

# Public Employee Retirement in Oregon: Where does the system stand and where could Oregon go from here?

Prepared for

The Chalkboard Project and  
The Oregon Business Council

**ECONorthwest**

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The report was written by John Tapogna and Carl Batten of ECONorthwest under contract to The Chalkboard Project and the Oregon Business Council. It benefits from the review and comment of PERS staff; however, any errors remain the responsibility of the authors. PERS staff were asked to clarify only factual content and did not provide opinions regarding report's recommendations or options.

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## PURPOSE OF THE REPORT

Few public programs in Oregon have received as much attention over the past decade as the Public Employees Retirement System—or PERS. In April 2003, the program’s costs loomed as a significant threat to the state’s fiscal and economic health. The system’s actuary predicted that—if unaddressed—PERS’ unfunded actuarial liability (UAL) would exceed \$18 billion, which was more than all the taxes and fees collected by Oregon state and local governments in a given year.

Since 2003, policy changes, legal settlements, strong investment returns, and higher contributions by public employers have improved the system’s fiscal position. Mercer Human Resources recently estimated that—as of December 2005—the system’s UAL stood at \$4.6 billion.

Continued improvement will come at a cost to public employers. Based on an evaluation of Mercer data, ECONorthwest estimates that—under expected market conditions—public employers will make average pension contributions of 16.6 percent of payroll, which is about 6 percentage points higher than rates paid during 1975-2000. But the future employer contributions remain highly uncertain and hinge on investment returns. Very weak investment returns could push employer rates to 22 percent of payroll while very strong investment returns could lower rates to about 7 percent of payroll.

These findings elicit two, opposite reactions. Some observers view the upcoming pension costs, and their effect on public services, as unacceptably high and call for additional changes to supplement the recent reforms. Others counter that the 2003 reforms appropriately shared the cost of addressing the system’s excess liabilities between taxpayers and PERS beneficiaries and argue that no additional changes are necessary.

This report seeks to provide clear, objective information to policymakers, so they can evaluate whether additional changes to the system are necessary. The report concludes with a range of policy options designed to further reduce the cost of the system to public employers and ultimately taxpayers. The report does not consider options designed to expand retirement benefits or increase the cost of the system.

## FINDINGS

### BACKGROUND ON PERS

Oregon has provided public employees with a retirement plan, in one form or another, since 1945. The system, which covers employees of most public agencies in Oregon including all school districts, evolved over time to include an unusual and complex set of rules.

The costliest of the PERS provisions was the “money match” program under which six percent of employees’ pay (originally paid by employees, but later “picked up” by many employers) was deposited in one of two accounts, regular or variable. The regular account was credited each year with the higher of market returns or a guaranteed rate, which for most of the period was set at eight percent. The cost of covering the difference between the market and guaranteed rates fell on employers and, ultimately, taxpayers.

When employees retired, the accumulated value in their accounts was doubled, and the PERS agency calculated an annuity payment based on outdated life expectancy tables and an eight percent rate. The result was compared to a traditional defined-benefit formula and the higher was then adjusted upward to become their initial pension benefit. Their pension benefit was then adjusted upward in each subsequent year for cost of living. The entire cost of the cost-of-living adjustments was borne by employers (taxpayers).

In the 1990s, it became apparent that the cost of the system could not be sustained. A gain-loss reserve was established to protect against the costs of market volatility. New employees after 1996 (Tier Two) were not given the guaranteed return. As market volatility increased in the late 1990s and early 2000s, though, the gain-loss reserve proved insufficient and the employers’ liabilities soared. Exacerbating the problem, the OPERS Board decided to credit 1999 earnings at well over twice the guaranteed rate.

Several employers sued OPERS and the courts ruled that the excess crediting had to be reversed or justified. In the 2003 Legislative Session, Oregon lawmakers passed a number of reforms designed to comply with the court’s ruling and to reduce the likelihood of future excess costs in the pension program. Key changes included:

- Creating a new retirement system—Oregon Public Service Retirement Program (OPSRP)—for employees hired on or after August 29, 2003. OPSRP is a hybrid retirement program that consists of a conventional defined-benefits program and an Individual Account Program, which is similar to a defined-contribution program.
- Adopting actuarial tables that more accurately reflect the life expectancy of PERS retirees.
- Ending contributions to the accounts subject to the “money match” and guaranteed rate provisions
- Reversing the crediting decisions of the PERS Board related to 1999 earnings.
- Making it more difficult for future boards to credit more than the guaranteed rate

## CURRENT AND NEAR-TERM CONDITIONS

Since 2003, market and policy factors have combined to strengthen the system's fiscal position. Strong 2003-2005 investment returns boosted system assets, which earned 23.8 percent in 2003, 13.8 percent in 2004, and 13.2 percent in 2005. As a result, in December 2005, the system had \$4.1 billion more in assets than circa 2003 forecasts had foreseen. On the policy side, the adjustment of 1999's excess crediting to Tier I accounts, the update of actuarial tables, and redirection of member contributions to the Individual Account Program curbed the growth of Tier I-related liabilities.

The actuary's recent valuation (conditions as of December 31, 2005) reported an unfunded actuarial liability of \$4.6 billion. The system's funded ratio—assets divided by liabilities—stood at 91 percent, which is four percentage points above the average for 125 large public pension programs.<sup>1</sup>

Employer contributions will remain well above their historic average for much of the next decade. As discussed previously, employer rates (expressed as a share of payroll) would equal an average 16.6 percent through 2014 under expected investment returns (8.1 percent annually). Complex PERS Tier I rules make the forecasts highly dependent on investment outcomes. With particularly strong or weak investment returns, employer rates vary from 7 to 22 percent of payroll. Employers who “pick up” the member's PERS contribution will contribute an additional 6 percent of payroll.

The strategy of prepaying PERS liabilities by issuing debt appears to have paid off for some employers at this stage. Employers borrowed at rates between 5 and 6 percent and hoped that investments of the bond proceeds would earn 8 percent or more. Any gains from the strategy would reduce the PERS liabilities. Employers who borrowed and invested beginning in 2002 fared particularly well and earned the double-digit investment returns. Accounts for certain employers have grown so large, they may be sufficient to fund the employers' entire PERS/OPSRP liabilities for the next two decades and have resources left over after debt service on the bonds expires.

## POLICY OPTIONS

The Oregon Supreme Court—through its interpretation of employees' contract rights—will be the ultimate arbiter of how much change would be constitutionally permissible, whom the changes could affect, and when it could affect them. Through rulings on *Strunk* and the *Eugene Settlement*, policymakers have better insights into the Court's views on the legal environment. The policy options outlined in this report are bounded by two key interpretations of the Court's rulings:

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<sup>1</sup> The 91 percent funded ratio does not take into consideration side account funds. While the side accounts add to PERS assets, the state and local governments that created side accounts borrowed funds to create the asset and will pay related debt service through the mid-2020s. If one considers the side accounts a PERS asset—but ignores the related debt held by the state, schools and local governments—the PERS funded ratio increases to 104 percent.

- PERS Tier I members have the right to retire under Money Match—with accounts adjusted through the Eugene Settlement—if it provides higher retirement income than the full formula; Adjustments for other instances of excess crediting, prior to 1999, are not permitted.
- State and local governments cannot simply walk away from the PERS-related obligations by claiming economic or fiscal hardship.

The possibility of significantly lowering the cost of Oregon’s public retirement system hinges on whether one agrees with these two interpretations of the Court’s ruling in *Strunk*. Agree with them, and the range of reforms and expected near-term savings is limited. Reject them, and policy options and opportunities for savings expand. Consistent with this interpretation, the report advances the following policy options that either reduce system liabilities, foster stability, or improve transparency.

**Option 1: Forbid crediting in excess of the guaranteed rate.** Among the 2003 reforms was a law that prohibited crediting in excess of the guaranteed rate of return until a newly created Tier I reserve account was fully funded. Because the actuary’s estimate of a fully funded reserve would be inherently complex and controversial, some stakeholders have proposed a permanent prohibition on crediting Tier I accounts with more than the guaranteed rate of return.

**Option 2: Eliminate state tax adjustment for non-Oregon residents.** In 1995, the Legislature enacted HB 3349, which increased PERS benefits to offset the effect of the state taxation. Only PERS members who established membership prior to July 14, 1995 are eligible for the benefit increase. PERS makes the so-called state tax adjustment to the pension whether or not the retiree lives or pays taxes in Oregon. Under this proposal, PERS would not include the benefit increase for retirees who declare residency (for tax purposes) outside of Oregon.

**Option 3: Lower the guaranteed/assumed rate of return.** The guaranteed rate of return paid to PERS Tier I members is the key driver of the system’s unfunded liabilities. Lowering the assumed rate has different impacts across the system: Tier I, Tier II, OPSRP, and Retirees. Given its varying effects across the system, a lowered assumed earnings rate shows the potential to lower employer costs only *if the change were isolated to the active members*, which could be accomplished through a so-called plan partition. Any near-term change in the assumed rate would run into a practical challenge. Mercer recommended an assumed 8 percent earnings rates to the PERS Board on June 16, 2006, and the Board adopted the earnings assumption.

**Option 4: Provide additional flexibility in charges against side accounts.** In some instances, the side accounts of individual employers have grown so large that—under expected investment environments—they could cover the entire retirement liability and have resources left over when debt service on the bonds expires in the mid-2020s. Given the size of the accounts,

some observers have called on the PERS Board and policymakers to consider policies that would allow governments and school districts to liberate some of the investment gains sooner. To do so, PERS could expand the range of expenses that districts could charge against their side account balances. To provide further flexibility, the PERS Board could explore allowing governments and school districts to fund some of their core health insurance obligations—for current employees—through the side accounts; however, such a move may require a change in state and federal law regarding fiduciary and tax qualification requirements.

**Option 5: Sunset the member contribution requirement.** Before the 2003 legislative changes, the members' contributions were deposited into regular accounts that were eligible for money match. Today, member contributions build an Individual Account Program, which functions like a traditional defined-contribution plan. Given that the member contributions no longer have money match implications, some observers argue the requirement could be phased out or made optional over time. Phasing out the member requirement under PERS would moot the politically charged issue of who pays the member contribution when it is picked up by employers. In agencies that phase-out the employer pickup, any savings would be likely offset in part—or in whole—by negotiated increases in other aspects of compensation.

**Option 6: Review board and agency implementation of existing statutes.** The PERS Board should work with its staff and investigate areas in which implementation of program rules may be out of line with the statute or common financial practices. PERS' method of crediting member accounts is worthy of discussion as is the agency's application of cost-of-living adjustments under the Money Match option.

**Option 7: Evaluate rules on minimum hours required to qualify for retirement benefits.** The current system allows membership in OPSRP (and PERS) when an employee works in a covered position for six consecutive months. Covered positions include those expected to work at least 600 hours in a calendar year. Consequently, the current system allows employees working less than 30 percent full-time, full-year employment to accrue and eventually receive retirement benefits. By contrast, a retiree receiving retirement or pension benefits can work up to 1,039 hours without affecting benefit levels. Requiring that individuals work at least half of the regularly scheduled hours for a given position to gain OPSRP eligibility would reduce employer liabilities.

**Option 8: Replace OPSRP's defined-benefit plan and share risk with employees.** OPSRP is a hybrid that couples a traditional defined-benefit plan with an Individual Account Program. Costs for OPSRP's defined-benefit plan remain uncertain. The system's actuary recently estimated employer contributions would run at 7.3 percent of payroll to fund the system. Two types of risk—both borne by the employer in a defined benefit plan—will raise and lower the system's cost over time: longevity and investment risk. The transition away from a defined benefit plan involves a transfer of risk from the employer to the employee. Any step away from OPSRP's defined-

benefit would have to evaluate both the overall generosity of the plan, as well as how the plan's risk is shared between employers and employees. While the defined-contribution plans shift all the risk to the employee, other plan designs, including a retirement shares program, could share risk.

## OVERVIEW OF PERS LEADING UP TO 2003<sup>2</sup>

Oregon has provided public employees with a retirement plan, in one form or another, since 1945. The system, which covers employees of most public agencies in Oregon including all school districts, evolved over time to include an unusual and complex set of rules.

The system's original design was built on the "money match" concept and funded through equal employer and employee contributions and investment returns earned on those contributions. Weak investment returns during the 1950s and 1960s resulted in low incomes for retiring members. In 1968, the Legislature repealed the money match concept and replaced it with a Pension Plus Annuity benefit formula. The PERS Board discovered that one or two members were adversely affected by the repeal of Money Match, so the Legislature reinstated the feature.

In 1979, the PERS Board issued a system goal that stated "[t]he system's retirement benefit for a career employee (30 years of service) retiring at age 62 when added to the Social Security benefit, should provide the same standard of living immediately after retirement." The Board policy assumed a comparable post-retirement income required a PERS benefit—when added to Social Security—that replaced 75 to 85 percent of the employee's pre-retirement gross income.

In 1981, the PERS Board proposed a Full Formula option to replace the Pension Plus Annuity, which converted the system to a fully defined-benefit plan. Given the evolution of the plan, PERS members hired before 1981 had, and continue to have, three methods available to calculate their retirement income—Money Match, Pension plus Annuity, and Full Formula. PERS calculates retirement income under each method, and member receives the highest of the three calculations. Members hired on August 21, 1981 and after compare results under the Money Match and Full Formula options.

The money match option ultimately proved the costliest provision. Under money match six percent of employees' pay (originally paid by employees, but later "picked up" by many employers) was deposited in one of two accounts, regular or variable. The PERS Board credited the regular account each year with the higher of market returns or a guaranteed rate of return. The Board set guaranteed rate at 5 percent in 1974, 7 percent during 1975-1978, 7.5 percent during 1979-1998, and 8 percent in 1989 and thereafter.

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<sup>2</sup> This section draws heavily from the *Special Master's Written Report and Recommended Findings of Fact* in the Matter of the Consolidated Public Employees Retirement System (PERS) Litigation. Supreme Court of the State of Oregon. Undated.

In the money match calculation, the accumulated value of a retiree's account was doubled and an annuity payment created based on life expectancies in 1978 and an 8 percent interest rate. PERS compared the money match result to outcomes under the Full Formula (and Pension Plus Annuity if the member was hired prior to 1981). The highest pension benefit was then adjusted upward in each subsequent year for cost of living. The entire cost of the cost-of-living adjustments was borne by employers (taxpayers).

Policymakers recognized the cost of the system could not be sustained. A gain-loss reserve was established to protect against the costs of market volatility. New employees after 1996 (Tier Two) were not given the guaranteed return. As market volatility increased in the late 1990s and early 2000s, though, the gain-loss reserve proved insufficient and the employers' liabilities soared. Exacerbating the problem, the OPERS Board decided to go against its own policies regarding funding the gain-loss reserve and to credit 1999 earnings at more than twice the guaranteed rate.<sup>3</sup>

## PERS' KEY COST DRIVERS

The pre-2003 PERS retirement plans are extraordinarily complex, but three factors converged to drive the system's high costs: the money match benefit option, the guaranteed rate of return to Tier I regular accounts, and the PERS Board's mismanagement of the rate guarantee.

In any given year, three rates play a role in determining how much a Tier I member's account grows (see Figure 2-1):

- **Actual investment returns** earned on the PERS Fund through investment decisions of the Oregon Investment Council
- **Guaranteed rate of return** is the statutory minimum rate promised to Tier I members. The guarantee is equal to the actuary's assumed rate of return for long-term investment growth.
- **Credited returns**, or the rate of return the PERS Board credited to the Tier I member account in a given year. Credited rates of return fall between the actual and guaranteed rates of return.

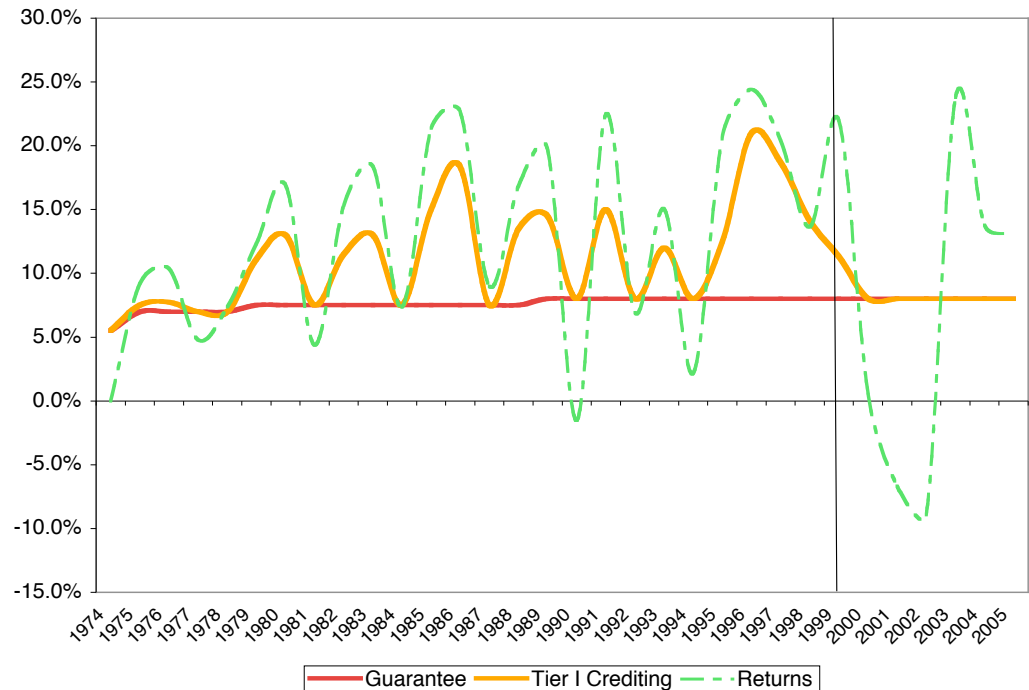
Actual investment returns on the PERS Fund have been strong since 1973, which has proven to be a double-edge sword. Across the entire 1973-2005 period, which includes the market's downturn in 2000-2002, the PERS Fund earned an average 11.4 percent return. While robust returns typically reduce liabilities for most traditional defined-benefit plan, they can also increase liabilities under the money match program. High investment returns grow member accounts, which in turn increase the member's final retirement payment.

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<sup>3</sup> The OPERS Board adopted a goal to reserve 30 months' earnings at the assumed earnings rate—a reserve equal to 20 percent of assets. After the Board allocated its 1999 earnings, the gain-loss reserve had a positive balance of \$4.744 billion or approximately 72 percent of the 30-month goal.

Figure 2-1 shows that when the actual returns exceeded the rate guarantee, the PERS Board routinely credited the accounts with rates in excess of the guarantee. During 1974-1999, actual returns exceeded the guarantee 19 times, and in 17 instances, the PERS Board elected to credit account in excess of the guarantee. Through the Board's policy, Tier I members participated in the upside potential of the system's investment strategy through excess crediting but were shielded from downside potential through the rate guarantee.

**Figure 2-1: Actual, Guaranteed, and Credited Investment Rates of Return for Oregon PERS (Tier I), 1974-2005**



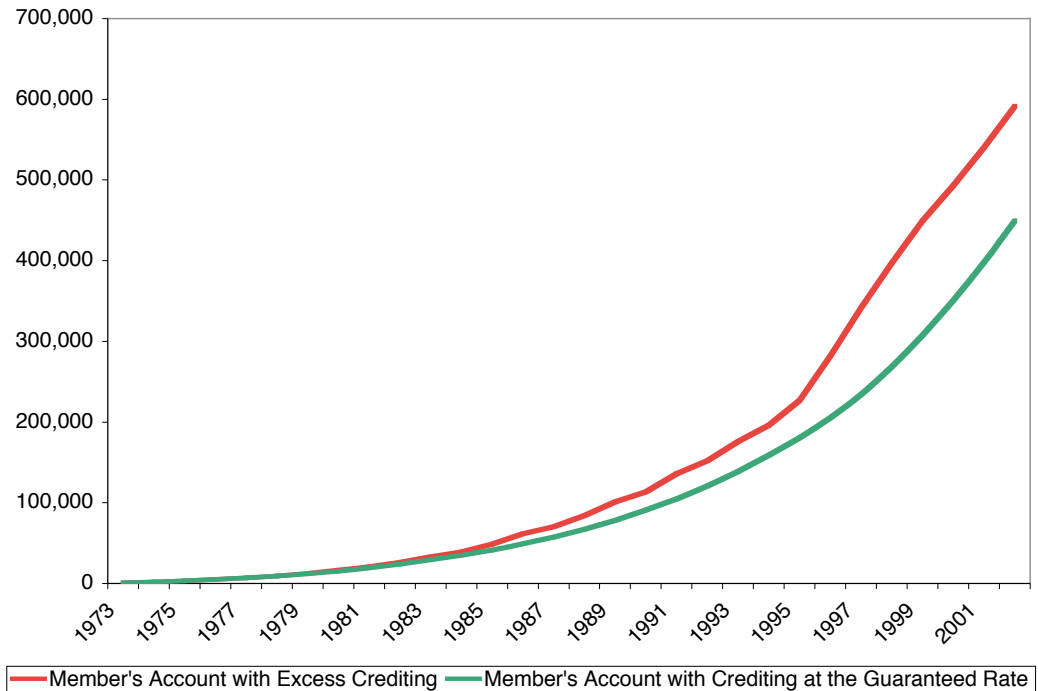
Source: OPERS. October 2005. *PERS: By the Numbers* and the OPERS website

Taken together, strong investment returns, excess crediting, and the guarantee in years of weak returns insured growth in Tier I member accounts. The complex interaction between these factors is best illustrated through a case study. In this example, the Tier I member started work in 1973 at \$36,000 (in 2005 dollars), worked 30 years, and retired with a final salary of \$64,597 in 2002. Figure 2-2 reports the illustrative member's account under two crediting scenarios: routine excess crediting as implemented by the PERS Board and crediting limited to the guaranteed rate of return. If credits had been limited to the rate guarantee, the member's ending balance would have reached \$449,517, which includes the employer's share under the money match rules. However, through the Board's repeated excess crediting decisions, the account grows to \$591,792—or almost one-third larger than through the alternative.

The effect of excess crediting on the member's account balance accelerates during late-1990s when market gains were driven by speculation in high technology and Internet sectors. During 1995-1999, the PERS Board credited accounts at more than double the guaranteed rate of return—a 17.2 percent annual

average rate. Through its negotiated settlement to the Lipscomb ruling, the PERS Board reduced the 1999 crediting from 20.00 to 11.33 percent, which lowered the five-year average return to 15.5 percent.

**Figure 2-2: Illustrative PERS Tier I Member Account Under Actual Crediting and Crediting at the Guaranteed Rate of Return, 1973-2002 (Not Adjusted for Inflation)**

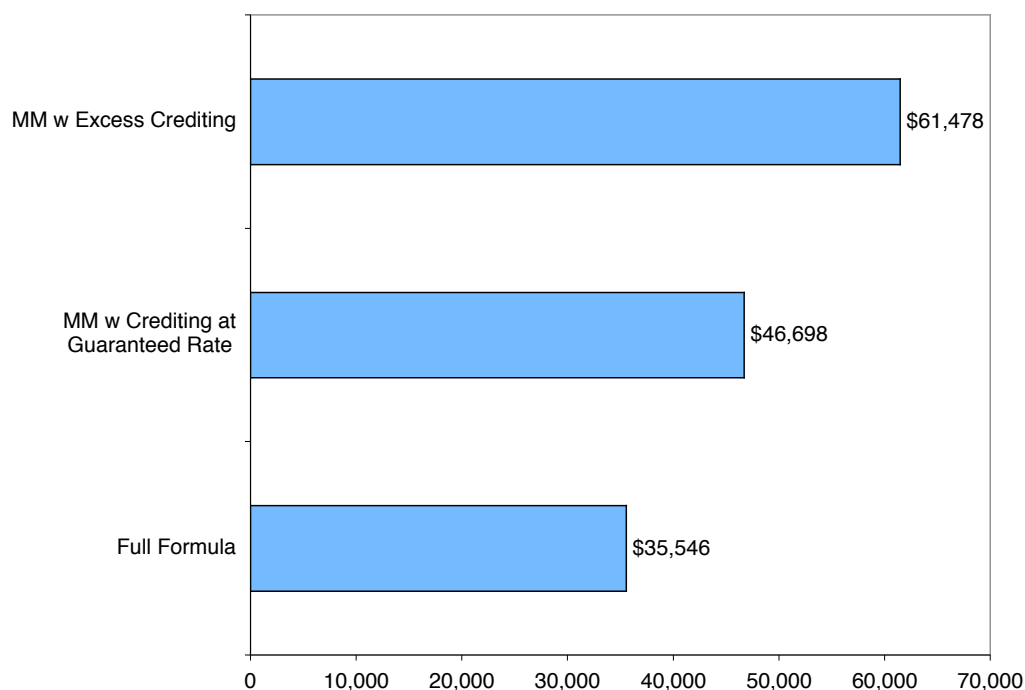


Source: ECONorthwest

ASSUMPTIONS: Employee starts in 1973 earning \$36,000 (2005\$\$). The employee retires with 30 years of service and an ending salary of \$64,596 (2005\$\$). The credited account balance uses a 11.33 percent rate of return in 1999 as ordered by Marion County Judge Paul Lipscomb and upheld by the Oregon Supreme Court.

Under money match, the larger account balances yield larger pension payments in retirement. The illustrative member's payment starts at \$61,478 annually under money match and the Board's excess crediting policies—or 95 percent of the member's final pay. Had the Board credited Tier I accounts with no more than the 8 percent guarantee, the pension payment falls to \$46,698—or 72 percent of final pay. Finally, under the full formula, the pension payment equals \$35,546—or 56.6 percent of final pay.

**Figure 2-3: First Year Pension Payment for an Illustrative Tier I Member under Alternative Policy Scenarios, 2005 Dollars**



Source: ECONorthwest

ASSUMPTIONS: Employee starts in 1973 earning \$36,000 (2005\$\$). The employee retires with 30 years of service and an ending salary of \$64,596 (2005\$\$)

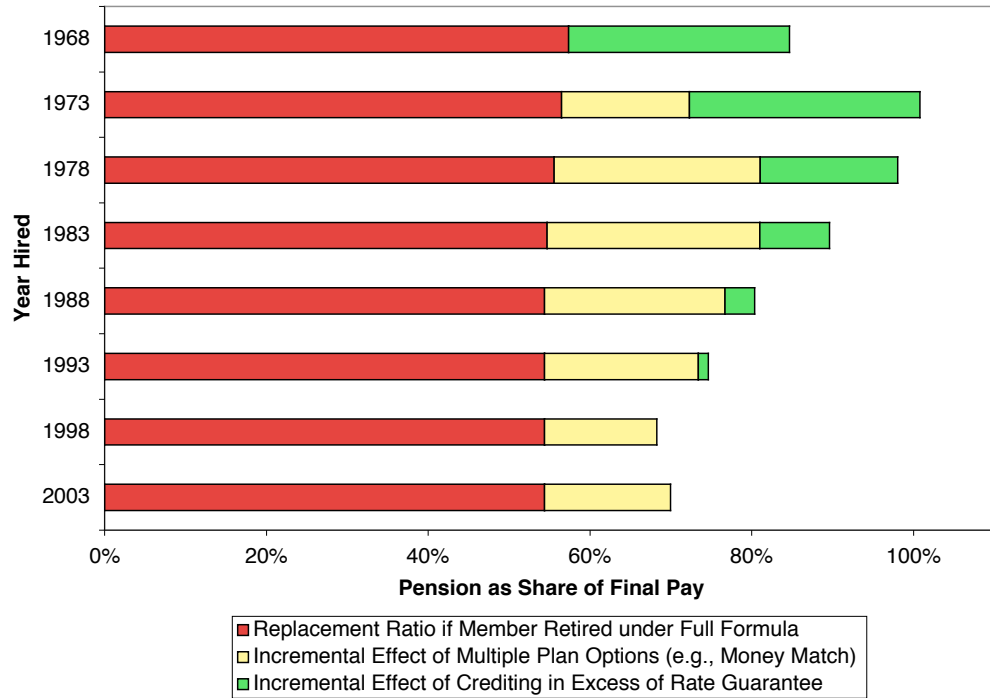
The effects of the money match rules and excess crediting vary depending when a member entered in the PERS system, whether they maintain continuous employment, and when they retire. Figure 2-4 shows replacement ratios—pensions expressed as a share of final pay—for career employees hired in 1968 and in five-year increments thereafter. The figure also illustrates how money match and excess crediting add to the member’s pension. In this example, members hired in 1973 fares the best. Starting in 1973, the member’s account was sizable by the mid-1990s and grew rapidly with the strong markets and excess crediting of the late 1990s. Moreover, through the guaranteed rate of return, the account’s balance continued to grow during 2000-2002 when actual market returns were low or negative.

For members hired in other years, the timing does not work quite as well, and replacement ratios are not as high. The 30-year member hired in 1968, for instance, missed some of the extraordinary returns of the late 1990s. The 30-year member hired in 1978 had a lower account balance in the mid-1990s than his 1973 counterpart, so the extraordinary returns of the late-1990s grew off of a lower base.

Roughly speaking, career employees hired in the 1970s could expect replacement ratios of 90 to 100 percent; those hired in the 1980s could expect 80 to 90 percent, and those hired in the 1990s could expect 70 to 80 percent. Two points stand out. First, in every case, the pension exceeds the adequacy levels articulated by the PERS Board in the late 1970s (i.e., PERS plus Social Security

income replaces 75 to 80 percent of final pay). Second, money match and excess crediting produced significant inequities in retirement benefits earned by Oregon's state and local government employees.

**Figure 2-4: Replacement Ratios for Employees Starting at \$36,000 (2005\$) and Working 30 Years and Effect Key Plan Features**



Source: ECONorthwest

## RECENT SYSTEM CHANGES

In the late 1990s, public employers became increasingly aware that the money match provisions—together with the PERS Board's crediting policies—were going to drive retirement benefits to unsustainable levels. A 1999 crediting decision by the PERS Board triggered a lawsuit by public employers, led by the City of Eugene. Weak investment returns during 2000-2002 compounded the system's problems. Early in the 2003 legislative session, the PERS actuary estimated the system's unfunded actuarial liability would soon exceed \$18 billion<sup>4</sup>. ECONorthwest analysts testified that, if the system remained unchanged, employer contributions would increase from 10.7 percent to 26.2 percent of payroll in 2007 and average almost 24 percent over the subsequent two decades<sup>5</sup>.

The system's escalating costs, which coincided with recession-driven shortfalls in the state's General Fund, created an environment ripe for

<sup>4</sup> See Johnson, Mark O. April 15, 2003 email to Margaret Hallock (Office of the Governor) and Representative Gregory Macpherson.

<sup>5</sup> See ECONorthwest. April 16, 2003. *Oregon PERS Policy Options: Effects on Employer Rates and the State General Fund*.

comprehensive system reform. The balance of this chapter discusses the scope of these related cost-containment efforts and Court's rulings to date.

## CITY OF EUGENE LITIGATION

During 1998-2000, seven public employers, including the City of Eugene, challenged their employer rate orders by filing a lawsuit against the PERS Board in Marion County Circuit Court. The key challenge related to the Board's 1999 decision to credit PERS Tier I accounts with a 20 percent return—actual returns available for crediting equaled 24.89 percent. Attorneys for the public employers argued that the PERS Board had violated its own reserve policy and that the system should have retained a larger share of earnings in excess of the 8 percent guarantee.

In 2002, the Marion County Circuit Court Judge Paul Lipscomb agreed with the public employers and held that the Board had abused its discretion by failing to build a contingency reserve and had not adequately funded the Tier I rate guarantee in years of weak market returns. The Judge ruled that, if the Board had fully funded its reserves, it would have credited members 11.33 percent in 1999 rather than 20 percent. The PERS Board and public employers later entered into a settlement agreement through which the Board agreed to recalculate accounts of current and retired Tier I members using the revised 11.33 percent rate because of the result of the Oregon Supreme Court's decision in the *Strunk* case challenging the 2003 PERS Reform legislation.

## 2003 LEGISLATIVE REFORMS

In the 2003 Legislative Session, Oregon lawmakers passed a number of reforms to reduce the likelihood of future excess costs in the pension program. The proponents of the legislation sought to curb the growth in average employer contributions but recognized the reformed system, in the immediate term, would remain costly by historic standards.

Key changes in the legislative package:

- **Created a new retirement system.** The Legislature created the Oregon Public Service Retirement Program (OPSRP)—for employees hired on or after August 29, 2003. OPSRP is a conventional defined-benefit program without a money match option. In addition to earning a defined-benefit, employees (or their employers through the pickup) contribute six percent of their salaries to an Individual Account Program, which functions like a defined-contribution plan.
- **Adopted new actuarial tables that more accurately reflected the life expectancy of PERS retirees.** PERS used outdated actuarial tables that systematically underestimated the longevity of retirees. The Legislature required the use of mortality assumptions developed by the actuary in 2001. For members retiring under money match, an assumption that they would live longer reduced their annual pension.

- **Froze crediting to active Tier I member accounts until the Tier I system was “fully funded.”** The legislature redefined the Tier I rate guarantee as a *career* guarantee rather an *annual* one. Through the legislative change, the PERS Board would credit Tier I members up to 8 percent each year if earnings or reserves were available but would not credit accounts if they were not. At retirement or withdrawal, the member would be credited with a minimum rate of 8 percent—calculated across his or her career.
- **Temporarily suspended Cost-of-Living Adjustments (COLA) for retirees who benefited from 1999’s inappropriate crediting.** Legislation directed PERS to suspend the COLAs of Tier I money-match retirees who benefited from the 20 percent earnings credit in 1999. Subject members would not receive COLAs until their monthly allowances equal the allowances they would have received had their accounts been credited with 11.33 percent in 1999. The provision was the legislature’s remedy for the over-crediting found in the *City of Eugene* case.
- **Ended new contributions to the accounts subject to the “money match” and guaranteed rate provisions.** Legislation diverted all member contributions after January 1, 2004 to an Individual Account Program (IAP). The IAPs, which apply to active Tier I, Tier II, and OPSRP members, function like traditional defined-contribution plans. The legislation curbed the growth of existing accounts subject to money match and the rate guarantee.
- **Prohibited future boards from crediting more than the guaranteed rate unless the system was “fully funded.”** The Legislature prohibited future PERS Boards from crediting Tier I accounts with returns in excess of the guarantee rate until the actuary declares the guarantee obligation fully funded.

## OREGON SUPREME COURT RULINGS

PERS members challenged a number of the legislative changes in *Strunk v. State of Oregon*, including the Tier I crediting freeze, COLA reductions, creation of IAPs, and implementation of updated actuarial tables. Generally, the plaintiffs argued that the legislative changes reduced pensions promised to members and, in doing so, breached PERS contracts. During 2004-early 2005, policymakers, public employers, and PERS beneficiaries waited for the Oregon Supreme Court to rule on which of the reforms could stand under the state constitution.

In a March 2005 ruling, the Oregon Supreme Court upheld all but two of the challenged legislative reforms. The court invalidated the legislature’s attempts to freeze Tier I crediting and temporarily suspend COLAs. In rejecting the Tier I crediting freeze, which had projected savings of \$4.5 billion, the Court wrote:

*... in providing the career-basis remedy, the 2003 PERS legislation disregards entirely PERB’s earlier crediting decisions -- decisions that*

*generally were not challenged....Absent some legal basis for such a downward adjustment, that legislative choice amounts to nothing more than a unilateral decision to reduce benefits already earned. That, in our view, is a substantial impairment of the contractual obligation respecting the assumed earnings rate guarantee. Accordingly, we reject respondents' argument to the contrary.*

Put simply, the Court found that—despite their costly implications—employers never challenged the multiple instances of excess crediting to Tier I member accounts during 1974-1998. Given the lack of a timely challenge, the Court ruled that the Tier I accounts built on those excess returns were “benefits earned,” and employers could not withdraw them retrospectively. This ruling, more than any other, created a limit on how much policymakers could affect PERS costs in the short-term. The Court also found PERS members were “entitled to receive” the annual COLA and invalidated the legislative attempt to reduce COLAs of retirees who had benefited from 1999’s excess crediting.

In addition to ruling on the special legislative actions, the Court’s March 2005 opinion addressed an “economic hardship” defense. Attorneys for the public employers argued that overturning the 2003 legislative reforms would put considerable stress on the state’s fiscal position and undermine economic growth. Defense experts<sup>6</sup> predicted that higher employer contributions to PERS would generate structural budget deficits and result in a decline in public services. While the Court recognized the potential harmful effects of the system’s high costs, it ruled those fiscal and economic outcomes did not justify a blanket acceptance of the 2003 reforms. On that topic, the Court wrote:

*The parties introduced voluminous documentary and testimonial evidence concerning the financial status of PERS and the Oregon economy generally in support of and against what the Special Master described as respondents' "economic hardship defenses." That evidence, and specifically the recommended findings that the Special Master derived therefrom, do not convince us that the situation rises to the high threshold that would have to be met for an economic hardship defense -- were we to recognize one -- to succeed.*

By rejecting the economic hardship defense, the Court ruled that—despite adverse effects on public services or the economy, state and local government must meet their PERS obligations.

In August 2005, the Court recognized the settlement between the City of Eugene and the PERS Board through which the PERS Board agreed to reduce the 1999 account crediting from 20.00 to 11.33 percent. PERS rebalanced accounts for active Tier I members. However, for Tier I members who retired after 1999, PERS recalculated the present value of their expected retirement income—assuming their account had been credited at 11.33 percent in 1999.

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<sup>6</sup> Including analysts from ECONorthwest.

# ONGOING LEGAL CHALLENGES TO THE RECENT SYSTEM CHANGES

Some public employees and union representatives continue to challenge recent legislative decisions and court rulings. In all, eight cases related to PERS were active as of January 2006. At this time, three cases draw the bulk of attention from attorneys representing public employers.

1. *White v. The PERS Board*. The petitioners claim that the PERS Board breached its fiduciary responsibilities by reallocating the 1999 earnings to fund reserves. Put simply, the petitioners argue that the Board must keep reserve accounts at a minimum level and provide sufficient evidence to allocate investment earnings to any account other than member accounts. If the petitioners prevail, public employers would lose most of the savings associated with the *Strunk v. PERS Board* and *City of Eugene v. State* rulings.

Motions to dismiss petitioners' claims were argued in December 2005. At the time of publication, the claims are pending before Multnomah County Circuit Judge Henry Kantor.

2. *Arken v. City of Portland and Robinson v. PERB/State of Oregon*. Petitioners filed separate but related lawsuits on behalf of so-called "window retirees" who retired between April 1, 2000 and April 1, 2004. The lawsuits challenge the authority of the PERS Board to recoup overpayments associated with 1999's excess crediting for these specific retirees.

On June 20, 2007, Multnomah County Circuit Judge Henry Kantor ruled that the 2003 PERS legislation provided only two mechanisms to recoup for overpayments: 1) freeze retirees' cost-of-living adjustments or 2) take the overpayments out of the plan's earnings, which effectively transfers the cost—about \$800 million—to younger public employees. Because the Supreme Court prohibited use of COLA adjustments in the *Strunk* ruling, Judge Kantor concluded the agency is left with only one option and must charge the overpayments against system earnings.

The issue of who pays for the overpayments to window retirees will be appealed and most likely land in Oregon Supreme Court.

### **EFFECTS OF LEGISLATION, LAWSUITS, AND INVESTMENT RETURNS ON SYSTEM HEALTH**

The fiscal condition of Oregon public retirement system today is considerably different than it was just four years ago. In April 2003, the system's actuary projected that—by December 31, 2005—PERS' liabilities would balloon to \$58.4 billion—well above projected system assets of \$40.3 billion. The \$18.1 billion forecasted shortfall (or, unfunded actuarial liability) exceeded the total amount of tax and fee revenue collected by Oregon's state and local governments in a given fiscal year.<sup>7</sup> Since 2003, market, policy, and administrative factors combined to significantly strengthen the system's fiscal position:

1. **Strong investment returns.** Higher than expected investment returns during 2003-2005 are the key reason the actual assets in December 2005—\$44.7 billion—are higher than were predicted in April 2003—\$40.3 billion. System assets earned 23.8 percent in 2003, 13.8 percent in 2004, and 13.2 percent in 2005.
2. **Implementation of the Eugene Settlement.** The settlement corrected 1999's excess crediting to Tier I accounts, adjusting the earnings credit from 20 percent to 11.33 percent.
3. **2003 Legislative changes.** Updating actuarial tables (\$1.6 billion in projected savings), redirecting member contributions to the Individual Account Program (\$1.9 billion in projected savings), and making excess crediting conditioned on fully funded reserves (\$904 million in projected savings) all played roles in reducing the system's liabilities relative to expectations in 2003<sup>8</sup>.

Together with the Eugene Settlement, key legislative provisions reduced the balances and future growth of Tier I member accounts. Consequently, money match has become a less lucrative option over time. PERS reports that the share of members retiring under the money match rules fell from 87 percent to 72 percent during 2003-2005. Going forward, money match will determine the pensions of only 44 percent of future retirees.

4. **Change in actuarial methods.** In 2006, the PERS Board adopted a change in the method by which the system recognizes the cost of benefits earned by members each year. The new method—projected

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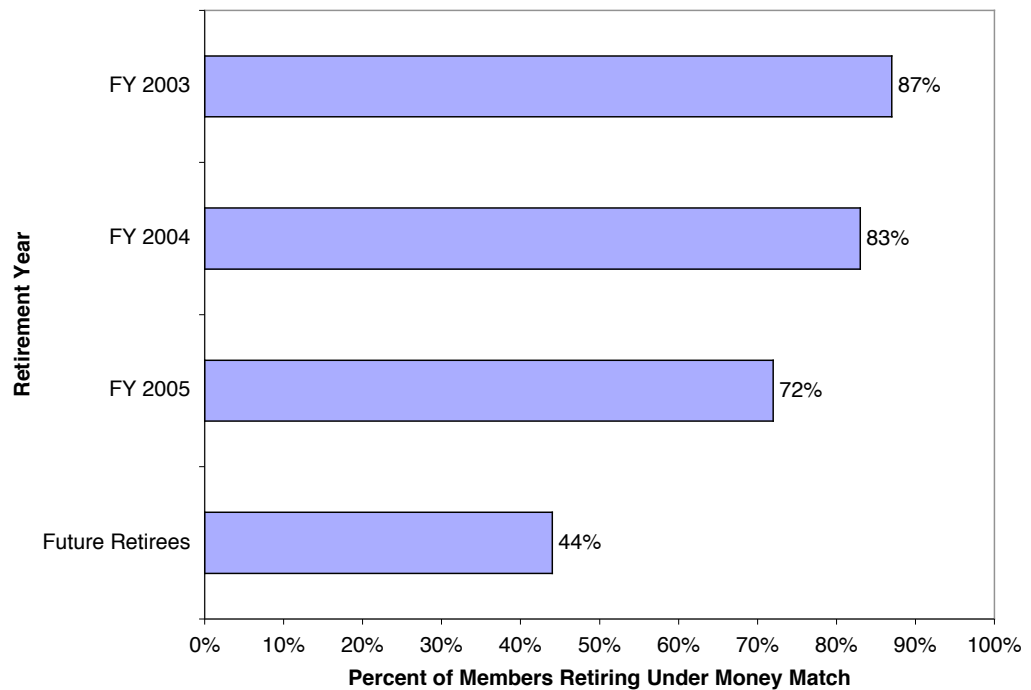
<sup>7</sup> In fiscal 2003-04 (most recent data available), the US Census reports Oregon's state and local governments had \$16.8 billion in own-source (e.g., non-federal) revenue.

<sup>8</sup> Projected savings at the time legislation was passed and reported in OPERS, October 2005. *PERS: By the Numbers*.

unit crediting (PUC)—recognizes that the value of benefits earned *increases* over an employee’s career. That is, retirement benefits earned in Year 30 of a career are considerably more valuable than benefits earned in Year 15 or Year 1. Relative to the previous method (Entry Age Normal), PUC requires employers to contribute less early in employees’ careers and more later. Proponents argue the PUC method provides a more accurate view of the system’s financial status and a better allocation of costs between the unfunded actuarial liability (UAL) and normal cost.

If implemented in isolation, the change to the PUC would slow employer contributions, curb the the growth of the PERS asset base, and increase the likelihood of future unfunded liabilities. However, the Board simultaneously accelerated its payments toward the UAL, which increased employer contributions and offset—in part—the near-term savings associated with the switch to PUC.

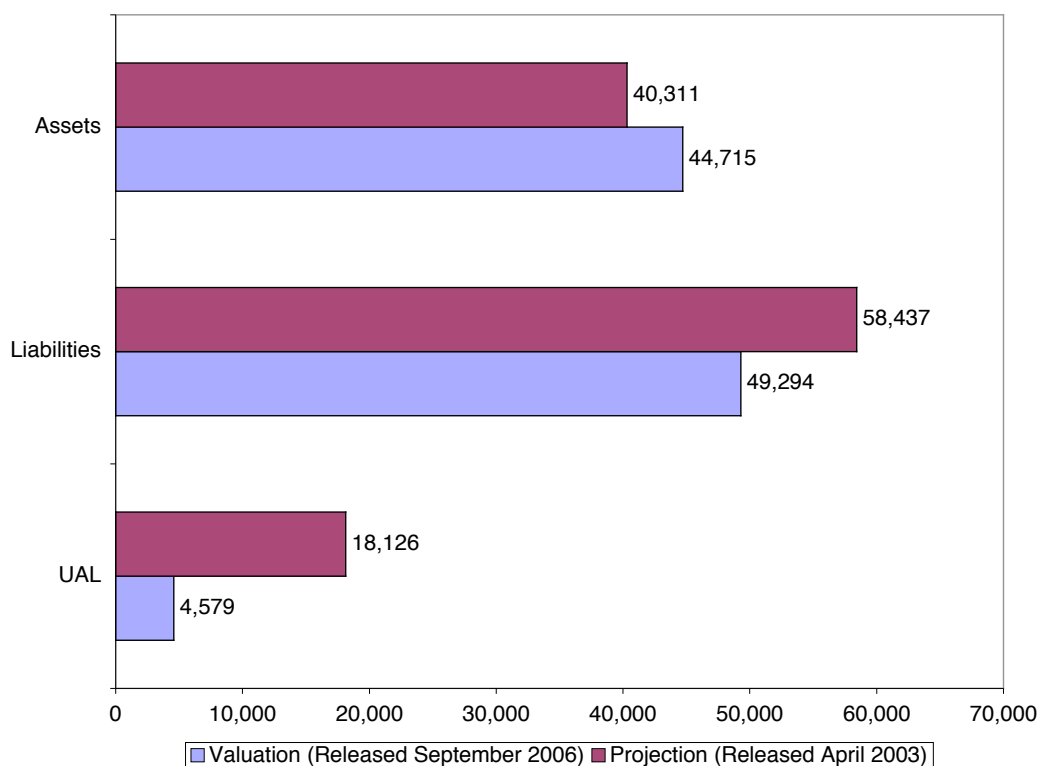
**Figure 3-1: Share of PERS Retirees Using the Money Match Method to Determine their Pension, 2003-2005 and Future Years**



Source: PERS Correspondence with ECONorthwest

Several indicators underscore the system’s improved health. One way to illustrate the improvement is to compare circa 2003 *forecasts* to what actually happened. Figure 3-2 compares two perspectives on the system: 1) the actuary’s April 2003 *forecast* of December 2005 conditions and 2) the December 2005 valuation.

**Figure 3-2: Fair Market Value of PERS/OPSRP Assets, Liabilities, and Unfunded Actuarial Liability as of December 31, 2005, April 2003 Forecast vs. Valuation Results (in Millions)**



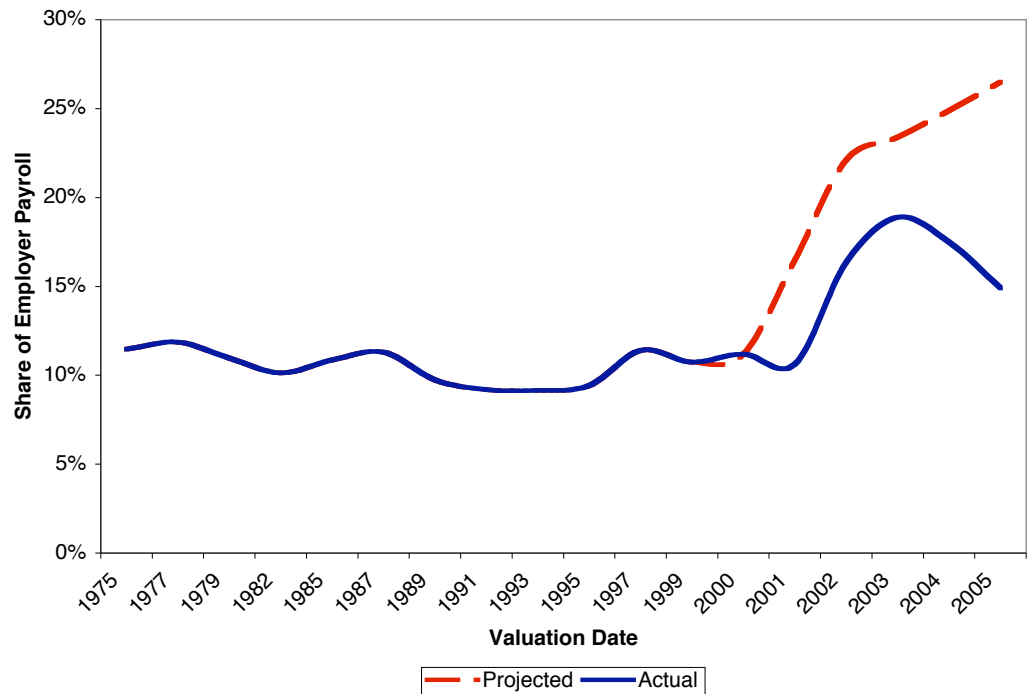
Source: Milliman Letter to Hallock and MacPherson (April 15, 2003); Hallmark, Bill and Annette Strand. September 15, 2006. *Oregon PERS December 31, 2005 Actuarial Valuation Results*

Lower unfunded liabilities have curbed the growth in employer rates relative to expectations in 2003. Figure 3-3 compares pre-reform, projected employer rates with actual rates. In April 2003, Milliman forecasted that—absent changes to the system—employer rates would increase to almost 27 percent of payroll (*excluding* the 6 percent “pickup” of the member’s contribution) beginning with the December 2005 valuation. ECONorthwest drew similar conclusions and estimated employer rates in an unreformed system would remain at average 23.9 percent for a 25-year period<sup>9</sup>.

As just discussed, pension reform, a legal settlement, strong investment returns, and changes in actuarial methods combined to curb the previously expected growth in employer contributions. After rising to 18.9 percent (without member contributions) in 2003, the employer rates fell to a system-wide average of 14.9 percent with the December 2005 valuation. The rates estimated through the December 2005 valuation determine employer contributions during July 2007-June 2009. Despite the reduction, the July 2007 rate remains well above rates paid during the 1975-2000 period.

<sup>9</sup> See ECONorthwest. April 16, 2003. *Oregon PERS Policy Options: Effects on Employer Rates and the State General Fund*. Prepared for the Oregon Business Council.

**Figure 3-3: Average System-Wide Employer Contributions, April 2003 Projection versus Actual 1975-2005 Contributions Expressed as a Share of Employer Payroll**

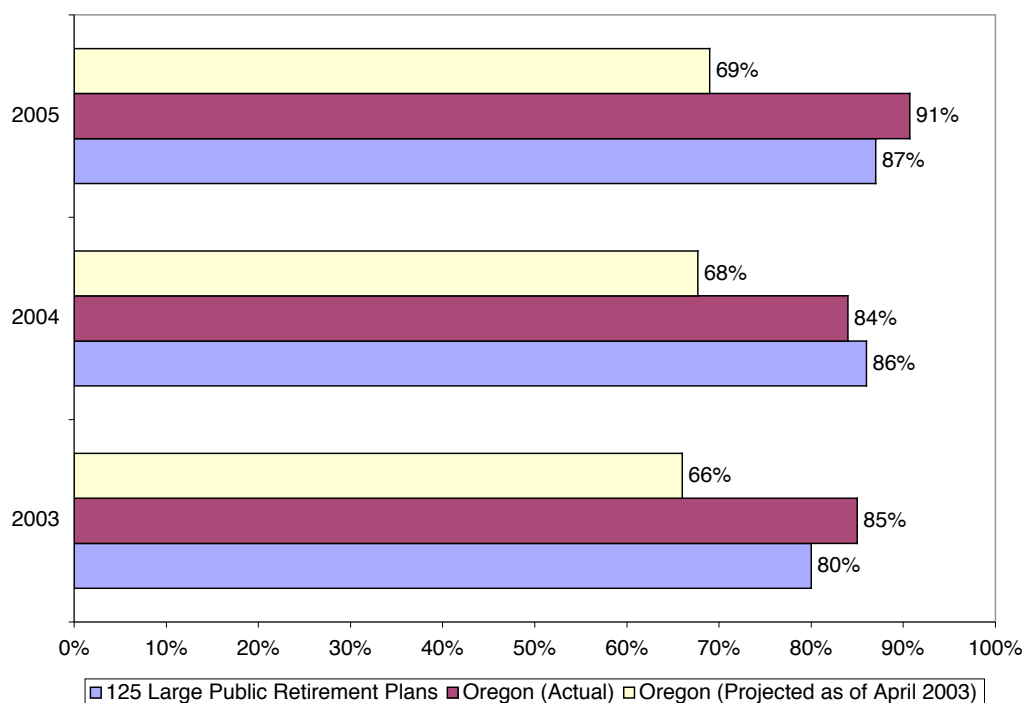


Source: Milliman December 31, 2003 Actuarial Valuation; Milliman Letter to Hallock and MacPherson (April 15, 2003); Hallmark, Bill and Annette Strand. September 15, 2006. *Oregon PERS December 31, 2005 Actuarial Valuation Results*

The system’s improving position is also illustrated through recent increases in the funded ratio. The ratio, which is a common measure of a pension health, divides total assets by total liabilities. Nationally, funded ratios were volatile in the periods before, during, and after the recent recession. Measured across 125 large public retirement systems, funded ratios stood at 112 percent in 2000 thanks to the atypically strong investment returns of the late 1990s. Ratios fell to 80 percent by 2003 and then rose to an estimated 87 percent in 2005.

Figure 3-4 reports funded ratios during 2003-2005 and compares Oregon’s pre-reform expectations to Oregon’s actual experience, and to a weighted average for other large public retirement plans. Absent reform and without knowledge of the strong markets after 2003, the PERS actuary predicted the funded ratio would fall into the mid-to-high 60s. With reforms and strong investment gains, PERS’ funded ratio reached 84 percent in the December 2003 valuation and 91 percent in the December 2005 valuation. The 2005 ratio is four percentage points higher than the estimated weighted average for 125 large public retirement systems.

**Figure 3-4: Comparison Funded Ratios, 125 Large Public Systems and Oregon (Actual and Projected), 2003-2005**



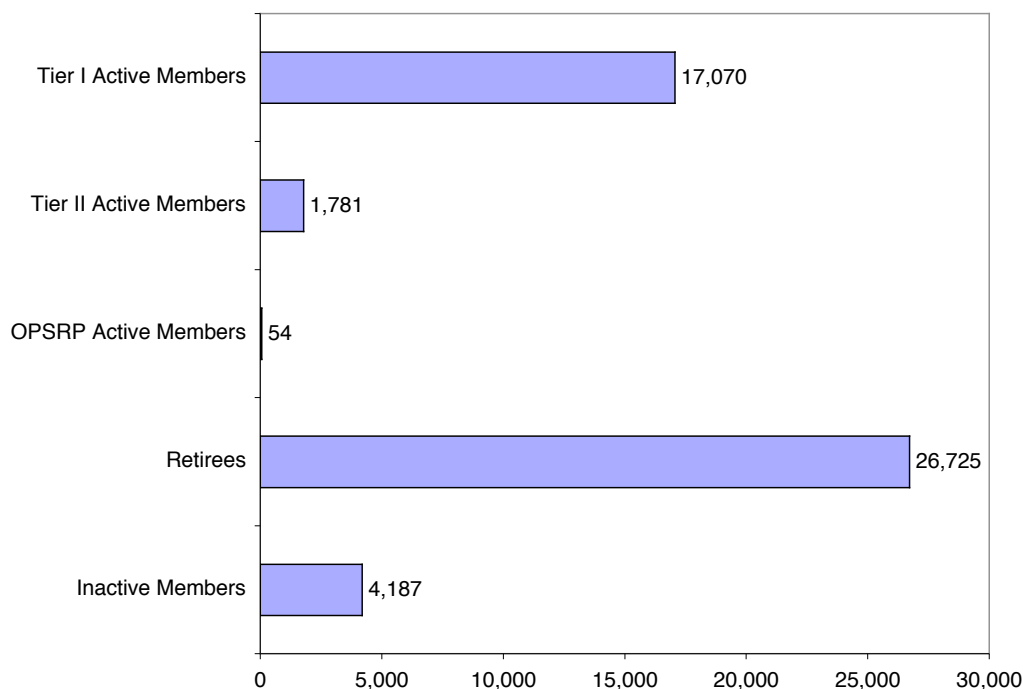
Source: Milliman Letter to Hallock and MacPherson (April 15, 2003); Hallmark, Bill and Annette Strand. September 15, 2006. *Oregon PERS December 31, 2005 Actuarial Valuation Results; 2006 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation.*

## EARLY FINDINGS ON THE OPSRP PROGRAM

As of December 2005, the accrued benefits of OPSRP members composed a tiny fraction of the system’s liabilities (see Figure 3-5). PERS Tiers I and II will continue to drive the system’s overall health for a number of years to come.

Over time, the new OPSRP system, which serves most new hires since August 29, 2003, will gradually grow in importance. As discussed in the previous chapter, a standard defined-benefit program serves as the foundation of the program. Under OPSRP’s full formula calculation, a retiree’s annual benefit amount equals his benefit factor (1.5 percent for general employees; 1.8 percent for police and fire employees) multiplied by the number of “creditable” years of service, which, in turn, is multiplied by the retiree’s final average salary. For example, a general service retiree with 30 years of service and a final average salary of \$60,000 would receive an initial defined benefit of \$27,000. In addition, the employee receives the assets from an Individual Account Program (IAP). The IAP receives member contributions (often paid by employers) equal to 6 percent of salary. At retirement, employees may receive the IAP as a lump-sum payment or in equal installments over a 5, 10, 15 or 20-year period.

**Figure 3-5: Actuarial Accrued Liabilities as of December 31, 2005 (in Millions)**



Source: Mercer Human Resources

At the time of plan creation, Milliman estimated OPSRP's defined-benefit plan would require employer contributions of slightly more than 8 percent of payroll. OPSRP's December 31, 2005 valuation—the first for the program—indicates the costs may run lower than originally projected. Mercer pegged OPSRP's normal cost at 6.3 percent of payroll in the immediate term but noted the system's costs should gradually rise to 7.3 percent. As of December 31, 2005, OPSRP assets totaled \$55 million compared with liabilities of \$53.8 million<sup>10</sup>.

## 2004-2014 PERS/OPSRP PROJECTIONS

The sizable liabilities associated with Tier I members implies that the outcomes for those members will affect employer contributions and system volatility for the next couple of decades. For those members, the rate guarantee and money match provisions will continue to affect system costs. If investment returns fail to reach the guaranteed rate, reserves and additional employer contributions would have to make up the difference. Conversely, if investment returns outpace the guaranteed rate, the cost of Tier I, and the system as a whole, would fall. In short, Tier I's unique rules will continue to create atypical uncertainty.

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<sup>10</sup> Hallmark, Bill and Annette Strand. September 15, 2006. *Oregon PERS December 31, 2005 Actuarial Valuation Results*.

To gain a better understanding of near-term costs and volatility, the PERS Board directed its actuary to model employer contributions assuming a range of investment outcomes. Mercer presented their findings to the Board in December 2005<sup>11</sup>. Subsequent to the release of Mercer's report, the Chalkboard Project contracted with ECONorthwest to review and extend the Mercer work. Specifically, the Chalkboard Project was interested in investigating the effects of the newly implemented OPSRP program and the pre-payment of PERS obligations through so-called side accounts. The Chalkboard Project was also interested in pension contributions that school districts could expect to pay, which were not addressed separately by Mercer.

The following sections summarize ECONorthwest's evaluation of the December 2005 work.

## **PROJECTED RATES FOR ALL PUBLIC EMPLOYERS**

ECONorthwest evaluated Mercer's PERS findings for all public employers and incorporated a rough estimate of the early effects of the OPSRP program. Underlying Mercer's work was a stochastic model through which Mercer estimated PERS costs across 1,000 different possible investment return and inflation scenarios. Mercer developed the range and distribution of investment outcomes based on the risk characteristics of PERS' existing investment portfolio.

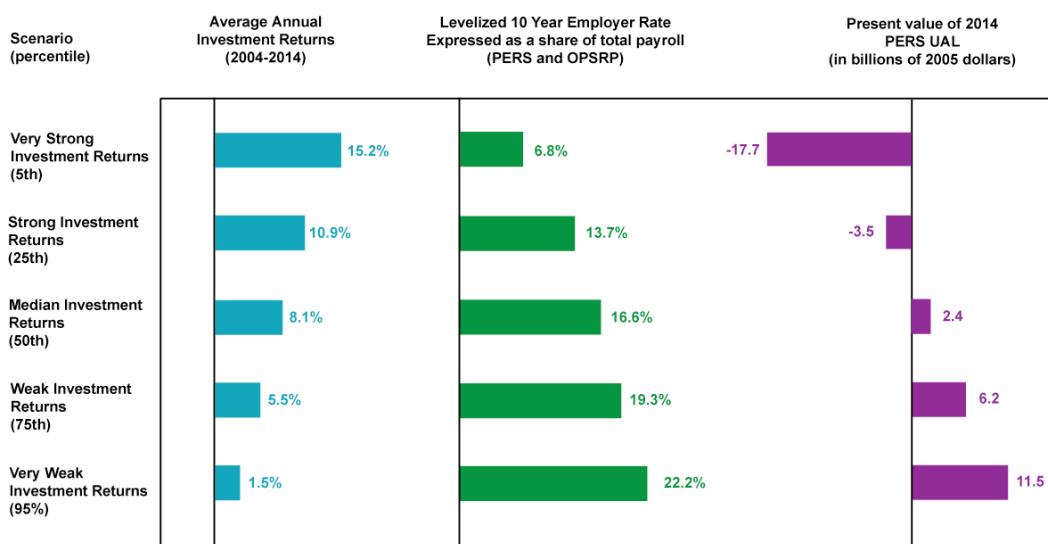
Even after reform, the system's costs are highly sensitive to investment returns. Generally speaking, returns in excess of the assumed rate of 8.0 percent lower employer costs while returns below the assumed rate raise employer costs.

The left-hand bars in Figure 3-6 illustrate the range of investment returns assumed in the Mercer model. The "Very Strong Investment" (5<sup>th</sup> percentile) path assumes the PERS investment portfolio would generate returns at an annualized rate of 15.2 percent through 2014. On the opposite end, the "Very Weak Investment" (95<sup>th</sup> percentile) assumes 1.5 percent annualized returns.

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<sup>11</sup> See Hallmark, Bill and Greg Smith. December 16, 2005. *Oregon PERS Financial Modeling Results*. Mercer Human Resource Consulting.

**Figure 3-6: Expected PERS/OPSRP Investment Returns, Employer Costs, and Unfunded Actuarial Liabilities, 2004-2014**



Source: ECONorthwest calculations based on data provided by Mercer and ECONorthwest assumptions about OPSRP costs.

The next two columns illustrate how the assumed investment returns translate into employer costs during 2004-2014 and the present value of the PERS 2014 UAL (in 2005 dollars). The employer rates are a measure of how much Oregon public employers can expect to pay—expressed as a share of combined payroll (PERS *and* OPSRP)—through 2014 under current crediting and accounting practices<sup>12</sup>. The 2014 PERS UAL signals how much of the existing PERS liability would persist after they have paid those rates.

For example, under the “Median Investment Return” scenario (i.e., 8.1 percent investment returns), employers would pay an average<sup>13</sup> of 16.6 percent of their combined PERS/OPSRP payroll to cover their pension obligations during 2004-2014. At the end of 2014, the PERS UAL would stand at \$2.4 billion (expressed in 2005 dollars).

The figure demonstrates a wide variation in possible outcomes depending on investment returns. Under “Very Strong Investment Returns”, which corresponds to the 5<sup>th</sup> percentile of employer costs, employer rates stand at 6.8 percent annually and the UAL turns into a \$17.7 billion surplus. At the opposite end of the distribution, “Very Weak Investment Returns” show 22.2 percent employer rates and by 2014 the UAL grows to \$11.5 billion.

<sup>12</sup> For the purposes of these estimates, we adopted Mercer’s projections on growth of the OPSRP payroll and set the new program’s cost at 8 percent of payroll. We report “levelized” employer rates over the 2004-2014 period. A levelized rate is the rate that, if paid each year, has the same present value as the stream of actual employer rates. Historically, PERS rates have increased and decreased over time.

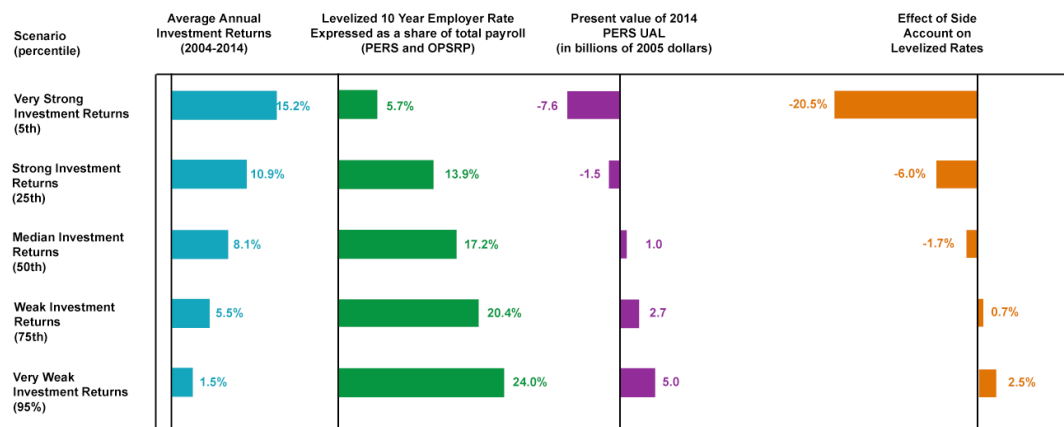
<sup>13</sup> The reported rates are “levelized”, meaning that if employers paid the reported rate in each year, the present value of their payments would equal the present value of payments made under the projected series of rates.

## PROJECTED RATES FOR SCHOOL DISTRICTS

In recent years, school districts have paid higher PERS rates than other state and local governments because they tend to have longer term employees who are less likely to withdraw from the system and have lower mortality rates. Consequently, school districts have a higher share of employees in the more-expensive and less-predictable PERS Tier One category. Consistent with this point, information provided by OPERS indicates that—as of the December 2003 valuation—43 percent of the PERS UAL was associated with school districts<sup>14</sup>; however, school districts’ payroll represented only 38 percent of all PERS payroll. Put differently, PERS UAL per dollar of school district payroll is higher than for other governments, which will translate into higher PERS rates charged to school districts until the UAL is eliminated.

Assuming a disproportionate UAL/payroll, Figure 3-7 repeats the investment return, employer rate, ending UAL analysis but for school districts only. The first column shows the investment return assumptions, which are identical to those reported in Figure 1. The second column reports the corresponding levelized rates school districts would pay during 2004-2014. System rates—expressed as a share of combined PERS/OPSRP payroll—would range from 5.7 percent to 24.0 percent. The third column reports the 2014 UAL associated with school districts (expressed in 2005 dollars). Applying Mercer data, ECONorthwest estimates school-specific UALs will range from –7.6 billion to 5.0 billion.

**Figure 3-7: Expected PERS/OPSRP Investment Returns, Employer Costs, and Unfunded Actuarial Liabilities, School District Pool Only, 2004-2014**



Source: ECONorthwest calculations based on data provided by Mercer and Seattle Northwest Securities and ECONorthwest assumptions about OPSRP costs.

Figure 3-7 also shows estimates of the effects of so-called side accounts. School districts funded their side accounts with the goal of reducing their net pension costs. During 2002-2005, participating districts bonded some, or all, of their estimated UALs and transferred the bond proceeds to PERS. PERS invests the district side accounts with the rest of the PERS portfolio. Districts borrowed at a 5.5 percent rate with the hope that PERS would earn an average 8.0 percent

<sup>14</sup> As of December 31, 2003, the PERS UAL associated with school districts stood at \$3.1 billion.

annual return on their accounts. Higher earnings on the side accounts produce higher savings. Of course, if PERS' investments yield earnings below the interest and fees paid on the bonds, the side accounts will add to the districts' pension costs.

To estimate the savings associated with the side accounts, ECONorthwest requested data from Seattle Northwest Securities, which issued bonds on behalf of all districts that created side accounts. Seattle Northwest provided the issuance dates, issuance amounts, and debt service schedules for every participating district. With the debt-service schedules fixed for the life of the bonds, the cost of the side accounts is certain into the future. Offsetting those debt-service costs are the investment returns earned on those proceeds. Using issuance dates and amounts, ECONorthwest estimated historic side account earnings and future earnings under a range of investment return scenarios<sup>15</sup>.

The final column reports the effect of the side accounts on the levelized rates. Under the "Very Strong Investment" path, the side account savings are so large they fully fund districts' pension contributions and essentially create surpluses (that is, the side account reduces employer rates by 20.5 percentage points, but districts' pension contributions are only 5.7 percent under the scenario). Under this scenario, the districts have borrowed at 5.5 percent and earned 15.2 percent annually on their borrowed money. Under the "Very Weak Investment" path, districts earn only 1.5 percent annually on their side accounts in 2004 and beyond, the accounts have the effect of *adding* 2.5 percentage points to the employer rate<sup>16</sup>.

## CONCLUSIONS ON NEAR-TERM FORECASTS

Public employers generally—and school districts specifically—will pay pension costs that are well above their historic averages. Assuming 8.1 percent investment returns during 2004-2014, school districts would make pension contributions equal to 15.5 percent of payroll (net of side account savings), which is about 5 percentage points higher than rates paid during 1975-2000. Given the structure of the PERS program, however, rates vary significantly with investment returns. Under optimistic investment scenarios, excess earnings in school district side accounts would fully fund pension costs and create surpluses. Under less-optimistic investment scenarios, district pension costs could greatly exceed the average projection.

Focusing on the "middle" outcomes (those that fall between the 25<sup>th</sup> and 75<sup>th</sup> percentile) may be most appropriate for drawing broad conclusions about the system's fiscal condition. In that range, which assumes investment returns would range from 5.5 to 10.9 percent, school district costs—net of side account savings or costs—would be as high as 21.1 percent or as low as 7.8 percent. The 2014 UAL (expressed in 2005 dollars) for school districts falls between a high of \$2.7 billion and a low of -1.5 billion.

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<sup>15</sup> Appendix A reports estimated side account balances as of December 31, 2005 for each school and educational service district in the state.

<sup>16</sup> The adverse consequences of weak returns have been mitigated by strong side account earnings prior to 2004.

# ASSESSING THE EMPLOYER SIDE ACCOUNTS

As discussed in the previous section, a number of state and local employers effectively pre-paid a portion their unfunded liabilities by issuing debt. Through this approach, public employers sought to exploit the difference between the interest rates on bonds—around 5.5 percent—and investment returns they could expect to earn through PERS—8.0 percent annual return on their accounts. Higher earnings on the so-called side accounts produce higher savings. Of course, if PERS' investments yield earnings below the interest and fees paid on the bonds, the side accounts would add to the districts' pension costs (as illustrated in the 2004-2014 projections of school district rates in the previous section).

As of December 31, 2005, the side account balances for all state and local government employers totaled \$6.67 billion. The outstanding principal on the pension obligation bonds that created the accounts totaled \$6.39 billion. Double-digit investment returns in each of 2003, 2004, and 2005 have favored employers that started side accounts, particularly those who borrowed in 2002 and earned a 23.8 percent investment return in 2003.

Given the strong 2003-2005 investment returns, a number of employers use their side accounts to pay almost its entire PERS/OPSRP obligation. In those cases, PERS deducts a payment from the side account, and the employer makes only a small additional contribution to PERS<sup>17</sup>. The employer's retirement costs become the annual debt service on the pension obligation bonds. Some balances are so large, the side accounts—under reasonable forecasts—may fund all the employer's PERS/OPSRP obligations for the next two decades *and have money left over after the employer has fully paid off the bond*. If that comes to pass, certain employers could face a few years—in the late 2020s—with almost no retirement costs. That is, the side accounts would continue to pay their PERS/OPSRP obligations and debt service would have expired.

The position of the Portland Public Schools (PPS) illustrates the point. The district issued \$208 million in debt in 2002 and another \$281 million in 2003. The account benefited from the strong returns of 2003-2005, and by the end of 2005 was valued at more than \$680 million. At that level, the account could pay combined PERS/OPSRP rates of 19 percent through 2027. Put differently, if combined PERS/OPSRP rates remained at 19 percent throughout the next 21 years, the side account would gradually trend to a zero balance.

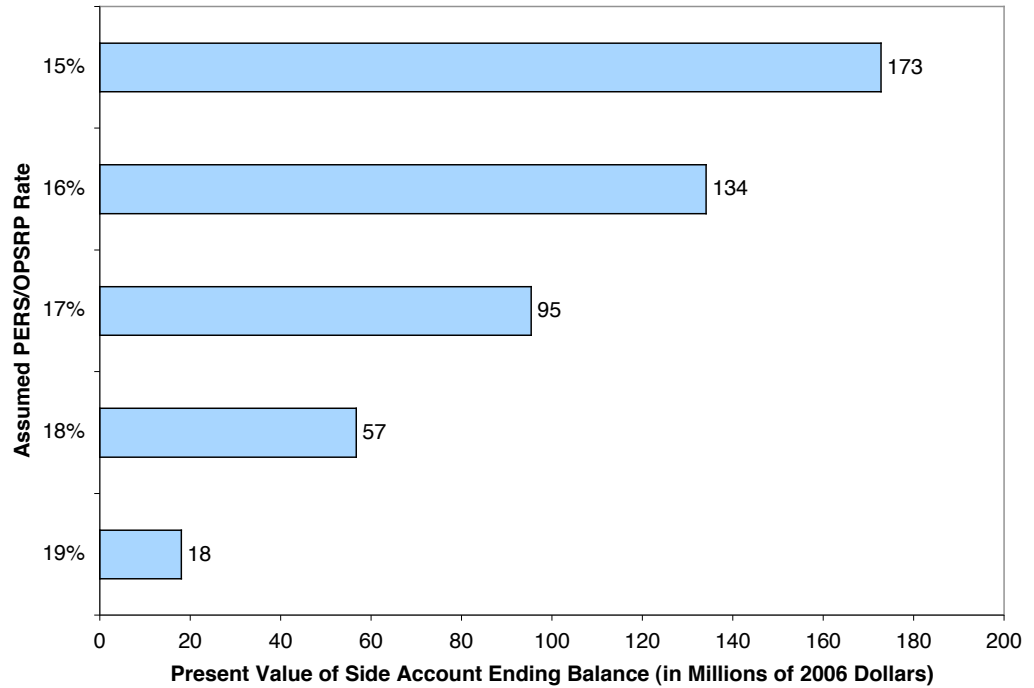
While PERS rates are expected to remain high in the near term, simulations by Mercer suggest the PERS unfunded actuarial liability (UAL) could be significantly reduced—or even eliminated—by 2017 or soon thereafter. Elimination of the UAL could pull PERS rates to below historic averages. Moreover as time passes, more and more PPS employees will be in the OPSRP program, which would pull down rates even further. Take the two trends together,

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<sup>17</sup> The employer may pay a small contribution if its PERS and OPSRP rates differ. In those cases, the lower pension program rate becomes zero, but the employer must pay the portion of the higher rate that is not offset by the side account rate. Additionally, side accounts do not offset payments for the PERS administered Retirement Health Insurance Account (RHIA) and Retiree Health Insurance Premium Account (RHIPA). Finally, side accounts cannot offset the 6-percent member contribution.

and PPS could expect blended PERS/OPSRP rates of around 10 percent during 2017-2020. If that happens, the side account would accrue sizable “unused” balances. Figure 3-8 reports the estimated present value of PPS’s side account, assuming a range of average contribution rates

**Figure 3-8: Estimated Present Values (2006 Dollars) of Portland Public Schools’ Side Account when Debt Expires on its PERS Pension Obligation Bonds**



Source: ECONorthwest

To summarize, given strong returns earned on side accounts in their initial years, as well as expectations of declining PERS/OPSRP rates at some point after 2017, PPS and a number of other public employers will likely be in PPS’s position of accruing “unused” side account balances.

## LEGAL BOUNDARIES

Throughout much of the next decade, state and local employers will make retirement contributions that are 50 to 100 percent higher than during the previous three decades. These higher rates come despite the significant changes enacted by the 2003 Legislature, as well as the Oregon Supreme Court's upholding of the Lipscomb settlement—reversing the PERS Board's 1999 crediting decision. Assuming no corresponding change in government revenue, the higher PERS rates imply governments will pay more for labor during the next 10 to 15 years than they have in the past and, therefore, will have to reduce their levels of service. In schools, the higher pension payments will crowd out spending for new teachers and put upward pressure on class sizes. Fire, police, corrections and the full range of human services will be affected as well.

Some observers view the upcoming pension costs, and their effect on services, as unacceptable and call for an additional changes to supplement the recent reforms. The goal of the policy changes would be to quickly drive employer rates to levels that employers paid throughout the 1970s, 1980s, and 1990s.

The Oregon Supreme Court—through its interpretation of employees' contract rights—will be the ultimate arbiter of how much change would be constitutionally permissible, whom the changes could affect, and when it could affect them. Through rulings on *Strunk* and the *Eugene Settlement*, policymakers have better insights into the Court's views on the legal environment. The policy options outlined in this chapter are bounded by two key interpretations of the Court's rulings:

- **PERS Tier I members have the right to retire under Money Match—with accounts adjusted through the Eugene Settlement—if it provides higher retirement income than the full formula; Adjustments for other instances of excess crediting, prior to 1999, are not permitted.** The majority of PERS extraordinary, near term costs are driven by large Tier I member accounts that grew with multiple instances of excess crediting during 1974-1999. While the reversal of 1999's crediting decision and the creation of IAPs have curbed Tier I-related costs, reforms aimed at further lowering the cost of Tier I would face significant legal obstacles. Because employers failed to challenge the multiple instances of excess crediting during 1974-1998 in a timely manner, the Court views the Tier I accounts, built on those excess credits, as "benefits earned". With little ability to address Tier I costs for active members or retirees, the potential for significant savings in the near term is limited.
- **State and local governments cannot simply walk away from the PERS-related obligations.** In *Strunk*, the defense (public-sector

employers) offered an economic hardship defense and argued that paying the anticipated costs of PERS would threaten the state's economic and fiscal stability. The Oregon Supreme Court ruled that the evidence presented did not prove economic hardship and that, even if it had, the Court may have rejected the defense anyway. In short, the Court has ruled that state and local government employers must meet their PERS commitments.

The possibility of significantly lowering the cost of Oregon's public retirement system hinges on whether one agrees with these two interpretations of the Court's ruling in *Strunk*. Agree with them, and the range of reforms and expected near-term savings is limited. Reject them, and policy options and opportunities for savings expand.

The balance of the chapter advances only policy options that are consistent with these two interpretations of the Court's ruling. Consequently, the chapter does not consider simply eliminating the money match option for Tier I employees or other policies that would reduce balances in Tier I member accounts.

The chapter does discuss a range of statutory and administrative changes that show potential to reduce employer costs or strengthen system stability. While the options show some potential to withstand a legal challenge, most observers believe stiff challenges would be forthcoming.

## **OPTION 1: FORBID CREDITING IN EXCESS OF THE GUARANTEED RATE**

Given the key role of excess crediting in driving up past PERS liabilities, the 2003 Legislature sought to curb the practice in the future. Among the 2003 reforms was a law that prohibited crediting in excess of the guaranteed rate of return until a newly created Tier I reserve account was fully funded. The PERS actuary would deem the account fully funded when it contains funds sufficient to ensure a zero balance when the last Tier I member retires.

In March 2007, the actuary provided guidelines that could be used by the Board to establish funding thresholds for the Tier I Rate Guarantee Reserve. The Board has not made policy decision on the reserve and, to this point, the PERS Board has not credited Tier I accounts in excess of the guaranteed rate of return.

Because the actuary's estimate of a fully funded reserve would be inherently complex and controversial, some stakeholders have proposed a permanent prohibition on crediting Tier I accounts with more than the guaranteed rate of return. While such a change may have no practical cost effect in the short-term, a permanent prohibition could prevent excess crediting by a future Board.

## OPTION 2: ELIMINATE STATE TAX ADJUSTMENT FOR NON-OREGON RESIDENTS

Until the late 1980s, PERS pensions were exempt from state taxation; however, federal pensions were taxed. In 1989, the US Supreme Court ruled that state pensions could not receive more favorable tax treatment than federal pensions. In 1991, the Legislature imposed a tax on PERS pensions, but the Oregon Supreme Court later ruled the tax effectively reduced the value of the benefit and, therefore, violated the PERS contract. In 1995, the Legislature enacted HB 3349, which increased PERS benefits to offset the effect of the state taxation. Only PERS members who established membership prior to July 14, 1995 are eligible for the benefit increase.

PERS makes the so-called state tax adjustment to the pension whether or not the retiree lives or pays taxes in Oregon. At various times, policymakers have proposed limiting the adjustment to only retirees who designate Oregon as their place of residence. Under such proposals, PERS would not include the benefit increase for retirees who declare residency (for tax purposes) outside of Oregon. In 2005, Mercer Consulting estimated that denying the adjustment to out-of-state retirees could reduce the PERS actuarial liability by \$127.4 million to \$637.2 million. Correspondingly, employer rate would fall by 0.07 to 0.36 percent. The lower bound estimates assume 5 percent of retirees live out-of-state; the upper bound assume 25 percent.

## OPTION 3: LOWER THE ASSUMED RATE OF RETURN

The guaranteed rate of return paid to PERS Tier I members is the key driver of the system's unfunded liabilities. As members' accounts grew through strong returns and excess crediting during the 1980s and 1990s, the cost of guaranteeing the larger accounts increased. Clearly, if PERS could lower the guarantee, the system's cost would decline. The 2003 Legislature attempted to reduce the cost of the guarantee by effectively converting it into a *career* guarantee rather than an *annual* one. Under a career model, subpar returns in one year could be offset by strong returns in other years, which, for example, would permit zero crediting if it was offset by gains. In *Strunk*, the Oregon Supreme Court rejected that concept and ruled PERS had to meet the guarantee *every year*. Moreover, the Court was clear that the guaranteed rate was inextricably tied to the system's assumed earnings rate. The assumed rate of return is the actuary's estimate of the long-term investment returns on the system's assets.

PERS' assumed earnings rate, and the Tier I guarantee, has varied over time. Historical assumed earnings rates were 5.0 percent during 1971-1974, 7.0 percent during 1975 to 1978, 7.5 percent during 1979-1988, and 8.0 percent during 1989 and thereafter. The PERS Board could change the assumed rate if they concluded long-term investment returns are going to fall below current expectations.

But even if the Board's actuary came forward with a recommendation to lower the assumed earnings (and guaranteed) rates to 7.0 or 7.5 percent, the systems cost would go up rather than down in the short run. The effects would

vary across the system: Tier I, Tier II, OPSRP, and Retirees. In the case of *retirees*, a lower assumed rate of return would imply that PERS would expect to have lower investment earnings to fund retiree benefits. PERS would then call on employers to make higher contributions to offset the expected loss in investment earnings.

*For active Tier I members*, a lower assumed earnings rate would have offsetting effects. By reducing the guaranteed rate of return, the plan's liabilities would decline because Tier I member accounts—with a lower guaranteed rate of return—would grow at a slower rate. The money match option would decrease in value, and a larger share of Tier I retirees would base their pensions on the formula. However, as with the retirees, the reduction in the assumed rate would simultaneously lower the actuary's valuation of the assets used to cover the benefits of active Tier I members. Employer contributions would have to make up for the lost earnings, which would increase employer rates. On net, however, the cost of the Tier I program would decline.

Given its varying effects across the system, a lowered assumed earnings rate shows the potential to lower employer costs only *if the change were isolated to the active members*, which could be accomplished through a so-called plan partition.<sup>18</sup> The actuary would have to justify separate rates for Tier I, Tier II, OPSRP, and retired members. With the plan partitioned into its constituent parts, the PERS Board and Oregon Investment Council could evaluate the nature of each group's liabilities. Given Tier I and II are *closed programs* with relatively short-term liabilities that will decline as members transition into retirement, the actuary could argue the assets should be invested in a more conservative portfolio. Even under a plan partition, lowering the assumed rate would increase employer contributions initially. However, lower money match benefits in the long term would generate net savings.

If a plan partition proves impractical, the PERS Board might consider lowering the assumed rate even with an increase in employer costs. Lower assumed earnings provide an easier target for the Oregon Investment Council. While employer contributions would increase in the short term, the system's volatility—in both PERS and OSRP—would fall.

Any near-term change in the assumed rate would run into a practical challenge. Mercer recommended an assumed 8 percent earnings rates to the PERS Board on June 16, 2006, and the Board adopted the earnings assumption. Analysis by Wilshire Consulting indicates PERS's 8 percent rate is roughly line with expected long-term rates of return for state pension systems across the country. The median state pension fund has an expected return of 7.7 percent.<sup>19</sup>

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<sup>18</sup> This partition recommendation would affect only the annual earnings credited to Tier I accounts—not the amortization rate used in the retirement benefit calculation.

<sup>19</sup> See Bonafede, Julia K. et al. March 2006. *2006 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*. Wilshire Consulting.

## **OPTION 4: PROVIDE ADDITIONAL FLEXIBILITY IN CHARGES AGAINST SIDE ACCOUNTS**

School districts and other state and local governments essentially prepaid large portions of their PERS/OPSRP liabilities by issuing long-term debt. For most governments and districts, the move has proven to be a financial success at this early point. Put simply, governments borrowed money at between 5 and 6 percent and have earned between 11 and 20 percent annually during 2003-2006. In some instances, the accounts of individual employers have grown so large that—under expected investment environments—they could cover the entire retirement liability and have resources leftover when debt service on the bonds expires in the mid-2020s. So, depending on market returns going forward, some governments and school districts could see two to three years in the late-2020s during which their debt service on their side account will have expired, *and* the residual side account balances would fully fund their retirement obligations at PERS. Put simply, it's conceivable that some governments and school districts would have virtually no retirement-related expenses in the late 2020s.

Given the size of the accounts, some observers have called on the PERS Board and policymakers to consider policies that would allow governments and school districts to liberate some of the investment gains sooner. To do so, PERS could expand the range of expenses that districts could charge against their side account balances. PERS already allows employers to buy down their retirement-related obligations (PERS and OPSRP). To provide further flexibility, the PERS Board could explore allowing governments and school districts to fund some of their core health insurance obligations—for current employees—through the side accounts, which would fundamentally alter the retirement plan's fiduciary obligations and would likely require a change in federal law.

Other observers have discussed the possibility of creating a market for “side account credits.” An employer with a large side account and a low PERS rates could sell credits to an employer with a higher PERS rate and no side account. Such an approach would leave dollars in the system and would not violate existing statutes or regulations..

## **OPTION 5: SUNSET THE MEMBER CONTRIBUTION REQUIREMENT**

State law requires PERS and OPSRP members to contribute six percent of their salary to retirement. Many public employers negotiated to “pick up” the employee's contribution. Before the 2003 legislative changes, the member's contribution were deposited into regular accounts that were eligible for money match. Today, member contributions build an Individual Account Program, which functions like a traditional defined-contribution plan.

Given that the member contribution no longer has money match implications, some observers argue the requirement could be phased out or made optional over

time. In lieu of the PERS IAP, employees could make individual retirement contributions under an alternative program (Section 457).

Phasing out the member requirement under PERS would moot the politically charged issue of who pays the member contribution when it is picked up by employers. Critics of PERS high costs view the pick up as net 6 percent increase in the cost of retirement. Meanwhile, advocates of public employees see the pick up as a tradeoff for accepting lower salaries.

Because the pick up is assumed in numerous locally negotiated contracts, state lawmakers would have to sunset the requirement a few years in the future. At that time, local employers and employee representatives would negotiate whether they would continue the practice and, if not, how the overall compensation package would change as a result.

## **OPTION 6: REVIEW BOARD AND AGENCY IMPLEMENTATION OF EXISTING STATUTES**

The PERS Board should work with its staff and investigate areas in which implementation of program rules may be out of line with the statute or common financial practices. PERS' method of crediting member accounts is worthy of discussion. The agency credits a member's annual contributions with a full year's interest regardless of the timing of the contributions. A more standard practice would adopt time-weighted crediting and apply interest on the average daily balances over the course of the year.

The application of cost-of-living adjustments under the Money Match option is another area worth review. At retirement, the employer matches the employee's regular account balance—dollar for dollar—in the Money Match calculation. Using the resulting total, the agency calculates a lifetime annuity. Then, during retirement, the employer additionally funds a 2 percent COLA, which is added to the annuity. State statute is clear that the employer is responsible for the COLA<sup>20</sup>. However, some observers argue that, at the time of retirement, PERS could calculate the annuity and build in a COLA from the outset using the employer's match to do so. The employee would start with a lower annual payment that would increase at 2 percent annually thereafter.

To illustrate the competing methods, an employee with a \$500,000 account receives \$500,000 from the employer at retirement (the match). Under current practice, PERS uses the combined \$1 million to calculate an annuity. The employer subsequently funds the COLA, which adds roughly 20 percent, or \$200,000, to the cost of the retirement package. Under the alternative method, the employer's liability would stop at the \$500,000 match. A portion of the employer's match would fund the COLA. Officials at the PERS agency are aware of the competing methods and contend theirs is consistent with both the state statute and the Oregon Supreme Court's ruling in *Strunk*.

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<sup>20</sup> See ORS 238.360

## OPTION 7: EVALUATE STATUTE ON MINIMUM HOURS REQUIRED TO QUALIFY FOR RETIREMENT BENEFITS

The current statute allows membership in OPSRP (and PERS) when an employee works in a covered position for six consecutive months. Covered positions include those expected to work at least 600 hours in a calendar year. Consequently, the current statute allows employees working less than 30 percent full-time, full-year employment to accrue and eventually receive retirement benefits. By contrast, a retiree receiving retirement or pension benefits can work up to 1,039 hours without affecting benefit levels. Requiring that individuals work at least half of the regularly scheduled hours for a given position to gain OPSRP eligibility would reduce employer liabilities.

## OPTION 8: REPLACE OPSRP'S DEFINED BENEFIT PLAN AND SHARE RISK WITH EMPLOYEES

From many observers' perspectives, the OPSRP program is a significant improvement over its predecessor programs. OPSRP is considerably less complex than either Tier I or Tier II, and relative to its predecessors, costs are in closer alignment with public pension programs in other states.

OPSRP is considered a hybrid program consisting of a defined-benefit program (funded by employer contributions and investment earnings) and a supplemental defined contribution program (funded by employees whose contributions are often made by employers). Costs of the defined contribution program are well known. Fixed contributions fill member accounts, and balances grow and decline with investment earnings and losses.

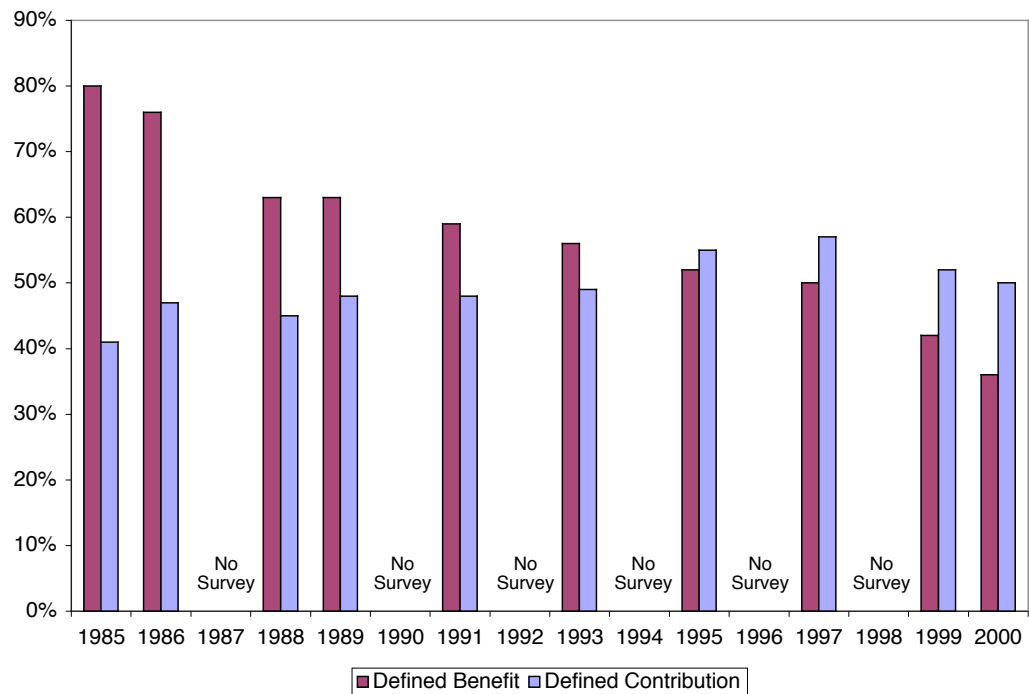
Costs for OPSRP's defined-benefit plan are uncertain. The system's actuary recently estimated employer contributions would run at 7.3 percent of payroll to fund the system. Two types of risk—both borne by the employer in a defined benefit plan—will raise and lower the system's cost over time:

- 1) **Longevity risk.** If the actuary's projections on member longevity prove inaccurate, the system's cost will increase or decrease. If the actuary has overestimated members' life expectancies, the plan will cost less than currently estimated. Conversely, if the actuary has underestimated members' life expectancies, system costs would rise.
- 2) **Investment risk.** As with PERS, the investment earnings on employers' contributions to the system are an important source of the system's assets. As discussed previously, the actuary periodically adopts an assumed investment earnings rate. For PERS, and now OPSRP, the assumed earnings rate is 8 percent. If actual earnings fall short of the actuary's assumption, the employer's cost would increase relative to current expectations. If actual earnings exceed the assumed rate, employer costs would fall.

So to summarize, while the costs of OPSRP are less volatile than the costs of its predecessor plans, uncertainty persists through mortality and investment risk. The inherent uncertainty of defined-benefit plans is a key reason many firms in the private sector have stopped offering them. During 1985-2000, the share of full-time employees in medium and large private firms participating in defined-benefit plans fell from 80 percent to 36 percent (See Figure 4-1). Meanwhile, participation in defined contribution plans rose. The public sector has not experienced a similar trend, and roughly 90 percent of state and local government employees are enrolled in defined-benefit plans<sup>21</sup>.

The transition away from a defined benefit plan involves a transfer of risk from the employer to the employee. Any step away from OPSRP's defined-benefit would have to evaluate both the overall generosity of the plan, as well as how the plan's risk is shared between employers and employees. While the defined-contribution plans shift all the risk to the employee, other plan designs, including a retirement shares program, could share risk. The following sections outline two alternatives to OPSRP's defined-benefit plan.

**Figure 4-1: Percent of Full-Time Employees in Medium and Large Private Establishments Participating in Defined Benefit and Defined Contribution Retirement Plans, Selected Years, 1985-2000**



<sup>21</sup> See Brainard, Keith. February 2005. *Myths and Misperceptions of Defined Benefit and Defined Contribution Plans*. National Association of State Retirement Administrators.

Source: US Bureau of Labor Statistics

NOTE: The sum of participation in DB and DC plans can exceed 100 percent, which reflects that an employee can participate in two plans simultaneously.

## CREATING A DEFINED CONTRIBUTION PLAN FOR NEW EMPLOYEES

The Chalkboard Project's Finance and Accountability Taskforce recommended replacing OPSRP's defined-benefit plan with a defined contribution plan. From the employer's perspective, the change would achieve certainty in program costs. Employers could direct 8 percent of payroll (or some other amount) to members' IAPs in addition to 6 percent currently deposited by the member (or on the member's behalf by the employer).

As discussed previously, from the employer's perspective the advantage of the defined contribution is cost certainty. The employer's financial obligation under a DC plan is limited to the contribution. DC plans are also much easier to administer for employers. The employer accounts for contributions on an income statement but, unlike defined benefit plans, the employer does not have to consolidate plan assets and liabilities on its balance sheet. Cost certainty and administrative ease are the key reasons DC plans have rapidly gained favor in the private sector.

Employers achieve cost certainty by shifting longevity and investment risk to the employee. In deciding how much to contribute to a plan, or to spend down in retirement, each individual employee must anticipate how long he or she is going to live. An employee who assumes an average life expectancy has a 50 percent chance of exhausting the plan's funds before death. In order to be 90 percent certain he will not outlive his fund, an employee has to increase the plan's assets by 25 to 30 percent. If the employee outlives expectations, the account is exhausted, and he or she relies on other assets, help from relatives, or government assistance. If, on the other hand, she dies prematurely, the DC plan's assets remain with her estate.

The DC plan's assets rise and fall with investment earnings. In most private sector DC plans, employees have control over directing the plan's investments<sup>22</sup>. Unlike DB plans, the employee bears the full risk of strong or weak market returns.

DC plans are more portable than DB plans and easily "rolled over" from one job to the next. They also lack vesting periods, so employees retain benefits for even very brief employment spells. By contrast, in OPSRP's DB plan a member is eligible for benefits only after five continuous years of service, or at age 65.

As discussed previously, DC plans have proliferated in the private sector but represent the main retirement vehicle in only a limited number of state and local governments. A number of state retirement systems—including those in Florida,

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<sup>22</sup> . In the PERS/OPSRP Individual Account Programs, the Oregon Investment Council manages the plans' investments.

Ohio, South Carolina, Montana—have offered employees the option of enrolling in either a DB or DC plan, and most employees have selected the DB option.

State employees in Michigan hired after 1997 have only a DC plan through which the state contributes 4 percent of salary and matches up to an additional three percent. The Alaska Legislature closed its DB plan for public employees hired after June 2006. All new public employees are enrolled in a DC plan.

## CREATING A RETIREMENT SHARES PLAN FOR NEW EMPLOYEES<sup>23</sup>

Mercer Human Resource Consultants—PERS’s current actuary—recently unveiled an alternative to DB and DC plans through which the employer would assume longevity risk and employees would assume the investment risk<sup>24</sup>. Through a so-called “retirement shares” plan (RSP), employers would guarantee lifetime benefits, but the level of retirement payments would rise and fall based on the plan’s investment performance.

Participants in the RSP would accrue benefits in much the same way they would under a traditional DB plan; however, the value of the benefits would vary with investment returns. Under a traditional DB plan with a benefit formula equal to one percent of pay, an employee paid \$50,000 annually would earn a pension benefit equal to an annual income of \$500. In a RSP, the benefit would be converted to 50 retirement shares valued at \$10 each. The employee would accumulate additional shares each year (See Table 4-1)

**Table 4-1: Illustration of the Accumulation of Retirement Shares and Pension Income under a Retirement Shares Plan**

	Year 1	Year 2	Year 3	Year 4	Year 5
RSP shares earned	50	45	48	43	45
Accumulated RSP shares	50	95	143	186	231
End-of-year share price	\$10.00	\$11.00	\$10.50	\$11.50	\$11.00
Year-end pension income	\$500.00	\$1,045.00	\$1,501.50	\$2,139.00	\$2,541.00

Source: Mercer Human Resource Consulting

At retirement, the total number of shares accumulated over a career and share price would determine the initial retirement payment. An employee with 1,800 shares at a value of \$12 per share would receive an initial annual income of \$21,600.

The key difference between a traditional DB plan and the RSP is the ability for the share price, and the retirement income, to rise and fall with investment returns. The flexibility in share price transfers the investment risk to the employee.

<sup>23</sup> This section draws heavily from Fuerst, Donald E. Winter 2006. “Risk Allocation in Retirement Plans: A Better Solution. *Journal of Applied Corporate Finance*. Volume 18 Number 1. pp. 95-103. Morgan Stanley Publication.

<sup>24</sup> See <http://www.mercerhr.com/summary.jhtml?idContent=1197485> accessed on September 19, 2006.

The employer would assume longevity risk by promising to fund the plan sufficiently to guarantee lifetime income assuming the plan's assets earn the *Share Interest Rate* (SIR). The SIR could equal the rate earned through high quality, relatively risk free investments (4 to 5 percent in today's market). The value of retirement shares would rise and fall with the difference between actual returns and the SIR. For example, if the SIR were set at 5 percent, and the assets earned 8 percent, the share price would increase by 3 percent. Alternatively, if the assets earned only 2 percent, the share price would decrease by 3 percent.

Employees would hold all their shares throughout retirement. Their annual income would vary depending on the share price. Over the course of their employment and, through their retirement, participants could purchase different classes of shares. For example, a RSP could offer stable shares, equity shares, and diversified shares. A young employee may purchase primarily equity shares with a potential for high returns while a retiree may shift to stable shares that would support a stable income. Diversified shares would fall between equity and stable shares and could be appropriate for those late in their careers.

An employee's retirement income, expressed as a share of Final Average Pay (FAP), would vary depending on average investment returns. Table 4-2 compares outcomes for a traditional DB plan with the RSP. The traditional DB plan illustrated here provides one percent of Final Average Pay per year of service. The RSP purchases retirement shares worth one percent of annual pay each year. The SIR is equal to 4 percent. In each plan, the retiree is age 65 and has worked 30 years.

The traditional DB plan provides a benefit equal to 30 percent of Final Average Salary regardless of average investment returns. By contrast, the RSP outcomes fall between 24.3 percent and 36.7 percent. Higher investment returns yield higher annual income. However, while the level of income varies with investment returns, the duration of income would not. The RSP would guarantee a lifetime income.

**Table 4-2: Illustrative Benefits Between a Traditional Defined Benefit and Retirement Shares Plans**

Average Investment Return	Defined Benefit: Final Average Pay	Retirement Shares Plan Benefit
5%	30.0%	24.3%
6%	30.0%	27.7%
7%	30.0%	31.8%
8%	30.0%	36.7%

Source: Mercer Human Resource Consulting

NOTE: The defined benefit plan assumes the employee earns 1 percent of final average pay for each year of service. The retirement shares plan assumes the employee purchases retirement shares equal to 1 percent of annual pay during each year of service. In both plans, the employee retires at age 65 with 30 years of service.

## Summary of Potential Fiscal Impacts of Policy Options

Estimating the fiscal impacts of any policy would require member-level records, which are not available to ECONorthwest. In the absence of an in-depth analysis, this summary indicates which options would be designed to generate employer savings and which ones would not.

**Option 1: Forbid Excess Crediting.** Change would have no practical cost effect in the short-term. A permanent prohibition could prevent excess crediting by a future Board.

**Option 2: Eliminate State Tax Adjustment for Non-Oregon Residents.** Denying the adjustment to out-of-state retirees could reduce employer rates by 0.07 to 0.36 percent. Assuming \$2.4 billion in payroll, Oregon school districts could save between \$1.6 million and \$8.5 million annually.

**Option 3: Lower the Assumed Rate of Return.** A lowered assumed earnings rate shows the potential to lower employer costs only if the change were isolated to the active members, which could be accomplished through a so-called plan partition.

**Option 4: Provide Flexibility in Use of Side Accounts.** Proposal does not generate savings but allows school districts, and other employers, to access investment gains on their side accounts sooner.

**Option 5: Sunset the Member Contribution Requirement.** Policy does not generate savings but would allow districts and employee unions to bargain out the 6-percent pickup.

**Option 6: Review Board and Agency Implementation of Existing Statutes.** A change to the method PERS calculates cost-of-living adjustments retirees leaving under Money Match could reduce employer costs significantly.

**Option 7: Evaluate rules on minimum hours required to qualify for retirement benefits.** Requiring individuals to work at least 50 percent of the regularly scheduled hours for a given position to gain OPSRP eligibility would reduce employer liabilities.

**Option 8: Replace OPSRP's Defined Benefit Plan and Share Risk with Employees.** Savings associated with a Defined Contribution or Retirement Shares Plan would depend on the specific plan design. The Legislature could design a new plan to be cost neutral. Reduced volatility—rather than savings—would be the main goal of the policy.

# Agency Response

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# Oregon

Theodore R. Kulongoski, Governor

## Public Employees Retirement System

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July 25, 2007

**To:** John Tapogna, Managing Director  
ECONorthwest

**From:** Paul R. Cleary, Executive Director  
Dale S. Orr, Coordinator, Actuarial Analysis Section

**Subject:** PERS Comments Regarding:  
“Public Employee Retirement in Oregon: Where does the system stand and where could Oregon go from here?”

Thank you for providing Oregon PERS an opportunity to comment on ECONorthwest’s study that it conducted for the Chalkboard Project. PERS has benefited greatly from our open and ongoing collaboration between our two organizations. In support of this collaboration, I am providing the following comments regarding the study.

We have developed our comments and suggestions on two levels for your consideration. The first level covers general comments contained in the body of this memo. The second level contains factual issues or other comments where PERS’ understanding of actions, history, etc. may differ from ECONorthwest’s. These comments are electronically noted on the report proper (attached).

### General Comments:

#### 1. Appropriate Level of Benefits

While the study contains a number of recommendations on how to reduce pension costs for PERS employers, the analysis does not provide a broader view regarding the impact on benefits. It would have been helpful had the study made its recommendations in the context of an “appropriate level of benefits”. By looking at only one side of the pension equation, the reader might get the impression that cost savings for employers will have little or no impact on member’s benefits. Having some appropriate level of benefits as a target would help the reader in assessing the tradeoffs involved in the various recommendations.

## **2. Historical Level of Employer Rates**

The analysis appears to accept the assumption that historical (pre-1997) employer rates were set at an appropriate level. As events over the past decade have borne-out, we now know that the employer rates set in the 70's through the 90's were too low to fund the growing liabilities under the Money Match formula. Had Oregon PERS set higher rates during that period of time, the system would not have been as under funded even with the growing dominance of the Money Match formula. To benchmark the study by using rates that were not fully funding all liabilities may mislead the reader regarding the appropriateness of both past and future employer rates.

## **3. Projected Employer Rates**

The study is based on a level of projected employer rates that we now know are unlikely. This is understandable in that a combination of recent events and timing of the study did not allow for a good coordination of information between OPERS and ECONorthwest on this subject. Here is a brief summary of variables that will cause a probable near-term (next 5 years) decline in current employer rates:

### **a. Different amortization period for Projected Unit Credit (PUC) component of Unfunded Actuarial Liability (UAL)**

The amortization of the UAL related to the change in valuation methodologies from Entry Age Normal to Projected Unit Credit constitutes the largest portion of the School District Pool's (Pool) employer rate. Beginning 07-01-07, the Pool's total pension UAL rate component is 13.83% of payroll (total pension rate is 17.64%). Of that 13.83%, fully 8.3% is related to the amortization of the PUC UAL. While all Tier One/Tier Two pension UAL's are amortized over a 22 period (from 12/31/05), the PUC UAL is being amortized over a rolling-three year period. Because OPERS sets rates every two years, two-thirds of this 8.3% rate will be paid-off before the next rate-setting calculation is conducted with the remaining one-third being amortized over another three years. This should have a significant impact on employer rates beginning July 1, 2011.

It should be noted that there will be an offsetting increase in the Tier One/Tier Two normal cost during this time, but it should not have the same magnitude as the reduction in employer rates caused by the accelerated funding of the PUC UAL.

### **b. Superior 2006 Earnings**

The study correctly states that earnings will be the primary driver of future employer rates as it applies to the Tier One/Tier Two pension program. The study does not communicate that OPERS earned well in excess of the 8% assumed earnings rate in 2006 and that Fund earnings are already approaching 8% in the first half of 2007. As a result, without a significant downturn in the markets, these

earnings will put downward pressure on employer rates beginning July 1, 2009 (based on the December 31, 2007 Valuation).

**c. Rate and Funding Comparability; Exclusion of Side Accounts**

Because the study excludes the use of side accounts when stating rates and funded ratios, it runs the risk of not being comparable to the rates that many employers (particularly school districts) are paying or to our officially reported funded ratios. While the study discusses the recent benefit to those employers that have issued pension obligation bonds, it does not fully cover the extent of this benefit either to the employers or to the pension system.

Fully 89 school and ESD districts have made UAL payments to OPSRS. These employers encompass most of the state's largest school districts that provide the vast majority of employer contributions to the School District Pool. By quoting only the general school employer rate, the study vastly overstates employer rates and understates the significant impact that side accounts have had and will continue to have regarding the bulk of school districts (based on size). Again, the study does provide a good analysis of side accounts, but it does not give the magnitude of the impact that these accounts have on the School District pool as a whole. Indeed, after adjusting for side account amortization, the statewide average school rate for 2007 – 09 is 7.92%.

OPERS' official 2005-funded ratio of 104% is widely published in the financial statement disclosures of OPERS and its employers. This number is also used in national surveys. The funded ratio used in the study is 91%, which excluded the some \$6.7 billion held in employer side accounts. This funded ratio is used only as a part of the OPERS rate development process. The use of this unofficial number could create confusion and credibility issues should the study be reviewed in context of other authoritative documents. To avoid such confusion, the report should also note that the official funded ratio including side accounts stood at 104% as of December 31, 2005.

As noted above, other comments or concerns are detailed in the attached copy of the report.

I hope that these comments are helpful and we look forward to working with ECONorthwest in the future.