Public Employees Retirement System Legislative Review of System Financing

Joint Committee on Ways and Means

Capital Construction Subcommittee

March 29, 2019

Select Proposed Concepts

1. Side Account participation by state agencies
2. Side Account participation by local governments
3. Pension Obligation Bonding
4. Amortization Schedule(s)
5. Assumed Earnings Rate

Policy Questions

as related to system financing

1. What factors are driving the increase in the unfunded liability?
2. **What efforts can be taken to improve system funding?**
3. How successful were prior reform efforts and what is the long-term outlook?
4. **What efforts can be undertaken to prudently add assets to the system?**
5. **Is bonding a viable financing option?**
6. What efforts can be undertaken to improve investment returns?
7. What efforts can be undertaken to lower costs?
8. **How can the growth in employer contributions be moderated?**
9. Are changes needed to the Individual Account Program?
10. How can employee participation in various deferred compensation plan(s) be improved?

Definition of a Side Account

- Employers have the option to make voluntary lump-sum payments to PERS that are in addition to the employer's required contribution.
- Lump-sum payments are deposited into "side accounts," and are used to offset a portion of the contributing employer's future PERS contribution rate, according to an amortization schedule.
- Side account balances are never entirely utilized in a single biennium.
- Once deposits are made into side accounts, employers are unable to withdraw or repurpose the funds.
- Employers without a side account pay the employer contribution rate without side account offset.

Difference with Lump-Sum Payments

- Confusion can arise between a side account contribution and a ***system-wide*** lumpsum payment.
- Foundational to this discussion is understanding that the financial responsibility for the UAL belongs to the individual PERS employers and not the State of Oregon.
- Side account contributions are employer-specific and provide rate relief only to the contributing employer.
- ***System-wide*** lumpsum payment to paydown the ***total*** UAL has no precedent.

Financial Prudence of Side accounts

- Reduces the financial impact of paying full employer contribution rates in any single budget cycle.
- Serves as a lockbox dedicating funding for only PERS employer contributions exclusive to the employer that funded the side account.
- An asset of the system.
- Provides for an actuarially sound mechanism for reducing employer contributions over time.
- Allows for professional investing and presumably superior returns.
- Provides a mechanism for funding part of a future liability.

Administrative Limits to Side Accounts

- Under PERS Oregon Administrative Rule, the PERS Board requires a minimum deposit of the lesser of $250,000 or 25 percent of the employer's UAL for each new side account.
- There is no minimum payment required to add funds to an existing side account.
- The cost for an employer to establish and maintain a side account has two components: (a) administrative costs and (b) investment expenses. The PERS Board charges an administrative fee of $1,500 for the first year to establish a side account and a $500 fee each year thereafter, which are within the statutory limitation.

Recent Legislative Changes

SB 1067 Change	Legislative Intent
Modifies the law regarding PERS side accounts.	Prior to SB 1067, statute required each lump-sum payment to be deposited into a new side account. SB 1067 allows employers to make additional deposits into existing side accounts.
Requires the Governor’s budget proposal to include recommendations on funds available for additional side account deposits.	A new requirement to encourage side account deposits by state agencies.
Ensures that communications regarding the PERS unfunded accrued liability include information on side accounts.	Seeks to ensure an accurate statement of the UAL, by ensuring that side accounts balances are taken into account when the UAL is reported.

Side Account Offset History

	Biennia	Valuation Year	Actual State Agencies Only	Average State and Local Government Rate Pool	Average School Districts Pool	Average Independent Employers	Average PERS System Totals
1	2019-21	2017	7.44%	4.99%	10.66%	1.13%	6.51%
2	2017-19	2015	7.11%	4.70%	10.26%	1.05%	6.14%
3	2015-17	2013	7.78%	4.99%	10.62%	1.06%	6.38%
4	2013-15	2011	6.79%	4.25%	8.35%	0.86%	5.26%
5	2011-13	2009	6.67%	4.24%	7.75%	0.87%	5.11%
6	2009-11	2007	9.83%	6.20%	10.51%	1.14%	7.20%
7	2007-09	2005	9.47%	6.37%	9.72%	0.70%	6.71%
8	2005-07	2003	8.06%	n/a	n/a	n/a	4.54%

Side Account Summary Data

Entity	Side Account Balance	% of Total		Entities with Side Accounts	% of Total		Average	Median	Max	Min
School Districts	$ 3,009,658,434	54%		95	66%		$ 31,680,615	$ 16,138,646	$ 606,925,156	$ 1,652,332
State Agencies	$ 1,832,000,595	33%		1	1%		$ 1,832,000,595	$ 1,832,000,595	$ 1,832,000,595	$ 1,832,000,595
Cities	$ 132,973,514	2%		13	9%		$ 10,228,732	$ 3,342,969	$ 53,788,781	$ 116,389
Counties	$ 90,002,476	2%		10	7%		$ 9,000,248	$ 6,716,571	$ 27,753,728	$ 1,036,653
Special Districts	$ 93,897,926	2%		8	6%		$ 11,737,241	$ 10,971,740	$ 31,463,686	$ 164,066
Community Colleges	$ 402,669,839	7%		17	12%		$ 23,686,461	$ 11,254,669	$ 110,143,803	$ 324,003
	$ 5,561,202,783	100%		144	100%		$ 38,619,464	$ 11,545,258	$ 1,832,000,595	$ 116,389

State Government Defined

- The 144-employer figure is misleading in that over 100 agencies of state government are counted as a single employer.
- The “state,” as defined by PERS, has a somewhat unique definition and includes some entities that are not typically considered state agencies, such as the public universities, Lottery Commission, Oregon Corrections Enterprises, the State Accident Insurance Fund Corporation, the Oregon State Bar Association, and 23 other boards and commissions.
- The “state,” under this definition, does not include local school districts.

Side Account Participation – State Agencies

Findings

- State agency UAL is not disaggregated by agency
- State agencies have no individual side accounts
- Some state agencies have the financial capability to make ***cash-only*** side account contributions

Staff Recommendations

- Review and make recommendations that would provide state agencies with actuarial reports.
- Review and make recommendations on opportunities to improve state government side account participation.
- Review the viability of having unamortized side accounts.

Side Account participation – Local Gov’t.

Findings

- Side account participation rates are low among local government entities.

Staff Recommendations

- Review and make recommendations on opportunities to improve local government ***cash-only*** side account participation, including the use of state pass-through funding.

Pension Obligation Bonding

Pension obligation bond (POB) are a financing mechanism that allow the state, school districts, and local governments the ability to borrow funds long-term to offset all or a portion of a retirement system's unfunded accrued liability (UAL).

Understanding Pension Obligation Bonding

- POB proceeds are not needed immediately for retiree or beneficiary benefit payments.
- Deposited into side accounts.
- Used to pre-fund or pre-pay a portion of future employer contributions, which is more commonly referred to as the "offset."
- Bond proceeds are invested alongside other PERS assets with the goal of producing investment returns higher than the interest rate on the POBs.
- If investment returns exceed bond costs, the offset to employer contribution rates will be larger than the bond cost; if borrowing costs exceed investment returns, then the offset to employer contribution rates may be less than the bond cost. In other words, the financial advantage of issuing POBs is realized only if investment earnings exceed the cost of borrowing over the bond's maturity.

Pension Obligation Bonding Example

- Reducing an employer's UAL through the issuance of POBs is not a one-time event and does not prevent future changes to an employer's UAL. For example, even though the state bought down most of the existing 2003 UAL ($2 billion out of an estimated $2.3 billion), the 2008 market downturn created a new UAL of $11 billion and triggered higher future employer contribution rates, even with the 2003 POB issuance used to offset employer contribution rates.
- The selling of POBs converts a "soft," or somewhat flexible, UAL obligation into a "hard" liability, or debt instrument, with contractually fixed principal and interest payments. This does not mean that POB proceeds are used to pay off or pay down the UAL. Instead, POB proceeds are drawn down over time to offset future employer contributions.

Pension Obligation Bonding Viability

- A common misunderstanding is that POBs represent an arbitrage opportunity, which is generally defined as a short-term price differential between the same asset, but different markets.

- POBs, on the other hand, are considered investment speculation and viability is based on investment returns exceeding debt service or principal and interest costs over the long-term (rather than a short-term market inefficiency).

Pension Obligation Bonding Factors

Any decision to issue POB's means that various factors, such as the current debt and equity markets, the state's overall debt capacity, the size of the Unfunded Accrued Liability (UAL), and the potential effects on employer contribution rates all need to be carefully considered because the inherent risk of POBs is that they could increase total employer PERS costs if investment returns fall below debt service costs.

Pension Obligation Bonding

Findings

- The authorization of POB's was a key legislative financing reform.
- The financial viability of issuing POBs must be carefully determined.
- Entities have little independent support in determining the financial viability of issuing POBs.

Staff Recommendations

- Review and make recommendations on setting statutory limits around the issuance of POBs.
- Review and make recommendations on providing independent reviews of pending issuances of POBs.

Amortization Schedule(s)

- A retirement system’s unfunded accrued liability (UAL) is the actuary’s calculation of the amount needed to fully fund the retirement system whenever liabilities exceed assets.
- Set to eliminate the UAL over a specific period, if all actuarial assumptions are maintained.
- Statute (ORS 238.225) limits the amortization period to no more than 40 years.
- PERS’ unfunded liabilities are amortized over:
  - Period of 20 years for Tier 1/Tier 2
  - Period of 16 years for the Oregon Public Service Retirement Plan (“Tier 3”)

Amortization Schedule(s)

Findings

- Statute provides the PERS Board with broad authority to set amortization periods.
- PERS Board's amortization periods are conservatively established.

Staff Recommendations

- Review and make recommendations on the financial viability, and employer contribution rate impact, of extending the amortization schedules for all benefit plans.

Assumed Earnings Rate

- The assumed earnings rate is the actuarial assumed rate of return on investments and is comprised of a series of assumptions about current and projected interest rates; rates of inflation; and historic and projected market rates of returns for various asset classes invested and the historic returns on the PERS fund portfolio.
- The assumed earnings rate is used to estimate long-term investment returns, determine the present value of assets and liabilities, credit some investment earnings, and calculate some member benefits.
- "Long-term" is considered by PERS to match the 20-year amortization period for Tier 1/Tier 2 plan liabilities.

History of the Assumed Earnings Rate

- Since PERS' inception in 1946, the Legislature has delegated to the PERS Board the authority to set the assumed earnings rate administratively.
- By statute, the Board undertakes a review of the assumed earnings rate each biennium.
- Over the last 73 years, the PERS Board has made ten changes to the assumed earnings rate.

Assumed Earnings Rate History

Year(s) Changed	Assume Earnings Rate	Years in Effect
2017	7.20%	>1
2015	7.50%	2
2013	7.75%	2
1989	8.00%	23
1979	7.50%	10
1975	7.00%	4
1973	5.50%	2
1970	5.00%	3
1966	3.75%	4
1946	2.25%	20

Impact of Assumed Rate Changes to the UAL

- Actuarial Valuation 2013 (8.00% to 7.75%) = \$2.5 billion
- Actuarial Valuation 2014 (7.75% to 7.50%) = \$1.7 billion
- <u>Actuarial Valuation 2016 (7.50% to 7.20%) = \$2.3 billion</u>
- Total increase to UAL = \$6.5 billon

Assumed Earnings Rate

Findings

- PERS Board changes to the assumed earnings rate have had a material financial impact on the UAL and employer contribution rates.
- There is no reporting to the Legislature of PERS Board changes to the assumed earnings rate.

Staff Recommendations

- Review and make recommendations on setting statutory limits around changes to the assumed earnings rate.
- Review and make recommendations on PERS Board reporting to the Legislature of assumed earnings rate changes.

Questions, comments, or concerns?

Thank You.