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Analysis

Am. Sub. S.B. 82 - Sen. Snyder

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Am. Sub. S.B. 82 - Sen. Snyder, et al.

The act implements the following staff recommendations included in the preliminary report of the Joint Legislative Committee to Study Ohio's Public Retirement Plans (JLC) which were generally agreed to by the state retirement systems involved:[1]

• expands the investment authority of the five state retirement systems, the Bureau of Workers' Compensation, and the Ohio Tuition Trust Authority by abolishing the current "legal list" of permissible investments and adopting the "prudent person" rule.

• establishes a 30-year funding period for pension benefits in each system, with a ten-year transition period for SERS and PFDPF.

• requires the five systems to report separately their pension costs and health care costs to the Ohio Retirement Study Commission (ORSC) and the standing committees of the Senate and House with primary responsibility for retirement legislation.

• requires each system to have prepared an actuarial analysis of any introduced legislation having a measurable financial impact upon the system.

• requires an annual medical re-examination of all disability retirees in all five systems, with board authority to waive this requirement based on the recommendation of the board physician on a case-by-case basis.

• requires each board to adopt an administrative rule relative to the coordination of benefits among the five systems' health care plans.

• requires the three non-uniform employee retirement systems (PERS, STRS, SERS) to develop for legislative consideration, within one year of the effective date of the bill, an alternative benefit plan, in conjunction with their existing defined benefit plan, to provide greater pension portability and options for their members.

• requires PFDPF to have prepared an annual actuarial valuation based on the entry age normal cost method and submit it to the Ohio Retirement Study Commission for purposes of determining the adequacy of the statutory contribution rates.

• makes certain miscellaneous changes.

The act addresses the concerns raised by interested parties during hearings before the House Health, Retirement & Aging Committee by eliminating all changes to existing law relative to retiree health care benefits, including the proposed creation of a separate health care fund in each system.

Details of these changes follow.

Prudent Person Investment Authority - The act expands the investment authority of all five systems by eliminating the current legal lists of permissible investments and adopting the prudent person rule.

Under the prudent person rule, the systems are required to discharge their duties with respect to the investment of funds *with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use*

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in the conduct of an enterprise of a like character and with like aims. They are also required to diversify investments so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent *not* to do so. This standard, sometimes referred to as the "prudent investor" rule because it calls for a special capacity beyond ordinary diligence, is modeled after the standard set forth in the Employees Retirement Income Security Act (ERISA) which is applicable to most private pension plans.

Currently, the five systems are governed by the prudent person rule with respect to their investments. In addition, however, current law provides a legal list which further restricts the types and amounts of investments the systems may make. Under the current legal lists, unless an investment instrument is specifically authorized, the systems are prohibited from investing in it, regardless of whether the investment would otherwise be prudent. Also, the current legal lists provide the following maximum limitations on major asset allocation decisions:

Asset Class	Maximum Limitation
U.S. Equities	50% of Total Assets
Real Estate	25% of Total Assets
Canadian Bonds	15% of Total Assets
International Securities[1]	10% of Total Assets
Venture Capital[2]	5% of Total Assets

The act requires each board to adopt annually definitive, written investment guidelines in the following areas: asset allocation targets and ranges; risk factors; asset class benchmarks; time horizons; total return objectives; and performance evaluation measures. The act also requires each system to comply with the performance presentation standards established by the Association for Investment Management and Research (AIMR) when reporting on its investment performance.

The act authorizes each system to establish a corporation exempt from taxation under section 501(c)(2) of the Internal Revenue Code (IRC), a limited liability corporation, or any other legal entity authorized to transact business in Ohio in order to avoid unwanted liability exposure to the rest of the system's assets and certain taxes otherwise payable. The act also modernizes the systems' investment language to recognize electronic wire transactions for custodial purposes.

The act expands the investment authority of the Bureau of Workers' Compensation to the same prudent person standard established for the five state retirement systems. Currently, the investment authority of the Bureau is restricted to a "legal list" similar to that of the five state retirement systems.

The act also expands the investment authority of the Ohio Tuition Trust Authority to the same prudent person standard established for PERS. Currently, the Ohio Tuition Trust Authority has delegated the investment management function to PERS. Therefore, this change is intended to make PERS' investment of tuition trust funds consistent with its investment of retirement funds.

The act makes *no* changes to the investment authority of the Ohio academic scholarship payment fund and the Ohio student aid commission, whose investment authority is referenced to the present investment authority of the Public Employees Retirement System. Therefore, investments by these governmental entities remain subject to the current legal lists.

The five state retirement systems in Ohio are among the largest in the nation. The January 22,

1996 issue of Pensions & Investments, which listed the top 1,000 private and public pension funds, ranked PERS as the 15th largest with nearly $35 billion; STRS as the 17th largest with over $33 billion; PFDPF as the 113th largest with $5.4 billion; SERS as the 124th largest with $4.8 billion; and HPRS as the 797th largest with $405 million.

The change to the systems' investment authority is intended to provide for greater flexibility in asset allocation and selection of investment vehicles in order to achieve further growth in investment earnings and more diversification of plan assets.

Investments play a critical role in the funding of benefit costs. Investment earnings constitute the major source of revenue for all five systems. Twenty years ago, approximately 25% of benefit costs were funded by investment earnings; today, up to 65% of benefit costs are funded by those earnings. The more revenue that is generated by investments, the less contributions that are required from employers and employees, and Ohio taxpayers as the ultimate guarantors of these promised benefits.

As the state pension funds mature, the number of active members eligible for retirement will increase from current levels. The effect will be that the ratio of beneficiaries to active members will increase, and that benefit payments will exceed retirement contributions. It should be understood that this characteristic is to be expected for maturing pension plans, such as Ohio's, and that investments are thus to be relied upon to meet these pension obligations as they become due. The use of investments to pay benefit obligations is part of the intended design of an actuarially-funded pension plan upon reaching maturity.

A widely used actuarial rule of thumb indicates that a 1% increase in the long-term investment return will finance benefit improvements in the range of 10 to 15%, or will allow a similar reduction in contributions or actuarial debt.

The following table shows the annualized rates of return for each system:

System	One Year	Three Year	Five Year	Ten Year
PERS	14.0%	8.9%	9.3%	10.5%
STRS	17.3%	10.1%	10.5%	11.1%
SERS	16.6%	8.8%	9.4%	10.4%
PFDPF	16.9%	10.1%	10.7%	11.1%
HPRS	15.5%	7.9%	9.8%	11.6%

Asset allocation decisions concerning how much to invest in the various asset classes (fixed-income, equities, real estate, international, cash-equivalents, etc.) have a significantly greater impact upon the investment portfolio's long-term rate of return than decisions concerning which specific securities to buy or sell within each asset class. Investment consultants estimate that asset allocation decisions account for approximately 75 to 80% of the overall rate of return on assets.

The following table shows the asset allocation of each system:

System	Fixed-Income	Equities	Real Estate	International	Cash Equiv.
PERS	65.5%	19.5%	7.4%	0.7%	6.9%
STRS	39.0%	46.0%	7.0%	5.0%	3.0%
SERS	32.0%	46.7%	5.0%	8.5%	7.0%
PFDPF	38.9%	39.9%	6.2%	4.8%	9.5%
HPRS	39.5%	48.3%	4.5%	3.0%	4.7%

According to the Knoll Survey of State Public Pension Funds Investment Policies and Practices conducted in 1995, approximately three-fourths of state public pension funds operate under some prudent investment authority and only one-fourth still operate under legal lists of permissible investments. This survey received responses from all 50 states, representing 91 state pension funds with assets of nearly $1 trillion.

The prudent person rule is well understood, has ample case history, and is flexible enough to adjust to modern investment strategies. It has survived the changing economic circumstances of the last 150 years, while the ERISA rule has been used for over 20 years.

In Public Pensions: A Legislator's Guide, NCSL recommends that state legislatures should adopt the prudent person rule, as modified by ERISA, as the basis for allowable public pension fund investments. It further recommends that any statutory restrictions on investments should be broad enough to allow fund managers flexibility in investment policy and strategy.

30-Year Maximum Funding Period - The act establishes a maximum 30-year funding period for amortizing each system's unfunded actuarial accrued pension liabilities. This standard is modeled after the national standard recently adopted by the Governmental Accounting Standards Board (GASB) for all governmental pension plans.[2]

Each board is required to prepare a report in any year in which the funding period exceeds 30 years. The report shall include both of the following: (1) the number of years needed to amortize the unfunded actuarial accrued pension liabilities as determined by the most recent actuarial valuation; (2) a plan approved by the board to reduce the amortization period to *not* more than 30 years.

The report shall be submitted, no later than 90 days after receipt of the actuarial valuation, to the Ohio Retirement Study Commission (ORSC) and the standing committees of the House and Senate with primary responsibility for retirement legislation.

The act requires PFDPF and SERS to report annually on their progress toward meeting the 30-year funding period until a 30-year funding period has been met by these systems.

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[2]Statement No. 25 of the Governmental Accounting Standards Board , effective June 15, 1996, establishes a maximum 40-year funding period for amortizing the unfunded liabilities for benefits, other than post-employment health care benefits, provided by a governmental pension plan for a period of not more than ten years after the effective date of the statement. After that ten-year period, the maximum acceptable funding period is 30 years.

This change is intended to maintain inter-generational equity among taxpayers by limiting the ability to fund benefit costs by simply extending the funding period beyond 30 years. The act provides a ten-year transition period to achieve this maximum 30-year funding requirement for PFDPF and SERS and ensures that all five state retirement systems meet the national standards for governmental pension plans.

The following tables show the funding periods for benefits, other than post-employment health care benefits, in each system:

System	Funding Period
PERS	
• State	17.0 Years
• Local	21.0 Years
• Law	12.0 Years
STRS	29.3 Years
SERS	34.0 Years
PFDPF	39.0 Years[3]
HPRS	27.0 Years

Reporting of Pension Costs and Health Care Costs - The act requires the systems to submit the following information to the ORSC and the standing committees of the House and Senate with primary responsibility for retirement legislation:

• An **annual actuarial valuation** of the system;

• A **five-year experience study** of the system;

• An **annual report providing a full accounting** of the revenues and costs relating to the provision of retiree health insurance.

The act defines "actuary" to mean an individual who is a member of the American Academy of Actuaries, is an associate or fellow of the Society of Actuaries, and has a minimum of five years' experience in providing actuarial services to public retirement plans.

The **annual actuarial valuation** shall be made as of the end of each fiscal year by an actuary in accordance with actuarial standards promulgated by the Actuarial Standards Board of the American Academy of Actuaries. The valuation shall include the following information: a summary of the benefit provisions on which the valuation is based; a summary of the census data and financial information used in the valuation; a description of the actuarial assumptions, actuarial cost methods, and asset valuation methods used in the valuation, including a statement of the assumed rate of payroll growth and the assumed rate of growth or decline in the number of contributing members; a summary of findings that includes a statement of the actuarial accrued liabilities and unfunded actuarial accrued liabilities for all benefits other than post-employment health care benefits; a schedule showing the effect of any changes in the benefit provisions, actuarial assumptions, or cost methods since the last annual actuarial valuation; and a statement of whether contributions to the retirement system are expected to be sufficient to satisfy the funding objectives established by the board.

The actuarial valuation shall be submitted no later than the first day of the eleventh month following

the end of the previous fiscal year

The **five-year experience study** of the system shall also be made by an actuary, and shall provide a comparison between the *actual experience* of the system and the *actuarial assumptions* of the system. The study shall include the following information: a summary of the relevant decrement and economic assumption experience observed over the five-year period; recommended changes in actuarial assumptions; a measurement of the financial effect of the recommended changes in actuarial assumptions.

The study shall be submitted no later than the first day of the eleventh month following the last fiscal year of the period the study covers.

An **annual report providing a full accounting** of the revenues and costs relative to the provision of retiree health care benefits shall be prepared by each board as of the end of each fiscal year. The report shall include the following information: a description of the statutory authority for retiree health care benefits; a summary of the benefits; a summary of the eligibility requirements for the benefits; a statement of the number of participants eligible for the benefits; a description of the accounting, asset valuation and funding methods for these benefits; a statement of the net assets available for these benefits; a statement of any changes in net assets available for these benefits, including participant and employer contributions, net investment income, administrative expenses, and benefits provided; a schedule of the net assets available for these benefits, the annual cost of benefits, administrative costs incurred, and annual employer contributions allocated for these benefits for the last six consecutive fiscal years. and a description of any significant changes that would affect the comparability of the report.

The report shall be submitted no later than the last day of the six month following the last fiscal year.

Actuarial Analysis of Proposed Legislation - The act requires each system to have prepared by an actuary an actuarial analysis of any introduced legislation having a measurable financial impact on the system. The actuarial analysis shall include the following information: a summary of the statutory changes; a description of the actuarial assumptions and cost method used in the analysis; a description of the participant group included in the analysis; a statement of the financial impact of the legislation, including the resulting increase, if any, in the employer normal cost percentage; the increase, if any, in the actuarial accrued liabilities; and the percentage of payroll that would be required to amortize the increase in the actuarial accrued liabilities as a level percent of payroll over a period not to exceed 30 years; and a statement of whether the scheduled contributions to the system after the proposed change is enacted are expected to be sufficient to satisfy the funding objectives established by the board.

The act requires the system to submit, no later than 60 days from the date of introduction, an actuarial analysis of the proposed legislation to the ORSC, the Legislative Budget Office (LBO), and the standing committees of the House and Senate with primary responsibility for retirement legislation. This change recognizes that there is often either inadequate information, uncertain understanding, or both, when decisions about public pension plans are made. These decisions often involve significant long-term costs. A single, ill-conceived retirement bill could have serious fiscal consequences which are not fully recognized for many years later. If not made carefully and with foresight, these decisions can threaten the budgetary stability of state and local governments years later when the pension obligations become due. They can also affect the credit rating of the state or local government's debt. Therefore, the requirement that an actuarial analysis be attached to all introduced pension legislation is intended to provide immediate recognition of the long-term cost implications of retirement decisions made today.

Annual Medical Re-examination of Disability Retirees - The act requires an annual

medical re-examination of all disability retirees in all five systems with board authority to waive this requirement if the board physician specifies that the disability is ongoing.

Currently, the non-uniformed employee systems (PERS, STRS, SERS) *may* require disability retirees to undergo a medical re-examination. If the retiree refuses, the disability benefit shall be discontinued until withdrawal of the refusal. If the refusal continues for one year, the retiree's rights to the disability benefit shall be forfeited. The act mandates an annual medical re-examination unless the board physician determines the disability to be ongoing.

Current law also permits HPRS to require disability retirees under age 55 to undergo a medical re-examination at such times as the board considers necessary. The act retains the age limitation under current law, but requires the system to conduct annual medical re-examinations unless waived by the board physician.

The PFDPF disability provisions were recently amended in H.B. 226 (121st G.A.) to authorize the board to conduct medical re-examinations of disability retirees at such times as the board considers necessary. The act requires these medical re-examinations on an annual basis for all disability retirees who have been members of the fund for less than 25 years and have not attained age 48, with board authority to waive this requirement based on the recommendation of the board physician. All other disability retirees are still subject to medical reexaminations at such times as the board considers necessary. The act also eliminates the annual filing statement of medical condition for all PFDPF disability retirees.

This change is intended to identify disability retirees who are capable of resuming employment in their previous position or a position similar thereto, thereby removing them from the systems' disability rolls.

Board Rule on Coordination of Health Care Coverage - The act requires each board to adopt a rule for the coordination of health care coverage provided by the system with similar coverage provided by any of the other four systems.

This change is intended to prevent certain individuals who qualify for health care coverage under more than one plan from abusing the system.

Alternative Retirement Proposals - The act requires the three non-uniform employee retirement systems (PERS, STRS, SERS) to prepare a report that establishes a plan providing for an alternative benefit program. The board shall submit, no later than one year after the effective date of the bill, the report to the ORSC and the standing committees of the House and Senate with primary responsibility for retirement legislation.

This change is intended to provide greater pension portability and benefit options for short-term, mobile public employees.

Entry Age Normal Cost Method - The act requires the PFDPF actuary to prepare for the ORSC an annual actuarial valuation based on the entry age normal actuarial cost method for purposes of its review of the adequacy of the statutory contribution rates pursuant to R.C. §742.311. The entry age normal cost method is traditionally used to evaluate the adequacy of fixed contribution rates, and is used by the other four systems.

Currently, the PFDPF actuary provides to the ORSC an annual actuarial analysis based on the frozen initial liability normal cost method. Though a generally acceptable actuarial cost method, this method is not the ideal method for purposes of evaluating the adequacy of fixed contribution rates, and makes the Commission's actuarial review more difficult.

Miscellaneous Amendments - The act amends STRS and SERS laws to grandfather in members who first establish membership prior to July 1, 1996 under the higher compensation limits permitted under prior federal tax law. The lower compensation limits ($150,000), upon which retirement contributions may be based, would apply to all members who join either system on or after July 1, 1996.

The act limits PERS retirees, who held public office at the time of retirement and who were subsequently elected or appointed to the same office for the remainder of the term or for the immediately succeeding term, to the following option under existing law:

- forego the original retirement allowance during the period of employment (the pension portion based on employer contributions is forfeited and the annuity portion based on employee contributions is suspended) and become a "new" member of the retirement system, with all rights, privileges and obligations of such membership except survivor coverage.

As a new member, the PERS retiree contributes to the system and accrues service credit. Upon termination of employment, the retiree receives either a refund of the member's accumulated contributions made during the re-employed period, without interest, or a "2.1% formula benefit" based solely on the service accrued during the re-employed period. The retiree is *not* permitted to combine the service for the two period of employment and have the original retirement allowance recalculated based upon the combined service. The retiree receives the suspended annuity portion of the original retirement allowance in a lump sum payment and the original allowance resumes on the first day of the month following termination of employment.

This change is intended to curb the abuse of double-dipping by certain elected officials covered under PERS.

ORSC Position - At its meeting of March 13, 1996 the Ohio Retirement Study Commission voted to recommend that the 121st Ohio General Assembly approve Sub. S.B. 82 upon the adoption of several technical amendments to be worked out with the systems. These technical amendments have been subsequently worked out and agreed to by the five systems, and are incorporated in the act.

Effective Date - March 7, 1997, except that the legislative changes relative to elected officials shall take immediate effect on December 6, 1996.

[1]Exclusive of Canadian and Israeli government bonds

[2]Restricted to Ohio-based entities

[3]Data are not comparable based on the use of a different actuarial cost method.