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TO: Joint Committee on Way and Means
Sen. Richard Devlin, Co-Chair
Rep. Peter Buckley, Co-Chair

FROM: Paul R. Cleary, PERS Director

SUBJECT: Report to the Joint Committee on Ways and Means regarding Contingency Reserve Options that Could Lower Employer Contribution Rates

The Joint Committee on Ways and Means acknowledged the receipt of the PERS Board's 2012 preliminary earnings crediting report and included the following direction:

> *The PERS Board is directed to report back to the Joint Committee on Ways and Means by April 15, 2013 with options for the deployment of Contingency Reserves that could lower employer contribution rates for the 2013-15 and the 2015-17 biennia.*

For the following reasons, PERS sees few circumstances under which any further reserve deployment is practicable for the 2013-15 biennium, but a deployment could be considered in connection with 2013 earnings crediting to affect rates in the 2015-17 biennium.

<u>BACKGROUND</u>

The Contingency Reserve is established under ORS 238.670(1). Under that statute, the PERS Board can allocate earnings to the reserve only in calendar years that actual earnings exceed the assumed rate (currently 8%). When that occurs, the PERS Board can allocate up to 7.5% of the PERS Fund's earnings to the reserve. The reserve can be used only for the purposes provided in the statute, but that includes a broad grant of authority to use the reserve for any contingency "that the board may determine to be appropriate."

The Contingency Reserve is only funded from the earnings on following accounts and reserves in the PERS Fund:

- Tier One and Tier Two member regular accounts;
- Employer contribution accounts and reserves;[1] and
- The Benefits in Force reserve (from which member benefits are paid).

The table below shows a history of the Contingency Reserve after it was re-established in 2003 (the reserve was liquidated in 1977 and held no funds until it was credited in 2003 to conform to Judge Lipscomb's opinion, discussed below). The table shows the Contingency Reserve's balance over recent years and the reason for previous deployments. The balance has increased to about $600 million with the PERS Board's final allocation of 2012 earnings at their March 29, 2013 meeting.

[1] Earnings from employer side accounts, usually funded through the proceeds of pension obligation bonds, are specifically exempted by ORS 238.229(2) from being available to fund the Contingency Reserve.

TABLE – CONTINGENCY RESERVE HISTORY

Year	Transaction	Balance	Reason
2003	$524,818,646.48	$524,818,646.48	Reserve is credited earnings from 2003.
	$584,784,004.07		1999 earnings re-allocated to Reserve to conform to Judge Lipscomb's opinion.
	-$61,410,984.00		Transfer to select employers in settlement of *Eugene* case.
2004	$370,944,585.36	$1,419,134,394.89	Reserve is credited earnings from 2004.
2005	-$1,169,134,394.89		Distribute all but $250,000,000 of Reserve proportionally to accounts and reserves following Board adoption of the rate collar as its method to stabilize employer rates.
		$250,000,000.00	
2006	-$3,977,823.66 -$707,864.19		Lump Sum Vacation Pay (LSVP) contributions and earnings charged to Reserve to resolve costs from 2005 law change applied retroactively to "salary" definition.
	$50,000,000.00		Reserve is credited earnings from 2006.
		$295,314,312.15	
2007	$357,901,761.23		Reserve is credited earnings from 2007.
		$653,216,073.38	
2008	-$101,713.42		Remaining LSVP Contributions and Earnings charged to Reserve.
		$653,114,359.96	
2009		$653,114,359.96	(No additional crediting or distributions.)
2010	$81,312,000.00		Reserve is credited earnings from 2010.
		$734,426,359.96	
2011	-$199,165,108.61	$535,261,251.35	Eliminate remaining deficit in Tier One Rate Guarantee Reserve from 2008 losses.
2012	$66,900,000.00		2012 earnings allocation.
	-$2,000,000.00		Litigation settlement costs.

Current Balance: $600,161,251.35

PRIOR RESERVE ACTIONS THAT MITIGATED OR REDUCED 2013-15 RATES

Any consideration of future actions that might be taken to deploy the Contingency Reserve to reduce employer rates should recognize the PERS Board's prior actions and their effect on reducing 2013-15 employer rates. Three such dynamics are:

1. The deployment of $199,165,108.61 in 2011 to eliminate the remaining 2008 deficit in the Tier One Rate Guarantee Reserve removed the potential obligation for employers to eliminate that deficit (ORS 238.255(1) directs that this reserve cannot remain in deficit for more than five years). Liquidating the 2008 deficit by deploying a portion of the Contingency Reserve increased the assets available for paying benefits by almost $200 million.
2. PERS has started a 10-year process to recover roughly $167 million in benefits that were determined to have been overpaid when the legislature adopted the 2003 PERS reforms (court challenges to that recovery were only recently resolved, allowing that effort to commence). Because the Contingency Reserve is adequately funded, any shortfall in that recovery can be paid through a transfer from the Contingency Reserve, so that entire $167 million is currently considered as an asset available to pay benefits, further reducing employer rates, instead of delaying any crediting of the overpaid amounts until they are actually recovered.
3. This legislative assembly is considering bills that would reduce benefits and contain the projected increases in PERS costs, and many of those bills direct the PERS Board to recalculate employer rates to become effective July 1, 2013. The PERS Board can prudently follow that direction only because it has an adequately funded Contingency Reserve to make up for any shortfalls in the reduced benefits required under these cost containment measures, should a court subsequently overturn them.

HYPOTHETICAL EFFECT OF ADDITIONAL CONTINGENCY RESERVE DEPLOYMENT

At its March 29, 2013 meeting, the PERS Board adopted final crediting for the system's 2012 earnings. After that action, the current balance in the Contingency Reserve stands at just over $600 million. For illustration purposes, what would the effect of deploying 20%, or $100 million, of that reserve have on employer rates to go into effect July 1, 2013, and how could that deployment be effectuated?

As a rule of thumb, about $1 billion in asset gains or liability reductions (outside of the actuary's assumptions) reduces employer rates by 1% of covered payroll. Therefore, bringing $100 million in assets back in to be available to pay benefits (through a Contingency Reserve deployment) would reduce employer rates by .1% of payroll. We project the PERS-covered payroll to be around $18.4 billion in the 2013-15 biennium so a .1% employer rate reduction would reduce system-wide employer costs by $18.4 million in the next biennium.

ADMINISTRATIVE CONCERNS AND EARNINGS CREDITING

As a practical matter, deploying the Contingency Reserve to reduce employer rates in 2013-15 is problematic. Employer rates are derived from a system valuation, which compares the liabilities for benefits payable by the plan with assets available to pay those benefits. The employer contribution rates to become effective July 1, 2013, are based on the system valuation as of December 31, 2011, comparing the system's assets and liabilities as of that date.

The legislature is considering a number of concepts to contain PERS costs and is expected to direct the PERS Board to reduce the employer contributions rates that are slated to become effective on July 1, 2013, based on any concepts that may be adopted. Those concepts, however, can effectuate changes because they either reduce liabilities (i.e., drop the level of benefits expected to be paid after their adoption) or shift the cost to members (e.g., redirect members' IAP contributions). Deploying the Contingency Reserve, however, could only affect employer contribution rates if those funds were added to the assets available to pay member benefits.

The manners in which assets are brought into the system are either through contributions or earnings. Contributions from employers come into the PERS Fund over the course of time, but members no longer make contributions that are considered in setting employer rates (their contributions go into the IAP, which self-funds its benefits and does not include employer contributions). Earnings are credited only when allocating annual earnings once a year, which most recently occurred for 2012 earnings after the PERS Board adopted the final allocation at its March 29, 2013 meeting.

Following the 2012 earnings allocation, the employers' share of deployed Contingency Reserve funds could perhaps be added to their accounts. That share would have to be deployed across the 900 participating employers by allocating those funds to each employer's reserve account, an actuarial re-computation of the impact of the change in that employer's asset value, a re-determination of that employer's resulting Unfunded Actuarial Liability (if any), and a re-calculation of their July 1, 2013 rates.

Since the rates vary by employer, there would be significant disparity. For example, employers with effective contribution rates already at or near 0.00 would not benefit from any rate reduction achieved through deploying the Contingency Reserve. Lastly, consider that the vast majority of employers' 2013 contribution rates have been constrained by the rate collar, pushing increases of about two percent of payroll into the next biennium. Any rate reduction from deploying the Contingency Reserve would only marginally reduce the amount of the rate collared off, and not reduce rates for 2013-15.

As complicated as that process would be for employers, there is no comparable path for member accounts. Any solution would require an ad-hoc, artificial determination of interim crediting rates until earnings for 2013 are allocated to member accounts.

LEGAL CONSIDERATIONS

One of the first legal authorities to address the use and adequacy of the Contingency Reserve was the Honorable Paul Lipscomb back in October 2002 when he issued an opinion in the *City of Eugene* case, where the PERS Board's failure to fund the Contingency Reserve was challenged by PERS employers:

> "…ORS 238.670 (1) mandates that a reserve account to cover unforeseen contingencies 'shall be maintained and used by the board to prevent any deficit of moneys available for the payment of retirement allowances….' This language is neither discretionary nor ambiguous. The Board's persistent failure to follow this statute is improper. While the Board maintains a range of discretion in determining how much of the earnings to allocate each year to the Contingency Reserve, it has no discretion to simply ignore the legislature's specific direction that this account 'shall be maintained and used to prevent any deficit.'

> By ignoring its obligation to fund and maintain the Contingency Reserve in place, the Board has improperly impaired the overall resiliency and flexibility of the entire PERS system and has forced the system to rely almost exclusively on periodic increases to the employers' contribution obligations in order to keep its accounts in balance."

The Contingency Reserve is part of the PERS Fund, and uses of those funds are controlled by statute. ORS 238.660(2) states in part:

> "Until all liabilities to members and their beneficiaries are satisfied, assets of the fund may not be diverted or otherwise put to any use that is not for the exclusive benefit of members and their beneficiaries. "

This statutory limitation parallels federal law that requires a tax qualified retirement fund to be administered for the "exclusive benefit of … employees or their beneficiaries." 26 USC 401(a). These provisions constrain the PERS Board's discretion in deploying the Contingency Reserve.

Those constraints were recently discussed by the Supreme Court in *White v. PERB*, 351 Or 426, 268 P3d 600 (2011), where the court reiterated that Oregon law requires that the PERS trust be administered for the sole benefit of PERS members. In *White*, the court considered the extent to which the Board owes fiduciary duties to one member or one class of members in light of the Board's fiduciary duties to members as a whole. The court reiterated that the Board's duties are to "PERS retirees and active members." 351 Or at 440. Its duty is to "protect the corpus of the fund and to manage the fund for the benefit of all PERS beneficiaries."

Prior deployments of the Contingency Reserve have either been in relative proportion to the member and employer accounts and reserves that generated the Reserve, or for broad purposes that benefitted both members and employers. The Committee's request to consider deploying the Contingency Reserve needs to be understood as not being solely for the purpose of reducing employer rates as that would use funds in the Contingency Reserve for the benefit of employers only, which appears to be contrary to the constraints in Oregon and federal law.

ADEQUATE RESERVE LEVELS

The PERS Board must determine what they consider to be an adequate level to retain in the Contingency Reserve, or run afoul of Judge Lipscomb's admonition. PERS staff have advocated that, as a general rule, the Contingency Reserve be maintained at one percent of the PERS Fund, so the 2012 earnings allocation will raise the reserve to around $600 million, one percent of the PERS Fund's approximately $60 billion balance at the end of 2012. Staff continues to believe that funding level to be prudent, given the uncertain nature of impending exposures and costs that could be funded from the Contingency Reserve, such as those discussed above.

DEPLOYMENT AFFECTING 2015-17 RATES

As a review of the Contingency Reserve history shows, the PERS Board has deployed the reserve in the past when system dynamics or projected exposures seem to warrant a lower amount in reserves. That issue will be considered again when the Board allocates earnings for 2013. Any amounts deployed out of the Contingency Reserve in connection with that earnings allocation will count as assets of the system in the valuation based on December 31, 2013 assets and liabilities, and would therefore contribute towards reducing 2015-17 employer contribution rates to be effective July 1, 2015.

In conclusion, PERS reports that there do not appear to be practical reasons to support further deploying the current Contingency Reserve, and particular legal concerns if that deployment were to be solely to reduce employer contribution rates slated to become effective July 1, 2013. Any deployment of the Reserve occurring in the normal course of crediting earnings in future years will operate to marginally reduce employer rates that are charged after that deployment.