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Oregon PERS
Impact of Strunk Ruling

Marcia L. Chapman, FSA, EA
William R. Hallmark, ASA, EA
Portland, Oregon

MMC Marsh & McLennan Companies

Agenda

- Background
- Tier One/Tier Two Member Benefits
- Tier One/Tier Two Employer Rates
- Open Issues
- Measures – Near Term
- Measures – Long Term
- Decision Points
- Certification
- Assumptions

Background
Overview of Court Ruling

- The Oregon Supreme Court held that two aspects of the reform legislation impair the PERS contract. Those two aspects are:
  - (1) eliminating annual crediting at the assumed rate for Tier One member regular accounts and
  - (2) temporarily suspending COLA to certain retired members
- The court affirmed the following reform aspects:
  - Redirection of employee contributions from regular and the Variable Annuity Account to the Individual Account Program; and
  - Use of updated actuarial factors
- The court also concluded that Tier One members had no contract right to annual earnings crediting in excess of the assumed rate

Background
Environment Prior to 2003 PERS Reforms

- Money Match benefits became more predominant than Full Formula benefits for Tier 1 members due to favorable investment returns of the 1990s and earnings crediting decisions of the prior Board
- Unfavorable investment returns of 2000, 2001, and 2002 resulted in:
  - Employer rates increasing to 16% of payroll; projected to reach 25% of payroll within a few years
  - The unfunded liability of the System increasing to $17 billion and the funded status of the System decreasing to below 70%
- School and other government budgets were impacted
- Long-term viability of the System came into sharper focus
- Parameters of the Board’s discretion were questioned; resulting in litigation (Eugene), court judgment, and settlement changing 1999 earnings credits. An appeal is pending before the Oregon Supreme Court

Background
Outline of 2003 PERS Reform

- Oregon Public Service Retirement Plan (OPSRP) and Individual Account Program (IAP) were established for employees hired after August 29, 2003
- Future member contributions were diverted from PERS Tier One/Two to IAP
- Tier One assumed rate was re-characterized as a guarantee over the member's career and not on an annual basis
- Actuarial equivalency factors for converting Money Match benefits to annuities and other actuarial conversions were updated
- Temporary COLA freeze for certain retirees was established in response to Eugene case decision
- State of Oregon authorized $2 billion in pension obligation bonds which combined with other employers brought the total bonding for the system to over $4 billion

Overview of Changes
Estimated Impact of 2003 PERS Reform*

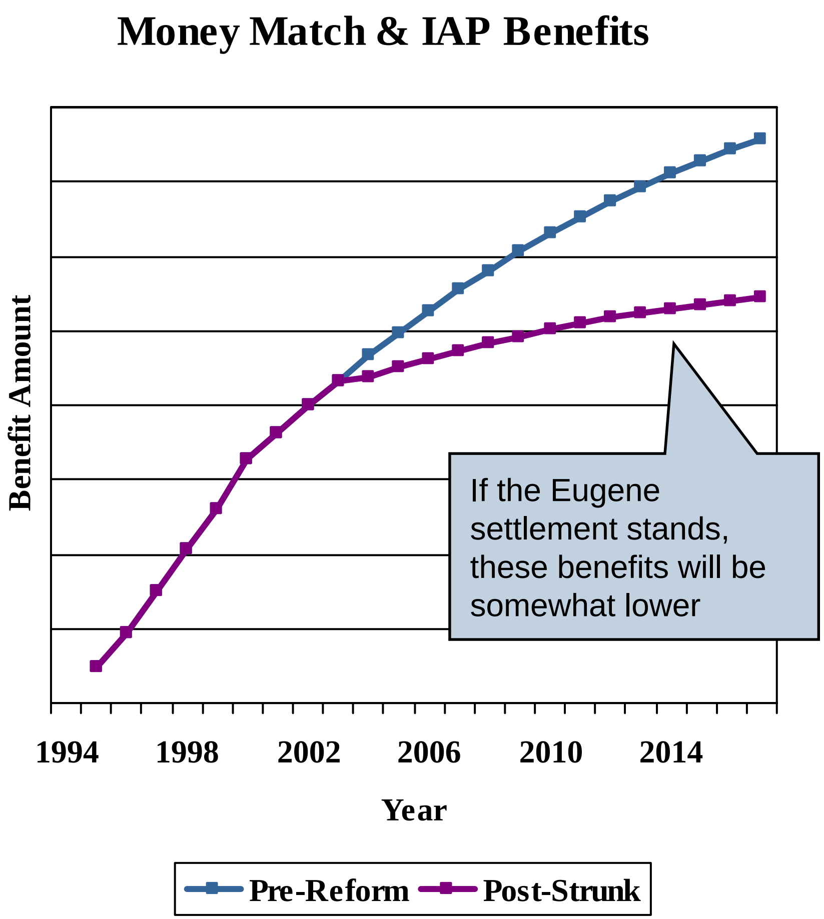
- Unfunded accrued liability decreased by an estimated $8 to 9 billion
- Employer contribution rates decreased by 5.84% of payroll
- Future growth of Money Match benefits was significantly reduced
- Full Formula benefits were more likely to be be paid out
- Member (or employer pickup) funding of 6% of costs was moved from Tier One/Tier Two to IAP
- OPSRP was estimated to save $7 billion in future years

**Based on estimates provided by prior actuary using 12/31/2001 valuation data*

Overview of Changes
Tier One/Two Member Benefits

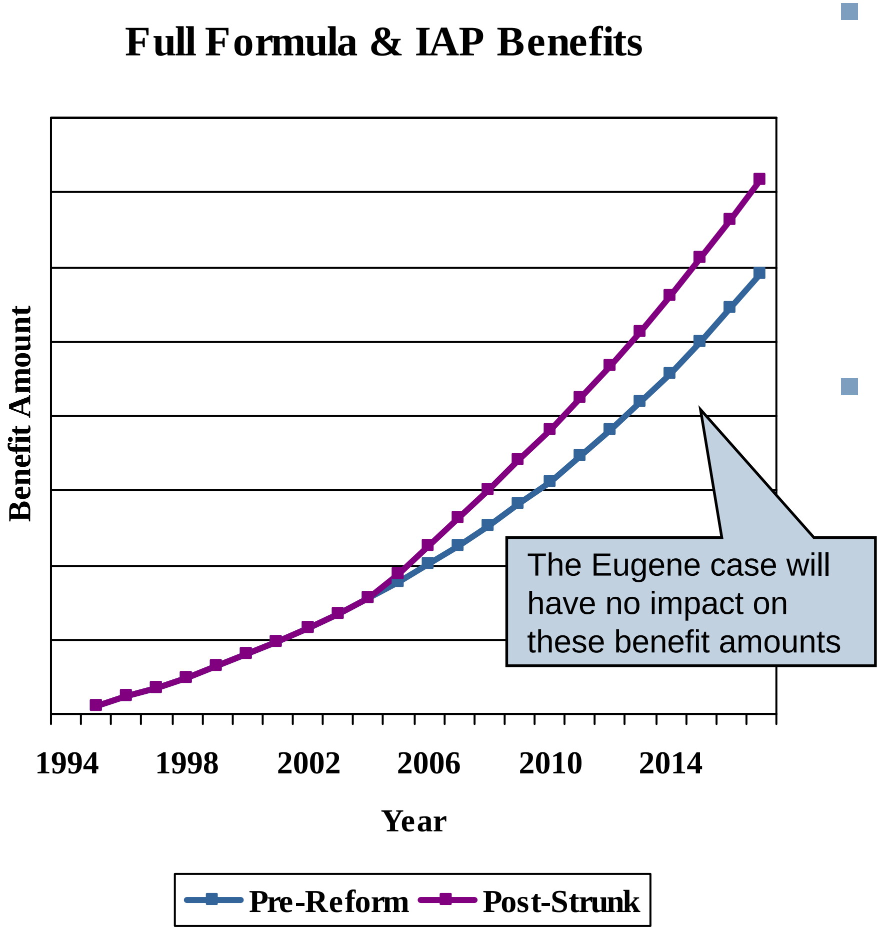
Changes	Impact on:	Pre-Reform	Post-Reform	Post-Court Ruling
Member Contributions and Money Match	Tier One and Tier Two	6%	0%	0%
IAP	Tier One and Tier Two	0%	6%	6%
Earnings Crediting Guarantee	Tier One	8% per year	8% over career	8% per year

Tier One/Two Member Benefits
Impact on Money Match Benefits



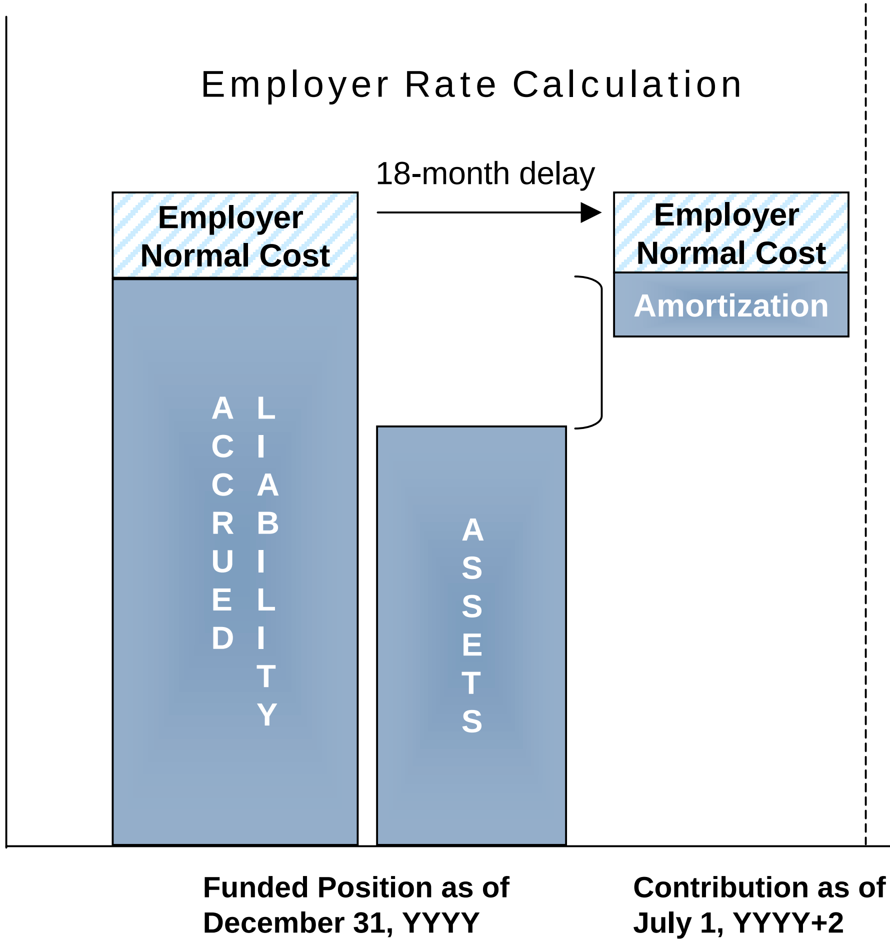
- This graph shows projected Money Match and IAP benefits for a sample member hired in 1994 both pre-reform and after the Strunk ruling assuming 8% earnings in all future years
- The reduced rate of accrual after the Strunk ruling reflects the updated actuarial equivalency factors and the redirection of the 6% member contribution into the IAP
- The PERS reforms were primarily targeted at curtailing the growth of Money Match benefits, and even after Strunk, the future growth of these benefits has been reduced

Tier One/Two Member Benefits
Impact on Full Formula Benefits



- This graph shows projected Full Formula and IAP benefits for a sample member hired in 1994 both pre-reform and after the Strunk ruling assuming 8% earnings in all future years
- The PERS reforms did not affect the amount of the Full Formula benefit. Consequently, by re-directing the Member contributions to the IAP, the Legislature provided an additional benefit to any Member who retires under Full Formula instead of using those contributions to offset the cost of the Full Formula benefit

Tier One/Two Employer Rates
How are Employer Rates Calculated?



Adjustments

- Lump Sum payments
  - Made by employers up to unfunded liability by using general assets or issuing bonds
  - Offsets employer rates but employers may have additional borrowing costs external to PERS
- Transition liabilities or assets
  - Applicable to pooled employers
  - Increases or decreases pooled rate

Tier One/Two Employer Rates
Impact on Rates

System-Wide Rates December 31, 2003			
	Employer	*Member*	*System Total*
Pre-Reform	22.2%	6% to Member Accounts	28.2%
Post-Reform	18.9%*	6% to IAP	24.9%
Post-Strunk	21.0%	6% to IAP	27.0%

- Much of the expected reduction in accrued liability was lost when 2003 and 2004 investment returns eliminated the Tier 1 deficit reserve 3 to 4 years earlier than expected
- Similarly, much of the expected reduction in Money Match benefits was restored by the 2003 and 2004 investment earnings
- The Strunk ruling reduced the savings and restored the benefits further
- With the diversion of Member contributions to the IAP, the employer-paid normal cost actually increased, especially for Full Formula benefits
- Post-Strunk calculated employer rates will be lower if Eugene case settlement stands

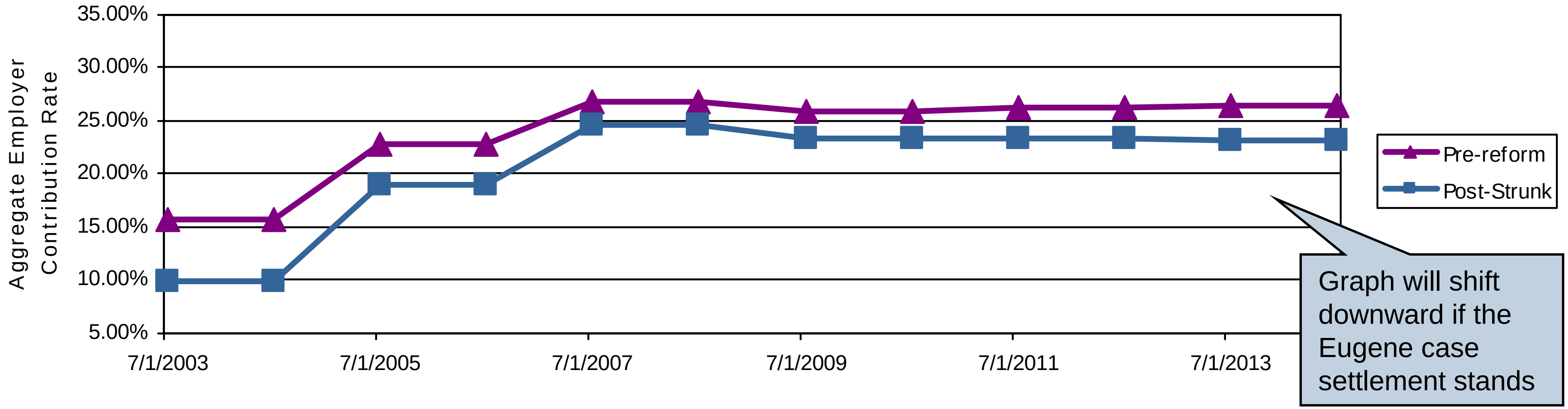
** From December 31, 2003 actuarial valuation prepared by Milliman*

Tier One/Two Employer Rates
Impact on Accrued Liability

December 31, 2003 Accrued Liability Before Strunk	$44.6
Impact of minimum interest guarantee for Tier One members	1.4
Impact of restoring COLA for certain retirees	0.7
December 31, 2003 Accrued Liability After Strunk	$46.7

- The Strunk ruling added $2.1 billion in liability as of December 31, 2003
- The $1.4 billion impact of restoring the minimum earnings guarantee is due to providing Tier One members with 8.0% earnings for 2003 and 2004
- The impact of restoring the COLA is greater than previously anticipated due to the unexpectedly large number of retirements during 2002 and 2003
- December 31, 2003 post-Strunk accrued liability will be lower if the Eugene case settlement stands

Tier One/Two Employer Rates
Projected Impact



- Re-instatement of the 8% guarantee and elimination of COLA freeze reduced magnitude of savings from original estimates
- Reduction in growth of Money Match accounts creates long-term savings

Graph compares costs pre-reform and post-Strunk decision. Only Tier One/Two pension costs are included in these projections
Projections use actual 2004 earnings and assume 8% in all future years
Rates are not adjusted for side accounts
Rates do not include any use of non-valuation reserves

Open Issue
Eugene Case

- In the City of Eugene case, Judge Lipscomb ruled that the PERS Board exceeded its authority in crediting 20.0% earnings to Tier One member accounts in 1999
- The Strunk ruling did not address Member appeals to the Eugene case
- Final benefits remain uncertain until all legal issues are resolved
- If 1999 earnings crediting is reduced from 20% to 11.33%, then it will offset the estimated $2 billion increase in the liability due to the Strunk ruling by $1.5 to $2.0 billion. The average employer rate would be reduced from the post-Strunk estimates by 1.5% to 2.0%

All of the calculations shown in this presentation reflect the Strunk decision but use the 20% earnings crediting in 1999

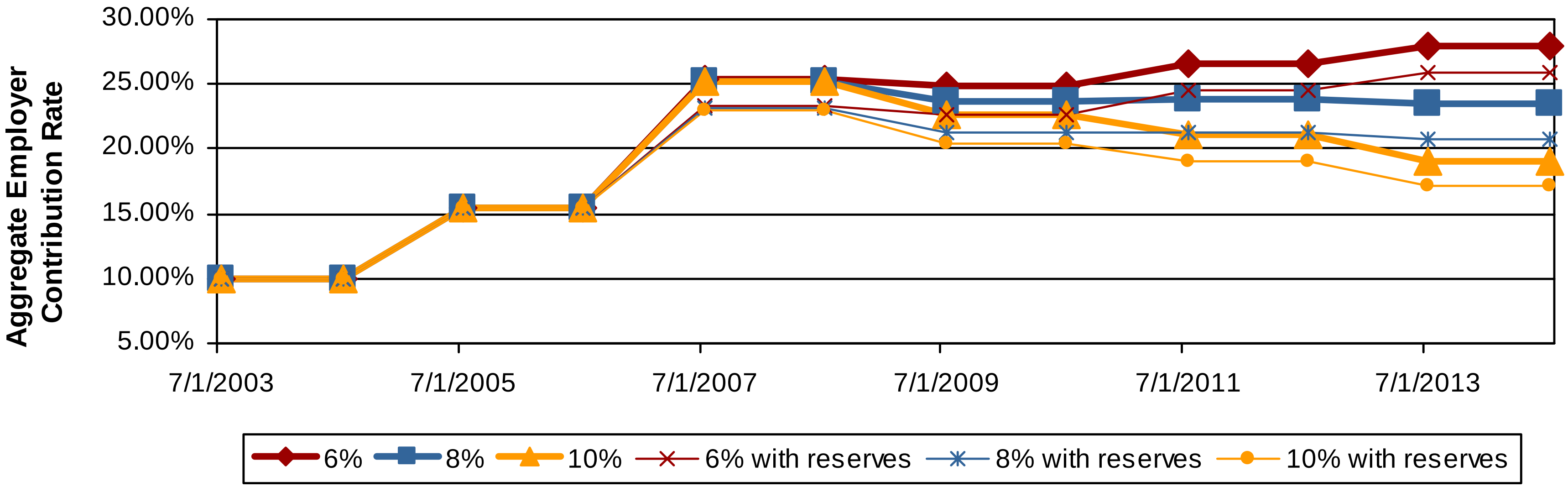
Measures – Near Term
Overview

Board Decision on changes to employer rates, if any

- Options Include:
  - Adjust rates effective July 1, 2005
  - Adjust rates effective as of an interim date (e.g., July 1, 2006)
  - Adjust to rates effective July 1, 2007
  - Wait for a Supreme Court ruling on Eugene case to make further decisions on rate changes

- Use of Contingency and Capital Preservation (non-valuation) reserves
- Establish Board policy on earnings crediting

Measures – Near Term
Use of Non-Valuation Reserves



- As part of the 2003 earnings crediting decision, the Board set aside approximately $1.2 billion in the contingency and capital preservation reserves. Staff has recommended the Board set aside an additional $600 million in these reserves out of 2004 earnings
- This chart shows the expected employer rates in the future, with and without using $1.8 billion of non-valuation reserves as of December 31, 2004
- The funded status of the System is expected to decline from 86% (without side accounts) on December 31, 2003 to about 79% using non-valuation reserves and about 75% not using reserves
- The funded status of the System is expected to decline from 96% (with side accounts) on December 31, 2003 to about 90% using non-valuation reserves and about 88% not using reserves

Measures – Near Term
Summary of Impact on July 1, 2005 Rates

	Pre-Reform	Post-Reform	Post Supreme Court Ruling
Full Rate	23.4%	19.7%	22.1%
Phased-In Rate	N/A	15.4%	16.7%

- System average rates prior to the Strunk ruling as of July 1, 2005 were calculated under a two-step phase-in as well as the normal full rate*
- The same calculations reflecting the impact of the Strunk ruling are shown in the last column

* *Based on December 31, 2003 valuation results prepared by Milliman*

Measures – Near Term
Summary of Strunk Ruling Impact on Expected Rates

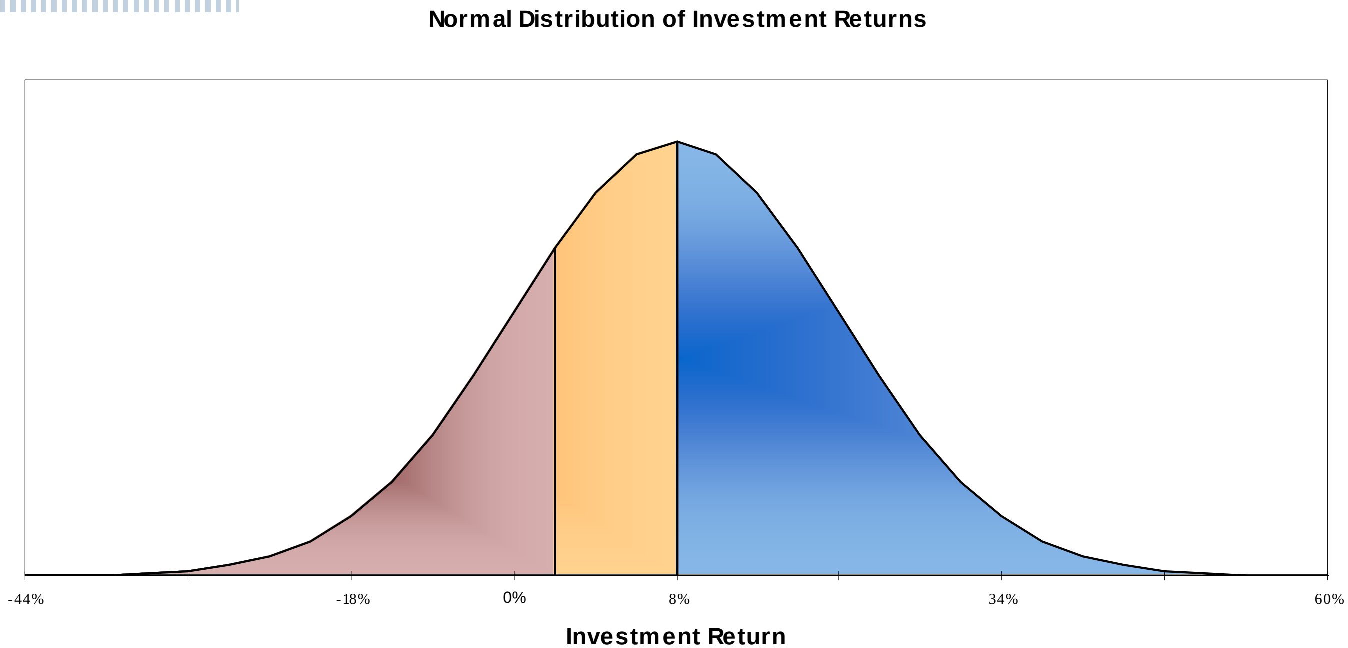
	Reserves	Impact on July 1, 2005 Rate	Impact on July 1, 2007 Expected Rate
No Phase-In	Don't Use	+2.4%	+2.7%
	Use	N/A	+0.4%
Phase-In	Don't Use	+1.3%	+2.7%
	Use	N/A	+0.4%

Actual 2004 earnings and 8% of earnings for 2005 are used to estimate July 1, 2007 rates

July 1, 2007 expected rates assume no change is made to July 1, 2005 rates

Please note that these results do not include additional expected increases in rates due to other factors such as the actuarial smoothing of investment gains and losses

Measures – Near Term
Board Policy on Interest Crediting



- In the past, Tier One Member accounts were assumed to be credited with an average of 8.5% each year. All post-Strunk numbers in this report assume 8.0% earnings credited in the future
- An established Board policy regarding the crediting of interest will guide the actuary's assumption
- If the assumption is increased from 8.0% to 9.0%, estimated average employer rates as of December 31, 2003 increase from 21.0% to 22.0%
- With the Supreme Court ruling, the minimum interest credit for Tier One Member accounts is 8.0% each year. The Board may credit amounts greater than 8.0%, subject to ORS 238.255 reserving requirements

Measures – Long Term
Overview

What measures can be adopted in the long term to control the volatility in employer rates?

- Review actuarial methods and assumptions to better control volatility
- Financial modeling of reserving policies
- Asset-liability study to assess the risk-return trade off of different asset allocations

Measures – Long Term
Review Actuarial Methods and Assumptions

- The actuarial methods and assumptions primarily affect the pattern of contributions over the life of the retirement System
- Transparency, generational equity, funded status, and volatility of employer contribution rates can all be affected by the actuarial methods and assumptions
- Review of the underlying methods and assumptions is currently in process

Measures – Long Term
Financial Modeling of Reserving Policies

- The amount placed in reserves has an impact on current employer rates and affects the ability of the System to absorb financial volatility
- How much should be put in reserve in years with excess earnings?
- When should reserves be used?
- Using the deterministic and stochastic parts of the financial model, the Board can explore the impact of different reserving policies on the level and volatility of employer contribution rates under a variety of scenarios

Measures – Long Term
Asset-Liability Study

- The Oregon Investment Council determines the asset allocation for PERS
- The asset allocation determines the expected level and volatility of investment returns for the System
- The level and volatility of investment returns have a direct impact on the level and volatility of employer rates
- How much volatility in investment returns can the System withstand?
- How would a more conservative/aggressive asset allocation affect the current level of employer rates?

Decision Points
Immediate Priorities

- Board Decision on changes to employer rates, if any.
  - Options Include:
    - Make no further changes before July 1, 2007
    - Adjust rates effective July 1, 2005
    - Adjust rates effective as of an interim date (e.g., July 1, 2006)
    - Wait for a Supreme Court ruling on Eugene to make further decisions on rate changes
- Use of Contingency and Capital Preservation (non-valuation) reserves
- Establish Board policy on earnings crediting

Certification

We have prepared this report for the Oregon Public Employees’ Retirement System to assist the Board in understanding the financial implications of recent legislation and court rulings on the System. The information in this report is based on the data, assumptions and methods used for the actuarial valuation report as of December 31, 2003 which was prepared by Milliman. Note that the Oregon Public Service Retirement Plan is not considered in this report.

This report also contains projections of assets and liabilities. We used actual asset returns for 2004 and for years beyond 2004 we assumed asset returns as described in the various projections.

We are available to answer any questions on the material contained in the report, or to provide explanations or further details as may be appropriate.

Marcia L. Chapman, FSA, MAAA **Date**
Enrolled Actuary No. 02-5650

William R. Hallmark, ASA, EA **Date**
Enrolled Actuary No. 02-5656

Mercer Human Resource Consulting
111 SW Fifth Avenue, Suite 2800
Portland, OR 97204
503 273 5900

Appendix
Key Assumptions

Assumption	Scenario		
Investment Return (Regular and Variable)	6%	8%	10%
Expenses	Investment returns are assumed to be net of expenses.		
Contingency Reserve	No allocation and no withdrawal	Earnings attributable to the contingency and capital preservation reserves are allocated to the contingency reserve.	Allocate 7.5% of available earnings in first 3 years, 5.0% of available earnings thereafter.
Capital Preservation Reserve	No allocation and no withdrawal.	No allocation and no withdrawal.	No allocation and no withdrawal.
Tier 1 Rate Guarantee Reserve	No allocation. Balance is withdrawn as needed to credit 8.0% to Tier 1 member accounts.	No withdrawal. Earnings on the current reserve are allocated to the reserve.	All earnings available in excess of 8.0% for Tier 1 member accounts are allocated to the reserve.
All other assumptions	Based on assumptions used for 12/31/2003 actuarial valuation	Based on assumptions used for 12/31/2003 actuarial valuation	Based on assumptions used for 12/31/2003 actuarial valuation