefit increases after the establishment of the ARP. The Legislature decided to exempt from the supplemental contributions costs associated with benefit improvements enacted after March 31, 1997. But the legislature did not address what should happen if UALs remerge due to actuarial losses. While there are many possible solutions to this problem, the following two alternatives highlight the choices involved.

The time period over which supplemental contributions would be payable could be set as:

1. the funding period reported in the annual actuarial valuation of the Retirement System ***next following the establishment of the ARP;*** or

2. the funding period reported in the ***most recent*** annual actuarial valuation of the Retirement System **minus** an adjustment to **decrease** that period to reflect benefit increases subsequent to March 31, 1997 which the supplemental contributions should **not** assist in financing.

The difference between these two alternative methods for determining the length of time the supplemental contributions will be payable relate to their treatment of actuarial gains (or losses) subsequent to the establishment of an ARP. The first alternative method would ignore actuarial gains and losses subsequent to the establishment of the ARP while the second method would adjust the period during which the Supplemental Contribution would be payable to reflect them (since the funding period is adjusted each year).

If the first of these alternatives were chosen, once the time period ends, the supplemental contribution would not be payable even in the event significant actuarial losses create unfunded actuarial pension liabilities. But the supplemental contribution would have been paid even if actuarial gains subsequent to the establishment of the ARP eliminated the UAL earlier than expected.

The second alternative would allow the Supplemental Contribution to be reinstated in the event that future actuarial losses exceed any remaining unamortized unfunded actuarial pension liabilities that were created by benefit improvements that the Legislature allocated to retirement system members only. This is what has happened due to the 2000-2003 market decline. To implement the second alternative, it would be necessary for the PERS, SERS and STRS actuaries to identify the portion of the UAL attributable to benefit increases subsequent to March 31, 1997 in each annual actuarial valuation.

The current interpretation of the statute effectively has given to employees otherwise eligible for PERS or SERS and their employers the benefit of the market peaks from early 2000 even though a significant market decline/correction occurred immediately thereafter.

Should the supplemental contribution rate mitigate the effect on the Retirement Systems' abilities to fund discretionary healthcare benefits?

As indicated above, the higher education employees eligible to join an ARP generally receive compensation higher than the average compensation provided to other members of the retirement systems. Employer contributions allocated to fund health insurance benefits for retired members are expressed as a percentage of pay in each of the three retirement systems. But the cost of health insurance does not vary in proportion to earnings. Thus, if the employees with higher than average earnings transfer to an ARP, contributions to finance health insurance will decrease disproportionately.

In past calculations of the supplemental contribution rate, we have reflected this factor in the calculation of the supplemental contribution. For example, the supplemental contribution to STRS developed in our report of July 1, 2002 indicated that a supplemental contribution rate of 0.87% would be needed to mitigate the adverse effect of the ARP on STRS's ability to fund discretionary healthcare benefits. This was in addition to the supplemental contribution rate of 3.33% necessary to mitigate the adverse effect of the ARP on STRS's ability to fund mandated pension benefits.

Section 3305.061 of the Revised Code became effective in 2001. It limits the supplemental contribution rate to no more than the rate to mitigate the negative financial impact of members electing the defined contribution plan. In the case of STRS, this limited the supplemental contribution rate to 3.50% even though the total contribution rate we calculated to mitigate the adverse effect of the ARP on both mandated pension and discretionary healthcare benefits was 4.20% (3.33% + 0.87% = 4.20%). It is not clear to us whether this rate includes a supplemental contribution rate to mitigate the adverse effect of the ARP on STRS' ability to fund discretionary healthcare benefits.
Should the supplemental contribution rate ignore UALs caused by benefit increases subsequent to March 31, 1997?

HB 337 would allow members of PERS, SERS and STRS who were assumed to help to fund the cost of the benefit increases enacted in 2000 and 2001 to transfer to an ARP and would exempt them from helping to fund the cost of those benefit increases. But when those benefit increases were enacted, the ORSC, legislature and the systems anticipated that those members would help to fund the 2000 and 2001 benefit increases. HB 337 would require the systems to transfer all of the employee and employer contributions to the ARP, less the supplemental contributions that would have been payable under 3305.06(D) which explicitly excludes the cost of benefit increases subsequent to March 31, 1997. Section 3305.06(D) of the Revised Code states that the supplemental contribution rate is intended to "mitigate any negative financial impact of the Alternative Retirement Program on the State Retirement System". However, the exclusion of benefit increases subsequent to March 31, 1997 in the determination of the supplemental contribution rate for members who would transfer in 2004 under HB 337 seems inappropriate since they were expected to assist in funding the costs of the benefit increases in 2000 and 2001.

## Estimated effect of HB 337 on the actuarial status of the systems

The actuaries for PERS, SERS and STRS each prepared an estimate of the effect of HB 337 on the actuarial status of the mandated pension benefits it provides to members. While they all used slightly different assumptions regarding which members would be likely to join an ARP and had somewhat differing understandings of exactly how to determine the total employee and employer contributions to be transferred to an ARP on behalf of members who elect to transfer, they generally concluded that the estimated effect of HB 337 would be relatively de minimus on the actuarial status of the mandated pension benefits.

But the SERS actuary estimated that the transfer of current members to an ARP due to HB 337 could reduce contributions available to fund discretionary healthcare benefits by $2 to $4 million per year if as many as 50% of the eligible members elected to transfer. Since SERS paid slightly more than $200 million in healthcare benefits in the year ending June 30, 2003, these estimates indicate that the enactment of HB 337 could cut SERS resources to provide discretionary healthcare benefits by roughly 2%. (Since SERS does not offer a DC alternative option to members, it seems reasonable to anticipate that they may have a higher percentage of their members electing to transfer to an ARP than PERS and STRS. PERS and STRS may have some members choose to remain if they are satisfied with their DC option.)

In performing this analysis, we relied on the data and other information provided by the ORSC, the systems and their consulting actuaries. We have not audited or verified this data and other information. If the underlying data or information is inaccurate or incomplete, the results of our analysis may likewise be inaccurate or incomplete.

We performed a limited review of the data used directly in our analysis for reasonableness and consistency and have not found material defects in the data. If there are material defects in the data, it is possible that they would be uncovered by a detailed, systematic review and comparison of the data to search for data values that are questionable or for relationships that are materially inconsistent. Such a review was beyond the scope of our assignment.

Differences between our projections and actual amounts depend on the extent to which future experience conforms to the assumptions made for this analysis. It is certain that actual experience will not conform exactly to the assumptions used in this analysis. Actual amounts will differ from projected amounts to the extent that actual experience deviates from expected experience.

Please let me know if you have any questions.

Sincerely,

William A. Reimert

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