SENATE COMMITTEE ON GENERAL GOVERNMENT

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March 9, 1999 Hearing Room C

3:00 p.m. Tapes 36 -38

MEMBERS PRESENT: Sen. Verne Duncan, Chair

Sen. Cliff Trow, Vice-Chair

Sen. John Lim

Sen. Marylin Shannon

Sen. Frank Shields

STAFF PRESENT: Marjorie Taylor, Administrator

Patrick Brennan, Administrative Support

MEASURE/ISSUES HEARD: PERS Overview - Presented by Employers

These minutes are in compliance with Senate and House Rides. Only text enclosed in quotation marks reports a speaker's exact words. For complete contents, please refer to the tapes.

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TAPE# Speaker Comments

TAPE 36, A

003 Chair Duncan Calls the meeting to order at 3:07 p.m. Indicates that the committee will be hearing testimony from local government employers regarding the Public Employees Retirement System (PERS).

PERS OVERVIEW

011 Lauren Chouinard Chair, PERS Taskforce; Director, Human Resources and Risk Services, City of Eugene. Explains that the presentation will be given in five parts:

A brief description of the problem

The causes of the problem

The effects of the problem on local government employers

The efforts of the PERS Taskforce to study the problem and come up with solutions

Possible legislative action to alleviate the problem

033 Chouinard Outlines the problem. Says that large PERS employer rate increases, resulting from the 1997 actuarial valuation that becomes effective 7- 1 - 1999, will place a huge burden on local governments. Describes the increase in employer rates **EXHIBIT** A). Argues that the higher rates are not sustainable for many employers and will result in layoffs and reduction of services.

065 Chair Duncan Asks how the 1997 actuarial increase fits into the historical progression of rate increases.

070 Chouinard Replies that the question will be answered by later testimony.

078 Sen. Trow Wonders if the PERS Taskforce has considered the benefits of a good retirement program with regards to employee recruitment and retention.

098 Chouinard Replies that the PERS Taskforce agrees that PERS is probably the best retirement system in the nation from the employee's perspective. Indicates that there have been large increases in unfunded liabilities which means that PERS is over $2 billion short of meeting its member entitlements over the next 20 years. Says that the shortfall is being compensated for by increased employer contribution rates, which are ultimately paid for by taxpayers. Explains that much of the liability is due to structural problems in the PERS system related to the Money Match and variable investment programs.

125 Jerry Lidz Attorney with Harrang, Long, Gary, and Rudnick. States that local government employers have had discussions with PERS for over two months to seek resolution to the problem. Explains that there are multiple causes of the problem. Says that there has been a change in that the predominant method of calculating retirement benefits shifted from the Full Formula plan to the Money Match plan. Explains that when the stock market does well under the Full Formula the employer contribution goes down, whereas with under the Money Match a rising stock market causes employer rates to increase. Asserts that the problem is that PERS has not altered its systems and processes to reflect the change from Full Formula to Money Match.

166 Sen. Trow Asks if the switch to the Money Match formula was a result of actions taken by PERS or as a result of market forces.

172 Lidz Replies that it is a combination of both. Says that the Money Match system is "counter-intuitive," in that employers suffer when the market does well. Suggests that the gap between the employer and employee positions can be repaired administratively.

179 Sen. Trow Mentions that the predominance of the Money Match is due more to the performance of the market than any change in PERS policy and that the market currently justifies almost exclusive use of the Money Match formula.

184 Lidz Responds that the change in the market would seem to require a change in the way that the system is administered. Asserts that the issue is whether PERS has the statutory authority to change its policies to maintain the solvency of the employers given the new character of the system. Suggests that there may be a need for the legislature to clarify the statutory authority and duties of the PERS board.

203 Lidz Discusses the effect of HB 3349 (1995) which provides compensation to retirees for the income tax levied on retirement benefits. Indicates that the provision in HB 3349 that employers would pay for the increase resulted in a $1.3 billion burden on local government employers statewide.

233 Chair Duncan Wonders what the effect would have been had the increase been paid for by the state rather than local governments.

238 Sen. Trow Says that the General Fund could not have paid for the increase, especially with the "kicker" coming due at the time.

243 Lidz States that the reason that the Money Match formula has become the predominant calculation is due to the outstanding PERS investment performance. Explains that employee regular account returns

have been over 12 percent, while variable account returns have been over 16 percent. Reiterates that the employee accounts are matched upon retirement by the employer. Says that PERS estimates that 95 percent of new retirees will be calculated under the Money Match formula.

280 Lidz Says that, until 1999, PERS has set employer contribution rates according to Full Formula calculations. Says that the disparity between the Full Formula contributions employers have made and the Money Match formula which they now owe their employees means that the employers now have a massive unfunded liability. Argues that PERS should have anticipated the problem earlier. Adds that employers have paid the rates set for them by PERS and are being held accountable for the fact that they were charged too little. Explains that employers have, in effect, been borrowing money at 15 percent interest, since they now are liable for making up for shortfalls.

330 Sen. Trow Asks if PERS has offered administrative solutions to the problem.

335 Lidz Replies that there may be administrative solutions. States that employers are burdened with matching the high rate of return on employee accounts as well as making up the difference in funding due to the shortfall. Says that PERS has distributed earnings to employee accounts during the year in which they retire without crediting the employer account in a similar fashion, which has also resulted in added cost to employers.

364 Sen. Trow Asks if the year-of-retirement crediting is an administrative decision on the part of PERS.

367 Lidz Replies that it is an administrative decision and that it is not a new one. Suggests that the cost of these shortfalls and miscalculations will result in a reduction in critical services within many local governments. Reiterates that PERS trust responsibilities are to employees. Says that, in a private trust, the trustee does not have the right to tell the trustor when to put more money into the trust, which is the position that local government employers find themselves in. Says that the PERS board has been responsible only to the employee members, but not to employers.

TAPE 37, A

024 Lidz States that ORS 238.670 requires the PERS board to maintain and use a contingency reserve to fund liabilities. Says that no such contingency reserve exists, since the PERS board did not foresee a need for one. Argues that there should be a statutory amendment to create the contingency account in the event that the PERS board fails to do so.

043 Sen. Lim Asks if "employers" refers to the cities and counties.

046 Lidz Replies that cities and counties are considered to be employers.

050 Sen. Lim Asks if the general public represented by those city and county governments is considered to be an employer.

053 Lidz Replies that the terms "employee" and "employer" as mentioned with regard to PERS refers solely to where the financial responsibilities lie. Says that it may be more accurate to refer to taxpayers as the employers, since they eventually pay the employer's contribution to the PERS system.

060 Chair Duncan Indicates that he would like to hear a report from PERS regarding to attempts to create a contingency fund in the past.

067 Sen. Trow Explains that the statutes have been constant over time, while external factors have forced PERS to be less constant. Adds that federal employee lawsuits and market forces have put additional stresses on the PERS system. Says that the major factor faced by the employers has been the passage of Measures 49 and 5 1. Argues that the problems outlined by the Taskforce have compounded existing problems. Says that it makes no sense to lay blame when the root cause of the problem has been external factors.

080 Lidz Concurs with Sen. Trow's statement.

093 Pete Neuwirth Actuary, Coates Kenney, Inc **(EXHIBIT B).** Says that the

Money Match formula has an entirely different structure than the Full Formula. States that the Money Match structure is not consistent with a "defined benefit" plan that guarantees benefit rates. Argues that the Money Match has created a situation where there is only "down-side risk" for employers, in that they cannot hope to save money in contribution rates through the current structure. Says that the unlimited potential for benefit increases carries with it an unlimited potential for increases in employer contributions.

130 Neuwirth Explains that the guaranteed rate of return is currently 8 percent, which represents the actuary's best estimate of return on investments over the long term. Says that there are years when the fund earns over 8 percent, which means that the difference between the guaranteed rate and actual rate paid to members must be made up by employer contribution rate increases.

150 Sen. Trow States that his understanding of the "guaranteed 8 percent" was that members could choose a guaranteed 8 percent or opt for a variable program which may pay more or less than 8 percent. Indicates that he was unaware of any implication that the fund was expected to earn 8 percent over time. Says that the 8 percent is simply the floor that was set for the guaranteed rate.

159 Neuwirth Indicates that the floor is set according to the actuary's estimate of long term rates of return.

164 Sen. Trow Asserts that the actuary formulates a realistic projection that may or may not be the actual rate of return.

168 Neuwirth Explains that the rate of return credited to both employee accounts and employer reserves is the same. Suggests that this approach does not create stable contribution rates in the event of unfunded liabilities. Says that employers cannot remain fully funded for several reasons beyond their control, as was the case with HB 3349. Says that if the earnings fall either above or below 8 percent the employer contribution will go up.

200 Sen. Lim Says that the employer loses either way.

207 Neuwirth Offers an example of how the phenomenon occurs in practice as described in the handout. Uses the hypothetical employer to show that employers can fail to prevent increased rates even if they plan ahead and pay down unfunded liabilities ahead of schedule. Explains that when employers lose ground the roll over liabilities create higher contribution rates while starting the cycle again.

279 Sen. Trow Asks if there could be variations to the pattern, for example as a result of a reduction in the unfunded liability or returns falling below 8 percent.

290 Neuwirth Replies that a 6 percent rate of return would lead to shortfalls, as the member accounts would need to be credited with 8 percent, and that the difference would be made up for through increased employer contribution rates.

307 Sen. Trow Wonders if there is any "capturing" of earnings that could reduce the rates. Agrees that the earnings of the fund are tremendous.

315 Neuwirth Replies that the high earnings of the system are credited almost exclusively to member accounts.

316 Sen. Trow Says that in, the past, under the Full Formula, the employer rates often went down. Says that the changes in the market have put more members into the Money Match formula which has led to the changes in the system.

320 Neuwirth Asserts that increased earnings are detrimental to employers. Indicates that there are many employers who have no hope of catching up to their unfunded liabilities. Says that when an employee retires his or her account is credited up until the date of retirement, whereas employer accounts are not, which creates actuarial losses.

340 Chair Duncan States that the last few years have seen returns far exceeding the 8 percent employer rates.

358 Sen. Trow Wonders if there are funds within the system which pay for the cost of living adjustment (COLA).

366 Neuwirth Replies that employers get a share of gains on retiree liability but that they do not address the structural problem. Says that some employers see reductions in their contribution rates but that the structural soundness of the system as a whole is in question. Says that another administrative practice which has contributed to the problem is that employer reserves have been credited with the same rates as Tier I regular accounts even though some of those reserves have to equal variable accounts which have a much higher rate of earnings.

400 Neuwirth Argues that the investment policy of the Oregon Investment Council (OIC) has contributed to making the problem worse. Says that the investment policy was created in the context of a defined benefit liability structure in which the idea is to maximize returns.

406 Sen. Trow Inquires as to how the OIC's investment strategy should be altered.

412 Neuwirth Replies that the OIC should take less risk.

413 Sen. Trow Asks if the OIC should try to earn less by taking less risk.

430 Neuwirth Explains that taking less risk would lead not only to lower returns but to less variability in returns as well. Asserts that the wild fluctuations in investment returns have been a major cause of unfunded liabilities.

TAPE 36, B

009 Sen. Trow Asks Mr. Neuwirth if he is suggesting that the OIC invest more conservatively merely to keep investment gains more stable.

012 Neuwirth Replies that he is not making any suggestions but rather is pointing out that there is an inconsistency between the policies and liabilities of the PERS system.

016 Chair Duncan Says that there is an expectation of returns by the members who have elected for a more aggressive approach. Says that those members have taken the risk of the variable plan with the expectation that there may be financial rewards and would be disappointed if PERS failed to invest with the intention of making money. Asks if the situation is a "catch 22."

018 Neuwirth Replies that it is a "catch 22" in that there is a fundamental unsoundness in providing an unlimited benefit potential within a defined benefit framework, as is the current case within PERS.

032 Helen Berg Mayor, City of Corvallis **(EXHIBIT Q.** Says that the City of Corvallis was notified that it's PERS employer rate will increase from 9.42 percent of payroll to 13.75 percent on 7-1-99. Indicates that the city was notified that it has an unfunded liability of $11.7 million, which is equal to 62 percent of the city's annual payroll. Suggests that the unfunded liability was caused by design flaws within the PERS system. Offers an example to illustrate the problems which have resulted in the unfunded liability.

083 Berg Estimates that rate increases are projected to cost Corvallis $850,000 annually for the next 20 years. States that Corvallis has a good bond rating which could be jeopardized by the financial burden that PERS is imposing. Suggests that employee pensions should be based on investment earnings rather than higher taxes to local governments. Adds that revisions to PERS, are necessary to keep local government affordable and capable of providing services.

133 Sen. Lim Asks Ms. Berg if she has any suggestions on possible solutions to the problem.

136 Berg Says that PERS should be thinking about how to pay for its liabilities. Says that the earnings of the collective investments should pay for the liabilities.

170 Bobby Green Chair, Lane County Board of Commissioners **(EXHIBIT D).** Says that Lane County's PERS, employer rate will increase from 7.82 percent of payroll to 13.73 percent on 7-1-99, which represents a $40 million liability. Describes the reduction in services and workforce which will result from the PERS-related deficits.

223 Green Asserts that Lane County no longer has the ability to increase its workforce to respond to population growth or demographic changes. Suggests that the bulk of the financial liabilities suffered by Lane County are a result of the Money Match program. Urges the legislature to intervene and direct PERS to solve the problem, since it is PERS that is responsible due to the failure to create the required reserves.

255 Sen. Trow Says that the committee wants PERS to address the problem through administrative changes. Says that the committee will discuss proposed changes with PERS as well.

265 Green Says that Lane County would appreciate any change that the committee could facilitate.

274 Mike McArthur Judge, Sherman County; President, Association of Oregon Counties (AOC). States that smaller employers, such as Sherman County, have suffered similar problems in relation to PERS, as have larger employers. Explains that the employer rate for Sherman County will increase on 7-1-99 from 8 percent of payroll to 14.2 percent, which represents more than double the expected new tax revenues for next year. Says that the unfunded liability represents 70 percent of payroll. Indicates that the threat of layoffs has led to employees volunteering to take no COLA for the next year. Adds that AOC supports several legislative remedies that could alleviate the problem.

320 Ken Rust Director, Bureau of Financial Management, City of **Portland (EXHIBIT E).** Explains that the city has paid every bill that PERS has sent to them and yet finds itself with $257 million in unfunded liability, approximately $170 million of which is directly related to PERS management issues. States that the increase of $16 million per year will result in the displacement of many funding priorities.

383 Rust Argues that the PERS system must be stabilized so that employers know how much they are expected to pay. Suggests several changes that could help to solve the problem:

Elimination of the mismatch between the earnings of the employer and employee accounts

Crediting employer accounts in the same way and for the same time periods that employee accounts are credited

Creation of a contingency reserve

Pooling of local government resources

Says that, if there can be no assurance that the system can be remedied, the city of Portland will look towards some sort of opt-out or Tier 3 legislation.

TAPE 37, B

028 David Boyer Director of Finance, Multnomah County **(EXHIBIT F).** States that an aspect of the problem is that when an employee retires in the middle of a year his account is credited through the day of retirement, whereas the employer account is only credited through the end of the previous year. Suggests that $191 million could have been credited to employer accounts had that change been made for 1998 alone.

042 Chair Duncan Wonders if the $191 million represents Multnomah County alone or the entire state of Oregon.

044 Boyer Replies that it refers to the entire state. Discusses the incorrect billing due to the changes related to Money Match. Says that, had employers been eligible for participation in the variable account, there would have been an additional $333 million credited to employer accounts in 1998.

050 Chair Duncan Asks if employers would be allowed to participate in the variable program, given its speculative nature.

056 Boyer Replies that participation in the variable program is allowable under statute but that PERS

has not chosen to do so in the past. Says that unfunded liabilities in Multnomah County have tripled since 1993. Says that Multnomah County will have to pay an additional $9 million annually for the next 30 years to compensate.

090 Boyer Describes a PERS oversight which cost the county $1.2 million. Says that PERS has not followed the basic principles of cash management. Says that past failures by PERS will be costing Multnomah County for decades to come.

125 Jim Orgliosso Treasurer and Director of Financial Services, Eugene Water & Electric Board (EWEB) **(EXHIBIT G).** Says that the PERS board has ordered an increase of the EWEB employer rate from 12.16 percent of payroll to 21.76 percent. Indicates that EWEB has been given the largest increase, and consequently has the largest pension cost, of any local government in the state.

149 Chair Duncan Inquires as to why EWEB has been allocated the largest increase.

155 Orgliosso Says that the EWEB account is in serious trouble. Says that there is no difference between EWEB and other local governments, in that others will soon be in similar situations should conditions remain the same. Says that Money Match resulted in some employees retiring in excess of 100 percent of final salary. Says that the assets in the EWEB employer account are inadequate, due to the maximization of member benefits to the detriment of the employer reserve.

189 Origlosso Gives reasons why EWEB has begun to suffer adverse effects to a greater extent than other local governments:

EWEB has employee longevity and low employee turnover

EWEB pays its employees fairly well

Many EWEB employees have chosen the variable option Suggests that other local governments will have similarly critical problems in the future. Argues that e mployer shortfalls should be funded in part by the investment returns of the system and the allowance of employer participation in variable investment. Says that the balance of the Gain/Loss Reserve could provide immediate relief.

239 Terry McCall Director of Finance, City of Gresham. Says that PERS investments are made by the Treasury, with variable and fixed rate funds pooled together. Indicates that Gresham has no unfunded liabilities and is not adversely impacted, due more to luck than business practice.

280 McCall Argues that PERS cannot continue to provide excellent benefits to employees while placing a heavy burden on employers. Says that the program can be fixed by responsible management and legislative support.

300 Chouinard Indicates that four employers have petitioned PERS to reconsider their rate increases; EWEB, the City of Eugene, Lane County, and the City of Portland. States that several employers have met with PERS to review the rate setting process. Says that PERS staff and actuary have formed the Employer Rate Committee to brainstorm solutions to the employer problem. Says that there has been a great deal of employer activity with regards to working with PERS to solve the problem.

324 Lidz Asserts that there are numerous possibilities for statutory amendments to address the problems. Says that the potential changes would address the contingency reserve, allowance of employer contributions to match those of employees, and investment of employer funds into variable accounts. Says that there should also be analysis of possible use of the Gain/Loss Reserve to alleviate employer liabilities. Suggests that there are ways to fix the problem without creating a third tier.

380 Sen. Trow Argues that the creation of a third tier would not solve the current problem, but would rather serve only to prevent future problems.

383 Lidz Concurs with Sen. Trow's statement. Says that some of the legislation suggested has been drafted and could be analyzed from a legal perspective.

395 Maria Keltner Representative, AOC, League of Oregon Cities (LOC). Discusses pending legislation in regards to the current situation **(EXHIBIT** Lists some of the potential legislative stances as adopted by LOC and AOC:

Restoration of the state and local government tax exemption

Opposition of any legislation which could potentially increase PERS benefits and employer costs

Allowance of employer participation in variable investment plans

Allowance of local governments to opt out of PERS for future hires in favor of lower cost, non-PERS retirement plans

TAPE 38, A

021 Keltner States that virtually all members of the PERS Taskforce are members of the PERS system who are putting aside their self interest to discuss potential solutions to the problems faced by employers and taxpayers.

035 Sen. Lim Indicates that the solutions discussed by Ms. Keltner appear to be cosmetic changes that do not speak to the fundamental problems.

038 Keltner Replies that the solutions which she proposed deal only with legislative options and not with potential administrative changes. Letters were submitted to the committee for the consideration of its members with regards to local government employer problems with the PERS system (EXHIBIT 1).

060 Chair Duncan Adjourns the meeting at 5:00 p.m.

Submitted By,

Patrick Brennan,

Administrative Support

Reviewed By,

Marjorie Taylor,

Administrator

EXHIBIT SUMMARY

A- Chart, Lauren Chouinard, 1 p.

B-Printed Materials, Pete Neuwirth, 5 pp.

C-Testimony, Helen Berg. 2 pp.

D-Testimony, Bobby Green, 3 pp.

E-Testimony, Ken Rust, 2 pp.

F-Testimony, David Boyer, 4 pp.

G-Testimony, Jim Origliosso, 5 pp.

H-Testimony, Maria Keltner, 1 p.

I-Testimony, various, 5 pp.

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