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H.B. 242 of the 132nd General Assembly

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Staff Recommendation

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Summary of H.B. 242

H.B. 242 removes the *requirement* that the School Employees Retirement System (SERS) annually increase retiree and disability recipient cost-of-living-adjustments (COLA) by 3%. Instead, the Board would be *permitted* to provide a COLA, and if the Board chooses to do so the COLA would be restricted to the increase of CPI-W, not to exceed 2.5%.

Additionally, the SERS Board is authorized to adjust COLAs below or above CPI-W if the board's actuary "determines that an adjustment does not materially impair the fiscal integrity of the retirement system or is necessary to preserve the fiscal integrity of the retirement system." Therefore, under this provision, the SERS Board could increase a COLA beyond CPI-W (even exceeding 2.5%) or provide a COLA that is less than annual CPI-W, as determined is necessary or possible by the Board's actuary.

H.B. 242 is an updated version of a draft bill (LSC 132 0362-2) reviewed by the ORSC at its April 2017 meeting. The ORSC disapproved of the discretionary authority provided in that draft bill. That disapproved authority is contained in H.B. 242. H.B. 242 also removes statutory requirements regarding a delay of COLA benefits that, according to the ORSC actuary, provided the majority of the draft bill's savings.

Background

COLAs have experienced significant alteration in Ohio law. Immediately prior to 2002, COLAs were based on CPI-W, plus any additional amounts accrued in what was known as the "COLA bank," capped at 3%. The COLA bank was fairly complicated but allowed members to store increases in the CPI-W that were beyond 3% and use them in years that CPI-W was less than 3%. This system enabled those whose benefits had been eroded during high inflation years (such as the late 70s or 80s) to receive larger COLA increases during moderate inflation periods. This was frequently combined with other ad hoc COLA increases to provide retirement income protection.

Effective February 1, 2002, H.B. 157 modified COLAs to be a flat 3%, regardless of any CPI-W changes.[1] Since enactment, only four of sixteen years have seen CPI-W increases of greater than 3%, with six of those years achieving inflation of less than 2%. The following chart below details CPI-W since 2002.

[1] ORSC staff had recommended disapproval of the bill and to instead allocate additional funding to discretionary retiree health care (H.B. 157 Staff Recommendation, June 1, 2001).

Year	Annual Average % of Change	Year	Annual Average % of Change
2002	1.4	2010	2.1
2003	2.2	2011	3.6
2004	2.6	2012	2.1
2005	3.5	2013	1.4
2006	3.2	2014	1.5
2007	2.9	2015	-0.4
2008	4.1	2016	1
2009	-0.7		

Under pension reform, and as approved by the ORSC, four of the five systems altered COLA formulas again. As seen below, SERS is now an outlier among the systems in maintaining a 3% fixed COLA.

System	COLA Benefit
PERS	Until January 2019, 3%. Thereafter, for recipients of benefits beginning not later than January 7, 2013, 3%. For recipients of benefits beginning after January 7, 2013, any increase in the CPI-W, not to exceed 3%.
STRS	Beginning July 1, 2017: 0% For those receiving an allowance or benefit on or after August 1, 2013, five years must pass before the first COLA is applied to an allowance or benefit, unless retirement is immediately preceded by a disability benefit. STRS Board may adjust the COLA if the Board's actuary determines that an adjustment does not materially impair the fiscal integrity of the retirement system or is necessary to preserve the fiscal integrity of the system.
SERS	Flat 3%, irrespective of CPI-W changes.
OP&F	(1) Annual COLA of 3% for those who have at least 15 years of service credit on or before July 1, 2013. (2) Annual COLA of the lesser of 3% or the increase in CPI-W, if any, for all others. COLA is provided only to recipients who have attained age 55 and have received the pension or benefit for one year, except that disability recipients who are permanently and totally disabled do not have to attain age 55.
SHPRS	Authorizes the Board to grant a COLA of no more than 3%, except that the Board is to grant a COLA of 3% to a recipient age 65 whose benefit is less than 185% of the federal poverty limit for a family of two. (2017 COLA is 1.25%)

> A recipient of a retirement, disability, or survivor pension whose pension effective date is on or after January 7, 2013, will not be eligible for a COLA until age 60.

Ohio law has frequently adjusted post-retirement COLAs. More recent precedent is that, though the five systems have diverged in how and when COLAs are to be calculated, a fixed COLA of 3% is being phased out. H.B. 242 would be in line with this precedent.

Staff comments

COLA, proactive funding measures, and intergenerational equity

According to SERS, H.B. 242 is being taken as a proactive measure to strengthen the SERS funding position and enable a portion of employer contributions to be set aside for retiree health care.[2] According to the most recent actuarial valuation, SERS is within the statutory 30-year funding period[3] and is therefore not statutorily required to submit a funding plan to ORSC.[4] Even so, both the ORSC and the ORSC actuary have advocated and encouraged the systems to be proactive on funding levels and seek to reduce the funding period.[5]

H.B. 242 improves the SERS funding position by reducing COLA expenses. According to the SERS actuary, a similar draft bill would reduce SERS unfunded liabilities by approximately $1.2 billion and increase the funded status to 71% (from 66%). COLA benefits are a significant cost to the retirement systems but the main source of retirement income protection provided to Ohio's state retirees (state employees in Ohio are not eligible for Social Security for their state employment). This is particularly true for SERS beneficiaries, whose average 2016 benefit of $14,206 is the least among the five systems. This makes SERS beneficiaries particularly susceptible to inflation. H.B. 242 seeks to moderate the loss of retiree purchasing power by permitting the SERS Board to match future COLAs with CPI-W. Since this amount is capped at 2.5%, it is possible that the purchasing power of retirees will decrease if inflation exceeds 2.5% or the Board elects to use its authority to suspend a COLA.

It is important to note that the 2012 pension reform affected only active SERS members and that 60% of SERS current unfunded liability lies with retirees,[6] suggesting that further benefit adjustments must include retirees in order to maintain intergenerational equity. Because H.B. 242 reduces COLAs, it would appear to be

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[2] SERS, "COLA Changes—What You Need to Know" (January 2017). Available online at: https://www.ohsers.org/Document/Get/16495

[3] The period to pay down unfunded liabilities in SERS is 28 years.

[4] Cavanaugh Macdonald Consulting, "SERS: Report on the Annual Basic Benefits Valuation of the School Employees Retirement System of Ohio, Prepared as of June 30, 2016."

[5] ORSC Minutes, November 3, 2014 and William B. Fornia, Linda L. Bournival, and R. Paul Schrader, "Analyzing Retirement Systems' 30-Year Plans and Alternative Pension Reform Solutions," July 2012, pg. 36.

[6] SERS, "COLA Changes."

directed solely at retirees, but this would be incorrect. In fact, according to the ORSC actuary, a similar bill's cap on COLA would actually reduce current active members' benefit more than that of current retirees. This is because active members will have a full retirement of reduced COLA, while those now retired have about half of their retirement (on average) with higher COLAs. However, H.B. 242 would affect both active and retired members, and therefore be in line with ORSC recommendations regarding proactive stabilization of funding and intergenerational equity standards.

The COLA provisions of the five state retirement systems have diverged since pension reform. However, with the exception of SERS, all are moving away from a fixed 3% COLA. H.B. 242 has precedent with previous bills approved by the ORSC to eliminate a fixed COLA in favor of a COLA indexed to CPI-W. The bill has an added measure to protect SERS funding by providing that the SERS Board may elect to provide no COLA, presumably to be used should funding conditions necessitate such an action.

H.B. 242's likely impact on SERS health care funding

In accordance with SERS funding policy, if H.B. 242 results in SERS funding status increasing above 70%, SERS will redirect 0.50% of employer contributions to SERS post-retirement health care coverage.[7] With the exception of the SERS surcharge,[8] SERS currently allocates 0% of employer contributions to post-retirement health care benefits. The current solvency period of the health care fund is 2024. Health care benefits are a discretionary benefit and not guaranteed under Ohio law. Therefore, a portion of the potential savings achieved by H.B. 242 would be diverted to the retiree health care fund rather than to reducing the funding period of SERS.

Effect on employer normal cost

According to the SERS actuary, the employer normal cost (that is, the contribution amount needed from the employer to fund active member's benefit that is in addition to employee contributions) resulting from a similar bill would be 0.11% (decreased from 0.73%) and therefore would remain positive, if only by a small amount.[9] ORSC does not have a strict policy on maintaining a positive employer normal cost, but with recent changes it is attracting greater attention and concern from the ORSC. Normal cost is affected by a large number of actuarial assumptions and may fluctuate up or down in the future.

Expansion of board authority and unconstrained COLA increase

[7] "SERS Funding Policy" June 2015, IV(C).

[8] Ohio law permits SERS to impose a surcharge on employers of up to a statewide average of 1.5% of employee payroll for health care coverage of retirees.

[9] The employer normal cost provides an approximation of the benefit an active employee receives in retirement beyond the employee's own contributions. A 0% employer normal cost would imply that the benefit of an employee is entirely self-funded; that is, any employer amounts are redirected for other purposes, such as paying down unfunded liabilities. A positive employer normal cost indicates that an employees' benefit is funded in part by employer contributions rather than purely self-funded. A negative employer cost indicates that a current employee is actually contributing *more* to the system than they can anticipate in future benefits. For comparative purposes, the employer normal cost for the five retirement systems according to the most recent actuarial valuations is as follows: PERS 3.22%, OP&F 5.31%, STRS (-3.05%), and SHPRS 7.2%.

Under H.B. 242, SERS is provided with the authority to adjust COLA rates in accordance with an actuarial review. On April 9, 2013, the ORSC indicated a preference that any plan design changes made by the systems be subject to prior ORSC review in order to maintain ORSC oversight of the state retirement systems. Therefore, this provision, while consistent with existing *law*, is inconsistent with prior ORSC *recommendations*.[10]

Of greater concern is that the authority to modify COLA rates is not constrained by the general 2.5% CPI-W cap proposed by H.B. 242. The SERS Board would be permitted to raise COLAs to any level permitted by an actuarial analysis. While the ORSC is well aware that the financial condition of SERS would suggest that a large increase is, practically speaking, highly unlikely, ORSC is charged with evaluating the *policy implication* of any bill effecting the retirement systems. The policy implication of this change is that a retirement system board may be unconstrained in its COLA increase under certain actuarial conditions.

As with a draft bill submitted earlier this year, ORSC staff recommends that the ORSC again disapprove of this policy change for two reasons. First, a temporary and large COLA increase would result in pension assets being shifted to *current retirees* at the expense of *active members*, a clear violation of the standards of intergenerational equity. Second, the policy change is against longstanding and prevalent Ohio policy that constrains and sets definite limits to board action. Ultimately, the policy change would erode ORSC authority and oversight of board actions, which the ORSC has consistently opposed.

Intergenerational equity. While maintaining retirement income protection is a worthy goal, it cannot be done if it results in a shifting of active employee assets to retirees. With a current employer normal cost of 0.11%, any additional benefits to retirees should be reviewed by the ORSC and the General Assembly to evaluate the potential of a negative employer normal cost and violation of intergenerational equity.

Consider a scenario in future years in which an actuarial analysis suggests that a 5% COLA is, actuarially speaking, possible. Pressure on the board to provide a 5% COLA could be immense. It is in these times that a measured, limited, and conservative response is necessary. Actuarial conditions can change rapidly and COLA adjustments are unrecoverable. A larger temporary COLA followed by a deterioration of conditions could cause deterioration of the fund. This is precisely what happened with H.B. 157. A fixed 3% COLA was provided to retirees to the financial detriment of the entire fund.

Board constraints. If the SERS Board is provided with COLA authority, it should be accompanied by hard caps. One of the key ways that Ohio has avoided many of the problems of other states is that the actions of the retirement boards are constrained. The boards are constrained when it comes to employee and employer contributions; benefit levels and retirement eligibilities; and the period in which the boards must pay

[10] "Report on Board Authority Provisions of S.B. 340, 341, 342, and 345 of the 129th General Assembly," (April 9, 2013).

unfunded liabilities. And the boards are constrained on how much they may raise COLAs. ORSC staff recommends the continuation of these constraints. [11]

Actuarial Impact

ORSC's actuary reviewed the analysis performed by the SERS actuary on a similar bill. Although they were not able to replicate the calculations, and would have come up with a slightly different analysis, they agree with the conclusion that costs and liabilities would decrease materially, and the funded percentage would rise to be above 70%. The ORSC actuary noted that the major contributor to the cost savings was a suspension of the COLA until 2021. Because H.B. 242 does not have this statutory suspension, the savings from H.B. 242 may depend on the SERS Board using its authority to suspend the COLA in future years.

Staff recommendation

In line with its April 13, 2017 recommendation to approve, with amendments, LSC 132-0362-2, ORSC staff recommends that, only with amendments, the General Assembly approve H.B. 242 for the following reasons:

1) H.B. 242's removal of a fixed 3% COLA has previous precedent;
2) The COLA modification will proactively improve SERS funding status in line with previous recommendations from the ORSC and ORSC actuary;
3) H.B.242 will more accurately reflect actual inflation figures but also provide retirement income protection; and
4) By applying to both retirees and active members, H.B. 242 will provide intergenerational equity.

In accordance with ORSC policy regarding intergenerational equity and the longstanding tradition of constraining board actions with ORSC oversight, the ORSC staff recommend that H.B.242 be amended by:

1) Requiring ORSC review of suspended COLAs or changes that are above CPI-W;
2) Imposition of a cap on COLA increases.

ORSC staff also recommend non-substantive amendments to reflect the schedule of COLA calculations in SERS.

[11] This comment applies equally to current law regarding STRS COLA adjustments.