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THE PERS CRISIS - HOW THE PERS CRISIS OCCURRED

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Randall Pozdena knew how rare it was to make $6.3 billion in a year. He had watched the state's pension fund do it in 1999.

He knew it couldn't last.

As chairman of the Oregon Investment Council, a governor-appointed panel, Pozdena oversaw the state's pension trust fund as huge Wall Street investment returns poured in during the 1990s.

He also watched as another state panel, the Public Employees Retirement Board, each year took the investment returns and put them, billions at a time, into public employees' pension accounts.

The money by law belonged to public employees who are members of the pension system.

But Pozdena, an economist, knew employee accounts were being pumped up with paper stock profits, billions that could quickly turn to vapor. He believed the PERS board wasn't saving enough money for the inevitable day the stock market stumbled.

"That's a defiance of financial gravity," he told the board in January 2000, echoing his earlier warnings.

PERS board members sounded concerned as they discussed Pozdena's warning -- and then didn't heed it.

They dumped nearly all the $6.3 billion into employee accounts and left the system's rainy-day fund -- intended to protect against downturns in the stock market -- short by $1.5 billion.

"They knew what they had to do to protect the system," Pozdena says now. "They didn't do it. It turns out it was the last chance they had."

Today, Wall Street is getting the blame for PERS' problems. And PERS' financial tailspin certainly grew worse when it lost money as the stock market fell in 2000 and 2001.

But it's not that simple.

Oregon's pension fund started the 1990s fully funded, raked in $27 billion from investments over the next decade and should have been fat for years to come.

Instead, PERS is now in the worst financial straits it has seen in decades, and it will cost, beginning in 2003, $260 million more a year of public money to make up for the lost ground.

How did this happen?

The answer lies with haphazard laws and the operation of an obscure but immensely powerful panel, the PERS board, that repeatedly acted to improve public employees' pensions without regard to the system's long-term financial health.

It all went unnoticed for years, shaded by the historic days on Wall Street. Almost no one questioned how PERS operated. Pension officials assured everyone that they knew how the system worked and that it was under control.

This is the story of how that all changed, what happened when someone did raise questions, and why the answers mean bigger costs to Oregon taxpayers.

The making of Money Match

When a public employee retires, PERS calculates the size of the pension using three different formulas. Two of the formulas are based on the employee's years of service and final salary. The third formula is based strictly on the amount of money that's accumulated in the employee's retirement account. PERS takes the face-value of the account and requires taxpayers to double it. This formula is nicknamed Money Match, and more than 90 percent of retirees now use it to calculate their pensions.

But Money Match did not turn out as planned.

When the Legislature created PERS in 1946, Money Match was the only pension calculation. But Money Match proved inadequate. Employers and employees both contributed to retirement accounts, but the accounts grew so slowly that too many public employees faced retiring with too little to live on.

So the Legislature in 1967 did away with Money Match. Lawmakers replaced it with a pension based in part on the face-value of the employee's account but also based on final salary and years of service. Everyone agreed it was a richer deal for employees.

The next year, however, PERS officials discovered a few employees would have done better under the old system. The new formula cheated them. So PERS officials asked lawmakers to restore the Money Match in a limited way.

"(PERS) has found that in one or two occasions that employees would be entitled to less money under the 1967 act than under the prior plan," according to testimony before the Joint Ways and Means Committee on May 7, 1969.

So lawmakers made what everyone thought was a technical and largely meaningless fix. But they fumbled it. Instead of writing a bill that restored a very limited Money Match for existing employees -- for the "one or two occasions" cited by PERS -- lawmakers left the bill's language so broad as to cover every public employee in Oregon, then and in the future.

No one noticed. Not for a long time.

In 1975, the Legislature voted to guarantee that public employees' retirement accounts would grow every year, no matter what. The decision came after accounts took a beating from Wall Street investments. Today, most retirement accounts are guaranteed to grow annually by at least 8 percent.

In 1981, the Legislature decided to add another retirement formula, one based solely on years of service and a worker's final salary. Lawmakers set a clear goal with the new formula: Public employees with at least 30 years of service (25 years in the case of police and firefighters) should receive a pension equal to about 50 percent to 60 percent of their final salary.

Everyone -- PERS officials, lawmakers and union lobbyists -- saw this as another major improvement for public employees.

No one gave a second thought to the Money Match calculation still on the books.

"Everyone still believed the Legislature had never intended for Money Match to have any consequence," says

Paul Hart, the PERS actuary who testified for the agency before the Legislature in 1981. "So no one talked about it or bothered to delete it."

Tapes from the 1981 Legislature bear that out.

When the pension bill reached the Senate floor, Sen. Keith Burbidge, D-Salem, read a statement that claimed this new formula -- based on years of service and final salary -- "replaces" the only other pension formula, which he said was also based on years of service and final salary. When the bill reached the House, Rep. Ed Lindquist, D-Portland, read the same statement.

The claims were inaccurate. No formula was being replaced; a new one was being added.

Moreover, the statements showed that lawmakers thought there were two -- and only two -- ways to calculate a PERS pension, and both were based on the employee's years of service and final salary.

No one said anything about a third calculation -- Money Match -- that required the doubling of employees' accounts and remained untouched by the new law.

With the Legislature rushing toward adjournment, not a single lawmaker rose to debate the bill or even ask a question. The Senate and House approved the bill and went home.

Money Match sat there in the law books, overlooked, ticking like a bomb.

Stock market surprise
Part of the reason that Money Match didn't alarm anyone was that the cash value of employee accounts still grew slowly, thanks to a moribund stock market in the 1970s.

What's more, employee salaries kept climbing, and -- as the Legislature had intended -- salaries played a major role in retirement benefits.

Then all that changed.

During the 1980s, many public employees went years without raises. Meanwhile, the stock market began a steady climb. The Oregon Investment Council -- including the state treasurer and four members appointed by the governor -- started to take better advantage of the rising stock market.

Slowly, the way public employees' pensions were calculated shifted in favor of Money Match. In fewer cases, the calculation would depend on the employees' salary and years of service. In more and more cases, the calculation would be driven by what was happening on Wall Street.

The shift also gave the PERS board -- with its members appointed by the governor -- greater power to increase retirement benefits across the board.

In the years when the PERS fund had low investment returns, the system had to dip into its savings to pay the 8 percent guarantee.

But in good years, the PERS board had a choice. It could put the extra money into employee accounts, increasing them by more than 8 percent. Or the board could take that extra money and put it in a rainy-day fund for those years the returns were low again.

How much should the board save? As a rule, board members agreed that they should keep enough money on hand to meet the 8 percent requirement for 24 months. Doing so would mean putting less money in employee accounts.

But year after year, PERS records show, the board increased employee pension accounts by shortchanging its rainy-day fund.

Money Match magnified the impact. PERS records show the board was warned as early as 1990 that increasing employee accounts above the 8 percent guarantee would accelerate Money Match and increase costs.

Still, many PERS board members saw it as their duty to increase retirement accounts as much as possible, even if that meant putting less money aside in reserves.

"If you put the money in reserves, then it wouldn't be there for someone who might be getting ready to retire," said Glenn Harrison, a Linn County math teacher who served as PERS chairman from 1993-94. "There was also a lot of doubt that we needed to have that much in reserves."

But other PERS board members grew increasingly alarmed at the practice.

"We realized very early on Money Match was increasing costs," says Peter Ozanne, a Portland lawyer who simultaneously served on the PERS board and the Oregon Investment Council.

By the mid-1990s, Ozanne said, the board heard reports of people retiring with more money than they were making while working.

"We knew that could not be maintained," he said.

PERS board minutes show Ozanne often tried to push the board to save more money. He was not successful, he says, because public employees controlled the PERS board.

Back in 1987, the Legislature had expanded the PERS board from five members to nine to create more seats for government managers along with union representatives. The number of seats for people from the private sector was cut from two to one.

"Eight of the nine people on the PERS board had a financial stake in the pension system, and that was the reality that drove the board's majority," Ozanne said, "It was to pass on as much as it could to current members without much regard to the future."

Fuzzy math
Enter Randall Pozdena.

He had taught economics at the University of California at Berkeley and had served as vice president of the Federal Reserve Bank of San Francisco before coming to Portland as managing director of ECONorthwest, a consulting firm.

When Gov. John Kitzhaber named him to the Oregon Investment Council in early 1995, Pozdena still felt new to Oregon and had little at risk in the state's political scene.

"That allowed me to speak my mind," Pozdena says. "Which I did."

At first, Pozdena struggled to understand how PERS really worked.

"I'm a Ph.D. in economics, and even I didn't understand PERS right away," Pozdena says. "But something about how it worked didn't seem right."

In January 1995, during one of his first investment council meetings, Pozdena listened as Mark Johnson of Milliman & Robertson, the PERS actuary, described how the pension system worked.

According to a tape of the meeting, Johnson explained that PERS assumed retiree accounts would grow, on average, by 8 percent a year.

That troubled Pozdena.

He could see that PERS guaranteed employees 8 percent in their accounts. But he also saw that the PERS board often increased retirement accounts by more than that -- and that the system's liabilities would grow faster than planned.

"Which means," Pozdena said, "the fund is less well-funded than it appears."

Johnson didn't agree, but he did note that PERS has a safety valve if someday it can't afford to meet the 8-percent guarantee: the rates charged to government agencies would be increased.

"There is something to fall back on," Johnson said. "And it is the taxpayer."

8 percent guarantee adds up

In 1995, the Legislature decided to end the 8 percent guarantee for employees hired after Jan. 1, 1996, creating a second "tier" of PERS members. In time, this second tier will begin to slow down the growth of the pension system's costs but not for 10 to 15 years, according to PERS estimates.

In the meantime, the 8 percent guarantee for previous members -- called Tier 1 -- will dominate and require PERS to put money aside to meet the costs.

And the actions of the PERS board have only increased that domination, compounding the costs of the 8 percent guarantee.

During the 1990s, as Pozdena had noted, the PERS board had increased employee pension accounts by an average 13 percent a year. Increasing the accounts faster meant the 8 percent guarantee would cost more later.

Even with that, Jim Loewen thought the PERS board could do even more for employees.

Loewen, named to the PERS board in 1992 by Gov. Barbara Roberts, worked as a counselor at the state's MacLaren Youth Correctional Facility in Woodburn.

Loewen also was a high-ranking official in the Oregon Public Employees Union, the largest union for state workers. He served as vice president of the union and chairman of its political action committee, helping steer campaign contributions.

Loewen had seen a few bad years on Wall Street that forced the PERS board to dip into its savings to meet the employees' 8 percent guarantee.

Still, he questioned the PERS board's policy to keep 24 months' worth of money in the rainy-day fund.

"That two-year figure was just pulled out of the hat," he said.

The board settled on an 18-month cushion. Doing so freed up at least $1 billion a year that could be used to increase pensions.

But it also raised the odds the system could come up short and the rainy-day fund would dry up if the stock market turned sour.

PERS board members asked their actuary, Johnson, what the odds were of that happening. Johnson said they were about one in five.

"I thought that was a very significant risk to take," Johnson said in a recent interview. But he noted that the board wanted only his analysis of the odds, not warnings.

"I was asked a very specific question," Johnson said. "I gave a very specific answer."

Loewen liked those odds and lined up a majority on the board. Not everyone went along.

"We had some very tough conversations about this over coffee during breaks in the meetings," said one PERS board member, Bud Hakanson, who served as president of Umpqua Community College in Roseburg and Clark College in Vancouver.

"The union members were all over me about this."

Hakanson said his experience in running colleges had taught him to save money where you can. That meant you didn't reduce your savings.

"I didn't see the sense in it," he said.

The board approved Loewen's plan on Feb. 11, 1997. With other opponents absent, Hakanson was the lone vote against it.

Today, Loewen acknowledges the decision looks different to him.

"In hindsight, one would probably not do that again," he says. Yet Loewen thinks the PERS fund can grow out of its current shortfall.

"I trust the American economy," Loewen says. "We trust our actuary. The entire economy runs on actuaries. Unless they have made a horrible blunder somewhere, the numbers in the end will balance."

"It shocked everyone"

But Money Match knocked the system off balance. In June 1998, Johnson, the PERS actuary, told the board that the stock market's faster-than-expected growth meant Money Match now was the formula most retirees used. PERS wasn't prepared for those costs.

"It shocked everyone," said Fred McDonnal, then the PERS executive director. "Money Match came along with big returns from Wall Street and upset the apple cart."

In 1999, PERS increased payroll charges to government agencies to cover the growing Money Match costs.

Today, government agencies contribute $84 million each year -- on top of all the other PERS costs -- to pay for Money Match.

It's a result Randall Pozdena had worried about.

For years, Pozdena sat on the Oregon Investment Council, unhappy about what he saw at PERS. He had no power to change it.

But in 1999, he became the investment council's chairman, and he gained the power to raise new questions.

Pozdena launched his own inquiry into the pension system's finances, sidestepping the PERS actuary and ignoring the objections of PERS staff. He asked a company under contract to the investment council, Frank Russell Co., to study the situation.

The September 1999 Russell report stunned everyone: PERS officials, investment council members and even Pozdena.

The report warned that if the stock market turned sour, there was virtually no way PERS could earn its way out of the hole.

The PERS board's actions to rapidly increase employee accounts meant the annual cost to meet the 8 percent guarantee had grown huge: $2 billion a year by 2000. Because the PERS board had in turn put away too little money, a flat stock market could send PERS spiraling downward quickly.

When the report was issued, the market hadn't faltered yet. The report presented a worst-case scenario in which the PERS fund lost money and predicted the shortfall could balloon to $10 billion within five years.

As it turns out, the stock market's decline pushed the current shortfall to $8.5 billion in just two years.

At the time, the report came as a blow to the PERS board; one member found the news so shocking she called it an "ambush."

Yet the sobering news led the PERS board in February 2000 to increase its rainy-day fund. Rather than keeping enough money to cover the 8 percent guarantee for 18 months, the board voted to increase the target to 30 months.

Then, despite having just raised the target -- and despite all the warnings -- the PERS board again violated its own policy. The board voted to increase retirement accounts so much that it left the rainy-day fund $1.8 billion short.

"We didn't want to do the reserve all in one whack," says Dawn Morgan, the PERS board's current chairwoman and a former president of the Oregon Public Employees Union. "We wanted to do it gradually. In retrospect, all of us wish we had done the whole thing."

Still, the PERS board's efforts to set any more money aside angered public employee unions. They also resented what they saw as intrusion by Pozdena and the investment council.

"We thought Pozdena and the investment council were pushing buttons he had no business pushing," says Greg Hartman, lawyer for the PERS Coalition, a collection of the state's major public employee unions.

In May 2000, the union coalition filed a court claim, alleging that the PERS board's decision to set aside more money was outside the board's "range of discretion."

The union coalition agreed to withdraw the claim if PERS agreed to commission a new study that would determine just how much money PERS needed in the bank. PERS agreed and hired Pozdena's firm to do it.

The new study produced even more surprises for PERS officials: The pension system's costs could grow no matter what the stock market did, and the more volatile Wall Street was -- the more stock prices swung up and down over the years -- the bigger the costs.

Clock is ticking
What has been the cost of the PERS board's actions to date?

The Oregonian, using PERS financial records, reviewed how the PERS board has handled the system's rainy-day fund since 1995. The newspaper estimated what would have happened if the PERS board had not cut its savings targets and had fully funded the rainy-day fund.

The result: The PERS shortfall would be at least $2 billion smaller today.

When asked about the newspaper's analysis, Jim Voytko, PERS' current executive director, said that his agency has not performed a similar analysis.

"I'd say that the numbers you have are probably not that far off," Voytko said.

Estimates aside, what actually happened?

After two years of losses on Wall Street, PERS burned through its inadequate reserves and drove its rainy-day fund into the hole.

Of the system's total $8.5 billion shortfall, $2.3 billion is the rainy-day fund's red ink. The public has the luxury of years to close the system's overall shortfall.

But not so with the rainy-day fund.

The fund is supposed to help keep PERS stable. A little-known state law forbids PERS to carry a deficit in its reserve fund for more than five years.

The fund went into deficit in March. The clock is running. If time runs out, the law triggers an immediate bailout -- even if it totals billions.

"Which means it will end up just as the PERS actuary said it would," Pozdena says today. "On the taxpayer."

Caption:
Graphics -- Diagrams, charts by STEVE COWDEN and BRENT WALTH - The Oregonian -- HOW PERS WORKS: 1. Governments and employees contribute to pensions, 2. Money is invested, 3. PERS board allocates earnings, 4. Employee prepares to retire, 5. Employee retires; PERS retirees...
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