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August 19 2010

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

Re: Include Reciprocal Service in TDROP Reduction

Dear George:

Section 24-2-402 of the Laws of the State of Arkansas defines the rules for receiving reciprocal service credit and Section 24-7-601(e)(2) states that when establishing eligibility for a benefit from the Arkansas Teacher Retirement System (ATRS), "the credited service under all reciprocal systems shall be totaled and the total credited service shall be used in determining eligibility for a system benefit."

When establishing eligibility for TDROP, 30 years of total service credit is needed according to Sections 24-7-1301 (Election to participate) and 28 years is needed according to section 24-7-1314 (Early participation). The TDROP reduction amount is defined in Section 24-7-1306. It is 100% of the accrued plan benefit reduced by 1.0% for each year of contributory service credit and fractions thereof and 0.6% multiplied by each year of non-contributory service and fractions thereof. Members who participate in TDROP with 28 or more years of service but less than 30 years of service suffer a further reduction of 6% for each year (0.5% per month) below 30 years.

Our understanding is that while reciprocal service is used to establish eligibility for TDROP, such service is not used in calculating the reduction factor. In other words, an individual who has 5 years of actual ATRS service and 25 years with a reciprocal system could enter TDROP. A contributory individual in this circumstance would receive 95% of the retirement benefit as a TDROP deposit, while an individual with 30 years of actual ATRS service would only receive 70% of the retirement benefit as a TDROP deposit (of course in the latter case, the benefit calculation would be based upon 30 years of service, while in the former case, it would be based upon 5 years). You have asked us to provide an analysis of the financial impact of including the reciprocal service in the calculation of the TDROP reduction. We assume it would not be used in the calculation of the retirement benefit itself.

This change would likely result in overall TDROP deposits that are smaller than they are now, which would produce a savings for ATRS. We do not have specific information on amounts of reciprocal service for current active members or members participating in TDROP. Therefore, our cost analysis is based on individuals currently in TDROP. For the analysis, we assumed that any individual in TDROP who had 28 or more years of service had no reciprocal service, and that any individual who had less than 28 years of service had exactly enough reciprocal service so that the total would be 28 years. We then re-calculated the TDROP reduction to include the presumed amount of reciprocal service. The assumption that we made will not be accurate for any individual, but we believe that the resulting calculations will be sufficient to approximately estimate the financial effect of the proposed change.

Based on these assumptions, we estimate that the effect of using reciprocal service in the calculation of the TDROP reduction for current members in TDROP to be an ultimate savings of about $21 million dollars per year. Unless the changes were applied to individuals presently in TDROP, this savings would not be seen all at once. Rather, the savings would emerge gradually over a period of years. Based upon the data we have observed, and assuming that the distribution of future TDROP participants with reciprocal service is similar to what we have assumed in our analysis, we think that the initial savings will be on the order of $2 to $3 million, increasing by approximately the same amount each year as each new cohort of members enters TDROP until $21 million is reached after 7 to 10 years.

If the proposed change is applied to people currently in TDROP, we would expect a reduction of approximately 9 months in the amortization period initially with continued downward pressure on the amortization period each year, as each year's savings materializes. The total effect over time could be as much as several years. If it is applied only to new people entering TDROP, we would expect to see a reduction of approximately one month in the amortization period each year until the ultimate reduction is achieved.

You should be aware that calculations such as this one are heavily dependent upon where the amortization period is now (45+ years). When the amortization period is high, small changes can have a material impact on it. When the amortization period is low, it can take a very large change to impact it by more than a few years.

Please let us know if this analysis meets your needs and if there are any questions, please call us.

The undersigned are Members of the American Academy of Actuaries and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

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

Sincerely,

Judith A. Kermans, E.A., M.A.A.A.

Brian B. Murphy, F.S.A., E.A., M.A.A.A.

JAK:BBM/bd