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June 6, 2002

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

Re: Review of OP&F contribution rates

Dear Aris:

Pursuant to section 742.311 of the Ohio Revised Code, we have reviewed the adequacy of the Ohio Police and Fire Pension Fund, "OP&F", contribution rates. This review is based on the Actuarial Valuation as of January 1, 2001 and the 2001 Report on the Solvency of the Health Care Stabilization Fund both prepared by Watson Wyatt, OP&F's consulting actuary.

Summary Conclusions/Recommendations

Based on the above reports,

1. OP&F will have a funding period of slightly more than 30 years as of January 2007, when the 30-year funding period limitation of Senate Bill 82, effective 1997, first applies to OP&F. Thus there is no margin for benefit increases or adverse actuarial or investment experience between now and that date.
2. The OP&F Health Care Stabilization Fund is projected to be exhausted during 2008. Increases in contributions from employers, active or retired members or the State or reductions in health insurance benefits will be necessary before that date. If such actions do not occur, Watson Wyatt's projections indicate that the retiree contributions will need to be increased at that time to 7 times their current level in order to continue current levels of insurance coverage to retired members and their dependents and beneficiaries.
3. The statutory contribution rates applicable to police officers and firefighters should be equalized. The current rates (19.5% for police officers and 24.0% for firefighters) result in firefighters subsidizing the cost of providing benefits to police officers.

Summary of the Watson Wyatt reports

The major conclusions and recommendations from these two Watson Wyatt reports are summarized below by subject.

30-year funding limit under SB 82

- "Based on the results of this valuation and the 1998 Forecast Study, it is our opinion that, under current benefit provisions, the funding objective can be met, but this may require a decrease in the ultimate 8% employer-allocation to the Health Care Stabilization Fund. Investment performance, membership growth, and retirement patterns over the next five years will all be key factors in determining if the decrease is needed and how much it should be." – cover letter valuation report
- "Based on the results of the 30-year forecast study dated April 10, 1998, the requirements of SB 82 will be met, provided that the Fund's investments return an annual average of 8.5% before investment expenses, during the 30-year period and the Board continues to effectively manage net health care costs. Such management may include increasing member premiums or revising the health care benefits." – page 12 valuation report
- "The results of this (the January 1, 2001) valuation are, overall, somewhat less favorable than the expected results of the forecast. Specifically, unfunded actuarial accrued liability as a percentage of payroll is 71.63%, compared to 64.11% in the forecast, and the funded status of 89.93% compares to 91.01% from the forecast. In addition, asset performance during 2001 may result in valuation results for 2002 and later years which are more unfavorable when compared to the forecast. However, other factors such as growth in active membership, changes in retirement patterns and a possible capital market rebound could mitigate this effect. If this does not happen, it will be necessary to either allocate less to Health Care Stabilization Fund in order to achieve the pension funding restrictions of SB 82 or determine new statutory rates." – page 12 valuation report

Solvency of Health Care Stabilization Fund, "HCSF"

- "The HCSF balance is expected to grow to a peak of approximately $286 million as of January 1, 2003. The HCSF then begins to decline until the fund is depleted sometime in the year 2008." – page 2 solvency report
- "Comparing this scenario to the 2000 HCSF report shows that the expected longevity of the HCSF has been reduced from year 2014 to year 2007." – page 2 solvency report
- "… the "pay-as-you-go" funding rate … is estimated to be 8.34% for 2001, above the 7.50% funding allocation. Also, the rate steadily increases by about .6% each year through 2027." – page 2 solvency report

Statutory employer contribution rates

- "… an adjustment should be made to eliminate the disparity between police and firefighters statutory rates, and to ultimately enable both groups to satisfy the 30-year amortization period." – page 11 valuation report

30-Year Funding Period

Senate Bill 82, effective March 7, 1997, requires that all of the five Ohio Retirement Systems limit the funding period for unfunded actuarial liabilities to 30 years. This limitation applies currently to four of the five systems and is to become effective in 2007 for OP&F. The January 1, 2001 actuarial valuation of OP&F indicates that the funding period is currently 29.49 years on a combined basis based on the 7.50% allocation to the HCSF in 2001. The funding period increases to 38.1 years when adjusted to reflect the increase in the portion of the statutory contribution rate allocated to the HCSF to 7.75% in 2002 and 8.0% in 2003. Thus absent any gains due to favorable experience, the funding period would be 32.1 years as of January 1, 2007 which is slightly higher than the 30-year limit.

All else being equal, this is not necessarily a cause for concern since factors such as growth in the number of members could reduce the funding period to the 30-year limit by that time. But this projection does indicate that there is no margin for adverse experience.

As of January 1, 2001, the actuarial value of assets ($8,463.7 million) was $313.9 million less than the market value of OP&F's assets ($8,777.6 million). Thus OP&F had deferred the recognition of $313.9 million of gains. During 2001, OP&F earned actual investment returns of (3.83%), which is 12.08% less than the actuarial assumed rate of 8.25%. Based on the January 1, 2001 actuarial value of assets, this 12% shortfall produced an actuarial investment loss of over $1 billion in 2001 and offset the $313.9 million of gains deferred as of the beginning of 2001. We do not have sufficient information to estimate how much of these losses will be recognized in 2002 with the balance deferred to 2003 and later years. Some very significant actuarial gains will be needed during 2002 and subsequent years or significant favorable data changes will need to arise from the "data clean-up" project undertaken by OP&F to offset these losses. Otherwise, OP&F will not be able to meet the 30-year funding period requirement by 2007.

Health Care Stabilization Fund

As indicated above, the 2001 Report on the Solvency of the Health Care Stabilization Fund indicates that the HCSF will be exhausted sometime during 2008. Unless future experience is significantly more favorable than assumed in the Watson Wyatt projections, in order to prevent this from occurring, one or more of the following actions will be required.

1. The statutory employer and/or member contribution rates will need to be increased.
2. Retired member contributions will need to be increased.
3. The health care benefits provided to OP&F retirees, dependents and beneficiaries will need to be decreased.

If the statutory employer and/or member contribution rates are increased, the portion of the statutory employer rate allocated to the HCSF can be increased without decreasing the portion of the rate allocated to pensions. As noted above, the portion of the statutory rate allocated to pensions is slightly less than the amount required to achieve the 30-year funding period goal by January 1, 2007.

Exhibit 2 of the solvency report indicates that the “pay-as-you-go” rate will be 12.94% in 2008, the year the HCSF is projected to become depleted. If no changes were made during the interim and experience were in accord with the assumptions used for their projection, the current schedule of retiree member contributions would have to be increased in 2008 to 7 times the current schedule, or from roughly 6% of total retiree health insurance costs to 42% of total costs, in order to continue the health care benefits during that year. Clearly modifications will be necessary between now and 2008 in the current schedule of retiree contributions, insurance benefit levels or member and employer contribution rates in order to avoid such a possibility.

A reduction in health care benefits could be accomplished in many ways such as by increasing deductibles and/or co-pays or by limiting covered services.

Disparity in Statutory Contribution Rates

By statute, the employer contribution rate applicable to police officers is 19.50% and to firefighters is 24.00%. The January 1, 2001 actuarial valuation indicates that on a combined basis these rates will fund the unfunded actuarial liabilities over 29.49 years, assuming that the 7.50% of these rates are allocated to the HCSF. But on a stand-alone basis, the 19.50% rate applicable to police officers is unable to finance the unfunded actuarial liabilities attributable to police officers. On the other hand, the 24.00% applicable to firefighters could finance the unfunded actuarial liabilities attributable to firefighters over 7.07 years. As a result, Watson Wyatt recommends that the statutory rates applicable to police officers and firefighters be equalized. We have also recommended such a change since 1994.

If the current statutory rates are not equalized, the employers of the 12,131 firefighters covered under OP&F will continue to subsidize the pension costs for the employers of the 15,702 police officers covered under OP&F.

Watson Wyatt's actuarial valuation report indicates that a composite rate of 21.47% would be equivalent to the current 19.50% and 24.00% rates. Thus revising the current statutory rates for each group to 21.50% would seem to be a reasonable way to accomplish this.

Basis for Analysis

This analysis was based on the OP&F Actuarial Valuation Report as of January 1, 2001 and the 2001 Report on the Solvency of the Health Care Stabilization Fund. Both of these reports were prepared by Watson Wyatt and are dated November 1, 2001.

In preparing this analysis, we have relied on the above-cited reports. We have not audited or verified this data and other information. If the underlying data or other information are 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 figures, it is possible that they would be uncovered by a detailed, systematic review and comparison of the figures to search for values that are questionable or for relationships that are materially inconsistent. Such a review was beyond the scope of our assignment.

Differences between Watson Wyatt's 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,

William A. Reimert

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