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Analysis

Sub. S.B. 340 – Sens. Niehaus and Kearney
(As Enacted)

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Staff Recommendation

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Substitute Senate Bill (Sub. S.B.) 340 would make the following changes to the laws governing the Ohio Police and Fire Pension Fund (OP&F) in order to ensure the continued to solvency of the retirement system:

- Increase the employee contribution rate to 12.25% by 7/2/2015. (R.C. §742.31(A))

- Give the board authority to adjust the employee contribution rate, in consultation with its actuary, if necessary to preserve the fiscal integrity of the fund, following the actuarial investigation due on 11/1/2017 and each quinquennial actuarial investigation thereafter. (R.C. §742.31 (B), Section 4)

- Require employers to pay the employer contribution monthly. Employer contributions due between the effective date 1/7/2013 and 90 days after are to be remitted in 1/3 installments each on December 31, of 2013, 2014, and 2015. (R.C. §742.33, §742.34, §742.35, Section 3)

- Increase the retirement age to 52 for members who begin service on or after 7/2/2013. (R.C. §742.37 (C)(1))

- Increase the average annual salary to five years for members with less than 15 years of service (YOS) credit as of 7/2/2013. Members with 15 or more YOS credit as of 7/2/2013 the average annual salary will continue to be determined with three years of contributions. (R.C. §742.01(G), §742.37 (C)(1)-(4), §742.39(A))

- Provide an actuarially reduced retirement benefit for members who reach age 48 with 25 YOS who begin service on or after 7/2/2013. (R.C. §742.37 (C)(4))

- Give the board authority to adjust age and service retirement eligibility, in consultation with its actuary, if necessary to preserve the fiscal integrity of the fund, following the actuarial investigation due on 11/1/2017 and each quinquennial actuarial investigation thereafter. (R.C. §742.161, Section 4)

- Change "terminal pay" to include terminal pay payments before or at the time of termination and to include overtime pay that was not included the payroll period 60 days after the overtime work was performed. (R.C. §742.01 (K), §742.01 (K)(3))

- Change "salary" to include overtime pay in the payroll period for which the overtime was worked and up to 60 days after. (R.C. §742.01 (L)(1))

- Allow the Board to set definition of "salary" and "terminal pay" based on elements of the compensation provision and W2 form of the United States Internal Revenue Code (IRC), which may differ from definition of "terminal pay" in §742.01 (K)(3) and "salary" in §742.01 (L)(1). (R.C. §742.013)

- Establish an anti-spiking provision by setting a salary benchmark, which caps salary increases in the member's final three years to a 10% increase per year and refunds member contributions that exceed the salary benchmark. The salary benchmark is applicable for members with 15 or more YOS as of 7/1/2013. (R.C. §742.01(G)(1)-(5), R.C. §742.012)

- Change Cost of Living Allowance (COLA) eligibility, rate, base calculation and eliminate COLA in the Deferred Retirement Option Plan (DROP) for new members on or after 7/2/2013. (R.C. §742.3716)

- Require permanent disability to receive a benefit for a heart, cardiovascular, or chronic respiratory disease and permanent partial disability in performance of their official duty to receive benefit. (R.C. §742.38 (D)(2), (D)(3))

- Allow board to waive the requirement that the disease was not documented before or at the time the member began. (R.C. §742.38 (D)(3))

- Change the DROP eligibility, member contribution accrual schedule, interest accrual requirement and eliminate the COLA in DROP for new members on or after 7/2/2013. (R.C. §742.443, §742.444, §742.3716 (E))

- Set the annual actuarial valuation of pension liability, annual health care liability and presentation of employer liability to the General Assembly to be conducted every three years. Remove the requirement for OP&F to submit a plan to comply with the 30-year amortization "in any year" the amortization period falls outside of 30 years to sync with the triennial actuarial valuation. (R.C. §171.04, §742.14, §742.16, §742.30, §742.45)

- Consider active and reserve members of the Armed Services as members of the fund for the duration of service if called to service by an Act of Congress or Executive Order by the President. (R.C. §742.01 (E))

- Change the date to vote in an election to the thirty-first day of January from the first Monday in March and first Monday in April. (R.C. §742.04)

- Clarify that any person or person's beneficiary paid any benefit payment made erroneously by the fund is subject to repayment and/or withholding from fund. (R.C. §742.64)

Background

Pursuant to S.B. 82 (eff. 12-6-1996), each retirement system whose funding period exceeds 30 years in any given year is required to submit to the Ohio Retirement Study Council (ORSC) and the standing committees of the House and Senate with primary responsibility for pension legislation a plan approved by the retirement board that reduces the funding period to no more than 30 years, along with any progress made by the board

in meeting the 30-year funding period. This standard was modeled after the national standard adopted by the Governmental Accounting Standards Board for all governmental pension plans. The change was intended to maintain inter-generational equity among taxpayers and system members by limiting the ability to fund benefit costs by extending the funding period beyond 30 years.

In 2003, the ORSC voted to have its actuary, Milliman USA, review the adequacy of the contribution rates in all five retirement systems. That report, which was updated in 2004, generally concluded that in the case of the Ohio Police and Fire Pension Fund (OP&F) and the State Teachers Retirement System (STRS) one or more of the following actions would need to occur to achieve compliance with the 30-year funding requirement: contribution limits increased; mandated pension benefits reduced; state subsidies provided; and/or contributions reallocated from discretionary health care benefits to mandated pension benefits.

Given the severe decline in investment market values since the end of fiscal year 2008 and the need to begin evaluating options to address this situation proactively, the Council approved a motion to have staff work with OP&F on December 10, 2008, on March 11, 2009, with STRS, and with the Public Employees Retirement System (PERS), School Employees Retirement System (SERS) and the State Highway Patrol Retirement System (HPRS) on April 8, 2009. All five systems, in consultation with the ORSC, developed legislative proposals that would reduce their unfunded actuarial accrued liability periods.

STRS, SERS, OP&F, and HPRS presented their board-approved funding plans at the September 9, 2009, ORSC meeting. PERS presented its board-approved plan at the December 9, 2009, ORSC meeting. Both STRS and OP&F presented updated plans in early 2011. S.B. 340 contains the OP&F board approved plan.

In 2011, the ORSC hired Pension Trustee Advisors and KMS Actuaries (PTA/KMS) to complete a review of the boards' plans and make recommendations related to pension reform. PTA/KMS presented its review at the July 11, 2012 ORSC meeting. They found that the plans are a positive step and will, generally, enable the majority of the systems to meet the goals of funding reasonable health care benefits at no increased cost to taxpayers.

Staff Comments

Employee Contributions – (R.C. §742.31, Section 4) Effective 7/2/2013, Sub. S.B. 340 would begin to phase in an increase to the employee contribution rate. The employee contribution rate would be increased to 10.75% by 7/2/2013, 11.5% by 7/2/2014, and 12.25% by 7/2/2015. Sub. S.B. 340 would allow the board, in consultation with their actuary, to increase and/or decrease the employee contribution rate in accordance with the rules adopted by the board not earlier than 11/1/2017 and thereafter, following each quinquennial actuarial investigation. The rates may be adjusted on the basis that it is necessary to preserve the fiscal integrity of the fund. Sub. S.B. 340 would delay the board's authority for 180 days after the effective date of the bill, January 7, 2013.

The current employee contribution rate is 10% of a member's annual salary. The employee contribution rate increased from a rate of 6% set by House Bill (H.B.) 642 (eff. 11/5/1965) to the current rate of 10% set by Am. Sub. H.B. 389 (eff. 9/9/1988). The employee contribution rate has changed only three other times between 1965 and the current statutory rate.

Historically, the costs of benefits have been shared between employees and employers. Compared to systems with uniformed members, OP&F employers contribute 19.5% annually on behalf of its police officers, higher than the 18.1% rate PERS Law Enforcement (LE) employers contribute annually on behalf of its officers. The State, as the sole employer in HPRS, contributes 26.5% to HPRS on behalf of its Highway Patrol members, the highest employer rate among all five retirement systems. OP&F police officers contribute 10% of annual salary, which is the same annual rate as required for HPRS members. However, PERS LE officers contribute a rate of 11.6% of annual salary.

The employee contribution rate is used in conjunction with employer contributions and investment income to finance the pension fund and health care benefits. Increasing the employee contribution rate will create a better cost balance between the employee and the employer, thus preventing an increase in state contributions while simultaneously reducing taxpayer risk. Under Sub. S.B. 340, the OP&F board would be able to increase and decrease the employee contribution rate to sustain the fiscal integrity of the fund on the basis of the five year actuarial valuation. The modification would enable OP&F to increase employee contribution rates when the fund's fiscal integrity erodes and decrease the employee contribution rate when the fiscal integrity of the fund improves. While OP&F is ultimately responsible for the pension, this reform would shift a degree of risk and responsibility to employees for financing a larger portion of their benefit based on the fund's fiscal performance.

This bill would enable the OP&F board to act without legislative approval to address funding and solvency issues. Consulting with the board's actuary and relying on the five year actuarial valuation would be prudent practice; however, Sub. S.B. 340 would not require the OP&F board to make an adjustment to the employee contribution rate necessary to meet the 30-year amortization period requirement in the actuarial valuation. Rather, the provision would merely require the OP&F board to adjust the employee contribution rate to "preserve the fund's fiscal integrity," which, therefore, wholly relies upon the OP&F board's definition and interpretation of "fiscal integrity."

The delegation of authority would provide the OP&F board with a power historically reserved for the legislature. Although the board's authority is not functional until 11/1/2017 and the bill delays the board's authority by 180 days after the effective date of 1/7/2013, the bill does not allow the ORSC to determine the appropriate division of authority between the board and the Legislature and ensure consistency among all five statewide retirement systems. Moreover, the OP&F board authority provision does not prescribe any parameters regarding the employee contribution rate and does not provide any process for members to comment or mechanism for oversight and/or transparency.

Therefore, we recommend removing the provision and study further to ensure legislative oversight of future changes or to develop with appropriate language to add safeguards to the board's ability to determine employee contributions without legislative input.

Employer Contributions – (R.C. §742.33, §742.34, §742.35, Section 3) Employers would be required to pay OP&F contributions in monthly payments under Sub. S.B. 340. The bill specifies that payment would be due on the last day of the month after the month for which police and firefighter employee contributions were withheld. Sub. S.B. 340 would transition employer contributions due between the effective date of the bill and 90 days after to be remitted to OP&F in 1/3 installments on December 31, of 2013, 2014, and 2015.

Currently, employers are required to submit the annual employer contributions under §742.33 (Police Officers) and §742.34 (Firefighters) in quarterly installments on dates set by the OP&F Board of Trustees. H.B. 642 (eff. 11/5/1965) scheduled the remittance of employer contributions to OP&F on a quarterly basis. Since 1965, the Board has coordinated the quarterly remittance of employer contributions among hundreds of employers to OP&F.

The bill's proposed change from a quarterly employer remittance schedule to a monthly employer remittance schedule is to increase the cash flow in the OP&F fund. While the bill does not change the employer contribution rate, the monthly installments would allow OP&F access to the employer contributions sooner and enable them to use the cash flow for investments and liabilities. Sub. S.B. 340 would provide OP&F employers 90 days to transition to the monthly payment schedule to prevent OP&F employers from paying on the old quarterly schedule and new monthly schedule in the same month. OP&F employers would be able to remit employer contributions for the 90-day period to OP&F in three installments due at the end of the year for years 2013, 2014, and 2015. This schedule would avoid financially burdening police and fire departments moving to the new remittance schedule.

Eligibility: Age & Service – (R.C. §742.37, §742.161 Section 4) Sub. S.B. 340 would increase the retirement age to age 52 and provide an actuarially reduced retirement benefit at age 48 with 25 YOS for members who begin service on or after 7/2/2013. Sub. S.B. 340 would allow the board, in consultation with the OP&F actuary, to increase and/or decrease the age and service requirements in accordance to the rules adopted by the board not earlier than 11/1/2017 and thereafter, following each quinquennial actuarial investigation. The age and service requirements may be adjusted on the basis that it is necessary to preserve the fiscal integrity of the fund. Sub. S.B. 340 would delay the board's authority for 180 days after the effective date of the bill, January 7, 2013.

Currently, to retire from active service for a full retirement benefit, a member may elect to retire at 48 years of age with 25 YOS. After 15 YOS, a member of the fund may retire and receive a reduced benefit calculated with a lower benefit multiplier. Pension payments do not commence until the member reaches age 48 year and 25 years have

passed from the start of the member's service. Members are also eligible to retire after 15 YOS at age 62, calculated at the normal service benefit multiplier.

S.B. 340	Members prior to 7/2/2013	New Members as of 7/2/2013 & after
Normal Retirement	• Age 48 with 25 or more YOS • Age 62 with 15 or more YOS	• Age 52 with 25 or more YOS • Age 62 with 15 or more YOS
Early Retirement (normal benefit reduced)	15 YOS. Pension payments not to begin until age 48 & 25 years passed since service began	15 YOS. Pension payments not to begin until age 52 & 25 years passed since service began Age 48 with 25 YOS reduced to the actuarial equivalent had the member retired at age 52

Age and service retirement eligibility has been infrequently changed since H.B. 642 (eff. 11/1/1965), which set the normal service retirement eligibility to age 52 with 25 YOS. It gave members the option to retire at age 48 with 25 YOS and receive a reduced benefit. It established an early retirement after 15 YOS, with the reduced benefit not to commence until the member reached age 52 and after 25 years had passed since the member began service. S.B. 137 (eff. 6/28/1972) allowed members to retire after 15 YOS at age 62 and receive a pension calculated at the normal service benefit multiplier. Am. Sub. H.B. 389 (eff. 9/9/1988) eliminated the reduced benefit at age 48 and lowered the normal service retirement eligibility to age 48 with 25 YOS for a full pension benefit.

Sub. S.B. 340 would increase the normal service retirement age to 52 and would offer new members an actuarially reduced retirement benefit at age 48. Under Sub. S.B. 340, the OP&F board would be authorized to make adjustments after the completion of the five year actuarial valuation in order to preserve the fiscal integrity of the fund. This provision would enable OP&F to increase retirement eligibility should the fund's fiscal integrity erode and decrease retirement eligibility should the fiscal integrity of the fund improve. Extending the retirement eligibility would provide OP&F with at least four more years of employee contributions at a higher rate, which would boost the solvency of the OP&F fund. Increasing the retirement age would also extend the DROP entry and separation age. Delaying retirement for members would permit OP&F to save on expenses for retiree health care coverage. Since employees receive health care coverage through their employer, requiring future and current members to work longer would reduce the amount of time OP&F would need to provide health care coverage for retirees.

Sub. S.B. 340 would authorize the OP&F board to address the fiscal integrity of the fund by adjusting retirement eligibility independent of legislative approval. Consulting with the board's actuary and relying on the five year actuarial valuation would be prudent practice; however, Sub. S.B. 340 neither requires the OP&F board to make adjustments to retirement eligibility on the basis of the five-year actuarial valuation nor requires adjustments on the basis of meeting the statutory 30-year amortization period. Rather, the provision is permissive, merely allowing the OP&F board to determine whether an

adjustment is necessary to "preserve the fund's fiscal integrity" after the five year actuarial valuation. Sub. S.B. 340 does not define "fiscal integrity" and would permit the OP&F board to wholly craft and interpret its own definition.

The delegation of authority would provide the OP&F board with a power historically reserved for the legislature. Although the board's authority is not functional until 11/1/2017 and the bill delays the board's authority by 180 days after the effective date of 1/7/2013, the bill does not allow the ORSC to determine the appropriate division of authority between the board and the Legislature and ensure consistency among all five statewide retirement systems. Moreover, the OP&F board authority provision does not prescribe any parameters regarding the age and service eligibility and does not provide any process for members to comment or mechanism for oversight and/or transparency.

Board authority to change retirement eligibility would, indeed, have considerable consequences for the OP&F membership. Adjusting age and service eligibility to meet funding levels would have a far greater impact on an OP&F member than requiring a higher rate of employee contributions or reducing the COLA. Increasing contributions equates to requiring a member save more for retirement to ensure the viability of the pension. However, adjusting the retirement age and service credit eligibility is a unique means to address funding because it determines a member's life plan. This would create instability and uncertainty as to how long members must work to reach retirement eligibility.

The PTA/KMS Report on 30 year Plans and Pension reform noted that the OP&F plan did not satisfy both the 30-year pension funding plan and long-term health care solvency. With no room for any adverse experience, OP&F would have to take action immediately to exercise the board authority and make additional changes to the plan. Again, we note no such provision in this bill requires the OP&F board to take action with the authority granted by Sub. Sub. 340. As such, current and future members would have to work longer to finance current retirees and grandfathered members. Future decisions made by the board to increase retirement eligibility and employee contributions could create resentment among the board and between current retirees, grandfathered, non-grandfathered and future members.

Therefore, we recommend removing the board authority language and study further to ensure legislative oversight of future changes or develop with appropriate language to add safeguards to the board's ability to solely determine retirement eligibility.

Average Annual Salary; Salary Benchmark - (R.C. §742.01(G), §742.012, §742.37 (C)(1)-(4), §742.39 (A)) For all new members and members with less than 15 years of service as of 7/2/2013, Sub. S.B. 340 would calculate the average annual salary with the highest five years of salary, divided by five. The bill would continue to use three years for the average annual salary calculation for members with 15 YOS as of 7/2/2013. The calculation would apply to normal, early and reduced benefit calculations. Sub. S.B. 340 would not change the benefit multipliers used in the calculation.

For members with 15 or more YOS as of 7/2/2013, Sub. S.B. 340 would establish a salary benchmark as an anti-spiking measure that would cap salary increases in the final three years prior to a member's retirement. The bill would set the salary benchmark by averaging three years of annual salary earned for the three-year period prior to the immediate three-year period before a member's date of retirement. The average salary for the three-year period before the final three years would be limited to an annual 10% increase by multiplying the three-year average by 110% for each of the final three years. Salary that exceeds the benchmark would be refunded and would not be used in the annual average salary calculation. To date, there is no anti-spiking provision in Chapter 742.

S.B. 340 §742.01 (G)	Members w/ 15 years or more Service as of 7/2/2013	New Members & Members w/ less than 15 years of service as of 7/2/2013
Average Annual Salary Calculation	Average: Highest 3 years of salary combined & divided by 3 Salary Benchmark: Limits increases in Final 3 years to 10% increase per year	Average: Highest 5 years of salary combined & divided by 5

Sub. S.B. 137 (eff. 6/28/1972) established the average annual salary provision in §742.01, which calculated the average by combining the highest five years of compensation, divided by five to set the average annual salary. The current calculation was set by Sub. S.B. 48 (eff. 1/1/1974), which reduced the number to three years of annual compensation, combined and divided by 3 to set the annual average salary. Am. Sub. H.B. 721 (eff. 7/24/1986) substituted the term "compensation" for "salary" and added separate subsections to define which payments could be included as salary for the purpose of calculating the annual average salary. These sections were added to eliminate payments for various types of leave, holiday pay, longevity pay, deferred overtime and pay for services not within a member's scope of employment.

The bill's proposed changes to the annual average salary provision and addition of a salary benchmark is an effort to limit abnormal salary increases in the final years of a member's career. Salary spiking generally results from promotions to higher paying positions that occur at the end of a member's career. These spiked years distort a member's annual average salary. The skewed average annual salary sets a lifetime benefit that is disproportional to the member's low career contributions, which creates a fiscal deficit in the pension system. Over time, the fiscal shortfall between a member's career contributions and lifetime benefit is exacerbated. The additional two years of salary would help counterbalance salary spikes and reduce its effectiveness by about half. Limiting the final three years of salary to annual incremental increases of 10%, based upon the average of the prior three years, would limit the amount of salary recognized in the annual average salary calculation.

Increasing the years in the average to five years of salary would reduce the effects of salary spiking, but it would not prevent the practice from continuing. Second, the salary benchmark only applies to members with 15 or more YOS as of 7/2/2013 and in 10 years, this provision would be inapplicable to OP&F members. Moreover, working longer would easily neutralize the salary benchmark's effectiveness. The benchmark presumes a member's spike will occur in the final three YOS. To thwart its effects, the member need only work a couple of years longer for the abnormal increase in salary to fall within the three-year period that sets the salary average for the benchmark. The spiked salary year would inflate the average used for the salary benchmark and the 10% increase cap would be applied to the exaggerated salary benchmark and rendered ineffective.

Therefore, we recommend a contribution-based anti-spiking measure be adopted, similar to that established under Sub. S.B. 343 (OPERS, Pension Reform). We further recommend the salary benchmark provision be applied equally to all members.

Definitions – Salary, Terminal Pay, Overtime – (R.C. §742.01(K), (K)(3), (L)(1)) Sub. S.B. 340 would change the definition of "salary" to include overtime pay that is included in the payroll for the period in which the overtime worked or the payroll for any period up to 60 days after the overtime is worked. Sub. S.B. 340 would change overtime pay that is not paid prior to 60 days after the overtime work is performed to "terminal pay." The bill would allow terminal pay payments to be made before or at the time of termination. Further, the bill would allow the board to independently define what constitutes "salary" and "terminal pay." Sub. S.B. 340 would allow the board to set the definitions of "salary" and "terminal pay" on the elements of the compensation provisions in the IRC and from W2 federal income tax forms. The bill would permit the definitions to be distinctive from the statutory meaning found in §742.01 (K) & (L) of the Ohio Revised Code (O.R.C.).

Currently, "salary" includes overtime pay that is earned in the payroll period or the subsequent payroll period for which the overtime work was completed. "Salary" is defined as all compensation, wages, and other earnings paid to an employee by reason of employment. "Salary" does not include terminal pay. "Terminal pay" includes overtime pay that is not paid in the payroll period or the payroll period after the overtime work has been completed. "Terminal pay" is pay made on termination of employment for unused types of leave, such as sick, vacation, personal, and compensatory time. Pay for services rendered outside of a member's regular employment such as pay deferred for over one year in compensation to the employee for holidays worked or for longevity is also "terminal pay."

Am. Sub. H.B. 721 (eff. 7/24/1986) added the sections "terminal pay" and "salary" to classify the various types of pay members receive. "Salary" listed the types of pay that were not considered salary. On the other hand, "terminal pay" is used as the catchall, including payments and earnings not considered compensation, such as various types of leave, holiday, longevity, deferred overtime and pay for services not within a member's scope of employment. Various amendments were added to define what was not "salary" until Am. Sub. H.B. 382 (eff. 6/30/91) defined "salary" to mean all compensation, wages,

and other earnings paid to an employee by reason of employment, without regard to deferred income for federal income tax purposes. "Salary" also included overtime pay that was paid to a member not later than the payroll or the payroll after the overtime was worked. Overtime paid later than the payroll or the payroll after the overtime was worked was included as "terminal pay." The bill also granted power to the board to set by rule what pay was to be included as "salary."

These provisions hold great significance because of their role in calculating the final pension benefit. A member's final pension benefit is calculated by multiplying the member's annual average salary by a pension multiplier, which is determined on the basis of a member's YOS. All pay that qualifies as "salary" would be included in determining the annual average salary. Sub. S.B. 340 expands the definition of "salary" by including overtime pay that is paid up to 60 days after the overtime work was completed. These payments would be factors in determining a member's annual average salary.

Sub. S.B. 340 would allow the OP&F board to define "salary" on the basis of W2 federal income tax forms and elements of the compensation provisions in the IRC. The bill would permit the definitions to be different from the statutory meaning held in the Ohio Revised Code (ORC). When filing federal income taxes, a tax filer must list all wages, tips and compensation as "income" on the W2 federal income tax form. "Salary" could encompass far more pay than is currently qualified depending upon which elements of compensation the board could choose from within the IRC. The ORC definition of "salary" excludes compensation outside the scope of employment, reimbursement pay, terminal pay and pay for various leave. However, if the board chose to use a broader definition of compensation, aspects of "terminal pay," such as certain overtime pay and pay for leave could be included as "salary." Using unspecified components of the federal definition, along with expanding the time to receive overtime pay used in the "salary" calculation, could expand eligible pay as "salary" used in the annual average salary calculation.

Expanding the scope of "salary" and time period for overtime pay to be included as "salary" only counteracts and frustrates the efforts of increasing the annual average salary to five years to prevent salary spiking. As noted above, when salary spiking occurs, the retirement system is forced to pay out high retirement benefits that exceed a member's low career contributions to the retirement system. Over time, the shortfall between a member's career contributions and lifetime benefit is exacerbated. Expanding the definition of "salary" to encompass more types of pay will only amplify a member's annual salary and average annual salary. Members would be able to spike salaries since more pay would be considered "salary." This is counterproductive to anti-spiking efforts and the proposed five-year annual average salary.

Therefore, we recommend removing language that gives the board authority to set the definition of "salary" and "terminal pay" and remove language increasing the time period overtime can be paid and still counted as "salary."

Cost of Living Allowance – (R.C. §742.3716) Sub. S.B. 340 would change the COLA to be the lesser of the Consumer Price Index (CPI-W) or 3% for members as of 7/2/2013

that have less than 15 YOS. The bill would keep the COLA at 3% for members that have 15 or more YOS on or before 7/1/2013. Sub. S.B. 340 would codify the CPI-W as the index prepared by U.S. Department of Labor, the U.S. City Average for Urban Wage Earners and Clerical Workers, or a generally comparable index if the CPI-W were no longer published. The bill would require all members and current retirees to be age 55 to be eligible a COLA after receiving a pension for at least one year. But, disability recipients would remain eligible for a COLA after one year of receiving a benefit, with no age requirement.

Currently, a 3% COLA is granted to retirees that have been receiving a pension for at least one year, with no minimum age. After the first COLA is granted 12 months after the member has been receiving a pension, the pension benefit used in the first calculation of an increase remains the base for the annual increase.

H.B. 215 (eff. 11/25/69) granted the first benefit increase with an *ad hoc* adjustment for retirees and disability recipients receiving a benefit prior to 1/1/67, and reached age 65 by 1/1/70. The first increase was 10% of an eligible member's benefit. It also provided *ad hoc* adjustments for survivors prior to 12/31/1969. OP&F continued to provide *ad hoc* adjustments to the benefit of retirees, survivor and disability recipients to keep up with inflation. OP&F made *ad hoc* adjustments on a flat dollar basis until H.B. 721 (eff. 7/24/86), which granted a 3% increase in any year the CPI-W increased 3%. H.B. 365 (eff. 9/9/1996) created the COLA bank. This authorized the board to issue a COLA equal to the actual change in the CPI-W, up to 3%, and to apply any accumulation over 3% to the recipient's COLA in any year in which the percentage change in the CPI-W is less than 3%. The COLA bank was eliminated by H.B. 157 (eff. 2/1/2002) and changed the COLA to a flat 3% increase.

For the pension and health care funds, modest adjustments to the COLA would create long-term financial gains. The COLA provision is consistent with the PTA/KMS Report on 30-Year Plans and Pension Reform to the ORSC. The PTA/KMS report found that 40% of the present value of future benefits is due to currently retired and inactive members. Delaying the COLA until age 55 would save nearly $900 million and create long-term gains. However, by limiting most of the changes to future members and current members with less than 15 YOS by 7/2/2013, OP&F would miss an opportunity to maximize financial gains and would leave savings on the table. Tying the COLA to the CPI-W would make adjustments to the pension consistent with the actual rate of inflation. Historically, the CPI-W has been higher than 3% COLA, as the 30-year CPI-W is 4%. However, in the most recent 10-year experience, the COLA has been far greater than the CPI-W and retirees have been receiving a COLA higher than inflation. The COLA provisions are consistent with current and past ORSC recommendations.

We recommend including language that clarifies COLAs granted after the effective date of the bill are not vested.

Disability – (R.C. §742.38) Sub. S.B. 340 would require a member's partial disability be "permanent" to be eligible for a disability benefit. The bill would apply the permanent

partial disability clause to disabilities caused by the performance of official duties and to those not caused or not incurred within the performance of a member's official duties. The bill would require a member to be permanently disabled as a result of heart disease or any cardiovascular or respiratory disease of a chronic nature to be eligible for a benefit. Sub. S.B. 340 would independently allow the board to waive the requirement that the disease was not documented by a physical examination. The board, by rule, may accept specified competent medical evidence that the disease was or was not evident prior to service with a police or fire department.

The current law states that a member can receive a partial disability award from an injury or illness incurred within a member's official duties or from an injury or illness not caused by the performance of a member's official duties. The partial disability standard is an injury or illness that must prevent the member from performing their official duties and impairs the member's earning capacity. To evaluate this standard for a disability application, a disinterested physician and vocational evaluator will examine the illness or injury in relation to member's defined occupational duties. A written report summarizing the findings and medical opinions is submitted to the Board for final determination. This standard is applicable for a member of the fund who is suffering from heart disease or any cardiovascular or respiratory disease of a chronic nature. However, the heart disease or any cardiovascular or respiratory disease of a chronic nature must not have been revealed in the physical examination required on entry to a police or fire department. The reasoning being that the condition is presumed to have developed during service if it was not detected prior to commencing service as a police officer or firefighter.

Sub. H.B. 648 (eff. 9/16/1998) adopted recommendations from the comprehensive Mercer disability study, which strengthened disability standards in OP&F. The bill required the board to adopt objective criteria to administer its disability process to provide greater uniformity throughout the retirement systems. The bill separated the disability standards from the retirement eligibility section and codified the disability rules used to administer the process in §742.38. Among the disability provisions implemented, the board adopted statewide minimum standards for physical examinations for prospective members, which included an evaluation of the existence of any heart disease or cardiovascular or respiratory disease of a chronic nature. It also carried penalties for employers that did not comply with and incorporate the standards in the physical examination. It also prescribed fines for employers that did not provide the board with the report 30 days after the prospective member's examination. This provision was adopted to assist OP&F in determining which disabilities were developed on-duty and which existed prior to service.

Sub. S.B. 340 would allow the board and the member to use other evidence in the disability application process, beyond a traditional physical examination, to prove that a member's disease was or was not present at the time of entry into a department. The bill would codify the board's ability to use different medical tests from doctors, cardiologists and respiratory specialists to determine if the member had the condition prior to service. Medical conditions often require multiple opinions to provide an accurate diagnosis, which the bill appropriate recognizes; however, expanding the types of tests and

competent medical evidence for the disability application process will erode uniformity in the disability process, potentially leading to "doctor shopping" for test results. The effect of this provision would be negligible due to the fact that the board has final say in determining disability. But we find the expansion of eligible types of evidence could lead to a scenario in which the legitimacy of certain medical tests that produce conflicting evidence is challenged.

Nonetheless, Sub. S.B. 340 would strengthen the disability standard by requiring partial disabilities to also be permanent. The section defines "permanently disabled" as a condition of disability from which there is no present indication of recovery. Under the partial disability standard, a member need only suffer injury or illness, which prevents them from performing their official duties and impairs their earning capacity. By adding "permanent" to the partial disability standard, it would therefore require a member's injury or illness to be such that it prevents them from performing their duties, impairs the member's earning capacity and also have no present indication of recovery. This would set a stricter standard and if there was any indication of recovery, a member would not be eligible for a disability benefit.

Deferred Retirement Option Program – (R.C. §742.3716 (E), §742.443, §742.444) Sub. S.B. 340 would eliminate the COLA for members that elect to participate in the DROP on or after 7/2/2013. For members in the DROP prior to 7/2/2013, the bill would defer the COLA until the member was age 55 with one full YOS in the DROP. Sub. S.B. 340 would change the accrual schedule for a member that elects to participate in the DROP on or after 7/2/2013. The bill would allow a member to accrue 50% of their contributions from the start of DROP up to three years; accrue 75% for years four and five; and accrue 100% of their contributions for the years after, up to eight years. For members who elect to participate in DROP on or after 7/2/2013, Sub. S.B. 340 would increase the minimum participation time to five full years of service in DROP to receive the accrued interest on member contributions. Otherwise, the bill provides a member would forfeit the entire accrued interest if service were terminated prior to completing five full years in DROP. For members that elect to participate in the DROP prior to 7/2/2013, three full years is the minimum participation time to receive the entire accrued interest.

Currently, a DROP member is eligible to receive the flat 3% COLA after one year of receiving a pension. In DROP, 50% of a member's contributions accrue to their benefit during the first two years of participation. The member accrues 75% of their contributions in the third year of participation and 100% of contributions thereafter until separation. A member is eligible to receive all accrued interest on member contributions during DROP after three full years of participation.

The adjustments to the DROP would capture more employee contributions due to the expansion of years of reduced member accruals and due to delaying the minimum time to five years to receive the full accrual with interest. The adjustments would allow OP&F to maintain the incentives of DROP while incurring financial gains from these provisions.

Eliminating the COLA from the DROP for future members, in tandem with the deferral until age 55 for current members, would increase savings to the fund.

Sub. S.B. 340 would increase retirement eligibility to age 52, which would increase the entry and exit age in DROP. Under the bill, DROP members that participate for the entire duration of DROP would be age 60 by the end of service. OP&F members must maintain rigorous fitness standards and be able perform all the require duties of either a police officer or a firefighter. However, the provision raises the concern that the disability rate could still increase among older OP&F members. The physical demands of policing and firefighting are tremendous and do not become easier with age, regardless of fitness standards. Thus, close attention should paid if rates begin to rise, which would nullify any savings from requiring members to serve longer.

OP&F Reports – (R.C. §171.04, §742.14, §742.16, §742.30, §742.45) Sub. S.B. 340 would require the actuarial valuation to be completed every three years, which determines the amortization period for the pension's accrued liabilities and the accounting of the health care fund. The bill would remove the requirement that OP&F report in any year the amortization period falls outside the 30-year amortization requirement to match the triennial reporting schedule. The bill would no longer require OP&F to report biennially during the first regular session of the General Assembly (GA). Sub. S.B. 340 would allow OP&F to update the GA every three years on the status of the pension fund and employer's accrued liability.

Current law states that OP&F must conduct and submit an independent annual actuarial valuation that measures actuarial assumptions and methods, the adequacy of contribution rates to amortize the unfunded actuarial pension liability. A full accounting of the revenues, costs, liabilities and benefits of the health care is also required annually. Also if in any year, the time period to amortize the pension fund is greater than the 30-year amortization requirement, OP&F must complete and submit a new plan that can amortize the liabilities within the 30-year period. This schedule is consistent with all of Ohio's public pension funds. OP&F reports to each new GA during the first regular session to update the new assembly. The report to the GA is a presentation on the condition of the OP&F pension fund. OP&F briefs the GA on the ability to pay the employer's accrued liability and makes recommendations, after consultation with their actuary, as it considers necessary to properly fund employer liabilities.

The actuarial valuation and health care reports are vital to the sustainability of the pension fund. They provide an in depth diagnosis of the fund's actuarial assumptions, amortization period for accrued liabilities and the sustainability of the benefit structure. While pension plans must be looked at on a long-term basis, annual reports are useful to scrutinize the components of the plan to test, identify and rectify any issues. Inconsistency in a single element can upset broader assumptions upon which pensions rely. Issues that arise in any given year, such as a severe negative fiscal experience, would go unaddressed and thus would become intensified by the time the pension is evaluated. Finally, the triennial reporting cycle is inconsistent with the annual reporting cycle of the four other Ohio public pension systems.

The biennial report to the new GA in the first full session is intended to update legislators on the pension liabilities the State has guaranteed public employees. The report details the employer's contribution rate and the employer's funding policy to pay off the accrued liabilities. The GA is seated every two years and a triennial reporting cycle would bypass a full GA. Moving the report to every three years might increase efficiency for OP&F but it would undermine public transparency and the GA's ability to provide pension oversight as to the funding policy toward their accrued liabilities. Reporting to the GA to ensure appropriate funding and solvency is imperative since the State is ultimately liable for the pensions guaranteed to Ohio's public employees.

We recommend removing the provision that allows OP&F to complete the actuarial valuation every three years instead of annually. We recommend removing the requirement that OP&F report to the GA regarding their accrued liability every three years instead of every two years in the first full session of the GA.

Membership – (R.C. §742.01 (E)) Sub. S.B. 340 would allow members of the Ohio National Guard, Ohio military reserve, Ohio naval militia or a reserve component of the armed forces who are called to service by an Executive Order from the President or Act of Congress, to be considered members of the fund for the duration of active military service.

Currently, members of OP&F must contribute a percentage of annual salary to the fund or be receiving a disability or pension benefit as a result of service in a police or fire department. Persons that are separated from service in a police or fire department will remain a member of the fund for a period of 12 months provided the sum of contributions deducted from a person's salary remains on deposit with the fund.

This provision in Sub. S.B. 340 is necessary to comply with federal law. The bill authorizes service members who are called to active service to remain as "members of the fund" for the duration of their deployment. The current language would technically remove OP&F members deployed to active service for longer than 12 months. This would have unintended and adverse consequences for OP&F members called to serve their country. Sub. S.B. 340's provision recognizes that military service deployments often last longer than 12 months. This would accommodate numerous OP&F members who are also members of the armed services in the event they are deployed longer than 12 months.

Fiscal Impact

The OP&F actuary, Buck Consultants, determined that Sub. S.B. 340's proposed changes would enable the pension fund to reduce its liabilities by $3.2 billion and amortize the pension in 30 years. The pension would move from 72.8% funded position to a funded position of 76.8%. The savings in Sub. S.B. 340 would allow OP&F to contribute 10.42% to the unfunded accrued liability (UAL). On top of the changes proposed in this bill, the contribution rate to the Health Care Stabilization Fund would be reduced to 4.69% and would be projected solvent by year 2027.

The PTA/KMS report found that 40% of the present value of future benefits is due to currently retired and inactive members. Delaying the COLA until age 55 and eliminating the COLA from DROP would combine to produce the largest cost savings. According to the OP&F actuary, the COLA changes would save nearly $1.3 billion and it would continue to generate long-term gains. Prior to the passage of Sub. S.B. 340, the DROP interest rate was changed from 5% to the 10-year Treasury rate, capped at 5%. According to the OP&F actuary, the switch to the 10-year Treasury rate, currently at historic lows, has provided $17 million in savings to date.

Staff Recommendations

The staff recommends the Ohio Retirement Study Council vote to recommend that the 129th General Assembly vote to approve Sub. S.B. 340 with the following amendments:

- *Remove the provision that allows OP&F to complete the actuarial valuation every three years instead of annually. Remove the requirement that OP&F report to the General Assembly regarding their accrued liability every three years instead of every two years in the first full session;*

- *Adopt a contribution-based anti-spiking measure, similar to that established under Sub. S.B. 343 (OPERS, Pension Reform). We further recommend the salary benchmark provision be applied equally to all members;*

- *Include language that states COLAs granted after effective date of bill are not vested;*

- *Remove the board authority provisions and allow the ORSC to study further to ensure legislative oversight of future changes or to develop with appropriate language to add safeguards to the board's ability to determine employee contributions and retirement eligibility without legislative input;*

- Remove language that gives the board authority to set the definition of "salary" and "terminal pay" and remove language increasing the time period overtime can be paid and still counted as "salary."

At its meeting of September 10, 2012, the Ohio Retirement Study Council voted to accept the Staff recommendations.

Effective Date

January 7, 2013; certain sections effective 180 days later.