PERS in Crisis: The Sequel

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To: Interested parties

From: Phil Keisling

DRAFT –Supersedes all previous versions, but still subject to further revision

Background and Introduction

Less than a decade ago, the Oregon Public Employees Retirement System (PERS) was widely touted as the "most generous – and best managed -- public pension plan in the U.S." From 1991 to 1999, the PERS Fund soared an eye-popping 180%, from $14 billion to $40 billion. In 1999 alone, the Fund's value jumped 25%. That same year, 6,843 PERS members retired, 14% of them with projected annual benefits 100% or more of their final average salary.

Then came the dot-com bust, followed by the 2001-02 economic downturn. By the time the 2003 Oregon Legislature convened, many were predicting disaster. As PERS officials themselves describe it, in an August 2009 hand out, "PERS had an unfunded actuarial liability of over $17 billion, (and) employer contribution rates were projected to rise to 29% of payroll." (The Employer Contribution rate – which is individually calculated for each of PERS' 887 separate public employers – is represented as a percentage of payroll and reflects what employers must pay into the PERS fund to meet obligations to current and future retirees.)[1]

In response, the 2003 Oregon Legislature made major changes to PERS. The politics were difficult and contentious. Business groups and a few Democrats – most notably Governor Ted Kulongoski and freshman Democratic Representative Greg Macpherson – championed the changes. But it took mostly Republican votes to pass the major reforms, as public employees and unions such as the Service Employees International (SEIU) and the Oregon Education Association (OEA) strenuously opposed them.[2]

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[1] The "Employer Contribution" rate is perhaps the most important single term in understanding PERS – and accordingly will be capitalized throughout this paper. Each government employer has its own, individualized rate, expressed as a percentage of their payroll, which represents what it must contribute to PERS each biennium to meet specific, legal obligations to the system's current and future retirees. However, this rate is *only one component* of how public employers currently finance the PERS system.

[2] Governor Kulongoski found his advocacy for PERS reform politically painful. In his 2006 re-election bid, he was strongly opposed in the Democratic primary by two challengers who argued the PERS reforms were wrong and/or unnecessary. The OEA made no endorsement, and SEIU endorsed one of his opponents, former Treasurer Jim Hill. (Kulongoski did win the primary, and ultimately re-election). The ripple effects of PERS were also felt in the 2008 Democratic primary, when Rep. Macpherson lost a hotly contested bid for Attorney General. The SEIU alone contributed more than $300,000 to his opponent, now Attorney General John Kroger.

Then, almost as quickly as the crisis arrived, PERS largely vanished from the radar screen. And it's easy to see why. After two years (2001-02) of modest losses, the PERS Fund once again grew at a ferocious clip. Between 2002 and 2007 its value nearly doubled, soaring to a record $62.9 billion as of December 31, 2007.

But nothing – not even close – has matched PERS' dismal performance during 2008 and that fall's and this spring's severe economic downturn. By December 31, 2008, the fund – technically known as the Oregon Public Employee Retirement Fund, or OPERF – plunged 27%, finishing at $45.7 billion. In one year alone, 2008's losses wiped out the previous 4 years' of investment gains, essentially returning OPERF to within 10% of its valuation almost a decade earlier -- in 1999.

But could PERS now be built on such solid bedrock, that even the worst economic crisis in 75 years would leave it relatively unscathed? Could a 55% drop in major stock indexes, and the near-overnight collapse of America's once vaunted financial sector, prove nothing more than a passing annoyance to a retirement system whose obligations extend to more than 300,000 Oregonians?

These are some of the questions this white paper examines. And the answer, not surprisingly, is a resounding "No."

But first, a few disclaimers.

PERS is a deeply complex system, underlain by many assumptions and consisting of many inter-locking parts and fast-changing dynamics. I am not an economist, an attorney, nor an actuary. PERS' many acronyms, statistical terms, and stochastic economic models are more than a little daunting. Inevitably, any "primer" will leave out – or even potentially mischaracterize – important information, and for that I take full responsibility.[3]

I also want to emphasize that this white paper – and the judgments, analyses, and recommendations in it -- are mine alone. While many have assisted me in this effort – including PERS managers and experts who were most gracious with providing

[3] To try to "see the forest" – and "not get lost in the needles, much less the trees" as one person put it – I have largely chosen (unless otherwise specified) to use "aggregate" and "average" figures throughout this paper. Accordingly, many of the statistics, and especially percentages, apply across broad classes of employers (e.g, the state or K-12 schools) and sometimes even across the entire system.

PERS' total impact on any individual employer –of which there were 887 as of July 2009, according to PERS officials -- vary, and often dramatically, depending on individual circumstances. Each employer has a separate PERS Employer Contribution rate, though rates are often identical for various entities because they're set across certain broad categories – e.g, most state agencies are pooled together, as are Oregon's 199 K-12 school districts. (Among the remaining, 600+ city and county government entities there's a good deal more variability). But even within broad pools, an individual entity's rate may vary according to the existence, and size, of different employee "classes" such as police and fire employees.

information and suffering through many ignorant questions -- I take full responsibility for those opinions, as well as all attendant errors and omissions contained herein.

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What's arguably the most dangerous myth in Oregon politics today?

That in 2003, reforms enacted by the Oregon Legislature to rescue the "Oregon Public Employee Retirement System (PERS) from financial catastrophe, also put PERS on a relatively stable, sustainable path for the foreseeable future.

Much as the near-silence about PERS in public forums might otherwise suggest, the severe recession of 2008-09 that's shaken America's economy to its roots – not to mention, made many citizens afraid to even look at their monthly 401 (k) statements – also holds potentially profound consequences for PERS and Oregon taxpayers.

In the 12 months between December 31, 2007 and December 31, 2008, the official value of the Oregon Public Employees Retirement Fund (OPERF) dropped $17.2 billion, from $62.9 billion to $45.7. billion. PERS fell even more in the first 3 months of 2009, finally bottoming out on March 31, 2009 at $41.5 billion.

OPERF's value has rebounded since –as have many Oregonians' 401 (k) plans – as leading stock indicators such as the Standard and Poors 500, NASDQ, and even the Dow Jones Industrial index have risen significantly. Even so, as of August 31, 2009 (PERS' last available estimate), OPERF's value had increased just 9% for 2009 Year to Date, to about $48.5 billion. [4]

The result? Combined with existing policies, labor contracts, and key decisions earlier this decade ostensibly touted to help stabilize the system, PERS currently

[4] Many might assume that the stock market's April-September 2009 robust rebound – an 18% jump in the S and P 500, a 30% gain for NASDQ – would just as quickly recoup OPERF's massive losses. Unfortunately, the same "hyper charged" investment returns that made PERS such an envy of its peers during the 1990s – and then again during the 2003-2007 "bull market echo" – were due in no small part to PERS' appetite for riskier investment instruments that the average person can't (and arguably, shouldn't) go near.

For example, Private Equity Funds and Real Estate Investment Trusts (REITS) comprise almost 30% of OPERF's portfolio. This is roughly triple what most other states have. These classes performed very strongly during the two periods noted above. (1990-99 and 2003-2007). But from January 1, 2009 through August 31, 2009, the value of these investments still fell 18.5% and 13.9% respectively, offsetting the 24% January-August gain in public equity funds that now comprise less than half OPERF's portfolio. The Private Equity and REIT sectors have proven far slower to bounce back -- and some believe there's more bad news hidden in these portfolios that has yet to emerge.

faces a crisis that could prove even more difficult – and ultimately more costly to current and future Oregon taxpayers -- than even the 2003 version.

Perhaps most unsettling is how virtually no one of consequence – the Governor, legislative leaders, and the PERS governing board and staff –have done anything significant to date to publically call attention to a crisis whose main dimensions have been well known since earlier this spring.

During the 2009 session of the Oregon Legislature, not a single public hearing was held to focus on PERS' long term prospects. Search the entire archive of the *Oregonian*, and aside from several excellent pieces by Ted Sickinger –which focused on the underlying reasons for OPERF's massive losses, but largely bypassed the implications down the road for taxpayers – there's virtually no mention of the problem.

In fact, earlier this year, just the *opposite* seems to have happened. During the fall of 2008 – literally as the nation's financial markets were melting down on a near-daily basis – PERS officials essentially approved a *significant reduction* in the benchmark Employer Contribution rate, from a system-wide average of 15% of payroll in 2007-09, to 12% in 2009-11.

This seeming paradox results from PERS' decision to use an "18 month lag" policy when setting Employer Contribution Rates. So for the 2009-11 biennium, which began on July 1, 2009 and lasts through June 30, 2011, PERS' Employer Contribution rates are actually based on the -- now distantly remote -- OPERF valuation of December 31, 2007.

It's as if a Category 5 financial hurricane were a few days from slamming into our shores, unbeknownst to most citizens, whose glances outside reveal nothing but blue skies.

Meanwhile, have those with intimate knowledge of the system been warning residents to board up their windows, stock up on batteries, and inform themselves about evacuation routes? Hardly. If there has been a strategy, it largely seems so far to simply hope the nation's financial winds would suddenly and vigorously shift in a much more favorable direction, causing the PERS storm suddenly to veer back out to sea. [5]

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[5] As discussed in more detail below, the PERS Board and staff knew by May 2009 – and arguably, a good deal earlier -- that the dimensions of PERS' potential crisis were unprecedented and enormous. Indeed, consider this comment from Mercer's May 16, 2008 report that showed Employer Contribution rate scenarios of 30% under certain "worst case" economic scenarios. Mercer didn't just expect readers to closely follow their chart; they highlighted the following point in the upper right corner of Slide 21: "In poor investment environments, contribution rates may still exceed 30% of payroll."

It is highly probable that the Governor and legislative leadership also had direct knowledge well before May 2009-- and certainly should have once the May 2009 Mercer was posted on PERS' web site last spring. However, not until October 1, 2009, with Ted Sickinger's front-page story in the Oregonian, did the story come to the attention of a significant, broader audience.

For the May 2009 Mercer report, see
http://www.oregon.gov/PERS/section/financial_reports/Financial_Modeling_52909.pdf

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What are the dimensions of this potential crisis? **Within just 5 years, PERS could end up in *worse financial shape* than what was anticipated when the Oregon Legislature stepped in and made major changes to the system in 2003.**

This isn't my judgment, but that of the PERS' system's own hired experts. And the evidence for it has arguably been "hidden in plain sight" since earlier this year.

By law, the PERS Governing Board – a 5 member, citizen panel appointed by the Governor – must set "Employer Contribution" rates to ensure that OPERF has sufficient funds to meet its legal and contractual obligations to 105,000 current retirees, and another 200,000 active and inactive members who've not yet reached retirement age.

In May, 2009, PERS' long-standing actuary, the Mercer Consulting Group, released a little noticed study whose conclusions -- combined with the continuation of existing state law, and the current practices and policies of both public employers and PERS governing officials -- add up to the following scenario:

For the 2011-13 biennium, to finance the pension obligations of current and future retirees, state and local government employers will need to increase their "Employer Contribution" rate from an average of 12% of aggregate payroll, to 18%. [6]

This sounds relatively innocuous until one realizes three things.

First, across all levels of Oregon government – the state, K-12 school districts, community colleges, cities and counties, etc – the estimated combined payroll for the current 2009-11 biennium is over $16 billion.

Based on current payroll costs, a 6% jump in this core "Employer Contribution" rate translates into an *additional $1 billion of tax dollars that will be needed for PERS-related obligations in 2011-13, compared to what was required for 2009-11.*

Second, this 6% of payroll increase is essentially a given, "baked into" PERS' future. This is the "flip side" of the 18-month lag policy. Employer Contribution rates for 2011-13 will be officially set in the fall of 2010, based largely on PERS' official valuation as of December 31, 2009. Under existing PERS policy, the 6% increase – from a system wide

[6] May 29, 2009 Mercer report, "Oregon PERS Financial Modeling," at Slide #12, at mid-point year in biennium of 2012. This 6% jump is actually *less* than what it would be, in the absence of an existing PERS policy known as the "rate collar," which limits biennial hikes in the Employer Contribution rate to 3% when PERS' funded status is above 80%, and to 6% ("double rate collar) if it falls below 80%. Without the rate collar, the system-wide rate would jump 10% in 2011-13, to 22%.

average of 12% to 18% -- can only be avoided if OPERF's portfolio increases by 26% for 2009. Through August 31, 2009, it has risen less than 9%.

Third, for government entities that make up the vast majority of PERS payroll – the state, most of Oregon's largest K-12 districts, and some key local government players – the total, "net effect" of the PERS rate hike in 2011-13 will be *significantly higher* than 6%, and closer to 9% of payroll.

Why? Between 2002-2007, about 125 public employers – including the state, about 100 K-12 districts, and another few dozen local governments – sold more than $6 billion in "Pension Obligation Bonds." Bond proceeds were then largely invested in OPERF "Side Accounts," whose value rose – and then, just as dramatically -- fell with OPERF's fortunes.[7]

For the 2009-11 biennium, earnings from these Side Accounts will help reduce Employer Contribution rates significantly for participating employers. For example, for the state of Oregon, the average PERS Employer Contribution rate of 13% of payroll for 2009-11 will be reduced by an average of 10%, producing a *net* Employer Contribution rate of just 3% of payroll. For Portland Public Schools, Side Account proceeds will reduce a base Employer Contribution rate of 14% to almost 0%. System-wide – including both employers with Side Accounts and those without – the net Employer Contribution rate for 2009-11 will be a paltry 4% -- literally, an all time "low" coinciding with PERS' worst all time year.

But this "Side Account discount effect" -- based, too, on the December 31, 2007 valuation -- is also fast changing.

In 2011-13 (and likely beyond), public employers with significant Side Accounts will experience a PERS "double whammy." While their base, Employer Contribution rates will increase by 6% in 2011-2013, their Side Account discounts will fall the equivalent of 3-4% of payroll. For these employers, their *net* Employer Contribution rates will increase the equivalent to 9% (or more) of payroll -- just for 2011-13 compared to 2009-11. [8]

Again, on a system-wide basis, Oregon's public employers will go from an average *net* Employer Contribution rate of about 4%, to nearly 13% in 2011-13. And by 2011-13, public employer payrolls will have grown from an estimated $16.5 billion (in 2009-11) to

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[7] "Side Account" is also a very important concept in understanding PERS, and will also be capitalized throughout this report.

[8] The State's Side Account was valued at $2.791 billion on 12/31/07. Disbursements largely based on that value in the 2009-11 biennium will be about $200 million, to produce a "discount effect" of about 10% of payroll for state agencies. *Even if* OPERF gains 12% during 2009 – PERS current prediction for 2009 – the State Side Account's projected value for 12/31/09 will be approximately $1.9 billion. Accordingly, the "discount effect" will fall to about 6-7% of payroll for 2011-13.

$17.6 billion. On a system-wide biennial payroll of $17.6 billion, this is the equivalent of paying an *additional $1.6 billion* to meet PERS-related obligations. [9]

By the 2013-15 biennium, Mercer's model projects – again, at the middle, "50% probability" level – that the system-wide average for the Employer Contribution rate will increase another 6% to 24% -- double the 2009-11 base rate. [10]

Meanwhile, the Side Account discount effect drops to 4%, system-wide – just half it's 2009-11 amount -- producing a net Employer Contribution rate of 20% -- *five times* the amount of 2009-11. Against a projected payroll now of $19.1 billion – and again, compared to 2009-11 levels – state and local governments would require an additional $3 billion for PERS.[11].

How probable is this 2013-15 scenario? Mercer gave this second, 6% increase in the Employer Contribution rate a 90-95% certainty in its May 2009 report, again assuming the continuation of existing policies. In a September 2009 follow-up report to the PERS Board -- that used updated (and somewhat higher) OPERF valuations through July 31, 2009 and a mid-point 8% annual growth assumption -- Mercer still projected the 24% rate for 2013-15. [12]

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[9] More accurately, most public employers with Side Accounts will experience more of a "triple whammy." Pension Obligation Bonds are simply loans, whose principal (with interest) must be repaid. For example, the state of Oregon will make $280 million in bond payments for 2009-11, the equivalent of about 6% of payroll. Portland Public Schools' repayment of $61 million will represent about 11% of its payroll.

Unlike, say, a conventional home mortgage, these loans are "back-loaded," with payments structured to *increase* each year until the loans are fully repaid. For example, the state of Oregon's payments will increase 8% each biennium. PPS' loan payments, which are projected at $61 million for 09-11, will be $106 million by 2019-21.

Additional background and discussion about Side Accounts is found later in this paper.

[10] See May 29, 2009 Mercer report, Slide 12: 50% probability at year 2014.

[11] The average, system wide net Employer Contribution rates can be found on Slide 21 of the Mercer May 2009 report.

PERS currently estimates that public employer payrolls will grow by 3.75% a year. Largely fixed pension obligations, against a *slower pace* of payroll growth, would result in even higher hikes, in percentage terms.

[12] On September 25, 2009, after this paper had been largely completed, Mercer released a supplemental report, using new projections of future OPERF growth and starting with the July 31, 2009 valuation of about $47.3 billion , rather than the significantly lower valuation of $41.5 billion for March 31, 2009 (literally OPERF's recent low point).

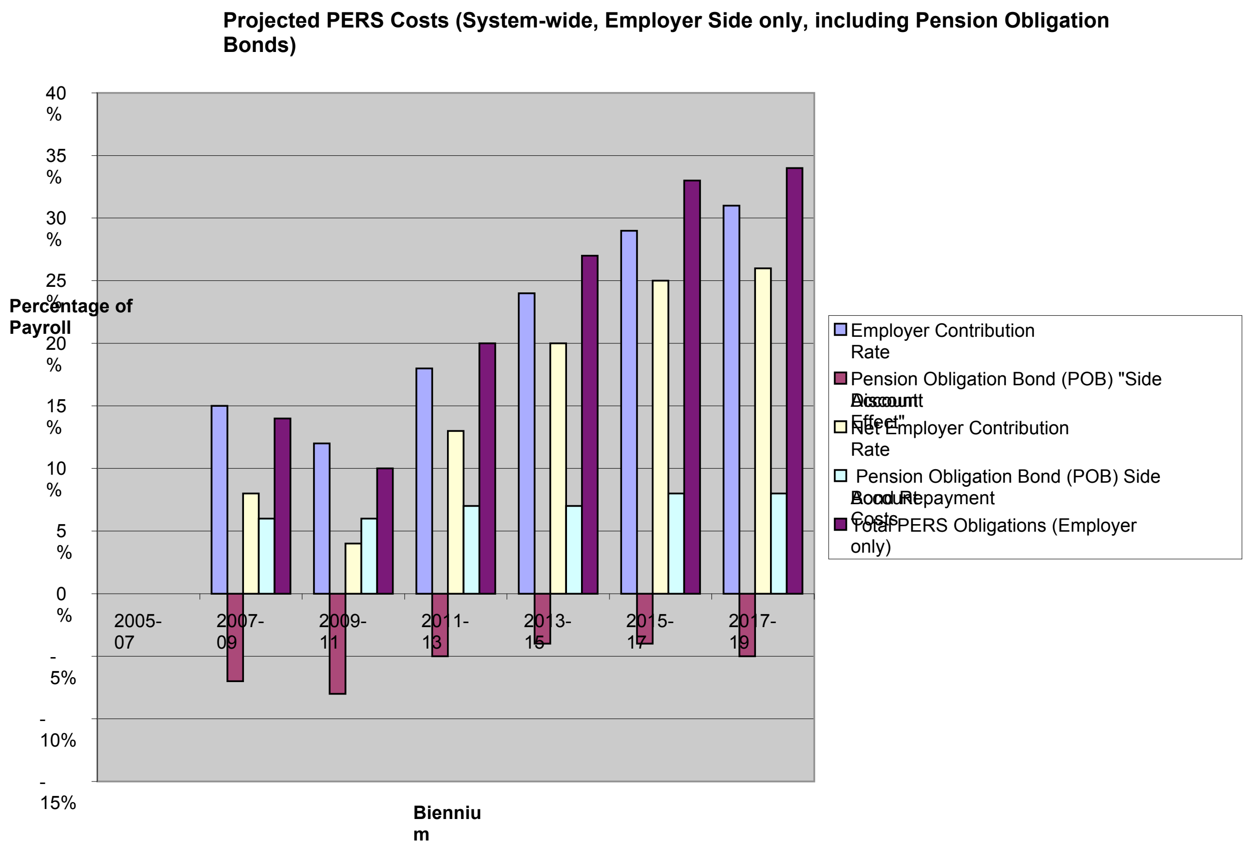
http://www.oregon.gov/PERS/docs/financial_reports/dec08_mercer_actuarial_valuation_report.pdf

However, even at this report's "mid point" assumption, of 8% economic growth, the base Employer Contribution rates are nearly identical through the 2013-15 biennium. Only in the 2015-2017 biennia and beyond does the higher "starting point" affect the model at the "mid-point" probabilities. (See Slide 38)

Beyond 2013-15, things could get *even worse, still* -- though as with any projection, the further out one goes, the more uncertainty exists.

By 2017-19 Mercer's May 2009 model – again, at 50% probability, assuming existing policies and assumptions -- showed the base Employer Contribution rate rising still further, to 31%. The net Employer Contribution rate, after Side Account discounts, would still be 26%. [13]

The chart below reflects at these trends over the next decade. Again, this is on a system-wide basis and based on Mercer's May 2009 report at the 50% probability scenario. It also assumes the continuation of existing PERS policies and approaches, including the current "rate collar policy" in effect since 2004. The key column is the last in each series: the Total PERS Obligations, just from the Employer side. (The "Employee" side of the equation will be discussed later in this paper):



[13] For 2017-19, the September 2009 Mercer report shows the base Employer Contribution Rate at 24%, compared to 31% in the May 2009 report. This is at the "mid point" growth assumption of 8% annual increases in OPERF. However, if OPERF's annual growth rate in falls to 4.5%, the 2017-19 rate *would* be about 31%. (Comparison of May 2009 report at Slide 12 vs September 2009 report at Slide 38, 8% "with double collar")

Note: The September 2009 Mercer report showed almost identical trends through 2013-15, then leveling off for 2015-2017 and 2017-19. Data for 2007-09 and 2009-11 are based on actual rates and official projections; for 2011-13 and beyond, rates are based on the May 2009 Mercer report, 50% probability, with POB repayment costs as a percentage of payroll based on projections by the author.

By 2017-19, total public employer payrolls are projected to be $22 billion. The additional money needed by PERS by this point – again, based on the May 2009 Mercer report and using current policies and assumptions and compared to 2009-11 -- is ***nearly $5 billion*** compared to 2009-11. This money would need to be found -- somewhere, somehow – to meet various legal and contractual obligations – and ensure PERS stays on a "sound" actuarial footing.

However, the term "semi-sound" is actually more accurate. *Even with* the projected 24% Employer Contribution rate by 2013-15, projected by both the May and September 2009 Mercer reports, PERS' "Funded Status" – the ratio of its Assets to Liabilities – would stand at just 61% (Mercer, May 2009). As of December 31, 2007, this actual ratio was 96%, and as of December 31, 2008 it had fallen to an estimated 71%.[14]

Under Mercer's May 2009 modeling exercise, even at a 31% Employer Contribution rate in 2017-19, PERS' funding status would still only be 67%. Use the more optimistic, September 2009 modeling exercise, and a projected 24% rate in 2017-19 would still produce a Funded Status of just 77%. [15]

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Ponder these numbers -- and their enormity -- for a moment longer. Even assume, for the sake of argument, that the May 2009 Mercer modeling exercise proves doubly pessimistic, and that by 2017-19, public employers need only find half that $5 billion, or $2.5 billion in additional dollars, compared to 2009-11.

PERS Employers would need to find this kind of money, from whatever revenue source they could. Regardless of whether the money came from income tax receipts, property taxes, lottery proceeds, federal grants, higher user fees, or any other sources, it would essentially mean $2.5 billion would be "taken off the table," no longer available to pay for any other basic state and local government services.

These programs include K-12 and college education, providing health care, paving roads, incarcerating criminals, etc. Money that could go to pay for existing –not to mention to hire new -- teachers, state troopers, public health nurses, or highway engineers, would

[14] See May 2009 report, Slide 13. These Funded Status numbers do *not* include the asset value of the Side Accounts mentioned earlier, for a simple reason. PERS does not carry the liabilities for these accounts, which are on the books of state and local governments that own these accounts.

[15] These Funded Status numbers reflect either Mercer's"50% probability" estimate (Slide 13, May 2009) or the "mid point" growth rate (Slide, 39 September 2009). These slides also model Funded Status at better – and worse – assumptions.

instead need to be re-directed into financing pension obligations for former and current employees.[16]

Here are a few other ways to look at this kind of money. If Oregon's public sector today had an *additional* $2.5 billion to spend, it could (CK all facts) :

- Hire 20,000 new K-12 teachers *and* provide for universal pre-school for all 4-5 year olds; or
- Double state support for the Oregon University System and abolish all undergraduate tuition; or
- Re-pave an estimated ____ miles of road and finance (all on our own) another _____ miles of new light rail lines; or
- Extend Medicaid to at least ____ uninsured; or
- Reduce personal income taxes by almost 20%

No doubt about it – this is real money.

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It's important to recognize that even the first 6% increase in the Employer Contribution rate projected for 2011-13 – much less two, additional 6% hikes in subsequent biennia ---- are utterly without historic precedent.

For more than a quarter century – between 1975 and 2001 – the PERS Employer Contribution rate *never once* fluctuated outside a narrow band between 9 and 12%. Despite volatile market ups – and downs – the underlying dynamics of the PERS system were remarkably stable.[17]

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[16] The "type" of money various state and local governments would use to fund these additional obligations will vary between jurisdictions. For the state government, officials estimate 40% of any additional state obligations would come from general fund revenues (mostly income tax and lottery receipts). Federal funds and other fees would make up the bulk of the remainder.

For K-12 schools the picture is much bleaker. About 65% of K-12 funding now comes directly from the state, and that consists almost entirely of general fund dollars. Most of the remaining 35% of school funds involves local general funds, such as property taxes.

For other local governments – e.g, most cities and counties – funding sources would be a combination of federal, state, and local funds. But regardless of the "type" of tax dollars available for PERS-related obligations, the larger point is that re-directing *any* additional money for this purpose will make it unavailable for other, existing uses, and that will have real and lasting impacts on government service levels.

[17] According to a November 2008 report by Alicia Munnel and colleagues of the Boston College Center for Retirement Research, the average state/local public pension plan had an employer contribution rate of about 7%. So even at 9-12%, Oregon's system appears to have historically been significantly better financed than most states.' See http://crr.bc.edu/images/stories/Briefs/ib_8-19.pdf

What may well become known as Oregon's "First PERS Crisis" in 2003 was certainly politically traumatic. It also exposed a level of volatility inherent to the system—largely driven by how retirement benefits had evolved over several decades -- that few had previously understood.

Still, even at the depth of the crisis – in the 2003-05 biennium – the Employer Contribution rate spiked to "only" 19%. And even then, the real impact for the state of Oregon and many public employers was actually much less, since this is when the vast majority of pension obligation bonds were sold. These employers used the bond proceeds to "buy down" their Employer Contribution rates, while their bond payments were structured to be relatively low in these initial years. In effect, the fiscal "pain" of the first crisis was never felt by many public employers.

It's useful to recall that at the height of the 2003 crisis, PERS officials and their actuaries were making dire predictions that without major reforms, the Employer Contribution rate would soar within 5 years to 29% -- and PERS' "funded status" (the ratio of its Assets to Liabilities) would plunge to just 65%.

What's remarkable is that notwithstanding 2003's major reforms, Mercer's 2009 modeling exercise predicts a similar – if not worse – future for PERS under current circumstances. Indeed, even at a staggering 31% Employer Contribution rate for 2017-2019, Mercer projects OPERF's funding status will still fall to 67%. This is a "danger zone" figure to virtually any pension fund manager.

How could the PERS system's funded status actually deteriorate further, *even with* such massive increases? [18]

In 2004, the PERS governing board adopted policies to "cushion" employers from too-steep rate hikes, putting what is known as "rate collars" into effect. These policies allow a biennium-to biennium increase of up to 3%, or double that (6%) should OPERF's "Assets to Liabilities" ratio fall to below 80%. As of December 31, 2007, PERS' funded ratio stood at a robust 98%. By December 31, 2008, it had plunged to below 71%.

In the absence of such rate collars, Mercer noted, widely used actuarial practices would suggest the prudence of rates that were *even higher*. How much higher? Without the "rate collar/double rate collar policy – which the PERS board has adopted as policy, but state law does *not* require – the 2011-13 overall Employer Contribution rate wouldn't jump to 18%. **Instead, it would soar to 22%, even** according to Mercer's most recent estimate in its September 2009 report.

Put another way, without the rate collar in effect, state and local governments for 2011-13 would actually need to find an additional $1.4 billion (compared to "only" $1 billion).

[18] One observer raises – and answers – a related question. "What if the reforms hadn't been enacted in 2003 -- and then 2008 came along? We'd be facing Pension Armageddon, rather than just Pension World War II."

Rather than a 9% system-wide increase (including Side Accounts), they'd face a 13% jump.

No "economic miracle" can now recoup the massive losses of 2008. Under existing PERS policies, the "double rate collar" – allowing a 6% biennial jump – is basically "locked in" for 2011-13. As for 2013-15, Mercer estimated in May a "90-95% probability" for a second, 6% bump. And at 50% probability, when did Mercer in May predict a return to OPERF funded status of at least 80%? Not until 2024.

# # # #

The two biggest players in Oregon's PERS system are the state government – with a combined payroll for 2009-11 of about $4.6 billion – and Oregon's almost 200 K-12 school districts (Combined payroll: $6 billion). The hundreds of other local government entities like cities, counties, community colleges, and other special districts account for the remaining public employer payroll, of about $5 billion. [19]

The dizzying complexity of the PERS system cannot be underestimated. Many of the state's public employers stand alone; others combine in certain kinds of "pools." Many have multiple types of rates, applied to different classes of employees.

Then there are the different classifications of retirees. These fall into three different categories, based on the PERS benefits for which they're eligible.

So called Tier I employees, hired before January 1, 1996, enjoy the most generous benefits, with certain "defined benefits" guaranteed regardless of OPERF market performance.[20]

In addition to 105,000 current retirees, there are another 90,000 Tier I members. About 65,000 are currently working. They – as well as another 25,000 "inactive" Tier I members -- are eligible for benefits once they reach retirement age. For most employees, that's at 58, though for "Police and Fire" employees, eligibility for retirement comes either at age 55, or age 50 with 25 years+ service.

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[19] This "other" sector of some 700 local government units is even more complex than the state/K-12 world. This report doesn't examine this world as closely as state government and K-12 districts. However, many of the same dynamics apply, and it's likely some of these local governments will face even steeper cost hikes due to PERS.

[20] "Defined Benefit Plans" – which are increasingly rare in the private sector – essentially "guarantee" that a retiree's pension will be worth a specific amount, based on key metrics like years of service, final average salary, etc. In contrast, the pension from a Defined Contribution Plan" –e.g. typical IRAs and 401-k accounts –will be entirely based on its market value at the time of retirement.

Even when OPERF plunges in value – as it did in 2008 -- Tier I members receive a guaranteed, annual increase in their retirement accounts. This amount is currently 8%, or the equivalent to what the PERS board has adopted as the "assumed earnings rate." [21]

At retirement, Tier I members' benefits are calculated by one of several methods, and retirees can then choose the best one. In recent years, most Tier I retirees have opted for the "Money Match" method, by which the state "matches" the size of an employee's account, then adds a 2% "Cost of Living" assumption. [22]

Tier II's 80,000 active and inactive members – hired between 1996 and 2003 -- have slightly less generous deals. For example, their normal retirement age is 60, and their accounts aren't automatically credited with 8% annual returns. Still, they have strong guarantees, and like Tier I members, theirs is also primarily a "Defined Benefit" plan, and is eligible for Money Match. [23]

So called Tier III employees – technically, members of the Oregon Public Service Retirement Plan (OPSRP) program --were hired after August 28, 2003 when the PERS reforms went into effect. There are about 45,000 of these members. The defined benefit portion of their plan is significantly less generous than it is for Tier I/Tier II members, and the Money Match is not an option. Far more than their Tier I/II colleagues, Tier III members' benefits at retirement will largely be based on the value of their 401-k-like Individual Account Program (IAP) whose value rises and falls with OPERF's fortunes.[24]

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[21] Many believe – erroneously – that the 8% "Assumed Earnings Rate" is a legal or contractual obligation. It's not, and could be changed by the PERS board. (Indeed, the rate was 5% for 1971-74; 7% for 1975-78; and 7.5% from 1979-88). But were the board to reduce this now 20-year old rate, it would have the seemingly paradoxical effect – at least in the short term – of ***increasing*** the Employer Contribution rate. PERS would need to assume that future investment earnings of OPERF would similarly be less robust, which in turn would require additional Employer Contributions to make up the difference.

[22] The "generosity" of PERS benefits is a fiercely debated topic. For 20 years, PERS has tracked some basic metrics, that are useful to keep in mind. The "average retiree" in 2008 had 21 years of service, and retired with an annual benefit of about $30,000, or 52% of final salary. Retirees with a full 30 years, retired with 80% of Final Average Salary (FAS), and 5% retired with more than 100% of FAS. These numbers have actually drifted down in recent years, driven in part by the 2003 PERS reforms. In 2000, for example, the average retiree with 30 years retired with 100% of final salary, and 16% did so with more than 100% of FAS.

[23] Since the 2003 reforms, all three Tiers are hybrid plans that include, in addition to the defined benefit formulas, a 401(k)-like Individual Account Program (IAP) whose value rises and falls with OPERF's fortunes. For Tiers I and II, the IAP includes member contributions made since January 1, 2004. For Tier III (a/k/a the OPSRP), it includes all the member's contributions.

[24] These statistics and explanations are largely drawn from PERS' very useful July 2009 report, **PERS: By the Numbers.** This publication conveys PERS' many complexities and nuances; for the patient reader it also offers a great deal of useful history and insight into PERS' current challenges.

Another very useful publication, entitled "**Public Employee Retirement in Oregon**, was done by John Taponga of ECONorthwest for the Chalkboard Project and the Oregon Business Council. Published in August 2007 – arguably the flood tide of PERS recent good fortunes – it is eerily prescient in many of its observations about PERS' structural challenges.

# # # #

The potential size of what one observer calls a "PERS Tsunami" is bad enough. Then there's the timing. In a multitude of ways, it couldn't be any worse.

It's widely acknowledged that Oregon's combined 2007-09 and 2009-11 budget crises would have been far more painful, had it not been for the state's ability to use "one time" funds from several sources.

For starters, the state received $1.6 billion in federal stimulus money. Another $230 million went directly to help K-12 school districts. Legislators used another $600 million from Oregon's Rainy Day fund and other reserves. Finally, to stave off even deeper budget cuts for 2009-11, the 2009 Legislature enacted $800 million in permanent corporate and personal income tax increases. These tax hikes will be voted on next January by Oregon voters.[25]

As PERS managers rightly note, pension funds need to be managed with a long-term perspective. Markets rise, and fall; quick, sudden moves often lead to even worse outcomes. Patience -- and sometimes steely nerves -- are required to ensure good, healthy returns over a 10 or even 30 year period. And as PERS managers are proud to note, since 1970 – even factoring in 2008's fall –annualized returns for PERS have exceeded 10%. [26]

Compared to other state pension funds, PERS' situation is also unusually volatile. Each year, OPERF's future obligations increase, and some of that is funded by Employers and employees enrolled in the system. But almost 67% of this additional money historically comes from "investment earnings," on the money already in the fund.

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[25] Were the *permanence* of these tax increases essentially an undisclosed, "PERS Bail-out strategy?"

There is no direct evidence of this, though it's important to recall that major business organizations pledged to support (or not actively oppose) such tax hikes in 2009, ***provided*** they would be temporary, with new revenues used to deal with the current budget crisis. However, the 2009 legislature made may of these increases permanent, with the total package amounting to about $750 million/biennium.

For 2009-11, state government's biennial payroll is about $4.6 billion, and K-12 school support (from state general fund and lottery funds) will amount to about $6 billion. About $5 billion of the K-12 figure will arguably be used to defray personnel costs, which account for 85% of K-12 budgets. Based on these numbers, a 12% required hike in Employer Contribution rates by 2013-15 for just these two sectors alone would require an additional $1.1 billion, approximately $800 million of this in general fund and lottery revenues.

[26] However, PERS also notes that 3 of the 4 "negative years" since 1970 have occurred within the last decade. The "last 10 year" annualized rate of return, including 2008's dive, is closer to 6%. The last 5 year run is closer to 4%.

OPERF is the highest among Western States' pension funds (including CALPERS) in this regard – one reason that Oregon's system is subject to even more sudden valuation ups – and downs – than funds elsewhere. [27]

But the size – and rapidity – of 2011-13's projected rate hikes are also due to PERS' own decisions. In the fall of 2008 –as the global financial world was melting down on a daily basis – the PERS governing board chose to hold fast to its "18 month lag policy." As they set Employer Contribution rates, for 2009-11, they still relied on the $62.9 billion "official valuation" of December 31, 2007 – even though OPERF's estimated value had by then plunged to about $50 billion. Despite this unprecedented economic crisis, they essentially directed state government, K-12 schools, and other public employers to significantly ***reduce*** their rates, and build their budgets accordingly.[28]

Nothing prohibited the state of Oregon – or any of PERS' other public employers --from setting additional funds aside to help fund future rate hikes. If some PERS employers did this, they're in a distinct minority, and they do not include the state of Oregon or major K-12 school districts, cities, or counties.[29]

This collective desire of Oregon's public employers to "limit their budget pain" -- and not make it even worse by diverting scarce resources to shore up PERS -- is not surprising. But far more puzzling is the virtual lack of any explicit public debate – much less action – taken by legislators and other PERS leaders in these last 12 months, in response to OPERF's fiscal free fall.

Had there been, some of the bigger questions would have included these:

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[27] Just how volatile? When Mercer, using 2007 valuation figures, modeled PERS' future in May 2008, it showed virtually flat "Employer Contribution" Rates for the coming decade, including a projected rate of 12%, at 50% probability for 2017-2019. Its 5% "worst, worst" case scenario predicted a 29% rate. By comparison, the May 2009 model at 50% probability showed a 2017-2109 rate of 31%; the September 2009 update a 2017-2019 mid-point probability rate of 24.

Any pension fund's volatility also depends on the actual mix of investments. As noted earlier, certain investment classes (e.g, private equity and REITS) are subject to more variability than, say, stock index or bond funds. While the PERS governing board sets the general "mix", the actual execution of the investment strategy is the responsibility of the Oregon State Treasurer, through the Oregon Investment Council (OIC). An earlier Mercer study found that notwithstanding OPERF's potential volatility, the fund was not invested "more conservatively" than those in 13 other Western States with less volatility. Indeed, there was no such pattern among any of the Western states studied.

[28] Such an 18 month "lag policy" isn't common practice in the pension world, and Mercer in 2008 specifically recommended that PERS discontinue the practice and set rates based on more recent information. PERS did not adopt the suggestion.

[29] In some K-12 districts, *the opposite* actually seems to have happened. Despite the severe recession and budget crises, some districts succumbed to pressure from both employees and parents, to dip into existing reserve funds. This has helped reduce lay-offs, and in some instances have helped finance pay ***increases*** negotiated in 2009 contract talks.

What happens in 2011-13, when these unwelcome PERS bills come due – and there's no second round of federal stimulus cash waiting in the mailbox? And meanwhile, what if the state's 'reserve fund" cupboards are also bare? In a major economic rebound, perhaps some of these costs can be "absorbed" amidst increased revenues – though at the expense of funding other programs. But in a flat – much less declining – economic scenario, the budget hole will be truly daunting.[30]

What additional cuts, in basic public services, will need to be made simply to feed the growing appetite of the PERS system? And what if the "economic recovery" that everyone is banking on – including both the May and September 2009 Mercer studies – stumbles, falters, and perhaps even suffers a serious relapse during the next decade? [31]

# # #

On the other hand, couldn't PERS' fortunes reverse as quickly as they've tanked? Couldn't another stretch of robust market growth over the next 3-5 years restore most – if not all – of PERS lost fortunes, and return the Employer Contribution Rates to their more manageable, historic levels of 9-12%?

These are good questions, too. And as PERS managers are quick to note, Mercer's May 2009 report was based on OPERF's estimated value as of March 31, 2009 – which literally was at the bottom of the market.

Mercer's modeling exercise started with an assumption that 2009 would end with a 3% annual loss for the OPERF account. This "assumption" will likely prove wrong, given that OPERF is currently up by about 9% for the year, through August 31, 2009. While OPERF certainly could drop in the next three months, it's also possible OPERF's value could increase even more by December 31, 2009, when the next official valuation occurs for setting future PERS rates.

Indeed, this is the first answer that PERS officials and others give in response to the dire predictions within the Mercer report. These are only "modeling exercises," they note,

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[30] For state government, there's also the quite "inconvenient" issue of the State's kicker law. Under this law, much of the additional revenue generated by any strong economic rebound – should it occur – would not be available for spending, but instead be slated to return to taxpayers under Oregon's "Kicker" law. "Kicker reform" is a contentious issue under the best of circumstances. Proponents likely won't relish fending off accusations that a major motive would not be to fund additional programs like schools, health care, and jobs – but to divert most or all of such one-time money to shore up PERS.

[31] Even Mercer's "more pessimistic" May 2009 report essentially models a return to much happier days, at least in terms of real investment returns, after 2009 is over. For example, in 2010, the "Annual Asset Return" rate is modeled to rebound to 7%, and basically stay between that and 9% for the next 20 years.

The September 2009 report only models 3 growth scenarios, all of them positive; the most negative of them still shows 4.5% annual growth. In contrast, the May 2009 report modeled a 0% annual growth rate (at 25% probability) and a -8% annual growth rate (at 10% probability) – though it also modeled even higher growth rates as well.

based on a multitude of assumptions, not just about the economy, but about the continuation of existing policies and practices that the PERS Governing board could change. And just because something could happen, doesn't mean it will. Indeed, PERS has plenty of experience with the "future" playing out much differently than expected, and in both directions.

All of which is true – but here's the problem. Even assuming a "Third Great Run" of 25% annual returns for PERS over, say, the next 5 years -- essentially, the "Best 10% Case Scenario" that Mercer also modeled in May 2009 – the Employer Contribution rate by 2017-19 would still need to be close to 20% – *nearly double historic rates* for most of PERS' history.

In recent weeks, a second potential response has also emerged: change PERS' model to reduce the sudden impact of these rate hikes. The concept is known as "rate smoothing" – and would be based on the assumption that the 2008 event was so severe – and so unlikely to recur in the foreseeable future – that its full impact should be "smoothed out," not over the next biennia or two, but over the next 10 years (or more).

The most likely mechanism to accomplish this change would be to abolish PERS' existing "double rate collar policy." That is, even if OPERF's funded status drops to 80% or less, biennial increases would be limited to just 3%, not 6% as is currently assumed.

The September 2009 Mercer report modeled exactly this scenario, using 3 assumptions: 10.5% annual growth; 8% annual growth; and 4.5% annual growth. At the "middle scenario" of 8% annual growth for the next decade in OPERF valuations, Mercer concluded that retaining the 6% "double rate collar" policy would produce a funded status of 74% by 2017-19. By limiting biennial increases to 3% for the next decade, the funded status would be 71%.

Reducing the next 2 – if not 3 – 6% biennial rate hikes would certainly prove popular among public employers struggle to meet a host of other obligations. But several things are worth noting.

PERS already uses a "rate smoothing" strategy. This is precisely what the "rate collar" -- double, or not - is. PERS's existing policy – which was adopted by the board in 2004, and is not set in statute – already limits increases that otherwise would be significantly higher. So the real issue isn't whether to adopt rate smoothing, It's whether to smooth rates out even more, over a longer period, by further modifying existing policy.

More "rate smoothing" would, by definition, "push into the future" potentially even higher increases to help restore PERS' long term health. And arguably, some of the increases now on the horizon are there because past PERS boards decided to do the

opposite – to artificially reduce Employer Contribution rates, too much and too quickly, during relatively good times.[32]

Any rate smoothing policy – double collar or no – also raises issues of generational equity. Just what obligations should future taxpayers bear, to ensure that today's – and indeed, yesterday's – public employees receive the pension benefits they've been promised by current (and past) policy makers?[33]

Indeed, the "gains now/pain later" approach arguably underlay the first PERS crisis of 2003, not to mention the 2004 decision to adopt a rate collar. Recall that without a rate collar, the 2011-13 base employer Contribution rate would be 22%, not 18%.

Additional rate smoothing would also leave the PERS fund that much more vulnerable, even if only a relatively minor "after shock" hit financial markets in the next few years.

Mercer's September 2009 report used as its most pessimistic scenario a 4.5% annual growth. Even with the double rate collar in place, PERS' funded status would slip to just 59% by 2017-19; limit hikes to 3%, and it falls to 51%. Based on its May 2009 report, Mercer pegged the probability of worse performance than 4.5% positive growth at greater than 1 in 3. [34]

But assume PERS policy-makers essentially decide that a 70% funded rate (or even lower) could be tolerated, since it's a level that admittedly is now common with many other state and local government pension funds around the country?

Oregon wouldn't just lose bragging rights among its pension fund peers for PERS' exceptional performance. Such a "new normal" would have direct costs. In the past, when the state of Oregon has sold bonds to borrow money -- for capital construction, road improvement projects, etc -- it touted OPERF's exceptional funded status to help reduce those costs. Lose that edge, and Oregon state and local governments start paying higher interest costs every time they borrow money.

Finally, should PERS decide that a funded status between 50 - 70% is tolerable, even for long periods of time, it would further underscore a very uncomfortable truth at the heart of the PERS system. At anything less than 100% funded, there's danger that PERS will be unable to meet its full legal obligations to existing and future retirees. In such an

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[32] Again, recall that for 2009-11, PERS actually lowered Employer Contribution rates, from 15% system-wide in 2007-09 to 12% for 2009-11. Throw in the "Side Account discount" rate, and the ***net*** Employer Contribution rate for 2009-11 of just 4% is one of – if not the lowest -- in PERS history.

[33] According to PERS, almost 40% of funds generated by the "Employer Contribution" rate – now, and in the future – will go to fund the obligations of public employees who are *already retired*.

[34] PERS Director Paul Cleary is quoted in the October 1, 2009 Oregonian story by Ted Sickinger this way: "If we're staring off at a new normal, we've got problems…Our business model doesn't work with 4.5% returns."

instance, state and local taxpayers would be obligated to make up the difference – above and beyond what they already pay via the Employer Contribution rate.

# # # #

The discussion until now has focused exclusively on the primary driver of PERS costs – the "Employer Contribution" rate. But from a taxpayer's perspective, what's the total cost of the system – what' we'll call the "Total PERS-Related Obligation" (TPRO) – now and for the foreseeable future?

For all its dizzying complexities – of which we'll examine a few more in the pages that follow -- PERS boils down to a basic cost of doing business. Government entities deliver a wide range of services. Most are delivered by hiring people to do certain things – patrolling streets, educating children, providing health care, paving roads, enforcing environmental laws, running prisons, and so on.

All employers -- state and local governments included – have costs beyond salaries when they hire and employ people. These include Social Security, unemployment, and worker's compensation taxes. They typically also include the costs of providing employees with health insurance and other benefits. In many -- though not all – cases, private employers also contribute to employees' retirement funds – though typically this means a "401 (k) matching" program.

Some of these costs – e.g, the 7.65% of payroll combined FICA taxes for Social Security and Medicare, and levies such as unemployment taxes – are paid as a fixed percentage of payroll. In other cases, they are fixed amounts. For example, an employer might decide to pay $400/month for each employee's health care, regardless of whether the employee makes $20,000 annually or $50,000.

However, for budgeting purposes, it's common to blend together all these costs – variable and fixed – and translate them into a percentage of overall payroll. Employers then set aside these funds and disburse them to the proper recipients (e.g. the Social Security Administration, state unemployment fund managers, health insurers, or employees) to ensure their total obligations are met.

Just like private sector employers, government employers must do the same. They, too, must pay FICA and unemployment taxes. They, too, can decide whether – and then, how much – health insurance and other benefits to provide to employees.

So PERS is simply one of these costs of doing business, though exactly how much an employer pays obviously can vary dramatically.

Here's how the core part of this system works:

Each fall of even-numbered years, the PERS Board sets Employer Contribution rates for all participants. These rates are based largely on the previous December's OPERF valuation. However, they also take into account a host of other variables, including actuarial assumptions, actual experience with retirement rates, etc. [35]

Again, each of Oregon's 887 PERS Employers has its own, specific Employer Contribution rate. But for illustration purposes, let's assume an entity has a $100 million annual payroll, and their Employer Contribution rate for a biennial (two year) period is set at 12%. Each year, they will owe PERS $12 million. If the rate moves up to 18%, their obligation also increases, to $18 million a year.

But to understand PERS' total impact on the public purse, it's important to recognize that the "Employer Contribution" is just the most visible tip of the PERS iceberg. There are two other major components to the PERS picture, both of which are not well known or even well understood. While one of them has actually decreased PERS costs in the short term, in the years ahead, both of them could likely *add even more costs to PERS,* relative to today's situation.

The first is known as the "*Employee* Contribution pick up." This is the long-standing practice of many jurisdictions to use their own (read: taxpayer) funds to pay for what is officially the "employee" contribution to the fund.

By law, employees participating in PERS are required to contribute 6% of their paychecks to PERS. So when the public employer decides to finance this cost, this amounts to an additional 6% of payroll, now borne by taxpayers.

Contrary to widespread perception, the 6% pick up is *not* required by state law. State government has decided to "pick up" 100% of this cost. However, many large K-12 school districts– e.g, Portland, Beaverton, and North Clackamas – don't pay this 6%, while others do (E.g. Salem and Tigard-Tualitan).[36]

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[35] The fall of 2010 may prove the most important rate-setting moment in recent PERS history. Using the December 31, 2009 valuation – which will be known far before then – PERS is scheduled to decide just how much Employer Contribution rates will need to be increased for the 2011-13 biennium.

[36] Most K-12 districts that no longer pay employees' 6% contributions have largely done so through collective bargaining agreements with their employees. The ostensible trade off: employees get higher pay and other benefits – e.g, health insurance – in exchange for financing their 6% pick up out of their own paychecks.

So do teachers in districts without the 6% pick up get commensurately higher pay? This isn't quite so clear, at least based on an admittedly cursory analysis. For example, according to a 2008-09 salary survey by the Confederated Oregon School Administrators (COSA), the Salem and Redmond school districts pick up the 6% -- and pay a teacher with 12 years' service and a Master's Degree $38,903 and $39,191, respectively. North Clackamas and Albany don't pay the 6% -- and such teachers earn only $36,758 and $36,144 respectively.

Since the PERS reforms of 2003, all "employee" contributions have actually gone into separate, Individual Accounts – called IAPs. (Prior to that, these funds also went into regular PERS accounts, where they were

The state of Oregon first "picked up" the 6% Employee Contribution in 1980, when then-Governor Vic Atiyeh agreed to the change in collective bargaining negotiations, in lieu of giving state employees the raises they were demanding amidst a bad recession and double-digit inflation.

This provision has been in every state collective bargaining agreement since then -- including the one negotiated by Governor Ted Kulongoski and ratified by the state's major public employee unions after the close of the 2009 session. For the 2009-11 biennium, this "pick up" across state government's $4.6 billion payroll will amount to almost $300 million – and will actually exceed the amount paid through the net Employer Contribution rate, of about $150 million.

# # #

The third major component of PERS is a bit more complicated, and involves the seldom-discussed – and admittedly, somewhat arcane – world of "Pension Obligation Bonds." This will take a little explanation, so be patient.

Between 2002 and 2005, the state government – and more than 125 K-12 school districts, ESDs, and local government units – sold about $6.4 billion in Pension Obligation bonds. At the time, PERS was still widely considered to be in peril. Even with the 2003 reforms that advocates said would significantly reduce the trajectory of future costs, the Employer Contribution rate was still expected to increase dramatically.

The thinking went as follows. What if Public Employers borrowed money at then-quite favorable interest rates – about 5.5% -- and invested the proceeds in OPERF, whose investment returns over 30 years -- even after various market ups and downs – had still averaged a more than 10% annualized rate of return?

Most of these pension obligation bond proceeds were invested directly in OPERF, and are widely known as PERS "Side Accounts." [37]

Between 2002-2005, the state of Oregon sold about $2.1 billion of these Pension Obligation Bonds (POBs), while a consortium of about 90 K-12 school districts and Educational Service Districts (ESDs), sold about $2.6 billion. Most community college districts – and a smattering of cities and counties -- also sold bonds during this era, and a few additional K-12 districts decided to participate in 2007.

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guaranteed to grow by 8%, regardless of market performance. If an employee pays their own 6% contribution, the amount is not subject to taxation.

[37] Some pension bond proceeds were used differently by the state and some local governments, to "buy down" specific liabilities. However, they're not discussed here because their impact is both complex and relatively minor for purposes of this discussion..

This was a classic "arbitrage" strategy, to use the expected net proceeds– in the long run, of course -- between gains and costs to essentially "buy down" the otherwise steep hikes that were expected in Employer Contribution rates, even with the 2003 reforms.

Though there certainly were risks, it wasn't necessarily a bad strategy. Most advocates were careful to urge participants to set aside reserve funds to cover "down years," and to be modest in their expectations. Projections done at the time, based on PERS' assumed annual earnings rate of about 10%, suggested the "net effect" of this strategy would be a reduction of total costs to participants equivalent to about 2-3% (of payroll). [38]

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Between 2002 and 2007, OPERF's valuation shot up by a remarkable 90%. So, too, did the value of these side accounts. During these initial years, the Side Account strategy wasn't just considered successful. Like so much else in the world of investing, it looked like a staggering act of financial genius. [39]

Those who placed the biggest bets on Side Accounts looked especially astute. For example, the Portland School District sold about $490 million of these bonds. By 12/31/07, the value of its Side Account was $786 million. And this was *after* PPS had regularly used a portion of earnings to "buy down" its Employer Contribution rate.

How much did it help? For 2007-09, the base Employer Contribution rate for PPS was over 17%. With side account earnings, the district was able to buy down the effective rate to almost 0%. For 2009-11, PPS' 14% Employer Contribution rate is also expected to be "bought down" to close to 0%, courtesy of side accounts whose contributions will be based on the December 31, 2007 valuation.

The state of Oregon's pension obligation bond strategy was less ambitious, but the effect has still been significant. For 2009-11, its base "Employer Contribution rate was pegged at 13%. But its Side Account allowed a "buy down" of about 10% of payroll, producing a *net* Employer Contribution rate of just 3%.

However, Side Accounts are not "free money." Like a home mortgage, pension obligation bonds are loans that must eventually be repaid, with principle and interest.[40]

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[38] While it's tempting to second guess the Side Account strategy, it was based on widely shared assumptions at the time that extended far beyond the public sector. And in comparison to sub-prime mortgages, securitized debt swaps, and other financial exotica that brought America's financial system to its knees a year ago, this basic arbitrage strategy was a relatively tame variant..

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[39] An analysis by the consulting firm ECONorthwest, published in August 2007 amidst a series of 20%+ investment gains, also illustrates how seductive these bonds appeared. At a "high growth" scenario – essentially, a continuation of then-existing return rates of 20% or more– it concluded that some K-12 districts would build up such large surpluses, they could repay all their PERS bonds (with interest) and then for several years simply draw down their remaining surpluses to meet their PERS obligations.

[40] To offer a more precise metaphor, the Side Account strategy was not unlike those who took out home equity loans at 6% interest during the boom years, and then invested the proceeds elsewhere in the hope of 10% or even 25% annual returns for the foreseeable future

So the real test of the Side Account strategy isn't simply the positive effect of reducing PERS Employer Contribution rates. It's ultimately the "net benefit" to employers, after both the "buy down" effect *and* the costs (bond repayments) are factored in – and not just in today's world, but over the entire life of the bonds, most of which won't be fully repaid until between 2025 and 2028. [41]

So for illustration purposes, let's use the Portland Public Schools. For the 2009-11 school years, side account proceeds are scheduled to be used – once again – to reduce the effective rate (now 14%) to 0%. However, bond repayments costs for 2009-11 will be $63 million, or roughly 11% of projected payroll.

So for 2009-11, even though PPS "virtually eliminated" its 14% Employer Contribution rate, its *net* Side Account benefit is roughly 3%. What happens in 2011-13? While PPS' base Employer Contribution rate is projected to go to 20%, the ability of the Side Account to discount that rate will plummet also. (Just how much, has not yet been determined). [42]

Meanwhile, what about PPS' bond repayments? They will *actually increase* to about $71 million for 2011-13. And by the 2019-21 biennium, they will amount to more than $106 million.

This is a very important – and little known -- aspect of the PERS Side Account world. And unlike even the Employer Contribution rate – whose amount could literally fluctuate, even a lot, depending on economic circumstances – the bond repayments have become the fixed, new baseline for those PERS employers who decided to embark on a Side Account strategy.

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[41] One might think that tracking current and projected Total PERS-related costs, including the net effects of pension obligation bonds, would be relatively easy. Such a rate would include the base Employer Contribution rate, the amount (if any) by which "Side Account" earnings reduce that rate, the bond-repayment costs (if any), and government paid "employee contributions" (if any).

However, PERS does not keep track of employer-paid employee contributions, nor does it tally (or project) the net cost of pension obligation bonds. Instead, it directs inquiries back to individual employers – e.g, the state and school districts.

However, PERS sometimes *does* count the value of these Side Accounts when discussing PERS' overall health. For example, in an August 2009 publication PERS uses a *Forbes* magazine chart from February 2009, listing each state pension fund's "Asset to Liability" ratio. Oregon's rate was pegged at 82% -- literally making it appear as the nation's "healthiest system." The assets of the Side Accounts are included here; what's missing are all the liabilities associated with them, whose values technically lie on the books of individual government entities. Without this "bump," Oregon's ratio falls to about 71%

[42] The official, 12/31/08 valuation for PPS' side account will be released later this fall. However, it's widely assumed that the number will now be less than $600 million – still above the original value, but a loss of more than $150 million in a single year.

With a conventional homeowner mortgage, there are regular and uniform payments each month, over the life of the loan. And as homeowners know, far more money ultimately is repaid in interest than in principle.

In contrast, Pension Obligation Bond repayments were structured so that they start low, and then increase over time. The specific repayment terms vary by jurisdictions, but for the state of Oregon, the built in increase amounts to about 8% each biennium. Thus, for 2009-11, the POB repayment line in the state budget was about $265 million. For 2011-13 it will be $288 million, and so forth.

A similar situation exists with the approximately 96-member K-12 school district pool. Collectively, these districts will re-pay about $350 million in bond costs during the 2009-11 biennium, apportioned to each member by size and timing of the bond issuance. By the 2025-27 biennium, when most of the bonds are finally paid off, total payments will have risen to $735 million. [43]

This structure was implemented on the assumption that total government payrolls would continue to increase each biennium. The expected result would be to "hold constant" these fixed payments <u>*as a percentage of payroll*</u>. [44]

An earlier Mercer report published in May, 2008 -- during much sunnier times – reviewed the Side Account strategy, and even modeled the possible scenario of <u>*significantly increasing*</u> their use across the system.

Noting that these bonds were largely sold towards the bottom of a fast-escalating market, Mercer observed that the "timing was close to perfect," and the result was "significant gains… and significantly lower expected long term pension costs."

But as Mercer went on to note – quite presciently, it's now apparent -- "Risks remain, and the ultimate results may be different… In the next few years, the payments on the pension obligation bonds may exceed what would have been required to be contributed to PERS without a side account."

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[43] As homeowners also know, interest costs add up over the life of a 25 or 30 year loan. For example, participating K-12 districts are currently scheduled to repay $2.6 billion in POB principal, and another $2.9 billion in interest costs.

[44] Contrast this to conventional home mortgages. A homeowner who pays $2,000 a month – but whose income rises at, say 4% annually -- will see the portion of income devoted to housing costs drop over time

The economic "logic" behind many sub-prime and variable rate mortgages of recent years was that future, much higher payments could be handled because incomes would continue to rise, and/or rising equity values would allow future re-financings.

The 2008 Mercer report also made another important point: that because of how these bonds were structured, "the reward for any additional gains will be deferred many years into the future, while the impact of losses may be felt in a shorter timeframe."

Such a "reversal of fortunes" is precisely what now appears to have happened. Since the bonds must still be repaid, the ability to use proceeds from these Side Accounts to "buy down" the Employer Contribution rates have diminished quickly, and dramatically. Meanwhile, the repayment costs of these bonds are slated to significantly increase – on a fixed, inexorable schedule, regardless.

This strategy also raises a host of other questions. What if payrolls don't keep up? What if significant reductions occur in the size and workforce of government – forced perhaps by major budget cuts, or even by escalating PERS costs that put a damper on new hiring patterns?

Then, as a percentage of overall payroll, the costs of financing these bonds will actually go up even more. Meanwhile, their ability to "buy down" the Employer Contribution rates will likely move in exactly the opposite direction. Not unlike a homeowner with a $200,000 mortgage, and a house now worth only $150,000, public employers may soon find themselves "underwater," with few good options. [45]

For example, Mercer's 2009 modeling exercise shows that – again, this is across the entire system; individual results will vary – the overall Side Account "buy down effect" would be about 8% for 2009-11. By 2011-13 it will be about 5%. For many public employers, the benefit of these Side Accounts next biennium will be roughly equivalent to -- and for some, even less than -- the cost of repaying these bonds.

# # # #

So add it all up – the Employer Contribution, the Employee pick up (where applicable) and the benefits (and costs) of Side Accounts (where used). . What does the "Total PERS Obligation" for the state of Oregon– and other major public employers – look like today? And how might it change over the next few years?

For illustration purposes, let's first look at state government, with a payroll for 2009-11 estimated at about $4.6 billion

For 2009-11, the state government will need to set aside about **<u>$15 for every $100</u>** in payroll to meet its PERS-related obligations. This breaks down as follows:

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[45] Timing matters with POBs – in some cases, a lot. Those who sold their bonds in 2002-03 – and then invested the proceeds at the "bottom" of the market, like Portland Public Schools – are largely still in positive territory, with valuations in excess of the original cost.

In contrast, those whose bonds sold in 2005 or even 2007 – when 8 relatively small school districts including Banks, Coos Bay, David Douglas, Willamina, and Tigard-Tualitan – are probably already "underwater," and potentially may be able to contribute nothing to buying down their Employer Contribution rate to ensure they can repay bond costs.

- A “*Net”* Employer Contribution equivalent to about **3%** of total payroll. This is based on a starting “Employer Contribution Rate” of about 13%, then offset with proceeds from the state’s PERS Side Account that amount to the equivalent of 10% of payroll. (Remember, both the base Employer Contribution rate, and the size of the Side Account contribution, is based on valuations of 12/31/07);
- **6%** of additional payroll, to pay for the agreed-to “Employee pick up”;
- The equivalent of almost another **6%** of payroll to repay its Pension Obligation bonds.

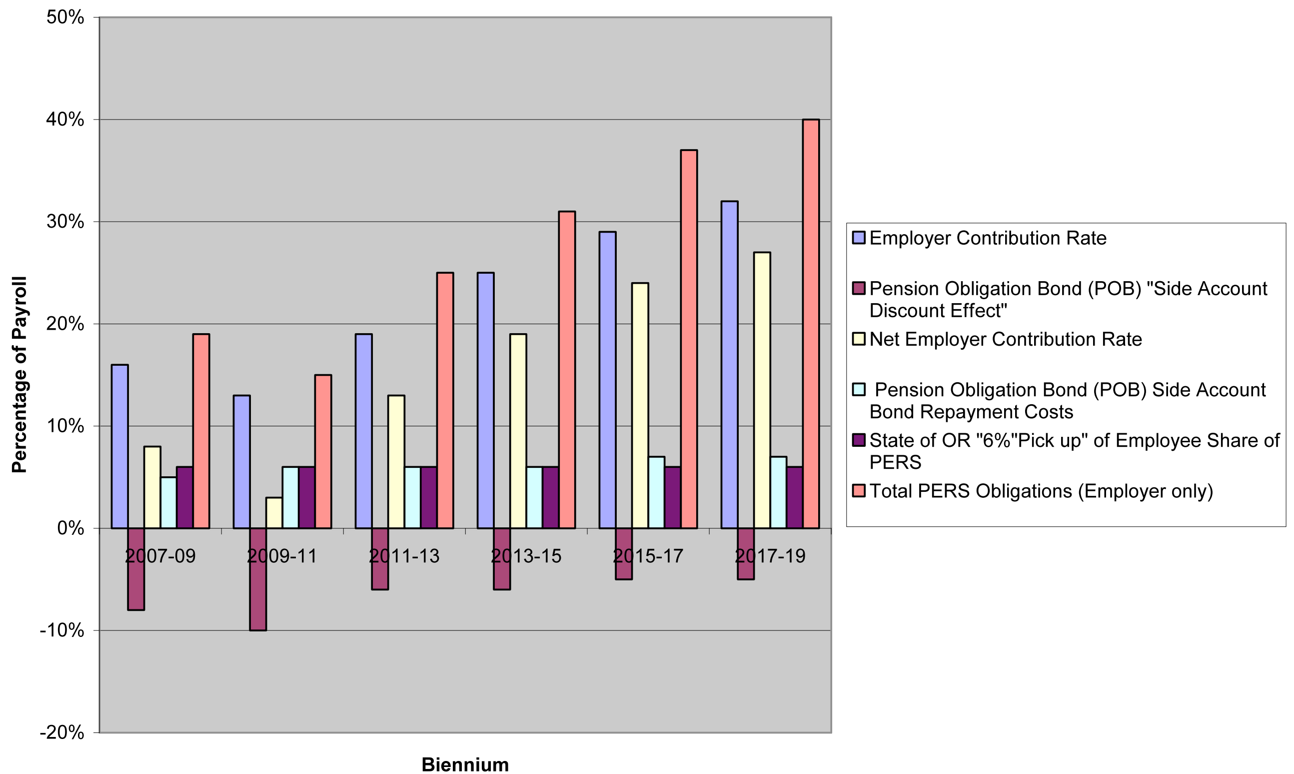
What’s the picture for the next biennium, 2011-2013? For 2011-13, the state government will need to set aside about **$26 for every $100** in payroll to meet its PERS-related obligations (again, assuming the continuation of current policies and practices). This is projected to break down as follows:

- A “*Net* “Employer Contribution equivalent to about **13%** of payroll. While the state’s base “Employer Contribution Rate will jump 6% to an estimated **19%** -- the Side Account offset will only be an estimated **6%**, due to the plunge in Side Account valuations. (CK)
- **6%** of additional payroll, to continue to pay for the “Employee pick up”:
- The equivalent of almost **7%** of payroll to repay Pension Obligation bonds. [46]

On a payroll of about $4.6 billion (CK), the difference between a 26% rate and a 15% rate is about $500 million extra needed in 2011-13 (vs 2009-11) -- for state government alone.

The chart below illustrates this situation for State Government:

[46] Note that this assumes the “6% rate collar” will remain in effect. Without the collar, and using Mercer’s 2009 report, the total PERS-related obligation rate in this example would be more like 30% of payroll in 2011-13, compared to 15% in 2009-11.



Note: The September 2009 Mercer report showed almost identical trends through 2013-15, then leveling off in 2015-2017. Data for 2007-09 and 2009-11 based on actuals; other data based on May 2009 Mercer report. For 2011-13 and beyond, the POB/Side Account "discount effect" for this chart and the one that follows is estimated based on Mercer's projections of "system-wide" changes in this rate, while POB/Side Account repayment rates as a percentage of payroll assume slower payroll growth than 3.75% annually.

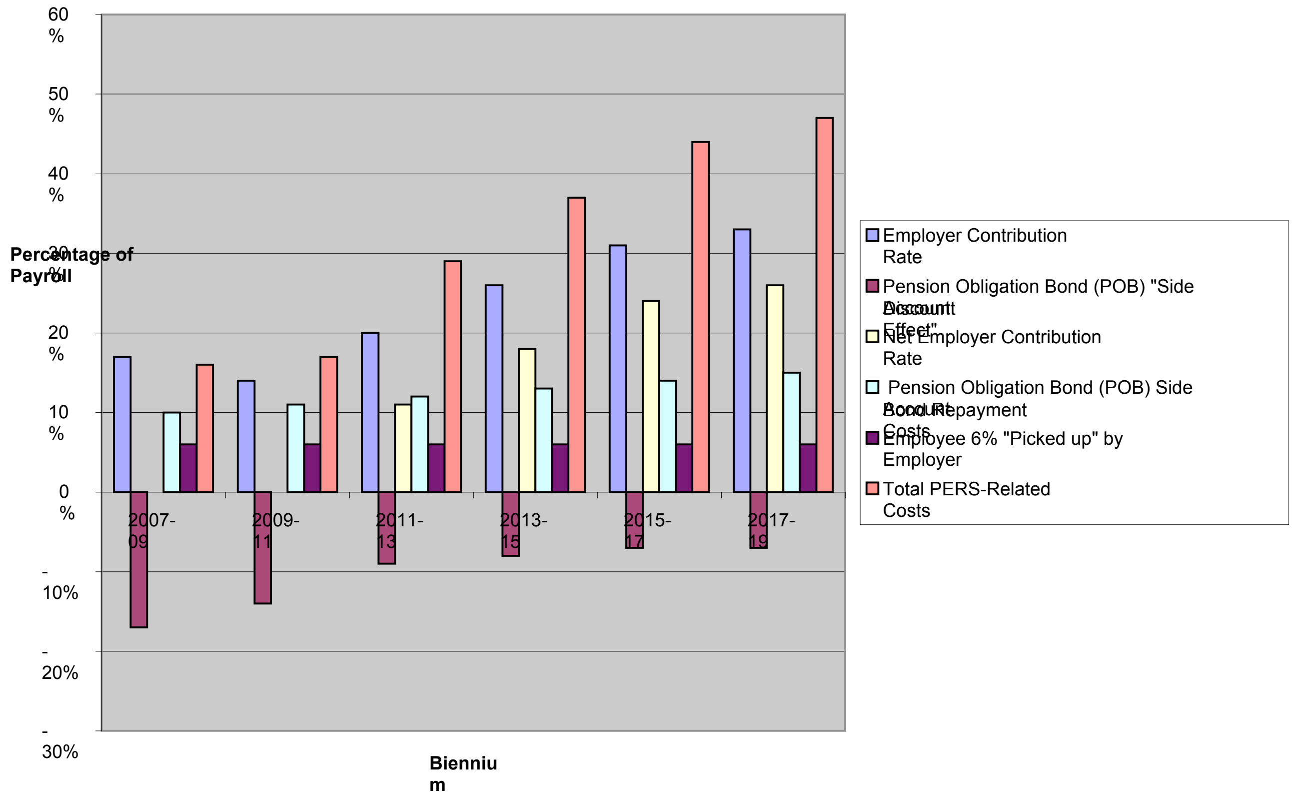
What about the expected jump in Total PERS Obligations for K-12 school districts? This isn't just important to local taxpayers; it's also highly relevant to state legislators, since Oregon's general fund now pays for about 65% of K-12 costs. [47]

Consider a K-12 School District that still picks up its employees' 6% share – and which also went "long" with Side Accounts. While its 2011-13 Employer Contribution rate will jump 6%, from 14% to 20%, the ability of its Side Account to "buy down" this rate will be dramatically diminished. Meanwhile, its bond payments will escalate, perhaps against a static (or even shrinking) payroll, due to wage freezes and/or staff lay-offs.

For such a K-12 district, as the chart below illustrates, it's not inconceivable its Total PERS Obligation could rise from 16% to almost 30% of payroll for 2011-13 -- and even

[47] As noted earlier, in 2009-11, an estimated $6 billion –almost 50% of the state general fund – will go to K-12 districts. About 85% of that money will help finance personnel costs – salaries, benefits (and yes, pension obligations) for teachers, administrators, and other personnel.

to beyond 40% by 2017-19, should Mercer's May 2009 scenario (at 50% probability) occur.



In the K-12 world, every 1% increase in pension costs has an impact of about $60 million per biennium – virtually all of which must be financed with property taxes or state general fund/lottery dollars. A jump from an effective rate of about 16% of payroll – 6% pick up, plus, say, 11% in bond repayments – to 33% (6% pick up, 12% in bond payments, 15% in net Employer Contribution rate after Side Account discounts) would translate into an additional $1 billion.

And again, this is just for 2011-13, compared to 2009-11. As Mercer looked beyond 2011-13, it saw at least _two more likely rounds_ of Employer Contribution rate increases in the neighborhood of 6% of payroll, for all public employers. And across the entire system – remember, $16 billion in payroll now, supposedly getting higher each biennia – each 6% hike translates into roughly another $1 billion. [48]

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[48] PERS related costs, as a percentage of payroll, are just one component of what's often referred to as "Total Compensation Burden." In the private sector, payroll-related costs for FICA (Social Security and

# # # # #

Of course, the future is inherently unpredictable. As noted above, the conclusions of the May 2009 Mercer report are based on a "modeling exercise," that relies on dozens of assumptions and scenarios. Almost as soon as such a model is built and run – and as PERS officials note, Mercer literally ran theirs around the March, 2009 low-point of the market – reality changes.

And things have definitely gotten better in the last 6 months, as PERS officials are quick to point out. For example, the S and P has risen almost 50% since its March low point, and now stands about 30% higher for the year to date. PERS officials are right to note that should OPERF rebound significantly – and then "get back on track," growing at annualized rates of 8% or more for the foreseeable future – actual Employer Contribution rates will be less.

And who would wish otherwise? After all, a rising market will be nice for everyone with pensions, including private citizens and their 401 (k)'s.

However, it's also possible that the current market rebound could stumble, and things could play out *worse* in the next 5 years than even Mercer's 50th percentile scenario. Indeed, what happened in 2008 wasn't even on Mercer's radar screen as a 5% probability – but it happened.

And what if 2008-09 wasn't just an air-clearing "thunderstorm," but the opening act in a generation-defining re-ordering of America's and the world's financial markets? What if the market rebound of the last 6 months suddenly gives way to another plunge – the so called "W" scenario as opposed to the rapid "V' shaped recovery everyone would certainly hope proves true?

So some skepticism is certainly warranted. But skepticism can – or at least should – go both ways. One cannot extol the virtues of a model – and make decisions based on its sunny projections in good times, as the PERS board has done with previous Mercer reports – and then disclaim its applicability when a far bleaker picture emerges. And at

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Medicare), unemployment tax, workers' compensation, health care and other benefits, and pensions or 401 (k) matching (when provided) --typically run an additional 25-35% on top of salary.

In addition to being obliged to pay most of the same government taxes, the public sector's health insurance costs are worth noting. For state employees and many K-12 districts, these policies often have no co-pays, and typically cover – at no or little additional cost -- all members of an employee's household. For 2009-11, these policies will cost about $12,000 per employee, or 24% of payroll on an annual $50,000 salary.

Combining all costs, many Oregon public employers in 2011-13 will have a **total burden of 60-70%,** which may then rise to **almost 80%** in subsequent years. In terms of the total public employee burden rate, his could put Oregon's public employers close to – if not at the top of – jurisdictions in the U.S.

any given moment, policy makers have to rely on *some* version of a future reality – and then carefully adjust and re-calibrate as events dictate.

# # #

And finally, what should – or even can – be done?

In 2003, the fight over changes to the PERS system – especially with relation to benefits – was fierce and contentious. There's little reason to believe the dynamics would be profoundly different in the years ahead. It's also important to understand there are significant legal constraints, to what is even possible.

I am not a pension expert, so will not attempt to make my own specific recommendations in this very complex field. (I do offer, however, in Appendix A, a sampling of some of the ideas that I encountered in the course of doing this report.)

But no matter the merits of particular ideas, few would disagree that examining a full range of possible options -- no matter how contentious or politically sensitive – is vastly preferable to doing nothing. As a business colleague is fond of saying, "In difficult times, "Hope" is always a comforting refuge– but should never be confused for an actual strategy."

Even if this potential Category 5 financial hurricane suddenly veers out to sea, it won't be because those stationed on deck focused their energies on humming in unison to Willie Nelson's "Blue Skies." Or as one PERS staffer wryly observed, "If you don't come into the office every day, convinced that our best days are still ahead of us, this isn't a place you want to work, especially now."

Oregon's best days may yet indeed be ahead. But if Oregon policy makers are unable or unwilling to curb the PERS system's potentially unbridled appetite for more and more of our scarce resources, that exactly the kind of future we may never have the chance to truly see.

Appendix A – Possible PERS Changes

So, what is to be done? Perhaps just as important, what even *can* be done?

To date, these questions seem to have gone virtually unasked – at least in any meaningful public setting – by those who oversee PERS, including the Governor, state legislators, PERS board members and staff, school and local government officials, and public employees and their unions.

Many of PERS' current problems are inherently structural and difficult to change, both for policy and political reasons. There are also important legal constraints. Certain possibilities that some might want to explore have essentially been ruled "off limits" by the courts – most notably the "contractual promise" to Tier I PERS members of guaranteed returns equivalent to PERS' "Assumed Earnings Rate," which is currently pegged at 8%.

What follows are some of the suggestions – in no particular order – made by those I interviewed, who either oversee or have closely observed the PERS system in recent years.

Should the state – and other jurisdictions – continue the practice of the 6% pick up?

When existing labor/management contracts are renewed – or re-opened -- this could be a topic for discussion and possible change through the collective bargaining process. Or, state law could address this issue, either by setting limits on the practice, or prohibiting it outright. In either case, other arrangements could include eliminating the pick up -- outright or in exchange for other benefits – or something like a 3%/3% "matching" program.

Such conversations could be timely as early as this spring, should the two tax measures scheduled for a January 2010 be defeated by Oregon voters. This would create a $700 million hole in the 2009-11 state budget, with large "ripple effects" down through K-12 and local governments. Additional lay-offs and/or pay reductions could result, which could also require the re-opening of various labor contracts.

Should the Legislature simply abolish the Employee Contribution, period?

Current state law actually requires an "employee contribution." During contract negotiations, for example, the 6% "pick up" is often discussed in context of this statutory provision – i.e, "If it's required by the state, then it's logical for the state to pay for it."

As noted earlier, many employers do not pay the pick up. But since employees cannot receive pensions, without contributing, perhaps it should just be left to them to decide whether to put additional money into their IAP account. (Recall that since the 2003

reforms, this is where the Employee share is placed, whether it's funded by the employer or the employee). Employees could then choose how much – of their – money to put into their IAP portions of PERS.

This would not have an immediate effect on PERS' current problems, but it would help change expectations around the 6% pick up, that could result in lower costs (and liabilities) down the road.

Should the state create a "Tier IV" system, whereby new employees' pensions after a future date would be 100% in the form of a Defined Contribution Plan, like the ubiquitous 401 (k)s of the private sector?

It's widely -- but erroneously --believed that Tier III employees hired after August, 2003 have such a plan. They actually have a hybrid plan, which consists of a less generous "Defined Benefit Plan" along with a 401-k like "Individual Account Plan (IAP). Indeed, even Tier I and Tier II employees also now have a "hybrid plan," since their 6% contributions have also been put into IAPs since the August 2003 reforms.

Such a "Tier IV" system would make it easier for PERS to predict future costs, since these retirees' benefits would be based only on actual investment returns. But employers would still need to decide such basic questions as whether to "pick up" some or all of employees' contributions, and whether such plans would be voluntary or mandatory.

Should certain actuarial assumptions be revisited, that might spread out the pain of projected rate hikes over more years?

Some have suggested that pension obligation bonds could be re-financed to longer terms – e.g, 30 years. It's also possible the PERS board could change certain assumptions that would have the effect of spreading future, projected costs over a longer number of years. This could alleviate some of the short-term "rate hike shocks. One way to do that, discussed earlier, would be to eliminate the "double rate collar," which would mean only 3% hikes (rather than 6%) in 2011-13 and future biennia where PERS' Funded Status is below 80%. .

However, such a move would push today's costs into tomorrow – increasing the risk (especially in another economic downturn) that *even steeper* hikes would be needed later in the decade to keep OPERF financially sound.

There's also serious "generational equity" issues with both existing policy – e.g, the rate collar – and any additional changes in this direction. Is it good policy to put additional burdens on future generations of employees (and taxpayers), essentially to finance the unexpectedly high costs of paying for existing and current employees' retirement? Put another way, should tomorrow's taxpayers' level of services be reduced below what they'd otherwise be, to finance obligations made by the previous generation?

Should policies be enacted – either by PERS, the Legislature, or through other means -- that actually run in the ***opposite*** *direction, to force today's employers (and potential retirees) to accept more "pain" today in order to make future increases not quite as severe?*

For example, the current "rate collar" could lifted, or modified to allow even larger hikes, above 6%/biennium. Of course, this would drive short term (e.g, 2011-13 and 2013-15) Employer Contribution rates even higher.

While painful in the short term, such approaches would help insulate future generations of public employees -- and recipients of tomorrow's government services – from additional costs that they essentially had no role in creating.

Should some of factors that go into calculating PERS benefits –incuding for long-standing Tier I/Tier II employees – be re-examined and changed?

For example, Tier I and Tier II retirees who choose the "Money Match" option also get to add unusued sick leave into their final salary calculations. And if they choose the "Money Match" option at retirement, there's a built in, 2% "Cost of Living Allowance" (COLA). These are not requirements of state law, but long-established policies and agreements in collectively-bargained contracts.[49]

For Tier I/Tier II employees who choose the "Money Match" formula, the 2% COLA provision has the effect of bumping up the final value of their pensions – and thus, their monthly benefit checks – by a significant amount. It's not clear whether such changes could be changed in collective bargaining, or even through new state laws, so the possibility of legal challenge is almost assured.

Should the next round of contract negotiations be the main arena for PERS changes, allowing management and labor to negotiate various options and trade-offs with an eye to avoiding protracted legislative and court battles?

While the PERS governing board and the Legislature have been the focus of past PERS reform efforts, many of the current arrangements (e.g, the 6% pick up) are really the result of management-labor negotiations. Might labor unions and their members be willing to give up certain PERS-related benefits, in exchange for changes in other, non-PERS related areas? (E.g, protections against future lay-offs, or being able to "capture" in their compensation packages savings that they help identify).[50]

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[49] The "Money Match" option was used by about 80% of retirees during the peak years of PERS' health in the late 1990s; today, it's chosen by about 65% of Tier I retirees. This was an intentional result of the 2003 reforms, and helps reduce future PERS obligations. However, this trend is also "accounted for" when PERS sets its Employer Contribution rates.

[50] Indeed, while some may be tempted to focus on public employee and their unions for the PERS mess, the fundamental principle of collective bargaining is that there are two sides to every negotiating table. If state managers of the past have bargained ineffectively, that's not necessarily labor's fault – and there may well

One model that's been used in the private sector (and some public sector agencies in other states???) is to set an given amount for employee benefits – say, X% of payroll or $Y dollars -- and then let employees choose how to apportion that money between various categories – e.g, health care, disability insurance, retirement plans, etc.

Should Tier I and Tier II beneficiaries who are still a long way from actual retirement, be provided with a "one-time" buy out package?

Such an approach has sometimes been used in the private sector with thorny pension challenges. Money could be offered in large, lump sums, mostly likely focused on TierI and Tier II PERS members, in exchange for removing significant amounts of future liabilities from PERS' books.

Such an approach would face enormous financial hurdles, not to mention potential legal and practical ones. Clearly, public employers don't have massive amount of excess cash lying around to fund an effort on such an unprecedented scale. ("Think billions of dollars," as one observer said.)

Such a move would almost certainly require a massive amount of borrowing. Even so, this could prove a better way to use a second round of "Pension obligation bonds" than simply as an arbitrage mechanism for buying down the employer contribution rates.

Should PERS reduce future benefit obligations for Tier I members, by changing its "Assumed Earnings Rate" from 8% to a lower figure?

This idea has been examined at length. Lowering the current 8% rate to 7.5% was actually discussed – though rejected – at the July 2009 PERS board meeting.

Such a change would essentially reduce the future value of Tier I members' projected retirement accounts – and thus, their pension benefits.

That would certainly spark controversy – not to mention legal challenge. But here's the real dilemma of such a move. If the earnings rate were reduced to, say, 7%, PERS would also be required to reduce what it assumes OPERF will earn in future years. In the short term, this would actually require *even larger* Employer Contribution rates to make sure future obligations are fulfilled.

Should those with Side Accounts "Just Say No" to reducing the 2009-11 Employer Contribution rate?

Just because an employer can use its side Account to "buy down" the Employer Contribution rate, doesn't mean it's *required* to do so.

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be some "win-win" scenarios here that would benefit all three parties (taxpayers being the third, and arguably most important of all).

Indeed, there's a good argument that the smartest thing for public employers who embraced this strategy to do would be to defer some -- or even all – of the discount effect, and keep the money in OPERF instead. If the market is now currently "undervalued" -- and thus, poised for some more double-digit returns, as PERS managers clearly hope – it's arguably very short-sighted to spend that money today. Better to keep it in, to recover tomorrow's gains, just as individual investors were advised to not panic with their 401(k)s during the 2008-2009 economic crisis.

However, such "fiscal self-restraint" has a flip side: it will mean even deeper budget cuts, and/or the need to re-open labor contracts. Again, such an approach would be very contentious. But over time, such a move – in the here and now – could significantly assist the long-term prospects of PERS.

# # # #

Needless to say, a full-fledged PERS debate would and should involve many other suggestions. The important point isn't to decide what can and should be done immediately. These are volatile economic times, and what many once assumed to be a "relatively certain" future has become a good deal more cloudy amidst the recent generation-defining (and global) economic recession.

What is important is that the PERS issue take a visible – if not, front and center stage – place in Oregon's public conversation. To do anything less would be to increase the odds that the dire predictions that today at least are only that – predictions – will actually become reality.