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January 9, 2003

Yvette Elledge
Public Employee Retirement System
PO Box 23700
Tigard, OR 97281-3700

Re: Proposed Amendments to OAR 459-005-0055
Our File No.: 5415-237

Dear Yvette:

The purpose of this letter is to provide additional testimony on behalf of the PERS Coalition regarding the board's current rulemaking process on actuarial equivalencies. The discussion on potential changes to the board's actuarial equivalency factors has gone on for some time and the PERS Coalition has been a full participant in that process. Over that period of time there have been multiple suggestions about the appropriate approach for the board to take to any change in actuarial equivalencies. As we reach the conclusion of that process the board has narrowed the options under consideration with the proposed rule providing a target date for implementation with the potential of some form of "look-back" to protect the rights of PERS members. Among those options currently under consideration, the PERS Coalition supports what has been referred to as Option D.[1]

Contract Rights

Over the last several years there have been substantial discussions about the contractual nature of PERS and the PERS Coalition has in numerous circumstances provided the board with analysis in support of their understanding of the PERS pension contract. This

[1]Option D would involve the selection of the following alternatives: [A1], [E1], [C1], [D], [E], [F], [G], [H1], [I1]. The fact that the PERS Coalition offers testimony in support of Option D does not mean that the PERS Coalition has abandoned its position that any change in actuarial equivalencies must fully and completely preserve the rights of individual PERS members. The PERS Coalition's support of Option D is simply a recognition that among those approaches still under consideration, Option D comes closest to protecting members' rights than any other option.

section will give a brief overview of the PERS Coalition's position rather than provide an additional in-depth discussion of contractual issues.[2]

That PERS constitutes a unilateral contract which cannot be amended even prospectively is now clearly settled in the state of Oregon.[3] The actuarial factors which are used by the plan are clearly part of that PERS contract, as they are integral to the calculation of most, if not all, PERS benefits. A rather straightforward application of the legal principles enunciated by the Oregon Supreme Court would be that actuarial factors cannot be changed in a manner which is to the detriment of current participants. This simple statement of the law is entirely consistent with the uniform position of the PERS board over the last 25 years. Resolution of the *Henderson* case[4] was motivated in part by the need to protect the contract rights of male members of PERS. The current PERS rule (OAR 459-005-0055) makes the board's position very explicit. There is to be no change in actuarial factors for current participants if the adoption of those new factors would have an adverse impact on their benefits. The history of the adoption of the enabling statute which permits PERS to make changes in actuarial equivalencies, ORS 238.630(g), was that any changes contemplated by the board would require the "grandfathering" of the benefits of current PERS participants.[5]

In sum, the PERS board position on actuarial factors has been entirely consistent with the proposition that actuarial equivalency factors may not be amended to the detriment of current participants of the plan.

Proposals for Modification of the Actuarial Equivalency Factors

During the extended period that the board has been considering the possibility of adopting new actuarial factors there have been a variety of approaches suggested to implement new factors. These have included approaches described as "wear-away" approaches, and also a proposal by the PERS Coalition for what has been referred to as the multiple segment approach. Under the multiple segment approach when actuarial factors are adjusted any benefits which are ultimately attributed to the period prior to that adjustment would continue to be determined under the old actuarial factors. Thus, each segment of service would be calculated under the actuarial factors in existence for that segment. This approach is entirely consistent with the board's current rule for those PERS participants who joined the system in 1999 or thereafter. The PERS Coalition pointed out that if the board was to abandon their long-held position that actuarial equivalencies could not be modified to the detriment of current participants, then the multiple segment approach was most consistent with providing protection for the benefits for current members.[6] The PERS board has rejected all of these approaches and instead has opted for a fixed date implementation with continued consideration of a "look-back" to provide some protection for member rights.

The Proposed Rule

The proposed rule which is under consideration takes a substantially different approach to the protection of current members of the system than those which had been considered previously. In addition to providing for implementation at a fixed date the current rule involves defining what is referred to as "an accrued

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[2]If the position of the PERS Coalition is unclear in any respect we would be happy to clarify that position.

[3]*Hughes v. State of Oregon*, 314 Or 1 (1992); *Oregon State Police Officers v. State of Oregon*, 323 Or 356 (1996).

[4]*Henderson et al. v. State of Oregon et al.*, U.S. District Court (Oregon) Case No. 74-538. This case was discussed in greater detail in the previous testimony of the PERS Coalition by letter dated December 10, 2002.

[5]The minutes of the PERS meeting of April 26, 1985 are enclosed with this letter, including testimony of Tom Dearing, at that time PERS's outside tax counsel, in which he specifically advises the board that any change in actuarial factors would require a "grandfather protection" for all those members currently in the plan.

[6]Whether the multiple segment approach sufficiently protects members' contract rights is an issue as yet undetermined by the courts.

benefit" and provides protection for that accrued benefit. The concept of an accrued benefit is not a concept commonly discussed in public sector pension law. It is, rather, a private sector concept which appears both in ERISA as well as the Internal Revenue Code. In the private sector ERISA permits an employer to amend a pension plan prospectively as long as that amendment does not adversely affect a participant's accrued benefit.[7] The reason that the concept of accrued benefit is not well developed in the public sector is that pension changes may not be made even on a prospective basis without offending members' contract rights. Thus the accrued benefit concept is not necessary in the public sector as the protection of pension contract rights is in excess of the protections in the private sector. Indeed, the commentators have noted that one of the reasons Congress decided not to apply IRC §411 to public sector pension plans was the well-developed case law which provides that benefit formulas cannot be reduced for current participants even for future service.[8]

The rule under consideration uses the private sector concept of the protection of an accrued benefit even though that protection is substantially less than the protections under well-developed Oregon public pension law concepts. The fact that the term "accrued benefit" is used in the rule suggests that the board is attempting to apply well-understood Internal Revenue Code concepts to the PERS plan.[9] Providing a number of options in the definition of accrued benefit gives the board the opportunity to craft a rule which is specifically applicable to the PERS plan.

Accrued Benefit

In order to determine the application of the term "accrued benefit" to PERS it is necessary to consider some of the unique aspects of PERS. PERS is a defined benefit plan which provides for two and in some cases three different means of calculating an individual participant's monthly retirement benefit. Although most of the discussion here will concern the money match benefit, which is currently the primary driver of pension benefits, nonetheless any definition of accrued benefit must apply equally well to the other forms of benefit provided by PERS. A second unusual aspect of PERS is though it is a defined benefit plan, nonetheless it requires an employee contribution and maintains employee accounts. Further, PERS permits at least some limited control by members in investing their funds by permitting a member to place part of their funds in the variable account.

The calculation of an individual's accrued benefit under the Internal Revenue Code for a simple defined benefit plan is relatively straightforward. It is the member's "accrued benefit under the plan *** expressed in the form of an annual benefit commencing at normal retirement age***." Internal Revenue Code §411(a)(7)(A). The key elements are (a) an annual benefit; (b) commencing at normal retirement; (c) under the plan. The PERS full formula method is a typical defined benefit pension plan formula and if it were the only form of benefit under PERS then calculation of the accrued benefit would be according to the above formula. However as will be discussed below a somewhat different analysis is appropriate in order to assure internal consistency within the plan.

The calculation of a member's accrued benefit under the money match method is somewhat more complicated. Internal Revenue Code §411(c)(2) provides guidance in calculating accrued benefits based on a

[7]29 USC §1054. This concept has been incorporated in the Internal Revenue Code at IRC §411.

[8]From the Thompson-RIA website (at http://checkpoint.riag.com/):

> "RIA Observation: While the Code §411(d)(6) anti-cutback rules don't apply government plans, many government plans are subject to state constitutional impairment of contract rules. In many cases, these provisions not only prohibit cutbacks in a government plan participant's accrued benefits, but also prevent plan benefit formulas from being reduced for current participants (so that the formula continues to apply to future service). Thus, in these cases, benefit formula reductions can be applied only to future hires."

[9]Indeed, if it was not the intent of the PERS board to provide at least the minimal protections provided by the Internal Revenue Code for private plans, then presumably the board would not have used the term "accrued benefit" in the rule itself.

member's contributions in a defined benefit plan. It focuses on how to determine the employee's portion of accrued benefits which in PERS is the employee account upon which the money match calculation is based. First, it states that the accrued benefit as of any applicable date is the "amount equal to the employee's accumulated contribution expressed as an annual benefit commencing at normal retirement age***." Thus the key elements are (a) the accumulated contributions; (b) expressed as an annual benefit; (c) commencing at normal retirement age. Second, "accumulated contribution" is defined. The accumulated contribution is the employee's contributions plus interest to the end of the plan year in which there is a change. Internal Revenue Code §411(c)(2)(C). This amount must then be compounded annually at an interest rate from the date of the change until the employee attains normal retirement age. The resulting amount is then converted to an annual pension benefit.[10] As an example, if the PERS board were to determine to amend actuarial equivalencies effective January 1, 2004 and a 53-year-old PERS member had an account on December 31, 2003 valued at $100,000, then the proper method of determining the value of that individual's accrued benefit would be to take the $100,000 account compounded by an interest rate for the five remaining years until normal retirement and then calculate a pension based on that projected account and the old actuarial factors. This would represent the accrued benefit as calculated pursuant to the Internal Revenue Code.

The final aspect of this analysis is to determine an appropriate interest rate to be used in projecting benefits to retirement date. Internal Revenue regulations state that if there is a rate stated in the plan, that is the rate to be used to compound the value of an individual's account.[11] Though PERS does not have a specified rate, for most participants it provides a guaranteed rate of no less than the actuarial assumption.[12] The actuarial assumption which currently stands at 8% should be the interest rate selected for calculating the amount of the accrued benefit.

Applying these minimal IRS requirements to PERS leads to the conclusion that Option D is the only option consistent with IRS requirements. Although Option D does not specifically follow the methodology prescribed by the Internal Revenue Code, it does provide in general that the accrued benefit will be calculated on the amount in an individual's account including earnings to the date of that individual's retirement. Adoption by the PERS board of any option which does not include either a projection or an actual calculation of additional interest accrued would be inconsistent with the IRS requirements and provide a lower level of protection of accrued benefit than even that provided in the private sector.[13] Such an approach would be highly likely to be overturned by the courts as it would not be consistent with any recognized method of protection of individual members' pension benefits in either the public or the private sector.

Yours very truly,

Gregory A. Hartman

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cc: PERS Board

[10]Internal Revenue Code 1.411(c)(1)(c) has examples of these calculations.

[11]IRC Regs 1.417(e)-(1)(d)(10)(vi)(B). The interest rate is part of the accrued benefit protected by IRC 411(d)(6).

[12]ORS 238.255. Even for those members whose accounts do not enjoy a guarantee, internal consistency as well as IRS regulations suggest that the use of the 8% assumption for such accounts as the variable account and Tier Two members' accounts would be appropriate in making this analysis. Similarly internal consistency would suggest that calculation of the full formula minimum would also project benefits based on actual final salary.

[13]IRC §411 provides a fully developed body of law developed in the private sector to protect "accrued benefits" when prospective changes are made to a pension plan.