



# **City Club *of* Portland**

Good citizens are the riches of a city

## **OREGON'S PUBLIC EMPLOYEES RETIREMENT SYSTEM (PERS)**

**Comprehensive Study Charge  
May 2010**

**Approved for Study  
by the Board of Governors on March 30, 2010**

**City Club of Portland  
901 SW Washington St.  
Portland, OR 97205  
(503) 228-7231  
[tony@pdxcityclub.org](mailto:tony@pdxcityclub.org)**

## BACKGROUND

The recent economic recession has hit Oregon's Public Employees Retirement System (PERS) particularly hard. This is not the first time that PERS has threatened to create an enormous burden on state and local governments. Most recently following the 2001 recession, the PERS fund had a 20 percent unfunded liability. Although the PERS fund recovered due to the favorable investment returns between 2003 and 2007, the current economic downturn has created an even greater unfunded liability—almost 30 percent.

Most public employees participating in Oregon PERS are in an employer-funded defined benefit program rather than a defined contribution program. Accordingly, when the system's investments falter, the beneficiaries are held harmless and employers must find additional resources to meet the benefit obligation. The PERS fund is supported by three sources: investment returns, employer contributions, and employee contributions. In order to maintain an acceptable Fund Status (the ratio of fund assets to liabilities) the investment returns and employer contributions maintain a direct, but inverse relationship. In other words, when investments lose money, contributions must go up. It now appears state and local governments may face average employer contributions climbing from single digits to 24 percent of payroll by 2014. According to one official, the PERS system is simply not sustainable with returns on investment at 4.5 percent.

In addition to investment downturns, the most frequently cited cause of the PERS funding problem is the long-standing practice of the PERS Board to attribute additional earnings beyond 8 percent to PERS members who elected a guaranteed return rather than a more volatile market rate of return. That practice is now discontinued. However, the Oregon Supreme Court has made clear the remedy cannot be to deny earned benefits or to reclaim from PERS members previously attributed additional earnings beyond 8 percent.

In 1995 and again in 2003, the Oregon Legislature addressed public employee pension benefits, resulting in three PERS member classes:

1. Employees who were hired before January 1, 1996 are known as Tier I members. Employers carry all the investment risk only for Tier I members who chose guaranteed investment returns. These members receive fixed returns (currently 8 percent) on their accounts; however, in many high-return years past, these Tier I members' accounts received more than 8 percent by PERS Board action.
2. Tier II employees, hired between January 1, 1996 and August 28, 2003, have lesser benefits, with regular accounts receiving market returns.
3. Employees hired on or after August 29, 2003 are members of the Oregon Public Service Retirement Plan (OPSRP), a third tier with still lesser benefits. PERS calculates Tier I and Tier II pensions using three methods and pays the highest calculated benefit. Tier III benefits are calculated using only one method.

It is an open question whether the legislative remedies that apply to Tier III members will put PERS on a sustainable path into the future. But there is no question that, absent extraordinary market returns over the next decade, meeting Tier I member benefit obligations (those hired prior to 1996) will place an enormous burden on public employers. The result, some fear, when combined with other personnel costs such as rising health care costs, will be reduced resources available for public services, even if tax revenues are increased.

Three key events in PERS history are critical to the circumstances that we find PERS in today:

- First, in 1979 the Oregon Legislature amended the statute to permit public employers to "pick up" the 6 percent employee contribution to the PERS fund as a bargained-for benefit in lieu of a wage increase. Many labor contracts now provide that employers do so. Until 2004, the employee's contributions, including amounts employers "picked up" for employees, were deposited in the money match account.
- The second event (or series of events) related to the amount of return that was credited to individual member retirement accounts. Public employees were able to choose a variable return that fluctuated with market returns or a guaranteed return, which, after 1989, was set at 8 percent. In 17 years of high investment earnings, PERS credited the individual accounts of members who chose the guaranteed return option with additional earnings. As an example, in 1997 variable accounts received nearly a 25 percent return while guaranteed member accounts received nearly 20 percent. In other words, the guaranteed account members shared in the potential upside of the market but were shielded from a declining market by their guaranteed return.
- Third, PERS used outdated actuarial tables to estimate retirees' life spans that, by 2003, were 20 years lower than the life expectancy of PERS retirees. As a result, PERS paid and is paying pensions for longer than planned.

The Legislature recognized that the above conditions had established a system that could not be sustained. It made several attempts to rein in the system, with mixed results. In 1995, the Legislature eliminated the guaranteed return option for all new members. Returns for PERS members hired after January 1, 1996 fluctuate with market returns.

Weak investment returns in 2001 and 2002 triggered another attempt to revise the PERS system. The 2003 Legislature made six changes:

1. It created Oregon Public Service Retirement Program (OPSRP) for public employees hired after August 27, 2003. OPSRP eliminated the money match option and created an Individual Account Program, which functions as a defined contribution program for the employee's 6 percent contribution (even if paid through an employer "pick up").

2. It adopted new actuarial tables that more accurately reflected the life expectancy of PERS retirees.
3. It defined the 8 percent guaranteed return requirement as a "career" return requirement and froze all guaranteed accounts until the PERS fund was fully funded (assets equal liabilities).
4. It temporarily suspended cost of living increases for guaranteed account members.
5. It diverted all member contributions made after January 1, 2004 to Individual Account Programs rather than to the money match option.
6. It prohibited future PERS Boards from crediting more than the guaranteed amount until the PERS fund was fully funded.

Ruling on a public union challenge, the Oregon Supreme Court invalidated the freeze on guaranteed accounts (item 3 above) and the elimination of the cost of living increases (item 4 above).

Some public employers have tried to cushion their total PERS funding obligations by issuing bonds to create PERS side accounts from the proceeds. They gambled that PERS investment returns would more than compensate for the cost of debt service for the bonds. For some, such as Portland Public Schools, the side accounts have been an effective way to reduce the PERS bite on their budgets. Others, like the David Douglas School District, made a bad bet, failing to realize any benefit from the bond sales.

The market recovery between 2002 and 2007 and the 2003 legislative changes, among other factors, significantly strengthened the system's fiscal position and effectively removed PERS from public view. In fact, the Funded Status of the PERS fund—the ratio of assets (including side accounts) to liabilities—reached 98 percent in 2007, one of the highest ratios in the nation. It appeared sufficient to meet the outstanding obligations to Tier I, Tier II and Tier III active members along with the retired members.

The dramatic market downturn in 2008 saw the fund lose \$17 billion (approximately 27 percent of its value). The Funded Status dropped to 71 percent by the end of 2008. The drop of the Funded Status below 80 percent triggered a PERS Board option to increase the employer contribution by up to 6 percent year over year rather than only 3 percent in order to make up for low investment earnings. However, at this point, the Board has kept the increase below the possible maximum in light of the critical financial condition of most public employers in 2009.

In 2007 the Chalkboard Project and the Oregon Business Council commissioned a study of the PERS system that was performed by ECONorthwest. The study, released in August 2007, identified weaknesses in the PERS system and offered options for addressing those weaknesses. Even though this report was critical of PERS, it appeared before the 2008 economic collapse that further jeopardizes PERS and public employers. ECONorthwest has published a 2009 supplement to this report. Other commentators, including former Secretary of State Phil Keisling, have cautioned that PERS as currently constituted is not sustainable.

## ISSUES AND CHALLENGES

While rates for individual employers vary significantly, the historical employer contribution to PERS between 1975 and 2000 averaged 9 to 10 percent of payroll. Employer contribution rates rose to 18.9 percent of payroll in 2003 and then settled back to 14.9 percent in 2005 and declined even further in 2007. In a September 2009 report, the PERS Board actuary, Mercer Consulting Group, projected that in order to keep the Funded Status at a safe level (assuming 8 percent annual returns on investment), the average employer contribution would have to increase to 13.1 percent by 2011 and as much as 24 percent of payroll by 2014. It appears that the employer contribution as a percentage of payroll will continue to increase or remain at very high levels even assuming an 8 percent rate of return on the fund investments.

As of December 31, 2008, PERS had an Actuarial Accrued Liability of \$16,474,000 for active Tier I members and \$28,167,000 for then current retirees. The Legislature's attempts to reduce this liability have met with resistance by the Oregon Supreme Court, which has concluded that public employers have an obligation to honor their contracts with PERS members. Even demonstrating economic hardship will not likely pass Supreme Court muster.

The Legislature has established a level of retirement benefits that it has deemed to be adequate for PERS retirees. A benefit is "adequate" if the PERS benefits, when added to the retiree's Social Security benefits, equal between 75 to 80 percent of the retiree's final pay. Benefits for PERS members hired in the 1970s and 1980s exceeded that amount. Those hired in and after the 1990s are receiving approximately "adequate" benefits. Therefore, reducing benefits to future PERS members may result in less than adequate retirement benefits.

Many of the remedies that are available without running afoul of established contractual obligations have already been implemented in the 2003 reforms. Early analyses of the 2003 reforms suggest that they have been at least somewhat effective in reducing the overall obligation to PERS members.

If the Research Study Committee concludes that PERS obligations will lead to untenable employer contributions if left unchecked, the Committee will have to consider the intergenerational burdens of each option that it offers to address the problem. As an example, using public bonding authority to spread the burden thirty years into the future will mean that future generations will be paying for the retirement benefits for Tier I PERS members.

In sum: In future years, PERS may dramatically increase system-wide employer contributions unless legislative and/or administrative changes are made. These increases may affect services and/or taxes in all communities, since virtually all state and local governmental employees are members of PERS. Millions of dollars annually may shift from services to pensions and failure to pay such pension contributions may risk the sustainability of the pension system.

However, in light of the careful study others have already given to PERS, a serious question naturally arises: "What can City Club contribute to the civic conversation on PERS?" Fortunately, the history of other Club comprehensive studies provides a response: Across many decades, the Club has helped citizens and policy-makers focus their attention on and understand complex

problems, and many of the Club's recommendations have led to legislative and administrative action.

Circumstances surrounding PERS call out for a description of the issues that the public can understand and recommendations to help mitigate the impact of these coming changes on governmental services, employees and/or taxes. City Club is well positioned to provide an understandable description of the problems, options to address them, and recommendations for solving them.

## **STUDY OBJECTIVES**

Objectives for a study of PERS are to:

- Provide a very brief (2 to 6 page) summary of PERS history, governance, pension plans and related financing arrangements. Refer interested readers to existing documents and resources that provide a comprehensive background on the system.
- Summarize, briefly, the latest available projections of employer costs by Mercer.
- Report the short- and long-term financial impact of Mercer's baseline forecast on three geographically diverse local governments that deliver a variety of public services, and discuss potential impacts on government services assuming no change in tax effort.
- Review and assess the policy options advanced in ECONorthwest's August 2007 report "Public Employee Retirement in Oregon: Where does the system stand and where could Oregon go from here?" and in The Pew Center on the States February 2010 study, "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform." Determine whether any of these options, or other options identified by witnesses or research, taken together, could significantly reduce the system's liabilities and would be likely to survive a legal challenge.
- Review and assess recent actions by the PERS Board, including those that change timing of employer payments but do not change the system's liabilities.
- Prepare useful recommendations for legislative and administrative action.
- Explicate the criteria, principles or values used in determining which recommendations to make.

## SCOPE

The City Club report should describe the existing problem and recognize that its scale changes almost daily with investment returns. To ground the reader and witnesses, the study should succinctly summarize the system's liabilities and assets as reported by Mercer and as understood by the PERS Board. The study should avoid a lengthy commentary on whether Mercer's technical projections could be improved and should not rehash the long history of PERS decisions during 1970-2010, although a brief summary of the most recent legislative and administrative adjustments and Court-imposed limitations may be included. The study should accept the Legislature's most recent determination of the adequacy of benefit levels.

Assuming Mercer's baseline projections are accurate, the study should offer tangible examples of how an increase in employer rates during the next decade would affect three local governments. The impacts on local governments could be conveyed through self-standing case studies.

The heart of the study should focus on possible policy responses rather than a debate about the scope and scale of the problem. Policy responses fall into two broad categories:

1. Policies that modify the benefit to some participants (such as the calculation of cost-of-living-adjustments to pensions) within the limitations of Court rulings and the Legislature's determination of benefit adequacy, and thereby reduce system liabilities.
2. Policies that leave benefits to participants unchanged, do not lower liabilities, but alter the time horizon over which public employers reduce the system's net liabilities.

With these two categories in mind, the study should ask and answer the following questions:

1. Given Mercer's projections and the PERS Board's understanding of the problem as of April 2010, are the fiscal and service impacts anticipated by local government sufficiently large to justify a major policy response by legislative or administrative agencies?
2. Could any policy options including, but not limited to, the options from the studies by ECONorthwest for Chalkboard and the Oregon Business Council in 2007 and by The Pew Center on the States in 2010 measurably reduce the system's liabilities and have a reasonable chance of withstanding a legal challenge?
3. As the PERS Board evaluates methods to determine the timing of a return to full funded status, what criteria should it use to address issues of generational equity?
4. Having reviewed policy options in each of the two categories, specifically how should the Legislature, PERS Board, and other key actors proceed?

## **TENTATIVE REPORT OUTLINE**

- Executive Summary
  - Composition of committee
  - Summary of study charge
  - Method employed
  - Summary of conclusions and recommendations
- Background
  - Description of PERS, with brief-as-possible history
- Discussion
  - Identification of issues needing attention
  - Identification and evaluation of possible actions to address them
- Conclusions
- Recommendations
  - Steps that can and should be taken by the Legislature, the PERS Board, and local governmental agencies

## **TIME FRAME**

Comprehensive studies should take 12 months from the time of the first meeting of the Study Committee to the vote of the membership on the report. The Research Board must approve any exceptions to this time frame.