

February 12, 2003

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

Re: House Bill 2003: The PERS Reform and Stabilization Act of 2003

Dear Representative Knopp:

Thank you for the opportunity to address your committee with regard to House Bill 2003. My testimony first describes the problems that confront the Public Employees Retirement System (PERS), then discusses the root causes of those problems, and finally explains how HB 2003 solves those problems by addressing the structural and administrative issues that contributed to them.

The Problem

The current structure of PERS threatens the financial stability of this state, and that of the other public employers that participate in the system, because of an unexpected combination of statutory provisions, economic circumstances and Board actions. This combination of circumstances created unforeseen and unintended consequences that resulted in benefits being paid to and accrued by public employees that far exceed the benefits intended by the Legislative Assemblies that created the benefit structure. These excess costs are paid by employers through dramatically increasing contribution rates and inevitably are passed along to Oregon taxpayers through tax increases or service reductions. Unless the problem is addressed, costs will continue to escalate.

1. Escalating costs for participating public employers.

Until relatively recently, the average public employer's contribution rate to PERS was eight to ten percent of payroll. Beginning in the late 1990s, many employers began to see sharp increases in those rates despite sizable gains in the value of the PERS Fund's investment portfolio. For instance, the City of Roseburg's rate went from 10.22 percent of payroll in 1995 to 16.0 percent of

payroll in 1999. During those five years, the PERS Fund earned an average of 21 percent per year, but those gains did not keep up with the rising cost of the system. Now that the stock market has been in serious decline for three consecutive years, rates for all employers have skyrocketed to new levels. In December of 2002, the PERS actuary recommended marked increases in the contribution rates for nearly all employers for the period beginning in July, 2003. The City of Roseburg's rate is projected to be nearly 21 percent of payroll. State agencies will see an increase of nearly seven percent of payroll – from 10% to 17%, approximately – and school districts's rates will rise by about five percent of payroll – from 13% to 18%, approximately.

A Financial Simulation completed by PERS in December, 2002, shows that employer contribution rates are expected to reach an average of 30 percent of payroll within the next ten years. At that point, the ratio of employer contributions to member contributions will be five to one – *i.e.*, employers will be paying five times as much as members toward the retirement plan. Employer rates “probably will remain at higher than historic levels for the next 30 years,” according to the simulation. The inevitable result of these escalating pension costs is that public employers will be forced to make massive cutbacks in essential government services and eliminate the jobs of many public employees, which will not only be harmful to Oregon but will also undermine the public's trust in their governmental institutions.

2. Escalating retirement benefits.

As the cost of PERS has increased, retirement benefits for PERS members also have increased. In 1990, the average 30-year PERS member retired with a benefit equal to 63 percent of the member's final average salary. According to PERS, by 2000, the average member retiring with 30 years service received a benefit equal to 106 percent of final average salary. As the system currently exists, retirement benefits will continue to grow, and long-term PERS members will retire with pensions that far exceed their final average salaries. Indeed, PERS staff predict that the salary replacement ratios for Tier 1 members are “highly likely to rise dramatically from their current levels over the next 15 years.”

The retirement system was never intended to provide benefits in excess of the members' pre-retirement income. Instead, the objective of PERS since 1953 has been to provide a pension that, when combined with Social Security benefits, will replace 75 to 85 percent of a member's pre-retirement income. This 75-85 percent replacement ratio target is well within the industry standard for pension plans.

The Causes

The PERS problem is a case study in unexpected consequences. Its causes reach back into the tangled roots of a 50-year-old retirement system. An accurate understanding of the present situation requires a brief historical overview of how the system evolved.

The Legislative Assembly enacted the Public Employees Retirement Act in 1953 in order to ensure a reasonable retirement income for public employees. The stated objective of the Act was to provide a benefit equal to 50 percent of the final average salary of a 30-year employee (25 years for police and fire). The amount of the benefit was not guaranteed but was based on accumulated contributions, and it was to be funded by equal contributions from employee and employer. This type of plan is commonly called a money purchase plan, and the retirement benefit is based solely on contributions and interest.

In 1967, the Legislative Assembly repealed the original benefit structure and replaced it with a two-part retirement allowance consisting of an *annuity* funded by employee contributions and an employer-funded *pension* determined by a formula (percentage of final average salary multiplied by years of service). This benefit is now known as the “Pension Plus Annuity” benefit. The Legislative Assembly intended that this new benefit would come closer than the previous benefit to reaching the system’s objective and thus would result in a higher overall benefit to retirees. It also instituted a variable annuity program by which employees could direct a portion of their contributions into higher risk investments.

In 1969, the PERS Board reported to the Legislative Assembly that a few long time members actually would fare better under the discarded money purchase plan than they would under the new Pension Plus Annuity formula. In response, the legislature added a provision that the pension portion of the allowance could be no lower than the annuity portion. The legislature wanted to allow existing members to receive the benefit that had accrued under the prior system, and it intended this provision to act as a safety net for those few members whose benefits would be lower under the new benefit structure. The Legislative Assembly did not intend this provision as a new benefit and did not anticipate that it would increase costs to employers.

In 1975, the Legislative Assembly amended the PERS statutes to require that each year members’ accounts would be credited with no less than the assumed interest rate for that year. The assumed interest rate of the system was 5.5 percent in 1974, seven percent from 1975 to 1978, 7.5 percent from 1979 to 1988, and eight percent from 1989 to the present. The Legislative Assembly intended the 1975 amendment to ensure that the annuity portion of the benefit would not be negatively impacted by low investment returns in an employee’s retirement year. (Low earnings did not affect the formula pension portion of the benefit.) Lawmakers did not intend this guarantee to increase costs to employers but instead provided that future earnings would be used to cover any deficits created by the guarantee.

In 1981, the Legislative Assembly replaced the two-part benefit with a single formula allowance equal to 1.67 percent of final average salary for each year of service, or 50 percent of final average salary for a 30-year employee. Police and fire employees received two percent of final average salary for each year of service and were eligible to retire after 25 years of service. The employer-paid pension would equal the difference between the annuity and the formula. The Pension Plus Annuity benefit was discontinued for new members. The Legislative Assembly intended this change to convert the system to a defined benefit plan that would ensure the desired retirement outcome with no risk to employees. It left the variable annuity program in place, allowing employees the opportunity to enhance their benefit if investment returns in that program were favorable. Employers costs were expected to remain at or near their prior levels.

In 1995, the Legislative Assembly eliminated the assumed interest rate guarantee for new members, thereby creating a second tier of PERS members (now known as Tier 2 members).

1. The Money Match.

The primary driver behind escalating system costs is the “money match” benefit – that small statutory provision, now found in ORS 238.300(2)(b)(A), that was enacted in 1969. The 1969 legislature intended only to reinstate the prior money purchase system for existing members, but unfortunately, the language it used was somewhat ambiguous. The provision lay dormant for more than 20 years, its potential impact unrecognized, until a combination of economic factors (slowing salary inflation and unusually strong investment performances), other unrelated plan features (assumed interest guarantee) and certain Board actions (generous crediting decisions and inadequate reserving practices) created an unexpected situation. Now, rather than being a rare occurrence suited primarily for members who have been inactive for many years, the money match became the dominant method of calculating benefits in the last half of the 1990s. More than 95 percent of PERS members now retire with a money match benefit.

The fact that the money match benefit is dominant has increased the importance of certain other board practices that would be relatively insignificant in a Full Formula benefit. These practices include the use of outdated mortality tables and the matching of excess earnings in a member’s variable annuity account. In short, the Board’s income crediting practices helped create the money match problem, and the methods by which it calculates benefits exacerbated the problem.

Another factor that contributed to the rise and dominance of the money match benefit is the assumed interest rate guarantee enacted in 1975. Although not designed as a way to increase the pension portion of the benefit, the guarantee has that effect when combined with the money match benefit.

2. The actions of the PERS Board.

Since 1953, contributions from both employees and employers have been placed in the PERS Fund, which is held in trust for the payment of retirement benefits. Between 1980 and 2000, the value of Fund investments has risen an average of approximately 13 percent – significantly more than the system’s assumed interest rate. Although it knew the system’s assumed rate over the long term was expected to average only 7.5 or 8 percent and that it had an obligation to credit the assumed rate in poor earnings years, the PERS Board routinely credited interest to members’ accounts at rates well in excess of the assumed rate in years when Fund earnings were strong. It was, in essence, sowing the seeds of financial instability and inevitable system collapse by crediting earnings far in excess of the assumed rate. Only if the actuary had been underestimating the long-term earnings rate by five percentage points could the Board’s practices have been harmless. If the actuary’s predictions were correct, the Board’s practice increased benefits at the cost of public employers and taxpayers.

When the legislature enacted the guaranteed crediting provision in 1975, it intended that the guarantee would smooth out the volatile returns of the market and moderate the effect on the annuity portion of the benefit. The board’s crediting practices twisted that intent and turned the provision into an unexpected windfall for members. The practical effect of its practice was to “lock in” the prior year’s crediting decision in the following year. Thus, when the Board credited 20 percent interest at the end of 1999 and the Fund lost all those gains in 2000 and 2001, a member’s account nonetheless *increased* by eight percent in each year, thereby compounding the generosity of the Board long after the gains were gone. The earnings credited in the late 1990s (12.5% in 1995, 21% in 1996, 18.7% in 1997, 14.1% in 1998, and 20% in 1999) will continue to grow by an additional eight percent each year.

As a result of the Board’s generous crediting practices, balances in employees’ accounts grew faster than expected. Eventually, employees’ accounts grew so large that by 1995, the money match provision created retirement allowances that began to exceed the formula benefit. As members’ accounts continued to grow by enormous sums in the late 1990s, the liabilities of employers grew as well. The members’ accounts became artificially and permanently inflated by market gains that were never actually realized. When those market gains were lost, members’ accounts continued to grow while the rest of the Fund suffered the full brunt of the losses. Employers were left with unfunded actuarial liabilities that can be fully repaid only through increased contribution rates, which then consume a larger percentage of tax revenues. It is unlikely that Fund earnings can ever make up the difference.

Two other board practices also have contributed to the system’s problems: the use of outdated mortality tables, and the matching of excess variable account earnings. During the 1990s, the PERS Board adopted a rule that required it to retain the use of outdated mortality factors in calculating retirement benefits. By 1999, the Board’s use of inaccurate mortality tables had

increased the costs of participating public employers by approximately two percent of payroll. Also during the 1990s, the PERS Board credited members' accounts with almost the full rate of Fund earnings. Consequently, it failed to reserve any of those earnings in a contingency reserve, and it failed to reserve enough of those earnings in its gain-loss reserve to meet the goal that it had set for that reserve to cover future investment losses. For instance, in 1999, the Fund earned 24.89 percent, and the Board credited 20 percent earnings to employees' accounts. The remaining earnings were credited to the Board's gain-loss reserve. The Board's goal for that reserve was a balance sufficient to pay the assumed interest rate for 30 months of no net gain by the fund, but after earnings were set aside from 1999 earnings, the reserve contained only approximately 74 percent of that amount.

In 2000, the Fund earned 0.63 percent, and the Board credited 8 percent earnings to employees' accounts by debiting funds in the gain-loss reserve. In 2001, the Fund lost 7.17 percent, and the Board credited 8 percent earnings to employees' accounts by using the remaining funds in the gain-loss reserve and creating a deficit entry therein. The 2001 actuarial valuation shows that Fund had assets of \$39.77 billion and an unfunded actuarial liability of \$5.613 billion at the end of 2001. The Fund is expected to have lost seven to eight percent of its value in 2002, and its unfunded actuarial liability will continue to grow if the system remains unchanged. Because of the statutory guaranteed crediting provision and PERS's implementation of it, losses are not debited to members' accounts but instead must be borne by the remainder of the Fund. Because employees' accounts grow both by employee contributions (six percent of salary) and by the assumed interest rate (eight percent of account balance) even when the Fund as a whole loses money, these deficits cannot be eliminated or significantly reduced without extensive structural changes to the existing retirement system.

The Solution

Because history has shown that a piecemeal approach to amending PERS can create more problems than it solves, House Bill 2003 is designed to be a comprehensive solution that integrates well with the fundamental intent and structure of the basic plan. It is intended both to remedy past errors by the Board and to correct the structural anomalies that helped cause the problem. In addition to substantive provisions, the bill also contains a provision for changing the board's makeup, a provision for independent legal counsel, and a provision for expedited legal review of the bill by the Oregon Supreme Court.

1. Remedy for past wrongs.

In 1998, eight public employers petitioned for judicial review of the contribution rate orders issued to them by PERS in 1998. That petition was later amended to include a challenge to rate orders issued in 2000 and a challenge to the PERS Board's 2000 order allocating 1999 earnings. The challenged 1998 rate orders were based on actuarial investigations and PERS practices carried out after its 1996 rate orders, which had not been challenged by the petitioners.

On October 7, 2002, the Marion County Circuit Court issued an opinion following trial in the matter, holding that certain actions of the PERS Board were based on a misinterpretation or disregard of its statutory duties and had wrongly increased the costs of the system to the petitioners. The court held that the Board erred by requiring employers to match excess variable earnings, by failing to distribute funds to a contingency reserve, by distributing excess earnings to employees' accounts at the expense of prudent Fund reserves, and by failing to adopt and use accurate mortality tables. The court remanded the orders to the PERS Board and directed the Board "to correct the various legal errors and several abuses of discretion in administering the fund" as described in the court's opinion. The court concluded that the sustainability of the system could be jeopardized unless the Board's errors were corrected. The court also held that the petitioners cannot be charged with the costs associated with the Board's erroneous practices.

Since the court's decision, the Board has continued to calculate retirement benefits based on the errors identified by the court, and PERS members who retired during that time are receiving benefits in excess of the amount they are legally entitled to receive. Members who retired between October 14, 1996, and October 7, 2002, received benefits that were higher than the benefits they were legally entitled to receive because the benefits were based in part on the erroneous practices identified by the court as forming the basis of the challenged orders.

HB 2003 provides a remedy for the past wrongs identified by the court in three ways. First, in Section 25, the bill directs the Board to correct its practices with regard to the payment of retirement benefits, beginning immediately. Specifically, the board is directed to cease the use of outdated mortality tables, to cease matching excess earnings on members' variable accounts, and to incorporate the court's judgment in its calculation of future benefits. The immediate use of accurate mortality tables will, by itself, reduce employer contribution rates by more than two percent of payroll.

Second, in Section 26, the bill provides that the costs of the Board's past errors will be paid out of future Fund earnings as an administrative cost. Those costs include the amount of 1999 earnings credits to members' accounts in excess of the assumed interest rate, the costs of excess benefits paid since October 14, 1996, the legal fees paid to petitioners, as ordered by the court, and all other costs that flow from the judgment. Designating these costs as administrative costs will

lower the system's assumed interest rate until they are paid off and thereby reduce the amount of earnings that will be distributed to members' accounts during that period.

Third, Section 27 requires the Board to recalculate the contribution rates, effective July 1, 2003, of all participating public employers based on the provisions of HB 2003.

2. Elimination of member contributions.

As a means of returning the system to its intended form and to thereby stabilize the system, the bill includes one simple but significant structural change to the system – the elimination of the requirement for an employee contribution. Currently, the statutes require members to contribute six percent of their salary to the system. Although many employers have opted, through the collective bargaining process, to pay this contribution on behalf of their employees, this six percent provision remains a member obligation under PERS.

The elimination of the six percent contribution to members' accounts will slow the growth of those accounts over time. As a direct consequence, projected money match benefits will become lower over time. The effect becomes greater the further a member is from retirement age. Members who are close to retirement age will see little impact on their retirement allowance from this change. This reduction in the projected future cost of benefits will significantly reduce the unfunded actuarial liability of the system.

The institution of this change, combined with the implementation of the court's decision, will nearly eliminate the system's current unfunded actuarial liability and improve the financial stability for the system while maintaining the intended benefit for public employers. The bill as a whole will reduce the expected costs for public employers by approximately \$615 million per year and reduce the employer contribution rate by nearly ten percent of payroll.

3. Changes in governance.

The bill contains some changes in how PERS is governed. First, in Sections 20 and 21, it reduces the number of PERS members from 12 to five. Of the five members, three would be non-PERS members, one would be a PERS member in a management position, and one would be a PERS member in a union-represented position. The governor would continue to appoint the members, and he would also name the Board chair.

Second, Section 20 includes a provision requiring the Board to retain independent counsel for its legal advice. The legal counsel cannot be a PERS member. Section 20 also explicitly prohibits the Board from taking actions to increase retirement benefits.

4. Clarification and implementation.

In order to correct the board's erroneous interpretation of the law and to clarify the meaning of the existing law, it is necessary to make explicit what was already implicit in the law prior to this bill with regard to the payment of benefits and with regard to the distribution of investment income to members' accounts and Fund reserves. HB 2003 amends the provisions concerning reserving practices, the adoption of actuarial factors, and the assumed interest rate.

Section 29 provides that any existing collective bargaining agreement between PERS members and a participating employer may be reopened by either party to negotiate provisions dealing with wages or PERS matters.

Section 28 provides for expedited review of certain challenges to HB 2003 by the Oregon Supreme Court.

Very truly yours,

William F. Gary

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c: Committee Members
Committee Administrators

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