A Report to the
Ohio Retirement Study Council
Feb. 4, 2003

The State Teachers Retirement System of Ohio (STRS Ohio) is subject to the reporting requirements of Ohio Revised Code (R.C.) Section 3307.512, enacted by Senate Bill 82 in 1997. This section of the Revised Code requires the State Teachers Retirement Board to provide the Ohio Retirement Study Council with a report in any year that the funding period for the unfunded actuarial accrued liability (UAAL) of the pension fund exceeds 30 years. The report must also indicate how the board will reduce the amortization period to below 30 years.

In November 2002, the Retirement Board received a report from its actuary — Buck Consultants — for the year ended June 30, 2002, that shows, in part, the negative effects of the long and severe declines in financial markets on the retirement system's assets.

The actuary has determined that the system now will require 39 years to retire the UAAL. Consequently, this report is being submitted in compliance with the Ohio Revised Code.

Background

Ohio law (R.C. Chapter 3307) requires teachers in the public schools and institutions of higher education to contribute to STRS Ohio while employed in service to its citizens. It requires the teachers' employers to similarly contribute, based on the salaries paid. The current contribution rates are 9.3% of gross earnings for employees and 14% of salary from employers.

The same laws that create and govern STRS Ohio also create an "obligation" to these educators as a result of their participation in STRS Ohio. Financial benefits result if and when a teacher demonstrates attainment of eligibility for these benefits.

STRS Ohio is required to pay the following when eligibility is demonstrated:

- Age/service benefits for Defined Benefit plan participants (R.C. 3307.58, 3307.59 and 3307.60)
- Annuities to reemployed retirees who are already receiving pensions (R.C. 3307.352)
- Disability benefits (R.C. 3307.62–3307.64)
- Survivor benefits (R.C. 3307.562 and 3307.66)
- Defined contribution plan benefits under terms specified by the plan document (R.C. 3307.81)

Other guaranteed payments/programs are:

- Annual 3% COLA (cost-of-living adjustment) for recipients of defined benefits (R.C. 3307.67)
- Partial reimbursement of Medicare Part B premiums paid by Defined Benefit Plan recipients
- (R.C. 3307.39)
- Help with the cost of Medicare Part A equivalent coverage for qualifying benefit recipients (R.C. 3307.61) and their spouses
- $1,000 lump-sum benefit upon death of a benefit recipient (R.C. 3307.661)
- Refunds in lieu of any other benefit upon withdrawal by members who leave teaching in Ohio and request a refund (R.C. 3307.56 and 3307.563)

Ohio law ***does not currently guarantee nor require*** the following to be provided by STRS Ohio. However, it instead directs STRS Ohio to offer its participants access to other benefits and act, as it is able, to help members by paying all or part of the following:

- Payment of all/part of health coverage cost for Defined Benefit Plan recipients (R.C. 3307.39)
- Supplemental benefit (R.C. 3307.671)
- Additional retiree-funded lump-sum benefit upon the death of a recipient of an age/service or disability benefit (R.C. 3307.392)
- Excess benefit plan to pay guaranteed benefit excluded by IRC section 415 (R.C. 3307.461)
- Participation in retiree health care program to Defined Contribution Plan retirees upon payment of 100% of costs by individual or the DC plan (R.C. 3307.39)

Ohio law directs the Retirement Board to collect contributions and invest the funds prudently under a plan that a qualified actuary determines will cover the cost of the pension and other benefits earned by the participants for performing the current year of service **and** pay off any UAAL over a period not to exceed 30 years. Ohio law allows the Retirement Board to use as much as 10% of compensation earned by each participating teacher and 14% of total teacher payroll from each employer to fund the guaranteed benefits, to administer the system and to operate the nonguaranteed benefits described in law.

The Retirement Board's Plan to Reduce the Amortization Period

The Retirement Board has responded to the current funding situation appropriately. Given this new information, it will increase the required member contribution to the maximum allowed under Ohio law — 10% — beginning July 1, 2003. It cannot collect a larger contribution annually from either the teachers or their employers unless the Legislature raises the contribution ceiling. As to increasing future returns on existing assets, the board's mandate in Ohio law is to act prudently. Adoption of a more aggressive investment philosophy could increase the potential for higher returns, but it would also raise the "downside" risk of future losses. The Retirement Board's independent investment consultants have confirmed that the board has been and continues to follow a responsible, prudent and appropriate asset allocation plan.

From the 1995 fiscal year through last year, the funding period for the STRS Ohio pension fund was substantially under 30 years. However, this country has now experienced three consecutive years of losses in the stock market — a phenomenon that has occurred only three times in the last 100 years.

New security concerns after Sept. 11, an unexpected collapsed demand in the telecommunications sector, corporate scandals and heightened tensions in the Middle East and in Asia continue to play havoc with the stock market. To put the situation in perspective, the current stock market decline (48%) is greater than any bear market since the Depression era. The decline through 12/31/02 surpassed the brutal period of 1973-1974, in which the stock market lost approximately 46% of its value. After that decline, it took six years — until 1980 — for the market to build back up to the level it had reached in late 1972.

Reasonable actuarial projections show that **even if the Retirement Board devoted 100% of contribution income to pension funding every year for the foreseeable future, the amortization period for the UAAL will climb above 41 years over the next decade and then only begin to decline gradually** — *if* STRS Ohio this year begins experiencing an annual 7.75% return on the market value of its assets.

Unfortunate Collateral Harm Results From Implementing the Plan

Complicating the issue for the Retirement Board is its commitment to helping current and future retirees with the cost of their health care coverage, like the other Ohio public retirement systems. Today, more than 118,000 retired teachers and dependents are helped with their medical costs by the Retirement Board. It has arranged access to quality health plans and subsidized the cost of participating in them for most retirees and their dependents. STRS Ohio has done so ever since the Legislature authorized this practice in the early '70s.

For a number of years, a percentage of employer contributions (2%), investment earnings, plan changes and premium contributions from plan participants were adequate to cover rising health care expenses and helped create a reserve in the Health Care Stabilization Fund for future claims. Wise management of STRS Ohio resources and healthy investment returns also enabled the Retirement Board to allocate an additional $3 billion to the fund. Without these allocations, STRS Ohio retirees and their dependents would have starting paying 100% of their health insurance premium costs in 1990. However, as is currently being experienced all over the country, rising medical and prescription drug costs, increasing utilization and investment market losses are impacting how much public and private employers can help their workers and retirees with their health care costs.

Of the 14% of pay STRS Ohio collects from employers, the Retirement Board is today dedicating just 1% to help retirees with the cost of health care. This 1% of teacher payroll will generate about $90 million in 2003. The estimated cost of retired teacher and dependent health care in 2003 is about $550 million. Money this year from employers to help with the cost of retiree medical care will cover just 16% of the annual outgo.

If the Retirement Board had not "banked" some dollars in the good years of the '90s, the average retiree would have to pay 84% of the health care cost in 2003. The board will spend some of those "banked" dollars this year so that the average retiree will pay about 23% of the cost for the retiree and spouse or dependents.

However, using money this year from the funds set aside in earlier years to keep retirees from bearing the full brunt of rapidly rising health care costs will "bleed" money now that the Board had hoped to keep in reserve and invest for a few more years until the baby boomers begin retiring in truly prodigious numbers in 2005.

By 2008, total expenditures for retired Ohio teachers and dependent health care may exceed $1 billion; 1% of teacher payroll in 2008 is apt to generate around $110 million. Approximately 140,000 retirees and their dependents then may have to pay 90% of their annual health insurance premiums, on top of the office visit and drug copayments and deductibles. The annual bill for a typical retired couple under the age of 65 in 2008 may approach $20,000.

As noted earlier, the Retirement Board's legal obligations delineated in the Ohio Revised Code include providing retirees assistance with Medicare Parts A and B. The Legislature instituted such mandatory benefits as an offsetting benefit for retirees who would never collect Medicare benefits through participation in Social Security. Funds must be maintained in the Health Care Stabilization Fund to meet these obligations.

Further, as a self-insured plan, STRS Ohio has a fiduciary obligation to have enough money on hand at the end of each year to pay claims in the following year, as they are presented for work done in the prior year. Assuming no benefit cutbacks and that retirees continue to participate in the present plan even after big premium increases are instituted, the estimated present value of the reserves needed at the end of 2013 for *these legal and fiduciary obligations* is $2.8 billion.

The fund balance as of Jan. 1, 2003, stands at $2.68 billion. Effectively, this means that all the current money in the fund must be saved and either some earnings on the fund or some new income must be added to the current fund balance (and not spent on retiree health care) to have the $2.8 billion needed in reserve 10 years from now.

The Retirement Board's one immediate option is to further reduce the subsidies provided to retirees to help with the cost of their and their spouses' health care. Next year, the Retirement Board plans to ask retired teachers and their dependents to pay much more of their health care costs. Although the board is still analyzing its options, it appears that many retirees will be asked to pay 100% of their premium cost in 2004; some subsidies will be provided to career teachers over age 60. The elimination of any subsidy for many or a much smaller subsidy in 2004 will undoubtedly anger many who for years have depended on STRS Ohio for significant help with the high and growing cost of health care.

Given the social problems the nation has with millions of older Americans facing health care costs they cannot afford, action at the national level is needed. In the interim, although health care costs are predicted to go up at least 10% annually for many years to come, the Retirement Board will continue to seek ways to reduce total health care costs. The board will do all it can to keep a quality plan affordable to the retired career teachers, although the definition of "affordable" is in the eye of the beholder.

Further, the more health care dollars the Retirement Board spends keeping retirees healthy, the longer they live. But healthier retirees also means their pensions are paid longer, requiring the system to set aside even more dollars for retirement guarantees. There is a strong commitment on the part of the board to do all it can to continue offering a high quality, affordable health care package for retirees. But the full "cost" of doing so is not measured by just the outgo for drugs and medical services.

With the maximum amount of employee contributions going to the pension fund, along with 13% of the employer contribution, it will take until 2034 for the pension fund's UAAL to decline to 30 years — again assuming an annual 7.75% return on the market value of assets beginning this year.

The Future

Since 1920, the State Teachers Retirement Board has provided pension, survivor and disability benefits to the public teachers of Ohio. The services the system provides to its members and retirees are considered second to none. Further, STRS Ohio has provided subsidized health care benefits for more than 25 years — one of only seven teacher retirement systems in the non-Social Security states to even offer health care coverage to its retirees. The total benefits package received by STRS Ohio members ranks the system in the top quartile of public teacher pension plans in the country. All of this is evidence that the Retirement Board has and continues to manage its assets well.

The current funding situation STRS Ohio finds itself in is being repeated in both public and private sector pension funds across the country, as well as at all levels of governance — local, state and national.

The members of the Retirement Board understand that as fiduciaries, their first and foremost priority and legal obligation is to protect the system's ability to honor the pension and other promises in state law. Under the current laws, the board has done everything it can to reduce the UAAL to 30 years or less.

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