Legislative Fiscal Office

Ken Rocco
Legislative Fiscal Officer

Daron Hill
Deputy Legislative Fiscal Officer

900 Court Street NE
H-178 State Capitol
Salem, Oregon 97301
503-986-1828

Budget Information Brief / 2016-5

Projected Increase in PERS Unfunded Accrued Liability

The $9.5 billion increase in the Public Employee Retirement System (PERS) Unfunded Accrued Liability (UAL) has been attributed to the Oregon Supreme Court's decision to reverse some of the 2013 PERS benefit reform legislation. The Supreme Court's decision, however, only partially explains the increase in the UAL. This brief provides further explanation and why an additional increase is likely.

Unfunded Accrued Liability Defined

Each calendar year, an independent actuarial firm hired by PERS conducts a system wide valuation of PERS assets and liabilities. An Unfunded Accrued Liability (UAL) is created if the present value of the system's liabilities (benefits earned up to that point) exceeds the present value of the assets available to pay those liabilities (accumulated member, employer contributions, and investment earnings). Assets can include employer side accounts, which are pre-paid deposits primarily from the proceeds of pension obligation bonds. The converse of a UAL is where assets exceed liabilities and the system is overfunded.

The system wide funded status is a composite of UALs that exist for each benefit program, which include Tier One, Tier Two, and Oregon Public Service Retirement Plan, as well as retiree medical benefits. UAL's are calculated for each major rate pool (State and Local Government Rate Pool and School Districts) and for each independent employer that is not part of a rate pool. The UAL is expressed as a dollar amount, or by funded status, which is the percentage of assets in relation to liabilities.

PERS UAL and Funded Status History

The most current actuarial valuation for calendar year 2014 places the PERS UAL at $12.1 billion with a funded status of 84%. (These figures, and other totals shown in this report, include employer side accounts. At the end of 2014, side accounts represented $5.9 billion in assets available to pay benefits. Without side accounts, the PERS' funded status was 75.6% in 2014.) A funded status of 80% is generally considered the threshold for a reasonably healthy retirement system.

In 12 of the past 16 calendar years, beginning in 1999 and through 2014, PERS has had a UAL. In the remaining four years, assets exceeded liabilities and PERS was overfunded. Over this period, PERS' funded status has ranged from a high of 111.5%, with a $6.1 billion surplus (2007), to a previous low of 80%, with an $11 billion deficit or UAL (2008).

Decomposition of the 2014 UAL Increase

The change in the UAL from calendar year 2013 ($2.6 billion) to calendar year 2014 ($12.1 billion) is $9.5 billion and the increase is commonly attributed to the Oregon Supreme Court *Moro* decision. There are, however, other factors that have increased the UAL. They are: a) administrative decisions of the

PERS Board; and b) investment returns below the assumed earnings rate as generated by the Oregon Investment Council.

The following chart details the relative impact of each factor on the change in the UAL and is followed by a more detailed description.

Table of Summary of changes to PERS Unfunded Accrued Liability (2013 to 2014)

Source of UAL Increase	Oregon Supreme Court	PERS Board	Oregon Investment Council	Change in UAL	% of Total
Oregon Supreme Court *Moro* decision	$5.1B	--	--	$5.1B	54%
Updated mortality assumptions	--	$1.8B	--	$1.8B	19%
Decrease in assumed earnings rate	--	$1.7B	--	$1.7B	18%
All other assumption changes/actual experience	--	$0.5B	--	$0.5B	5%
Expected UAL increase (2014)	--	$0.2B	--	$0.2B	2%
Actual investment returns (2014)	--	--	$0.2B	$0.2B	2%
Total	$5.1B	$4.2B	$0.2B	$9.5B	100%
% of total	54%	44%	2%	100%	

Oregon Supreme Court Decision

The Oregon Supreme Court's decision to overturn some of the 2013 legislative reforms added about $5.1 billion (or 54% of the change) to the system's UAL. In April 2015, *Moro* upheld eliminating the tax remedy payments for non-residents. The modification of a retiree's cost-of-living adjustment (COLA) was ruled unconstitutional as applied to benefits earned prior to the effective date of the reform. The court found that a reduced COLA could only be applied to benefits earned after reform legislation became effective. This introduces a blended COLA for many PERS members as they retire into the future, but restores the full COLA for members who retired prior to the legislative changes.

PERS Board Decisions

The PERS Board added about $4.2 billion (or 44% of the change) to the system's UAL due to actuarial and other administrative actions. The Board reduced the assumed earnings rate from 7.75% to 7.5% and made other assumption changes and adjustments, such as updating mortality tables. Statute generally directs the PERS Board to adopt updated actuarial factors every two years (ORS 238.607).

Investment Returns

Actual earnings below the assumed earnings rate added about $200 million (or 2% of the change) to the system's UAL. Actual earnings of 7.2% for calendar year 2014 were below the assumed earnings rate of 7.75% for that period (that assumed rate was adopted by the PERS Board in 2013 after being at 8% since 1989). As noted previously, the assumed earnings rate has since been lowered to 7.5% for calendar year 2016.

Employer rates for the 2017-19 biennium will be based upon actual investment returns through calendar year 2015. Therefore, the current $12.1 billion UAL must be qualified until the 2015 actuarial valuation has been completed; however, a preliminary statement to the PERS Board in January of 2016 by the agency's actuarial firm noted that 2015 actual investment return (the one year return for the Oregon Public Employees Retirement Fund was 2.11%) was well below the assumed earnings rate of

7.75%. This could increase the UAL by an additional $3 to $4 billion for a total UAL of $15.1 to $16.1 billion. This would reduce PERS' funded status, with side accounts, to just below 80%.

Recovery of the UAL

When the valuation results in a UAL, employer contribution rates are set at a percent of covered payroll to amortize, or repay, the UAL over 20 years for Tier One/Two; or 16 years for the Oregon Public Service Retirement Plan (OPSRP); or 10 years for retiree health care, using the current actuarial methods and assumptions. If all the actuarial assumptions are met, the UAL will be recovered over the amortization period and the retirement system will be restored to fully funded status after the amortization period.

Rate Collaring

The increase in employer contribution rates from 2015-17 to 2017-19 will be significant enough to trigger, or continue, in some instances, an actuarial method termed "rate collaring." The PERS Board rate collaring methodology is used to limit short-term (biennial) rate fluctuations by deferring a portion of a rate change to future biennia. The rate collar has two hurdles to reflect smaller or larger fluctuations in potential rate changes.

> *Single Collar* - The single rate collar methodology limits the biennium to biennium change in employer contribution rates to no more than the greater of 3% of payroll or 20% of the employer's current contribution rate.

Most 2017-19 employer contribution rates are currently subject to a single rate collar. The rate collar, however, can increase incrementally up to twice the single collar depending upon the funded status of the individual rate pools or independent employers. This is double rate collaring, which is defined as:

> *Double Collar* - PERS rate collar methodology also allows the width of the collar to increase when the employer's funded status drops below 70%, or increases above 130%, with the width of the rate collar doubling at a funded status of 60% or 140%. For a double width rate collar, the biennium to biennium change in employer contribution rates is constrained to the greater of 6% of payroll or 40% of the current contribution rate if the funded status drops to 60% or below or increases to 140% or above. Between 70% funded to 60% (or from 130% to 140%), the collar applies incrementally (e.g., a 65% funded employer's collar is 3.5% of payroll or 30% of their current contribution rate).

A system-wide double rate collar was not projected by the PERS actuary since the 2014 valuation showed system funded status above the trigger threshold. A double rate collar will be triggered for certain employers in the 2015 actuarial valuation given the expected decline in the funded status.

2017-19 Advisory Employer Contribution Rates

The following table details advisory employer rates for two of the major rate pools. The average rates for each pool are the average Tier One/Two and OPSRP weighted by payroll costs (i.e., the apportioned payroll by Tier One/Two and OPSRP members). The figures exclude health care costs and Individual Account Program (IAP) contributions.

The table reflects that the single rate collar has limited the average weighted employer advisory rate growth for the State and Local Government Rate Pool (SLGRP) to 3.1% and the School District rate pool to 4.01% (including the effect of side account offsets and other dynamics). The specific amount of the rate collar, or deferred contribution, is 6.26% for the SLGRP and 5.83% for the School District rate pool. These represent the largest rate collars for these pools since rate collaring was first implemented by the PERS Board in 2004.

2017-19 Advisory Employer Rates for Select Employer Pools

Rate Pool Weighted Average Contribution Rates	Collared 2015-17 Net Rate*	Uncollared 2017-19 Base Advisory Rates	Impact of Single Rate Collar	Side Account (Offset)/ Other Pool Offset	Collared 2017-19 Net Advisory Rates	Rate Increase from 2015-17	Percent Change from 2015-17
State and Local Government Rate Pool	10.52%	25.62%	-6.26%	-5.74%	13.62%	+3.10	+29.47%
School District Rate Pool	9.38%	29.83%	-5.83%	-10.61	13.39%	+4.01%	+42.75%

*Collared 2013-15 Net Rate reflects the Oregon Supreme Court *Moro* decision.

PERS estimates that system-wide 2017-19 advisory employer contribution rates will generate $2.8 billion in contributions, which is $800 million more than the amount generated during the 2015-17 biennium.

Summary

The Oregon Supreme Court *Moro* decision explains only $5.1 billion (54%) of the $9.5 billion change in the UAL from calendar year 2013 ($2.6 billion) to calendar year 2014 ($12.1 billion). Administrative decisions of the PERS Board and investment returns below the assumed earnings rate generated by the Oregon Investment Council explain the remaining $4.4 billion increase (46%).

Preliminary estimates suggest that the UAL will increase by an additional $3 to $4 billion for a total UAL of $15.1 to $16.1 billion due to 2015 investment returns being significantly below the assumed earnings rate. This will reduce PERS' funded status from 84% to just below 80%. This level of increase will subsume the UAL increase attributable to the Oregon Supreme Court *Moro* decision and underscore the impact of investment earnings on the PERS UAL.

A fall in the PERS funded status to 70% or below will trigger double rate collaring from some employers and a further increase in their 2017-19 employer contribution rates. The currently projected $800 million increase in employer contribution rates for the 2017-19 biennium will need to be adjusted upward. The PERS Board will officially adopt 2017-19 employer contribution rates in the fall of 2016.