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BY EMAIL AND FAX: 503-598-1218

Laurie Warner
Acting Executive Director
Public Employee Retirement System
PO Box 23700
Tigard, OR 97281-3700

Re: April 12, 2004 PERS Board Meeting
Our File No.: 5415-237

Dear Ms. Warner:

The purpose of this letter is to follow up on the PERS Board meeting of April 12 and to indicate the position of the PERS Coalition on a number of issues which were addressed by the Board. As I stated in my comments at the end of the meeting I was disappointed that the Board did not permit testimony on these issues prior to taking action and hope that they will consider changing their approach to receiving public comment.

As will be addressed more fully below, the PERS Coalition believes that several of the actions taken by the board at its recent meeting, particularly in adopting the sequential crediting method and funding reserves, are inconsistent with PERS statutes. In order to understand the position asserted by the PERS Coalition it is necessary to understand the basic statutory funding system which has been in existence for PERS since its inception.

PERS at Inception: 1945

At the inception of PERS the legislature stated its specific goal was to provide a retirement allowance for full career employees of one-half of their final salary based on service after July 1, 1946. OCLA Section 90-714. The legislature provided that each employee would make contributions to the plan in an amount actuarially calculated to be sufficient with earnings to provide one-half of that employee's proposed retirement benefit. OCLA Section 90-714. At retirement a participant was to receive an annuity based on the amount in their individual account matched by a similar annuity provided by the employer (OCLA Section 90-719), which combination of annuities would hopefully reach the goals established by the system. In addition a retiree was entitled to receive a prior service pension

based on service prior to 1946 which was funded solely by employer contributions. OCLA Section 90-715.

The statute provided specifically for the creation of employee accounts and in language which has remained virtually unchanged, provided that those accounts were to receive the contributions of the employees as well as the interest they earned. OCLA Section 90-710. The statutes made the employers the ultimate funders of the system by requiring funding by employers on an actuarial basis sufficient to meet the goals of the system and more specifically to provide the matching annuity as required under the statutory scheme. Though the statute did not specifically authorize the creation of individual employer accounts, funding on an actuarial basis would require the creation of separate employer accounts except for school districts, who were to be considered a single employer for actuarial purposes. OCLA Section 90-715(1). The statute contained no specific directive to the PERS board on the disposition of the earnings on employer accounts, though the requirement of actuarial funding would presuppose that the interest on those accounts would, in fact, be credited to the employer accounts. Thus from the very outset the only policy which would be consistent with the statutory scheme was an equal crediting policy requiring employee earnings to be paid to employee accounts and employer earnings to be paid to employer accounts. Though there have been a multitude of changes to the system since 1945, these funding statutes (now found at ORS 238.250 and ORS 238.225) have remained fundamentally unaltered.

Creation of the Benefits-in-Force (BIF) Reserve

The benefits-in-force reserve was created by PERS board action taken at the board's March 4, 1947 meeting. Upon recommendation of the actuary the Board agreed to pool all employer liabilities for retirees into a single reserve (which contributed both to the actuarial stability of the system as well as providing for significant administrative convenience). Thus, after the creation of that reserve, once an employee retired and the reserve had received both the employee's account and a matching employer contribution, the obligation to fully fund that annuity was now spread across the entire employer base of the system.

Creation of the Contingency Reserve

Concerns about the liquidity of the newly-created BIF [1]reserve were first expressed by the board at its November 12, 1948 meeting and at the board's subsequent meeting the board approved language to be submitted to the next legislature to create a contingency reserve. At

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[1]This account has been referred to by a number of names over the years. Originally it was referred to as the reserve for pension and annuities, though throughout this letter it will be referred to by its current description as the benefits-in-force reserve or BIF.

the time the language was conceived the board was clearly concerned about the liquidity of the BIF, as its approved annual financial statement showed that of the approximately $5.5 million that the PERS system had in assets at that time, only $33,651.08 had been transferred to the newly-created BIF. The 1949 legislature adopted PERS's proposed language and authorized the PERS board to create the contingency reserve (Or. Laws 1949 Ch. 586 §1). The statute was phrased in mandatory terms although permitting the board at its discretion to direct no more than 5% of the earnings of the fund in any year to this reserve. The purpose of the reserve was "to prevent any deficit of monies available for the payment of retirement allowances due to interest fluctuations, changes in mortality rate, losses of invested capital or other unforeseen contingency." A careful examination of the statutory language in light of the financial condition of PERS at that time makes it clear that the concern was that there would be insufficient money in the BIF to pay the benefits when due. The statute itself specifically refers to a "deficit of monies" as well as variations in mortality and earning rate, both of which are critical in assuring the liquidity of the BIF. Quite simply, the purpose for the enactment of the contingent reserve was so that PERS would have the money to pay the bills at the time that they became due.[2]

Establishing a Preference for the BIF

In 1951 the legislature took an additional significant step to protect the liquidity of the BIF by giving it a preference in the distribution of the earned income of the fund. The language of the statute is awkward, but a careful reading shows that the intention of the legislature was to create a preference to protect the BIF. The statute at that time required an initial distribution of 2 1/4 % (the then-existing PERS actuarial assumption) to the BIF and then provides that if total income is in excess of 2 1/4 % then the BIF shall participate in such excess (Or. Laws 1951 Ch. 323 §1). In other words, if total income was less than 2 1/4 % then the BIF would receive a preferential distribution of the full 2 1/4 % with the remainder distributed pro rata to the employer and employee reserve accounts. Conversely, if total income is in excess of 2 1/4 % then it is to be shared pro-rata throughout the system. The need for such a preference can be seen by reviewing PERS earnings up to that time which were substantially below expectations (earnings for 1949-50 were 1.879% and for 1950-51 were 1.9694%). Actual distribution of the earnings of the fund by PERS for the years

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[2]This concern for liquidity must be understood in the context of the PERS benefits structure. While at that time only minimal benefits would have accrued on the current service portion of the plan, participants were given up to 20 years of past service credit (OCLA Section 90-715) for which funding did not even commence until January 1, 1947. OCLA Section 90-715(2). As late as 1952 the PERS board noted that many employers continued to have overdrafts in their past service accounts.

following the enactment of this statute is entirely consistent with this reading of the statute as well as the board's continued application of the equal crediting policy.[3]

In 1967 the statute was amended to increase the preferential distribution to 3.25% for post January 1, 1968 retirees (Or. Laws 1967 Ch. 622 §21) to be consistent with the PERS interest assumption of 3.25%. Once again, in 1973 the statute was amended to authorize the PERS board to make a preferential distribution consistent with the board's actuarial earnings assumption (Or. Laws 1973 Ch. 704 §13).

Trueing Up

As stated above the creation of the benefits-in-force reserve in 1947 by board action transferred the overall responsibility for retirees from individual employers to the employers on a pooled basis. Although the initial PERS statutes provided for periodic actuarial analysis of the system, they provided no specific mechanism for making certain that the benefits-in-force reserve would continue to be funded on an actuarially sound basis. The _____ (195__) legislature took action to provide specific statutory authorization for what is now commonly referred to as trueing up the benefits-in-force account. Or. Laws 1955, Ch. 131 § 20. The statute now specifically authorized the board to transfer employer funds to carry out the trueing up recommendations of the actuary (now at ORS 238.605). This amendment was entirely consistent with the fundamental principle of the system which made the employers the ultimate funders of the system as well as the employers' acknowledged responsibility of funding retirement benefits, and provided a specific mechanism to assure that the BIF would be fully funded according to the actuary's recommendations from employer funds.

<u>The Movement to a Single Reserve – the Modern Gain/Loss Reserve</u>

As discussed above, in 1949 the legislature authorized the PERS board to establish a contingency reserve to make certain that there was no "deficit of monies" in the retiree reserve. The board funded that reserve from time to time and by 1974 the total amount of that reserve had reached its highest point, approximately $2.5 million, a relatively small reserve for a fund which at that time totaled approximately $222 million. The only other reserve account which existed in the fund at that time was referred to as the gain/loss reserve, which had been authorized by the legislature in 1967 (Or. Laws 1967 Ch. 335 §23 and Ch. 622§21(a)). The primary purpose for the establishment of the gain/loss reserve at that time

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[3]If the PERS board had discretion to distribute earnings within the fund in whatever manner it believed would be in the best interests of the fund then the creation of a preference for the BIF would be superfluous. Apparently neither the PERS board nor the legislature believed that the board had that discretion.

was to provide a mechanism for dealing with losses or gains on bonds which PERS chose not to amortize. After initial funding primarily by transfer from the contingency reserve in 1967, that fund simply acted as a balancing account for gains and losses on bonds which the system chose not to amortize. By 1979 that fund had accumulated only a total of $609,896.86. At the board meeting on April 25, 1979 the board decided to amortize all losses and gains on bonds therefore rendering the then-existing gain/loss reserve superfluous.

In response to the passage of the statute which guaranteed PERS participants a minimum return on their accounts (Or. Laws 1975, Ch. 333 § 2), the PERS board recognized the need to accumulate a significant reserve to pay out that guarantee in years in which there were poor earnings. The small balances which had been maintained in the existing reserves were not going to be adequate for this purpose. The first opportunity the PERS board had to discuss this issue came as the result of a good earnings year in 1975. At the PERS board meeting on March 18, 1976, member Meyer recommended that the board strive to build up the contingency reserve so that it would contain two years of minimum interest distributions (then about $30 million) and that this amount be placed in the contingency reserve. Adopting this recommendation, the board approved a distribution of a portion of 1975 earnings to the contingency reserve of $4.2 million. Thus, with the recognition that the contingency reserve would now be used for a new purpose, the board funded that reserve in an amount almost double the total which had accumulated during the first 25 years of its existence. The board followed that up in the next year with a similar distribution of approximately $4 million to the contingency reserve, again for the purpose of providing a reserve for the interest guarantee.

Unfortunately 1977 was not a good investment year and the board had to resort not only to the funds in the reserves but once again to the use of the deficit reserve to pay the guarantee. The board authorized the distribution of the total amount of the contingency reserve (approximately $10 million) to be paid to the gain/loss reserve and the total of that reserve to be distributed pro-rata throughout the system.[4] The board also authorized the use of a deficit reserve in the amount of approximately $9 million for payments to employee reserves to bring those accounts up to the guaranteed minimum.. The Board paid out the full amount of the contingency reserve and has not funded the contingency reserve since that time. Although the rationale for not funding this reserve was not articulated at the time, by the end of 1977 the BIF had accumulated to a total amount of approximately $420 million. Thus the original purpose of the contingency reserve, to assure the liquidity of the BIF, was no longer a substantial concern.

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[4]At that time the PERS director stated that the funds in the contingency reserve which had been accumulated from earnings of the entire fund had to be distributed pro-rata throughout the fund. In this case the board did not have authority to distribute those funds solely to the employee reserve to satisfy the guarantee.

From 1979 until 2004 the PERS board has funded only a single reserve account, the modern gain/loss reserve account, whose sole stated purpose has been to support the interest guarantee. The funding of that reserve has been on an entirely different scale from previous reserves, recognizing the need for a larger balance in order to meet the stated purpose. By the end of 1999 that fund had accumulated a balance of almost $3.9 billion. At that time the fund reserved the entire PERS fund (excepting only the variable account funds and Tier Two funds, for which there is no guarantee) and all payments into and out of the fund have been based on a pro-rata distribution at the time transfer was made in order to preserve equal crediting to the accounts within the system.

The purpose of this historic review was to provide some background to help explain the position of the PERS Coalition that equal crediting has been a fundamental of the system since its inception. Equal crediting is not based on an exercise of board discretion but has been the only system consistent with the fundamental statutory funding scheme of PERS. The second fundamental principle has been that from inception employers have always been the funders of last resort in the PERS system. Stated differently, employee contributions have always been fixed initially based on some actuarial formula, and later fixed at the same amount for all employees, while employers have always been required to be the ultimate funders of the system. It is the position of the PERS Coalition that any distribution of income within the system which is not consistent with equal crediting is contrary to statute. Similarly it is the position of the PERS Coalition that the use of reserves for the sole purpose of diverting employee earnings in order to relieve employers of the ultimate funding burden of the system is also inconsistent with the statute.

With that background, following are comments on a number of topics that the Board addressed at their meeting. I will organize them according to the Board agenda.

3.a. Sequential Crediting

The Board elected to adopt the sequential crediting rule with Board discretion for final distribution of earnings within the system. It was the PERS Coalition's position that the Board should have adopted the alternative sequential crediting/equal crediting version. By way of clarification the PERS Coalition has always recognized that the Board has discretion in the funding of statutory reserves. The PERS Coalition's opposition to the rule centers on provision 15, which provides that the remaining earnings may be distributed at the discretion of the Board. As we have stated previously we believe that ORS 238.250 specifically protects the rights of PERS members to receive distribution of all earnings attributable to their contributions once administrative expenses and statutory reserves have been properly funded. We believe the better interpretation of ORS 238.670(2) requires that the benefits-in-force reserve receive full crediting of earnings, again subject to the payment of the administrative expense and authorized reserves. This leaves only the employer reserves without specific statutory protection. However, as discussed above, from the

inception of the PERS system employers have always been required to fund the system on an actuarially sound basis. An underlying actuarial assumption which has always been implicit in that requirement is that employer reserves will also receive the full benefit of the earnings on those reserves, less only administrative expenses and properly-funded reserves. Hence the longstanding adherence to the equal crediting policy, which has been at the foundation of the system since its inception. It does not appear that the Board's decision to move away from equal crediting was based on a sufficient review of the legal and actuarial underpinnings of the system, and without a full review of the limitations which may be put on any discretionary distribution of funds within the system.

4. 2003 Earnings Crediting

Funding of Reserves

ORS 238.670 gives the PERS board the authority to fund certain identified reserves at their discretion from the earnings of the system. As with any other discretionary act, the board's fiduciary responsibility requires that the exercise of that discretion must be in the best interests of the members. To the extent that the board authorizes the funding of a reserve from the earnings of the system, then those earnings are not available for further distribution within the fund. Under equal crediting and the requirements of ORS 238.250 some portion of those diverted funds would ordinarily be paid into employee accounts. Clearly funding a reserve for the sole purpose of diverting earnings from members' accounts or alternatively to change the fundamental funding responsibilities of the system would be a breach of the board's fiduciary obligation. A proper exercise of the board's discretion in funding a reserve requires a clear identification of the potential uses of that fund as well as a determination of the proper funding level in order to meet those uses. As will be discussed more fully below it is the PERS Coalition's position that the substantial funding of both the contingency reserve and the capital preservation reserve was not consistent with the board's fiduciary obligation to the members of the fund.

Contingency Reserve

The PERS Coalition believes there is not an adequate reason for funding the contingency reserve to the full 7.5% permitted by statute. This amount is excessive as the uses for the fund permitted by statute do not justify funding in that amount. The potential use of the fund to pay miscellaneous costs and attorney fees associated with litigation, or the potential insolvency of a public employer, does not justify an allocation in excess of half a billion dollars to the fund. To the extent that the *Strunk* case or some other litigation may overturn some or all of the 2003 legislation, it is almost impossible to conceive of a scenario where the contingency fund could be used to satisfy all or part of that liability. If the legislation breaches or impairs member contract rights then using a reserve fund to accomplish the same result is not going to be a viable approach. Finally, while the

contingency fund language provides that it can be used to supplement the benefits-in-force reserve in the event of a "deficit of monies," no persuasive case can be made that the benefits-in-force reserve is likely to suffer a "deficit of monies." The trueing-up process has been a part of the basic funding mechanism of PERS for many years and specifically placed the responsibility for maintaining the BIF on employers (ORS 238.605). Use of the contingency fund to true-up the benefits-in-force reserve would not only be inconsistent with the specific statutory requirement but would also have the impact of shifting part of the burden of maintaining an adequate benefits-in-force reserve for retirees to active members of the system. The specific statutory language and the structure of the PERS system do not permit such a re-allocation of responsibility for the funding of already-retired PERS members.

Capital Preservation Reserve

For all the reasons discussed above the use of the capital preservation reserve to true-up the benefits-in-force reserve is also contrary to statute. In this instance use of the capital preservation fund to shore up the BIF would switch the burden of supporting the benefits-in-force reserve, which is almost entirely made up of Tier One participants, in part to earnings from the funds of Tier Two participants. Again, such a transfer of funding responsibility is inconsistent with the statute as well as the Board's fiduciary obligation to protect the interests of Tier Two members. Funding of the capital preservation reserve cannot be justified on the basis of evening out distributions to Tier Two member accounts. Funding the reserve provides no benefit to Tier Two members, it simply results in less money in Tier Two accounts during periods of time when the capital preservation is positive and upon payment out of the full amount of the capital preservation reserve, Tier Two participants would have no more in their accounts than they would have without funding of this reserve. In sum there is no benefit to Tier Two participants in funding this reserve, only a detriment. Absent an acceptable or useful use for funding this reserve it is the position of the PERS Coalition that no funding should have been made for the capital preservation reserve and that all of those funds should have been distributed on an equal crediting basis in the appropriate accounts throughout the fund.

4.c. Tier One Retiree Obligation to the Deficit Reserve

For reasons articulated by the Board a portion of benefits-in-force earnings were specially allocated to the payment of the Tier One employee deficit reserve. Despite the fact that this allocation of benefits-in-force income is, in the short term, to the benefit of Tier One members, nonetheless the PERS Coalition does not support that allocation. First it is contrary to ORS 238.255, which restricts payment of the deficit reserve to earnings on regular accounts of members. Second, it is likely a violation of ORS 238.670(2) which requires that the BIF "participate" in earnings in excess of the assumed rate. Consistently the PERS Board has interpreted the word "participate" to support the use of equal crediting

policy and this special allocation violates that principle. Finally, and perhaps most importantly from the point of view of the PERS Coalition, it is an exercise of the Board's authority under subsection 15 of the new sequential crediting rule to allocate remaining earnings of the fund. To the extent that this allocation is inconsistent with the equal crediting principle; at a minimum it creates a bad precedent which will lead to further turmoil within the system.

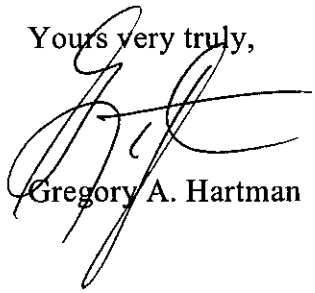
5. Re-Allocation of 1999 Earnings from Employer-in-Variable

As stated at the meeting, the intervenors in the *City of Eugene* case did not participate in, nor ratify, the Settlement Agreement between the PERS Board and the local jurisdictions. To the extent that the implementation of that agreement adversely affects the rights of the constituent members of the PERS Coalition, the PERS Coalition also opposes the Settlement Agreement. Both the intervenors and the PERS Coalition recognize the need to implement the 2003 legislative action and portions of the *City of Eugene* judgment which were not already addressed by the legislature. To the extent that that Settlement Agreement goes beyond those implementation topics to "settle the litigation" it does not appear that that Settlement Agreement was entered into with the best interests of the PERS membership in mind. This issue will be discussed in greater detail in response to Jim Baker's letter of April 14, 2004.

6. Adoption of OAR 459-013-0280

As stated in previous correspondence to the Board, it is the PERS Coalition's position that the adoption of the temporary rule as well as the final rule which implements the calculation of the variable match must respect the rights of the members who entered the system before 1981. We anticipate that we will provide additional comment on this issue during the rulemaking process.

Yours very truly,



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