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October 4, 2001

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

Re: Senate Bill 134

Dear Aris:

As requested, we have reviewed the actuarial cost statement prepared by Watson Wyatt dated July 19, 2001 regarding Senate Bill 134, "SB 134", which would establish a Deferred Retirement Option Plan, "DROP", in the Ohio Police & Fire Pension Fund, "OP&F".

Summary of Conclusions

The conclusions resulting from our analysis of this bill are summarized below.

1. SB 134 would be affordable in the sense that it would satisfy the 30-year funding requirements of SB 82 based on the actuarial assumptions utilized by Watson Wyatt if 0.25% to 0.50% of the employer contribution rate were allocated from Health Care to Pensions.
2. If actual experience is favorable, offering DROP could assist OP&F in managing the Health Care program within current contribution limitations.
3. If actual experience is unfavorable, the Board will have the flexibility to modify or cease offering DROP.

Proposed DROP

The bill would require the OP&F Board to establish a DROP. Participation in DROP would be limited to members who are age 48 and complete 25 years of service.

Members participating in the DROP would not accrue any additional service credit in OP&F or be eligible for the health insurance provided by OP&F as long as they participate in the DROP. While participating in the DROP, the following amounts would be credited to the member's DROP account:

1. The retirement allowance based on the member's service credit and average salary at the time he joined the DROP;
2. Annual COLAs granted by OP&F;
3. 50% of the member's contributions made during the first two years of participation in the DROP, 75% of the member's contributions during the third year of participation in the DROP and 100% of the member's contributions thereafter; and,
4. Interest at a rate determined by the Board.

At the time of the member's termination of active service and retirement, the balance of the DROP account would be payable. If the member participated in DROP for 3 or fewer years, the DROP account balance would be paid without interest. If the member participated in DROP for more than 3 years, the DROP account balance would be paid with interest.

In the event a member participating in DROP does not terminate active service and retire within 8 years of electing to participate in DROP, the member would forfeit the accrued DROP account balance. Upon subsequent retirement, the member's retirement allowance would be calculated as if the member had never elected to participate in DROP.

In the event the member becomes disabled during participation in DROP, he will have the option to receive a disability award. If he so elects, he will be treated as if he had never elected to participate in DROP.

In the event a member dies while participating in DROP, the member's death benefit will include:

1. The member's DROP account balance with interest;
2. A surviving spouse benefit based on a joint and 50% survivor annuity; and,
3. The monthly survivor benefit of $550 adjusted for COLAs beginning July 2000 (and, if eligible, surviving child(ren) or dependent parent(s) benefits).

The bill would require an actuarial investigation of the DROP at least once every five years to determine whether DROP has a negative financial impact on OP&F. In the event that it does have a negative impact, the Board will be permitted to either:

1. Modify DROP, or
2. Cease to allow additional members to elect to participate in DROP.

In the event the Board ceases to allow members to participate in DROP, the rights of members who had previously elected to participate would not be affected.

Actuarial Cost of the Bill

Adding a DROP to OP&F could either increase or decrease the long-term cost of the system.

Pension costs will increase to the extent that members who would have delayed retirement under current law elect to participate in the DROP. By electing to join the DROP, their pensions will commence earlier than otherwise.

Offsetting the increased pension costs are savings due to the following:

- Health insurance costs will be reduced to the extent that members who participate in DROP delay retirement; and,
- Member and employer contributions will continue while members continue to participate in DROP.

Watson Wyatt, “Wyatt”, OP&F’s actuary, prepared an actuarial analysis of SB 134 dated July 19, 2001. Based on their analysis, they concluded that the bill is “cost neutral”. Their analysis was based on member data as of January 1, 1998.

Wyatt’s analysis was based on the assumptions that:

1. The majority (60%) of the members who currently retire at first eligibility for unreduced pension (age 48 with 25 years of service) will forgo retirement and elect to participate in DROP instead;
2. All members who delay retirement past first eligibility under current law will elect to participate in DROP; and,
3. Members who participate in DROP will tend to defer retirement (relative to current retirement rates) until they have participated in DROP for four years.

To illustrate items 1 and 2 above, the current actuarial assumption is that out of 100 members attaining age 48 with 25 years of service, 35 will retire immediately and 65 will defer retirement for one or more years. For purposes of analyzing SB 134, Wyatt assumed that 60% of the 35 members (who currently retire at age 48) would elect DROP and defer their retirement. In addition, they assumed that all 65 of the members (who currently defer retirement beyond age 48) would also elect DROP.

Wyatt shared with us some experience data from a large city police and fire system that had higher election rates and longer delays in retirement than those assumed for OP&F. We have worked with several DROP programs where the election rates were lower than the assumptions utilized.

On balance, Wyatt's assumptions seem reasonable to us. But there is a significant degree of uncertainty associated with them. Differences between Wyatt's projections and actual costs will depend on the extent to which future experience conforms to the assumptions. It is certain that actual experience will not conform exactly to the assumptions used. Actual costs will differ from projected amounts to the extent that actual experience deviates from the assumptions.

SB 134 allows OP&F's Board to modify the DROP program in the future if experience is unfavorable. Changes could involve adjustments in the rate at which interest is credited to DROP accounts or other regulations established by the Board that govern DROP. In addition, the Board will have the ability to close the DROP program and cease accepting new elections into DROP. Thus the Board will have the ability to make significant changes in DROP in order to manage its cost.

<u>30-year Funding Period</u>

Senate Bill 82 requires that OP&F have a funding period for its Unfunded Actuarial Accrued Liability, "UAL", of 30 years or less by January 2006. Wyatt did not estimate the effect of SB 134 on OP&F's UAL or its funding period. Therefore we prepared such an estimate based on Wyatt's actuarial analysis. The results are summarized below for the combined Police and Fire groups.

($ Amounts in millions)

	1/1/2000 Actuarial Valuation – Current Law	Estimated Effect of SB 134	Estimated Actuarial Valuation as of 1/1/2000 as if SB 134 had been enacted as of that date
Employer Normal Cost	9.52%	0.41%	9.93%
Unfunded Actuarial Liabilities	$1,007.0	$112.2	$1,119.2
Funding Period for UAL	27 years	14 years	41 years
Member Contribution Rate	10.00%	0.00%	10.00%
Combined Employer Rate*	21.44%	0.00%	21.44%
Health Care Rate	7.25%	0.00%	7.25%
Employer Rate to fund UAL	4.67%	(0.41%)	4.26%

* The actual employer rates are 19.50% for police and 24.00% for firefighters.

The 41 year funding period indicated above would not comply with the 30-year funding period requirement of SB 82, which requires that OP&F have a funding period of 30 years or less by January 2006. The 41 year funding period shown above would only decline to a 36 year funding period by 2006 in the absence of actuarial gains.

Reallocating the employer rate so that more is allocated to pension benefits could decrease the funding period. Wyatt has indicated their intention to recommend a reduction of 0.25% to 0.50% in the portion of the employer contribution rate allocated to health care in the event SB 134 is enacted. A reallocation of 0.25% from health care to pensions would be adequate to bring the funding period down to 36 years, based on our estimates shown above. That would put OP&F exactly on target for achieving the 30-year funding period target by 2006.

Effect on Health Care Stabilization Fund

As indicated in Wyatt's actuarial analysis, there would be savings in health care costs if SB 134 were enacted based on their assumptions. To estimate the long-term effect of a reduction in the employer contribution rate allocated to the Health Care Stabilization Fund, "HCSF", we estimated the savings in health care costs due to DROP using Wyatt's assumptions. Our estimates indicate that savings in health care costs would be approximately 0.50% of payroll over the next 30 or so years based on Wyatt's assumptions. Thus, the employer contribution rate allocated to the HCSF could be reduced by 0.25% to 0.50% without adversely affecting the HCSF.

Note this does not indicate that there will be no challenges in managing the OP&F's health care program and the HCSF. It merely indicates that the enactment of SB 134 would not adversely affect the health care program or the HCSF if future experience were in accord with Wyatt's assumptions. As we have indicated in previous reports to ORSC, we believe that the OP&F Board will be challenged to manage the health care program and that significant increases in retiree contributions or reductions in benefits will be required in the future. The enactment of a DROP option could have a favorable effect on the ability of OP&F to support health care benefits to the extent that member's elect to participate in DROP and delay their retirement.

Data Reliance

In preparing this report, we have relied on the reports and other information provided by Wyatt and OP&F. We have not audited or verified these reports and other information. If those reports or information are 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.

Please let us know if you have any questions or if you need any additional information.

Sincerely,

William A. Reimert

Katherine A. Warren

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