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PERS in Crisis: The Sequel

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To: Interested parties
From: Phil Keisling

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Background and Executive Summary

Less than a decade ago, the Oregon Public Employees Retirement System (PERS) was widely touted as the "most generous – and best managed -- public pension plan in the U.S." From 1991 to 1999, the PERS Fund soared an eye-popping 180%, from $14 billion to $40 billion. In 1999 alone, the Fund's value jumped 25%. That same year, 6,843 PERS members retired, 14% of them with projected annual benefits 100% or more of "Final Average Salary."

Then came the dot-com bust, followed by the 2001-02 economic downturn. By the time the 2003 Oregon Legislature convened, many were predicting disaster. As PERS officials themselves describe it, in an August 2009 hand out, "PERS had an unfunded actuarial liability of over $17 billion, (and) employer contribution rates were projected to rise to 29% of payroll."[1]

In response, the 2003 Oregon Legislature made major changes to PERS. The politics were difficult and contentious. Business groups and a few Democrats – most notably Governor Ted Kulongoski and freshman Democratic Representative Greg Macpherson – championed the changes. But it took mostly Republican votes to pass the major reforms, as public employees and unions such as the Service Employees International (SEIU) and the Oregon Education Association (OEA) strenuously opposed them.[2]

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[1] The "Employer Contribution" rate is perhaps the most important single term in understanding PERS – and accordingly will be capitalized throughout this paper. Set by the PERS governing board each biennium and based on many factors, it is expressed as a percentage of payroll and represents what each of Oregon's 887 public employer must contribute to PERS to meet specific, legal obligations to the system's current and future retirees. While state agencies, Oregon's 199 K-12 districts, and most local governments belong to their own, common "pools" for Employer Contribution rate-setting purposes, the percentage of payroll a given public employer will actually pay for PERS-related obligations depends on a variety of factors, including the mix of employees in certain categories. As will be explained in more detail throughout this paper, the Employer Contribution rate is *only one component* of the total, PERS-related obligations of most public employers...

[2] Governor Kulongoski found his advocacy for PERS reform politically painful. In his 2006 re-election bid, he was strongly opposed in the Democratic primary by two challengers who argued the PERS reforms were wrong and/or unnecessary. The OEA made no endorsement, and SEIU endorsed one of his opponents, former Treasurer Jim Hill. (Kulongoski did win the primary, and ultimately re-election). The ripple effects of PERS were also felt in the 2008 Democratic primary, when Rep. Macpherson lost a hotly contested bid for Attorney General. The SEIU alone contributed more than $300,000 to his opponent, now Attorney General John Kroger.

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Then, almost as quickly as the crisis arrived, PERS largely vanished from the radar screen. And it's easy to see why. After two years (2001-02) of back-to-back losses totaling about 16%, the PERS Fund once again grew at a ferocious clip. Between 2002 and 2007 its value nearly doubled, soaring to a record $62.9 billion as of December 31, 2007.

But nothing in PERS' 40-year history – not even close – has matched its dismal performance during America's severe economic downturn. By December 31, 2008, the fund – technically known as the Oregon Public Employee Retirement Fund, or OPERF – plunged 27%, finishing the year at $45.7 billion. In one year alone, 2008's losses wiped out the previous 4 years' of investment gains, essentially returning OPERF to within 10% of its valuation almost a decade earlier -- in 1999.[3]

Could PERS now be built on such solid bedrock, that even the worst economic crisis in 75 years would leave it relatively unscathed? Could a 55% drop in major stock indexes, and the near-overnight collapse of America's once vaunted financial sector, prove nothing more than a passing annoyance to a retirement system whose obligations extend to more than 300,000 Oregonians?

These are some of the questions this white paper examines. And the answer, not surprisingly, is a resounding "No."[4]

In summary, here are this paper's major findings and conclusions– all of which assume the continuation of existing PERS policies:

- Even assuming double-digit investment returns for 2009, plus a return to an 8% annual earnings rate for OPERF investments beginning in 2010, a combination of the severity of the 2008 market crash; current PERS policies; and existing labor contracts and management practices will likely mean an **estimated $1.5 billion of additional tax dollars** will be

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[3] The actual, nominal value of OPERF actually fell even more: $18.3 billion, or about 29% between 12/31/07 and 12/31/08. However, also during this period there were "in and out" movements of money to OPERF – e.g. contributions from employers and employees in; benefits paid to retirees out. Such "outflows" currently exceed inputs, so while "OPERF investment earnings" as determined by the Treasury department show as 13.83% Year to date (through 9/30/09), the actual change in the total value of OPERF is closer to 10% for this period.

[4] Beginning in June, 2009, this author began asking a few questions about PERS of many knowledgeable observers of the system, including PERS staff. All were very helpful and open, though as the summer wore on, many answers seemed to raise additional new questions. After sharing some preliminary findings with PERS staff in August, the author circulated several drafts among interested parties. An October 12th, 2009 draft was shared with the PERS Board and PERS Staff, who offered numerous corrections and constructive commentary, most of which was incorporated into this draft. During this period, several in-depth newspaper articles – notably by the Oregonian's Ted Sickinger and Mackenzie Ryan of the Salem Statesman Journal – also contributed significantly to the discussion.

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required by state, K-12, and local government employers in 2011-13 to meet PERS-related obligations. This will be money essentially "taken off the table," unavailable for protecting – much less expanding – existing government services in such arenas as education, health care, and public safety.

- On a system-wide basis, by 2013-15 Oregon's state, K-12, and other local government employers face a high probability of seeing their benchmark, "PERS Employer Contribution rate" roughly double, from 12% of payroll today to about 24%. Using system assumptions that public employer payrolls will grow from $16 billion today to $20 billion by 2013-15, these PERS obligations will require **$2.5 billion in new, additional money** that could otherwise be used to provide government services and/or reduce taxes.
- Based on a more pessimistic, 5% annual earning rate for OPERF investments for the next decade – essentially matching average annual returns for the 1999-2009 period -- the PERS Employer Contribution rate could rise to 30% (system-wide) of payroll by 2017-19, or almost **$5 billion more** viz. 2009-11 levels;
- Even with such large Employer Contribution rate hikes, there is significant risk that PERS' "Funded Status" (its ratio of Assets to Liabilities) will drop to levels unprecedented in modern PERS history. Between December 31, 2007 and December 31, 2008, PERS' funded status plummeted from 98% to 71%, and "mid-point" scenarios of OPERF annual growth rates predict it staying in the 70-80% range throughout the next decade. Even a more optimistic, 10% annual investment return rate won't return PERS' funded status to 2007 levels until decade's end -- and lower earnings scenarios (e.g. 4.5%) show it plunging into the 50-60% range. [5]
- For many public employers, PERS-related costs will prove even higher – as a percentage of their payroll – to those noted above, should they choose to continue the practice of also paying their employees' required, 6% contributions to PERS.
- For 140 PERS employers who sold more than $6 billion in "Pension Obligation Bonds" from 1999-2007, the outlook is more complicated, still. Most of these proceeds were invested in PERS "Side Accounts," whose earnings (to date) have reduced overall PERS costs, after accounting for bond repayments. However, 2008 pulled some of these Side Accounts "underwater" – with earnings less than bond financing charges – and virtually all POBS are "backloaded," structured so that bond repayment costs steadily escalate throughout their 20-30 year lives. In lower-than-hoped for investment climates, POBs for these jurisdiction, too, could end up costing far more than their benefits.

[5] Or, as PERS Director Paul Cleary blunty told the Oregonian on October 1, 2009, "Our business model doesn't work at 4.5% returns."

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- PERS' vulnerability to market fluctuations– even those much less severe than the 2008 financial meltdown -- is largely inherent in the design of existing benefit structures and the system's heavy reliance on investment earnings to ensure pension liabilities can be met. The burden for any significant shortcomings in hoped-for investment earnings for OPERF -- a fund that's overseen by the Oregon Investment Council and managed by the State Treasurer, not the PERS Board -- will fall largely and directly on Oregon taxpayers.
- PERS-related obligations, while significant, are only one component of the total "burden" involved in hiring public employees. Combined with taxes and non-PERS benefits such as health insurance, many public employers currently must set aside an additional 50% of payroll, in addition to salary. With PERS hikes of the magnitude noted above, an overall burden rate of 70% or even 80% will be common by the end of the decade
- By early 2009, leaders and financial officials in Oregon state, K-12, and local governments were keenly aware – or should have been, based on available public documents produced by PERS, its staff, and hired experts – that PERS' benchmark "Employer Contribution Rate was heading (under a 50% probability scenario) from 12% of payroll to as high as 30% by 2017-19. Nonetheless, no widely visible, public debate of the enormous implications of this scenario occurred in key arenas – especially during the 2009 Oregon legislature –foreclosing the possibility of certain actions that could have been taken ameliorate the current crisis.
- In coming months, the PERS Governing Board and state lawmakers will be under intense pressure to change existing policies, actuarial assumptions, and laws to ameliorate the impact of pending rate hikes. The merits of any significant change –be it on PERS' benefit side or financing side – deserves a visible, robust debate that not only takes into account the interest of today's taxpayers, retirees and public employees, but those of tomorrow's citizens whose level of taxes and available government services for decades to come could be heavily affected by decisions made in the months and years ahead.

Finally, a few disclaimers.

PERS is a deeply, even "dizzyingly" complex system, underlain by many assumptions and consisting of many inter-locking parts and ever-changing dynamics. I am not an economist, an attorney, nor an actuary. PERS' many acronyms, statistical terms, and stochastic economic models are more than a little daunting. Accordingly, part of this white paper's purpose is to help explain, in broad and understandable terms, the essential parts and dynamics of the PERS system. However, I am also keenly aware that any such

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effort will inevitably leave out – or even potentially mischaracterize – important information, and for that I take full responsibility.[6]

I also want to emphasize that this white paper – and the judgments, analyses, observations, and recommendations in it -- are mine alone. While many have assisted me in this effort – including PERS managers and experts who were most gracious with providing information and suffering through many ignorant questions -- I take full responsibility for those opinions, as well as all attendant errors and omissions contained herein.

# # # #

What's arguably the most dangerous myth in Oregon politics today?

That in 2003, reforms enacted by the Oregon Legislature to rescue the "Oregon Public Employee Retirement System (PERS) from financial catastrophe, also put PERS on a relatively stable, sustainable path for the foreseeable future.[7]

Much as the near-silence about PERS in public forums during most of 2009 might otherwise suggest, the severe recession of 2008-09 that shook America's economy to its roots –and made millions of citizens afraid to look at their monthly 401 (k) statements – also holds potentially profound consequences for PERS and Oregon taxpayers.

In the 12 months between December 31, 2007 and December 31, 2008, the official value of the Oregon Public Employees Retirement Fund (OPERF) dropped $17.2 billion, from $62.9 billion to $45.7 billion. PERS fell even more in the first 3 months of 2009, finally bottoming out on March 31, 2009 at $41.5 billion.

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[6] To try to "see the forest" – and "not get lost in the needles, much less the trees" as one person put it – I have largely chosen (unless otherwise specified) to use "aggregate" and "average" figures throughout this paper. Accordingly, many of the statistics, and especially percentages, apply across broad classes of employers (e.g., the state or K-12 schools) and sometimes even across the entire system.

For those wishing to get a better sense of PERS' multi-faceted complexity, and especially all the various assumptions that underlay key policy issues such as establishing Employer Contribution rates, are directed to PERS latest, 2008 Annual Report at: http://www.oregon.gov/PERS/docs/financial_reports/2008_cafr.pdf -- especially the assumptions on pages 60ff.

[7] Perhaps the "second most dangerous myth" is that literally nothing can now be done to put PERS on such a stable, sustainable path. True, there is no "one big thing" that can fix the problems described here, and virtually anything of consequence will likely prove contentious. But taken together, a series of changes, both through law and the collective bargaining process, could make a tangible difference. Some of those possibilities are described in Appendix A of this paper.

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OPERF's value has rebounded since –as have many Oregonians' 401 (k) plans. Leading stock indicators such as the Standard and Poor's 500, NASDQ, and even the Dow Jones Industrial index have risen significantly. But less than 50% of OPERF's portfolio is in public equities, and as of September 30, 2009 (PERS' last available estimate), OPERF's overall value had risen 10% for 2009 Year to Date, to about $50.5 billion. [8]

The result? Combined with existing policies, labor contracts, and financial strategies many public employers embraced earlier this decade in the hope of reducing costs, PERS currently faces a crisis that could prove even more difficult – and ultimately more costly to current and future Oregon taxpayers -- than even the 2003 version.

This judgment is based largely on information the PERS governing board, its staff, and its own actuarial firm (the Mercer Consulting Group) has produced, publically discussed, and posted on its website over the last several years. While such key documents have arguably been "hidden in plain sight" for much of 2008-2009, the topic has received only a smattering of press coverage, mostly in the *Salem Statesman Journal* and *Oregonian*.

During the 2009 Legislative session, public discussion of PERS' long-term health seems to have largely been limited to one Ways and Means subcommittee. If the Governor and key legislative leaders knew about the scale of the problem, they certainly didn't feel compelled to call public attention to it. [9]

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[8] Many might assume that the stock market's robust rebound since its March 9 low – through September 30, 2009, the DJIA went up 48%, the S&P 500 by 58%, and NASDAQ by 69% -- would also recoup most of OPERF's massive losses. However, from OPERF's March 2009 low, its valuation is up just an estimated 22%. One factor: the same "hyper charged" investment returns that made PERS such an envy of its peers during the 1990s – and then again during the 2003-2007 "bull market echo" – were due in no small part to the Oregon Investment Council's appetite for riskier investment instruments that the average person can't (and arguably, shouldn't) go near. (Legal authority for how to invest OPERF funds lies outside the PERS Governing Board. The Oregon Investment Council sets investment policies, which the state Treasurer and his office then administers.)

For example, Private Equity Funds and Real Estate now comprise 28% of OPERF's portfolio, up from 19% just two years ago. These classes performed very strongly – at least, according to Treasury's valuations of these investments -- during the two periods noted above (1990-99 and 2003-2007). Looking at gains in various components of OPERF's portfolio from January 1, 2009 through Sept. 30, 2009 , public equities are up 30% -- but for the same period private equity investments are down 13%, and real estate by 12%, Public equity funds now comprise just 44% of OPERF's portfolio.

[9] PERS Board and staff correctly point out they've repeatedly discussed in public meetings the implications of OPERF's plunging values and various Mercer projections of future rates. Few, if any, of these meetings seem to have been attended by journalists, Not until October 1, 2009, did the Oregonian publish its first story, by Ted Sickinger, detailing projected PERS Employer Contribution rates. On October 25, 2009, Sickinger published a more complete front page story on PERS, which can be found at http://www.oregonlive.com/business/index.ssf/2009/10/looking_down_the_barrel_of_per html. MacKenzie Ryan of the Salem Statesman Journal has also published several lengthy pieces on the PERS issue, especially focusing on Pension Obligation bonds, which will be discussed later. These pieces can be found at http://www.statesmanjournal.com/article/20091101/GAMBLE/311010001/-1/gamble02,

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Was it true lack of knowledge– or, given so much other bad (and more immediate) budget news, a widespread tendency to dismiss, even repress the staggering implications of PERS' problems? (Or, perhaps some of both?) Regardless, the relative silence outside of a few, periodic PERS board and staff presentations, seems especially unsettling, given the rapidity and scale of PERS' impact on Oregon public employers and taxpayers.

What is the scope and breadth of that problem?

For 2009-11, the system-wide, Employer Contribution rate to PERS for Oregon state and local governments will be the equivalent of 12% of payroll, or approximately $2 billion. That's how much these entities will need to pay into PERS, based on what the PERS Governing Board has determined is necessary to meet the legal and contractual obligations to current and future retirees.

Based on the projections of PERS' experts and actuary – the Mercer Consulting Group – and the continuation of existing PERS policies, for 2011-13 the Employer Contribution will rise 50%, to 18% of payroll. This change alone will require the equivalent of $1 billion more in additional tax dollars from Oregon's state, K-12, and other local governments to meet their PERS obligations.

(And as will be explained in more detail later, the "felt" financial impact, system-wide, on state government, K-12 school districts, and other local governments in 2011-13 will actually be *significantly more painful* than this – more on the order of a $1.5 billion increase, compared to 2009-11 levels.)

After 2011-13, things could get *much worse*. In PERS' most comprehensive modeling exercise -- released in May 2009, while the Legislature was still in session – Mercer projected that at a 50% probability (OPERF annual average investment returns of about 8%), the system-wide Employer Contribution rate would rise another 6% -- to 24% of payroll – in 2013-15.

By 2013-15, what one observers calls Oregon's pending "PERS Tsunami" could literally "wash away" more than $2 billion in taxpayer funds that today are being used to provide actual government services – e.g. K-12 teachers and college professors, health care and early childhood education, building roads and repairing aging infrastructure, etc.[10]

Or, look at it this way. What would happen if $2 billion in new money suddenly materializes at the beginning of 2013-15 for state and local governments? Not a dime could go to reduce K-12 class sizes, expand Medicaid coverage, put more cops and

[10] While these "extra fund" numbers are across all levels of state and local government, it's important to recognize how "inter-connected" they all are. For example, the majority of K-12 and community college funding now comes via. the state general fund. Local governments, while more reliant on local revenue sources like property taxes, still depend heavily on state funding for programs such as corrections, mental health, and transportation. For all intents and purposes, any large impact on state government costs is also a problem for K-12 schools and other local governments – and vice versa.

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firefighters on the street, fix potholes and repair bridges, or even cut taxes. All of it would need to go to shore up PERS.

Later in the decade, things could get even worse, still. The May 2009 Mercer report projected that the Employer Contribution rate -- again, at 50% probability, assuming existing policies -- would soar to 31% by 2017-19. Assuming – as PERS does -- that public employer payrolls grow from $16 billion today to $22 billion, this means more than $5 billion in additional Employer Contribution dollars (viz 2009-11) from state and local governments, simply to put PERS on a sound footing and ensure it can meet existing contractual and legal obligations to current and future retirees[11].

On September 25, 2009, after much of the work on this paper had been completed, Mercer presented an updated report to the PERS Board. The May 2009 report had assumed that OPERF's investment return rate would fall another 3% in 2009 – and then return to annual growth rates of 7-9% for the remainder of the decade. By July, OPERF earnings had actually rebounded about 9%, so the September update started from a higher "base."

Notwithstanding 2009's gains, the September 2009 Mercer report also showed Employer Contribution rates roughly doubling, to 24%, for the 2013-15 biennium. Beyond that, the September 2009 report was less pessimistic. Using its comparable, mid-point scenario– an annual growth rate of 8% -- it predicted the Employer Contribution would not rise to 31% by 2017-19. But it would need to remain at 24%, to ensure PERS stayed on a sound financial footing. [12]

Actually, "semi-sound" is more accurate. That's because the key benchmark for any public pension system – its "Funded Status", or ratio of assets to liabilities – would also deteriorate significantly for PERS, even with these kind of dramatic hikes.

On December 31, 2007, that Funded status stood at 98% -- literally one of the highest of any fund in the U.S. By December 31, 2008, it had plunged to 71% -- a drop unprecedented in PERS history.[13]

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[11] If employer payrolls fail to keep growing at 7-8% per biennium – a realistic possibility, if the burden of significantly higher PERS costs lead to fewer new hires, smaller raises, and/or lay-offs – the Employer Contribution rates, expressed in percentage terms, could go even higher.

[12] By 9/30/09, OPERF earnings were up 14% for the year, according to Treasury statistics. It's certainly possible that the fund's benchmark, 12/31/09 valuation could reflect this (or even higher) gains, and brighten PERS' 2013-15 and beyond picture accordingly. But even a strong 2009, following 2008, will have little effect on future biennia if OPERF's 2010 and beyond performance averages 8% annual earnings. And for the last 10 year period – 1999-2009 – it will end up averaging (even with a strong 2009) about 5%.

[13] PERS often uses OPERF valuation numbers that also include the value of various "Side Accounts" it manages for the state and numerous local governments. However, these Side Accounts' original assets were generated by selling Pension Obligation Bonds, the liabilities for which – bond repayments – are not held by PERS, but by individual public employers. For accurate comparison purposes, all "Funded Status" figures in this paper do not include Side Accounts.

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The May 2009 Mercer report, at 50% probability, projected PERS' funded status at just 61% in 2013-15 – even with the Employer Contribution rate at 24% - and at 67% at the projected 31% rate in 2017-19. Mercer's September 2009 report – at its mid-point assumption of 8% annual growth in OPERF – wasn't that much better. It still put PERS' funded status at just 73% in 2013-15, and 77% for 2017-19.[14]

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The "tsunami" analogy is an apt one to convey the potentially devastating financial impact of PERS' projected rate hikes. But it's also an imprecise one, for other reasons.

In the natural world, the earthquakes that generate tsunamis are largely sudden and unpredictable. Experts have little time to warn the general population; many literally never know until the waves hit them.

In the political world, the pending PERS crisis is more akin to a Category 5 Hurricane. PERS officials and their actuarial experts have known of the potential for this kind of storm for years. As with the federal government employing skilled meteorologists, PERS has retained the Mercer Consulting Group to run the kind of "modeling scenarios" that can help predict the conditions under which such potentially devastating financial storms might develop.

In May 2008, during much sunnier economic times, Mercer presented such a modeling scenario to the PERS board. In it, Mercer described what it (then) considered a "worst case" financial storm: OPERF performance at an annualized -12% rate. Despite the low (5%) probability given to such a scenario, in a comment eerily prescient of the current situation, Mercer highlighted the headline to Slide 21 with the following comment: "However, in poor investment environments, contribution rates may exceed 30% of payroll."

So by the late fall of 2008 – and well before the May 2009 Mercer report was published -- those who understood the underlying dynamics of PERS knew that no ordinary "tropical storm" was bearing down. Yet until just recently, if most legislators, school superintendents, and other local government officials have had much awareness of a

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[14] Compare May 2009 Slide 13, to September 2009 Slide 39. Note that all figures are based on the mid-point values of each biennium – i.e., 2014 for 2013-15.

These slides also reveal Funded Status figures that are higher – but also lower – depending on how well PERS performs. For example, the September 2009 report shows that with 10.5% annual OPERF growth over the next decade, PERS funded status could rebound to as much as 93%. But at the lowest of 3 scenarios – 4.5% OPERF annual growth – the Funded Status could fall to as low as 51%.

It's important to note that employer contribution rates are set, each biennium, at levels PERS believes will return the fund to 100% funded status over 20 years. Both the May 2009 and September 2009 Mercer modeling exercises at 50% probability show the Funded Status dipping far lower – and staying there far longer – than has been previously been contemplated in PERS history

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"PERS problem" lurking just beyond the horizon, many seem to have thought its dimensions to be more "squall-like" -- perhaps some heavy rains and brief winds.

For more casual observers – not to mention, the general citizenry – a simple glance outside during most of 2009 would have actually suggested the equivalent of bright, blue skies and sunshine for the PERS system.

Indeed, in mid-September of 2008 – just as the nation's financial markets began what proved to be the worst, 6-month financial market meltdown since the Great Depression -- – PERS officials approved a *significant reduction* in the benchmark Employer Contribution rate, from a system-wide average of 15% of payroll in 2007-09, to 12% in 2009-11.

This seeming paradox results from PERS' long-standing use of an "18 month lag" policy when setting Employer Contribution Rates. So for the 2009-11 biennium, which began on July 1, 2009 and lasts through June 30, 2011, PERS' Employer Contribution rates are actually based on the -- now distantly remote -- OPERF valuation of December 31, 2007.[15]

As experience with real-world hurricanes also suggest, citizens often don't board up their windows and stock up on batteries – much less evacuate their homes – without repeated and often very pointed warnings. But the longer they wait, the fewer options they have, and the more difficult their choices become.

Which is exactly the situation today. The state's 2009-11 budget is already adopted, as are most local governments' 2009-10 budgets. Major labor contracts, some of which run into 2011 and beyond, have already been negotiated.

Indeed, throughout the entire 2009 legislative session – and even after its adjournment, as major labor contracts with state employees were being negotiated – the "issue" of PERS barely merited a few public murmurs in the halls of the State Capitol. If there was a strategy in such quarters, it seems to have amounted to little more than "hope" – that somehow, the nation's financial winds might suddenly shift in a much more favorable direction, causing the PERS storm to veer back out to sea.[16]

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[15] There are good reasons for the 18-month lag, given the realities of appropriately valuing PERS' various assets. However, the lag's effect has come into somewhat higher visibility since the PERS Board in 2005 adopted the policy of setting rates based on OPERF's market valuation every two years, replacing the the 4-year "asset smoothing" approach used prior to the 2003 crisis. This previous approach tended to mask – and arguably, artificially reduced – what PERS Employer Contribution rates needed to be to truly meet future obligations.

The flip side of this 18-month lag policy is that however much OPERF may gain back in the next few years, Employer Contribution rates for the 2011-13 biennium will be based on OPERF's December 31, 2009 value.

[16] The "fact" of future PERS rate hikes seems to have been reasonably known within public employer circles for some time, beginning in the fall of 2008. What's much less clear, is the extent to which the Governor, legislative leadership, and even the PERS Board and staff itself –pro-actively worked to alert

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# # # # #

Let's explore some basics of the PERS system, and the full dimensions of its many challenges in more detail.

By law, the PERS Governing Board – a 5 member, citizen panel appointed by the Governor – must set "Employer Contribution" rates to ensure that OPERF has sufficient funds to meet its legal and contractual obligations to 105,000 current retirees, and another 200,000 active and inactive members who've not yet reached retirement age.

As noted earlier, in May, 2009, PERS' long-standing actuary, the Mercer Consulting Group, released its annual "modeling exercise" that estimated how much the Employer Contribution rate would need to be in future years, under a wide range of assumptions about the performance of OPERF.

OPERF plays the central role in PERS' world because nearly 67% of the money needed to fund the PERS system comes from investment earnings. If OPERF racks up year-after-year increases of 15%, for example, the amount Employers need to "make up the difference" drops considerably. At the lower end of the probability curve, flat or even negative annual returns will force the rate up – and often dramatically so. Mercer's 50% probability point – the one that will largely be discussed in this paper – pegs annual OPERF growth at about 8%.

The PERS Board does not, however, manage the OPERF fund. By law, it is the responsibility of the Oregon Investment Council to set the general asset allocations – e.g., how much to invest in public equities vs. private equities or real estate, etc – and the

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public employers (not to mention the general public) of the *immediacy and immensity* of these looming hikes, especially as budgets were being decided in 2009 and labor contracts negotiated.

Another potentially major dimension to the PERS situation, well beyond the scope of this paper, involves the "solidity" of key elements of OPERF's portfolio – especially its "less transparent" portions now held in private equity and real estate holdings. As of 9/30/09, Treasury estimated the combined value of these two categories – now almost 30% of OPERF's portfolio – at $14 billion. That's actually higher than their 9/30/07 combined value of $12.3 billion – a notable thing, given that public equities (whose exact values, at any given moment, are readily determinable) went from a value of $34 billion to $22 billion during the same period.

By law, Treasury officials must base valuations on an independent review of these investments. However, as so many recent headlines attest, such third-party, independent reviews often fall short of being able to reveal the existence, much less full dimensions, of troubled investments in these portfolios. Some knowledgeable observers of the OIC/Treasury side of the PERS equation believe that there could be significantly more "bad news" yet to be revealed in these sectors If true, the estimated investment return for PERS of 13.83% through 9/30/09 that's now being cited by some as indicating PERS has successfully "weathered the storm" could fall significantly – affecting not only future Employer Contribution rate-setting deliberations, but future modeling exercises for PERS' future..

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responsibility of the State Treasurer and staff to manage the actual investments. Like the PERS Governing Board, the OIC is also an independent body, whose members are appointed by the Governor, not the Treasurer. The Treasurer and his staff in turn select – and then are responsible for holding accountable -- the private vendors and fund managers who actually make many of the specific investment choices and day-to-day decisions.

In the fall of every even-numbered year, the PERS Board establishes Employer Contribution rates for the upcoming biennium. So if PERS sticks to its regular rate-setting schedule, in the fall of 2010 – and based largely on the Treasurer's official valuation for OPERF as of December 31, 2009 – the PERS Board will establish these official rates for the biennium beginning July 1, 2011.[17]

For its May 2009 report, Mercer used 2008's actual performance – a 27% drop, three times worse than any in PERS history – and an estimate of -3% for PERS' 2009's performance. It then projected Employer Contribution rates for future biennia, using a range of probabilities based on assumed OPERF earnings.[18]

As noted earlier, the May 2009 Mercer report concluded that to **finance the pension obligations of current and future retirees, state and local government employers would need to increase their "Employer Contribution" rate in 2011-13 from an average of 12% of aggregate payroll, to 18%.**

This sounds relatively innocuous, until one realizes three things.

First, across all levels of Oregon government – the state, K-12 school districts, community colleges, cities and counties, etc – the estimated combined payroll for the current 2009-11 biennium is over $16 billion.

That means each 1% increase in the Employer Contribution rate translates, system-wide, into about $170 million per biennium. Based on current payroll costs, a 6% jump in this core "Employer Contribution" rate means an *additional $1 billion of tax dollars that will be needed for PERS-related obligations in 2011-13, compared to what was required for 2009-11.*

Second, Mercer noted that under an existing PERS policy known as the "double rate collar," this 6% of payroll increase is essentially a given, "baked into" PERS' future. Adopted in 2004, the rate collar policy – which will be examined in more detail later – *limit*s how much the PERS Employer Contribution rate can change from one biennium to the next. If PERS' Funded Status is between 80% and 120% -- not counting any Side

[17] Again, note footnote 15. While PERS officials make very important decisions based on PERS investment returns – past, and projected – it is the OIC and the Treasury Department that makes investment decisions – and provides valuations for various asset classes at a given time.

[18] The actual May 2009 Mercer report, -- and many other reports references in this white paper – is available athttp://www.oregon.gov/PERS/section/financial_reports/Financial_Modeling_52909.pdf

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Accounts -- Employer Contribution rates can increase (or decrease) by a maximum of 3% per biennium. If PERS' Funded Status is outside that band – and currently, it's about 73% -- the "double collar" comes into effect, limiting rate changes to 6%.[19]

Third, for government entities that make up the vast majority of PERS' payroll – the state, most of Oregon's largest K-12 districts, and some key local government players – the total, "net effect" of the PERS rate hike in 2011-13 will be *significantly higher* than 6%, and closer to 9% of payroll.

Why? Between 2002-2007, about 125 public employers – including the state, about 100 K-12 districts, and another few dozen local governments – sold more than $6 billion in "Pension Obligation Bonds." Some of the money was used by the state and local governments to eliminate certain liabilities that were essentially carrying 8% annual interest costs. But most bond proceeds were largely invested in OPERF "Side Accounts," whose values then rose – and then, just as dramatically -- fell with OPERF's fortunes.[20]

Effective July 1, 2009 for the 2009-11 biennium, earnings from these Side Accounts – based on their December 31, 2007 valuation -- will reduce Employer Contribution rates significantly. Across the entire system – including both employers with Side Accounts and those without – the *net* Employer Contribution rate for 2009-11 will fall to just 4%. This net rate will literally be an all time "low" in PERS history – literally coinciding with PERS' worst previous year in history.

Obviously, the actual decreases for employers with Side Accounts will be even greater. For example, the state of Oregon's baseline, PERS Employer Contribution rate of 13% of payroll for 2009-11 will be reduced by an average of 10%, producing a *net* Employer Contribution rate of just 3% of payroll. For Portland Public Schools, Side Account proceeds will reduce its base Employer Contribution rate from 14% to almost 0%.

But this "Side Account discount effect" is also fast changing as reality catches up with this aspect of the PERS system, too. [21]

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[19] This 6% hike for 2011-13 is significantly *less* than what it would be without the rate collar. The more recent, September 2009 Mercer report estimates the system-wide rate would otherwise jump *10%* in 2011-13, to 22% of payroll. This would require an additional $1.7 billion viz. 2009-11 levels.

[20] "Side Account" is also a very important concept in understanding PERS, and will also be capitalized throughout this report.

[21] As of 12/31/07, the total value of Side Accounts was $7.7 billion, with $6.2 billion in remaining liabilities. As of 12/31/08, their value had plunged to $5.1 billion, with liabilities of $6.2 billion. About $500 million of this reduction was due to disbursements employers took during 2008 to help pay for their Employer Contribution obligations.; the rest reflects the 2008 market drop.

Some of these Side Accounts – especially those bought closer to the "top of the market" in 2005 or even 2007 – are now essentially underwater, costing their employers more (in bond repayments) than they can generate in earnings to "buy down" the Employer Contribution rate. These side accounts will, of course, recover as OPERF does – but they could also fall again.

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In 2011-13 (and likely beyond), public employers with significant Side Accounts will experience a PERS "double whammy." While their base, Employer Contribution rates will increase by 6% in 2011-2013, their Side Account discounts will fall an average of an estimated 3-4% of payroll. [22]

More accurately, many public employers with Side Accounts will experience more of a "triple whammy." Pension Obligation Bonds are simply loans, whose principal (with interest) must be repaid. For example, the state of Oregon will make $280 million in bond payments for 2009-11, the equivalent of about 6% of payroll. Portland Public Schools' repayment of $61 million will represent about 11% of its payroll.

Unlike, say, a conventional home mortgage, these loans are "back-loaded," with payments structured to *increase* each year until the loans are fully repaid. For example, the state of Oregon's payments will increase 8% each biennium. PPS' loan payments, which are projected at $61 million for 09-11, will be $106 million by 2019-21. [23]

For 2011-13, the combination – again, system-wide -- of a 6% increase in the base Employer Contribution rate, and a 3% *decrease* in the Side Account discount effect, will mean that Oregon's public employers will see their average *net* Employer Contribution rate go from 4% in 2009-11 to nearly 13% in 2011-13.

This 9% difference better reflects the real impact that will be "felt" in the public sector, because this is the actual, net new tax money that will be needed. Since public employer payrolls are estimated to grow to $17.5 billion in 2011-13, this is the equivalent of paying an *additional $1.5 billion* viz. 2009-11 levels to meet on-going PERS obligations.

For the 2013-15 biennium, Mercer's model projects – again, at the middle, "50% probability" level – another 6% increase system-wide to 24% , or double the 2009-11 base rate. [24]

Meanwhile, the Side Account discount effect could drop to 4%, system-wide – just half its 2009-11 amount. So from a net Employer Contribution rate of just 4% in 2009-11, by 2013-15 this net rate could be 20% -- *five times* the amount of 2009-11. Against a

[22] For example, the State's Side Account was valued at $2.791 billion on 12/31/07. Disbursements based on that value during the 2009-11 biennium will be about $200 million, to produce a "discount effect" of about 10% of payroll for state agencies. *Even if* OPERF gains 12% during 2009 – PERS' current prediction for 2009 – the State Side Account's projected value for 12/31/09 will be approximately $1.9 billion. Accordingly, for the state the "discount effect" could fall to between 6-7% of payroll for 2011-13.

[23] Additional background and discussion about Side Accounts is found later in this paper.

[24] See May 29, 2009 Mercer report, Slide 12: 50% probability at year 2014.

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projected payroll now of $19.1 billion – and again, compared to 2009-11 levels – state and local governments would now require more than $2.5 billion additional for PERS.[25].

How probable is this 2013-15 scenario? Mercer gave this second, 6% increase in the Employer Contribution rate a 90-95% certainty in its May 2009 report, again assuming the continuation of existing policies. The September 2009 follow up report also still projected a 24% rate for 2013-15 under all but the most optimistic scenarios. [26]

Beyond 2013-15, things could get *even worse, still* -- though as with any projection, the further out one goes, the more uncertainty exists.

For example, by 2017-19, Mercer's May 2009 model – again, at 50% probability, assuming existing policies and assumptions -- showed the base Employer Contribution rate rising still further, to 31%. The net Employer Contribution rate, after Side Account discounts, would then be 26%. [27]

The chart below reflects these trends over the next decade. Again, this is on a system-wide basis, based on Mercer's May 2009 report at the 50% probability scenario. It also assumes the continuation of existing PERS policies and approaches, including the current "double rate collar policy".

[25] The average, system wide *net* Employer Contribution rates can be found on Slide 21 of the Mercer May 2009 report. PERS currently estimates that public employer payrolls will grow by 3.75% a year. Largely fixed pension obligations, against a *slower pace* of payroll growth, would result in even higher hikes, in percentage terms.

[26] The September 2009 Mercer report – and especially see slide 38 ("with double rate collar") is at: http://www.oregon.gov/PERS/docs/financial_reports/dec08_mercer_actuarial_valuation_report.pdf

[27] For 2017-19, the September 2009 Mercer report shows a happier result: the base Employer Contribution rate stays at 24%, compared to rising to 31% in the May 2009 report. This is at the "mid point" growth assumption in the September 2009 report of 8% annual increases in OPERF. However, if OPERF's annual growth rate is more like 4.5% - close to its actual average now in the most recent 10 years, -- the 2017-19 rate *would* be about 31%. (Comparison of May 2009 report at Slide 12 vs. September 2009 report at Slide 38, 8% "with double collar")

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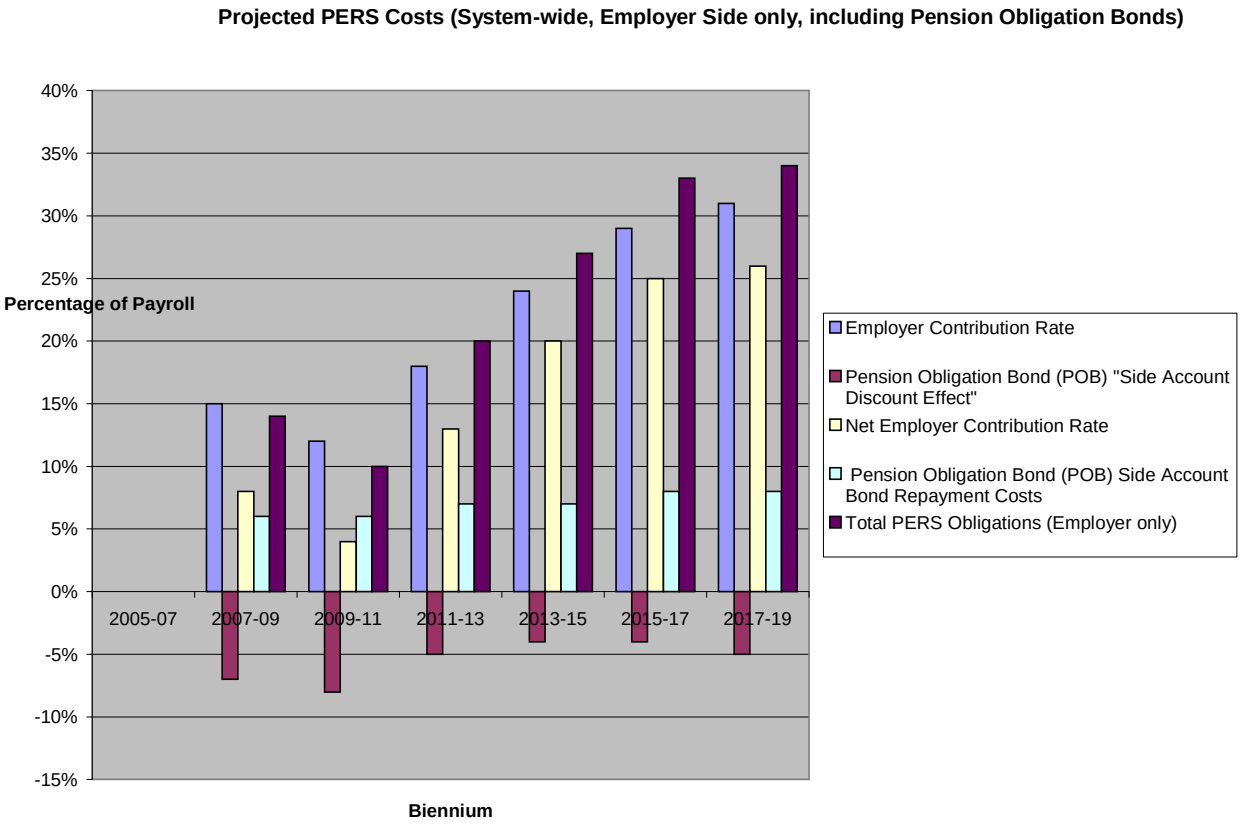

Note: Data for 2007-09 and 2009-11 are based on actual rates and official projections; for 2011-13 and beyond, rates are based on the May 2009 Mercer report, at 50% probability, with POB repayment costs slightly increasing as a percentage of payroll on the assumption that overall payroll growth of 8%/biennium will not be achieved.

By 2017-19, total public employer payrolls are projected to be $22 billion. The additional money needed by PERS by this point – again, based on the May 2009 Mercer report and using current policies and assumptions and compared to 2009-11 -- is ***nearly $5 billion*** more compared to 2009-11.

Ponder these numbers -- and their enormity -- for a moment longer. Even assume, for the sake of argument, that the May 2009 Mercer modeling exercise proves doubly pessimistic, and that by 2017-19, public employers need only finance half that $5 billion, or $2.5 billion in additional dollars, compared to 2009-11.

PERS Employers would need to find this kind of money, from whatever revenue source they could. Regardless of whether the money came from income tax receipts, property taxes, lottery proceeds, federal grants, higher user fees, or any other sources, it would essentially mean $2.5 billion would be "taken off the table," no longer available to pay for any other basic state and local government services.

These programs include K-12 and college education, providing health care, paving roads, incarcerating criminals, etc. Money that could go to pay for existing –not to mention to hire new -- teachers, state troopers, public health nurses, or highway engineers, would

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instead need to be re-directed into financing pension obligations for former and current employees. [28]

Here are a few other ways to look at this kind of money. If Oregon's public sector today had an *additional* $2.5 billion to spend, it could (CK all facts):

- Hire 20,000 new K-12 teachers – to join the 30,000 in the current system
- Abolish tuition for all Oregon University System students (estimated 80,000 FTE headcount); abolish tuition for all community college students (100,000 FTE) and have another $700 million left over for early childhood education; or
- Extend Medicaid to 300,000 eligible adults, plus another 200,000 eligible children
- Re-pave an estimated 10,000 lane-miles of roads
- Reduce personal income taxes by almost 20%[29]

At a $5 billion impact, simply double these numbers.

No doubt about it – this is real money.

# # #

[28] The "type" of money various state and local governments would use to fund these additional obligations will vary between jurisdictions. For the state government, officials estimate 40% of current state payrolls come from general fund revenues (mostly income tax and lottery receipts). The remainder comes from fees (e.g., gas taxes) or federal funds. However, that said, any increase in state employee compensation costs will invariably translate into real and tangible impacts. For example, fewer roads could be paved (for agencies like ODOT, now largely funded by gas taxes). If the state needs "higher administration costs" for administering the federal Medicaid program – which is predominately federally financed – the difference will translate into fewer people receiving federally-subsidized health care.

For K-12 schools the picture is arguably even worse. . About 65% of K-12 funding now comes directly from the state, and that consists almost entirely of income tax and lottery dollars. Most of the remaining 35% of school funds involves local general funds, such as property taxes. These are almost entirely "general funds," and their increased diversion to PERS-related costs will come at the expense of virtually every "choice" K-12 districts, parents, and staff would otherwise want to make: e.g., smaller class sizes, more arts and drama classes, more teachers and counselors, longer school years, etc.

For other local governments – e.g., most cities and counties – funding sources would be a combination of federal, state, and local funds. But regardless of the "type" of tax dollars available for PERS-related obligations, the larger point is that re-directing *any* additional money for this purpose will make it unavailable for other, existing uses, and that will have real and lasting impacts on service levels.

[29] K-12 Teachers: Assumes a $40,000 salary, plus $20,000 tax and benefit costs (including PERS); College Tuition: Assumes $7,000 OUS annual tuition, $3200 community college tuition; Medicaid: Assumes $14,000 total biennial costs for adults, $4,000 for kids, with 50% state money and 50% federal match; Road paving: assumes $250,000 per lane mile, 4" asphalt base; Taxes: based on 2009-11 projected receipts.

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It's important to recognize that even the first 6% increase in the Employer Contribution rate projected for 2011-13 – much less two, additional 6% hikes in subsequent biennia -- -- are utterly without historic precedent.

For more than a quarter century – between 1975 and 2001 – the PERS Employer Contribution rate *never once* fluctuated outside a narrow band between 9 and 12%. Despite volatile market ups – and downs – the underlying dynamics of the PERS system seemed to be remarkably stable.

What may well become known as Oregon's "First PERS Crisis" in 2003 was certainly politically traumatic. It also revealed deep, structural flaws inherent in the system that were largely the result of how retirement benefits had evolved over several decades, and in ways that few policy-makers really understood.

The essence of the problem was that those who oversaw PERS – which prior to 2003, was a 12-member board, half of whom were allowed to be PERS members – systematically under-estimated the system's liabilities, relative to the benefit levels they and the Legislature had essentially promised.

Once OPERF's investment returns slowed in 2000 –and then dipped about 16% in the 2001-2002 market downturn– it exposed a yawning gap between what had been promised and what could be financed. PERS was in crisis, with its leaders warning that Employer Contribution rates might soar to 29% -- and the Funded Status could drop to about 65%.

Still, even during the 2003-05 biennium the Employer Contribution rate never even rose to the 19% "spike" that at one point was predicted. The 2003 Legislative reforms, OPERF's robust gains that began in the same year, and (for many employers) the ability to use proceeds from newly-sold pension obligation bonds to help fund their Employer obligations all combined to ensure that the fiscal "pain" of the first PERS crisis was relatively mild for many – if not most -- public employers. And that, of course, meant taxpayers essentially felt little change, either, in expected levels of government services.[30]

Notwithstanding 2003's major reforms, Mercer's May 2009 modeling exercise predicted a similar – if not worse – future for PERS – but this time, not due to another 2008-like event (or even something much smaller), but under post-2010 scenarios of *normal, steady OPERF growth of roughly 8% a year.* .

This is a key point, whether one focuses on the May 2009 or September 2009 Mercer report—or even on 2009 calendar year gains that could wind up being 15% or more.

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[30] The 2003 reforms also arguably involved the "easier stuff," as one observer wryly notes. "What do we do now?"

Another observer raises – and answers – a relevant question this way: "What if the reforms hadn't been enacted in 2003 -- and *then* 2008 came along? We'd be facing Pension Armageddon, and not just Pension World War II."

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For illustration purposes, start with the benchmark OPERF valuation of 12/31/02 – the last year prior to the 2003 reforms, and the previous market "low point" for the OPERF fund. On that date, OPERF's value was about $34 billion.

During the 2002-2008 period, there were 5 years where returns averaged 15% a year -- or roughly double PERS' benchmark "Assumed Earnings Rate" of 8%. And then there was one very bad year (2008) of -27%, which resulted in OPERF's valuation as of 12/31/08 of about $45 billion.

What if investment returns had instead been a steady, positive 7% during each of these 6 years? After accounting in each of those years for employer and employee contributions into the system, and benefits paid out to retirees, OPERF's 12/31/08 valuation would have been pretty much the same . In other words, the PERS system would have still faced the exact same, steep climb in future Employer Contribution rates -- towards a 30%+ level -- as Mercer projected (at 50% probability) in May 2009.

Indeed, some who today might downplay the significance of the -27% drop in PERS investment returns in 2008, may also be implicitly treating these 15% returns over the preceding five years as the "norm." This why it's so important to base PERS policies and rate-setting on assumed actuarial rates that are averages of highs and lows. This helps ensure that big losses aren't seen as "aberrations" while super-sized gains (especially multi-year strings of them) are not.[31]

This example helps reveal an important point about PERS' current predicament. During the first 5 "post-reform years" of 2003-2007, unexpectedly high returns – again, nearly double PERS' 8% target – arguably "hid" a fundamental, structural problem in PERS' current trajectories of system revenues and existing, long-term liabilities.

The 2008 market collapse – what PERS officials sometimes characterize as the equivalent of a "100 year flood event" -- quickly, and dramatically revealed that problem. But that problem would have been just as evident, in the spring of 2009, had 2003-07 investment returns instead have consistently averaged just 1% less than PERS' assumed, 8% benchmark rate.

Regardless of what's used as a "starting point" for modeling the future – the most recent OPERF low of 3/31/09, the higher value on 9/30/09, or even a hoped for 12/31/09 valuation of, say, $52 billion -- PERS' modeling exercises to date all reveal a similar fate for PERS' future Funding Status. It will not just likely fall to between 60-80%, but it will likely remain there for many years, *even with* above-average positive growth scenarios.

[31] In investment parlance, very bad years are sometimes dubbed "black swans," to convey the rare likelihood of their ever occurrence in the "natural financial world," much less their likelihood of repeating themselves any time soon. But the number of years where PERS investments grew between 15% to 25% -- and in the 25 years between 1984 and 2008 there were 13 of those – were arguably somewhat akin to "golden eggs" that allowed the system to keep employer contribution rates at lower than expected rates, but also can't be expected to keep recurring with anywhere the frequency in coming years.

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At below-average scenarios – e.g, another 5 or 10 years of 5% annual investment returns – it will fall even lower.

Then there's the issue of the Employer Contribution rate. Because PERS' funding status will be significantly less than 80% as of December 31 2009, existing policy calls for the "double rate collar" of 6% to take effect. As for 2013-15, Mercer's May 2009 modeling gave a second, 6% bump a " 90-95% probability; " its more optimistic September 2009 report showed it could be avoided only if PERS achieved a 10.5% average return rate for each of the three years (2009-2011). [32]

Put another way, even if PERS quickly "gets back in the saddle," able to generate investment returns at 8% or even 10%, compounded annually, the benchmark Employer Contribution rate will likely still double to 24% by 2013-15. And going forward, even under relatively sunny economic skies, baseline Employer Contribution rates of 20-24% become the "new normal" for PERS, with the odds of ever getting back to 9-12% Employer Contribution levels increasingly fading into the distant past.

# # # #

The two biggest players in Oregon's PERS system are the state government – with a combined payroll for 2009-11 of about $4.6 billion – and Oregon's almost 200 K-12 school districts (Combined payroll: $6 billion). The hundreds of other local government entities like cities, counties, community colleges, and other special districts account for the remaining public employer payroll, of about $5 billion. [33]

The dizzying complexity of the PERS system cannot be underestimated. Many of the state's public employers stand alone; others combine in certain kinds of "pools." Many have multiple types of rates, applied to different classes of employees.

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[32] The October 25, 2009 Oregonian article used OPERF's investment gains through September 30, 2009 – almost 14% -- combined with 8% annual gains through December 31, 2011 to project a Funded Status sufficient to avoid a second, 6% bump in 2013-15. This would certainly be good news. But such a projection – which also assumes OPERF's 12/31/09 official valuation does indeed reflect a 14% or better gain for 2009 – barely avoids the double collar of 6%, putting PERS' Funded Status at just 81%. If OPERF's annual growth over calendar years 2009, 2010, and 2011 averages less than 10.5%, another 6% hike will be triggered, under existing PERS rules.

[33] This "other" sector of some 700 local government units is even more complex than the state/K-12 world. This report doesn't examine this world as closely as state government and K-12 districts. However, many of the same dynamics apply, and it's likely some of these local governments will face even steeper cost hikes due to PERS. One, notable outlier in the local government world is the City of Portland, that is not a member of PERS because it has its own system ultimately underwritten by the city's property taxpayers. Unlike PERS, which adjusts rates as needed to amortize liabilities over a 20-year time horizon, Portland's system is basically "pay as you go," with pension obligations enjoying a first claim on future property tax revenues.

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Then there are the different classifications of employees and retirees. These fall into three different categories, based on the PERS benefits for which they're eligible.

So called Tier I employees, hired before January 1, 1996, enjoy the most generous benefits, with certain "defined benefits" guaranteed regardless of OPERF market performance.[34]

In addition to about 100,000 retirees in the Tier I category, there are another 90,000 Tier I members. About 65,000 are currently working. They – as well as another 25,000 "inactive" Tier I members -- are eligible for benefits once they reach retirement age. For most employees, that's at 58, though for "Police and Fire" employees, eligibility for retirement comes either at age 55, or age 50 with 25 years+ service.

Even when OPERF plunges in value – as it did in 2008 -- Tier I members receive a guaranteed, annual increase in their retirement accounts. This amount is currently 8%, or the equivalent to what the PERS board has adopted as the "assumed earnings rate." [35]

At retirement, Tier I members' benefits are calculated by one of several methods, and retirees receive the one that produces the best result. In recent years, most Tier I retirees have qualified for the "Money Match" method, by which the employer "matches" the size of an employee's account, and from there calculates monthly payments. [36]

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[34] "Defined Benefit Plans" – which are increasingly rare in the private sector – essentially "guarantee" that a retiree's pension will be worth a specific amount, based on key metrics like years of service, final average salary, etc. In contrast, the pension from a Defined Contribution Plan" –e.g. typical IRAs and 401-k accounts –will be based on its market value at the time of retirement. PERS is now essentially a "hybrid" plan, though for Tier I and Tier II employees the vast majority of their benefits derive from the defined benefit portion, and a much smaller fraction through the Individual Retirement Plan accounts they've contributed to since the 2003 reforms.

[35] Many believe – erroneously – that the 8% "Assumed Earnings Rate" is a legal or contractual obligation. It's not, and could be changed by the PERS board. (Indeed, the rate was 5% for 1971-74; 7% for 1975-78; and 7.5% from 1979-88). But were the board to reduce this now 20-year old rate, it would have the seemingly paradoxical effect – at least in the short term – of *increasing* the Employer Contribution rate. PERS would need to assume that future investment earnings of OPERF would similarly be less robust, which in turn would require additional Employer Contributions to make up the difference.

[36] The "generosity" of PERS benefits is a fiercely debated topic. For 20 years, PERS has tracked some basic metrics that are useful to keep in mind. The "average retiree" in 2008 had 21 years of service, and retired with an annual benefit of about $30,000, or 52% of Final Average Salary (FAS). . Retirees with a full 30 years, retired with 80% of FAS, and 5% retired with more than 100% of FAS. These numbers have actually drifted down in recent years, driven in part by the 2003 PERS reforms. In 2000, for example, the average retiree with 30 years retired with 100% of FAS, and 16% of all retirees received more than 100% of FAS.

It's worth noting that in calculating FAS for PERS purposes, employees are typically allowed to add in such things as the value of overtime, unused sick leave and vacation time. This can push FAS significantly higher than an employee's *actual* gross salary; assumptions found at the end of PERS 2008 Annual Financial report suggest such factors typically add 5-15% to FAS for 30 year retirees..

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Tier II's 80,000 active and inactive members – hired between 1996 and 2003 -- have slightly less generous deals. For example, their normal retirement age is 60, and their accounts aren't automatically credited with 8% annual returns. Still, they have strong guarantees, and like Tier I members, theirs is also primarily a "Defined Benefit" plan. They, too, are eligible for Money Match. [37]

So called Tier III employees – technically, members of the Oregon Public Service Retirement Plan (OPSRP) program --were hired after August 28, 2003 when the PERS reforms went into effect. There are about 45,000 of these members.

The defined benefit portion of OPSRP participants' plan is significantly less generous than it is for Tier I/Tier II members, and the Money Match is not an option. Tier III members' benefits at retirement are designed so that the guaranteed benefit portion will replace about 45% of the member's Final Average Salary (FAS), with the IAP component expected to add another 15-20% of FAS.[38]

# # # #

The potential size of the PERS problem is bad enough. Then there's the timing. In a multitude of ways, it couldn't be any worse.

It's widely acknowledged that Oregon's combined 2007-09 and 2009-11 budget crises would have been far more painful, had it not been for the state's ability to use "one time" funds from several sources.

For starters, the state received $1.6 billion in federal stimulus money. Another $230 million went directly to help K-12 school districts. Legislators used another $600 million from Oregon's Rainy Day fund and other reserves. Finally, to stave off even deeper budget cuts for 2009-11, the 2009 Legislature enacted $800 million in mostly permanent corporate and personal income tax increases. These tax hikes will be voted on next January by Oregon voters.[39]

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[37] Since the 2003 reforms, all three Tiers are hybrid plans that include, in addition to the defined benefit formulas, a 401(k)-like Individual Account Program (IAP) whose value rises and falls with OPERF's fortunes. For Tiers I and II, the IAP includes member contributions made since January 1, 2004. For Tier III (a/k/a the OPSRP), it includes all the member's contributions.

[38] These statistics and explanations are largely drawn from PERS' very useful July 2009 report, **PERS: By the Numbers.** This publication conveys PERS' many complexities and nuances; for the patient reader it also offers a great deal of useful history and insight into PERS' current challenges.

Another very useful publication, entitled "**Public Employee Retirement in Oregon**, was done by John Taponga of ECONorthwest for the Chalkboard Project and the Oregon Business Council. Published in August 2007 – arguably the flood tide of PERS recent good fortunes – it is eerily prescient in many of its observations about PERS' structural challenges.

[39] Was the *permanence* of these tax increases essentially an undisclosed, "PERS Bail-out strategy?"

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As PERS managers rightly note, pension funds need to be managed with a long-term perspective. Markets rise, and fall; quick, sudden moves often lead to even worse outcomes. Patience -- and sometimes steely nerves -- are required to ensure good, healthy returns over a 10 or even 30 year period. And as PERS managers are proud to note, since 1970 – even factoring in 2008's fall –average yearly returns for PERS have exceeded 10%. [40]

Compared to other state pension funds, PERS' situation is also more prone to market swings – in both directions. That's because nearly 67% of the money required to cover the liabilities of the system are pegged to OPERF's investment earnings. OPERF is the highest among Western States' pension funds (including CALPERS) in this regard – one reason that Oregon's system is subject to even more sudden valuation ups – and downs – than funds elsewhere. [41]

Accordingly, virtually all pension funds are managed in a way that tries to "smooth" rates to avoid abrupt spikes and plunges. As noted earlier, prior to 2005, this was largely accomplished by something called "4-year asset smoothing." Rather than base rates on an

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There is no direct evidence of this, though it's important to recall that major business organizations pledged to support (or not actively oppose) such tax hikes in 2009, *provided* they would be temporary, with new revenues used to deal with the current budget crisis. However, the 2009 legislature made many of these increases permanent, with the total package amounting to about $750 million/biennium.

For 2009-11, state government's biennial payroll is about $4.6 billion, and K-12 school support (from state general fund and lottery funds) will amount to about $6 billion. About $5 billion of this K-12 figure will arguably also be used to defray K-12 payroll costs, which account for 85% of K-12 budgets. Based on these numbers, a 12% required hike in Employer Contribution rates by 2013-15 for just these two sectors alone would require an additional $1.1 billion.

[40] However, PERS also notes that 3 of the 4 "negative years" since 1970 have occurred within the last decade. The "last 10 year" annual rate of return, includes many 15%+ growth years as well as 2008's dive, has averaged closer to 5%, and is even less if calculated on a Compound Annual Growth Rate (CAGR) basis.

[41] Just how volatile? When Mercer, using 2007 valuation figures, modeled PERS' future in its May *2008* modeling exercise, it projected virtually flat "Employer Contribution" Rates for the coming decade, including a projected rate of 12%, at 50% probability for 2017-2019. Its 5% "worst, worst" case scenario predicted a 29% rate. By comparison, the May 2009 model at 50% probability showed a 2017-2109 rate of 31%; the September 2009 update a 2017-2019 mid-point probability rate of 24%. The fact that PERS's fortunes is so prone to such market swings is, in and of itself, a significant reality that many have tended to overlook in recent years, lulled by extraordinary returns that were *significantly higher* than those projected at 50% probability.

Any pension fund's volatility also depends on the actual mix of investments. As noted earlier, certain investment classes (e.g., private equity and REITs) are subject to more variability than, say, stock index or bond funds. While the Oregon Investment Council sets the general "mix", the actual execution of the investment strategy is the responsibility of the Oregon State Treasurer and the investment firms and managers they hire and oversee. An earlier Mercer study found that notwithstanding OPERF's potential volatility, the fund was *not* invested "more conservatively" than those in 13 other Western States with less volatility. Indeed, there was no such pattern among any of the Western states studied.

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actual, calculated valuation at a given point, PERS instead used a "four year blend" of values. While such an approach is not uncommon, it makes understanding an already complex system – for the average legislator, much less private citizen -- that much more difficult.

From 2004-2005, a newly reconstituted PERS board made a series of important changes to PERS' rate setting process. Most important, they decided to use a market-based valuation – rather than a 4-year "asset smoothing approach – when calculating Employer Contribution rates every two years. These calculations are done as of December 31st of each odd-numbered year. [42]

To avoid overly abrupt ups and downs, the PERS Board also adopted the "double rate collar" approach, by which rates could not go up or down more than 3% per biennium, provided PERS' funded status was between 80% and 120%. If PERS' funded status fell outside that band, a "double rate collar" of 6% would apply.[43]

There were strong reasons for the change to real market valuation-based rate setting, combined with the rate collar. The timing also worked fortuitously, since it allowed the PERS rate-making process to capture more quickly the gains OPERF made from 2003-2007. (Most of these gains however, weren't known at the time). Had the "four-year asset smoothing" policy remained in place, Employer Contribution rates would have otherwise gone higher in 2007-09 and 2009-11..[44]

However, the post-2003 PERS Board also made other significant changes, most of which pushed Employer Contribution rates higher than they might have otherwise been to ensure the system's future liabilities were better covered. These changes reflected a belief that PERS' previous design was not just excessively complicated, but had also artificially limited rates—again, relative to known and promised benefits – with the effect of pushing too many costs onto future taxpayers and citizens.

PERS based these policy changes on its adoption of six over-arching themes and principles: encourage more transparency in its decision-making, including the rate-making process; work to make rates more predictable and stable; maintain PERS' "Funded Status" at close to 100% based on 20-year amortization of system liabilities;

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[42] Mercer's first Modeling Exercise for PERS, done in December 2005, recommended this strategy, which the PERS Board then adopted. See http://www.oregon.gov/PERS/docs/financial_reports/actuarial_service/financialmodel121605.pdf

[43] For example, if OPERF's official valuation justified an even bigger increase than 6% for the next biennium, the "additional increment" would be deferred until the following biennium. By then, OPERF's valuation hopefully would have swung the other way, so that the remaining increment of increase could be taken along with the corresponding decrease in rates.

[44] See December 2005 Mercer report at slide 33. The slide suggests an 18.1% Employer Contribution rate would have taken effect in 2007-09 by keeping the 4-year asset smoothing approach; by comparison the adoption of the rate-collar centered approach ("rate smoothing") and market valuation put it at 14.7% (50% probability).

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promote equity across generations; and adhere to actuarially sound accounting principles, that were also compliant with national standards known as GASB.

Accordingly, the PERS Board established new reserve and contingency funds, eventually setting aside more than $2 billion to protect OPERF against unexpected economic downturns. It also decided to continue the effort – begun in 2000 – to reduce the amortization of PERS liabilities from 30 years to 20 years by 2007. This was done to strike a better balance between the interests of today's PERS retirees and members and tomorrow's taxpayers and citizens. It also updated mortality tables to better reflect the realities of how long retirees would live.[45]

While one can debate the length of the lag – after all, OPERF's valuation is largely known nearly a year before each biennium's start – it's important to recognize that the lag itself is not the cause of PERS' current problems. As long as it's adhered to consistently, rates will even out over time, averaging enough to sufficiently meet the system's long-term liabilities.[46]

Rather, the 18-month lag is better understood as a metaphor, since it helps illustrate one of the fundamental, historic dynamics within the PERS world when it comes to participants' willingness to see – and then act upon – the realities of any given moment.

Indeed, what was clearly revealed during the 2003 PERS crisis was the penchant of elected policy-makers and interested parties alike to quickly embrace any "positive" news about PERS – e.g., high investment earnings -- and then insist that most or even all the unexpected bounty be fully distributed to beneficiaries.

For example, during the 1990s, OPERF gains exceeded 20% in 5 of 10 years, and 15% in 2 other years. The PERS board decided to credit Tier I members' accounts with most of the additional increment above the 8% guarantee. When the value of OPERF fell by what now, in retrospect of 2008's plunge, seems a relatively modest amount – 16% over two years -- it revealed a system inherently incapable of covering future liabilities, given how benefits had been structured. [47]

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[45] The 2008 market fall wiped out the $2 billion Tier I reserve and put it an additional $1 billion in the red; PERS still has $650 million in a contingency reserve. Without these set asides – which some employers and public employee unions strongly opposed at the time– PERS' current predicament would be significantly worse.

[46] Oregon is also one of a handful of states that still budgets on a biennial, rather than annual, basis. There's no inherent reason PERS rates cannot be set on an annual basis, which could also reduce the full lag effect, by which employers in June, 2011 will still be paying rates based on the valuation of December 31, 2007.

[47] Between 1982 and 1999, PERS enjoyed 15% or higher returns in a remarkable 13 out of 18 years. In all 13 years, Tier I members were credited in excess of the 8% Assumed Earnings Rate, in some years as high as 21%. PERS members who'd invested in "variable accounts" during the same period had 20% or higher returns in 10 of those years.

The "compounding effect" of these (and related) dynamics eventually made the "Money Match option" – originally created by the Legislature in the early 1980s as literally a "tweak" to deal with a relative handful

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Whether one viewed this as an "excess crediting" problem -- promising higher benefits than could be paid for – or an "insufficient Employer Contribution" problem didn't change the underlying reality. Either way, PERS wound up staring down a financial abyss when the 2001-02 economic downturn – technically, one of the mildest recessions of recent decades – revealed how "over-committed and/or under-funded" PERS was. And by the time the 2003 reforms were enacted, many options were no longer on the table.

The flip side -- especially relevant again today -- has been the tendency of PERS stakeholders to downplay (or even ignore) bad news for as long as possible, hoping that somehow things would "fix themselves." Then, once events finally force the acknowledgement of a problem, these same stakeholders will instinctively seek ways to postpone some – or even most – of the consequences, even if it means pushing much higher costs onto future Oregonians.

In the fall of 2008, the PERS governing board set Employer Contribution rates for 2009-11. As per long-standing policy, they relied on the $62.9 billion "official valuation" of December 31, 2007. By March 2009 – four months before the new, lower rates were to go into effect, OPERF's financial free-fall finally bottomed out -- at $41.5 billion.

Notwithstanding the global economic crisis and the necessity of massive budget cuts elsewhere, state government, K-12 schools, and other public employers were able to significantly *reduce* their rates, and build their budgets accordingly.[48]

It's certainly true that by early 2009, the PERS board and staff had communicated a number of "warning messages" to public employers that this 2009-11 fiscal sunshine in their PERS worlds carried with it the near certainty of at least some heavy rain in 2011-13 and beyond. (Again, the flip side of the lag effect). And the scale and rapidity of how bad things *easily could* get could have been discerned by simply looking back to Mercer's May *2008* report, which had warned of Employer Contribution rates of 30% within several biennia, in "poor investment climates."[49]

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of cases –the "most favorable option" (and hence, the operative one) for more than 80% of retirees by the mid-1990s. In retrospect, the failure of PERS managers and legislators to fully grasp the financial and actuarial implications of this combination -- the Money Match, hyper-charged investment returns, and crediting of Tier I accounts -- was the core reason for the 2001-03 PERS crisis that came into stark relief once OPERF's growth slowed, then turned negative in 2000-2002.

[48] Employers with "Side Accounts" – created when they'd sold pension obligation bonds – were also able in 2009-11 to "buy down" this 12% rate significantly, using large earnings from those accounts, again based on December 31, 2007 valuations. As a result, the system-wide, *net* Employer Contribution rate for PERS employers was less than 5% -- far and away the lowest in PERS history. Amidst so much other bad budget news, this was about the only "bright spot" – however temporary – public employers could see.

[49] Indeed, OPERF's losses in 2008 were significantly outside even the worse case, 5% probability level in the May 2008 study.

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With the May 2009 report –commissioned by PERS to understand the potential implications of the 2008-09 losses in OPERF – the full dimensions of this fiscal storm finally came into sharp focus. Mercer's economic models revealed the certainty of at least 1 – and the high probability of 2, or even 3 additional -- "double rate collar," 6% per biennium rate hikes beginning in 2011-13.

In the space of just 6 years, the system-wide Employer Contribution rate was on track to sky-rocket -- from 12% to 30% -- with the potential effect of blowing a $5 billion+ hole by decade's end in already beleaguered state and local budgets.
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Of course, nothing prohibited the state of Oregon – or any of PERS' 886 other public employers --from setting additional funds aside to help fund these future rate hikes. And indeed, a few seem to have done so, -- including Multnomah County, Metro, and the Salem School district -- in special reserves that can now be accessed to help defray these rising costs. But such practices do not seem to be the norm, especially among some major employers such as the state of Oregon.[50]

This collective desire of Oregon's public employers to "limit their budget pain" -- and not make it even worse by diverting scarce resources to shore up PERS -- is not surprising. But far more puzzling was the virtual lack of any explicit acknowledgment of this issue, much less any real public debate as to the implications of OPERF's fiscal free-fall for public employers – and the services they provide to citizens.

Had there been, some of the bigger questions would have included these:

What happens in 2011-13, when these unwelcome PERS bills come due – and there's no second round of federal stimulus cash waiting in the mailbox? And meanwhile, what if the state's 'reserve fund" cupboards are also bare? In a major economic rebound, perhaps some of these costs can be "absorbed" amidst increased revenues – though at the expense of funding other programs. But in a flat – much less declining – economic scenario, the budget hole will be truly daunting.[51]

What additional cuts, in basic public services, will need to be made simply to feed the growing appetite of the PERS system? And what if the "economic recovery" that everyone is banking on – including both the May and September 2009 Mercer studies –

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[50] In some K-12 districts, *the opposite* actually seems to have happened. Despite the severe recession and budget crises, some districts succumbed to pressure from both employees and parents, to dip into already existing reserve funds. This has helped reduce lay-offs, and in some instances have helped finance pay *increases* negotiated in 2009 contract talks.

[51] For state government, there's also the quite "inconvenient" issue of the State's kicker law. Under this law, much of the additional revenue generated by any strong economic rebound – should it occur – would not be available for spending, but instead be slated to return to taxpayers under Oregon's "Kicker" law. "Kicker reform" is a contentious issue under the best of circumstances. Proponents likely won't relish fending off accusations that the lion's share of any new money re-directed to government, should voters approve any major change, would not go to increase government services such as K-12 education, health care, or aid to seniors, but would be swallowed up by having to shore up PERS.

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stumbles, falters, and perhaps even suffers a serious relapse during the next decade? Or, even if the economy starts growing again – and various retirement funds, including PERS, keep ticking up in value – we experience more of a "jobless recovery," causing additional, unexpected shortfall in tax revenues for the state of Oregon and other jurisdictions, putting even more pressure on budgets? [52]

Today, these questions are increasingly being asked, and the answers aren't pleasant. And again – not surprisingly – certain policy changes are being advocated by powerful players in the PERS world that would have the effect of pushing the full impact of the Employer Contribution rate hikes, even further into the future. (For a more complete discussion, see Appendix A).

# # # #

The discussion until now has focused exclusively on the primary driver of PERS costs – the "Employer Contribution" rate. But from a taxpayer's perspective, what's the total cost of the system – what' we'll call the "Total PERS-Related Obligation" (TPRO) – now and for the foreseeable future?

For all its dizzying complexities – of which we'll examine a few more in the pages that follow -- PERS boils down to a basic cost of doing business. Government entities deliver a wide range of services. Most are delivered by hiring people to do certain things – patrolling streets, educating children, providing health care, paving roads, enforcing environmental laws, running prisons, and so on.

All employers -- state and local governments included – have costs beyond salaries when they hire and employ people. These include Social Security, unemployment, and worker's compensation taxes. They typically also include the costs of providing employees with health insurance and other benefits. In many -- though not all – cases, private employers also contribute to employees' retirement funds – though typically this means a "401 (k) matching" program.

Some of these costs – e.g., the 7.65% of payroll combined FICA taxes for Social Security and Medicare, and levies such as unemployment taxes – are paid as a fixed percentage of payroll. In other cases, they are fixed amounts. For example, an employer might decide to pay $400/month for each employee's health care, regardless of whether the employee makes $20,000 annually or $50,000.

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[52] Even Mercer's "more pessimistic" May 2009 report essentially assumes a return to much happier days, at least in terms of real investment returns, after 2009 is over. For example, in 2010, the "Annual Asset Return" rate is modeled to rebound to 7%, and basically stay between that and 9% for the next 20 years..

The "more optimistic" September 2009 report only models 3 growth scenarios, based on "historic" growth assumptions, and all of them positive. The most negative of the 3 scenarios still shows 4.5% annual growth. Mercer's May 2009 report, at the 25% "low end" probability modeled 0% annual growth.

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However, for budgeting purposes, it's common to blend together all these costs – variable and fixed –into a percentage of overall payroll. Employers then set aside these funds and disburse them to the proper recipients (e.g. the Social Security Administration, state unemployment fund managers, health insurers, or employees) to ensure their total obligations are met.

Just like private sector employers, government employers must do the same. They, too, must pay FICA and unemployment taxes. They, too, can decide whether – and then, how much – health insurance and other benefits to provide to employees.

So PERS is simply one of these costs of doing business, though exactly how much an employer pays obviously can vary dramatically—and a good deal of it is often overlooked in PERS discussions.

For illustration purposes, let's assume a PERS entity has a $100 million annual payroll, and its Employer Contribution rate for a biennial (two year) period is set at 12%. Each year, they will transfer $12 million to their PERS account. If the rate moves up to 18%, their obligation also increases, to $18 million a year.

But to understand PERS' total impact on the public purse, it's important to recognize that the "Employer Contribution" is just the most visible tip of the PERS iceberg. There are two other major components to the PERS picture, both of which are not well known or even well understood. While one of them has actually decreased PERS costs in the short term, in the years ahead, both of them could likely *add even more costs to PERS,* relative to today's situation.

The first is known as the "*Employee* Contribution pick up." This is the long-standing practice of many jurisdictions to use their own (read: taxpayer) funds to pay for what is officially the "employee" contribution to the fund.

By law, employees participating in PERS are required to contribute 6% of their gross salary to PERS. So when the public employer decides to finance this cost, this amounts to an additional 6% of payroll, now borne by taxpayers.

Contrary to widespread perception, the 6% pick up is *not* required by state law. State government has decided to "pick up" 100% of this cost. However, many large K-12 school districts– e.g., Portland, Beaverton, and North Clackamas – don't pay this 6%, while others do (E.g. Salem and Tigard-Tualitan).[53]

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[53] Most K-12 districts that no longer pay employees' 6% contributions have largely done so through collective bargaining agreements with their employees. The ostensible trade off: employees get higher pay and other benefits – e.g., health insurance – in exchange for financing their 6% pick up out of their own paychecks.

So do teachers in districts without the 6% pick up get commensurately higher pay? This isn't quite so clear, at least based on an admittedly cursory analysis. For example, according to a 2008-09 salary survey by the Confederated Oregon School Administrators (COSA), the Salem and Redmond school districts pick up the 6% -- and pay a teacher with 12 years' service and a Master's Degree $38,903 and $39,191, respectively.

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The state of Oregon first "picked up" the 6% Employee Contribution in 1980, when then-Governor Vic Atiyeh agreed to the change in collective bargaining negotiations, in lieu of giving state employees the raises they were demanding amidst a bad recession and double-digit inflation.

This provision has been in every state collective bargaining agreement since then -- including the one negotiated by Governor Ted Kulongoski and ratified by the state's major public employee unions after the close of the 2009 session. For the 2009-11 biennium, this "pick up" across state government's $4.6 billion payroll will amount to almost $300 million – and will actually exceed the amount paid through the *net* Employer Contribution rate, of about $150 million. It's important to note that when the state negotiates such an arrangement with represented employees, it then extends to *all* employees, including management and elected officials.

The third major component of PERS is a bit more complicated, and involves the previously mentioned– and admittedly, somewhat arcane – world of "Pension Obligation Bonds." This will take a little explanation, so be patient.

Between 1999 and 2005, the state government – and more than 125 K-12 school districts, ESDs, and local government units – sold about $6.4 billion in Pension Obligation bonds. At the time, PERS was still widely considered to be in peril. Even with the 2003 reforms that advocates said would significantly reduce the trajectory of future costs, the Employer Contribution rate was still expected to increase dramatically.[54]

The thinking went as follows. What if Public Employers borrowed money at relatively favorable interest rates – about 5.5% -- and invested the proceeds in OPERF, whose investment returns over 30 years -- even after various market ups and downs – had still averaged a more than 10% annualized rate of return?

North Clackamas and Albany don't pay the 6% -- and such teachers earn only $36,758 and $36,144 respectively.

Recall that since the PERS reforms of 2003, all "employee" contributions have actually gone into separate, Individual Accounts – called IAPs. (Prior to that, these funds also went into regular PERS accounts, where Tier I members were guaranteed these funds, also, would grow by 8%, regardless of market performance.) If an employee pays his or her own 6% contribution, the amount may not subject to taxation depending on the employer's election.

[54] While jurisdictions like Multnomah County started selling POBs in 1999, the vast majority of this activity was between 2002 and 2005. In 2003, voters approved a statewide ballot measure, referred by the Legislature and backed by major bond firms such as Bear Stearns, J.P. Morgan and Seattle NW Securities – that made it significantly easier for public employers, including very small ones, to participate in the POB strategy. For an in-depth discussion of Side Accounts, see Mackenzie Ryan's recent series in the Salem Statesman Journal: http://www.statesmanjournal.com/article/20091101/GAMBLE/311010001/-1/gamble02,

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Between 2002-2005, the state of Oregon sold about $2.1 billion of these Pension Obligation Bonds (POBs), while a consortium of about 90 K-12 school districts and Educational Service Districts (ESDs), sold about $2.6 billion. Most community college districts – and a smattering of cities and counties -- also sold bonds during this era, and a few additional K-12 districts decided to participate in 2007. Most of the pension obligation bond proceeds were invested directly in OPERF, and are widely known as PERS "Side Accounts." [55]

This was a classic "arbitrage" strategy, to use the expected net proceeds– in the long run, of course -- between gains and costs to essentially "buy down" the otherwise steep hikes that were expected in Employer Contribution rates, even with the 2003 reforms.

Though there certainly were risks, it wasn't necessarily a bad strategy. Most advocates were careful to urge participants to set aside reserve funds to cover "down years," and to be modest in their expectations. Projections done at the time, based on PERS' assumed annual earnings rate of about 8%, suggested the "net effect" of this strategy would be a reduction of total costs to participants equivalent to about 2-3% (of payroll). [56]

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Between 2002 and 2007, OPERF's valuation shot up by a remarkable 90%. So, too, did the value of these side accounts. During these initial years, the Side Account strategy wasn't just considered successful. Like so much else in the world of investing, it looked like a staggering act of financial genius. [57]

Those who placed the biggest bets on Side Accounts looked especially astute. For example, the Portland School District sold about $490 million of these bonds. By 12/31/07, the value of its Side Account was $786 million. And this was *after* PPS had regularly used a portion of earnings to "buy down" its Employer Contribution rate.

How much did it help? For 2007-09, the base Employer Contribution rate for PPS was over 17%. With side account earnings, the district was able to buy down the effective rate to almost 0%. For 2009-11, PPS' 14% Employer Contribution rate will once again be

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[55] Some pension bond proceeds were used differently by the state and some local governments, to "buy down" specific liabilities. However, they're not discussed here because their impact is both complex and relatively minor for purposes of this discussion.

[56] While it's tempting to second guess the Side Account strategy, it was based on widely shared assumptions at the time that extended far beyond the public sector. And in comparison to sub-prime mortgages, securitized debt swaps, and other financial exotica that brought America's financial system to its knees a year ago, this basic arbitrage strategy was a relatively tame – though not by any means risk-free, as some might have convinced themselves -- variant.

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[57] An analysis by the consulting firm ECONorthwest, published in August 2007 amidst a series of 20%+ annual OPERF gains, also illustrates how seductive these bonds appeared. At a "high growth" scenario – essentially, a continuation of then-existing return rates of 20% or more– it concluded that some K-12 districts would build up such large surpluses, they could repay all their PERS bonds (with interest) and then for several years simply draw down their remaining surpluses to meet their PERS obligations.

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"bought down" to close to 0%, courtesy of side accounts whose contributions are based on the December 31, 2007 valuation.

The state of Oregon's pension obligation bond strategy was less ambitious, but the effect has still been significant. For 2009-11, its base "Employer Contribution rate was pegged at 13%. But its Side Account allowed a "buy down" of about 10% of payroll, producing a *net* Employer Contribution rate of just 3%.

However, Side Accounts are not "free money." Like a home mortgage, pension obligation bonds are loans that must eventually be repaid, with principle and interest.[58]

So the real test of the Side Account strategy isn't simply the positive effect of reducing PERS Employer Contribution rates. It's ultimately the "net benefit" to employers, after both the "buy down" effect *and* the costs (bond repayments) are factored in – and not just in today's world, but over the entire life of the bonds, most of which won't be fully repaid until between 2025 and 2028. [59]

So for illustration purposes, let's use the Portland Public Schools. For the 2009-11 school years, side account proceeds are scheduled to be used – once again – to reduce the effective rate (now 14%) to 0%. However, bond repayments costs for 2009-11 will be $63 million, or roughly 11% of projected payroll.

So for 2009-11, even though PPS "virtually eliminated" its 14% Employer Contribution rate, its *net* Side Account benefit is roughly 3%. What happens in 2011-13? While PPS' base Employer Contribution rate is projected to go to 20%, the ability of the Side Account to discount that rate will plummet also. (Just how much, has not yet been determined). [60]

Meanwhile, what about PPS' bond repayments? They are an exact certainty in this equation, and they will *actually increase* to about $71 million for 2011-13. And by the 2019-21 biennium, they will amount to more than $106 million.

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[58] To offer a more precise metaphor, the Side Account strategy was not unlike those who took out home equity loans at 6% interest during the boom years, and then invested the proceeds in large, highly regarded Mutual Funds whose annual returns had averaged 10% or more over several decades.

[59] One might think that tracking current and projected Total PERS-related costs, including the net effects of pension obligation bonds, would be relatively easy. Such a spreadsheet would include the base Employer Contribution rate, the amount (if any) by which "Side Account" earnings reduce that rate, the bond-repayment costs (if any), and government paid "employee contributions" (if any).

However, PERS does not keep a specific list of which public employers decide to pay their employees' 6% contributions, nor does it tally (or project) the net cost of pension obligation bonds. Instead, it directs such inquiries back to individual employers – e.g., the state and school districts.

[60] The official, 12/31/08 valuation for PPS' side account will be released later this fall. However, it's widely assumed that the number will now be less than $600 million – still above the original value, but a loss of more than $150 million in a single year.

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This is a very important – and little known -- aspect of the PERS Side Account world. With a conventional homeowner mortgage, there are regular and uniform payments each month, over the life of the loan. And as homeowners know, far more money ultimately is repaid in interest than in principle.

In contrast, Pension Obligation Bond repayments were structured so that they start low, and then increase over time. The specific repayment terms vary by jurisdictions, but for the state of Oregon, the built in increase amounts to about 8% each biennium. Thus, for 2009-11, the POB repayment line in the state budget was about $265 million. For 2011-13 it will be $288 million, and so forth.

A similar situation exists with the approximately 96-member K-12 school district pool. Collectively, these districts will re-pay about $350 million in bond costs during the 2009-11 biennium, apportioned to each member by size and timing of the bond issuance. By the 2025-27 biennium, when most of the bonds are finally paid off, total payments will have risen to $735 million. [61]

This structure was implemented on the assumption that total government payrolls would continue to increase each biennium. The expected result would be to "hold constant" these fixed payments *as a percentage of payroll*. [62]

An earlier Mercer report published in May, 2008 -- during much sunnier times – reviewed the Side Account strategy, and even modeled the possible scenario of *significantly increasing* their use across the system. Noting that these bonds were largely sold towards the bottom of a fast-escalating market, Mercer observed that the "timing was close to perfect," and the result was "significant gains… and significantly lower expected long term pension costs."

But as Mercer went on to note – quite presciently, it's now apparent --"Risks remain, and the ultimate results may be different… In the next few years, the payments on the pension obligation bonds may exceed what would have been required to be contributed to PERS without a side account."

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[61] As homeowners also know, interest costs add up over the life of a 25 or 30 year loan. For example, participating K-12 districts are currently scheduled to repay $2.6 billion in POB principal, and another $2.9 billion in interest costs.

[62] Contrast this to conventional home mortgages. A homeowner who pays $2,000 a month – but whose income rises at, say 4% annually -- will see the portion of income devoted to housing costs drop over time

The economic "logic" behind many sub-prime and variable rate mortgages of recent years was that future, much higher payments could be handled because incomes would continue to rise, and/or rising equity values would allow future re-financings.

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The 2008 Mercer report also made another important point: that because of how these bonds were structured, "the reward for any additional gains will be deferred many years into the future, while the impact of losses may be felt in a shorter timeframe." [63]

Such a "reversal of fortunes" is precisely what now appears to have happened. Since the bonds must still be repaid, the ability to use proceeds from these Side Accounts to "buy down" the Employer Contribution rates have diminished quickly, and in some cases dramatically. Meanwhile, the repayment costs of these bonds are slated to significantly increase – on a fixed, inexorable schedule, regardless.

This strategy also raises a host of other questions. What if payrolls don't keep up? What if significant reductions occur in the size and workforce of government – forced perhaps by major budget cuts, or even by escalating PERS costs that put a damper on new hiring patterns?

Then, as a percentage of overall payroll, the costs of financing these bonds will actually go up even more. Meanwhile, their ability to "buy down" the Employer Contribution rates may continue to move in exactly the opposite direction. Not unlike a homeowner with a $200,000 mortgage, and a house now worth only $150,000, many public employers may soon find themselves "underwater," with few good options. [64]

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[63] Whatever their merits as a financial strategy, perhaps the most debilitating effects of the Side Account strategy has been psychological. A half decade of super-charged returns –15% annual growth for the 5-year period of 2002-07 – combined with the "back-loaded" debt repayments --arguably led many jurisdictions to think Employer Contribution rate reductions of 10%, or even 20%, were somehow sustainable in the long run. During this time, they were also making other decisions –negotiating pay and benefit increases in collective bargaining, selling bonds for other purposes, or increasing service levels – that were themselves sustainable *only if* the Side Accounts kept performing at what, in retrospect, clearly seem to have been at financial gravity-defying heights.

Further compounding the problem has been the fact that the Side Account costs – the bond repayments – tend to be accounted for separately in government budgets, lumped in with other "bond repayments" for more typical purposes like building and capital improvements. Typical of many conversations with public officials about the "total, overall costs of PERS," is the tendency to focus solely on the Employer Contribution rate – and after the Side Account discount effect. The other costs – often much larger – of both the 6% pick up and especially the POB debt repayments are often overlooked , even though their key components of the total, PERS-related obligations of public employers now, and in the future..

[64] Timing matters with POBs – in some cases, a lot. Those who sold their bonds in 2002-03 – and then invested the proceeds at the "bottom" of the market, like Portland Public Schools – are largely still in positive territory, with valuations in excess of the original cost.

In contrast, those whose bonds sold in 2005 or even 2007 – when 8 relatively small school districts including Banks, Coos Bay, David Douglas, Willamina, and Tigard-Tualitan finally joined in – are probably already "underwater," able to contribute little or nothing to buying down their Employer Contribution rate in 2011-13 and beyond while their escalating bond repayment costs will be a certainty.

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So add it all up – the Employer Contribution, the Employee pick up (where applicable) and the benefits (and costs) of Side Accounts (where used). . What does the "Total PERS Obligation" for the state of Oregon– and other major public employers – look like today? And how might it change over the next few years?

For illustration purposes, let's first look at state government, with a payroll for 2009-11 estimated at about $4.6 billion

For 2009-11, the state government will need to set aside about **$15 for every $100** in payroll to meet its PERS-related obligations. This breaks down as follows:

- A "*Net"* Employer Contribution equivalent to about **3%** of total payroll. This is based on a starting "Employer Contribution Rate" of about 13%, then offset with proceeds from the state's PERS Side Account that amount to the equivalent of 10% of payroll. (Remember, both the base Employer Contribution rate, and the size of the Side Account contribution, is based on valuations of 12/31/07);
- **6%** of additional payroll, to pay for the agreed-to "Employee pick up";
- The equivalent of almost another **6%** of payroll to repay its Pension Obligation bonds.

What's the picture for the next biennium, 2011-2013? For 2011-13, the state government will need to set aside about **$26 for every $100** in payroll to meet its PERS-related obligations (again, assuming the continuation of current policies and practices). This is projected to break down as follows:

- A "*Net* "Employer Contribution equivalent to about **13%** of payroll. While the state's base "Employer Contribution Rate will jump 6% to an estimated **19%** -- the Side Account offset will only be an estimated **6%**, due to the plunge in Side Account valuations. (CK)
- **6%** of additional payroll, to continue to pay for the "Employee pick up":
- The equivalent of almost **7%** of payroll to repay Pension Obligation bonds. [65]

On a state government payroll of about $4.6 billion the difference between a 26% rate and a 15% rate is about $500 million extra needed in 2011-13 (vs. 2009-11). And that's

[65] Note that this assumes the "6% rate collar" will remain in effect. Without any collar, and using Mercer's 2009 report, the total PERS-related obligation rate in this example would be more like 30% of payroll in 2011-13, compared to 15% in 2009-11.

The estimate that POBs will rise from 6% to 7% of state employee payroll is the author's, and is based on the assumption that the annual 3.75% increase in state payroll that's currently assumed won't materialize, due to the 2009-11 budget crisis and the built-in, structural problems (including soaring PERS costs) that will put a damper on both future hiring and the ability of the state to raise pay levels.

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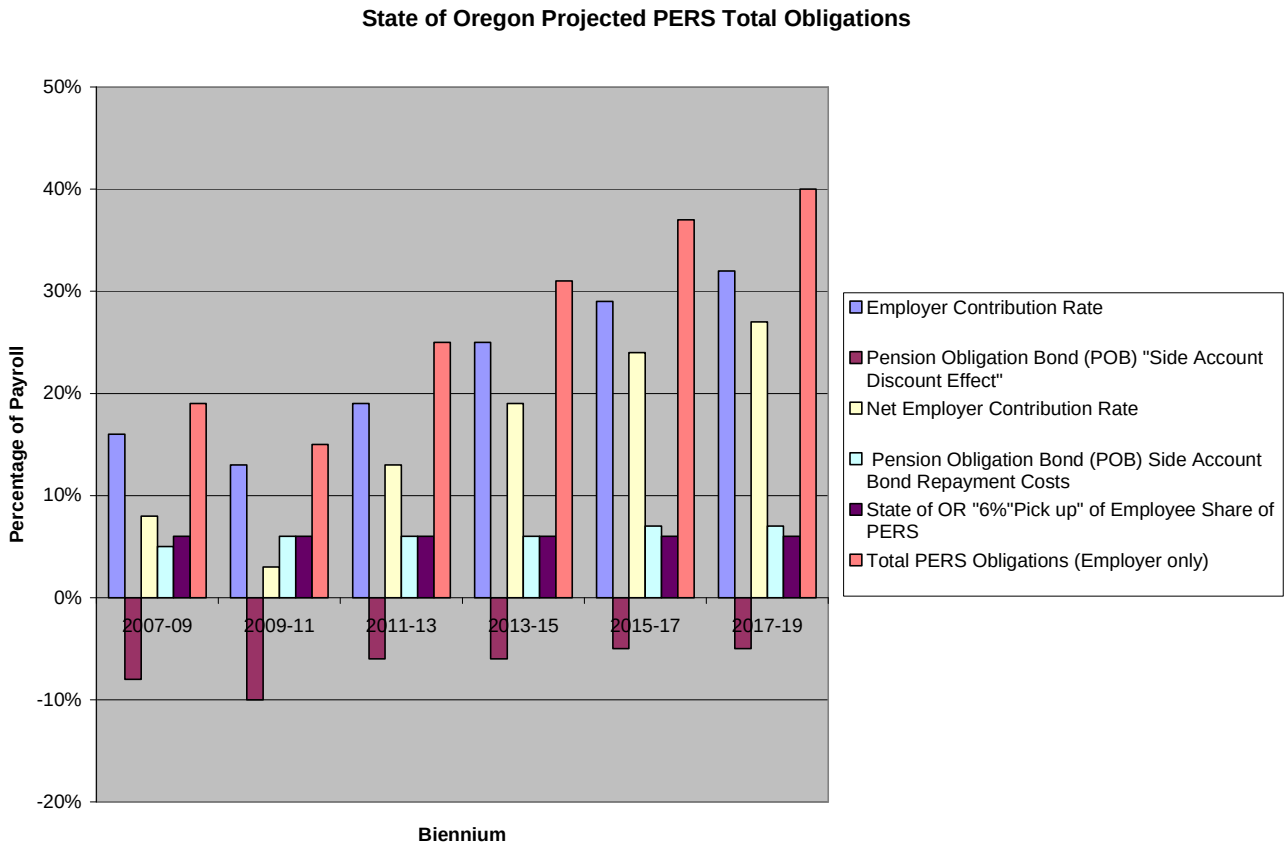
for state government alone. The chart below illustrates these dynamics, projected to 2017-19 and based on the May 2009 Mercer report:



Note: Data for 2007-09 and 2009-11 based on actuals; other data based on May 2009 Mercer report. For 2011-13 and beyond, the POB/Side Account "discount effect" for this chart and the one that follows is estimated based on Mercer's projections of "system-wide" changes in the Side Account rate applied proportionately, while POB/Side Account repayment rates as a percentage of payroll assume slower payroll growth than 3.75% annually.

What about the expected jump in Total PERS Obligations for K-12 school districts? This isn't just important to local taxpayers; it's also highly relevant to state legislators, since Oregon's general fund now pays for about 65% of K-12 costs. [66]

Consider a K-12 School District that still picks up its employees' 6% share – and which also went "long" with Side Accounts so that in 2009-11 it can buy its 14% share down almost to 0%, while bond payments constitute about 11% of payroll. While this district's 2011-13 Employer Contribution rate jumps 6% -- from 14% to 20% -- the "discount

[66] As noted earlier, in 2009-11, an estimated $6 billion –almost 50% of the state general fund – will go to K-12 districts. About 85% of that money will help finance personnel costs – salaries, benefits (and yes, pension obligations) for teachers, administrators, and other personnel.

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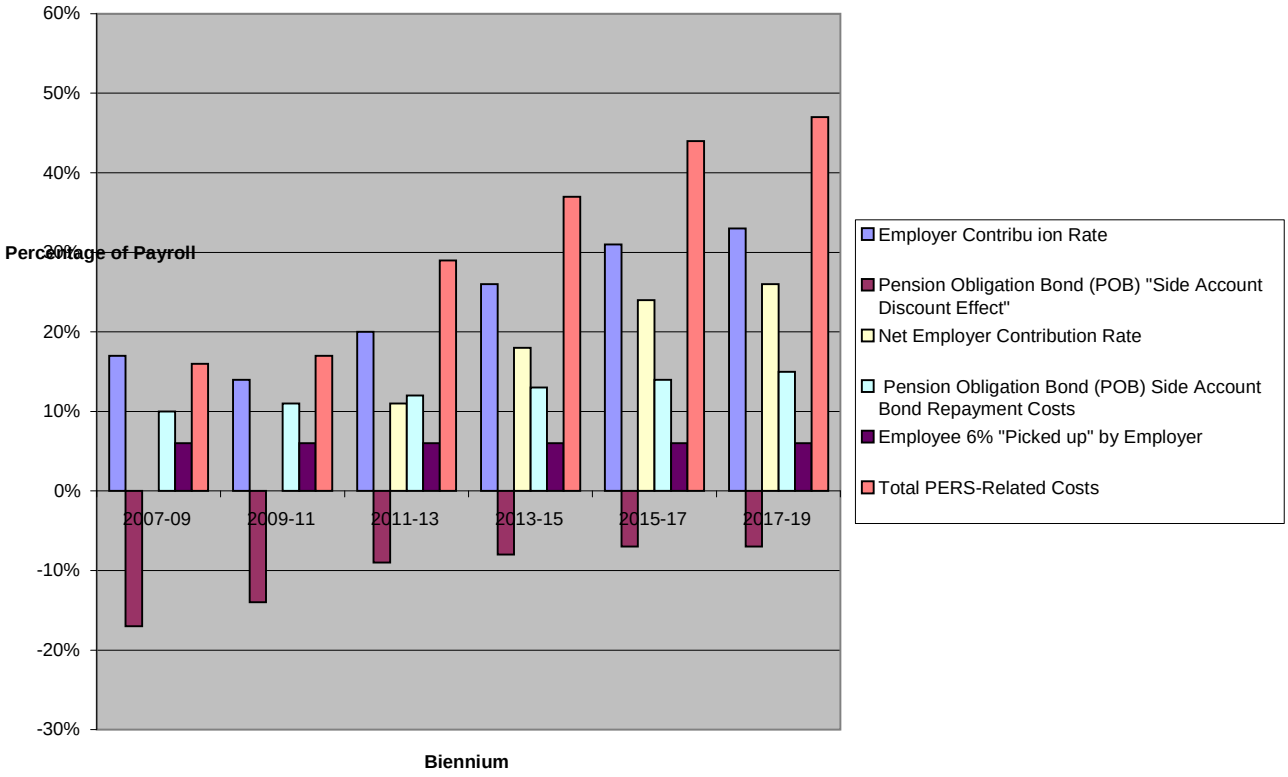
effect" of its Side Account is projected to drop from 14% to 9%. Meanwhile, its bond payments continue to escalate, perhaps against a static or even declining payroll.

For such a K-12 district, as the chart below illustrates, it's not inconceivable its Total PERS Obligation could rise from 16% to almost 30% of payroll for 2011-13 -- and even to beyond 40% by 2017-19, viz Mercer's May 2009 scenario (at 50% probability)

K-12 District with Large Side Account and 6% pick up: Projected PERS Total Obligations



In the K-12 world, every 1% increase in pension costs has an impact of about $60 million per biennium – virtually all of which must be financed with property taxes or state general fund/lottery dollars. A jump from an effective rate of about 16% of payroll – 6% pick up, plus, say, 11% in bond repayments – to 30% (6% pick up, 12% in bond payments, and 13% in the net Employer Contribution rate after Side Account discounts) would translate into an additional $850 million. [67]

Translate this number into the potential impact on teaching staff. Assume that districts can hire starting teachers at $40,000 in salary, and that the additional "total burden" -- of taxes, health insurance, and other benefits (including PERS) -- brings the total up to $60,000 a year, or $120,000 a biennium. Instead of being able to hire 7,000 new teachers,

[67] Again, if you assume the state general fund is essentially financing 65% of such an additional cost, the impact in 2011-13 on the state budget will be about $500 million more simply to maintain current funding levels, viz 2009-11..

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Oregon's K-12 system instead will need that money simply to pay for the new, higher costs of retaining the 30,000 teachers it currently has.

The converse is also true. If budgets remain static, a 14% increase means that where the system once could pay for 30,000 teachers, it now can pay for only 23,000, resulting in large increases in class size._.

And again, this is just for 2011-13, compared to 2009-11. As Mercer in May 2009 looked beyond 2011-13, it saw at least *two more likely rounds* of Employer Contribution rate increases in the neighborhood of 6% of payroll, for all public employers. And across the entire system – remember, $16 billion in payroll now, supposedly getting higher each biennia – each 6% hike translates into roughly another $1 billion.

There's also a larger context here, for state, K-12, and local governments alike.

PERS costs are a major – but not the only – component of the "employee burden" public employers must bear and budget for when it comes to hiring public employees to deliver essential government services.

In the private sector, the term "Total Compensation Burden" is commonly used to reflect these costs. Included in such a calculation – typically expressed as an overall percentage of payroll – are requirements such as FICA (Social Security and Medicare), unemployment tax, and workers' compensation, Also included are employee benefits, such as sick leave and vacation time, employer-financed health insurance, as well as pensions or (much more typically) 401 (k) matching contributions.

For most private sector employers, the Total Compensation Burden typically runs 25-35% in addition to salary. Public sector employers in Oregon are required to pay the same government taxes. Benefit levels are where the public sector and their private counterparts diverge dramatically

For example, health care policies in state and local government sectors often have small, or no co-pays, and in many cases cover not just the employee, but his or her entire household at little or no extra cost. A not a-typical cost for such coverage in Oregon's public sector for 2009-11 is about $12,000 a year; assuming an average $50,000 salary, that amounts to 24% of payroll.

Add PERS' total costs – now at 15% of payroll, fast heading towards 30-35% -- to these other costs, and what's the result? A combined, Total Compensation Burden of 70-75%. If a typical private sector employer has enough money to hire 3 people at $50,000, with benefits at 30% of payroll, Oregon's public sector with the same money will soon be able to barely hire 2 at that salary.[68].

[68] Just one example: on October 2, 2009, the Bend City council held a work session to review financial issues. Currently, the Total Compensation burden for Bend city employees is an additional 50% on top of salary. By 2014, driven largely by projected PERS costs, it is estimated to climb to 71%.

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Couldn't PERS' fortunes reverse as quickly as they've tanked? Couldn't another stretch of robust market growth over the next 3-5 years restore most – if not all – of PERS lost fortunes, and perhaps even return the Employer Contribution rates to more manageable, familiar levels?

These are good questions, too. And as PERS managers are quick to note, Mercer's May 2009 report was based on OPERF's estimated value as of March 31, 2009 – which literally was at the bottom of the market. Indeed, that report projected a 3% decrease in OPERF investment returns for 2009; as of September 30, 2009, PERS officials note OPERF has posted investment returns of nearly 14% in value, largely due to robust public equity gains in the stock market.

Indeed, this is the first answer that PERS officials and others give in response to the dire predictions within the Mercer report. These are only "modeling exercises," they note, based on a multitude of assumptions, not just about the economy, but about the continuation of existing policies and practices that the PERS Governing board could change. And just because something could happen, doesn't mean it will. Indeed, PERS has plenty of experience with the "future" playing out much differently than expected, and in both directions.

All of which is true – but here's the problem. Even assuming a "Third Great Run" of 25% annual returns for PERS over each of the next 5 years -- essentially, the "Best 10% Case Scenario" that Mercer also modeled in May 2009 – the Employer Contribution rate by 2015-17 would still need to be close to 20%.

In recent weeks, a second potential response has also emerged: to change existing PERS' policies to further reduce the size of the Employer Contribution rate hikes.

The general concept here is known as "rate smoothing," a familiar term in the world of public pension management. The idea is that the 2008 market crash was unprecedented and unlikely to repeat itself any time soon -- that in effect, it was a "rogue financial wave," or "outlier" event equivalent to the occasional birth of a "Black Swan" in the natural world. Thus, it would be "unfair," the argument goes, to ask employers (and their employees) to absorb the impact on the same terms (and timeline) as if it had been a less severe recession. [69]

[69] It is certainly true that 2008's 27% drop was 3 times larger than PERS' previous worse year – in 2002. But along with this one "Black Swan" have arguably been a dozen or more "golden geese" laying the financial equivalent of golden eggs. Just since 1982, PERS has enjoyed 8 years of 20%+ returns, and another 7 of 15% or more. So is 2008 a wild, aberrant swing – or a long-over due "market correction" to past, super-charged gains? And might both equity and real-estate (especially commercial) still be significantly over-valued, with more "re-adjustments" yet to come as expectations of future growth are re-

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Accordingly, PERS officials are now publically contemplating the abolition of PERS' existing "double rate collar" policy. That is, even if OPERF's funded status were significantly less than 80% as of December 31, 2009 – and it will be – the 6% rate hike would *not* be activated. Instead, the 2011-13 increase should be limited to just 3%, thereby saving public employers about $500 million.

It's hard to imagine that reducing the first 6% rate hike – much less a 2nd, and potentially even a 3rd – would *not* be wildly popular among *both* public employers and their employees. Notwithstanding how hard both might wrangle over the use of such "saved money" during budget hearings and contract negotiations, it would at least be there to fight over.

But just what are the implications of such a move, especially should the underlying assumption of 8% long term average rate of return for OPERF in the next several decades -- the "PERS returns to "normal" after an intense but brief storm" scenario -- fail to materialize?

First, recall that when the PERS Board decided to use actual, fixed valuations of OPERF in setting rates – rather than the somewhat arcane "4 year asset smoothing" approach – it faced a dilemma. While more transparent, this new approach was also far more prone to producing Employer Contribution rates that would mirror potentially large ups – and downs –in the financial markets.

Though PERS officials argue that in pension-speak, the "rate collar/double rate collar" policy isn't "rate-smoothing," it's actually helpful to consider it in exactly that way. In most foreseeable circumstances, it will have exactly that kind of effect, when applied consistently going forward.[70]

The situation for 2011-13 is a very good illustration of that. PERS' existing actuarial approach would have otherwise suggested a 10% rate hike for 2011-13. Applying the "double rate collar" based on PERS' projected sub-80% Funded Status, the policy limits the increase to just 6%. The "extra 4%" would need to be taken later – and hopefully, when it can be mitigated by market valuations that otherwise would suggest an Employer Contribution rate decrease.[71]

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calibrated amidst a national reckoning of the true costs of too much past growth fueled by excessive debt and unrealistic expectations?

[70] In its September 2009 report (Slide 8) Mercer describes the rate collar exactly this way: "The collar has the effect of smoothing rate increases for significant losses over two (or more) biennia."

[71] What's inherent in the rate collar concept, of course, is the danger of a "piling up" effect. What if OPERF's valuation suffers not one, but several consecutive down biennia, creating a situation where even 6% rate hikes aren't enough to reverse the downward spiral in PERS' Funded status?

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What PERS is now being strongly urged to do is abandon the "double" part of its existing collar policy, and limit the 2011-13 increase to just 3%, or just 30% of what (in the absence of any "rate collar) would be called for in 2011-13.[72]

But what will such a change in existing PERS policy do to PERS' funded status?

The September 2009 Mercer report modeled exactly this question. But whereas the May 2009 report modeled 7 different probabilities – ranging from an annual OPERF growth rate of 30% all the way down to -11% -- the September report only examined 3 scenarios. All of them were positive: 10.5% annual growth; 8% annual growth; and 4.5% annual growth.[73]

At the "middle scenario" of 8% annual growth for the next decade in OPERF valuations, Mercer concluded that retaining the 6% "double rate collar" policy would produce a funded status of 74% by 2017-19. By limiting biennial increases to 3% for the next decade, the funded status would be 71%.

The conclusion many will prefer to draw is pretty clear. Since this is such a relatively small difference, why endure the pain of two, back-to-back 6% hikes over the next two biennia, when two 3% hikes won't make PERS' Funded Status that much worse?

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[72] Ed Hershey, spokesman for Service Employee Union International (SEIU) 503, which represents 23,000 state workers, was quoted in the October 25, 2009 Oregonian story by Ted Sickinger this way: "Everyone we talk to thinks (a smaller rate increase) is a good idea. It's a totally acceptable way to do it. We would view this as the prudent way to do it."

[73] PERS officials note that the May 2009 report looked at "general capital market" projections for the future – while the September 2009 used "actual historical experience" for the last 10 and 25 year periods. Because these are two different "benchmarks," they warn of using the two comparisons for this purpose.

It's true there are several, though often subtle, differences that readers should bear in mind between the two concepts. The first is a "forward looking" estimate of capital markets generally – useful for helping policy makers project earnings generally, and even select an Assumed Earnings Rate figure. The second is a "backward glance, extrapolated forward" – i.e., if it's known that OPERF specifically has earned between X% and Y% during benchmark stretches of time – e.g., 10 years, and 25 years -- , then isn't it reasonable that we can expect a similar pattern to prevail in the future?

The problem with either kind of projection, of course, is encapsulated in a favorite quip attributed to John Maynard Keynes: "In the long run, we'll all be dead." Key decisions have to be made, in the here and now, based on best available information about the past and present – and expert modeling work about the future. Even if OPERF returns, looking back from 2030, ended up averaging 10.5%, that doesn't mean they will for the next 5 or even 10 years – and indeed, they could be negative. What's key here is that at the "50% probability" level in the May 2009 Mercer report – general capital markets gaining about 8%, year over year -- PERS still faces a serious "Employer Contribution rate hike/lower-than-historically comfortable Funded Status" problem of unprecedented dimensions. And at "more pessimistic" scenarios closer to 4.5% returns – essentially, having the1999-2009 investment performance repeat itself from 2009-2019 --the system arguably proves unsustainable.

Yes, should OPERF investments get back on a 10.5% annualized growth track – and consistently stay there – over the next 5 years and beyond, and these problems are ameliorated. But even then, they don't disappear; in effect, the system now needs to "meet" these historical averages, just to get rates to "only double" over a 10 year period of time.

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But what happens at 4.5% annual growth? Then the numbers are a good deal lower – and the gap a lot bigger. Even with the double rate collar in place, PERS' funded status would slip to just 59% by 2017-19. Abolish the "double rate collar," to limit rate hikes to 3%, and OPERF's Funded Status falls to heart-stopping 51%.

Indeed, PERS director Paul Cleary was quoted as telling the Oregonian in its October 1, 2009 story, "If we're staring off at a new normal, we've got problems…Our business model doesn't work with 4.5% returns."

Another strategy that could surface would be change the amortization of PERS liabilities – that is, assume that it will take longer to "true up" assets to those liabilities, and thus not require such steep hikes in the near term.

Oregon statutes simply direct the PERS Board to charge employers rates that are "actuarially necessary to adequately fund the benefits to be provided" (see ORS 238.225). But as noted earlier, the current PERS board earlier this decade continued the policy started in 2000 to reduce the amortization schedule from 30 years to 20 years. They did so largely based on the principle of "generational equity," so that tomorrow's taxpayers (and government service recipients) wouldn't be unfairly burdened by today's taxpayers (and public employees) natural tendency to minimize these costs and push as much as possible into the future.

Returning to a schedule of 30 years - or even longer– would help lessen PERS rates today, though an earlier Mercer analysis suggests the immediate impacts would be relatively small. But ven more important, it would represent a 180-degree turnaround in current PERS policy.

So the issue isn't whether PERS should adopt policies to 'smooth rates." The issue is whether PERS should essentially reverse a number of past, key decisions – some of which, like the "double rate collar" have never yet been actually applied. It would also mean adopting approaches that, had they been in effect during the last 5 years, would have made the current crisis significantly *worse.*

By definition, any additional "rate smoothing" to lower today's Employer Contribution rates would also push into the future potentially even higher increases to help restore PERS' long term health. And if – or more likely, when – another market downturn occurs, will the same argument be made, for yet more "rate smoothing?"

Indeed, PERS' current predicament is largely the result of past decisions by PERS overseers – both the old board, and the Legislature – to artificially keep rates far lower than they should have been, relative to the benefits promised. These decisions – and the faulty assumptions on which they were based -- masked the true costs of the system, which then became painfully revealed during what (in retrospect) was a relatively "minor" economic downturn in 2002-03.

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Any rate smoothing policy – even the current one, with its 20 year amortization of liabilities and a rate collar that can't exceed 6% even in severe downturns– also raises important issues of generational equity. Just how much obligation and risk should future taxpayers bear, to ensure that today's – and indeed, yesterday's – public employees receive the pension benefits they've been promised by current (and past) policy makers?

Indeed, the difference – assuming 8% annual growth, in the September 2009 Mercer report – between 74% Funded Status with the 6% increases, and 71% with just 3% increases -- seems relatively small. But the difference between either number -- and PERS' Funded Status as of December 31, 2007 of 96% -- is enormous.

In effect, PERS policy-makers are contemplating – for the first time in PERS' modern, 40 year history --- the very real possibility that a once unheard of Funded Status of 70-80% isn't just survivable for a short period of time – it's potentially tolerable over the long term. This is an enormous "paradigm shift" in the underpinnings of this system.

True, this level is admittedly common with many other state and local government pension funds around the country. But what are the implications of deciding that this reality might become the "new normal?"

Oregon wouldn't just lose bragging rights among its pension fund peers for PERS' exceptional performance. Such a "new normal" could have significant direct costs. In the past, when the state of Oregon has sold bonds to borrow money -- for capital construction, road improvement projects, etc -- it has touted OPERF's exceptional funded status to help reduce those costs. Lose that edge, and Oregon state and local governments start paying higher interest costs every time they borrow money.

Finally, should PERS decide that a funded status of around 70% -- much less in the 50%s should the markets fall to 5% or less annualized growth --is tolerable, even for relatively long periods of time, it would further underscore a very uncomfortable truth at the heart of the PERS system. At anything less than 100% funded, there's danger that PERS will be unable to meet its full legal obligations to existing and future retirees.

In such an instance, state and local taxpayers would be obligated to make up the difference – above and beyond what they already pay via the Employer Contribution rate, and (where applicable) escalating pension obligation bond costs and employee contribution "pick ups."

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Of course, the future is inherently unpredictable. As noted above, the conclusions of the May 2009 Mercer report are based on a "modeling exercise," that relies on dozens of assumptions and scenarios. Almost as soon as such a model is built and run – and as

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PERS officials note, Mercer literally ran theirs around the March, 2009 low-point of the market – reality changes.

And things have definitely gotten better in the last 6 months, as PERS officials are quick to point out. For example, the S and P has risen almost 50% since its March low point, and now stands about 30% higher for the year to date. PERS officials note that should OPERF close out 2009 with a 15% investment gain -- and then get back on an historical track of earnings at the 40-year historic average of more than 10% -- Employer Contribution might fall short of 20%.

And who would wish otherwise? After all, a rising market will be nice for everyone with pensions, including private citizens and their 401 (k)'s.

However, it's also possible that the current market rebound could stumble, and things could play out *worse* in the next 5 years than even Mercer's 50th percentile scenario of May 2009 – or its "mid point" probability of 8% growth in the September 2009 follow up. Indeed, what happened in 2008 wasn't even on Mercer's radar screen as a 5% probability – but it happened.

And what if 2008-09 wasn't just an air-clearing "thunderstorm," but the opening act in a generation-defining re-ordering of America's and the world's financial markets? What if the market rebound of the last 6 months suddenly gives way to another plunge – the so called "W" scenario as opposed to the rapid "V' shaped recovery everyone would certainly hope proves true? Perhaps more excrutiating, what if we wind up in "L" or "U" shaped territory – relatively long stretches of low or even flat growth, similar to the Japanese economic malaise of much of the last two decades in its equity and real estate markets?

So some skepticism is certainly warranted. But skepticism can – or at least should – go both ways. It is hardly surprising, that when happy economic news suggests that Employer Contribution rates can be lowered and/or retiree benefits raised, that virtually everyone affected – public employers, current employees, and retirees -- will strongly urge strict adherence to the model and policies in place that allow (or even dictate) such results.

But what happens when the opposite occurs? Will the same players accept the "flip side" of the bargain? That in exchange for taking advantage of past gains, they should accept, and then adjust to, the necessary fiscal pain of any downside, however inconvenient the timing or severe the consequences?

Or, will they suddenly find great merit in urging significant changes to those policies, couching them (naturally) in whatever policy rationale sounds plausible at the time, but with the underlying motive little more than simply "postponing" the full measure of consequences that were earlier accepted (if not embraced) in exchange for the benefits?[74]

[74] This is an inadvertent – but significant – impact of the 18 month lag effect in the real world of politics and interest groups. If existing rules mean that in 2009, the reality of 2007 now "requires" a rate decrease

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That is arguably where the debate – right now – has landed, especially in context of potential changes like moving back in the direction of 30-year amortization of liabilities or eliminating the "double" portion of the rate collar for 2011-13 and beyond.[75]

Based on its best understanding of the PERS system – and the necessity of needing to base decisions on the best possible version of future realities that can be discerned at a given moment – the PERS governing board has lived within its existing framework for the last 5 years. For most of the time, that framework has worked well – in no small part because OPERF's average annual gains for the vast majority of that period (2003-07) were 15%, or roughly double the 8% Assumed Earnings Rate. Put another way, it wasn't just the 2003 reforms that have helped PERS recover; until 2008, PERS was relatively lucky in the market place.

Today, that framework faces by far its greatest test. Every new dollar PERS will require to cover future liabilities is a dollar that cannot be available for the here and now – for new employees and programs, raises and benefit increase for existing employees, or potential tax cuts for citizens. In light of already tight, even declining budgets, it is inevitable that the PERS Governing Board will be under fierce pressure to tweak its existing model, or even craft a new one.

But at the end of the day, the most important decisions will be made by Oregonians, and their elected officials. Collectively, will we decide to fully accept the responsibility to fix this massive problem, however much it hurts, in a way that future generations aren't

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of 3%, who will complain, especially publically? And more to the point, even if some are concerned that this might prove "penny wise but pound foolish" – especially if they understand the future financial storm bearing down – won't they simply be shouted down by those who insist, "Play by the rules!"

But what happens now, when those same rules in 2011 mean a large 6% hike based on the reality of 2009 is "required"? This time, the complaints will likely be very public, and widespread, with the clear message: "Change the rules!" And more to the point, those who might now urge adherence to those rules – noting the inherent "quid pro quo" for the earlier decrease – will likely find themselves blamed by those who insist, "Why do *you* want to force us to now cut vital public services even more?!"

During such an 18 month lag, there's considerable time for employers, employees, and even today's taxpayers to lobby the PERS Board and/or legislators to change the rules in a way that ameliorates these otherwise steep hikes. However, as with many lobbying efforts, don't expect the argument to be couched in terms of "Push the problem further out into the future (where it could cost far more.)" After all, this is politics. Far more likely, advocates will converge on changes that can be portrayed as based on sound accounting principles used elsewhere – perhaps, even a return to some used by past PERS overseers— and that will be characterized as rational, sound, and relatively risk-free. (It just so happens they'll also have the desired effect of postponing projected costs further into the future.)

[75] In early November 2009, PERS officials indicated the very real possibility that the PERS' Governing Board could act by early 2010 to change one or more of these policies, especially the "double" portion of the "rate collar. Such action would arguably represent a notable "rush to judgment" since the normal cycle for PERS rate-setting would be the fall of 2010, and no rate hike of any kind would take effect until July, 2011. The case for a more deliberative, open process is further bolstered by how little awareness -- much less debate – has manifested itself to date among most public officials -- much less the general public who would be directly affected by any such decisions.

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unfairly burdened – much less inundated – should (or when) yet another storm of any consequence occurs?

# # #

Appendix A – Possible PERS Changes

In 2003, the fight over changes to the PERS system – especially with relation to benefits – was fierce and contentious. There's little reason to believe the dynamics would be profoundly different in the years ahead.

Indeed, there's always great likelihood that PERS discussions will quickly run to what one observer calls the "theological" questions. Are benefit levels fair and just – or excessively generous? Does the work of public employees deserve to be widely celebrated for providing vital public services– or diminished for alleged excessive costs and poor quality? Just what were public employees promised by their employers – and even if they were or weren't truly "promised" X or Y, what would be truly fair?

The author has worked hard to steadfastly avoid such debates for a basic reason. As emotionally satisfying as they might be to certain partisans on either side of these long-running debates, they are not central to the core question here. Regardless of what one believes is a "fair pension" within a larger compensation system for public employees, the issue is ensuring how PERS can best be sustained, over time, in a way that's consistent with basic financial and political realities.

It's also important to understand there are significant legal constraints to what is even possible, especially with regard to existing retirees. As noted earlier, nearly 40% of the Employer Contribution rate goes to pay for the benefits of the more than 100,000 already retired PERS members. Given a number of court decisions, significant changes in the benefit levels of these retirees aren't even possible.

That said, it would be a self-defeating myth – perhaps the "second most dangerous" involving PERS – to think that nothing of consequence can be done to deal with these problems. True, there seems to be no one, "silver bullet," and any single change, however modest in scale, will have its fierce opponents. But taken together, a series of changes – some made in statute, others through collective bargaining agreements or executive branch policy changes – could add up to a significant improvement in PERS' ability to sustain itself over time, through a wider range of economic scenarios.

I am not a pension expert, and will not attempt to make my own specific recommendations in this very complex field. Instead, what follows is a sampling of some

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of the ideas that I encountered in the course of doing this report that seem worthy of further legal analysis, public discussion, and possible enactment.

But no matter the merits of particular ideas, few would disagree that examining a full range of possible options -- no matter how contentious or politically sensitive – is vastly preferable to doing nothing. As a business colleague is fond of saying, "In difficult times, "Hope" is always a comforting refuge– but should never be confused for an actual strategy."

So, what is to be done? Perhaps just as important, what even *can* be done?

Many of PERS' current problems are inherently structural and difficult to change, both for policy and political reasons. There are also important legal constraints. Certain possibilities that some might want to explore have essentially been ruled "off limits" by the courts – most notably the "contractual promise" to Tier I PERS members of guaranteed returns equivalent to PERS' "Assumed Earnings Rate," which is currently pegged at 8%.

What follows are some of the suggestions – in no particular order – made by those I interviewed, who either oversee or have closely observed the PERS system in recent years.

Should the state – and other jurisdictions – continue the practice of the 6% pick up? Or should they modify it, or abolish it altogether?

As noted earlier, there is no legal requirement that public employers finance the 6% of employee's pay that is required for participation in the PERS system. However, most public employers currently finance this 6% out of taxpayer funds; by some estimates, this occurs in about 70% of covered payroll. Assuming $16 billion in public employer payroll for 2009-11, this amounts to almost $700 million.

When existing labor/management contracts are renewed – or re-opened -- this could be a topic for discussion and possible change through the collective bargaining process. A new state law could also address the issue. Possible changes could include eliminating the pick up outright; limiting the state-financed portion to, say, half (3%), or requiring that state contributions up to a certain limit would require a "match" from employees, allowing employees to decide how much they wanted to invest in their future pensions.

Such conversations could be timely as early as this spring, should the two tax measures scheduled for a January 2010 be defeated by Oregon voters. This would create a $700 million hole in the 2009-11 state budget, with large "ripple effects" down through K-12 and local governments. Additional lay-offs and/or pay reductions could result, which could also require the re-opening of various labor contracts.

Should the Legislature simply abolish the Employee Contribution, period?

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Current state law actually requires an "employee contribution." During contract negotiations, for example, the 6% "pick up" is often discussed in context of this statutory provision – i.e., "If it's required by the state, then it's logical for the state to pay for it."

However, one of the major PERS reforms in 2003 was to re-direct all members' 6% contributions – Tier I, Tier II, and Tier III – and put them in separate, Individual Account Plan (IAP) accounts. These IAP rise and fall with OPERF's fortunes, and upon retirement are transferred to their owners at current values. So these amounts no longer factor into determining Money Match eligibility – a major reason that this usually more costly method is now used by about 65% of new retirees, compared to about 85% a decade ago.[76]

Remove this mandate, and it would also eliminate the argument that employers *should* pay the 6%, since state law would no longer require it.

However, make no mistake: affected employees would likely fiercely oppose such a move . And if the Legislature removes the mandate anyway, they would then ,likely argue that pay levels should then be increased a commensurate amount.

But such a discussion would then be within the realm of collective bargaining negotiations, where a variety of other issues are also in play. Employees may decide certain things, including of a non-monetary nature – e.g. job classification policies, or job security guarantees -- might be of more importance.[77]

Such a change would not materially affect PERS' core funding status, given the separate nature of IAPs. However, the end result could reduce many public employers' on-going costs for their total PERS obligations.

Should the state create a "Tier IV" system, whereby new employees' pensions after a future date would be 100% in the form of a Defined Contribution Plan, like the ubiquitous 401 (k)s of the private sector?

It's widely -- but erroneously --believed that Tier III employees hired after August, 2003 have such a plan. They actually have a hybrid plan, which consists of a significantly less

[76] This trend away from Money Match has helped reduce future liabilities of the system, and thus decreased pressure on the Employer contribution rate. However, in determining rates, PERS already takes this – and related changes and trends – into account.

[77] The likely argument that since the "6% pick up in lieu of a raise" deal was made in 1980, that somehow it's legally "sacrosanct" is a most curious one. Contracts are typically bargained on 2 or 3 year cycles in the public sector – and unions often demand that management "re-visit" issues agreed to in the last contract, much less ones of 10 or 20 cycles ago. (Management, of course, can do the same). This might be such a heartfelt issue that labor might threaten to strike over it – and management might either be willing to have that happen, or not. But it doesn't mean it's somehow an illegitimate topic to discuss at the bargaining table.

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generous "Defined Benefit Plan" (viz Tier I and Tier II members) along with the same 401-k like "Individual Account Plan (IAP).

Such a "Tier IV" system would consist simply of employee contributions, and whatever Employer Contributions that were decided upon by legislative action and/or contractual agreement. This would be a major change, in effect giving newly hired employees after a certain effective date a compensation system more like those increasingly common in the private sector.

Whatever level of "Employer Contribution" to such a system, an especially contentious issue would be that of guarantees, since employer participation in such plans often changes based on economic conditions. In the recent recession, many such plans have gotten significantly less generous – and in some cases, private companies have abolished pension plans or drained them dry on the way to bankruptcy.
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While it would arguably be folly – even if it were legally possible, which it isn't – to impose such plans on existing employees, this kind of approach to new Employees would likely meet with fierce opposition, in part because of this private sector track record. [78]

Should the total of all Employer-financed taxes and benefits – not just PERS costs, but health insurance, paid time off, etc – be subject to an overall "cap", that could not be exceeded?

As noted earlier, the "total burden" for typical private sector employers – the taxes and employer-paid benefits for health, retirement, etc – typically runs from 25-35% on top of base payroll. Many public employers already have a burden of 50% or more – and fast-climbing PERS costs could make that 70%-80% before decade's end.

Again, this would be fiercely opposed by many, the argument being that over the decades, employees have consistently accepted lower pay than what they felt was deserved in exchange for higher benefit levels. There would also be a version of "generational equity" in this discussion, too, since 40% of current PERS Employer Contribution rates actually go to finance the benefits of the *already retired*. It arguably

[78] In past – and doubtless, future -- PERS debates, many will argue with considerable passion that "If anything, private workers deserve the kind of pensions public employees have, not vice versa." This is a legitimate point. However, the issue here, isn't taking away anyone's existing pension; legally, that can't be done. The question is whether it might prove necessary to further change the system for future employees, in part to increase the odds that promises already made to existing retirees and current Tier I to III members can be fulfilled, without inordinately burdening future and current taxpayers.

In this sense, a PERS crisis may quickly reveals significant conflicts between the interests of PERS' current retirees, and PERS future retirees (i.e, current workers). Current public employees with 12 or 20 years of PERS-eligible service will see their expected benefits diminish considerably if they don't keep receiving pay hikes – or lose their jobs entirely, 10 or 15 years short of their expected 30th year. If current retirees' benefits can't be touched; if financial markets fall into the doldrums, and if employers face rapidly rising bills in large part to pay for past decisions, what options are left, other than rapidly rising taxes and/or large-scale lay-offs and budget cuts?

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wouldn't be fair to include that portion of the PERS obligation in any calculation of a current employee's total compensation package.

Should certain actuarial assumptions be revisited, that might spread out the pain of projected rate hikes over more years?

Some have suggested that PERS return to its pre-2000 approach of amortizing pension liabilities over 30 years (or longer), rather than the 20 year schedule it moved to during the last decade. It could also decide to return to something like "4 year asset smoothing," which could change the benchmark valuation numbers for December 31, 2009 (and every two years beyond) from the current, "market valuation" approach.

As also discussed earlier, a third approach would be to simply eliminate the "double rate collar" that potentially adds 6% hikes to each of the next two biennia -- or even 3, should OPERF investment returns slow to 4.5% annual growth.

However, all three ideas, as discussed earlier , would arguably represent 180 degree reversals from PERS policies enacted over the last decade, that were based on a number of core principles such as promoting further transparency and protecting generational equity. Further, each would push greater costs – not to mention risks – into the future, giving PERS overseers later in the decade even fewer options should financial markets experience even a "2001-02"-style drop, that was roughly half the magnitude of the 2008 version.

Indeed, there are arguably already serious "generational equity" issues with existing policies – e.g., having a "rate collar (even with a "doubling" provision) at all, or allowing public employers to essentially finance an on-going obligation like pensions by borrowing money through Pension Obligation Bonds to meet today's demands(and committing future generations to repay it, regardless, and on ever-escalating rates). [79]

Is it good policy to put even greater burdens on future generations of employees (and taxpayers), essentially to finance the unexpectedly high costs of paying for existing and current employees' retirement? Put another way, should tomorrow's taxpayers' level of services be reduced below what they'd otherwise be, to finance obligations made by the previous generation?

*Should policies be enacted – either by PERS, the Legislature, or through other means -- that actually run in the **opposite** direction, to force today's employers (and potential retirees) to accept more "pain" today in order to make future increases not quite as severe?*

[79] For most public employers, on-going health insurance costs are currently even higher than PERS costs. If borrowing and bond "arbitrage" is considered an accepted strategy to finance pension costs, why not "Health Care Obligation bonds" also sold at 5%, and similarly invested in OPERF? While seemingly far-fetched – and there is no such current discussion this author is aware of – it should be noted that a small portion of PERS does indeed finance certain health-care related costs for retirees, primarily for Medicare-eligible members 65 and over .

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For example, the current "rate collar" could be lifted, or modified to allow even larger hikes, above 6%/biennium. While this would drive short term (e.g., 2011-13 and 2013-15) Employer Contribution rates even higher – such a "pay it all now" approach would increase the probability of a faster return to "historic ranges" of 12-15% for Employer Contribution rates, especially should U.S. economic growth slow and financial market gains drift down enough to require the setting of a lower PERS assumed earnings rate in the future.

While painful in the short term, such approaches would help insulate future generations of public employees -- and recipients of tomorrow's government services – from additional costs that they essentially had no role in creating.

Should some of factors that go into calculating PERS benefits –including for long-standing Tier I/Tier II employees – be re-examined and changed?

For example, Tier I and Tier II retirees now get to add unused sick leave and other factors when calculating their Final Average Salary under the Full Formula benefit method. And whether beneficiaries end up using the Full Formula or Money Match methods upon retirement, their pensions include a 2% "Cost of Living Allowance" (COLA).

Both unused sick leave and COLAs are subject to existing state law. What difference any changes would make in PERS liabilities would need to be modeled – and doubtless such changes would be fought in both the political arena and the court system.

Should the next round of contract negotiations be the main arena for PERS changes, allowing management and labor to negotiate various options and trade-offs with an eye to avoiding protracted legislative and court battles?

While the PERS governing board and the Legislature have been the focus of past PERS reform efforts, many of the current arrangements (e.g., the 6% pick up) are really the result of management-labor negotiations. Might labor unions and their members be willing to give up certain PERS-related benefits, in exchange for changes in other, non-PERS related areas? (E.g., protections against future lay-offs, or being able to "capture" in their compensation packages savings that they help identify).[80]

Should Tier I and Tier II beneficiaries who are still a long way from actual retirement, be provided with a "one-time" buy out package?

[80] Indeed, while some may be tempted to focus on public employee and their unions for the PERS mess, the fundamental principle of collective bargaining is that there are two sides to every negotiating table. If state managers of the past have bargained ineffectively, that's not necessarily labor's fault – and there may well be some "win-win" scenarios here that would benefit all three parties (taxpayers being the third, and arguably most important of all).

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Such an approach has sometimes been used in the private sector with thorny pension challenges. Money could be offered in large, lump sums, mostly likely focused on Tier I and Tier II PERS members, in exchange for removing significant amounts of future liabilities from PERS' books.

Such an approach would face enormous financial hurdles, not to mention potential legal and practical ones. Clearly, public employers don't have massive amount of excess cash lying around to fund an effort on such an unprecedented scale. ("Think billions of dollars," as one observer said.)

Such a move would almost certainly require a massive amount of borrowing. Even so, this could prove a better way to use a second round of "Pension obligation bonds" than simply as an arbitrage mechanism for buying down the employer contribution rates.

Should PERS reduce future benefit obligations for Tier I members, by changing its "Assumed Earnings Rate" from 8% to a lower figure?

This idea has been examined at length. Lowering the current 8% rate to 7.5% was actually discussed – though rejected – at the July 2009 PERS board meeting.

Such a change would essentially reduce the future value of Tier I members' projected retirement accounts – and thus, their pension benefits.

That would certainly spark controversy – not to mention legal challenge. (Tier I members would likely argue that PERS was breaking a contractual "promise" of 8% automatic increases, without justification that such returns weren't possible to achieve).

But here's the real dilemma of such a move. If the assumed earnings rate were reduced to, say, 7%, PERS would also be required to reduce what it assumes OPERF will earn in future years.. In the short term, this would actually require *even larger* Employer Contribution rates to make sure future obligations are fulfilled. However, it would also help return PERS' funded status closer to 100%, sooner and more certainly. [81]

What could jurisdictions with Side Accounts do to ameliorate the effects of declining future discounts, with increasingly escalating bond repayment costs?

This is a difficult conundrum, especially for jurisdictions that sold bonds most recently. They're required to use their Side Account earnings (as of December 31, 2007) to "buy down" the Employer Contribution rate – even if it means that this and the market collapse of 2008 puts their Side Accounts underwater.

[81] A move to lower the A.E.R. – especially to 1974-like levels of 5% -- would also likely spark a legal challenge, by PERS members who would argue that such a rate is 'artificially low," given historic rates of return. Indeed, some PERS-watchers have worried in recent years that too many 15%+ investment years might lead to litigation arguing the rate should be even higher than 8%.

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One strategy is to set aside other funds in reserve accounts, to better ensure future bond repayment costs can be covered. The problem, of course, is that pressure will be intense to dip into those accounts for more immediate purposes – e.g., hiring more teachers to reduce class size, or giving raises to existing employees.

In a down economy, such "fiscal self-restraint" will mean even deeper budget cuts, and/or even the need to re-open labor contracts. Again, such an approach would be very contentious. But over time, such a move – in the here and now – could significantly assist the long-term ability of these jurisdictions to deal with PERS costs.

# # # #

Needless to say, a full-fledged PERS debate would and should involve many other suggestions. The important point isn't to decide what can and should be done immediately. These are volatile economic times, and what many once assumed to be a "relatively certain" future has become a good deal more cloudy amidst the recent generation-defining (and global) economic recession.

What is important is that the PERS issue take a visible – if not, front and center stage – place in Oregon's public conversation. To do anything less would be to increase the odds that the dire predictions that today at least are only that – predictions – will actually become reality.

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