Oregon
Kate Brown, Governor

Public Employees Retirement System
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April 4, 2017

The Honorable Senator Richard Devlin, Co-Chair
The Honorable Representative Nancy Nathanson, Co-Chair
Joint Committee on Ways and Means
900 Court Street NE
H-178 State Capitol
Salem, OR 97301-4048

Dear Co-Chairpersons:

Nature of the Request

The Public Employees Retirement System (PERS) requests acknowledgement of receipt of this report on a recommended reallocation of the agency's Contingency Reserve, established under ORS 238.670. At its March 9, 2017 meeting, the Joint Committee on Ways and Means Subcommittee on General Government adopted a recommendation that the PERS Board report back to the Joint Committee on Ways and Means regarding which accounts the Contingency Reserve funds would be reallocated to and the associated rationale for the decision.

Agency Action

As first explained in the 2016 Preliminary Earning Crediting agenda item, at the January 27, 2017 PERS Board meeting, the Contingency Reserve is currently over-funded by approximately $345.8 million based on the funding level of 0.25% of the system's accrued liability, adopted by the Board at its March 2016 meeting.

Staff described options for reallocation of the excess funds, and stakeholder input was sought regarding reallocation. Letters from the following were submitted in response to the request for stakeholder input, and are attached to this report: 1) Greg Hartman, on behalf of the PERS Coalition; 2) Senators Kathleen Taylor and Tim Knopp, as Chair and Vice-Chair of the Senate Workforce Committee; 3) Senators Ted Ferrioli and Tim Knopp, on behalf of the Senate Republican Caucus; and 4) Governor Kate Brown.

At the April 3, 2017 meeting, the PERS Board approved a motion to adopt the preliminary allocation of excess funds in the Contingency Reserve to the Benefits in Force Reserve, subject to adoption at a future PERS Board meeting, contingent on legislative reporting and review. This report is intended to fulfill that contingency and, once acknowledged, the PERS Board will take final action to allocate these funds in accordance with any direction they receive from this body.

Rationale

The Benefits in Force Reserve, established under ORS 238.670(2), is the source from which all Tier One and Tier Two member benefits are paid. This reserve is funded through transfers of contributions and accumulated earnings from member accounts and employer reserves at the time of the member's retirement.

Based on the December 31, 2015 system valuation, PERS has an unfunded actuarial liability (UAL) of $21.8 billion, excluding side accounts. Retired members, or their beneficiaries, currently account for 64% of the system's liabilities, or approximately $13.9 billion of the UAL if that same proportion is applied. Compared to the system's liability for retired member benefits and the current funding level of their reserve, a direct infusion of the Contingency Reserve funds would incrementally increase the amount of funds available to satisfy these benefit payments as they come due. By shifting the funds from the Contingency Reserve to the Benefits in Force Reserve, those funds become available to pay member benefits and directly reduce the UAL.

This reallocation would be consistent with stakeholder input. Only Greg Hartman, for the PERS Coalition, advocated for a different allocation, which would have distributed the excess reserves back to the accounts whose earnings were used to fund the reserve. Staff recommended the direct allocation to the Benefits in Force Reserve given the current underfunding, so that every dollar would be used to reduce the UAL. The Coalition's recommendation would have incrementally increased member's accounts as well which meant a small portion of the funds may have been paid out as members withdrew their accounts pre-retirement. Allocating all of the excess funds to the Benefits in Force Reserve assures that even that small leakage will not occur.

Action Requested

PERS requests the Committee acknowledge receipt of the report.

Legislation Affected

No legislation is affected by this request.

Sincerely,

Steven Patrick Rodeman
Executive Director

Attachments
Greg Hartman Memo (February 12, 2016)
Senator Taylor and Senator Knopp Letter (March 7, 2017)
Senate Republican Caucus Letter (March 20, 2017)
Governor Kate Brown Letter (March 31, 2017)

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February 12, 2016

BY EMAIL ONLY
Steve Rodeman
Executive Director
Public Employee Retirement System
PO Box 23700
Tigard, OR 97281-3700

Re: Contingency Fund ORS 238.670(1)
Our File No.: 5415-237

Dear Steve:

At the upcoming PERB meeting the board will consider issues relating to the contingency reserve including how to determine adequate funding as well as appropriate uses of the contingency reserve. The purpose of this letter is both to make some observations about the contingency reserve and offer some hopefully helpful thoughts on both topics.

While the funding of the contingency reserve has been the topic of recent litigation, particularly in the *City of Eugene* case, none of those cases have offered any specific guidance on the related issue of how to appropriately size the contingency funds nor any guidance on the appropriate uses of the contingency fund. In addition the trial court opinion by Judge Paul Lipscomb in the *City of Eugene* was later vacated by the Supreme Court, so that decision should not play a major role in the board's discussions.

Prior to any specific discussion about the contingency reserve some historical perspective is appropriate. ORS 238.670(1), which authorizes the contingency fund, is currently part of a five-part statute and should be analyzed in the context of that overall statutory scheme. ORS 238.670(1) as well as ORS 238.670(2) were passed in 1951, shortly after the initiation of the system, and for the most part the operative language of these two reserve statutes has not changed. The contingency statute provides that it is to be used to prevent any "deficit of monies available for the payment of retirement allowances" arising from interest fluctuations, changes in mortality rates, loss of investment capital, or other unforeseen contingency. Though there is no legislative history to give any insight on the meaning of this language, contemporaneous PERS documents indicate that at that time there was a substantial concern that the newly-established system would not have sufficient money to pay benefits. It is reasonable to understand the "deficit of monies" language to mean exactly what it says and that initially the primary purpose of the contingency fund was to guard against not having the money to pay benefits. This interpretation is further supported by ORS 238.670(2), which provides a preferential allocation of income to the fund which we currently call the benefits in force reserve. Clearly the legislature wanted to make certain that the fund set up to pay benefits would receive adequate earnings to carry out its statutory purpose.

The first major amendment to ORS 238.670 took place in 1967 with the addition of sections (3) and (4), which provide for the establishment of additional reserves "to offset gains and losses of invested capital" or alternatively for the amortization of gains or losses if that is preferable. At that same time the contingency reserve language of subsection (1) was amended to delete the reference to loss of investment capital (as well as "unforeseen" contingencies), with new cross-references to sections (3) and (4). Clearly in 1967 the legislature authorized new reserves to address loss of investment capital rather than assigning that responsibility to the contingency reserve. The reserve authorized by subsection (3) has provided the basis for the establishment of the reserve formerly known as the gain/loss reserve, now known as the Tier One rate guarantee reserve. I don't recall that it has ever been used for another purpose as it is clear that the board has decided to use the authority under subsection (4) to deal with investment issues through amortization rather than by utilization of special reserves. In 1987 the legislature added subsection (5) which requires the board to report proposed earning creditings to the legislature.

In 2001 the legislature amended ORS 238.670(1) by adding three new provisions, subsections (a), (b), and (c), to add potential additional uses of a contingency reserve. A review of the 2001 legislative history of HB 134 which added these new provisions shows that there were multiple changes proposed to PERS, largely by those employers who were participating in the *City of Eugene* litigation which was pending at that time. Among these many changes were a number of proposed changes which would have allowed contingency fund reserves to be used in various ways for the benefit of the employers. During the course of multiple hearings on the bill both Bob Muir, then DOJ counsel to PERS, and David Heynderickx, then legislative counsel, testified at length on the impropriety of using the contingency reserve to pay expenses which were otherwise assigned to employers. Both argued that this was a breach of elementary trust law as well as potentially placing PERS' IRS qualification in jeopardy. The legislature ultimately rejected all of those proposed changes to the contingency statute with the exception of subsections (a), (b), and (c), which are part of today's statute. The limitation in subparagraph (a) which requires that only the portion of the reserve which is funded by employer fund earnings be used to address insolvency of participating public employers is clearly as a result of the Muir and Heynderickx testimony. While (c) gives the board authority to utilize the fund that discretion is subject to the board's fiduciary obligation to members and that discretion should not be used to pay expenses otherwise assigned to employers consistent with the testimony of Muir and Heynderickx in 2001.

With that background it should be clear that the uses of the contingency reserve under the current statute should be focused on subsections (a), (b), and (c), as given the current size of the fund there is not likely to be a lack of money to pay benefits, which is the focus of subsection (1). With the recent allocation of 2015 earnings the benefits in force reserve has in excess of $22 billion with an additional $23 billion in employer accounts available to pay benefits. This should lead to the conclusion that the current contingency fund is substantially overfunded and that a much smaller fund would be sufficient to meet the needs of subsections (a), (b), and (c).

If the board determines that the current reserve is overfunded, then the historical practice would be to return those funds to the accounts from which they were derived. An exception to that is the specific authorization in ORS 238.670(3) which permits excess funds in the contingency reserve to be paid to a reserve established under subsection (3). Though there has been no recent analysis of the appropriate funding level of the Tier One rate guarantee reserve there would appear to be little question that at the current time it is underfunded. After payment to the Tier Two employee accounts the board should consider whether any additional funds should be paid to the Tier One rate guarantee reserve to assure that it is adequately funded. Certainly at a minimum any funds which would otherwise be returned to Tier One employee accounts should be used to increase the funding of the rate guarantee reserve.

The January 29, 2016 memo to the board on the contingency reserve notes one recent use of the reserve and one pending request for the use of the reserve. The first use of the reserve was the payment of back COLA benefits to retirees as a result of the *Moro* decision. Consistent with basic trust principles that payment should ultimately be charged to the portion of the contingency reserve funded by earnings from the benefits in force reserve as the payment of COLA benefits is specifically assigned by statute to the employers (ORS 238.360(3)).

In settlement of the *City of Eugene* litigation a payment was made from the contingency reserve to certain employers to satisfy a judgment against PERS. In the *White* case the court approved the settlement agreement including a payment from the contingency reserve to satisfy the judgment against PERS, presumably under the authority of ORS 238.670(1)(b). In contrast, in *Moro* the court did not enter a judgment against PERS but only ruled that certain portions of the 2013 legislation were breaches of PERS contracts and set those portions of the legislation aside. There was no judgment against PERS and ORS 238.670(1)(b) provides no authority for the payment from the contingency reserve of COLA benefits. If the board decides that there should be a distribution of funds because the contingency reserve is overfunded then a lower distribution to the benefits in force reserve to take into account the monies already paid would be consistent with the statute and consistent with the board's fiduciary obligation.

The pending request is for an allocation from the contingency reserve to a small group of employers who argue that there was confusion on the appropriate start date for new members of the OPSRP system. They argue that PERS actions added to this confusion and that these confused employers should not be required to fully fund the benefits as required under OPSRP statutes. The board should reject that request if for no other reason than it relates to the OPSRP system which is a separate and distinct part of ORS Chapter 238. It is clear that the contingency fund established by ORS 238.670(1) was never meant to deal with issues relating to the OPSRP system. In addition, to the extent that this request is to compensate employers who did not properly comply with the statute that would run afoul of the board's fiduciary obligation not to use these funds simply to cover expenses otherwise assigned to employers within the system.

I trust that these comments will be helpful as the board addresses these contingency fund issues.

Yours very truly,

Gregory A. Hartman

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cc: Clients

OREGON STATE SENATE

Steve Rodeman
Executive Director
Public Employees Retirement System
P.O. Box 23700
Tigard, OR 97281-3700

March 7, 2017

Dear Mr. Rodeman:

In your January 31, 2017, letter to the Joint Committee on Ways and Means you wrote that the system's Contingency Reserve includes $536.3 million, more than twice what is needed to maintain the fund at the Board's approved level.

Specifically, the letter states that the "Contingency Reserve is currently over-funded by $345.8 million."

As the chair and vice-chair of the Senate Workforce Committee, we want to ensure that these funds will be used to best improve the health of the PERS system into the future. Toward that end, we request that PERS prioritize the application of the excess funding in the system's Contingency Reserve to the unfunded actuarial liability.

It is our understanding that the Board is scheduled to consider the issue of the excess funds in the Contingency Reserve at its April meeting. It is our strong recommendation that the Board allocate the excess Contingency Reserve funds to other reserve accounts where the funds will be credited toward the unfunded liability.

Sincerely,

Senator Kathleen Taylor
Senate Committee on Workforce
Chair

Senator Tim Knopp
Senate Committee on Workforce
Vice-Chair

cc: John Thomas, Oregon PERS Board, Chair
President Peter Courtney, President of the Senate
Speaker Tina Kotek, Speaker of the House
Senator Ted Ferrioli, Senate Republican Leader
Representative Mike McLane, House Republican Leader
Senator Richard Devlin, Joint Committee on Ways Means, Co-Chair
Representative Nancy Nathanson, Joint Committee on Ways and Means, Co-Chair

OREGON STATE SENATE

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March 20, 2017

Steve Rodeman
Executive Director
Public Employees Retirement System
P.O. Box 23700
Tigard, OR 97281-3700

Dear Mr. Rodeman,

On January 31, 2017, the Public Employees Retirement System (PERS) sent a letter to the Co-Chairs of the Joint Committee on Ways and Means stating that the PERS Contingency Reserve has a $345.8 million surplus.

In the letter, PERS requested input from stakeholders on a proposed reallocation of the surplus funds in advance of the April 3, 2017, PERS Board meeting where suggestions will be compiled and evaluated for the PERS Board's consideration. Below is the Senate Republican Caucus's direction for the PERS Board with respect to the Contingency Reserve surplus.

The $345.8 million surplus funds must be used in the most meaningful and effective manner possible to both preserve the health of the PERS system and help protect current and future retirees. To that end, the Contingency Reserve surplus should be reallocated to prudently address the PERS unfunded liability and to buy down rates for school districts and local governments. PERS's fiscal solvency requires the Board to do as much.

With these surplus funds, the Board has an opportunity to be proactive and bend down the cost curve on PERS. Inflated PERS costs continue to cause otherwise unnecessary cuts to essential funding for students and teachers, public safety, mental health, health care, seniors, and veterans. Oregonians want to see solutions and this is a judicious way to help maintain funding for these essential services.

It is the Senate Republican Caucus's position that the Board should mindfully devote the $345.8 million surplus to paying down the unfunded liability. Thank you.

Sincerely,

Ted Ferrioli
Senate Republican Leader
District 30

Tim Knopp
Senate Republican Deputy Leader
District 27

KATE BROWN
Governor

March 31, 2017

Public Employees Retirement Board
11410 SW 68th Parkway
Tigard, OR 97223

Dear PERS Board Members:

As you know, I have had a number of conversations over the past two years about PERS and how we might address the current Unfunded Actuarial Liability while also ensuring the system is strong moving forward. I appreciate all your work, and the conversations you and your staff have engaged in with me and with my staff on these issues. Thank you for your service to Oregonians.

As I have talked to a number of PERS stakeholders, including public employees and employers, two things have stood out to me as potential changes which, while small, will strengthen the PERS system and may lead to increased rate stability. The first relates to a decision I hope you will make today. The second relates to a structural change I hope you will consider addressing at your May 26, 2017 Board meeting.

Today, you will decide how to allocate excess funds from the Contingency Reserve. Rather than allocating these funds equally across accounts, as you have done at times in the past, I urge you to instead allocate them exclusively to the Benefits in Force Reserve. Given the historic imbalance between the assets in that reserve and the present liability to retired members, your action to bolster that reserve seems to be the most prudent action.

At your next meeting, please discuss options for easing the requirements around the creation of employer side accounts. These accounts offer employers the opportunity to pre-pay for their future obligations to PERS. I have heard from a number of employers that there are barriers to creation of these accounts which force them to hold reserves for predicted PERS rate increases in their own internal accounts. Their own accounts are not always interest bearing, and those that are rarely see the returns gained by the PERS fund.

Increasing flexibility for public employers to dedicate their resources most efficiently to satisfy their future PERS obligations would maximize their options to resolve this difficult financial situation. Please work with staff to determine how side accounts could be made more accessible to public entities wishing to set aside smaller amounts of funds or to set aside funds on a more frequent basis.

Thank you for your work. I know that you all take seriously your responsibility to oversee our state's public retirement system and I appreciate your diligent work.

Sincerely,

Kate Brown

Governor Kate Brown

KB/epg

Cc: Steve Rodeman, Executive Director, Oregon PERS