Oregon Public Employees Retirement System: Overview
April 2018

Overview

1. *What is PERS?*

a. Statewide retirement plan for teachers, state workers, employees of cities, counties and special districts in Oregon, as well as community colleges and public universities.

• PERS-covered workers			168,177
Schools	66,184		
State	47,331		
Local Gov't	54,662		
• Former workers (inactives) w/ vested pensions			42,849
• Retirees & beneficiaries receiving monthly pensions			136,298
		ALL	347,324

b. PERS used to consist of just a pension plan. But since 2003 it includes both a pension plan and a 401K-style savings plan. So it is really two separate plans within one retirement system.

c. The pension plan has three tiers of benefits, with the most generous – and most expensive – benefits reserved for those who entered public employment by mid-2003.

- Tier 1 benefits for those hired before 1996
- Tier 2 benefits for those hired from 1996 through mid-2003
- Tier 3 benefits for those hired after mid-2003

d. All three of these benefit tiers are paid in full by public employers, which is unusual even for public sector retirement systems. There is no employee contribution to the pension plan.

Among current workers, approximately 60% were hired after 2003 and are covered by the less generous pension plan. The remaining 40% are covered by the more generous Tier 1/2 pension plans, but their salaries constitute roughly half of public payrolls (as more senior employees, they are higher in the pay scales)

d. The savings plan is extra. Known as the IAP or Individual Account Program, it applies to everyone, regardless of when they entered public employment. It costs 6% of pay, which is either contributed by employees directly or picked up by their employers.

2. How do PERS benefits compare to those of other public retirement systems?

a. By one measure, PERS offers a standard retirement benefit for career public employees, which was designed to deliver a pension of roughly 50% of salary after a career of 30 years or so. With Social Security on top, the goal for the system was to guarantee a combined retirement income of about 75%-85% of pre-retirement salary. If this were the outcome of the benefit formulas in place, PERS would look like a standard retirement plan for public employees.

b. But that's not the whole story. For the past two decades, most career employees retired with PERS benefits that have far exceeded that 50% target, averaging 80% of final salary between 1995 and 2015 – because of add-ons to the basic pension formula. In fact, the average benefit for a 30-year employee reached 100% of salary in 2000 (130% with Social Security). That is far more than other public systems provide and far more than the system was originally designed to deliver.

c. Employees hired since 2003 have a cheaper and less generous pension plan. Their benefits are in line with that 50% target. But 40% of the workforce was hired before 2003, and their benefits at 30 years of service continue to exceed the 50% salary replacement target in many cases (although these cases are diminishing year by year).

d. Finally, the PERS pension plan is unusual in that it is paid in full by employers. Since 2003, public employees have not been required to contribute to their pension benefits. Most public pension plans are supported by employee contributions that average 6% of pay (for plans coordinated with Social Security) or 8% of pay (for plans without Social Security), according to the National Association of State Retirement Administrators.

3. What is the problem with PERS?

a. As has been the case in many pension plans in the public sector, and some in the private sector as well, the costs of PERS benefits have been underestimated over the years while the earnings expectations for the fund's investments were often overstated. This creates underfunding.

b. But the larger problem of underfunding for PERS arose from those add-on features, which generated pensions far above the 50%-of-salary target. Those add-on features have a long and complicated history, dating back to the 1960s. In some respects, you can view them like software patches that were intended to fix little things but ended up creating much larger problems elsewhere in the system.

The most significant of these add-on features are two: a guaranteed rate of return on employee accounts and a Money Match option that provided a way to get a higher pension than the basic years-of-service formula would provide. Of lesser consequence are features that allowed the use of unused sick leave and vacation balances to boost the basis for calculating pensions based on final salaries.

The guaranteed rate of return, which is limited to Tier 1 employees, is pegged to the assumed future earnings rate of the system's investments. It has ranged from 7% to 8% a year over the past 30 years. It is currently 7.2%. For years, this rate was treated as a floor on the interest credited to employee accounts. So when the fund's investments underperform or even lose money, employees still get their guaranteed return. When the fund did better in the 1980s and 1990s, the employees got the higher returns, which averaged 15% in the late 1990s. Because of the Money Match program (see below), these earnings generated larger benefits and additional costs for employers. The guaranteed rate of return was cut off for employees hired after 1995 and has been reduced from 8% to 7.2% in recent years. Also, excess crediting (crediting member accounts more than 8% when the market is hot) no longer occurs. But the Money Match system is still adding significant costs to the system as many active and inactive employees are still retire under it.

The Money Match option allows employees who retire to take their account balances (with accumulated earnings), double these balances with a match from their employers, compute an annuity (currently also using the 7.2% rate) based on that doubled-up amount and opt for that annuity whenever it produces a higher amount than the basic pension formula. This Money Match program was cancelled for employees hired after mid-2003. It is still generating higher pensions for a third of new Tier1/2 retirees. But the number of new Money Match retires is shrinking and the increment of benefits above the basic pension is diminishing year by year.

c. Money Match and the guaranteed rate of return made PERS a very expensive system. Contributions to the system haven't kept up with these costs. And the huge investment losses of 2008, combined with more modest earnings on investments since then, have ballooned the unfunded obligations of the system – known as the UAL, or unfunded actuarial liability – to more than $22 billion.

(This is an estimate. The system's last advisory valuation quantified the UAL at $25.3 billion as of 12/31/16. But higher investment returns in 2017 and minor adjustments to reserves have likely reduced the UAL to approximately $22 billion.)

d. Given the size of our economy, the comparative magnitude of Oregon's public pension liability is almost twice that of the public employee pension system in Washington State, according to ECONorthwest.

e. The sources of the pension plan's $22 billion UAL are estimated as follows.
   - For those already retired 37%
   - For former workers w/ vested pensions 7%
   - For Tier 1/2 employees 24%
   - For post-2003 employees 5%

4. What does this unfunded liability mean for PERS and for public employers going forward?

a. By state law, all of this this unfunded liability must be paid off by employers as a percentage of their payrolls over the next 20 years. (That duration is a function of state law and could be changed, but lengthening this period would increase costs over time.)

b. The ongoing costs of the system before accounting for unfunded liabilities, known as "normal costs," are comparatively modest. These amount to 14% of payroll for Tier 1/2 employees and 8.5% for Tier 3 (or OPSRP) employees. For the combined populations, the "normal costs" average out at about 11% of payroll. These costs are paid in full by employers.

c. But the legacy costs associated with the UAL, when paid off as a percentage of payroll, will triple these costs for employers – to what would equate to 34% of payroll for school districts and 30% for other government jurisdictions if applied in full today.

d. However, actual rates paid by employers are being phased in over time, from an average of 21% of payroll today to approximately 35% over the next 8 years.

e. <u>Rates for 2019-21 are expected to rise by an average of five to six points of payroll, claiming an additional $1.4 billion in public budgets above the $2.9 billion in employer costs for the 2017-19 biennium</u>.

f. Some employers are covering a portion of their PERS payroll costs with <u>pension obligation bonds</u>, the proceeds of which have been offsetting an average of six points of payroll system-wide. However, these offsets come with their own costs – namely the debt service these employers must pay on their bonds. And, even if the invested proceeds of these bonds continue to generate strong returns, they are unlikely to offset much of the increase in rates going forward.

5. What will be the effect of these costs for public employers, public employees and taxpayers?

a. An increase of $1.4 billion in PERS costs will consume most of the revenue dividends (revenue gains above inflation and population growth) generated by projected growth in the economy at all levels of government in Oregon for the next two years.

b. For school districts, each one point increase in PERS costs amounts to $36 million per year, which equates to more than one day of school in every district or 378 teachers statewide. With rates for school districts expected to rise by at least five points of payroll in 2019, the impact of this increase would equate to six or seven days of school and nearly 2,000 teachers.

c. Similar impacts will be felt at all levels of government, either in the form of reduced staffing and services or in the form of increased fees. Tuition rates in community colleges and universities are likely to bear the brunt of the increases in those institutions.

6. What have the courts said about what can be done to reduce the costs of the system?

a. In its most recent opinion (*Moro v. Oregon*) related to the legislature's 2013 reforms, the Oregon Supreme Court ruled that benefits payable to retirees and benefits earned to date by current employees are protected by the state constitution and are not modifiable. But the court reversed aspects of earlier decisions and ruled that benefits may be modified (within some limits) on a prospective basis.

7. What can be done that will pass muster with the court?

a. Based on the court's *Moro* decision and its dicta in the earlier *Strunk* case related to the 2003 reforms, it is clear that the terms of the supplemental retirement savings plan, known as the IAP, are modifiable going forward. Thus an employee or employer contribution of 6% to the IAP may be reduced or eliminated or redirected to the pension fund to help support the financing of pension benefits.

b. Also, based on the *Moro* decision, it would be legal to reduce benefits yet to be earned by current employees, e.g. by reducing the pension formula for future service. However, it would not be legal to extend the pension vesting period beyond five years for employees who are in their first five years of employment.

8. What about the recommendations of the Governor's UAL Task Force?

a. Unfortunately, the Governor's Task Force dealt almost exclusively with how to manage the pay-off of the system's liabilities, not how to reduce the cost of the system going forward. (The few exceptions have to do with reducing investment management costs and maximizing the returns from pooled borrowing to pay down the system's liabilities.)

b. The most significant recommendations, e.g. the use of reserves from the SAIF fund, are exercises in trade-offs. If such funds are available, would they be better used for bolstering school budgets, for example? Almost every recommendation that the Task Force came up with amounted to a demonstration of such trade-offs or what economists call "opportunity costs."

Observations

9. How do PERS benefits compare to private sector benefits?

Many would say that comparisons to the private sector are unfair, because of the erosion of pension benefits in the private sector since the decades following WWII. And this gets to the larger issue of how compensation for public employees should equate to compensation for their private sector counterparts, once you account for both pay and benefits. But there is no doubt that public sector retirement benefits are far richer than those in most private sector jobs.

Further, what I found in my five years in the Governor's office, during which I was covered by the system's Tier 3 pension benefit, is that my accrual of retirement benefits was far greater than my accrual of retirement benefits during any equivalent period in my 27 years of working for unions. So the cheapest (Tier 3) level of PERS benefits is still very good.

Finally, I've heard from different private sector unions that took actions to recapitalize their pension trusts after 2008 – by deferring the accrual of benefits or increasing employee contributions. The same can be done with PERS, provided benefits earned to date are protected.

10. What happens if we do nothing?

We'll see increased claims on budgets and reductions in services even if the economy continues to do well.

For kids in today's and tomorrow's classrooms, this is a discouraging prospect. It will be difficult to maintain the class sizes and school years we have now much less improve them when most of their new revenues will be siphoned off to PERS.

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For taxpayers and citizens, we'll see a loss of confidence in the management of our public resources.

Finally, for me, as someone who sees government as a force for good in our lives and public education as the path to opportunity for our people, doing nothing means defaulting to failure and letting government programs become increasingly cost prohibitive. This will be a huge setback for the progressive vision of an opportunity society.

"Doing more with more" for our people has to take precedence over doing less and pouring more money into the Wall Street investments of the PERS fund.

11. What are your solutions?

First, we should recognize that there are changes that can be made that are legal and are compatible with continuing to offer fair and competitive compensation packages for public employees.

Short term, the most effective solutions involve two approaches:

- First, reinstate employee contributions to the pension plan. This can be done by redirecting future contributions to what is now the supplemental retirement savings plan to support the pension plan. This is what the Portland City Club recommended in 2011. It made sense then and it makes sense now. What doesn't make sense is to run a second retirement savings plan when we can't afford the larger pension plan.
- Second, we should bring the future benefits of the Tier 1/2 workforce into alignment with the lower but still adequate level of benefits for the post-2003 workforce. This is a matter of fairness for younger workers.

These two reforms would offset all of the PERS cost increases slated for the next biennium. We can accomplish this without reducing any employee's take-home pay and while still keeping the total compensation package in line with the Governor's compensation goals.

Long term, we need to rethink and redesign a retirement systems that is better attuned to a younger and more mobile workforce, which means re-examining a system that disproportionately rewards career employees with high late-career salaries.

12. Is it fair to ask employees to bear the burden of solving this problem when most of the problem is due to benefits promised to those already retired?

There would be greater equity in involving retirees in the solution to this problem, but the courts have consistently rejected this approach. So we are stuck with next-best solutions. But these need not be unfair to current employees. For example, it's important to recognize that the underfunding for benefits for those still working amounts to only about a third of the system's unfunded liability. That should be the upper limit for what is expected from reforms that affect current employees. However, that still amounts to more than $7 billion in potential savings—more than was passed in the 2013 Grand Bargain reforms.

Also, there is the issue of fairness when it comes to the level of benefits for public workers going forward and the cost of those benefits to employers and, ultimately, to the taxpayers. This suggests that we should be asking ourselves what is an adequate retirement benefit for employees and what is an affordable benefit for the taxpayers. We shouldn't default to continuing in place a retirement system that doesn't meet those standards of adequacy and affordability.

Also, when it comes to fairness, we should ourselves what is fair for a younger generation of workers. Those coming into public service now are not benefitting from the excesses of the past but will otherwise bear the cost of those excesses. So, we should try to calibrate whatever reforms we pursue to mitigate the impacts on younger workers.

At the end of the day, though, legacy costs are inherently unfair to younger generations of workers, to students, to those who rely on public services and to those who pay for them. We have to balance those interests as best we can.