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Analysis

H.B. 151 – Reps. Mandel and Jones
(As Introduced)

May 9, 2007

Staff Recommendation

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H.B. 151 would generally prohibit the treasurer of state, the state board of deposit, the bureau of workers' compensation and the five state retirement systems from investing in foreign companies with active business ties or operations in Iran, and would require them to divest any existing investments in such companies. This analysis is limited to the provisions of the bill that relate to the five state retirement systems: the Public Employees Retirement System (PERS), the Ohio Police and Fire Pension Fund (OP&F), the State Teachers Retirement System (STRS), the School Employees Retirement System (SERS) and the State Highway Patrol Retirement System (HPRS).

H.B. 151 would prohibit the state retirement systems (or external investment managers under contract with the state retirement systems) from investing in foreign companies, either publicly-traded or non-publicly-traded, that have *active business ties or operations* with Iran.[1] This prohibition would also include investments in any mutual or index fund in which one or more such *companies* is listed.[2] A limited exception would be provided under the bill to a "social development company," meaning any of the following:

- Any company that is not an agency of the Iran government and holds a valid, current accreditation as a nongovernmental organization from the United Nations Department of Public Information;
- Any company whose primary purpose is to provide to the people of Iran goods and services intended to relieve human suffering, to promote health, religious or spiritual activities, and to provide education for humanitarian purposes, as identified by an independent research provider;
- Any company whose primary purpose in Iran is to provide journalistic activities, as identified by an independent research provider.

H.B. 151 would require the state retirement systems (or external investment managers under contract with the state retirement systems) to divest or redeem 60 percent of any prohibited investments no later than six months after the effective date of the act and 100 percent of such investments no later than 12 months after the effective date of the act.

Under the bill, each state retirement system would be required to contract with one or more independent research providers approved by the Treasurer of State. In order to

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[1] "Business ties or operations" means engaging in commerce in any form, including maintaining, selling, acquiring, developing, owning, possessing, operating, or leasing any equipment, facilities, personnel, products, services, personal or real property, or any other apparatus of business or commerce.
[2] "Company" means a sole proprietorship, organization, association, corporation, partnership, joint venture, limited partnership, limited liability partnership, limited liability company, business association, or other entity, including any wholly-owned subsidiary, parent company, or affiliate of the above entities, that exist for profit.

obtain approval as an independent research provider, the company would be required to submit to the Treasurer of State an affidavit stating all of the following:[3]

- The company is headquartered, domiciled, or incorporated under the laws of this or another state, or the United States;
- The company specializes in identifying and assessing companies that are exposed to global security risk;
- The company offers impartial research on companies' business ties or operations in Iran;
- The company has regularly maintained and provided to clients the information described immediately above for at least four consecutive calendar years;
- The company does not engage in or provide investment banking, brokerage, or corporate finance services.

The Treasurer of State shall compile and make available a list of approved independent research providers, and shall update such list on a quarterly basis.

Under H.B. 151, each publicly-traded foreign company identified by an independent research provider as being a company that has active business ties or operations in or with Iran or with any company domiciled in Iran would be a prohibited investment. Also, any mutual fund, separate account, index, index managed product, or compilation of stocks that is *not* certified by an independent research providers as excluding *all* such companies shall be a prohibited investment under the bill.

Under H.B. 151, each non-publicly-traded foreign company that seeks investment from a state retirement system would be required to submit to the retirement system (or external investment manager under contract with that state retirement system) an affidavit stating the following:

- That the company does not own or control any property or assets located in Iran;
- That the company does not have business ties or operations in or with Iran.

The initial affidavit shall be submitted no later than six months after the effective date of the act and annually thereafter. Failure to do so shall make the foreign company a prohibited investment under the bill.

H.B. 151 would require each asset manager under contract with a state retirement system to submit to the retirement system, at no additional cost, a report certifying both of the following:

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[3] The independent research provider shall include with the affidavit the following information: the name of the company and, if different, the name under which it is registered or organized; the state in which it was organized and the date it was formed; the name and address of agent for service of process, notice or demand; and an address to which interested parties may request articles of organization, operating agreement, by laws or other charter documents.

- That the asset manager has not loaned to, invested in, or otherwise transferred any of the state retirement system's assets to a prohibited company;
- That the asset manager has divested the state retirement system from any prohibited investments according to the schedule set out above.

Should an asset manager fail to comply with these requirements, the retirement system shall terminate the contract with the asset manager who shall be ineligible to conduct business for one year with any state retirement system, the bureau of workers' compensation, the state board of deposit or Treasurer of State.

The bill would provide that the board of a state retirement system is not liable for breach of fiduciary duty if the board complies with the requirements of the bill and that all members, officers, employees and agents of the board shall be indemnified for all claims, demands, suits, actions, damages, judgments, costs, charges and expenses, including court costs and attorney's fees, and against all liability, losses and damages of any nature that may be incurred by reason of any decision to restrict, reduce or eliminate investments in prohibited companies. A member, officer, employee or agent of the board shall be indemnified by the state retirement system in which they serve.

The bill would also provide that the provisions of the bill prevail over any conflicting provisions with the state retirement systems' governing investment statutes. The Attorney General shall enforce the provisions of the bill and may bring an action in court to enforce such provisions.

Staff Comments – The bill, as introduced, raises a number of significant financial, legal and public policy issues that merit serious consideration.

Investment Mandates

Historically, the Ohio General Assembly has rejected any type of investment mandates upon the retirement boards' "full power to invest the funds," including several proposed divestiture bills in the early 1980's relative to South Africa and in the early 1990's relative to Northern Ireland. Most recently, the Ohio General Assembly reaffirmed its longstanding policy of rejecting proposed legislative mandates in S.B. 133 (eff. 9-15-04) by eliminating language that would have required the retirement boards to use a specified percentage of Ohio-based asset managers and brokers for their investment transactions.

The Ohio General Assembly has considered such legislative investment mandates to be inconsistent not only with the fiduciary duties of the retirement boards to act "… solely in the interest of the participants and beneficiaries …" but also with the legal status of the retirement systems as trust funds. Once contributions are transferred to the state retirement systems, they belong solely to the participants as required under federal law to remain a "qualified plan" and to receive favorable tax treatment on the contributions and earnings thereon. While individuals are free to manage their own assets as they see fit, attempting to achieve foreign policy or other social objectives with other people's money violates basic trust law principles and intercedes in the fiduciary responsibilities of the retirement boards who are vested under current state law with plenary power to invest the funds solely in the interest of and for the exclusive purpose of providing benefits to participants and their beneficiaries. Public accountability is ensured by each board having one investment expert appointed by the Governor, one investment expert appointed by the State Treasurer, and one investment expert jointly appointed by the Ohio General Assembly.

Prudent Person Investment Authority

S.B. 82 (eff. 3-7-97) abolished the "legal lists" and adopted the "prudent person rule." The former "legal lists" placed significant restrictions on the retirement boards' investment authority and impeded the boards' ability to respond to changes in the economy and investment markets and rely upon professional investment managers and economic advisors to guide the investment decision-making process. The current "prudent person rule" is modeled after the standard established in the Employees Retirement Income Security Act (ERISA) that governs most private pension plans, and provides for greater flexibility in asset allocation and selection of investment vehicles so as to achieve further growth in investment earnings and diversification of plan assets.

In adopting the "prudent person rule," the Ohio General Assembly recognized the critical role investments play in the funding of benefit costs. Investment earnings constitute the largest source of revenue for all five state retirement systems, funding up to 80 percent of benefit costs. Simply put, the more revenue generated by investments, the less contributions required from employers and employees, and ultimately Ohio taxpayers.

H.B. 151 would mark the first set of restrictions placed upon the retirement systems' investment authority since the adoption of the "prudent person rule," and could set a dangerous and costly precedence for further restrictions upon the retirement systems' investment authority. While the bill, as introduced, would prohibit investments in companies doing business in Iran, a bill recently introduced in the Senate (S.B. 161) would similarly prohibit investments in companies doing business in Sudan. Other divestiture initiatives throughout the country include, but are not limited to, companies doing business in other terrorist states (e.g., Cuba, Libya, North Korea, Sudan, Syria), companies operating in other conflict zones (e.g., Burma, Israel), and companies engaged in certain industries (e.g., alcohol, gambling, tobacco, weapons manufacturing). There simply is no logical end to such restrictions once they are established as precedence.

In order to achieve the best risk-adjusted returns available, the state retirement systems must include foreign companies in their investment portfolios to take advantage of the diversification and risk reduction benefits offered through global investment. It should be noted that international and private equity have been the two largest contributors to the state retirement systems' double-digit total fund returns over the last three years which have outperformed the domestic equity and fixed income markets. The bill would have a significant negative impact on both of these asset classes by restricting the retirement systems' investment opportunities. There is legitimate concern that blue-chip private equity firms that often dictate terms to investors will walk away from the state retirement systems to avoid potential liability of certification and to protect proprietary interests. The bill is also not clear who should provide certification: the fund-to-funds managers; or the direct investment managers; or the portfolio companies.

Foreign Companies in Ohio

The Ohio Department of Development maintains 11 offices around the world not only to promote exports of Ohio goods and services abroad but also to promote new or expanded foreign investment in Ohio. Foreign companies in Ohio employ over 200,000 Ohioans, and provide the livelihood for more than four percent of Ohio's private sector workforce. These foreign companies support 95,000 manufacturing jobs in Ohio, and tend to have a strong "multiplier" effect on the economy by stimulating a substantial amount of activity and jobs in other sectors through their demand for inputs from other suppliers. Over 45% of the jobs at these foreign companies are in manufacturing industries and pay significantly higher than average compensation.

The bill would seemingly work at cross-purposes by requiring the state pension funds to divest in some of Ohio's major employers that are foreign companies with ties to Iran, while the State Department of Development provides financial assistance and incentives for such companies to locate or expand operations in Ohio, including, but not limited to, the following: Honda (17,350 employees); DaimlerChrysler (9,350); Deutsche Post (3,562); Nestle (3,296); Bridgestone (2,352); Siemens (2,242); ABB (1,970); ThyssenKrup (1,040); Mitsubishi Electric (970); Matsushita Electric Industrial (900); Rolls-Royce (900); and BP (750).

Attached is a complete list of foreign companies on Institutional Shareholder Services' Iran screen.[4] STRS has investments in foreign companies in Ohio that employ nearly 52,000 Ohioans and would become prohibited investments under the bill. Other prohibited companies on the list may also employ Ohioans but are not shown under the column Ohio Jobs because STRS has no investment in such companies. As can be seen, the proposed divestment mandate would affect a significant number of the world's largest companies.

Business Ties or Operations Definition

The bill, as introduced, has an overly broad, vague definition of "business ties or operations," with a very limited exception for "social development companies." "Business ties or operations" means "engaging in commerce in any form …" As such, this definition would create a blanket prohibition on investing in companies that do business in Iran irrespective of whether there is a link to terrorist activities, the magnitude of the business, or other criteria used to evaluate all other investment decisions under the "prudent person rule." Moreover, this blanket prohibition would apply to both public-traded foreign companies as well as non-publicly-traded foreign companies.

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[4] Institutional Shareholder Services is an independent research provider.

Since the stated purpose of the bill is to cut off financial support for terrorist-sponsored states and protect public investments from global security risk-related losses, there should be some requirement for proof of a nexus between the companies and terrorist activities and an opportunity for targeted companies to be heard and evaluated more specifically before mandating divestiture.

The Missouri State Employees' Retirement System (MOSERS) anti-terrorist policy and screening process, which has received considerable attention in Ohio and throughout the nation, is fundamentally different from what is being proposed under H.B. 151. It is **not** a legislative investment mandate, but rather a policy adopted by the retirement board which provides for due diligence in determining whether there is any link to terrorist activities and retains the board's broad discretion to make the ultimate investment decision consistent with its fiduciary duties.[5] Under that policy, the retirement staff identifies the universe of investment securities that will be subject to screening. The staff then compares the universe of investment securities to be screened with a list of companies identified by two independent research providers. Where there are matches, the staff will further investigate by asking the portfolio manager for any information known about the company and the reason for owning the security. After receiving any requested reports from the portfolio manager on specific companies, the staff will review those reports to determine if there is any conflicting information related to the following policy tenets:

- MOSERS will not punish companies whose activities abroad are supported by the U.S. government;
- MOSERS will not punish companies whose activities abroad do not further terrorism; and
- MOSERS will not harm U.S. companies and jobs.

If there is no conflicting information, the staff will prepare a report for the board indicating whether the staff believes the security should be held or should be sold. The board retains discretionary authority to agree or disagree with the staff recommendation to hold or sell the security. If the board votes to sell, the portfolio manager will be directed to sell the holding. If the board does not vote to sell, the company will remain in the portfolio and will be subject to routine monitoring.

If there is conflicting information, the staff will prepare a report for the board indicating whether the staff believes an additional report should be purchased to clarify, confirm and expand on publicly available information related to the board's policy tenets. After receiving and reviewing this additional report, the staff will prepare a report for the board indicating whether the staff believes the security should be held or sold. Once again, the board retains discretionary authority to agree or disagree with the staff recommendation to hold or sell the security, and votes accordingly.

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[5] A *non-binding resolution* was recently introduced in the Missouri legislature that would call on all Missouri public retirement plans to divest funds in any terrorist-sponsoring state.

This anti-terrorist policy and screening process clearly recognizes the fiduciary duties of the retirement board by allowing the board to conduct its due diligence and retaining the board's discretionary authority to decide whether to hold or sell the security. This anti-terrorist policy is significantly different from the legislative investment mandate proposed under H.B. 151. Mandatory divestment eliminates the ability of the state retirement systems as large shareholders to affect the company's action through voting proxies. Publicly-traded companies are more likely to respond to the concerns of shareholders than non-shareholders.

Other states have proposed limiting any investment restrictions to publicly-traded companies only or companies that have energy-related business operations that exceed a certain investment threshold or companies that fail to take substantial action related to the objectionable behavior.

Foreign Policy

The United States Constitution provides that the federal government has authority over foreign affairs and commerce with foreign countries. The federal government has the power to decide whether U.S. companies can do business in other countries based on national security interests. State and local retirement systems are neither positioned nor equipped to make foreign policy judgment calls as to which multi-national companies (foreign and domestic) are operating for or against the national security interests of the United States. The federal government should provide guidance to ensure that any divestment efforts to influence foreign policy are uniform throughout the nation and consistent with the objectives of the United States. The five state retirement systems currently use the U.S. Treasury's Office of Foreign Asset Control (OFAC) list of sanctioned entities to screen for terrorist related investments, and fully comply.

H.B. 151 would single out the five state retirement systems, the bureau of workers' compensation, the state board of deposit (i.e., Treasurer of State, Auditor of State, Attorney General) and the state treasurer to divest in companies with business ties or operations with Iran, and would create an inconsistent and ineffective policy within the State of Ohio itself. Other public entities **excluded** from the proposed investment mandates include, but are not limited to, the following:

- the alternative retirement plans (e.g., TIAA-CREF, AIG/VALIC) and endowments of public institutions of higher education;
- the Ohio Public Employees Deferred Compensation Plan (administered by the PERS Board, plus two legislators appointed by leadership);
- the Ohio Tuition Trust Authority; and
- the 403(b) tax-sheltered annuity plans and other supplemental retirement plans offered by school districts and other political subdivision in Ohio.

Mandating the state retirement systems to divest securities that these other public entities can then buy is not only an inconsistent state policy but also likely to be an ineffective state policy in achieving its purported purpose. Some have suggested that the proposed divestment mandate against foreign companies doing business with Iran could undermine the efforts of the Ohio State Department of Development not only to promote exports of Ohio goods and services abroad but also to promote new or expanded foreign investment in Ohio. It could also create conflict with our trading partners in Europe, Japan and China, and thwart U.S. diplomatic efforts to build international support for effective financial sanctions against Iran.

The bill would also **not** apply to private pension plans, other institutional investors and just about everyone with a 401(k) pension plan or mutual fund in Ohio.

Defined Contribution Plans

The bill would exclude defined contribution plans, such as the ARP available to employees of public institutions of higher education, from the investment mandates. Such exclusion is not only inconsistent with the purported purpose of the bill but also contradictory by mandating defined benefit managers, such as PERS, to divest securities that defined contribution managers can buy on behalf of public employees. The proposed divestiture mandates could complicate investing in most indexed funds, mutual funds and other collective funds and create additional investment costs to the individual participants if defined contribution plans were to be included under the bill. The same holds true for the defined benefit plans of the state retirement systems that have passive investments in index funds. Moreover, there is no requirement that these defined contribution plan even offer plan participants investment options that comply with the divestment mandates of the bill.

Legal Representation

The bill authorizes the Attorney General to bring a civil action against a retirement board to enforce the provisions of the bill. The Attorney General is also the legal advisor for each retirement board. This creates an inherent conflict of interest. The recent independent fiduciary audit for STRS and OP&F noted the conflict in such situations, and recommended that the law be amended to allow the retirement boards to retain outside legal counsel.

Cost to the State Retirement Systems

An independent research provider Conflict Securities Advisory Group (CSAG) screened the five state retirement systems against those foreign companies with active business ties or operations with Iran. CSAG estimated that H.B. 151 would require the state retirement systems to divest approximately $9.0 billion worth of investment securities in foreign companies ranging from a low of 79 companies for OP&F to a high of 170 companies for PERS. Attached is the complete analysis prepared by CSAG which does not list the specific companies due to its proprietary interest in such list.

Requiring the state retirement systems (or their external investment managers) to divest of the securities in these companies will impose at least trading costs as they sell the securities and buy replacements. Further, there will likely be market impact cost as traders, knowing that the retirement systems must sell 60% of these holdings no later than six months after the effective date of the bill and 100% no later than 12 months after the effective date of the bill, drive down the prices of the securities being sold. Moreover, the retirement systems will be required to contract with one or more independent research providers to prepare accurate lists of prohibited investments and monitor them on a continuous basis as foreign companies cease or commence business ties with Iran. Also, divestiture will reduce the opportunity set of investments, which has an implicit cost in terms of lower returns and higher risk. It should be noted that any investment losses incurred by any of the state retirement systems would further reduce the limited resources available for discretionary retiree health care benefits as each retirement system has a statutory obligation to fund mandated pension benefits within a 30-year funding period.

According to the STRS actuary Buck Consultants, it is estimated that H.B. 151 will result in investment returns decreasing between 10 and 25 basis points. The actuarial impact of reducing the current interest rate assumption from 8% to 7.9% would lower the current funded ratio from 76.1% to 75.2% and increase the funding period from 47.2 years to 56.5 years. The actuarial impact of reducing the current interest rate assumption to 7.75% would lower the funded ratio to 74% and increase the funding period to 79.1 years. In both cases, STRS would well exceed the maximum 30-year funding period established by the Ohio General Assembly, and would require either an increase in contributions and/or a reduction in benefits.

According to the PERS actuary Gabriel Roeder Smith & Company, it is estimated that H.B. 151 will reduce the long-term expected rate of investment return on pension assets by 33 basis points from the current 8% to 7.67%. An increase in the employer contribution rate would eventually be needed to offset the anticipated decrease in investment returns as a result of the bill. The stand-alone employer contribution rate increase would be 1.91% of active member payroll. For example, the estimated increase in calendar year 2007 employer contribution dollars is approximately $244.4 million. Alternatively, if the employer contribution rate remains at the current level, H.B. 151 would gradually increase the funding period required to amortize the unfunded accrued pension liabilities by approximately 26 years. Accordingly, the funding period for PERS is projected to be greater than the maximum 30-year funding period established by the Ohio General Assembly.

<u>Indemnification</u>

As noted above, any investment losses incurred by the five state retirement systems as a result of H.B. 151 would further reduce the limited resources available for discretionary retiree health care benefits as each retirement system has a statutory obligation to fund mandated pension benefits within a maximum 30-year funding period. While the bill provides that members, employees and agents of the retirement board shall be indemnified for any losses incurred as a result of the investment restrictions proposed under the bill, the bill provides no indemnification for the retirement systems themselves, meaning the members, retirees and their beneficiaries shall bear the financial burden for any losses. Legislation in California provides that the State of California shall provide indemnification to the state retirement systems for any losses incurred as a result of a similar investment mandate. Consideration should be given to do the same for the five state retirement systems in Ohio.

Fiscal Impact – See the attached actuarial cost statements prepared for the two largest state retirement systems PERS and STRS by their respective actuaries.

Staff Recommendation – That the Ohio Retirement Study Council recommend that the 127th Ohio General Assembly disapprove H.B. 151, as introduced, for the numerous reasons cited under staff comments.

ORSC Position – At its meeting of May 9, 2007, the Council deferred action on staff's recommendation pending the release of a substitute bill.

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May 7, 2007

Mr. Thomas L. Sherman
Government Relations Officer
Ohio Public Employees Retirement System
277 East Town St.
Columbus, Ohio 43215-4642

Re: House Bill No. 151, As Introduced

Dear Tom:

As requested, we have performed an actuarial analysis of House Bill No. 151, as introduced. Enclosed is our actuarial analysis.

Please feel free to contact us with any questions or comments.

Sincerely,

Mita D. Drazilov

MDD:mdd
Enclosures

cc: Karen Carraher (OPERS)
Norman Jones (GRS)
Brian Murphy (GRS)
Randall Dziubek (GRS)
Shannon Walsh (GRS)

Ohio Public Employees Retirement System
House Bill No. 151, As Introduced
Supplemental Actuarial Valuation - December 31, 2005

Submitted To: Thomas L. Sherman, Government Relations Officer
Ohio Public Employees Retirement System

Submitted By: Brian B. Murphy, F.S.A., Mita D. Drazilov, A.S.A. and Randall J. Dziubek, A.S.A.
Gabriel, Roeder, Smith & Company

Date: May 7, 2007

This report presents results of an actuarial valuation of a proposed change to the Ohio Public Employees Retirement System (OPERS).

The date of the valuation was December 31, 2005. This means that the results of the supplemental valuation indicate what the December 31, 2005 valuation would have shown if the proposed changes had been in effect on that date. This supplemental valuation does not predict the result of the December 31, 2006 valuation or of any other future actuarial valuation. (Future activities can affect future valuation results in an unpredictable manner.) Rather, the supplemental valuation gives an indication of the probable effect of **only the proposed change** on future valuations without comment on the complete end result of the future valuations.

Actuarial assumptions and methods were consistent with those used in the regular actuarial valuations as of December 31, 2005, unless otherwise indicated. In particular, the entry age actuarial cost method was utilized, the assumed rate of investment return was 8.0% for pension and 6.5% for retiree health, and the assumed rate of active member payroll growth was 4.0%. This supplemental valuation reflects revised assumptions and other technical changes that were made following the 2001-2005 Experience Study.

This report is intended to describe the financial effect of the proposed plan changes. No statement in this report is intended to be interpreted as a recommendation in favor of the changes, or in opposition to them.

The calculations are based upon assumptions regarding future events, which may or may not materialize. They are also based upon present and proposed plan provisions that are outlined in the report. If you have reason to believe that the assumptions that were used are unreasonable, that the plan provisions are incorrectly described, that important plan provisions relevant to this proposal are not described, or that conditions have changed since the calculations were made, you should contact the author of this report prior to relying on information in the report.

If you have reason to believe that the information provided in this report is inaccurate, or is in any way incomplete, or if you need further information in order to make an informed decision on the subject matter of this report, please contact the authors of the report prior to making such decision.

Ohio Public Employees Retirement System
House Bill No. 151, As Introduced
Supplemental Actuarial Valuation - December 31, 2005

A brief summary of the member data used in this valuation is shown below ($ in millions):

	2005					
			Law			
	State	Local	Public Safety	Law Enforcement	Total Law	Grand Total
Demographic Information						
1. Active Number Counts						
a. Traditional Plan	113,008	232,589	135	7,976	8,111	353,708
b. Combined Plan	1,612	3,484	0	0	0	5,096
c. Total	114,620	236,073	135	7,976	8,111	358,804
2. Active Payroll						
a. Traditional Plan	4,275	6,956	6	395	401	11,632
b. Combined Plan	64	110	0	0	0	174
c. Total	4,339	7,066	6	395	401	11,806
3. Retired Number Counts	53,813	96,836	102	3,184	3,286	153,935
4. Deferred / Inactive Number Counts	95,693	198,308	13	685	698	294,699
5. Member Directed Active Number Counts	1,773	3,530	0	0	0	5,303
6. Total Number Counts	265,899	534,747	250	11,845	12,095	812,741

A summary of the health trend assumptions used in this supplemental valuation is shown below:

	Health Trend Above Wage Inflation Assumption of 4.0%			
	Medical and Drug	Medicare		
Year	Intermediate	Part A	Part B	Part D Subsidy
2006				
2007	6.00%	6.00%	6.00%	3.00%
2008	5.00%	5.00%	5.50%	3.00%
2009	4.00%	4.00%	5.00%	3.00%
2010	3.00%	3.00%	4.50%	3.00%
2011	2.50%	2.50%	4.00%	3.00%
2012	2.00%	2.00%	3.50%	3.00%
2013	1.50%	1.50%	3.00%	3.00%
2014	1.00%	1.00%	2.50%	2.50%
2015	0.50%	0.50%	2.00%	2.00%
2016	0.00%	0.00%	1.00%	1.00%
2017	0.00%	0.00%	0.00%	0.00%
2018	0.00%	0.00%	0.00%	0.00%
2019	0.00%	0.00%	0.00%	0.00%
2020	0.00%	0.00%	0.00%	0.00%
2021 & Later	0.00%	0.00%	0.00%	0.00%

Ohio Public Employees Retirement System
House Bill No. 151, As Introduced
Supplemental Actuarial Valuation - December 31, 2005
Executive Summary

There is no single correct method for modeling a change in portfolio composition such as that described in House Bill (H.B.) No. 151. In this report, we have modeled the change by rerunning the December 31, 2005 actuarial valuation with a lower assumed rate of return. Whether or not assumptions would actually change would depend upon the results of an experience study.

As further explained in this report, the actuarial impact of proposed H.B. No. 151 can be summarized as follows:

- It is estimated that H.B. No. 151 will reduce the long-term expected rate of investment return on pension assets by 0.33%, from 8.00% to 7.67%. Given the fact that there is no allocation of retiree health assets to Private Equity or Real Estate (other than REITS), it was assumed that there would be no corresponding reduction in the long-term rate of investment return for the retiree health assets.
- However, it is our understanding that the Board is currently considering allocating some retiree health assets to Private Equity. Therefore, some potential investment return may be forgone in the retiree health program due to H.B. No. 151.
- An increase in the employer contribution rate would eventually be needed to offset the anticipated decrease in investment return in connection with this bill. The stand-alone employer contribution rate increase that would result is 1.91% of active member payroll. For example, the estimated increase in calendar year 2007 employer contribution dollars is approximately $244.4 million.
- Alternatively, if the employer contribution rate remains at the current level, the bill would gradually increase the amortization years required to fund the system's unfunded actuarial accrued liability by approximately 26 years. If the entire increase were reflected in the 2006 valuation, this would result in a projected amortization period as of December 31, 2006 in excess of 30 years.
- Due to the possible loss of qualified plan status under the Internal Revenue Code that may result due to adoption of H.B. No. 151, further consideration of the bill should include a legal opinion or IRS Private Letter Ruling on a potential violation of the exclusive benefit rule.

Ohio Public Employees Retirement System
House Bill No. 151, As Introduced
Supplemental Actuarial Valuation - December 31, 2005

Present Provision: OPERS or any asset manager investing on behalf of OPERS is not prohibited from investing in a foreign company with active business ties or operations in or with Iran.

Proposed Provision: OPERS or any asset manager investing on behalf of OPERS would be prohibited from investing in a foreign company with active business ties or operations in or with Iran.

Actuarial Analysis: The following illustrates (a) the computed increase in the employer contribution rate that would result from the proposed change on a level cost basis as a % of active member payroll if increases in the unfunded actuarial accrued liability are amortized over a 30-year period and (b) the expected change in the computed amortization period for the pension program if employer contribution rates remain unchanged:

	Retirement System
Increase/(Decrease) in	
Normal Cost	0.93%
UAAL % (30-year amortization)	0.98%
Total Employer Contribution - Rate	1.91%
Total Employer Contribution - $ (CY 2007)	$ 244,370,125
Increase/(Decrease) in	
Actuarial Accrued Liabilities	
Actives	$ 1,686,055,606
Inactives (Deferreds)	13,471,233
Retirees and Beneficiaries	802,103,803
Total	$ 2,501,630,642
Assets	(15,000,000)
UAAL	$ 2,516,630,642
Increase in Computed Amortization Period Assuming No Change in Employer Rate (Years) *	26

* *This is the estimated increase in the computed amortization period as of December 31, 2006. The computed amortization period for the Retirement System after reflection of the estimated effects of H.B. No. 151 is projected to be greater than 30 years as of that date.*

Ohio Public Employees Retirement System
House Bill No. 151, As Introduced
Supplemental Actuarial Valuation - December 31, 2005
Comments

(1) Based upon analysis performed by OPERS staff, it was assumed that a one-time expense of $15 million would be incurred to divest from investments prohibited in H.B. No. 151.

(2) OPERS staff has indicated that as a results of H.B. No. 151, funds currently allocated to Private Equity investments would be allocated to Domestic Equity investments. In addition, OPERS staff indicated that the long-term expected rate of return on Real Estate investments would be 1.0% lower than otherwise would be the case. Although the long-term loss of investment income is not known with precision, for purposes of this supplemental valuation, it was assumed that the long-term expected rate of investment return for pension assets would be 0.33% lower under the proposed provisions. This results in a reduction in the assumed rate of investment return for the pension program from 8.00% to 7.67%. Since the retiree health plan does not have any funds allocated to Private Equity or Real Estate, it was assumed that there would be no reduction in the assumed rate of investment return for the retiree health program. (However, it is our understanding that the Board is considering allocating some retiree health assets to Private Equity.) Please see Attachment A for a summary of the approximate asset allocations for the pension and retiree health programs currently and assuming that H.B. No. 151 is adopted.

(3) OPERS operates as a qualified plan under section 401 of the Internal Revenue Code which states in part:

> "(a) Requirements for Qualification. A trust created or organized in the United States and forming part of a stock bonus, pension, or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section…
>
> (2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of his employees or their beneficiaries …"

We recommend that if the bill is given further consideration, a legal opinion or an IRS Private Letter Ruling be sought to determine whether its adoption would violate the exclusive benefit rule stated above. Loss of qualified status could have serious detrimental effects on OPERS members.

Ohio Public Employees Retirement System
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Attachment A

Pension

Current		After H.B. No. 151	
Asset Class	Allocation	Asset Class	Alloc
U.S. Equities	43.0%	U.S. Equities	**48.0%**
Non U.S. Equities	20.0%	Non U.S. Equities	20.0%
Real Estate	7.0%	Real Estate	7.0%
REITS	1.0%	REITS	1.0%
Private Equity	5.0%	Private Equity	**0.0%**
Fixed Income	24.0%	Fixed Income	24.0%
	100.0%		100.0%

Retiree Health

Current		After H.B. No. 151	
Asset Class	Allocation	Asset Class	Allocation
U.S. Equities	30.0%	U.S. Equities	30.0%
Non U.S. Equities	15.0%	Non U.S. Equities	15.0%
REITS	5.0%	REITS	5.0%
Private Equity	0.0%	Private Equity	0.0%
TIPS	20.0%	TIPS	20.0%
Global Bonds	15.0%	Global Bonds	15.0%
Short-duration Bonds	15.0%	Short-duration Bonds	15.0%
	100.0%		100.0%

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May 2, 2007

Ms. Terri Bierdeman
Director of Governmental Relations
The State Teachers Retirement
System of Ohio
275 East Broad Street
Columbus, Ohio 43215

Re: State Teachers Retirement System of Ohio House Bill No. 151

Dear Ms. Bierdeman:

As requested, we have estimated the actuarial impact of adopting a provision that would prohibit STRS assets from being invested in foreign companies that have business ties with Iran as proposed under House Bill No. 151.

As of July 1, 2006, the System has a funded ratio of 76.1% and a funding period of 47.2 years, based on the valuation interest rate (investment return assumption) of 8.00%. STRS has estimated that the proposed legislation will result in investment returns decreasing between 10 and 25 basis points. Therefore, the valuation interest rate assumption should be reduced from 8.00% to between 7.90% and 7.75%. The actuarial impact of reducing the valuation interest rate to 7.90% or 7.75%, using the July 1, 2006 valuation as the baseline, is summarized in the following table:

	July 1, 2006 Valuation at 8.00%	**July 1, 2006 Valuation at 7.90%**	**July 1, 2006 Valuation at 7.75%**
Unfunded Accrued Liability	$ 19,363.0 M	$ 20,262.0 M	$ 21,610.5 M
Normal Cost Rate	14.82%	15.16%	15.68%
Funded Ratio	76.1%	75.2%	74.0%
Funding Period	47.2 years	56.5 years	79.1 years

Please call with any questions.

Sincerely,

Kim M. Nicholl

Kim M. Nicholl
Principal, Consulting Actuary

KMN:pl
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Enc.
cc: Damon Asbury
Robert Slater

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