

In 2008 Oregon PERS, along with other pension systems around the country, suffered a disastrous investment year when the U.S. stock market endured its worst year since the Great Depression. As a result of those losses — some 27 percent of the PERS' value — the system's actuarial unfunded liability increased to over \$16 billion by the end of 2008. Although good market performance in 2009 (and to date in 2010) has begun the process of a return to financial health, nonetheless some are arguing that the 2011 Legislature should once again, as in 2003, take up the task of "fixing" Oregon's Public Employee Retirement System.

But the two situations are not parallel.

As the 2003 legislative session convened, Oregon PERS had just suffered through three difficult investment years, causing a rapid increase in the unfunded liabilities of the system that topped out in the spring of 2003 at approximately \$17 billion, leading to significant increases in employer contribution rates. In addition, Marion County Circuit Court Judge Paul Lipscomb ruled (in the *City of Eugene* case) that the PERS Board had not followed the statute in administering the PERS system. In turn, the 2003 Legislature made significant changes to PERS that were challenged in the Oregon Supreme Court, with the Court eventually rejecting certain changes and holding that others were, in fact, constitutional. As a result of these changes — as well as improved market performance — the financial health of PERS quickly improved.

The purpose of this discussion is to point out how different today's PERS is from the system addressed by the 2003 Legislature. In 2003 active PERS participants were receiving a "Money Match" benefit significantly more generous than the historical benefit provided by PERS. In contrast, in 2011 over 80 percent of active PERS participants will receive a "Formula" benefit that is in line with historic PERS standards. Therefore, any attempt to "fix" Oregon PERS in 2011 will face a very different set of challenges from those that were addressed in 2003.

I. 2003 Changes

The 2003 legislature addressed a PERS system completely dominated and driven by the Money Match benefit. It was anticipated that all Tier One members would retire with a Money Match benefit *and* that if the system's actual earnings equaled or exceeded the actuarial assumptions, then Tier Two members would also retire with a Money Match benefit. Money Match benefits are calculated based on the amount in an individual member's account, which is matched by an amount taken from employer accounts and then converted into a monthly benefit. As a result of good investment performance, causing significant growth in those accounts, benefits had increased substantially beyond those that had historically been produced by the system. It was often repeated at that time that full career employees (30-plus years) were retiring at or in excess of the amount of their final average salary.

Prior to the commencement of the legislative session, Lipscomb in the *City of Eugene* case had determined that the PERS Board had erred in several respects in administering the system. Lipscomb held that PERS erred in not using up-to-date actuarial tables *and* that in distributing 1999 earnings, the PERS board had insufficiently funded reserves and therefore had distributed too much to Tier One member accounts. Both errors led to higher benefits for Money Match retirees.

The 2003 Legislature targeted the Money Match benefit to decrease the value of that benefit for active members of the system, thereby addressing the issues identified by Lipscomb. Clearly legislators believed that even with the changes, active members who later retired on Money Match would continue to receive a generous retirement benefit. The 2003 Legislature made four basic changes to PERS, all focused on the Money Match benefit:

1. The first change mandated by the Legislature was the use of updated actuarial tables for those retiring after Jan. 1, 2005. The PERS Board has implemented that change by adopting new actuarial tables, as well as a methodology to keep those tables current. This change was challenged before the Oregon Supreme Court in *Strunk v. PERB*, and the court ruled this change to be constitutional.

2. In response to Lipscomb's finding that there was an over-allocation of income to employee accounts in 1999 leading to increased benefits, the Legislature derived a method to recapture a part of these increased benefits by deferring cost-of-living increases for certain retirees ("window retirees") until at least a portion of that over-crediting had been recovered. This, too, was challenged and in *Strunk* the Supreme Court held the change to be unconstitutional, ruling in part that the COLA increase provided by PERS was contractual in nature and could not be modified.

3. Since the early 1970s, PERS has provided that Tier One members are entitled to receive an annual increase in their member accounts that is no less than the actuarial assumed earnings rate for the system. Since 1989, that rate has been set by the PERS Board at 8 percent (and has commonly, though technically incorrectly, been referred to over the years as "the 8 percent guarantee"). The 2003 Legislature amended the statute to provide that an individual was entitled to earnings no less than the actuarial assumption over the course of their career, but not entitled to that increase on a yearly basis. In *Strunk* the Supreme Court rejected this change as inconsistent with the contract rights of members, holding that the statute clearly required an allocation on a yearly basis of the amount of the system's actuarial assumption.

4. The final change made by the Legislature and the most significant was the mandate that beginning on Jan. 1, 2004, employee contributions would no longer be credited to the traditional PERS member account, but rather would be directed to the newly created Individual Account Program (IAP). The IAP is in essence a pension savings program similar to a 401(k) plan. Most importantly, as the funds that were now diverted to the IAP no longer went to individual members' PERS accounts, they no longer increased the value of the Money Match benefit. This change was challenged in *Strunk* and the court ruled it did not breach the PERS contract.

This change was intended to cause, and has caused, a profound change in PERS. It has substantially lowered the value of the Money Match benefit. By 2008, full career (30-plus years) Money Match retirees were no longer receiving 100 percent of their final average salary. That amount had dropped to 80 percent and it is anticipated that this value will continue to decrease. As the value of the Money Match benefit decreases, more and more retirees will retire under the alternative "Full Formula" benefit. It is now anticipated that all Tier Two retirements will retire under Full Formula and that perhaps as many as half of the remaining Tier One participants will also retire on Full Formula. As a result of these changes, the system is being transformed into a Full Formula system where retirements will be based on years of service and final average salary, and employee accounts will no longer play any role in the calculation of benefits.

Summary of 2003 Changes

In sum, the 2003 Legislature intended to transform PERS from a system whose benefits were determined by Money Match to a more traditional system where benefits are determined by a formula based on years of service and final average salary. We are well on our way to completing this transaction, which is why the 2011 Legislature will be reviewing a substantially modified PERS system.

II. Current PERS Members

As outlined above, in 2003 active PERS members were divided into Tier One and Tier Two participants, but all were deemed likely to retire on the Money Match benefit. In contrast, by 2011 approximately one-third of active PERS members will be Tier One, one-third Tier Two and one-third "Tier Three" — the Oregon Public Service Retirement Plan created by the 2003 Legislature for employees hired after Jan. 1, 2004. All OPSRP members receive only a formula benefit and again, as outlined above, it is anticipated that with the 2003 changes that virtually all Tier Two members and as many as half of current Tier One participants will also ultimately retire on the Full Formula benefit. **Thus over 80 percent of current active PERS members will retire on a formula benefit** — far less generous than the Money Match benefit that was being received in 2003 and indeed far less generous than the Money Match benefit that is being received by today's retirees.

By operation of the full formula benefit, general service OPSRP full career members (30 years) will receive a benefit of 45 percent of their final average salary, while both general service Tier One and Tier Two members will receive a benefit of 50 percent of their final average salary. **Therefore over 80 percent of current PERS participants will ultimately receive a benefit very much in line with historic PERS benefits.**

III. PERS Funding

By the end of 2009 good investment performance by the PERS fund (approximately 19.5 percent) had reduced the unfunded liability of the system to \$12.9 billion. At the end of 2009 PERS had total accrued liabilities of \$56.2 billion, with \$43.3 billion in the fund to meet those liabilities. Although investment performance in 2010 could change these numbers significantly prior to the 2011 session, it will not change the projected employer rates that will go into effect on July 1, 2011. By statute, those rates are calculated based on the condition of the system at the end of 2009. In 2011, employer contribution rates will average 15.8 percent, an amount that is high by the historic standards of the fund.

Of the \$56.2 billion in accrued liabilities of the PERS system, approximately 55 percent of those liabilities are attributed to those who have already retired from the system. These individuals are in “pay status,” receiving a benefit that has already been fixed and subject only to COLA increases as provided by the PERS statute. PERS estimates that another 9 percent of the liabilities are attributed to those who are no longer active employees but not as yet retired from the system. These inactive members accrue no additional benefits so they, too, have benefits which are fixed based on the service that they rendered prior to leaving the system.

PERS also estimates that approximately 30 percent of the liabilities of the system are attributable to Tier One employees and that roughly half of those employees will still retire on the Money Match benefit. Though the value of the Money Match benefit has diminished considerably since 2003, for those that retire on Money Match it will be a benefit in excess of the Full Formula benefit. It is safe to say, then, that well over half of the liabilities attributed to Tier One members will, in fact, be for those who retire on the Money Match benefit. Thus over 80 percent of the current liabilities of the system are attributable either to retirees, inactive members or those Tier One members who will retire on the Money Match benefit — and accordingly, less than 20 percent of the liabilities of the system to be attributed to Tier One Full Formula retirees, Tier Two Full Formula retirees and OPSRP retirees. **In other words, though these latter groups constitute only 20 percent of the liabilities of the system, they constitute 80 percent of the participants in the system.**

In 2003 the Legislature was able to focus on the Money Match benefit and diminish its value for active participants in the system. To reiterate, in contrast, by 2011 about 80 percent of the active participants in the system will receive a formula benefit that will produce a retirement benefit comparable with PERS’s historic standards. That means any attempt by the 2011 Legislature to modify the benefits of this group of active participants would require a downward adjustment of the existing formula — an action that would no doubt be held to be a violation of their PERS contracts. Perhaps more importantly, accomplishing any meaningful reduction in the unfunded actuarial liability of the system would require very significant cuts in the benefits of the Full Formula participants in the system, to levels substantially below PERS’s historic norms.

Should the Legislature once again focus its attention on Tier One Money Match retirees, it would quickly find that the 2003 reforms have already established the extent of modification that will be legally permitted to those benefits. Current active members who will retire on Money Match accrue no additional benefits by their additional service, but rather receive only the amount of the actuarial assumption (8 percent) credited to their account in each year. The Supreme Court has twice ruled that benefit to be contractual in nature, in both the *Strunk* and *Oregon State Police* cases.

It is generally acknowledged, as it was during the 2003 Legislature, that the retirement benefits of those who have already retired cannot be changed. Retirees receive only the COLA increase, which was declared to be contractual in the *Strunk* case. Similarly, inactive participants who have not, as yet, retired are beyond the reach of legislative change.

IV. Conclusion

The 2011 Legislature will address a very different PERS system than that which confronted lawmakers in 2003. The “fix” of the PERS system by the 2003 Legislature *is* converting the system into a formula system, which will produce a benefit far less than that which was being produced for participants in 2003. **The recognition of these fundamental changes to the system should lead to the conclusion that PERS has already been “fixed” and that no additional fixes are necessary or legally permissible.** The Legislature should recognize that the current unfunded liabilities are solely and exclusively the result of bad investment performance in 2008 and not because of any aspect of the PERS system which can, or should, be fixed.