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February 28, 2017

Mr. George Hopkins
Executive Director
Arkansas Teacher Retirement System
1400 West Third Street
Little Rock, Arkansas 72201

Re: HB 1287 of 2017 as Engrossed

Dear Mr. Hopkins:

You have asked us for our analysis of House Bill (HB) 1287 as it relates to the Arkansas Teacher Retirement System (ATRS).

Section 1 of HB 1287 modifies Arkansas Code §24-7-202 (17) to add new subdivision (G) which expands the definition of "employment in a school" to include employment with a covered employer that elects to treat embedded employees of contractors as members of the System.

Section 2 of HB 1287 modifies Arkansas Code to add an additional Section §24-7-506 concerning outsourcing of employees. This section first provides definitions of important terms that are needed for administration of the new outsourcing provisions. It then describes the choices that employers have regarding the treatment of outsourced employees with respect to participation in ATRS, and the required contributions to ATRS. Finally, it provides certain administrative rules and provides the ATRS Board with authority to promulgate additional rules as necessary.

Particular definitions of importance are:

1. A *covered employer* is an employer as defined in §24-7-202 except for any non-mandatory employer or post-secondary or higher education employer as defined in §24-7-1602.
2. *Outsource or Outsourcing means* the use of a (outsource) contractor by a covered employer to provide the covered employer with a "*service that is common to the daily operation of the covered employer"* (also a defined term).
3. An *embedded employee* is a person who provides outsourced services on the premises of a covered employer and is employed and paid by an outsource contractor.
4. A *participating employer* is a covered employer that outsources and opts for the embedded employees of all its outsource contractors to become members of ATRS and to accrue service credit therein.
5. A *surcharge employer* is a covered employer that outsources and pays a surcharge to ATRS in lieu of opting for embedded employees of outsource contractors to accrue service credit in the System.

A covered employer that enters into an agreement to outsource a service that is "*common to the normal daily operation*" must make an irrevocable election to either become a *participating* *employer* or a *surcharge employer* within 60 days of the outsourcing agreement (or within 60 days of the effective date of the Act corresponding to HB 1287).

HB 1287 provides that if a covered employer elects to become a *participating employer*, the employer is to remit employer and member contributions (if any) to ATRS in the same amount and in the same manner as otherwise would be required by §24-7-401 and §24-7-406.

If, on the other hand, a covered employer elects to become a *surcharge employer*, the employer is to remit a surcharge of up to 4% of the employee's salary to ATRS in the manner that otherwise would be required for covered employer contributions and reporting under §24-7-401. The percentage would be phased in as follows: 0.5% in Fiscal 2018, 1% in Fiscal 2019, 2% in Fiscal 2020, 3% Fiscal 2021, and 4% in Fiscal 2022 and in each subsequent year.

HB 1287 provides an option for an employer that begins outsourcing subsequent to the effective date of the Act corresponding to the bill, and elects to be a participating employer. In that case, the employer can select a delayed effective date for participation. The delayed effective date may be no later than the beginning of the third fiscal year after the effective date of the outsourcing agreement. During the delay period, the employer will be treated as a surcharge employer and its embedded employees will not receive service credit in ATRS.

Arkansas Code §24-7-401 provides that employer contributions to ATRS are a fixed percentage of covered employee payroll. That percentage is currently 14%. Based upon the June 30, 2016 actuarial valuation, 6.78% of payroll pays for benefits currently accruing on behalf of covered members and 7.22% of payroll is applied to the financing of unfunded accrued liabilities.

Under current law, when a position is outsourced, the entire 14% of payroll employer contribution is lost to the System and, in particular, the System does not receive the 7.22% of payroll that would otherwise be applied to the financing of unfunded accrued liabilities. Consequently, as a general rule, outsourcing acts to increase the amortization period and is therefore harmful to ATRS.

House Bill 1287 provides that regardless of the choice the covered employer makes with regard to becoming a *participating employer* or a *surcharge employer*, ATRS will continue to receive employer contributions at some level on the outsourced payroll. Depending on whether outsourcing employers elect to become *participating employers* or *surcharge employers*, the portion of employer contribution that will be applied toward the unfunded liability will be either 7.22% or an amount that gradually increases to 4% as described above.

Complete data regarding the outsourced positions that would immediately be affected by the provisions of HB 1287 is not available. Based upon discussions with ATRS staff, we understand that the amount of outsourced payroll may be on the order of $60,000,000. If HB 1287 becomes law and all of the outsourcing employers choose to be *surcharge employers*, the 4% cap on contributions would ultimately apply. The ultimate financial result would be increased contributions to ATRS of $2.4 million per year beginning in Year 5. A recurring contribution of that approximate magnitude would reduce the amortization period by about 5 to 7 months. If some outsourcing employers choose to be participating employers, the effect would be somewhat greater.

Please review this letter carefully to ensure that we have understood the bill properly and that the assumptions we have made are reasonable. The analysis in this letter should not be relied upon if there is doubt about our understanding of the bill or the reasonability of our assumptions. Our analysis relates only to the plan changes described in this correspondence. In the event that other plan changes are being considered, it is very important to remember that the results of separate actuarial analyses cannot generally be added together to produce a total. The total can be considerably greater than the sum of the parts due to the interaction of various plan provisions with each other, and with the assumptions that must be used.

We did not review this bill for compliance with Federal, State, or local laws or regulations, and internal revenue code provisions nor did we attempt to determine whether these changes would contradict or negate other related State, or local laws or provisions of other proposed legislation. Such a review was not within the scope of our assignment.

Brian B. Murphy, Judith A. Kermans and Heidi G. Barry are Members of the American Academy of Actuaries (MAAA) and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein.

This communication shall not be construed to provide tax advice, legal advice or investment advice.

Sincerely,

Judith A. Kermans

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