Members Brief

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Funding Public Retirement Benefits

Retirement benefits provided by the state retirement systems are funded through employee and employer contributions and earnings from investing those contributions. Each retirement board manages and invests the funds created to pay for retirement benefits. Federal and Ohio law, however, restrict each board's investment practices and with whom it may do business. This brief addresses the legal and other related issues that pertain to funding public retirement benefits.

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Funding public retirement benefits

> In 2022, retirement benefits totaled about $17 billion.

Most Ohio public employees are members of one of the five state retirement systems: the Public Employees Retirement System (PERS), Ohio Police and Fire Pension Fund (OP&F), State Teachers Retirement System (STRS), School Employees Retirement System (SERS), and State Highway

Patrol Retirement System (SHPRS).[1] With few exceptions, Ohio public employees do not participate in Social Security for their public service.[2] Each system provides retirement, disability, survivor, health care, and other benefits. Each system's primary responsibility is to provide retirement benefits.[3] Most retirement benefits provided by the systems consist of a lifetime benefit determined by a formula prescribed in law.[4]

Retirement benefits are funded through employee and employer contributions and investment earnings. The way benefits other than retirement benefits are funded may vary. For example, all of the systems, though not required by law, provide health care benefits. Health care benefits are funded only through part of the employer contributions.[5] This brief focuses on the issues related to funding retirement benefits.

State retirement boards

Each retirement system is overseen by a board that manages and invests the funds created by law to pay for retirement benefits.[6] Board members must complete an orientation and continuing education program that includes topics on board member duties and investments.[7]

Combined, the boards manage a total of about $250 billion in assets.

Federal tax treatment

As qualified governmental plans, the retirement systems receive favorable tax treatment under federal law with respect to retirement system contributions and investments earnings. In addition, they are not subject to minimum federal funding or other requirements under the federal Employee Retirement Income Security Act of 1974[8] (ERISA). Although exempt from ERISA, they are still subject to regulation. In addition to satisfying other requirements, the retirement boards must comply with fiduciary and other investment standards set by the federal Internal

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[1] One municipal retirement system, not addressed in this brief, exists: the Cincinnati Retirement System.

[2] See Publication 963 (PDF), which may be accessed by conducting a keyword "963" search on the Internal Revenue Service (IRS) website: irs.gov.

[3] This brief uses "retirement benefits" to refer to the payments made to a retirant from the retirement system. These payments are called a "retirement allowance" in the PERS, STRS, and SERS laws, and a "pension" in the SHPRS and OP&F laws. (R.C. 145.01(Q), 742.01(H), 3307.50(G), 3309.01(N), and 5505.01(M).)

[4] See page 11 of Historical Experience of the Five Ohio Retirement Systems (PDF), which may be accessed by conducting a keyword "historical" search on the Ohio Retirement Study Council (ORSC) website: orsc.org.

[5] R.C. 145.58, 742.45, 3307.39, 3309.69, and 5505.28.

[6] R.C. 145.04, 742.03, 3307.03, 3307.05, 3309.04, 3309.05, and 5505.04.

[7] R.C. 171.50, 145.041, 742.031, 3307.051, 3309.051, and 5505.064.

[8] 29 United States Code (U.S.C.) 1001, *et seq.*

Revenue Code, in Ohio law, and at common law.[9] For example, to receive favorable federal tax treatment, a governmental plan must use and invest plan assets for the exclusive benefit of employees and beneficiaries. If a plan violates that requirement, the violation could result in the loss of the plan's qualified status, which may cause adverse tax consequences.[10]

Contributions

About 660,000 active members are making retirement system contributions.

Ohio law prescribes the required employer and employee contribution rates for each retirement system. In some cases, the law authorizes a retirement board to establish them up to a statutory maximum. The employee contribution rate is a percentage of the employee's salary. The employer contribution rate is an amount equal to a percentage of an employee's salary. An employee's salary is used to determine the contribution amounts and, in most cases, calculate the employee's retirement benefit.[11] Salary includes the salary, wages, and other earnings paid to an employee for employment in a position covered by a retirement system. But, it does not include some other types of compensation, such as fringe benefits or payments for accrued but unused leave.[12] The table below shows the contribution rates for each system for 2024.

Employee and employer contribution rates to the state retirement systems for 2024		
Retirement system	**Employee**	**Employer**
PERS *(R.C. 145.47(A) and 145.48)*	10.00%	14.00%
PERS law enforcement officers *(R.C. 145.49)*	13.00%	18.10%
PERS public safety officers *(R.C. 145.49)*[13]	12.00%	18.10%

[9] 29 U.S.C. 1003(b)(1) and see, e.g., 26 U.S.C. 401(a)(2), R.C. 5801.05, and Restatement of the Law 3d, Trusts, Sections 78, 90, and 91 (addressing a trustee's duty of loyalty, to prudently invest and manage trust funds, and to follow state law regarding investments).

[10] 26 U.S.C. 401(a)(2), Revenue Ruling 69-494 and 73-532, Revenue Procedure 72-6, *Ada Orthopedic, Inc. v. Commissioner*, T.C. Memo 1994-606, *6 (1994), and see pages 12 to 14 of Qualification and Taxation Issues for Governmental Retirement Plans (PDF), which may be accessed by conducting a keyword "governmental retirement plans" search under "IRS Archives" on the National Conference on Public Employee Retirement Systems website: ncpers.org.

[11] Instead of "salary," the PERS law uses the term "earnable salary," and the STRS and SERS laws use the term "compensation" (R.C. 145.01(R), 3307.01(L), and 3309.01(V)).

[12] R.C. 145.01(R), R.C. 742.01(L), 3307.01(L), 3309.01(V), and 5505.01(R).

[13] What is OPERS?, which may be accessed by conducting a keyword "what is OPERS" search on the PERS website: opers.org.

Employee and employer contribution rates to the state retirement systems for 2024		
Retirement system	**Employee**	**Employer**
STRS *(R.C. 3307.26 and 3307.28)*[14]	14.00%	14.00%
SERS *(R.C. 3309.47 and 3309.49)*[15]	10.00%	14.00%
OP&F police *(R.C. 742.31 and 742.33)*	12.25%	19.50%
OP&F fire *(R.C. 742.31 and 742.34)*	12.25%	24.00%
SHPRS *(R.C. 5505.15)*[16]	14.00%	26.50%

Investments

Fiduciary and investment standards

Investment earnings fund the majority of a retirement benefit.

Ohio law governs each retirement board's investment authority with respect to the funds created to pay for retirement benefits. Each board has full power to invest the system's funds. Board members are the fund trustees. They and other fiduciaries must discharge their duties with respect to the funds (1) solely in the interest of participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the systems, and (3) by diversifying investments to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.

The standard under which the boards must make investment decisions is the "prudent expert standard." This standard requires them to act:

> [W]ith care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

[14] Contribution rates, which may be accessed by conducting a key word "contribution rates" search on the STRS employer website: strsoh.org/employer.

[15] Compensation and Contributions, which may be accessed by conducting a keyword "contributions" search on the SERS website: ohsers.org.

[16] See page 12 of the Highway Patrol Retirement System 2023 Annual Comprehensive Financial Report (PDF), which is available by clicking on "SHPRS-State Highway Patrol Retirement System" under "Reports" on the ORSC website: orsc.org.

No purchase or sale of any investments can be made except as authorized by the board. For PERS only, all investments must be purchased at current market prices.[17]

Investment programs and policies

The boards annually must adopt and publish policies, objectives, or criteria for their investment programs that include asset allocation targets and ranges, risk factors, asset class benchmarks, time horizons, total return objectives, and performance evaluation guidelines. They also must adopt written policies to establish criteria and procedures used to select agents to execute securities transactions.[18] The boards must establish goals to increase the use of Ohio-qualified agents to execute domestic equity and fixed income trades.[19] They also must establish policies to increase the use of Ohio-qualified investment managers.[20]

Investment officers and employees

Each board employs professionals, including a chief investment officer and other lower level investment officers, to carry out its investment program. To be employed as an investment officer, an individual must be licensed by the Department of Commerce's Division of Securities. An individual also must be licensed if employed in a position having charge of an asset class or in a substantially equivalent position.[21]

Prohibited transactions

Federal and Ohio law restrict the boards' investment practices and with whom they may do business. With some exceptions, a board cannot engage in a transaction that benefits a board member or other fiduciary. A board is prohibited from doing business with certain individuals or businesses with ties or former ties to the retirement system.[22] Ohio law authorizes the Attorney General to sue a board member for a fiduciary duty breach to obtain monetary or other relief, including an order preventing specified activities or removing the board member.[23]

Retirement plan types

The retirement plan type a member selects when starting public employment determines how contributions and investment earnings fund a retirement benefit.

[17] R.C. 145.11, 742.11, 3307.15, 3309.15, and 5505.06.

[18] R.C. 145.11, 742.11, 3307.15, 3309.15, and 5505.06.

[19] R.C. 145.114, 742.114, 3307.152, 3309.157, and 5505.068.

[20] R.C. 145.116, 742.116, 3307.154, 3309.159, and 5505.0610.

[21] R.C. 145.094, 742.104, 1707.01(JJ), 1707.162, 3307.043, 3309.043, and 5505.065

[22] 26 U.S.C. 503 and R.C. 145.111 to 145.113, 742.111 to 742.113, 3307.151, 3307.18, 3307.181, 3309.155, 3309.156, 3309.19, 5505.061, and 5505.08.

[23] R.C. 109.98.

- **Defined benefit (DB) plans** – the retirement benefit is based on a formula prescribed in law that is not influenced by investment earnings. The benefit is calculated based on a member's age, years of service, and final average salary. Contributions and investments of all DB plan participants are pooled, rather than placed in individual accounts. Most retirement benefits provided by the retirement systems are through the systems' DB plans.[24]

Close to 490,000 retirants are receiving retirement benefits from the state retirement systems.

- **Defined contribution (DC) plans** – the retirement benefit is based on investment earnings of contributions in an individual account. DC plan participants choose the investments into which their contributions are placed. The benefit is determined by the amount of money in the account on retiring.
- **Combined plans** – the retirement benefit is based on a combination of both a DB plan and DC plan. The member's account includes a portion of each plan type. Both portions determine the benefit.[25]

All five systems have DB plans. PERS and STRS also offer DC plans. Only STRS offers a combined plan. SERS may establish a DC or combined plan, but it has not done so, and PERS stopped offering its combined plan beginning January 1, 2022.[26]

30-year amortization period

Each retirement system collects contributions and invests them with the objective that those assets will be sufficient to fund retirement benefits. Ideally, sufficient assets are set aside to prefund the DB plan so that each generation pays for its own benefits (referred to as "intergenerational equity").[27] Actuaries assist the systems in valuing benefits and developing strategies to fund them. None of the systems, however, currently have sufficient assets to cover the actuarial accrued liability for all promised benefits. Thus, all of the systems have an unfunded actuarial accrued liability (UAAL). Ohio law requires the systems to pay down this UAAL over a period not exceeding 30 years. Eliminating the UAAL requires active members and their employers to pay more contributions than is necessary to fund the active members' future benefits, as those contributions also must cover the unfunded benefits of current retirants. Paying down this unfunded amount is not done immediately but over a period of time. This is referred to as the amortization of the UAAL.

[24] See page 11 of Historical Experience of the Five Ohio Retirement Systems (PDF).

[25] See Pensions 101, which may be accessed by conducting a keyword "pensions 101" search on the PERS website: opers.org, and Plan Options, which may be accessed by conducting a keyword "plan options" search on the STRS employer website: strsoh.org/employer.

[26] R.C. 145.81, 3307.81, and 3309.81. See also Employer Notice (PDF), which may be accessed by conducting a keyword "plan selection options" search on the PERS website: opers.org.

[27] See page 2 of UAAL and its Amortization (PDF), which may be accessed by conducting a keyword "amortization" search on the ORSC website: orsc.org.

If a system is unable to amortize its UAAL over a 30-year period, Ohio law requires that system to develop a plan to amortize those liabilities over a 30-year period. This is often referred to as the "30-year funding plan." The system must submit that plan to the Ohio Retirement Study Council and the House and Senate standing committees primarily responsible for retirement legislation.[28]

Mitigating rate

Members participating in a plan other than a system's DB plan, such as a DC plan, will affect how much is contributed to the DB plan for UAAL amortization purposes. To mitigate any negative financial impact to the DB plan, Ohio law authorizes a transfer of a portion of employer contributions for non-DB plan participants to the DB plan.[29]

[28] R.C. 145.221, 742.16, 3307.512, 3309.211, and 5505.121 and see UAAL and its Amortization (PDF).

[29] R.C. 145.222, 145.87, 3305.06, 3307.514, and 3307.84 and see R.C. 3309.212 and 3309.88.