

PERS 2009: WHERE DOES THE SYSTEM STAND AND WHERE COULD OREGON GO FROM HERE?

November 2009

BACKGROUND

The recent sharp declines in the stock markets and other investments have adversely affected the fiscal positions of public pension funds across the country. Oregon's PERS system is no exception. The system's investments declined by 27 percent in 2008, and the unfunded obligations of public employers ballooned to nearly \$17 billion as of December 31, 2008.

As a consequence, the system's actuary—Mercer—projects public employers will have to significantly increase their contributions to the system. If the actuary's projections come to pass, the increasing payments will stress state, local, and school district budgets for years to come.

This news may come as a surprise to some policymakers, who believe the 2003 legislative changes put the system on better fiscal footing. This issue paper outlines why the system is back in the news, outlines some key cost projections, and briefly introduces options policymakers could consider to address the rising system costs.

WHY HAVEN'T THE 2003 LEGISLATIVE CHANGES KEPT PERS OUT OF THE NEWS?

The 2003 legislative changes, while far reaching, fell well short of insulating the system from the kind of market losses incurred in 2008. Below are three key reasons public pensions are back in the news.

- **The cost of operating defined-benefit systems, like Oregon's, increases when underlying investments fall.** And investments fell sharply. Oregon's public pension system consists of three distinct programs: PERS Tier I, PERS Tier II, and OPERS. An employee's membership is based principally on when they started working for a participating public agency. To varying degrees, all three programs provide defined-benefits, which means that an employee's pension is determined by fixed and established formulae that are largely, or wholly, unrelated to the system's fiscal condition. Under a pure defined benefit plan, if the system's investments falter, beneficiaries are held harmless, pensions are unaffected, and the system must find resources to offset the investment losses.

Most public pension systems have a defined-benefit component and, consequently, have suffered in the recent market environment.



Oregon's 2003 legislative reforms made some changes—but all three programs still principally fall in the defined-benefit category, and, therefore, costs rise when investments fall. And investments declined sharply during 2008.

- **Unique rules of the Tier I program make Oregon's pension system unusually costly and volatile.** Oregon's system is especially prone to market downturns because of the unique structure of its Tier I program, which closed to new entrants beginning in 1996, but still counts about 64,000 active members. Under Tier I rules, beneficiaries are guaranteed a certain rate of return on their accounts—currently set at 8 percent. In 2008, the PERS investment portfolio lost 27 percent of its value. For those active Tier I members, public employers faced abrupt charges—in essence turning 27 percent losses on their accounts into 8 percent gains. So, for example, if a Tier I beneficiary entered 2008 with \$100,000; by year's end, his account's value fell to \$73,000 with the investment losses. But under Tier I rules, the beneficiary is guaranteed an 8 percent return. So the employer eventually has to find \$35,000 to bring the account to \$108,000.

The 2003 legislative changes aimed to reduce the cost of the Tier I guarantee. The legislature tried to recast the Tier I agreement as a *lifetime* guaranteed return rather than a *year-to-year* guarantee. Such a change could have lowered the cost of the guarantee significantly because most Tier I members earned lifetime returns well in excess of 8 percent. Investment returns were strong—especially in the 1990s—and the PERS Boards credited those strong returns to employee accounts rather than hold them in reserve for market downturns.

The Oregon Supreme Court struck down the law and ruled that years of crediting in excess of the annual guarantee could not be undone.

- **The sharp market declines of Fall 2008 have curbed the savings available through the creation of side accounts.** Starting in 2003, a number of public employers, including the

state and many school districts, borrowed funds at low, tax-exempt rates (e.g., 4 to 5 percent) and invested the proceeds with PERS in hopes of earning annual market returns of 8 percent or so. If market returns exceeded the cost of borrowing, the cost of pensions would be reduced.

The market losses in Fall 2008 were a temporary setback for the strategy. Employers who created side accounts early—circa 2003 and 2004—are still ahead, but their associated savings are diminished. Those who created side accounts shortly before the market declines have suffered losses and, for now, the strategy essentially adds to their pension costs. However, this strategy is a long-term one, so if market returns beat the 4 to 5 percent cost of funds over the next two decades, the strategy will eventually pay off.

HOW COSTLY COULD PENSIONS BECOME TO PUBLIC EMPLOYERS?

The 2008 investment losses generated a large, unfunded liability that's now estimated to total \$17 billion. State law requires that if investments don't shrink the liability, public employers—state agencies, school districts, and municipalities—must increase their contributions to gradually erase the liability.

Given the sharp declines in the investments, contributions are certain to rise. The only questions are when, by how much, and for how long? Many factors will determine the answers to those questions, but two are most important: future investment returns and PERS Board's policies that determine how soon the system returns to fully funded status. A slower return to fully funded status pushes the cost of the problem into the future and raises concerns about generational equity.

Before discussing how high rates could climb, it's useful to ask: compared to what?

Historically, employers have expressed their PERS contributions as a percentage of their total payroll costs. During 1975-2001, employer contributions averaged roughly 11 percent of payroll. In addition, some employers, including state agencies, agreed to pay (or “pick up”) the employee’s contribution—an additional 6 percent of payroll.

Since 2001, the ups and downs of investments, legislative changes, court rulings, PERS Board policy, and the creation of side accounts have all shaped the rates, with investment returns being the major driver. The complex mix of changes generated rates, during 2002-2009, that were 2 to 4 percentage points higher than employers experienced during 1975-2001. While unwelcomed, the increases were manageable for most employers.

Now, forecasts—under a variety of investment scenarios—anticipate increases well beyond those employers have experienced to date. Systemwide, the baseline projection shows employer rates increasing 20 percentage points during 2009-2019. But uncertainty reigns. For example, there’s a 1 in 10 chance that very weak investment returns would trigger increases as high as 30 percentage points—on top of 2009 levels. And a 1 in 10 chance that very strong investment returns could limit the increases to only 6 percentage points.

WHAT ARE THE POLICY OPTIONS TO ADDRESS THESE HIGHER COSTS?

Options available to policymakers fall into two broad categories:

- 1) proposals that push the system’s liabilities further into the future
and
- 2) proposals that fundamentally change the benefit and reduce costs.

The PERS actuary has illustrated a number of

ways to spread the cost of the liabilities into future decades. Selecting a specific approach will depend on policymakers’ views about intergenerational equity. The more costs PERS pushes into future decades, the less flexibility future Oregonians will have to design a package of public services tailored to their own needs and desires.

Options to reduce the cost of the pension system exist, but recent Oregon Supreme Court rulings suggest major savings will be hard to find. As mentioned previously, the Court blocked the legislature from recouping costs associated with years of excess crediting to Tier I accounts. The Court also threw out the state’s argument that severe budget shortfalls justified a pension overhaul. In other words, state and local governments cannot simply walk away from PERS-related obligations by claiming economic or fiscal hardship.

With the Supreme Court rulings in mind, an August 2007 ECONorthwest report, commissioned by the Chalkboard Project and the Oregon Business Council, advanced eight policy options that reduce system liabilities, foster stability, or improve transparency. The most aggressive of these options called on the PERS Board to investigate the agency’s application of cost-of-living adjustments under the Tier I Money Match option. A copy of the full report and policy options is available at the Chalkboard website:

<http://www.chalkboardproject.org/research-reports/reports.php>

The uncertain and long-term nature of the pension problem underscores the need for state and local governments to fully recognize the scale of the program and begin designing competent plans to mitigate the growth in employer contribution rates and, if necessary, prepare to adjust public services and other aspects of employee compensation to accommodate the higher pension costs.