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

Re: Adequacy of OP&F Contribution Rates

Dear Aris:

As requested, we have reviewed the adequacy of the current statutory contribution rates to the Ohio Police and Fire Pension Fund, "OP&F", based on the results of the January 1, 2005 Actuarial Valuation of OP&F dated December 14, 2005. This review is in response to the requirement of Section 742.311 of the ORC that the ORSC review the adequacy of OP&F's contribution rates and make recommendations to the Ohio General Assembly for the proper financing of the benefits provided by OP&F.

Summary

The valuation report indicates that, based on the current allocation of the statutory contribution rates, the Unfunded Actuarial Accrued Liability, "UAL", has an infinite funding period; i.e., the UAL can be expected to grow indefinitely into the future. An infinite funding period was reported in each of the prior two valuation reports also. Thus OP&F's current statutory contribution rates are not adequate to support both:

1. ***the statutorily mandated benefits within the 30 year limitation on the funding period in Section 742.16 of the ORC; and,***
2. ***the discretionary health insurance benefits provided by the Board to retirees and their dependents and beneficiaries in accordance with Section 742.45 of the ORC.***

In order for a retirement system to be "actuarially sound", it needs to have sufficient assets and dedicated future contributions to cover the actuarial value of all benefits it will pay. Since the Ohio Retirement Systems use the Entry Age Actuarial Cost Method, this means that the future employer and member contributions must be adequate to pay the system's normal cost and amortize its UAL over a reasonable timeframe. If the contributions are not adequate to cover the normal cost and amortize the UAL, the system's UAL will grow indefinitely, ***gradually disfunding the retirement system***.

The fact that the UAL grows over the short term does not mean that the retirement system is actuarially ***un***sound. Some amortization schedules will produce increasing UAL's over the near term even though the scheduled amortization payments will ultimately fully fund the UAL. Moreover, fluctuations in investment and other actuarial experience should be expected. Such fluctuations will cause the UAL to increase or decrease from year to year.

But if a retirement system has an infinite funding period for the UAL, it means that the UAL is expected to continuously grow into the future. This should be deemed to be an unacceptable situation. Moreover, the cost of bringing the funding period into compliance with the 30-year funding period requirement will grow the longer corrective action is delayed.

The OP&F Board is required to develop a plan to meet the 30-year funding period requirement by Section 742.16 of the ORC. We will be glad to review that plan when it is provided to the ORSC.

Recommendations regarding Contribution Rates and Benefits

Alternative A: Continue current discretionary health insurance and mandated pension, survivor and Medicare Part B premium reimbursement benefits

If the Legislature intends for OP&F to continue to provide discretionary health insurance benefits to OP&F retirees and their dependents, one or more of the following steps will need to occur.

- ***The statutory employer and/or member contribution rates to OP&F will need to be increased.***
- ***State subsidies will need to be provided to OP&F.***
- ***The pension, survivor and/or Medicare Part B premium reimbursement benefits mandated by statute will need to be reduced.***

Our reports entitled *Review of the Adequacy of the Contribution Rates to OP&F, SERS and STRS* dated November 5, 2003 and February 11, 2004 discussed these alternatives and illustrated the magnitude of the contribution and/or benefit changes required.

For example, if the Legislature intends to address the infinite funding period by increasing contribution rates, the infinite funding period could be reduced to 30 years while maintaining the 7.75% contribution rate allocation to health insurance benefits (including the Medicare Part B premium reimbursements) if:

- The employer contribution rate were increased by 5.0% of payroll to 24.5% for Police and 29.0% for Fire Members; or
- The member contribution rate were increased by 5.5% of payroll for both Police and Fire Members to 15.5%; or
- Half of the increase were funded by employers through a 2.5% of payroll increase in the employer contribution rates and half of the increase were funded by members through a 2.75% of payroll increase in the member contribution rates.

(The member contributions would need to increase more than employer contributions because a portion of the member contribution would be refunded to members who leave prior to becoming eligible for a pension.)

Obviously, other combinations of contribution rate increases, subsidy payments and/or benefit changes would also be possible.

<u>Alternative B: Continue current level of contribution rates</u>

If the legislature intends for OP&F to actuarially fund the mandated pension, survivor and Medicare Part B premium reimbursement benefits within the 30-year funding period requirement effective this year for OP&F but without increasing the current contribution rates or providing a State subsidy, then the OP&F Board will need to significantly reduce or eliminate the discretionary health insurance benefits currently provided to retirees and their beneficiaries.

<u>Recommendation to equalize Police and Fire Contribution Rates</u>

As indicated below, the normal cost of the benefits provided to Police are substantially the same as the normal cost of the benefits provided to Fire Members. Thus there is no apparent cost justification for the higher contributions required by employers of Fire Members who contribute 24.0% of payroll versus the 19.5% of payroll contributions required for Police Members. We have noted this in past reports to the ORSC and have recommended, and continue to recommend, that these rates be equalized. The OP&F

actuary in 2001, Watson Wyatt Worldwide, made a similar recommendation in their January 1, 2001 actuarial valuation report.

Recommendations regarding future Actuarial Valuations

Post-retirement mortality assumption

OP&F's 2005 actuarial valuation report indicated that there were significant actuarial losses during 2004 due to retirees and beneficiaries living longer than assumed. Significant actuarial losses from this same assumption were also reported in the prior two actuarial valuation reports with respect to experience during 2002 and 2003. The magnitude of these losses coupled with the fact that they have been reported in each of the past three years suggests that the current actuarial assumption regarding the life expectancy of retirees and beneficiaries may be materially deficient relative to current mortality. Moreover, the assumption provides no margin for reasonable expectations regarding continued improvement in life expectancy. We recommend that this assumption be reviewed by the OP&F actuary and Board prior to the preparation of the 2006 actuarial valuation, rather than waiting for the next regularly scheduled review of the assumptions in 2007.

Actuarial Cost of the Mandated Medicare Part B Premium Reimbursements

Since the Medicare Part B premium reimbursements are a benefit mandated by statute, we recommend that the 2006 and subsequent OP&F actuarial valuation reports include the actuarial cost of providing these benefits. (We recommended two years ago that the actuarial valuation reports of HPRS, OP&F, PERS and STRS include this information.) That information is necessary for the ORSC to appraise the adequacy of OP&F's employer and member contribution rates. (Note, OP&F will need to start disclosing the actuarial cost of providing all mandated and discretionary health insurance benefits in their 2006 financial statements in accordance with the requirements of Statement No. 43 of the Governmental Accounting Standards Board *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. Separate disclosure of the actuarial cost of the mandated Medicare Part B premium reimbursements in the actuarial valuation reports will allow the ORSC to determine the adequacy of the contribution rates to fund all mandated benefits, including the Medicare Part B premium reimbursements.

Background

The following table summarizes the number of members covered by OP&F and the results of the 2005 and 2004 actuarial valuations of OP&F.

Date	January 1, 2005	January 1, 2004	% change
Active members	27,735	28,268	(1.9%)
Retirees and beneficiaries	24,340	24,136	0.8%
Active Member Payroll (annualized)	$1.64 billion	$1.60 billion	2.5%
Actuarial Accrued Liability	$11.55 billion	$10.80 billion	6.9%
Actuarial Value of Assets	$9.34 billion	$9.34 billion	0.0%
Unfunded Actuarial Accrued Liability	$2.21 billion	$1.46 billion	51.4%
Funded Ratio	80.9%	86.5%	(5.6%)

Most of these figures indicate a relatively stable situation, as should be expected of a mature retirement system such as OP&F. For example, the number of active members declined slightly, while the number of retirees and payroll grew modestly. The significant percentage growth in the UAL is attributable to leveraging since assets cover a large portion of the Actuarial Accrued Liabilities. Since the Actuarial Accrued Liabilities grew $750 million while the Actuarial Value of Assets remained relatively unchanged, the UAL grew significantly – from $1.46 billion to $2.21 billion – and the Funded Ratio declined from 86.5% to 80.9%.

Current Contribution Rates

The following table summarizes the current employer and member contribution rates to OP&F.

Employer and Member Contribution Rates under current law

	Police	Fire	Combined
Employer contribution rate	19.50%	24.00%	21.56%
Member contribution rate	10.00%	10.00%	10.00%
Total Employer and Member contribution rates	29.50%	34.00%	31.56%

Contribution Rates necessary to fund Statutorily Mandated Benefits

Pension and Survivor Benefits

The following table summarizes the normal cost and amortization rates necessary to fund the pension and survivor benefits provided by OP&F based on the results of the January 1, 2005 actuarial valuation. The contribution rate that would be necessary to fund (or amortize) the UAL over 30 years was calculated by Milliman.

Contribution Rates necessary to fully fund the Statutory Pension and Survivor Benefits

	Police	Fire	Combined
Normal Cost	20.98%	20.90%	20.94%
Unfunded Accrued Liability Contribution rate required to meet 30-year funding period	8.15%	7.52%	7.86%
Total Contribution Rates needed to fully fund Statutory Pension and Survivor Benefits	29.13%	28.42%	28.80%

Medicare Part B Premium Reimbursements

The January 1, 2005 actuarial valuation of OP&F did not measure the actuarial cost of the Medicare Part B premium reimbursements that are required by statute. In order to estimate the cost of these mandated benefits, Milliman updated a rough estimate we had prepared of the cost of these premium reimbursements in our work for the ORSC in 2004, which indicates that the actuarial cost of funding these statutorily mandated benefits is roughly 2.25% of payroll (assuming a 30-year amortization of the unfunded actuarial liabilities attributable to these benefits.) We did not attempt to develop separate figures for the cost of these benefits to Police vs. Fire Members since that was beyond the scope of this assignment.

Adequacy of Current Contribution Rates

The following table compares the current employer and member total contribution rates with the contribution rates necessary to fund all statutorily mandated benefits; i.e., both (a) the pension and survivor benefits and (b) the Medicare Part B premium reimbursements. It indicates that the current employer and member contribution rates could be reallocated to fully fund the statutorily mandated pension and survivor benefits and the Medicare Part B premium reimbursements on a combined basis. But fully funding those benefits in compliance with the 30-year funding limitation in Section

742.16 of the ORC would require a significant reduction in, or the elimination of, the allocation to discretionary health insurance benefits.

Comparison of current contribution rates with the rates necessary to fund the Statutory Pension and Survivor benefits and Medicare Part B premium reimbursements

	Police	Fire	Combined
Cost of Pension and Survivor Benefits	29.13%	28.42%	28.80%
Estimated Actuarial Cost of Medicare Part B premium reimbursements	2.25%	2.25%	2.25%
Total	31.38%	30.67%	31.05%
Employer and Member Contribution Rates	29.50%	34.00%	31.56%
Residual Contribution Rates available to fund discretionary health insurance benefits	(1.88%)	3.33%	0.51%

The current statutory contribution rates are NOT adequate to both (1) fully fund the statutorily mandated pension and survivor benefits and (2) allocate 7.75% of payroll to the Medicare Part B premium reimbursement and discretionary health insurance benefits. On a combined basis, only roughly 2.76% (31.56% less 28.80%) of payroll is available to provide health insurance benefits *including* the Medicare Part B premium reimbursements. Since we estimated that roughly 2.25% of payroll is required to actuarially fund the Medicare Part B premium reimbursements, only roughly 0.51% of payroll is available to provide discretionary health insurance benefits.

Purpose of Review

This review is in response to the requirement of Section 742.311 of the ORC that the ORSC review the adequacy of OP&F's contribution rates. This review is to determine whether the current contribution rates, which are established by statute, remain adequate to fund the retirement system and, if not, indicate the magnitude of changes in contribution rates and/or benefit provisions that may be appropriate to restore each system's actuarial status.

The above analysis addresses primarily the pension benefits and Medicare Part B reimbursements mandated by Ohio statutes. It addresses discretionary health insurance benefits only to the extent that a portion of the maximum statutory rates is currently allocated to provide such benefits. To the extent that the portion of contributions allocated to such discretionary health insurance benefits is redirected to restore the actuarial status of each system's mandated pension and survivor benefits and Medicare Part B reimbursements, the discretionary health insurance benefits would need to be reduced or eliminated.

Basis for Review

This review is based on the results of the most recent Actuarial Valuation prepared for OP&F as of January 1, 2005.

In performing this analysis, we relied on the data and other information provided by the system and its consulting actuary. 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 figures used directly in our analysis for reasonableness and consistency and have not found material defects in them. 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 us know if you have any questions.

Sincerely,

Glenn D. Bowen

William A. Reimert

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