

Analysis  
**Public Employees Retirement System**  
2016 Preliminary Earnings Crediting

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**Analyst:** John Borden

**Request:** Acknowledge receipt of a report on preliminary 2016 earnings crediting

**Recommendation:** Acknowledge receipt of the report, with instruction.

**Analysis:** ORS 238.670(5) requires the Public Employees Retirement System (PERS) Board to submit a report to the Legislature on the Board's preliminary plan to credit calendar year earnings of the Oregon Public Employees Retirement Fund (OPERF) to member and employer accounts and other reserves. Under the statute, the Board must provide the report at least 30 days before the Board makes its final earnings crediting decision. The Board is scheduled to make its final 2016 earnings crediting decision on April 3, 2017. Statute give the PERS Board broad authority to make earnings crediting decisions and, according to the agency, allocations have generally been based on a proportional basis for member and employer accounts.

On January 27, 2017, the PERS Board approved preliminary earnings crediting for calendar year 2016 of \$4.6 billion. Allocating 2016 earnings will increase those reserves subject to crediting from \$64.8 billion to \$69.4 billion for a 7.1% increase. This is below the 2016 assumed earnings rate of 7.50% and the one-year OPERF benchmark of 9.04% established by the Oregon Investment Council (OIC). According to State Treasury, OIC "...has been deliberately lowering exposure to stocks and other equity-related securities in order to reduce the fund's [OPERF] cyclical volatility."

**Unfunded Accrued Liability**

The system-wide Unfunded Accrued Liability (UAL) for calendar year 2015 is \$16 billion after taking into account \$5.6 billion in pre-paid employer side accounts. This places the funded status of the system at 79% funded, which is the lowest percentage in the last 16 years, if side accounts are included. An update to the funded status due to 2016 earnings crediting, and the possibly the deployment of contingency reserves, will not occur until later this fall.

**Employer Reserve Accounts and Oregon Public Service Retirement Program**

The preliminary earnings crediting of the employer reserve account is \$1.7 billion for a balance of \$25 billion and a return of 7.12%. The preliminary earnings crediting for employer's Oregon Public Service Retirement Program Pension accounts is \$198.9 million for a balance of \$3 billion and a return of 7.06%.

**Retiree Benefits**

Upon an individual's retirement, funds are transferred into a Benefits-in-Force Reserve account, which is used to fund retiree benefits payments. The preliminary earnings crediting for this account is \$1.5 billion for a balance of \$22 billion and a return of 7.12%.

## **Member Accounts**

The preliminary earnings crediting for Tier One member regular accounts is \$343.2 million for a balance of \$4.9 billion. Earnings crediting for this account was at the 2016 assumed earnings rate of 7.50%. The preliminary earnings crediting for Tier Two regular member accounts was \$58.4 million for a balance of \$878.3 million and a return of 7.12%. Member variable accounts, which are invested in equities, earned 8.77% (before expenses).

## **Tier One Rate Guarantee Reserve**

The Tier One Rate Guarantee Reserve makes up any shortfall between the assumed earnings rate and investment returns for Tier One regular accounts. Since Tier One regular account earnings were below the assumed earnings rate, \$3.9 million of the \$183.2 million account balance will be transferred to Tier One member accounts. This will leave a balance of \$179.3 million. Since earnings for 2016 were below the assumed rate of 7.5%, no funds are credited to the reserve.

## **Individual Account Program**

The preliminary crediting for the Individual Account Program (IAP) is \$505.9 million for a balance of \$7.6 billion and a return of 7.14%.

Beginning around 2011, concern was raised about the risk the IAP potentially places on PERS members at retirement. Given that IAP accounts are invested long-term in the same manner as the rest of the PERS portfolio, a market downturn at an inopportune time could jeopardize a portion of a PERS member's retirement. A somewhat similar experience occurred with the Oregon 529 College Savings Network plan after the 2008-09 market downturn and the 2007-09 economic recession. The State Treasurer, the OIC, and the PERS Board have been evaluating options for reducing IAP investment risk; however, the de-risking of the IAP portion of the PERS portfolio could impact the OIC's ability to meet the assumed earnings rate. The Legislative Fiscal Office continues to remain concerned that this significant of an investment policy change by OIC should be formally reported to the Legislature.

## **Contingency Reserve**

When earnings on OPERF equal or exceed the assumed earnings rate, the PERS Board may credit up to seven and one-half percent of earnings to the Contingency Reserve. Statutorily, contingency reserves are for paying: (a) a deficit in the payment of retirement allowances; (b) employer insolvency; (c) legal expenses; and (d) unspecified contingencies. Since earnings for 2016 were below the assumed rate of 7.5% for the third calendar year in a row, no funds are credited to the reserve. The balance in the reserve account remains at \$583.7 million.

The 2016 earnings crediting report makes note of an overfunding of the PERS Contingency Reserve by \$345.8 million out of the \$583.7 million balance (59%). The overfunding of the Contingency Reserve has been an issue for the Legislature beginning with the 2012 earnings crediting report. Reserve funds are not accounted for in actuarial valuations and the deployment of any amount of reserves to member regular accounts and employer accounts would reduce employer rates. Additionally, the PERS Board's policy of rate collaring, or administratively limiting rate increases from one biennium to the next, practically eliminates the need for reserve funding. For example, in 2005, after the Board adopted its rate collaring methodology and the Oregon Supreme Court upheld significant provisions of the 2003 PERS reforms, the Board distributed about \$1.2 billion, or 82%, of its Contingency Reserve Account's \$1.4 billion balance (leaving only \$250 million in that reserve for ongoing litigation uncertainties) and fully deployed the \$460 million from the Capital Preservation

Reserve. The Capital Preservation Reserve has remained at a zero balance.

While the PERS Board's decision to allocate Contingency Reserve funds appears prudent, the Board has yet to make a final decision related to the deployment of excess reserves. The Legislative Fiscal Office believes that prior to the Board making a final decision, especially of this financial magnitude, the Board should report to the Joint Committee on Ways and Means as to which accounts the reserve funds are to be deployed and the associated rationale.

### **Expenses**

The preliminary earnings crediting for calendar year 2016 of \$4.6 billion is the net amount credited after \$396.6 million in calendar year investment expenses and brokerage commissions, \$2.4 million in administrative expenses directed by the Oregon Investment Council, \$9.9 million in State Treasury expenses, and \$42.7 million for PERS agency operational expenses are deducted.

### **Future Employer Contribution Rates**

Employer contribution rates have already been adopted by the PERS Board for the 2017-19 biennium and are based on 2014 and 2015 earnings crediting. Employer contribution rates for the 2019-21 biennium will be based on final earnings crediting for calendar years 2016 and 2017.

### **Recommendation**

The Legislative Fiscal Office recommends acknowledging receipt of the report with the direction that prior to the allocation of any Contingency Reserve funds under ORS 238.670, that the PERS Board report to the Joint Committee on Ways and Means on the Board's specific recommendation as to which accounts the reserve funds should be deployed to and the associated rationale.

### **Addendum-A**

The following addendum summarizes actual PERS account earnings history from 1997-2016, which is a period equivalent to the pension program's current 20-year amortization period and Oregon Investment Council's long-term investment horizon (see next page).

**PERS Investment Earnings History (1997-2016)**

Years	Calendar Year	OPERF	Assumed Rate	Tier 1	Tier 2	Variable	IAP
1	1997	20.42%	8.00%	18.70%	20.42%	28.87%	--
2	1998	15.43%	8.00%	14.10%	13.63%	21.45%	--
3	1999	24.89%	8.00%	11.33%	21.97%	28.83%	--
4	2000	0.63%	8.00%	8.00%	0.54%	-3.24%	--
5	2001	-7.17%	8.00%	8.00%	-6.66%	-11.19%	--
6	2002	-8.93%	8.00%	8.00%	-8.93%	-21.51%	--
7	2003	23.79%	8.00%	8.00%	22.00%	34.68%	--
8	2004	13.80%	8.00%	8.00%	13.27%	13.00%	12.77%
9	2005	13.04%	8.00%	8.00%	18.31%	8.29%	12.80%
10	2006	15.57%	8.00%	8.00%	15.45%	15.61%	14.98%
11	2007	10.22%	7.97%	7.97%	9.47%	1.75%	9.46%
12	2008	-27.18%	8.00%	8.00%	-27.18%	-43.71%	-26.75%
13	2009	19.19%	8.00%	8.00%	19.12%	35.57%	18.47%
14	2010	12.44%	8.00%	8.00%	12.44%	15.17%	12.13%
15	2011	2.21%	8.00%	8.00%	2.21%	-7.80%	2.15%
16	2012	14.29%	8.00%	8.00%	14.68%	18.43%	14.09%
17	2013	15.76%	8.00%	8.00%	15.62%	25.74%	15.59%
18	2014	7.29%	7.75%	7.75%	7.24%	4.29%	7.05%
19	2015	2.21%	7.75%	7.75%	1.87%	-1.61%	1.85%
20	2016	7.10%	7.50%	7.50%	7.12%	8.77%	7.14%
20-year	Average	8.75%	7.95%	8.96%	8.63%	8.57%	--
15-year	Average	8.05%	7.93%	7.93%	8.18%	7.11%	--
10-year	Average	6.35%	7.90%	7.90%	6.26%	5.66%	6.12%
5-year	Average	9.33%	7.80%	7.80%	9.31%	11.12%	9.14%
3-year	Average	5.53%	7.67%	7.67%	5.41%	3.82%	5.35%