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Analysis

Sub. S.B. 345 – Sens. Niehaus and Kearney
(As Enacted)

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Staff Recommendation

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Substitute Senate Bill (Sub. S.B.) 345 would make the following changes to the laws governing the State Highway Patrol Retirement System (HPRS) in order to ensure the continued to solvency of the retirement system:

- Set the final average salary (FAS) to five years, effective January 1, 2015. (R.C. §5505.01 (M), Section 3)
- Make changes to the Deferred Retirement Option Plan (DROP). (R.C. §5505.03 (B), (C) (1), §5505.54(B)(1)(a), (b))
- Give the board the authority to adjust the employee contribution rate between 10-14% of a member's salary. (R.C. §5505.15 (A)(1))
- Delay the board authority to increase and/or decrease the employee contribution rate for 180 days after effective date of the bill and require ORSC to study and make recommendations within 90 days after effective date of the bill, January 7, 2013. (R.C. §5505.15(A)(1), Section 3, Section 4)
- Increase the eligibility age to 60 to receive a Cost of Living Allowance (COLA) for retirees effective January 7, 2013. (R.C. §5505.174 (A)(2))
- Eliminate the annual 3% COLA except for benefit recipients receiving benefits at or below 185% of the federal poverty limit for a family of two. (R.C. §5505.174 (B)(1)(a))
- Give the board the authority to set the COLA between 0% and 3% based on annual actuarial valuation for all other benefit recipients. (R.C. §5505.174 (B)(1)(b))
- Clarify eligibility for medical coverage is under Part B of the Medicare program established under Title XVIII of the Social Security Amendments of 1965, 79 Stat. 301 (1965). (R.C. §5505.28 (B))

Background

Pursuant to S.B. 82 (eff. 12-6-1996), each retirement system whose funding period exceeds 30 years in any given year is required to submit to the Ohio Retirement Study Council (ORSC) and the standing committees of the House and Senate with primary responsibility for pension legislation a plan approved by the retirement board that reduces the funding period to no more than 30 years, along with any progress made by the board in meeting the 30-year funding period. This standard was modeled after the national standard adopted by the Governmental Accounting Standards Board for all governmental pension plans. The change was intended to maintain inter-generational equity among taxpayers and system members by limiting the ability to fund benefit costs by extending the funding period beyond 30 years.

In 2003, the ORSC voted to have its actuary, Milliman USA, review the adequacy of the contribution rates in all five retirement systems. That report, which was updated in 2004, generally concluded that in the case of the Ohio Police and Fire Pension Fund (OP&F) and the State Teachers Retirement System (STRS) one or more of the following actions would need to occur to achieve compliance with the 30-year funding requirement: contribution limits increased; mandated pension benefits reduced; state subsidies provided; and/or contributions reallocated from discretionary health care benefits to mandated pension benefits.

Given the severe decline in investment market values since the end of fiscal year 2008 and the need to begin evaluating options to address this situation proactively, the Council approved a motion to have staff work with OP&F on December 10, 2008, on March 11, 2009, with STRS, and with the Public Employees Retirement System (PERS), School Employees Retirement System (SERS) and the State Highway Patrol Retirement System (HPRS) on April 8, 2009. All five systems, in consultation with the ORSC, developed legislative proposals that would reduce their unfunded actuarial accrued liability periods.

STRS, SERS, OP&F, and HPRS presented their board-approved funding plans at the September 9, 2009, ORSC meeting. PERS presented its board-approved plan at the December 9, 2009, ORSC meeting. Both STRS and OP&F presented updated plans in early 2011. S.B. 345 contains the HPRS board approved plan.

In 2011, the ORSC hired Pension Trustee Advisors and KMS Actuaries (PTA/KMS) to complete a review of the boards' plans and make recommendations related to pension reform. PTA/KMS presented its review at the July 11, 2012 ORSC meeting. They found that the plans are a positive step and will, generally, enable the majority of the systems to meet the goals of funding reasonable health care benefits at no increased cost to taxpayers.

Staff Comments

Final Average Salary – (R.C. §5505.01 (M)(1), (2), Section 3) Effective January 1, 2015, the bill would change the final average salary (FAS) to the highest five years of salary. This bill would add two years to the current law, which states the FAS is the total of the highest three years of salary.

House Bill (H.B.) 840 (eff. 1/1/1966) established the FAS as the average of a member's highest five years of consecutive or non-consecutive years of salary, divided by five. If a member had less than five years of service, the FAS would be calculated on the average of the annual rates of salary paid during one's total years of contributing service. Since H.B. 1050 (eff. 9/30/1974), the FAS calculation has used the highest three years of annual salary.

HPRS uses the FAS to determine the member's final retirement benefit. At the end of a member's service, HPRS adds the member's highest three years annual salary of consecutive or non-consecutive service and divides the total by three to reach final

average salary. The bill would allow HPRS to add a member's five highest years of salary, divided by five, to reach the final average salary.

The PTA/KMS report recommended reducing a member's benefit by increasing the FAS. Increasing the FAS would work to reduce the unfunded actuarial accrued liability and member's actuarial accrued liability. The report calculated the FAS increase will moderately reduce benefits by 4% and will minimize the impact of salary spiking by approximately half.

Salary spiking generally results from promotions to higher paying positions that occur at the end of a member's career. These years skew a member's FAS by averaging only the highest years of salary, which are disproportional to the member's career average. HPRS is forced to pay out high retirement benefits that exceed the member's low career contributions to the system, thus creating a fiscal deficit in the pension system. Over time, the fiscal shortfall between a member's career contributions and lifetime benefit is exacerbated. The inclusion of two additional years of salary would provide some counterbalance to abnormal increases in salary. However, increasing the FAS to five years does not eliminate the ability of a member to spike their FAS, even though overtime is not calculated into a HPRS member's salary.

Therefore, we recommend that HPRS adopt and include an anti-spiking provision for the FAS.

Employee Contributions – (R.C. §5505.15 (A)(1), Section 3, Section 4) Sub. S.B. 345 would set the HPRS employee contribution rate to a range between 10% and 14% of annual salary. The HPRS board, in consultation with its actuary, may increase and/or decrease the employee contribution rate as it considers necessary to meet the 30-year amortization period as determined by the annual actuarial valuation. This would change the current employee contribution rate, which is set at 10% of annual salary. The bill delays the board's authority for 180 days after the effective date, January 7, 2013. The bill would require the ORSC to study and make recommendations regarding the board's authority to adjust the employee contribution rate to the General Assembly within 90 days of the effective date of the bill.

Over the years, the employee contribution rate has been adjusted to meet funding obligations. The employee contribution rate has ranged from as low 5%, as established by H.B. 1 (eff. 10/1/1953), to a rate as high as 10.5%, set by Am. Sub. H.B. 346 (eff. 11/2/1989). The employee contribution rate was set at the current 10% rate by Sub. H.B. 373 (eff. 3/24/2003).

Historically, the costs of benefits have been shared between employees and employers. The State, as the sole employer in HPRS, contributes 26.5% to HPRS, the highest employer rate among all five retirement systems. Compared to systems with uniformed officers, OP&F employers contribute 19.5% annually on behalf of its police officers, while PERS Law Enforcement (LE) employers contribute 18.1% annually on behalf of its officers. HPRS's employees contribute 10% of annual salary, which is the same annual

rate as required for police officers in OP&F. However, PERS LE officers contribute a rate of 11.6% of annual salary.

Increasing the employee contribution rate will create a better cost balance between the employee and the employer, thus preventing an increase in state contributions while simultaneously reducing taxpayer risk. Under Sub. S.B. 345, the HPRS board would be able to determine the employee contribution rate, between 10% and 14%, the exact percentage to be based on the HPRS annual actuarial valuation required by R.C. §5505.12. While HPRS is ultimately responsible for providing the pension, the employee would bear more risk and responsibility for financing the benefit on the basis of the fund's annual performance.

This bill would enable the HPRS board to act without legislative approval to address funding and solvency issues. The modification would enable HPRS to increase rates when the funding position declines and decrease the employee contribution rate when the funding position improves. However, Sub. S.B. 345 would limit the power of the HPRS board to adjust employee contributions within a range of 10%-14% of annual salary. The employee contribution rate range would be codified in statute, thus providing the employee with a safeguard. The bill would prevent arbitrary increases or decreases in the employee contribution rate by requiring board action to be based on meeting the 30-year amortization period in the annual actuarial valuation. The employee contribution rate range in Sub. S.B. 345 is consistent with the SERS, PERS, and STRS law, which permit those respective boards to adjust employee contribution rates within a range of 8%-10% of annual salary.

Sub. S.B. 345 would delay the board's authority for 180 days after the effective date 1/7/2013. The bill would require the ORSC to study and make recommendations, within 90 days after 1/7/2013, regarding the board's authority to adjust the employee contribution rates. This would allow the Council to determine the appropriate division of authority between the board and the Legislature and ensure consistency among all five statewide retirement systems.

We do note, however, an inconsistency in the language of the current law regarding the employer contribution rate. When H. B. 1, (eff. 10/16/2009) set the HPRS employer contribution rate to 26.5% from the total salaries paid by contributing members in §5505.15 (B), the prior language setting the employer contribution rate at no more than three times the employee contribution rate was not removed. Therefore, while merely technical, the current law does contain a conflict as to what is the employer contribution rate at HPRS.

Therefore, we recommend a technical amendment that removes the language allowing the employer contribution rate to be set at three times the employee contribution rate. This was inadvertently not deleted in §5505.15 (B) when the employer contribution rate was capped at 26.5% during the 127th G.A.

Deferred Retirement Option Program (DROP) – (R.C. §5505.54 (B)) Sub. S.B. 345 would change the DROP program by directing DROP member contributions over 10% to accrue to the employer fund. DROP members would continue to make contributions identical to normal service employees, but only 10% of the member's contributions would accrue to the member's direct benefit.

Currently, an employee participating in DROP contributes 10% of his/her salary to HPRS. The entire 10% is placed into that employee's savings fund and, upon separation from DROP and meeting the service and age requirements, the member receives all of his/her accrued contributions with interest. Employer contributions go to the employer's accumulation fund while the member is in DROP and all of those contributions are credited to HPRS.

Am. S.B. 206 (eff. 6/6/2006) created DROP in HPRS. Participation in DROP is limited to members that are otherwise eligible for normal service retirement and younger than age 58. Although technically considered retired, the member continues to be employed until age 60, or for a period no longer than eight years. During DROP, the member's monthly service retirement benefit is credited to a tax deferred account, along with annual compound interest at a rate specified by the board. Upon termination of employment, the member receives a lump sum distribution of the member's DROP account or some alternative distribution thereof and begins receiving his/her monthly service retirement benefit earned from his/her normal service. While participating in the DROP, the member does not earn any additional service credit, is not eligible to purchase any service credit, and is not eligible for any health care benefits under HPRS (including the member's spouse and dependents). For purposes of board elections, the member is eligible to vote for the retirant member of the HPRS board.

Under Sub. S.B. 345, the HPRS board would be able to determine the rate of annual salary DROP members would contribute between 10% and 14%, the exact percentage to be based on the HPRS annual actuarial valuation required by R.C. §5505.12. The proposed changes would prevent an increase in state contributions while simultaneously reducing taxpayer risk by applying the employee contribution rate range to the DROP and capping a DROP member's accrual of contributions to 10% of annual salary. DROP members would share the same risk as active service employees and responsibility for financing their benefit on basis of the fund's annual performance. Directing DROP member contributions in excess of 10% to the employer's fund would result in financial gains to the HPRS fund.

By capping the DROP member's contribution accrual at 10% of annual salary, the DROP becomes a less attractive option. If the employee contribution rate were set higher than 10%, the employee could, conceivably, accrue more by working in their current position than by participating in the DROP. An active service employee accrues, and would continue to accrue, all of his/her employee contributions in active service in addition to salary increases. However, under S.B. 345 a DROP member could only accrue a maximum of 10% of his/her contributions.

Cost of Living Allowance (COLA) – (R.C. §5505.174 (A)(1), Section 3) Sub. S.B. 345 would eliminate the annual 3% COLA and would permit the HPRS board to set a COLA that is not to exceed 3% or to not grant a COLA at all. Sub. S.B. 345 would grant the HPRS board the authority to adjust the COLA rate within a range of 0% and 3%; the exact percentage would be based on the HPRS annual actuarial valuation required by R.C. §5505.12, but not to exceed federal limits established by the Internal Revenue Service.

Sub. S.B. 345 would also alter the eligibility for future pension benefit recipients to receive a COLA. Under Sub. S.B. 345, a retiree in HPRS whose pension effective date is on or after January 7, 2013, would be eligible for a COLA at 60 years of age and older and who has been receiving a pension for at least 12 months. A member whose pension date is prior to January 7, 2013, and has been receiving a pension for more than 12 months would remain eligible for a COLA at 53 years of age. The bill would also keep the annual 3% COLA for current pension benefit recipients ages 65 years and older who are currently receiving a pension not greater than 185% of the federal poverty level for a family of two. This exception would maintain the current 3% COLA for the oldest living recipients, which annually receive the lowest benefits.

Currently, an annual 3% COLA is granted to all eligible HPRS pension recipients. A member is eligible for a COLA at 53 years of age or older and who has been receiving a pension at least 12 months. Benefit recipients receiving survivor benefits are eligible for the COLA after receiving benefits for at least 12 months. Disability benefit recipients are also eligible for the COLA after receiving benefits for at least 60 months or age 53, whichever comes first.

Initially, COLA eligibility was reserved for retirees 62 years and older who had been receiving a pension for at least 12 months. The COLA was established by S.B. 133 (eff. 11/18/1981), which set the COLA to match to the annual percentage change in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). For increases in the CPI-W above 3%, H.B. 10 (eff. 5/6/1988) created a COLA bank to accumulate the excess and apply it in succeeding years to set the COLA. The COLA bank was eliminated by H.B. 157 (eff. 2/1/2002), which untied the COLA from the CPI-W and replaced the provision with an annual 3% COLA.

Similar to the provision setting the employee contribution rate range, Sub. S.B. 345 would allow the HPRS board to issue a COLA in consultation with their actuary and only on the basis of the 30-year amortization period in the annual actuarial valuation. This adjustment would eliminate the adverse experience of the annual 3% COLA, which provided increased payments for retirees without considering the actual experience of the funds. Thus, in years when the actuarial experience underperformed, the difference between investment income and COLA outlays created a large deficit.

Rather than issuing a COLA on a reoccurring basis, Sub. S.B. 345 would permit the HPRS board to set the COLA on the basis of the fund's financial health. If the annual actuarial valuation report determined the fund increased, the board would have the

authority to issue a COLA if, in consultation with their actuary, it would be fiscally feasible. On the contrary, if the annual actuarial valuation determined the fund decreased and fell out of the 30-year amortization period, the board would have the authority to not issue any COLA.

Sub. S.B. 345 would address the shift in retirement and life expectancy demographics by increasing the eligibility age to receive a COLA. Retirees among all systems are living longer and while retirees of uniformed systems have shorter life expectancies compared to non-uniformed retirees, uniformed members retire at an earlier age and are eligible for more COLA increases.

Sub. S.B. 345 would maintain important public policies by not changing the COLA eligibility for its lowest pension recipients, which are typically HPRS's oldest retirees. This exception recognizes the limitations of recipients that lack the same ability to provide for their own retirement security as other retirees. By preserving the annual 3% COLA for the lowest wage earners, the bill would continue to adjust retirement income to match inflation and attempt to provide retirement security for its oldest retirees.

The COLA provision is consistent with the PTA/KMS Report on 30-Year Plans and Pension Reform to the ORSC. The report found that 48% of the present value of future benefits is due to currently retired and inactive members. For the pension and health care funds, modest adjustments to the COLA would create long-term financial gains. The report recommended that the HPRS board have the authority, within limitations, to adjust the COLA without being subject to the legislative process. As fiduciaries, the board is charged with the fiduciary duty of acting in the best interests of the pension system. The bill's proposed authority to adjust the COLA without the legislature's approval would allow the board to address funding issues without delay.

Sub. S.B. 345 is inconsistent with the prior ORSC recommendation to match the COLA with the CPI-W, not to exceed 3%. Historically, the CPI-W has been higher than the 3% COLA, as the 30-year CPI-W is 4%. However, in the last 10-year experience the COLA has been far greater than the CPI-W and retirees have been receiving a COLA higher than inflation. We find that tying the COLA to the HPRS's funded status is a reasonable accommodation.

The authority granted to the HPRS board to adjust the COLA within a statutorily set range combined is sufficient. The bill would give the HPRS board the authority to make adjustments to the system, but would simultaneously provide necessary safeguards. The HPRS board would also have the authority to not issue a COLA. Though it is not specifically stated within Sub. S.B. 345, HPRS's authority to change the COLA annually or whether to ever grant a COLA, implies the COLA is not a vested benefit. This is consistent with the ORSC position.

We recommend that Sub. S.B. 345 be amended to include language to clarify that the COLAs granted after the effective date of the bill are not a legally vested benefit.

Fiscal Impact

According to the HPRS actuary, Gabriel, Roeder, Smith & Co., increasing employee contributions to 14% in conjunction with reducing the COLA would create an additional 6.02% of pay that could be used to bring the amortization period for the pension's unfunded accrued liability (UAL) within the 30-year amortization requirement or extend the solvency period of the health care fund. The retirement systems have three sources of revenue to fund the level of benefits guaranteed by statute: (1) member contributions; (2) employer contributions; and (3) investment income. Addressing one measure independently of another would not completely address the major funding issues. However, increasing employee contributions while simultaneously reducing the COLA and increasing the FAS would enable HPRS to move the amortization period within the statutorily required 30-year funding period. These adjustments are projected to decrease the UAL by more than $87 million, reduce the employer's normal cost by roughly 7% and move the amortization period to 29.94 years.

Staff Recommendations

The staff recommends the Ohio Retirement Study Council vote to recommend that the 129th General Assembly vote to approve Sub. S.B. 345 with the following amendments:

- *Amend the reference in §5505.54 (B)(1), line 389, "division (A) of section 5505.15" to "division (A)(1) of section 5505.15";*
- *That the language allowing the HPRS board to establish the employer contribution rate at no more than three times the employee contribution rate be deleted;*
- *That language clarifying that the COLAs granted after the effective date of the bill are not a legally vested benefit;*
- *That the bill be amended to include an anti-spiking provision for the FAS.*

At its meeting of September 10, 2012, the Ohio Retirement Study Council voted to accept the Staff recommendations.

Effective Date

January 7, 2013; certain provisions effective 180 days later.