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ATTORNEYS & COUNSELORS AT LAW

March 26, 2003

Senator Tony Corcoran, Chair
Senate Committee on General Government
900 Court Street, NE, S-319
Salem, OR 97301

Representative Tim Knopp, Chair
House Committee on Public Employee Retirement System
900 Court Street NE, H-295
Salem, OR 97301

Re: March 11, 2003 Legislative Counsel Opinion

Dear Senator Corcoran and Representative Knopp:

In a letter to Senator Corcoran dated March 11, 2003, Legislative Counsel issued an opinion concerning HB 2003 and HB 2004A. The opinion expressed doubt about the correctness of Judge Lipscomb's decision in City of Eugene, et al. v. State of Oregon, et al., Marion County Circuit Court Consolidated Case No. 99C-12794, and questioned whether the provisions of the two bills would violate the contract rights of PERS members. This letter responds to the Legislative Counsel opinion.

It should be noted at the outset that it is neither unusual nor surprising that lawyers express divergent views about the legal issues addressed in Judge Lipscomb's opinion and implicated in the PERS legislation now being considered. All of the members of your committee are by now fully aware of the sharp disagreements that divide the lawyers who represent employers and those who represent the PERS Coalition. The PERS Coalition asserts that the legislature is powerless to rein in the dangerously escalating costs and benefits associated with PERS. According to the Coalition's lawyers, any legislation that reduces projected future member benefits is a breach of contract. We, on the other hand, have argued that the contract rights of PERS members are far more limited. To determine the nature and scope of these rights, one must carefully analyze the statutes that govern PERS and the intent of the legislature in enacting those statutes over time. While PERS reform measures must be carefully crafted to respect the contractual commitments of past legislatures, we believe it is possible to achieve meaningful reform without breaching or impairing the contract rights of PERS members.

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Legislative Counsel's opinion appears to adopt the absolute view of contract rights urged by attorneys for the PERS Coalition. However, it is difficult to identify precisely the legal theory underlying the opinion because it contains no analysis. The opinion simply states conclusions with no hint as to the underlying support for those conclusions. Where, as here, the disagreement about the law is well documented, one lawyer's unsupported opinion adds nothing to the debate.

1. The OSPOA Opinion.

Legislative Counsel prefaced his opinion by misquoting two passages from the Oregon Supreme Court's decision in Oregon State Police Officers' Assn. v. State of Oregon, 323 Or 356 (1996) (OSPOA). OSPOA concerned the validity of Ballot Measure 8, adopted by the voters in November, 1994. Three provisions of that measure would have imposed both retroactive and prospective changes to PERS. One provision would have prohibited participating employers from paying the mandatory employees' contribution to PERS. Many public employers previously had agreed to "pick up" the employee contribution. Measure 8 would have eliminated that practice and required all participating employees to resume making the 6% contribution themselves. The Oregon Supreme Court, in a 4-3 decision,¹ concluded that, by eliminating the "pick up" agreements between PERS members and some employers, Measure 8 impaired the obligation of contract.

Legislative Counsel's opinion does not describe the court's reasoning in OSPOA or explain how that reasoning applies to HB 2003 or HB 2004A. Legislative Counsel extracts portions of two sentences from the Supreme Court opinion to support his inferences that the PERS statutes create a contractual obligation to provide "an undiminished level of benefits" and that, once an employer offers a pension plan to its employees, the terms of the plan cannot be changed "so long as the employee continued to work for the employer." OSPOA does not say what Legislative Counsel suggests, and the provisions of Measure 8 that OSPOA invalidated are quite different from the provisions of HB 2003 and HB 2004A.

The first sentence quoted from OSPOA by Legislative Counsel is deceptively incomplete. The full sentence is: "The statutory pension system and the relationship between the state and its employees clearly established a contractual obligation to provide an undiminished level of benefits at a fixed cost." (Emphasis supplied to highlight the omitted language). 323 Or at 375.

The words that Legislative Counsel omitted dramatically change the meaning of the quoted passage. OSPOA was concerned with a ballot measure that increased the cost of the pension system to those members whose employer had agreed to "pick up" the member's

¹ The dissenting justices argued that it is permissible to change the terms of a statutory contract on a prospective basis. The changes made to PERS by HB 2003 are prospective only. Only one of the four Supreme Court justices who formed the majority in the OSPOA case remains on the court.

contribution. The quoted passage makes sense in this context only when read with the deleted phrase "at a fixed cost" included. The court concluded that Measure 8 impaired contract rights because it increased the amount that members had to pay for the same benefit structure. In contrast, HB 2003 would eliminate the requirement that PERS members contribute six percent of their income to help pay for the cost of their pension. HB 2003 does not change the benefit structure of PERS in any way for current members. OSPOA says nothing about the power of the legislature to eliminate the requirement that members contribute to PERS.

In the second sentence quoted from OSPOA, Legislative Counsel has pruned the Supreme Court language to make it appear that the court is adopting the view of contract law espoused by the union in that case. The court's opinion, however, makes clear that the court is merely describing the union's position, not adopting it: "In its reply brief, the state acknowledges that Taylor, on its face, is susceptible to the interpretation that plaintiffs give it, i.e., that once a public employer offers benefits plan terms to an employee, those terms remain as part of the employment contract so long as the employee continues to work for the employer." 323 Or at 373. (Emphasis supplied to highlight the omitted language).

Viewed in context, it is clear that the words quoted by Legislative Counsel are not a statement of a rule of law adopted by the Supreme Court, but merely the court's description of the arguments being made by the parties. The actual holding of OSPOA is considerably narrower than the rule that Legislative Counsel attempts to extract from it: OSPOA holds that the state cannot increase the amount that a member must pay toward the cost of his or her retirement benefits.

2. The "look back" Provision in HB 2004A.

a. Contract Rights.

According to Legislative Counsel, the validity of the "look back" provision in HB 2004A depends upon whether the legislature has delegated to the PERS Board the authority to promise PERS members that it will use outdated mortality tables to calculate member benefits. If the legislature has made such a delegation, then the "look back" provision is inadequate to protect members' contract rights. If the legislature has not made such a delegation, then the "look back" is entirely unnecessary. This analysis of the mortality table issue is as irrelevant as it is novel.

Whether the legislature may delegate to the PERS Board the power to create contract rights is irrelevant because there is nothing in the statutes that grants the PERS Board the authority to make promises on behalf of participating employers. Moreover, as far as we are aware, Legislative Counsel is the first to advance this unorthodox idea. In litigation and in extensive proceedings before the PERS Board, neither the PERS Coalition, nor PERS, nor the

attorney general, nor any court ever has suggested that the legislature has delegated to the PERS Board the authority to make contractual promises. In determining the terms of the PERS contract, the Supreme Court has looked only to the PERS statutes and never has held that board rules or practices constitute contractual promises. See, e.g., Hughes v. State, 314 Or 1, 25-27 (1992); OSPOA, 323 Or at 374, 377-79. The attorney general has concluded that board practices and rules cannot create permanent contract rights. See letter to Dale Orr, PERS Fiscal Services Administrator, from Assistant Attorney General Robert Muir, September 21, 2001, at p. 2 (attached as Exhibit "A"). Yet Legislative Counsel not only suggests that the legislature may have delegated contracting authority to the PERS Board, he also concludes that, once the PERS Board has promised enriched benefits to PERS members, the legislature can never alter the board's promise.

It is not surprising that Legislative Counsel cites no authority for this fantastic proposition. None exists. Only the legislature has the authority to create a statutory contract, and it does so only if it unambiguously expresses its intention to do so in a statute. Hughes, 314 Or at 22-25; Eckles v. State, 306 Or 380, 390-91 (1988); Campbell v. Aldrich, 159 Or 208, 213-14 (1938).

In City of Eugene, et al. v. State of Oregon, et al., Judge Lipscomb concluded that the PERS statutes promised a monthly retirement benefit that is calculated based upon the "actuarial equivalent" of the member's accumulated contributions and credited earnings. The court held that, by using outdated mortality tables, the PERS Board was paying benefits significantly in excess of those provided by statute. To date, the PERS Coalition has failed to point to any provision in the PERS statutes that remotely suggests that outdated mortality tables should be used in calculating benefits. Similarly, Legislative Counsel fails to cite any statute that remotely suggests that the legislature delegated to the PERS Board the authority to promise that outdated mortality tables will be used. Absent such authority, as Legislative Counsel recognizes, the "look back" provision of HB 2004A is unnecessary to protect member contract rights.

b. Federal Tax Law.

Legislative Counsel candidly acknowledges that he is not competent to determine whether HB 2004A would violate the Internal Revenue Code. However, he readily speculates that the PERS Board has received advice from legal counsel that a much broader "look back" provision is required by federal law. This speculation is unsupported by the facts.

The PERS Board has been studying possible amendments to its mortality tables rule for nearly two years. In the fall of 2001, a subcommittee of the board considered six options, one of which was immediate implementation with no "look back." The attorney general advised the committee that all six options were legal. See Committee Minutes, September 26, 2001, p. 3, and attached analysis by PERS actuary Mark Johnson (attached as Exhibit "B"). PERS staff

repeated this advice to the board several months later. See Dale Orr letter to PERS Board dated February 5, 2002 (attached as Exhibit "C").

The PERS Board and the attorney general inexplicably have refused to disclose the legal advice that the board has received concerning mortality tables. The limited discussion about that advice that has been disclosed suggests that the advice is consistent with the view of our own pension tax expert, Walter W. Miller, that immediate implementation of current mortality tables would not violate federal tax law. Legislative Counsel's contrary speculation is unsupported and should be given no weight.

3. HB 2003: The Elimination of the Member Contribution.

Legislative Counsel says very little about why it believes the "six percent solution" is invalid except to cite the OSPOA case. As explained in Section 1.a. of this letter, the OSPOA opinion does not address the validity of this provision. Furthermore, Legislative Counsel's statement that the PERS statutes "provide for an employee's contribution (and for the employer to pick up that contribution)" is incorrect. The current statutes require a member to contribute and allow the employer to agree to "pick up" that contribution. The mere fact that the member contribution is found in the PERS statutes does not mean that it is a protected term of the contract. A separate legal analysis must take place to determine whether a statute creates a contract right. See Hughes v. State, 314 Or 1, 17, 22-27 (1992). A contract is not created unless the statutory language clearly shows that the legislature intended to do so. The statutes do not state that a member has a right to contribute or a right to "the level of benefits that contribution would produce," and no case, including OSPOA, has so held.

In short, the validity of the "six percent solution" is not controlled by the OSPOA opinion because the member contribution provision was not at issue in that case, and because there are valid and material distinctions between Measure 8 and HB 2003.

4. HB 2003: The Adjustment For Past Errors.

Legislative Counsel opines that Judge Lipscomb's opinion in City of Eugene, et al. v. State of Oregon, et al. is wrong in two significant respects. First, he concludes that the court's ruling that the PERS Board unlawfully failed to fund a contingency reserve is a "close call." This surprising conclusion is unexplained. ORS 238.670(1) has long provided that the contingency reserve "shall be maintained and used by the board to prevent any deficit of moneys available for the payment of retirement allowances." ORS 238.670(1) (1999) (emphasis supplied). The PERS Board has failed to fund the contingency reserve in every year since 1978. It is difficult to see how the Board's decades-long disregard of its statutory duty can be characterized as a "close call."

Legislative Counsel also concludes that Judge Lipscomb's ruling that the PERS Board abused its discretion in allocating 1999 earnings is "incorrect." Once again, Legislative Counsel does not explain this conclusion. Judge Lipscomb's decision was given after a full trial and thorough legal argument. Legislative Counsel's opinion is given without the benefit of either. The evidence at trial showed, among other things, that the PERS Board credited Tier I regular accounts with income of 20% in 1999, twelve points more than the guaranteed rate of return. In order to do so, the board had to disregard the requirement to fund a contingency reserve and ignore its own policy concerning funding of the gain/loss reserve. It is well settled that a board abuses its discretion when it fails to follow its own carefully considered policies. ORS 183.484(5)(b)(B); c.f., Harsh Investment Corp. v. State, 88 Or App 151, 157 (1987).

It is not unusual for a lawyer to disagree with a court decision. It is extremely unusual for a lawyer to do so without being familiar with the pleadings, argument and evidence that framed the court's decision. The judgment in City of Eugene, et al. v. State of Oregon, et al. is entitled to a strong presumption of validity. Malick v. Malick, 271 Or 183, 186 (1975); Jaloff v. United Auto Indemnity Exchange, 121 Or 187, 193-94 (1927). Legislative Counsel's uninformed and unexplained criticism of the decision is entitled to no weight.

It is, of course, possible that Judge Lipscomb's decision will be reversed or modified on appeal. Legislative Counsel suggests that, if HB 2003 passes, a reversal of Judge Lipscomb's decision somehow might put the state in a worse position than it is now. Legislative Counsel is wrong. The judgment in City of Eugene, et al. v. State of Oregon, et al. identifies unlawful actions taken by the PERS Board which have the effect of increasing the cost of PERS. HB 2003 adopts a legislative remedy for those unlawful actions. Passing HB 2003 would put both the problem and the solution before the Supreme Court at the same time. If Judge Lipscomb is affirmed and HB 2003 is upheld, the problems identified in the litigation will be remedied promptly. Delaying the implementation of the remedy would promote continued uncertainty among PERS members and employers and would cost the taxpayers millions of dollars. On the other hand, if HB 2003 is enacted and Judge Lipscomb is reversed, the status quo will be restored. The state will be in no worse position than it is now.

Finally, Legislative Counsel suggests that using future earnings to pay for past errors, as proposed by HB 2003, would impair or breach the contract rights of PERS members because it would reduce the earnings available to credit Tier II member accounts. This conclusion depends entirely on the assumption that Tier II members have a right to have their accounts credited with a particular level of earnings. Predictably, Legislative Counsel cites no authority for this proposition because, once again, there is none. No statute promises anything concerning the level of earnings credited to Tier II accounts. Those accounts have always been credited with earnings after administrative expenses are paid. And, although the PERS Board has ignored the directive for nearly 25 years, ORS 238.670 requires the board to set aside a portion of the PERS fund's income in reserve accounts before crediting member accounts. HB 2003 does nothing

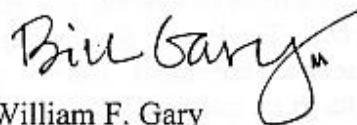
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more than establish a special reserve account to be funded out of future income to the fund. This account will be used to pay the cost of the errors identified by Judge Lipscomb. This approach is entirely consistent with the legislature's longstanding policy of using fund income to create reserves and to pay fund expenses.

Conclusion.

Without question, the legal issues posed by any attempt to correct the problems with the structure and administration of PERS are difficult. Legislative Counsel's legal opinion, given without analysis and without the benefit of essential facts and legal background, only serves to demonstrate the danger of forming conclusions without full information and careful consideration. We urge the committee to give Legislative Counsel's opinion little weight because it is not based on careful legal analysis, is overly simplistic, and is plainly biased toward maintaining the status quo. Oregon cannot afford the status quo.

Yours very truly,



William F. Gary

WFG:smd

cc: House Committee Members
Senate Committee Members
clients

HARDY MYERS
Attorney General



PETER D. SHEPHERD
Deputy Attorney General

DEPARTMENT OF JUSTICE
GENERAL COUNSEL DIVISION

September 21, 2001

Dale S. Orr, Administrator
Fiscal Services Division
Public Employees Retirement System
P.O. Box 23700
Tigard, OR 97281-3700

Re: Actuarial Equivalency Factor Rule
DOJ File No: 459001-GT0406-01

Dear Mr. Orr:

This is in response to your letter dated July 27, 2001, requesting advice relating to possible amendments to the Actuarial Equivalency Factors rule, OAR 459-005-0055. Those factors are used in providing estimates of, and calculating actual retirement benefits. They are based on various assumptions, such as investment earning rates, member life expectancy, etc. The factors in the current rule that are used for pre-1999 member benefit calculations are based on 1980's assumptions of average life expectancy that are lower than assumptions in current standard sources. The longer the life expectancy, the lower the monthly benefit, given the same account balances at retirement. The rule precludes updating those factors for pre-1999 members unless it results in an increase in, or has no effect on, benefits. The PERS actuary, MillimanUSA, and the recent actuarial auditors, William M. Mercer, Inc., recommend updating the actuarial equivalency factors to more closely match current mortality tables, so that pension account balances will better match the expected life spans of beneficiaries. However, they also agree that the board's current practice is not in violation of actuarial standards. As you have discussed the history of the current rule in your letter, we will not, except in discussing the particular questions that you have raised. Your questions and our brief answers are as follows:

1. May the PERS Board choose among the various mortality tables available with the express intent of avoiding any effect on the benefit calculations of active members at the time of their retirement and still be within its statutory authority and meet its fiduciary and statutory obligations?

Yes, the board may choose any mortality tables, if the choice is consistent with Internal Revenue Code requirements for qualified tax-exempt public pension plans, sound actuarial principles and with the board's general duty to administer the trust solely on behalf of the beneficiaries.

2. May the board selectively utilize different mortality tables (and associated equivalency tables) for different categories of members (such as pre-1999 members

and those that became members later)? Is the Board exposed to any potential legal liability in doing so?

Yes, the board may selectively utilize different mortality tables, if the choice is consistent with Internal Revenue Code requirements for qualified tax-exempt public pension plans, sound actuarial principles and with the board's general duty to administer the trust solely on behalf of the beneficiaries.

3. If the board chooses to adopt a new mortality table for purposes of calculating actuarial equivalency and that has the effect of generating a lower monthly benefit for active members upon their retirement at some future date:
 - a. does the board assume any potential legal liability generally, and
 - b. more specifically, with respect to members hired before 1999, does the board's past practice and current policy (in OAR 459-005-0055) create a permanent and indefinitely prospective contract right to the mortality table (and associated actuarial equivalency tables) then in effect?
 - c. Also, do members hired after 1999 have a contract right that is permanent and indefinitely prospective with regard to the mortality table policy applied to them?

The board is likely to prevail in litigation if it can show that its choice of a new mortality table was consistent with Internal Revenue Code requirements for qualified tax-exempt public pension plans, sound actuarial principles and with the board's general duty to administer the trust solely on behalf of the beneficiaries. The board's past practice and current policy, expressed in rule, do not under current Oregon law, create permanent contract rights to the mortality table (and associated actuarial equivalency tables) for members hired either before or after 1999.

4. If the answer to either 3(b) or 3(c) above (or both) is yes, would such contract rights extend to other plan parameters in place at the time of hire but periodically revised by the board?

The answers to questions 3(b) and (c) render this question moot.

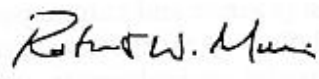
5. If the benefit estimates have been provided to members showing projections that are based on a certain set of mortality assumptions (copies of the estimate form and annual statements enclosed) and the board changes the mortality assumptions which results in the member's actual benefit being substantially different from the estimates, is the board:
 - a. breaching a contract with the member, or
 - b. violating its fiduciary responsibility to the member?

Dale S. Orr
September 7, 2001
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Under current Oregon law, the sample estimate form and annual statements that you have provided establish neither a contractual, nor a fiduciary, duty to the members that the board would breach by changing the mortality assumptions upon which the benefit estimates were partly based. The board should be able to successfully defend against claims based on either benefit estimates or annual member account balance statements, because ORS 238.630 expressly allows the board to modify actuarial equivalency factors. This and other statutes and administrative rules have been published, giving members adequate notice that actuarial assumptions change.

If we can be of further service, please advise.

Sincerely,



Robert W. Muir
Attorney-in-Charge
Tax & Finance Section

RWM:rwm/GEN96686

Actuarial Equivalency Factor Change Implementation Options

Options Criteria	Immediate (01/01/03)	Delayed Implementation (2, 5 or 10 years)	Wear- Away Approach*	Two Segment Approach	Multiple Segment Approach*	Keep Current Rule
When use of 1980's projections ends	Immediately 01/01/03	Immediately as of implementation	Gradually until end of period	Gradually until last Pre-1999 member retires	Gradual until last Pre-1999 member retires	Not until last Pre-1999 member retires
When use of most current mortality projections are fully implemented	Immediately	Immediately	Gradually through wear away period	Gradually for Pre-1999 members as post implementation portion of benefit grows/ immediately for post 1999 members	Never due to "lock in" of segmented approach	Never due to "lock in" of segmented approach
** Allows member time to plan for change	No	Some	Yes	Yes	Yes	N/A
** Avoids retirement rush	No	No; postpones it	Reduces	Minimal	Yes	Yes
** Impact on Trust Funding	Significant reduction in liabilities	Significant reduction in liabilities but varies with deferral date	Moderate to significant reduction in liabilities depending on length of transition period	Modest reduction in liabilities	Minor reduction in liabilities	None
** Impact on member benefits	Significant monthly benefit reduction, especially for older members	Significant monthly reduction, especially for older members	Monthly benefit reduction occurs gradually over time	Monthly benefit reduction increases slowly over time	Monthly benefit reduction increases slowly over time	None
Administration	Easy	Easy	Simple	Complex	Very Complex	Very Complex

*Options in which Advisory Committee expressed most interest

**Criteria in which Advisory Committee expressed most concern

PUBLIC EMPLOYEES RETIREMENT BOARD

ACTUARIAL SERVICES COMMITTEE

MEETING

September 26, 2001

2:00 p.m. - 4:00 p.m.

Room 343 - State Capitol
Salem, Oregon

MINUTES

Board members present:

Dawn Morgan, Committee Chair
George Russell
Todd Schwartz

Staff:

Jim Voytko, Director
David Bailey, Deputy Director
Dale Orr, Fiscal Services
Dale Wakabayashi

David Amick
Yvette Elledge
Kathleen Nash

Christine Brown was absent

Others

Mark Johnson
Bob Muir
Neil TenEyck
BethAnne Darby
Bob Livingston
Dick Berkey
Brian Delashmutt
Dan Mussman
D. D. Apple
Martha Sartain
Cynthia L. Foster

Dirk Borges
Gail Tsutsumi
Thomas P. Riordan
Cathy Bloom
Harlan Francis
Mary Botkin
Rich Peppers
Ron Gitle
Robert Jordon
Don Wence
Stephen Barrett

Deborah Tremblay
Glenn Harrison
Chelsey Bladine

The meeting was called to order by committee chairperson, Dawn Morgan, at 2:05 p.m.

George Russell arrived at 2:25 p.m., Christine Brown was absent.

Dale Orr, Fiscal Services Administrator and staff to committee, began the meeting with a brief overview of the meeting agenda. Mr. Orr announced that staff had arranged for a 'training/site visit' to Milliman USA for October 9, 2001 at 1:30 p.m. This was not a public meeting, but rather simply a training session for committee members to become more knowledgeable about actuarial work.

Mr. Orr mentioned that a growing number of issues were coming before the committee and the committee needed to work on developing a charter to better determine the committee's scope of work and consider planning meetings on a monthly basis until the backlog of issues have been resolved. One issue is the bonding of the school districts as it related to SB 134. Staff will be going before the full PERS Board on October 9, 2001 to discuss this issue and request the assignment of this issue to the Actuarial Services Committee. Another issue coming before the Board on October 9, 2001, is the de-linking of the Gain/Loss Reserve from the Benefits in Force Reserve. This issue may also be assigned to the Committee.

The committee was asked to vote on the minutes of the August 29, 2001 meeting, however, it was decided to wait until the end of the meeting to officially approve the minutes.

Mr. Orr announced another item for discussion before the committee is the Equal to or Better Than with Steve Delaney acting as PERS staff on the issue. According to Steve Delaney's staff, he would like to talk to an advisory committee first and schedule a meeting with an advisory committee first, possibly in late October or early November 2001 prior to coming before the Actuarial Services Committee for discussion. Dale Orr anticipated that it would possibly be late November 2001 before Steve Delaney would be prepared to come before the committee with a report.

B. 2000 ACTUARIAL VALUATION

At the August 29, 2001 Actuarial Services Committee meeting it was decided that the committee would recommend to the full PERS Board at the October 2001 Board meeting two things: (1) recommend that the Board use the 2000 Actuarial Valuation as an interim report, and not use this report to set the rates, but rather to use the report for informational purposes, and (2) that the Board adopt the 'Asset Smoothing Technique' using the four year asset smoothing method with a 10% corridor.

Committee Chair Dawn Morgan asked the audience if anyone wished to comment on the 2000 Actuarial Valuation. There was no public comment on the 2000 Valuation.

C. ACTUARIAL EQUIVALENCY FACTOR

The next item on the agenda was the Actuarial Equivalency Factor. Dale Orr advised the committee that they had been provided with a matrix in their packets of materials, and that copies of the matrix had been provided as handouts to the audience. On the matrix, there were six potential options on the top of the matrix. Dale Orr explained to the committee that the

original intent of the Advisory Committee in relation to the Actuarial Services Committee was that information would first come to the Actuarial Services Committee, then go to the Advisory Committee for them to make comments and recommendations to the Actuarial Services Committee. In turn, the Actuarial Services Committee would take the comments received from the Advisory Committee and make a recommendation to the full PERS Board.

It was further explained that because of meeting schedules, if the Actuarial Services Committee was going to make a recommendation to the full PERS Board at the October 9, 2001 meeting, the committee would have to decide on a recommendation at this September 26, 2001 meeting, and take that recommendation to the Advisory Committee which was meeting on Monday, October 1, 2001. The Advisory Committee could make comment to the recommendation after the committee's decision had been made, which was not how the process had been originally laid out. It was noted by staff that the Actuarial Services Committee had the option to defer their decision at today's meeting.

Since the Advisory Committee was not going to be meeting until October 1, 2001, the process for now would be: (1) information would come to the Actuarial Services Committee and they would make a recommendation at this meeting, (2) then staff would take that information and recommendation to the Advisory Committee meeting on October 1, 2001, and (3) take information and the Actuarial Services Committee recommendation along with the Advisory Committee comments on the recommendation to the PERS Board meeting on October 9, 2001.

At this time Mark Johnson presented his actuary report explaining the fiscal impact(s) of the options listed on the matrix given to the committee members. He talked about some of the options on the matrix such as a) immediate implementation, b) a delayed implementation in two, five or ten years, c) the "wear away" approach, d) the two-segmented approach and e) multi-segmented approach. Mark wanted to make a special note to the committee that the numbers in his report "assumes a normal pattern of retirements" or, in other words, no 'rush for the door' of retirements depending upon the options recommended by the committee. Mark also explained that the numbers in this report were slightly different from the numbers in his previous report to the committee in that in his previous report he used the 1999 Valuation Report instead of the 2000 Valuation Report and he used a different 'start' date of January 1, 2003 instead of January 1, 2002. Mark wanted to emphasize that his information was based upon current assumptions and a normal pattern of retirements.

Mark Johnson concluded his report to the committee and there were no further questions. At this time, staff Dale Orr informed the committee that Assistant Attorney General Bob Muir had prepared a public report/analysis that was requested of him from the Advisory Committee which was a summary of his analysis on the Equivalency Factor issue. In summation, Bob Muir's analysis concluded that the Actuarial Services Committee and the PERS Board could adopt any of the options presented to the committee provided the PERS Board takes into consideration their fiduciary responsibility.

At this time, Dale Orr asked the committee if they wanted to hear staff's recommendation, or hear public comment. Dawn Morgan and committee members preferred to hear public comment.

Thomas Riordan, Salem, spoke to the committee. He was concerned about the implementation date of January 1, 2002, as that was only a few months away. Dale Orr indicated that the implementation date, at the earliest would be January 1, 2003 which reassured Mr. Riordan. Mr. Riordan was concerned about the legal advice the committee received in that was there something that had changed in the law that prompted this sudden change? Dawn Morgan said that what prompted this process was the fact that the mortality tables were over 20 years old and the life expectancy of the members had changed; the legal advice had not changed. Mr. Riordan also wanted to know if the decision-making process was limited to just the options before the committee?

Jim Voytko, PERS Executive Director, explained that this process of selecting the options before the committee today had actually evolved over the past year, after an audit had been done by William Mercer, Inc., and the findings of that audit were that PERS should be addressing this issue soon since the mortality tables PERS was using currently dated back to 1978.

Martha Sartain, Silverton, spoke to the committee. She was within five years of planning her retirement and said that she was quite surprised when she read the news articles in the Oregonian. She brought a copy of her remarks to the committee and submitted a copy to staff for the record. She was concerned about the health insurance coverage. She explained that, as she understood it, under the proposal(s) being offered a person could retire but wait a few months to begin drawing their retirement, however, if a retiree does wait, under current PERS rules, and there is what is considered a 'break in service', a retiree may not qualify for the health insurance coverage. She stressed that PERS has encouraged members to take classes in planning their retirement. She further stated that she thought that these changes the committee was considering would create a feeling of distrust between PERS and its members to the point that she felt that members would pull their money out of PERS at their first opportunity, in masses and that there would be a 'rush to retirements.'

Bob Livingston, representing Oregon State Fire Fighters Council and a member of the PERS Coalition. He asked the committee to defer making a recommendation to the full PERS Board at this time given the fact that the Advisory Committee was meeting the following Monday. He said that if the committee was going to make recommendations without the input and hard work of the Advisory Committee taken into consideration, then what was the point of having a process of advisory committees? He also said that he thought it would be more helpful to the committee if the audience could participate in public comment on what the staff recommendation(s) were to the committee. Without knowing what the staff was going to recommend, the audience could not knowledgeably comment and give the committee their thoughts and ideas on the proposals.

Mary Botkin, AFSCME Council 75, spoke to the committee. She commented that she was very frustrated because she didn't know what the staff recommendation to the committee would be and she thought that it was pointless for the Advisory Committee to have yet another meeting this following Monday if the Actuarial Services Committee were to go ahead today and make a recommendation to the PERS Board without taking into consideration the comments of the Advisory Committee.

Rich Peppers, SEIU Local 503, OPEU, spoke to the committee and wanted to let the committee know that he agreed with his colleagues, Bob Livingston and Mary Botkin, as members of the Advisory Committee, that the committee not make an official recommendation today. He said that he too wished he knew what the staff recommendation to the committee was going to be so that he could make an informed comment on that staff recommendation.

Mary Botkin, AFSCME, Council 75, wanted to make an additional comment relating to the press. She felt as though the press had created a state of hysteria for the members of PERS and she had received several phone calls from members who were convinced that they were going to lose their retirement. She did not believe that it was necessary on the part of the press to create this mood of hysteria given the recent events in the news and that people everywhere, "are a little on edge right now" and they don't need this type of press because it does scare people if they think they are going to lose their benefits.

There was no further public comment.

At this time Dale Orr proceeded to explain to the committee staff's recommendation. Dale stated that what we were trying to accomplish, the goal, was to implement the most current mortality tables in our actuarial equivalency factors. With that goal in mind, we were also trying to avoid 'clustering' of retirements, having huge numbers of retirees retiring at once, a 'rush to retirement.' The staff recommended to the committee the five-year wear away option. Over a five-year period of time, PERS would incrementally move from the old mortality tables to the new mortality tables. The start date for the five-year wear away option would be January 1, 2003. The rule making process would most likely go past January 2002. Dale said that there would be some 'clustering' of retirements for each of the five years of the wear away plan, however, current staff would be able to handle the workload since it was anticipated that the increase in retirements was believed to be minimal and would most likely occur in November and December of each year, a slightly lower production time of year for PERS staff. Also, with the five-year wear away plan, PERS would not have to modify any of its current data processing systems, resulting in possible savings. PERS would have to modify OAR 459.005.0055, the current Actuarial Equivalency Rule, to incorporate these changes into the rule.

Jim Voytko, PERS Executive Director, commented that when staff approached this issue, they were going on the assumption that the PERS Board wanted to move to more modern accurate mortality tables. The five-year wear away option appeared to staff to be the best vehicle to get us "from where we are to where we want to be" via a definitive path over a defined time period that can be seen and understood. It minimizes the uncertainty of how we get from point A to point B. Another reason the wear away option was preferred by staff is that all members get treated the same. Also, there is no segmentation to this option which staff preferred.

Committee member George Russell wanted to know how this recommendation compared to the other options/recommendations in terms of a legal analysis and the likelihood of this recommendation being challenged in the courts. He also wanted to know if there was a possibility that if this committee made a recommendation today, and that recommendation were taken to the Advisory Committee on Monday, could this committee then review the Advisory Committee's response(s) to their recommendation, and if necessary, this committee could

incorporate the Advisory Committee's comments into this committee's recommendation to the full PERS Board at the October board meeting.

Jim Voytko responded stating that the Actuarial Services Committee did not have to make a recommendation today. They could wait to hear from the Advisory Committee, and set up a telephonic conference to discuss the recommendation. The staff had only suggested that the committee make their recommendation today since they had the information in front of them today. Jim Voytko continued that as staff understood it, the committee had "wide latitude to act in this area" to decide upon an option, provided the committee develop a record that shows a deliberate and thoughtful basis on which these actions were taken in the exercise of your fiduciary responsibility.

Bob Muir, Assistant Attorney General, commented that his office had provided to the committee a public document for general conclusions, but that if the committee wished to get into specifics of the relative risks of the various options, he recommended going into Executive Session.

Dawn Morgan, Committee Chair, wanted to discuss the matrix further. She asked the committee members and staff if they could stay beyond the set adjournment time, for more discussion. Mr. Voytko had to leave, but Dale Orr could stay as well as the other committee members. Ms. Morgan wanted to discuss with the committee members, staff's recommendation because she thought it was important to get the committee members comments on the record as part of the thorough record of "how and why we made the decisions that we made."

Todd Schwartz, committee member, initiated the discussion by stating that he was not in favor of the Actuarial Services Committee making a recommendation today. He wanted to hear what the Advisory Committee had to say about the staff's recommendation and, in turn, the committee's recommendation to the PERS Board.

George Russell, committee member, commented that he appreciated staff's work and analysis of the options and that he would have most likely come to the same conclusions as staff, however, he wanted to hear what the Advisory Committee had to say about the staff's recommendation. He also wanted to comment that he was surprised by the media coverage of the work of the committee and was inundated with telephone calls from members worried that PERS was going to take away their benefits.

Since the committee members present all agreed that they would like to defer their decision to make a recommendation to the PERS Board until they had heard from the Advisory Committee scheduled to meet the following Monday, Dawn Morgan suggested that the Actuarial Services Committee have an additional meeting. The meeting would take place after the Advisory Committee meeting. It was determined that it was not imperative that the Actuarial Services Committee make a recommendation to the PERS Board at the October meeting. The Actuarial Services Committee could make their recommendation to the PERS Board at the November Board meeting.

At this time, it was suggested by George Russell that the Actuary 102, training/site visit by the committee members and staff, scheduled for October 9, 2001, following the Board meeting be

Actuarial Services Committee
Minutes – September 26, 2001

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postponed and in its place a 'regular' meeting the Actuarial Services Committee take place following the PERS Board meeting. The purpose of that meeting would be to take into consideration the comments of the Advisory Committee and to develop a recommendation for the PERS Board.

Dawn Morgan asked members of the audience for additional public comment. Mary Botkin, AFSCME Local 75 said that she was quite satisfied with this committee's decision to wait on comments from the Advisory Committee.

At this time, staff Dale Orr suggested that the committee consider meeting on a regular monthly basis. It was determined that a good option for additional meetings in the future would be to hold the meetings directly after the regular PERS Board monthly meetings, thereby saving travel time for committee members. Dale Orr said that the committee needed to schedule a meeting in late November to discuss the Equal to or Better Than issue. Both committee members Dawn Morgan and George Russell said that early December would work better for them, rather than a meeting in November 2001.

The approval of the August 29, 2001 minutes was temporarily postponed until George Russell could be present.

A. MINUTES OF THE AUGUST 29 MEETINGS

Todd Schwartz amended the minutes to reflect that he had left the August 29, 2001 meeting at 4:15, before it officially adjourned at 4:30 p.m.

It was MOVED by George Russell and seconded by Todd Schwartz to approve the minutes for the August 29, 2001 meeting, as amended. The motion passed unanimously.

There being no further business before the committee, the meeting was adjourned.

Respectfully submitted,

Dale Orr,
Fiscal Services Administration



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September 26, 2001

VIA E:MAIL

Mr. Dale Orr, Administrator
Fiscal Services Division
Oregon Public Employees Retirement System

**Re: Actuarial Equivalency Factors
Actuarial Services Committee Meeting**

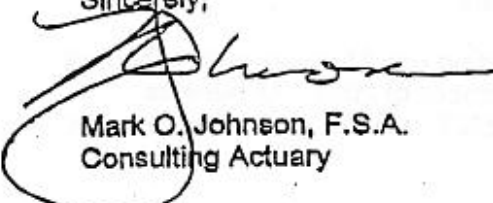
Dear Dale:

You have asked us to prepare materials for discussion at the next meeting of the Actuarial Services Committee. I will present the following information and be available for questions.

- Attachment A: Fiscal Impact of Implementation Options
- Attachment B: Impact of Implementation Options on Member Benefits
- Attachment C: Brief Survey of Peers and Private Sector Comparison

If you have any question, please let me know.

Sincerely,



Mark O. Johnson, F.S.A.
Consulting Actuary

MOJ:j
ors:018705

Attachment 4

OFFICES IN PRINCIPAL CITIES WORLDWIDE



Oregon Public Employees Retirement System Actuarial Equivalency Factors

Information for Actuarial Services Committee Meeting - September 26, 2001

Attachment A Fiscal Impact of Implementation Options

Summary of Provisions

The Actuarial Services Committee is considering alternatives for adopting current life expectancy projections for future benefit calculations. The focus has been on the factors used to convert member account balances to guaranteed lifetime annuity payments in the Pension plus Annuity and Money Match calculation methods. The options listed below were discussed by the Committee on August 8, 2001.

Immediate Implementation: All benefits commencing on or after January 1, 2003 would use the then current interest and mortality basis. Any future changes in the interest or mortality basis would be implemented for all non-retired members' benefits with a reasonable lead time.

Delayed Implementation: All benefits commencing after a specified date, but later than January 1, 2003, would use the then current interest and mortality basis. We used two, five, and ten years after the immediate implementation effective date.

Wear-Away Approach: All benefits commencing on or after January 1, 2003, would use a modified factor that graduates linearly from the factors currently in use to factors using the then current interest and mortality basis. We have graded into the current life expectancy factors over two, five, seven, and ten years.

Two Segment Approach: The current factors would be used for converting account balances generated from contributions through December of 2002. All benefits generated from contributions on or after January 1, 2003, would use the then current interest and mortality basis.

Multiple Segment Approach: The current factors would be used for converting account balances generated from contributions through December of 2002. Benefits generated from contributions on or after January 1, 2003, would use the then current interest and mortality basis. Any future change in the interest rate or mortality basis would be used prospectively.

Data, Method and Assumptions

All non-retired members of the System on January 1, 2003, could be impacted by one of these options. We have developed the following fiscal impact based on the data, methods, and assumptions contained in the Actuarial Valuation of the System as of December 31, 2000. Although the report is not completed, the results for the System were available to use in this analysis.

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OFFICES IN PRINCIPAL CITIES WORLDWIDE



Oregon Public Employees Retirement System Actuarial Equivalency Factors

Information for Actuarial Services Committee Meeting - September 26, 2001

For the purpose of this fiscal impact study, we assumed there would be no change in the assumed pattern of retirements by age or service. If, in fact, an extraordinary number of members retire just prior to any particular effective date, this could result in an actuarial loss and the reduction in long-term costs could be lower than presented in this study.

Fiscal Impact

Based on our understanding of the implementation options as previously stated, we have developed the following estimated actuarial impact on the System as a whole. Results may vary for each actuarial grouping.

Implementation Option	Effective Date	(\$million) UAL Change	Change in Employer Contributions		
			NCR	UALR	Total
Immediate Implementation	1/1/03	\$ (1,494)	(0.74)%	(1.33)%	(2.07)%
Delayed Implementation					
Delayed 2 years	1/1/05	\$ (1,246)	(0.67)%	(1.11)%	(1.78)%
Delayed 5 years	1/1/08	(920)	(0.56)	(0.82)	(1.38)
Delayed 10 years	1/1/13	(514)	(0.37)	(0.46)	(0.83)
Wear-Away Approach					
Over 2 years	1/1/03 - 12/31/03	\$ (1,429)	(0.72)%	(1.27)%	(1.99)%
Over 5 years	1/1/03 - 12/31/06	(1,253)	(0.58)	(1.12)	(1.70)
Over 7 years	1/1/03 - 12/31/08	(1,145)	(0.51)	(1.02)	(1.53)
Over 10 years	1/1/03 - 12/31/11	(1,001)	(0.39)	(0.89)	(1.28)
Two Segment Approach	1/1/03	\$ (477)	(0.11)%	(0.42)%	(0.53)%
Multiple Segment Approach	1/1/03	\$ (477)	(0.11)%	(0.42)%	(0.53)%

Note: Change in Employer Contribution Rates: Shown as a percent of payroll effective January 1, 2003
UAL Change: The decrease in the Unfunded Actuarial Liability as of January 1, 2003
NCR: Normal Cost Rate
UALR: Rate to amortize the decrease in the UAL over the period ending on December 31, 2027

These costs are subject to the uncertainties of a regular actuarial valuation; the costs are inexact because they are based on assumptions that are themselves necessarily inexact, even though we consider them reasonable. Thus the emerging costs or savings may vary from those presented above to the extent actual experience differs from that projected by the actuarial assumptions.



Oregon Public Employees Retirement System Actuarial Equivalency Factors

Information for Actuarial Services Committee Meeting - September 26, 2001

Attachment B Impact of Implementation Options on Member Benefits

The table below shows the actuarial factors to convert an account balance to a monthly Option 1 annuity. The Old Rule factors are grandfathered, and the 1999 Factors use the current interest and mortality basis.

Age at Retirement	Conversion Factors		Benefit Difference	
	Old Rule	1999 Factor	Dollar	Percentage
55	\$ 7.86	\$ 7.57	\$(0.29)	(3.8)%
56	8.00	7.65	(0.35)	(4.6)
57	8.16	7.74	(0.42)	(5.4)
58	8.32	7.83	(0.49)	(6.3)
59	8.49	7.93	(0.56)	(7.1)
60	8.67	8.04	(0.63)	(7.8)
61	8.87	8.16	(0.71)	(8.7)
62	9.08	8.28	(0.80)	(9.7)
63	9.30	8.42	(0.88)	(10.5)
64	9.54	8.56	(0.98)	(11.4)
65	9.79	8.72	(1.07)	(12.3)

The "benefit difference" represents the amount by which the monthly benefit (based on a \$1,000 account balance at the time of retirement) using the 1999 Factors is lower than the benefit derived from the Old Rule Factors. For example, at retirement age 55, the monthly benefit would be about 3.8% lower using the current factors, while at age 65, the monthly benefit would be about 12.3% lower.

One of the exercises we performed was to see how long it would take a member to make up this difference with interest accruing at the rate of 8% per year. For example, if the factors were changed immediately, interest would need to accrue for 6 months to accumulate the 3.8% difference for an age 55 retirement. Interest would need to accrue for an additional 19 months to accumulate to 12.3%.

However, if an age 65 member decided to wait for 19 months to accrue the additional 12.3% interest needed to replace the difference, the account would be converted at a later age at a higher conversion rate. Effectively, the age 65 member would need to wait 16 months to receive the same benefit, instead of 19 months.

The following table contains an illustration of the estimated number of months a member would need to wait to receive the same monthly benefit at the retirement age indicated. Note that the actual number of months would be slightly less if the member is still active and making member contributions.



**Oregon Public Employees Retirement System
Actuarial Equivalency Factors**

Information for Actuarial Services Committee Meeting - September 26, 2001

Implementation Option	Additional Months to Generate Monthly Difference at 8% Interest Credits per Year		
	Planned Retirement Age		
	<u>55</u>	<u>60</u>	<u>65</u>
Immediate or Delayed	6	11	16
2-Year Wear-Away			
Year 1	3	5	8
Year 2	6	11	16
5-Year Wear-Away			
Year 1	1	2	3
Year 2	2	4	6
Year 3	4	6	9
Year 4	5	8	12
Year 5	6	11	16
7-Year Wear-Away			
Year 1	1	2	2
Year 2	2	3	4
Year 3	3	5	7
Year 4	3	6	9
Year 5	4	8	11
Year 6	5	9	13
Year 7	6	11	16
10-Year Wear-Away			
Year 1	1	1	2
Year 2	1	2	3
Year 3	2	3	5
Year 4	2	4	6
Year 5	3	5	8
Year 6	4	6	9
Year 7	4	7	11
Year 8	5	8	12
Year 9	5	10	14
Year 10	6	11	16

The Two Segment Approach and the Multiple Segment Approach do not easily lend themselves to this type of analysis. In addition to being dependent on retirement age, the analysis would also be dependent on the size of the account balance accumulated at the effective date of the new segment, and the time elapsed from the effective date of the new segment to retirement. Nevertheless, we can say that for a member who retires shortly after the new segment is effective, the reduction in the monthly benefit would be relatively small.

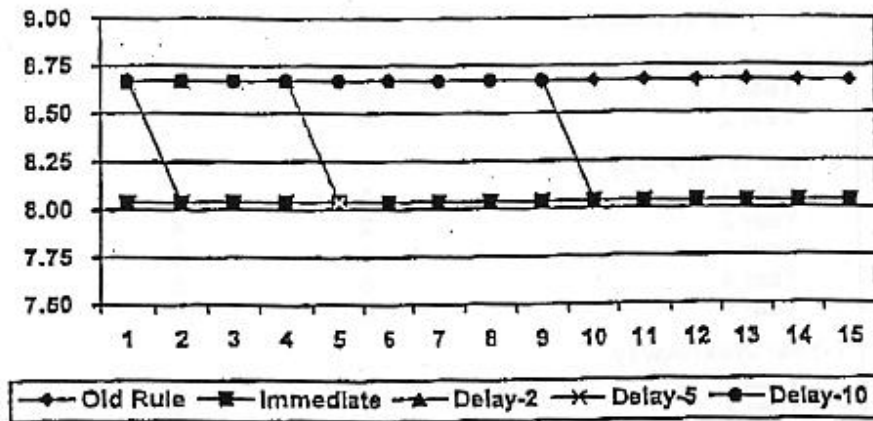


Oregon Public Employees Retirement System Actuarial Equivalency Factors

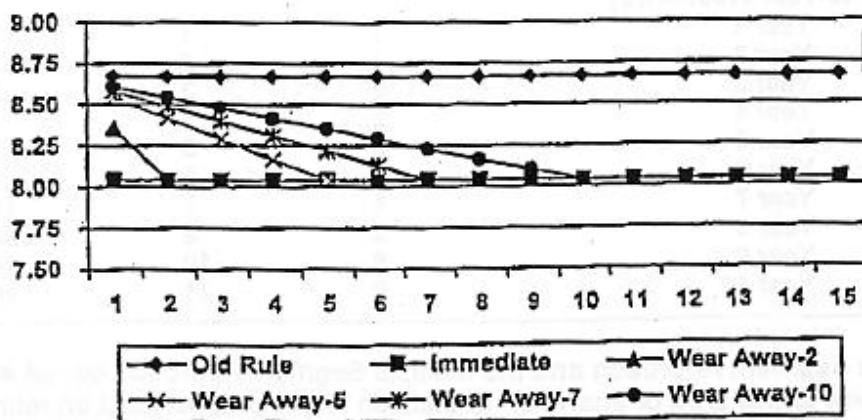
Information for Actuarial Services Committee Meeting - September 26, 2001

The following graphs illustrate the impact on benefits at retirement age 60 for the immediate, delayed, and wear-away options studied.

Age 60 Retirement Factors - Delay Options



Age 60 Retirement Factors - Wear Away Options





Oregon Public Employees Retirement System
Actuarial Equivalency Factors

Information for Actuarial Services Committee Meeting - September 26, 2001

Attachment C
Brief Survey of Peers and Private Sector Comparison

Changing Actuarial Equivalency Factors - Other Systems

The following information has been assembled from telephone calls with other Systems and their consultants. With only a few exceptions as noted below, actuarial equivalency factors are primarily used to calculate survivorship options. The impact of changing the interest and mortality basis for survivorship options does not generally have the same economic impact as changing the factors that convert account balances to lifetime annuities.

- California For *CalPERS*, a set of "best factors" was grandfathered for members on July 1, 1982. Since that time, actuarial factors have been modified periodically with the revised factors applied to the entire benefit.
- In *CalSTRS*, all actuarial factors are modified periodically with the revised factors applied to the entire benefit. Since 1996, *CalSTRS* has offered a Cash Balance Plan for certain part-time teachers. Even though no one has elected an annuity from the Cash Balance Plan as yet (the accounts are still very small) the conversion factors will be subject to change. Since 2001, *CalSTRS* has provided a supplemental cash balance account to members of the defined benefit plan. The factors to convert these accounts will be subject to change.
- Washington All actuarial factors are modified periodically with the revised factors applied to the entire benefit. All of the *PERS* and *TRS* Tier II plans have an early retirement reduction factor from age 65 which is based on actuarial equivalence. These factors are subject to change, and can make a significant difference in monthly benefits. The Tier III plans are similar to Oregon's Pension plus Annuity formula, but the factors for providing periodic payments have not yet been changed.
- Idaho All actuarial factors for *PERSI* are modified periodically with the revised factors applied to the entire benefit.
- Montana All actuarial factors for Montana *PERS* are modified periodically with the revised factors applied to the entire benefit. Montana *PERS* does have a money match formula, but it is rarely the most valuable method for active members because interest credits have historically been about 5%.
- All actuarial factors for Montana *TRS* are modified periodically with the revised factors applied to the entire benefit.



Oregon Public Employees Retirement System Actuarial Equivalency Factors

Information for Actuarial Services Committee Meeting - September 26, 2001

Changing Actuarial Equivalency Factors - Private Sector Comparison

Although not directly comparable, it may be of interest to be informed about the regulatory environment of conversions between life annuities and account balances in qualified private sector retirement plans. Generally, these regulations may also be applied when converting from account balances to life annuities. The IRS prescribes, in its published regulations, both the mortality table and interest rate that must be used for conversion factors to keep the plan qualified.

Mortality: The prescribed mortality table is a 50% male and 50% female blend of the 1983 Group Annuity Mortality Table. This specific mortality table is used for this purpose even if the Enrolled Actuary uses a completely different set of mortality tables for funding purposes. The IRS is considering updating the mortality table, and it is expected that the new table will be applied to the entire benefit without segmenting.

Interest: The interest rate must be set equal to a published 30-year treasury rate. Although plans may change interest rates as often as monthly, most plans change the interest rate annually.

Example: The change in conversion factors can be quite significant as illustrated below. Every January 1, a new set of present value factors is put into effect based on the new interest rate. If interest rates go up, the conversion factors will go up, and vice versa.

The present value factor is very sensitive to changes in the interest rate, with a one-half percentage point change, a factor may change 5% or more. Thus, from one year to the next the factor can change significantly, potentially more than any offsetting increase in the value of the account. The interest rates used during recent years, and the impact on the straight life annuity payable to a member age 55 with an account balance of \$100,000 are shown below:

Year	Prescribed Interest Rate	Age 55 Conversion from \$100,000 Account to Option 1	
		Monthly	Pct. Change
1998	6.33%	\$ 663	
1999	5.01%	581	(12.4)%
2000	6.26%	659	13.4%
2001	5.80%	630	(4.4)%

The fluctuation in interest rates can have a significant impact on conversions between account balances and equivalent annuity benefits. The fact that certain rates used by the plan fluctuate from year to year is an integral part of plan design that is meant to be responsive to economic conditions as they evolve.



Oregon

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February 5, 2002

MEMORANDUM

To: Members of the Board Actuarial Services Committee
Dawn Morgan, Board and Committee Chair
Christine Brown, Board Vice Chair
George Russell
Todd Schwartz

MEETING
DATE 02-12-02
AGENDA
ITEM # B-3

From: Dale S. Orr, Administrator
Fiscal Services Division

Re: Actuarial Equivalency Factor Rule Review

Executive Summary:

At its December 12, 2001 meeting, the Actuarial Committee (Committee) directed staff to request further legal analysis regarding federal and Internal Revenue Service requirements as they apply to the Committee's review of the Actuarial Equivalency Factor (AEF) Rule (OAR 459-005-0055). This analysis provided the following conclusions:

1. the Board's current AEF rule meets federal requirements;
2. the Board may not implement an AEF rule change that results in a lesser benefit than what the member has already accrued at the time of the change; and
3. all AEF implementation options under consideration by the Committee, with modification, meet federal requirements.

With the completion of this analysis, the Committee has received all requested information to date. In the absence of further informational requests, staff recommends that the Committee move forward in its decision regarding the modification of the Actuarial Equivalency Factor Rule. To assist the Committee in making its decision, staff has prepared the attached presentation. This presentation provides a methodology through which the Committee can use in its deliberations. The methodology is summarized in the remainder of this memorandum.

Decision Approach:

The following approach has been developed to assist the Committee in its review of work already completed and to organize its decision making process. This process has been segregated into three major steps with subcomponents under each one. The outline for this process is as follows:

I. Choosing Policy Priorities

The first step of determining policy priorities has received the greatest amount of the Committee's time in its review of the AEF rule issue. This step includes the determination if there is a need for change and then selecting the desired outcomes from which the Committee can develop policy priorities. Although the Committee has not made specific decisions in this area, staff has recommended to the Committee that there is a need for modification of the AEF rule and that the policy priorities that the Committee should adopt are:

1. fully implement the latest mortality tables (system accuracy);
2. avoid clustering or the acceleration of retirements to the extent possible given priority #1; and
3. provide a basis for implementing changes to the AEFs in the future.

Staff also has a secondary, though still important, recommended policy priority for the Committee's consideration and that is to:

4. to minimize the administrative burden associated with any AEF put in place at the agency.

It was during this step that staff and stakeholders developed the various implementation options. Also, it was at the step's conclusion that staff recommended the Five Year Wear Away as the implementation option that best addressed the outlined policy priorities.

II. Evaluate Requirements

This step involves a review of the Board's responsibilities and authority from a legal, regulatory, and fiduciary perspective. A good portion of this analysis was completed in parallel with the policy priority deliberations. This completed work was focused primarily on the Board's statutory authority and fiduciary responsibilities. The Board requested additional legal analysis on federal regulation requirements (compliance with the Internal Revenue Code (IRC)) and a review of potential litigation outcome risk (See III. "Potential Loss Risk Resulting From Litigation.")

Analysis to date:

Legal counsel has provide the Committee with the following analysis:

1. **Statutory Authority:**
Statute clearly gives the Board authority to change the Actuarial Equivalency Factor Rule.
2. **Fiduciary Responsibility:**
The Board may change the Actuarial Equivalency Factors Rule as long as they determine it is the best interest of all the beneficiaries of the trust.

3. Internal Revenue Code Compliance:

- The Board may change the Actuarial Equivalency Factor Rule as long as it does not result in a benefit that is lower than the benefit accrued by the member at the time of the change
- What precisely constitutes the "Accrued benefit" needs to be further clarified in far more precise programmatic terms
- All Actuarial Equivalency Factor Rule change options presented to the Committee thus far, with modifications, comply with IRC requirements

The IRC review was recently completed and a summary of our counsel's findings and its impact will be presented to the Committee on February 12. The attached presentation contains the highlights of that analysis and the impact on the various AEF implementation options.

III. Potential Loss Risk Resulting From Litigation

The Department of Justice, at the Committee's request, has advised the following:

- The Board faces a high litigation loss risk if the Actuarial Equivalency Factor Rule were to be changed for current members unless it results in a higher benefit.
- The litigation risk assessment is based upon potential claims of contract rights by current PERS members and an assessment of possible claims that such rights have been conferred by past Board action, specifically OAR 459-005-055.
- Whether contract rights can be conferred by administrative rule has not been tested in court.
- Change of the Actuarial Equivalency Factor Rule for future PERS members would not face such a loss risk from litigation.

The Committee will receive an analysis of the potential litigation loss risk prior to the Committee's meeting on February 12. This analysis, due to its confidential nature, will be provided in Executive Session.

IV. Select Implementation Strategy

With the receipt of all requested information, the Committee will be requested to review the implementation strategies in the context of agency priority, legal and regulatory requirements and litigation risk analysis. A decision matrix has been provided as an attachment to this memo to assist the Committee in this process.

The timeline for a Committee decision is driven by the PERS actuary's need to know which methodology will be used in order to complete the December 31, 2001 valuation. This knowledge would be helpful if it could be received by May, but any decision rendered beyond June could delay timely completion of the valuation. As such, a Committee decision at its February 12, 2002 meeting is not mandatory. If additional information or deliberation is needed, a decision could be deferred until the Committee's March 22nd meeting.

If you have any questions prior the Committee meeting, please contact me at (503) 603-7704.

Attachment

The IRC review was recently completed and a summary of the review's findings is being prepared to be presented to the Committee on February 12. The attached document contains the findings of the review and the impact on the existing Actuarial Equivalency Factor Rule.

The Department of Finance is currently reviewing the findings of the review and will be providing a report to the Committee on February 12.

- The Board has a right to review the Actuarial Equivalency Factor Rule and to be changed by the Board.
- The Department's review of the Actuarial Equivalency Factor Rule is an ongoing process and will be updated as needed.
- Whether contract rights can be maintained is a legal question that will be reviewed in court.
- Changes of the Actuarial Equivalency Factor Rule from the current PERM would not be made until the review is complete.

The Committee will receive an analysis of the Actuarial Equivalency Factor Rule at its meeting on February 12. This analysis will be provided in Executive Session.

With the receipt of all requested information, the Committee will be reviewing the Actuarial Equivalency Factor Rule in the context of agency policy, law and regulatory requirements and will make a decision on the rule in the near future.

The timeline for a Committee decision is driven by the PERM review's need to complete the review in order to complete the February 12, 2002 valuation. This timeline would be helpful if it could be reviewed by the Committee. As a result, the Committee may need to delay its decision on the Actuarial Equivalency Factor Rule until the February 12, 2002 meeting is not mandatory. If additional information or deliberation is needed, a decision could be deferred until the Committee's March 12th meeting.

Actuarial Equivalency Factor

Rule Review

Committee decision process

1. Choose policy priorities
 - Develop rule modification choices
2. Evaluate requirements
 - Statutory requirements and authority
 - Fiduciary responsibility
 - IRC requirements
3. Evaluate potential litigation outcome risk
4. Select implementation strategy

Actuarial Equivalency Factor

Rule Review

Choose policy priorities

Primary desired outcomes

- Fully implement latest mortality tables (system accuracy)
- Avoid clustering or acceleration of retirements when possible
- Revise rule to allow future AEF changes

Secondary

- Minimize administrative burden

Actuarial Equivalency Factor Rule Review

Develop rule modification choices

- Immediate implementation
- Five year wear-away (staff recommendation)
- Multiple segment approach
- Maintain current rule

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Actuarial Equivalency Factor Rule Review

Evaluate Requirements

Statutory requirement and authority

- Board has explicit statutory authority to change AEF

Fiduciary responsibility

- Board may change AEF if they determine it is in the best interest of all members

Actuarial Equivalency Factor

Rule Review

Evaluate Requirements

IRC requirements

- Member must not receive less than his or her accrued benefits as of date of change in AEF
- Accrued benefit based on:
 - Service time or member account balance at a point in time
 - Adjusted for subsequent earnings on original contributions or change in salary to time of retirement
 - Actuarial equivalency factor in effect
- Two approved methodologies
 - Segmented approach
 - Comparative approach (equivalent with modification to the Wear-away)

ACTUARIAL EQUIVALENCY FACTOR

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Actuarial Equivalency Factor

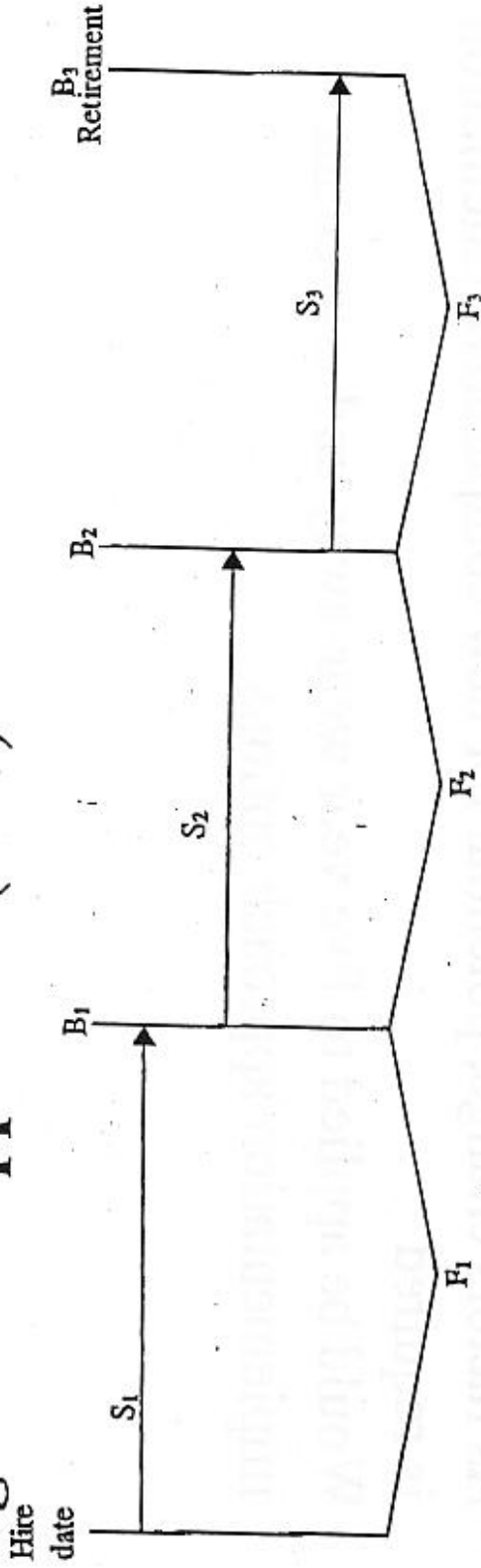
Rule Review

Segmented Approach (IRC)

- Accrued benefit earned during a period of time in which a set of actuarial equivalency factors are in effect
- As factors change, a new segment is created
- Segmented approach adopted by PERS Board for members joining the system on or after January 1, 1999
- Basis for multiple segment approach option

Actuarial Equivalency Factor Rule Review

Segmented Approach (IRC)



- Member's benefit calculated based on the accrued service time/account balance and the AEF in effect for each discrete segment

Retirement Benefits = $B_1 + B_2 + B_3$

F = Actuarial equivalency factor rule in effect

S = Service time adjusted for highest salary in career or contributions and savings on those contributions to time of retirement

B = Segment benefit

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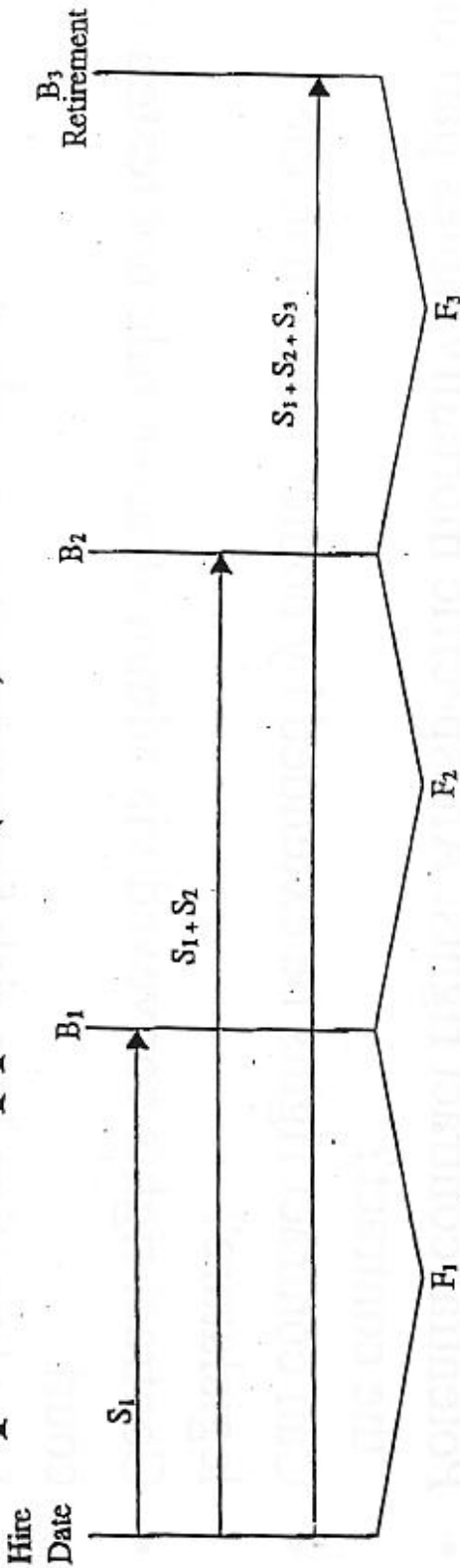
Actuarial Equivalency Factor Rule Review

Comparative Approach (IRC)

- Member receives the higher of accrued benefit as of change in AEF or total benefit as of retirement date using current AEF
- As factors change, potential for new comparative calculation is required
- Would be applied to five year wear-away and immediate implementation approach options

Actuarial Equivalency Factor Rule Review

Comparative Approach (IRC)



- Member's receives highest benefit based on the accrued service time at the end of each actuarial factor period

Retirement Benefits = B_1 or B_2 or B_3

F = Actuarial equivalency factor rule in effect

S = Service time adjusted for highest salary in career, or contributions and savings on those contributions to time of retirement.

B = Segment benefit

Actuarial Equivalency Factor

Rule Review

Evaluate Potential Litigation Risk

- Litigation risk high for any rule modification for current members
 - Somewhat reduced, but not eliminated on multiple segment approach
- Potential contract rights: Are specific mortality tables part of “the contract?”
- Can contract rights be extended by bodies other than the legislature?
- Contract rights conveyed via administrative rule not tested in court
- Low litigation loss-risk for prospective members

Actuarial Equivalency Factor Rule Review

Implementation Strategies & Impacts

	Current Approach (Grandfathered/segmented)	Immediate Implementation (Comparative)	Five Year Wear away (Comparative)	Multiple Segment (Segmented)
Priority: fully implement latest mortality tables?	No - neither for grandfather or segment classes	Yes After comparative worn-away	Yes Over period of time after comparative period worn away	No Requires perpetual use of old tables
Priority: avoid clustering/ac- celeration	Yes	No Could create significant clas- tering/acceleration	Minor clustering may occur particularly in older age groups	Yes
Priority: administrative burden	•Must track service segments •Must calculate benefit for multiple segment period plus grandfathered class	•Must calculate benefit at least twice for comparative period •One calculation thereafter until AEF changes again	•Must calculate benefit at least twice, but potentially more for each comparative period •One calculation thereafter until AEF changes again •Number of comparative calculations can be reduced through actuarial reduced testing	•Must track all service segments •Must calculate benefit for each of multiple segment periods
•Meets IRC requirements	Yes	Yes	Yes	Yes
•Avoids litigation loss risk	Yes	No	No	No