A Rebuttal of the State Teachers Retirement System Fact Sheet on the Mitigating Rate

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This fact sheet provides a point-by-point rebuttal to the State Teachers Retirement System of Ohio Fact Sheet titled "Mitigating Rate" (https://www.strsoh.org/aboutus/impact/_pdfs/40-307.pdf). All of my data are publicly available, and I am happy to provide any of it to you upon request.

ORC 3305.06(D)

The STRS fact sheet starts out by listing the requisite language in the Ohio Revised Code from section 3305.06(D). Their listing of the code as of the writing of their fact sheet is factual, however, you should note that Ohio Revised Code uses the word "mitigate". They do not use the word compensate, or remunerate, or repay. It is important to keep this word in mind when considering legislative intent.

How the alternative retirement plan (ARP) negatively impacts STRS Ohio.

When the ARP was established in 1997, STRS had an existing unfunded liability of $7.8 billion, or 20% of their assets. This means that STRS had already spent significantly more on benefits than they gained annually from contributions or investments well before ARP was established. They wanted anyone who already was in STRS, but opted out of STRS and into ARP, to help pay that off. They also were worried that people who would have lower benefits would opt out, while people with higher benefits would remain in the system, so they wanted a tax to help keep that from happening. That is, they worried about selection bias in that they thought that ARP would take away people who would have put more into the system than they got out, and that the people left in STRS would be people who put in less than they ultimately took out. There was debate about this in 1996/97 when ARP was adopted, with actuaries hired at the behest of the Ohio Inter-University Council suggesting small to no impact, and actuaries hired by STRS suggesting the impact would be large.

Explaining the mitigating rate and why it's necessary

STRS says "The rate was initially set at 6% - the amount actuarially determined to mitigate for the negative financial impact – and it was expected to be in place until the STRS Ohio's unfunded liability was retired." The law was written, and STRS agrees, ***such that the initial ARP entrants***, those who transferred from STRS, would help pay off the $7.8 billion unfunded liability. The law was not written to require mitigation beyond that because everyone expected that STRS would do the right thing and reduce their unfunded liability. What actually happened was something different. STRS boldly increased their assumed rate of return to 7.75% per year in 2000, and 8.0% per year in 2003, despite their own market returns of 6-7%. They consequently made benefit decisions based on the assumption that they would get the higher rate of return, when in fact they were getting 1-2% per year less in the market. The results were predictable, their unfunded liability ballooned to $47 billion in 2012 before the legislature stepped in and forced STRS to make changes. Although the generous 13th checks stopped in 2000, after a 20 year run that increased the unfunded liability by $711 million, STRS clearly continued to make bad decisions in the 2000s, and these bad decisions are what have encouraged the large unfunded liability to remain in place, not the ARP.

The mitigating rate allows employers to pay their obligations over time

Yes, the mitigating rate forces employers to pay STRS money on behalf of ARP members indefinitely. STRS points out that "This long-term approach also allowed the employers to avoid a larger upfront exit payment". Really? Look at the numbers. In 1996, the unfunded liability was $7.8 billion. ARP was initially 1.4% of the STRS total possible payroll. The initial buyout of the unfunded liability would have been 1.4% of $7.8 billion, which would have been $109 million. Using the long-term approach, however, ARP members have now paid out $331 million to STRS, which if invested in an S&P 500 index fund would be worth $689 million. An initial severance fee would have been far better for the individuals in ARP, while the mitigating clearly only benefits STRS.

Defined benefit plans are funded differently than 401k plans.
State law says the following in ORC 3305.06(B): "Each public institution of higher education employing an electing employee shall contribute a percentage of the employee's compensation to the provider of the investment option the employee has selected. This percentage shall be equal to the percentage that the public institution of higher education would otherwise contribute on behalf of that employee to the state retirement system that would otherwise cover that employee's position, less the percentage contributed by the public institution of higher education under division (D) of this section." It is clear employers are required to put money into ARP accounts by state law.

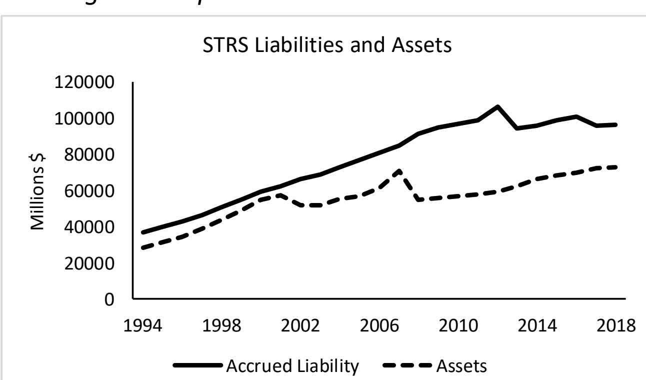
Debunking STRS so called "myths"

This section states the so-called myths about the mitigating rate that STRS has described in their fact sheet (https://www.strsoh.org/aboutus/impact/_pdfs/40-307.pdf), and it rebuts them.

Myth 1: Money is being diverted from ARP accounts to STRS Ohio
By ORC 3305.06(B), as quoted above, the state has written state law so that money can be diverted. Nobody argues that STRS is doing this illegally, however, we argue that there is no longer any justification for STRS to be diverting this money.

Myth 2: Employers will always put the maximum employer contribution allowed by Ohio law into ARP
STRS says "Once 14% of the employer contribution is no longer needed to pay down STRS Ohio's unfunded liability, employer contributions could be reduced". ORC 145.48 puts a cap on employer contributions at 14%. They have been 14% for 30 years, while STRS has maintained an unfunded liability. What incentive does STRS actually have to eliminate the unfunded liability? If they do, by their own admission, they may have to reduce the employer contribution for a time. Then what would they do when they inevitably had to raise it again? Imagine the howl from local school boards. If you think about it, it makes no sense for STRS ever to get rid of the unfunded liability because they would come under intense political pressure to reduce the employer contribution, and that would be disastrous.

Myth 3: STRS Ohio is NOT hurt financially because faculty who would have contributed to STRS Ohio are choosing an ARP plan

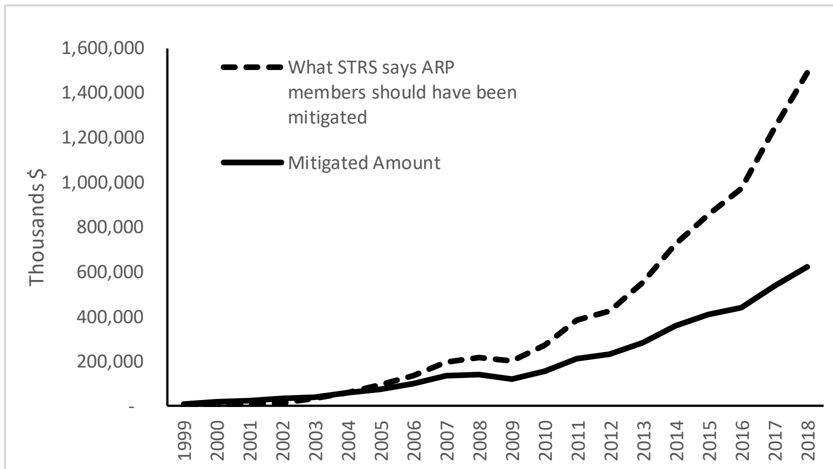


STRS conveniently forgets that their balance sheet includes assets and liabilities. Someone in ARP represents a future flow of both that STRS no longer has to keep on the books. The figure to the left, derived from STRS annual actuarial valuations, shows that the future flow of liabilities is larger than assets for 25 years. This means that for the last 25 years at least, STRS benefits when someone opts out of STRS, not the other way around.

Myth 4: ARP are the only faculty affected by the mitigating rate?
Everyone agrees that all faculty are affected by the mitigating rate. It harms ARP members and benefits STRS members.

Myth 5: Higher education employers are paying more than they are statutorily required to pay to STRS.
There was a short period in which STRS appears to have illegally gotten employers to increase their mitigation without consent of the Ohio Retirement Study Council, which the law requires. This is a matter for the courts to decide. But other than that, we all agree that the legislature has created the problem of mitigation, and it needs to correct it.

A more important question is whether the recent legislation that sets the mitigation rate is realistic. The calculation is specified by law in ORC 3307.514. It bases the determination of future mitigation essentially on the difference between what STRS says is the historical liability of ARP members, and what mitigation has actually provided, which is shown to the right (data directly from STRS). This difference, as of 6/30/2018, is $868 million.



While the unfunded liability has declined by $23 billion from 2012 to the present, the supposed shortfall of contributions by ARP members has increased by $673 million. In fact, STRS claims that ARP employers should be contributing over 17% of their ARP employees income each year to the unfunded actuarial liability. This is astounding, given that back when ARP started in 1996, STRS claimed that ARP should only pay 6% (see above). By the approach in law, if the unfunded liability were $0, and STRS followed ORC 145.48 and reduced the employer contribution to 0%, the calculation the legislature has devised would still state that the mitigating rate should exceed 17%.

This accounting magic, which the legislature has voted into law, only mirrors the accounting magic that STRS uses. Every year, they calculate what is known as the normal rate, which is the % of an individual's income that covers the benefits they earned that year. Currently, the normal rate hovers around 10.5%, meaning that only 10.5% of an individual's income is needed each year to cover their future benefits. By STRS accounting, they believe that they get enough from the 14% employee contribution each year to meet their benefit obligations, with 3.5% to spare. Just looking at the figure on assets and liabilities above, however, it's hard to take their accounting seriously when STRS actually gets 28% of each person's current salary, and the only dent in the unfunded liability they made in recent times was when they reduced benefit payouts and increased employee contributions from 2011-2015 and most recently when they eliminated the cost of living adjustment.