ORSC

Annual Report

The Ohio Retirement Study Commission October 12, 1994

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Adequacy of Contribution Rates for the Police and Firemen's Disability and Pension Fund

Actuarial Review and Summary

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The Ohio Retirement Study Commission was created by the Ohio General Assembly in 58 to provide continuing study of public pensions, their costs and financing. It was conceived as agency to review the administration and financing of pensions, with power to recommend provements in benefits, financing and the investment of funds. It must study all statutory changes he retirement laws proposed to the General Assembly and report to the General Assembly on their bable cost, actuarial implications and desirability as a matter of public policy.

The Commission is empowered to make an impartial review from time to time of the laws verning the administration and financing of the Public Employees Retirement System, the Police l Firemen's Disability and Pension Fund, the State Teachers Retirement System, the School ployees Retirement System, the Highway Patrol Retirement System and the Volunteer Fire hters' Dependents Fund. It may recommend to the General Assembly any changes it considers irable with respect to the allowances and benefits, the sound financing of the cost of benefits, the dent investment of funds, and the improvement of the language structure and organization of the s.

It must report to the Governor and the General Assembly concerning its evaluation and ommendations with respect to the operations of the systems and their funds.

The Commission is composed of fourteen members: three members of the House, three mbers of the Senate, three members appointed by the Governor, and the five executive directors he state retirement systems, who are non-voting members.

The annual expenses of the Commission are borne by the five state retirement systems in the portion determined by the ratio of the assets of each system to the total assets of all five systems.

INTRODUCTION

This report is submitted to the Ohio General Assembly pursuant to R.C. §742.311. That section was enacted in Am. Sub. H.B. 721 in 1986, and reads as follows:

> *"The Ohio retirement study commission shall annually review the adequacy of the contribution rates provided under sections 742.31, 742.33, and 742.34 of the Revised Code and the contribution rates recommended by the actuary of the police and firemen's disability and pension fund for the forthcoming year. The Ohio retirement study commission shall make recommendations to the general assembly which it finds necessary for the proper financing of the benefits of the police and firemen's disability and pension fund."*

In fulfilling this legislative mandate, the Ohio Retirement Study Commission engaged its consulting actuary, Milliman & Robertson, Inc., to review the adequacy of the employee and employer contribution rates to support the current level of benefits provided by the Police and Firemen's Disability and Pension Fund (PFDPF). This report is based on that review which, in turn, was based solely on information provided by PFDPF's actuary, the Wyatt Company.

BACKGROUND

PFDPF became operational in 1967 with the consolidation of 454 local police and firemen's relief and pension funds. The law establishing PFDPF provided for an actuarial valuation of the assets and liabilities of each local fund as of April 1, 1966. These local funds had assets of approximately $75 million and accrued liabilities of approximately $490 million, leaving an unfunded accrued liability of over $415 million.[1] This unfunded liability was frozen and charged to the respective local governments. The initial law allowed local governments to pay off their indebtedness over 20 years; this law was later amended to extend the funding period from 20 years to 59 years, and then to 67 years.[2] Under the present 67-year schedule the frozen initial liability will be paid off in the year 2035.[3]

The implication of this separate payment schedule for the frozen initial liability was that *no additional liability was to be generated in the future;* that is, all liabilities created since 1966 were to be treated as "current or normal" costs and were to be covered by contributions over the future working lifetime of current active members and by investment earnings on the assets. (The anticipated investment earnings are accounted for by the interest rate assumption used to discount future benefit payments.) Under this funding method, any increase in the cost of future benefits was to be paid for by (1) increased contributions over the future working lifetime of active members; or (2) investment earnings in excess of the actuarial interest rate assumption; or (3) actuarial gains resulting from non-investment experience being other than what was expected (e.g, shorter life expectancies than assumed).

Prior to 1986 the law authorized the PFDPF board to fix the employer contribution rates for police and firemen as of the first of each year based on the annual actuarial valuations of the fund. The employee contribution rates were fixed by statute.

On July 24, 1986 the legislature enacted Am. Sub. H.B. 721 which repealed the board's authority to fix the employer contribution rates on the basis of the actuarial evaluation. The Act froze the policemen's employer contribution rate at 19.5% of payroll and the firemen's employer contribution rate at 24% of payroll; these were the rates certified by the board for calendar year 1986.[4] This action was taken in response to employers' concerns over the ever increasing and fluctuating rates. The Act also increased the employee contribution rate from 8.5% to 9.5% of payroll, and required the Ohio Retirement Study Commission to report annually to the General Assembly on the adequacy of the employer and employee contribution rates established under the Act.

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[1]PFDPF Comprehensive Annual Financial Report (1993)

[2]Am. Sub. H.B. 642 (1965); Am. H.B. 756 (1967); Am. Sub. H.B. 215 (1969)

[3]In 1993 Am. Sub. H.B. 38 authorized the PFDPF board to enter into agreements with local governments permitting them to pay off the remaining balance of their unfunded liability at a substantial discount. The board adopted 65% as the discounted amount it would accept for payments received by October 15, 1994.

[4]PFDPF Memo to Municipal Fiscal Officers and Township Clerks, Certification of Employer's Rate for 1986, (July 1985)

BENEFIT IMPROVEMENTS SINCE 1986

Prior to the enactment of Am. Sub. H.B. 721 in 1986, benefit improvements were funded by increasing the contribution rates and also by assuming greater investment earnings through changes in the actuarial interest rate assumption.

The frozen rates of contribution established under Am. Sub. H.B. 721 significantly decreased the flexibility previously accorded to the PFDPF board to fund any increase in the cost of future benefits. Any increased costs resulting from benefit improvements could no longer be funded by increased contribution rates; such increased costs could only be funded through investment gains or other actuarial experience gains.

The legislature enacted several major benefit improvements in PFDPF since the contribution rates were frozen. In 1986 Am. Sub. H.B. 721 granted an annual 3% COLA for members retiring after July 24, 1986. The actuarial cost of this benefit change was 3.51% of payroll for police and 3.80% of payroll for firemen.[5]

Also, in 1986 Am. Sub. S.B. 112 was enacted which increased monthly survivor benefits from $256 to $310 for spouses, and from $68 to $93 for dependent children. It also provided an ad hoc post-retirement increase to members who retired before February 28, 1984 on an annual pension of less than $13,000. The increase was the greater of $600 per year or an amount necessary to increase the member's annual pension to $4,200. The actuarial cost of these benefit changes amounted to 0.93% of payroll for police and 0.99% of payroll for firemen.[6]

In 1988 the legislature enacted Am. Sub. H.B. 389 which reduced normal retirement age from 52 to 48. It also granted an annual $360 COLA for members who retired before July 24, 1986 on an annual pension of less than $18,000.[7] It further increased monthly survivor benefits from $310 to $410 for spouses, and $93 to $118 for dependent children. The actuarial cost of these benefit changes totaled 6.70% of payroll for police and 5.95% of payroll for firemen.[8]

In 1989 Am. Sub. H.B. 377 was enacted which provided a $1,000 lump sum death benefit. The actuarial cost of this benefit change was 0.08% of payroll for police and 0.09% of payroll for firemen.[9]

In addition to the increased costs resulting from the benefit changes enacted by the legislature, PFDPF continued to experience double-digit increases in retiree health care costs, which is financed on a pay-as-you-go basis, throughout most of this period. Though the cost and funding of retiree health care benefits are a continuing concern for each of the state pension funds, PFDPF is particularly hard hit by the younger retirement ages of its members who are not eligible for Medicare until age 65. The cost of providing health care coverage for non-Medicare eligible individuals is typically three to four times higher than for Medicare eligible individuals. In 1986 PFDPF allocated 5.63% of the employer contribution toward retiree health care costs. By 1992 7.51% of the employer contribution was allocated toward retiree health care benefits. Due to several cost containment initiatives taken by the board and lower medical inflation, PFDPF actually experienced a decrease in health care expenditures in 1993 for the first time since it began providing retiree health care benefits in 1974, and was able to stay just below the 6.5% health care contribution allocation established by the board.

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[5] PFDPF Actuarial Evaluation (October 23, 1987)
[6] PFDPF Actuarial Evaluation (October 23, 1987)
[7] The $18,000 is increased $500 each year thereafter.
[8] PFDPF Actuarial Evaluation (April 24, 1990)
[9] PFDPF Actuarial Evaluation (November 26, 1990)

DEVELOPMENTS SINCE 1992 ORSC REPORT

In 1992, the Commission submitted its review and recommendations to the Ohio General Assembly relative to the adequacy of the PFDPF statutory contribution rates. The actuarial review was prepared by Milliman & Robertson (M&R), the Commission's consulting actuary, and was based solely on various actuarial reports and analyses provided by the Wyatt Company, the actuary employed by PFDPF.

In that initial review, M&R concluded that there was a need for either increases in the contribution rates from employers, members or the state or reductions in benefits provided to the members (or some combination of these) in order to maintain the actuarial soundness of PFDPF. Of particular concern was the pay-as-you-go financing of post-retirement health care benefits and the projected growth in medical costs as determined in the Wyatt Company's 35-year forecast study.

Since the 1992 ORSC Report, there have been a number of significant changes which have occurred. There are still other changes, however, which were recommended in the report but have not yet been made. The following summary highlights each of these areas.

• No benefit changes have been enacted which would create any additional liabilities to PFDPF. The Commission has consistently recommended against all proposed legislation creating any additional liabilities to the fund.

There were only two benefit changes enacted in PFDPF during the last two legislative sessions: H.B. 394 (119th G.A.) and H.B. 197 (120th G.A.). H.B. 394 allowed members to purchase up to two years of service for any lay-off period, but was amended upon the recommendation of the Commission to require the member or the employer to pay the additional liabilities resulting from the purchase, as determined by the fund's actuary. Similarly, H.B. 197 allowed members to purchase up to five years of federal or out-of-state service, and was amended upon the recommendation of the Commission to require the member to pay the additional liability as determined by the fund's actuary. Neither piece of legislation had any adverse fiscal impact upon the actuarial condition of PFDPF.

• The PFDPF board has established a health care stabilization fund with an initial allocation of $150 million so that assets used to pay health care benefits are accounted separately from those used to pay pension and disability benefits. In conjunction with the establishment of this fund, the board has also adopted a goal to limit post-retirement health care costs to 6.5% of payroll. Both of these measures were recommended in the 1992 ORSC report.

In addition, the PFDPF board has implemented a retail pharmacy network and a managed care network, both of which incorporate negotiated payment levels and utilization controls to achieve savings. The board has also begun charging premiums to certain classes of benefit recipients, generally ranging from $5/month for retirees with Medicare coverage to $10/month for retirees without Medicare coverage ($40/month for certain retirees with partial or off-duty disabilities). Spouses without Medicare coverage also pay $40/month. No premiums are charged to spouses with Medicare coverage, dependent children under age 18 or retirees receiving annual pensions of less than $10,000. Other cost containment measures adopted by the board include a prescription drug formulary rebate program and subrogation recoveries.

The effect of these changes has been that for the first time since the fund began providing health care benefits in 1974, PFDPF actually experienced a decrease in health care costs from $68.1 million (7.7% of payroll) in 1992 to $64.3 million (6.4% of payroll) in 1993.

The 1992 ORSC report made several other recommendations with respect to the PFDPF health care plan which have not yet been implemented.

First, the 1992 report recommended that Medicare Part B reimbursements be capped in PFDPF. This recommendation was also made in the ORSC health care report which was done in 1991 pursuant to a legislative mandate. In 1993 legislation was introduced (S.B. 161 - 120th G.A.) which included such a provision, but was never enacted. The Medicare Part B premium is presently $41.10/month and will

increase to $46.10/month (12.2% increase) effective January 1, 1995. The legislature has capped the Medicare Part B reimbursement at $24.80/month in the School Employees Retirement System, $29.90/month in the State Teachers Retirement System and $41.10/month in the Highway Patrol Retirement System. Medicare Part B reimbursements in PFDPF increased from $2.94 million in 1992 to $3.51 million in 1993 (19.2% increase), with only an additional enrollment of 229 benefit recipients.

Second, the 1992 report recommended that the retirement board index deductibles and out-of-pocket maximums to the previous year's percentage increase in health care costs. This same recommendation was made in the ORSC health care report. Deductibles ($100/$200) and out-of-pocket maximums ($500/$750) remain flat dollar amounts under the PFDPF health care plan, which lose their intended effects over time due to medical inflation. Higher deductibles ($250/$500) and out-of-pocket maximums ($1,500/$2,250) are, however, applied to individuals who receive out-of-network medical services.

Third, the 1992 report recommended that the retirement board charge premiums for *all* dependents covered under the PFDPF health care plan, and that the premium charges for pre-65 retirees reflect the increased health care costs associated with the normal retirement age of 48 established under H.B. 389 in 1988.

Under the premium schedule adopted by the board, spouses covered by Medicare and dependent children under age 18 are exempt from any premium charges.

While the premium schedule generally distinguishes between retirees covered by Medicare and those not covered by Medicare, the amount of the premium does not vary based on the member's age at retirement. Service retirees who are not covered by Medicare pay a flat $10/month, whether they retire as early as age 48 or at later ages. The normal retirement age of 48 established by H.B. 389 in 1988 exposes the PFDPF health care plan to significant medical costs for up to 17 years before eligible retirees become covered by Medicare (generally age 65) as the primary payer of their medical claims. The cost of coverage is typically three to four times higher for individuals without Medicare than for individuals with Medicare. The premiums charged to individuals who retire at earlier ages should reflect these higher costs to PFDPF.

• Legislation was enacted (H.B. 38 - 120th G.A.) which authorized the retirement board to enter into agreements with municipal corporations permitting them to pay off the remaining balance of their initial indebtedness at the time PFDPF was created in 1967. The board adopted 65% as the discount amount it would accept for payments received by October 15, 1994. Under this legislation the cities received a substantial discount, while the retirement system exchanged a long-term, low-yielding asset (4.25% annual interest) for cash which could be invested to earn a higher return (8.25% actuarial interest rate assumption).

The legislation was recommended by the Commission, and was generally consistent with a recommendation included in the 1992 ORSC report that the statutory payment schedule for the frozen initial liability be accelerated.

• The 1992 ORSC report included other recommendations which received no legislative action. In the area of disability retirement, it recommended that legislation be enacted to offset Workers' Compensation benefits against PFDPF duty-related disability benefits. Also, it recommended that the annual $1.2 million state subsidy established in law upon the creation of PFDPF in 1967, otherwise known as the "state contribution," be increased to $4.8 million, indexed to general inflation. Finally, it recommended that the member contribution rate be increased from 10% to 11%. None of these recommendations were adopted.

SUMMARY OF ACTUARIAL REVIEW

Milliman & Robertson, the Commission's consulting actuary, has prepared the actuarial review to determine the adequacy of the current statutory contribution rates to support the benefits provided by PFDPF. The review is based solely on actuarial reports and analyses prepared by the Wyatt Company, the actuary employed by PFDPF, and is not based on an independent analysis of such data. The review includes the results of the quinquennial study completed by Wyatt in 1993 which compared the actuarial assumptions with the actual experience in PFDPF for the period January 1, 1987 to December 31, 1991.

Based on its analysis, M&R concludes that the current statutory contribution rates are likely to be deficient *unless future experience is more favorable than actual 1987-91 experience.* In particular, M&R cites more individuals retiring at age 48 than assumed, more individuals going out on disability retirement than assumed, and both healthy and disabled retirees living longer than assumed as reasons for this conclusion. Each of these factors has the effect of increasing future benefit costs.

M&R does *not*, however, recommend that the Ohio General Assembly remove the cap on the contribution rates which were frozen in 1986 at 19.5% for police and 24.0% for firefighters; that is, there is no recommendation that these contribution rates be increased by the legislature at this time.

M&R also concludes that aside from future medical inflation, demographic pressures alone will make it difficult for the PFDPF board to provide post-retirement health insurance at 6.5% of active member payroll *without significant increases in deductibles, co-pays and/or retiree contributions.* The ratio of active members to retirees is expected to decrease from two employees for every retiree in 1990 to approximately 1.2 to 1.4 employees for every retiree by the year 2025. This means that instead of having contributions from two active members to support health insurance for each retiree, there will be only 1.2 to 1.4 active members supporting each retiree's health care benefits. Under the pay-as-you-go financing method currently employed by PFDPF, this will have the effect of increasing health care costs as a percent of active member payroll. To the extent that the board is unsuccessful in limiting health care costs to 6.5% of payroll, such excess costs would add to any deficiency in the contribution rates.

M&R recommends that a study be made to examine the cause(s) of the high rates of disability among both police and firefighter since 1986. During the 1987-91 period, disabilities comprised 41% of all police retirements and 35% of all firefighter retirements, compared to 35% and 25%, respectively, during the 1982-86 period. One purpose of the study would be to determine if changes are necessary in the statutory provisions and/or administrative procedures governing disability retirement. Another purpose of the study would be to develop appropriate actuarial assumptions regarding future disability experience.

M&R makes the observation that the lower statutory employer contribution rate for police (19.5%) compared to firefighters (24%) is inconsistent with the actuarially determined rates for these two groups. Based on the Frozen Initial Liability Normal Cost method used by the Wyatt Company in its valuations, the actuarial rate is actually higher for police than firefighters. Based on the Entry Age Normal Cost method, the actuarial rates are roughly the same for both police and firefighters assuming a 40-year funding period.

The following table summarizes the effects of actuarial assumption changes, benefit improvements, plan experience and health insurance costs on the actuarially determined contribution rates since 1986, and compares the actuarial rates with the statutory contribution rates. The succeeding table gives a breakdown of the total actuarial rate between pension and disability benefits and health care benefits.

Effects of Assumption Changes, Benefit Improvements, Plan Experience and Health Care Costs on PFDPF Actuarial Rates Since 1986

Year	Employee & Employer Contribution	State Subsidy	Total Actual Contribution	Actuarial Rate % as of 1/1	Change due to Actuarial Assumptions & Methods	Increase due to Benefit Changes	Change due to Plan Experience	Change due to Health Insurance	Expected Rate % Following Year
Police									
1986				27.80%		4.44% [1]	(1.69)%	0.57%	31.12%
1987	29.00%	1.02%	30.02%	31.12%	0.63%		(0.86)	(0.21)	30.68
1988	29.00 [2]	0.88	29.88	32.38 [6]	(4.46) [3]	6.70 [4]	(1.04)	0.91	34.49
1989	29.50	0.78	30.28	34.49		0.08 [5]	0.35	(0.64)	34.28
1990	29.50	0.68	30.18	34.28	0.20		0.53	1.04	36.05
1991	29.50	0.65	30.15	36.05	(1.92) [8]		(0.56)	0.21	33.78
1992	29.50	0.60	30.10	33.78	0.11 [9]		0.28	(1.01) [10]	33.16
1993	29.50	0.50	30.00	33.16					
Total					(5.44)%	11.22%	(2.99)%	0.87%	
Firefighters									
1986				31.25%		4.79% [1]	(2.50)%	0.57%	34.11%
1987	33.50%	1.12%	34.62%	34.11	0.90%		(2.09)	(0.21)	32.71
1988	33.50 [2]	0.98	34.48	34.02 [7]	(4.39) [3]	5.95 [4]	1.33	0.91	37.82
1989	34.00	0.86	34.86	37.82		0.09 [5]	(1.67)	(0.64)	35.60
1990	34.00	0.74	34.74	35.60	(0.24)		0.01	1.04	36.41
1991	34.00	0.75	34.75	36.41	(1.76) [8]		(0.68)	0.21	34.18
1992	34.00	0.60	34.60	34.18	(0.92) [9]		(0.12)	(1.01) [10]	32.13
1993	34.00	0.60	34.60	32.13					
Total					(6.41)%	10.83%	(5.72)%	0.87%	

[1] Benefit changes enacted in H.B. 721 and S.B. 112.
[2] Increase to 29.5% for police and 34% for fire due to change in member contribution from 9.5% to 10% effective 10/1/88.
[3] Change due to increasing interest rate assumption from 7.75% to 8.25% and salary scale assumption from 5.5% to 5.75%, together with change due to new assumption on occurence of disability by type.
[4] Benefit changes enacted in H.B. 389.
[5] Benefit changes enacted in H.B. 377.
[6] Increase of 1.7% due to revised data.
[7] Increase of 1.31% due to revised data.
[8] Decrease due to new asset valuation method.
[9] Net change due to establishment of Health Care Stabilization Fund, use of new asset valuation method and adoption of new assumptions relative to terminations, salary increases, mortality and remarriage.
[10] Decrease due to board decision to allocate 6.5% of employer contribution to $150 million Health Care Stabilization Fund.

Breakdown of Total Actuarial Rate Between Pension & Disability Benefits and Health Care Benefits

Year	Pension & Disability		Health	Total Actuarial Rate	
	Police	Fire		Police	Fire
1983	25.22%	30.34%	3.15%	28.37%	33.49%
1984	26.12%	31.40%	4.73%	30.85%	36.13%
1985	24.55%	29.11%	4.91%	29.46%	34.02%
1986	22.17%	25.62%	5.63%	27.80%	31.25%
1987	24.92%	27.91%	6.20%	31.12%	34.11%
1988	26.39%	28.03%	5.99%	32.38%	34.02%
1989	27.59%	30.92%	6.90%	34.49%	37.82%
1990	28.02%	29.34%	6.26%	34.28%	35.60%
1991	28.75%	29.11%	7.30%	36.05%	36.41%
1992	26.27%	26.67%	7.51%	33.78%	34.18%
1993	26.66%	25.63%	6.50%	33.16%	32.13%