

Alaska Senate Finance Hearing of SB 121

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William B. Fornia Credentials

- Highest Actuarial Credentials
 - Fellow of the Society of Actuaries (1986)
 - Enrolled Actuary under ERISA (1984)
 - Member of the American Academy of Actuaries (1983)
 - Active in national actuarial organizations
- Author and Frequent Speaker
 - “A Better Bang for the Buck” (with National Institute on Retirement Security), 2008
 - “New Developments in DB/DC Plans”, National Council on Teacher Retirement, Anchorage, 2002
 - Frequent Testimony to Legislatures and City Councils
 - Regular Expert Witness

Sample Work History

- Corporate actuary for Boeing 1980-1984
- Alaska related experience
 - ARMB first ongoing review actuary 2005-2006
 - Audited Alaska PERS/TRS actuarial valuations 2009
 - Former leader of Buck Consultants' Denver retirement practice
- Consulting services for 22 statewide retirement systems in Alaska, Colorado, Missouri, North Dakota, Oklahoma, Puerto Rico, Utah, Texas, Wyoming and others.
 - Served as system actuary for most of these (including CO, MO, ND, OK, PR, UT, WY, Houston)
 - Currently working on pension reform with Ohio Retirement Study Council
- Expert testimony and consulting for pension systems, governments, and labor groups
- Other clients have included the US Department of State, Cities of Baltimore, Oakland and Philadelphia, IBM, US WEST and Ford Motor Company

Agenda

- Overview of SB 121
- Advantages of Including Defined Benefit Plan Option
- Financial Analysis of Defined Benefit Plan Option
- History of SB 121 Fiscal Notes and responses
- Discussion

Findings

- DB plan option is more economical for Alaska
 - DB more efficient delivery of retirement benefits
 - Helps keep jobs in Alaska
 - Provides the safety net others have from Social Security
- Have structured DB choice alternative at \$9,000,000 FY 2015 savings
 - Health cost risk shifted to employees
 - Higher employee contributions than current DB
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SB 121 – History & Background

- Two general types of retirement programs
 - Defined Benefit (DB): Annual pension or health care benefit are fixed in statute, contributions based on actuarial calculations
 - Defined Contribution (DC): Periodic contribution to account is statutory, benefits depend on what account accumulations will provide
- SB 141 closed defined benefit retirement and health benefits to those hired after July 1, 2006
 - Workers hired since then have DC accounts only
 - No secure retirement option or Social Security

More Background on SB121

- Several proposals have been introduced to permit DB program for those hired after June, 2006
- Extensive modifications have been made to achieve cost neutrality and concerns of risk
 - Continued opportunity for DC approach for those who choose
 - No adjustment for 2006-2012 DCR investment returns; can only purchase service based on actual DCR account balances
 - Costs set to be same or lower than latest DC tier
 - Increased worker contributions versus latest DB tier
 - Reduced health care benefits – retirees pay larger share of costs
 - Further reductions in benefits if health care costs increase beyond break-even cost levels

Key Features of SB 121

- Gives employees a choice between DC and DB
 - DC tends to be preferred by shorter service & younger workers
 - DB still very popular, particularly for full career workers
- SB 121 structures DB option to be cost neutral
 - Costs will not be more than current tier DC program
 - Worker contributions same as current DC tier
 - SB 121 also shifts much of the risk from the employers to the workers
 - Healthcare benefit will be reduced if employer normal costs increase

Other motives for SB 121

- Alaska public servants not covered by Social Security
 - Every state other than Alaska and Michigan offers Defined Benefit Option
 - Michigan public servants get Social Security, Alaska public servants don't
 - All private US employers pay at least 6.2% to Social Security; Alaska PERS employers pay 5.22%
 - Soon, Alaska will be largest employer in America with workers not covered by any safety net DB plan
- Current DC structure facilitates short service workers leaving Alaska public service for DB plan after a few years of service
- Retirement in Alaska is good for the State economy

Why should Alaska public servants have a Defined Benefit Option?

- By their nature, Defined Benefit (DB) plans provide workers what they need for retirement
- DB plans deliver benefits more efficiently than Defined Contribution (DC) plans, thereby saving money for same retirement benefit
- Particularly necessary because vast majority of Alaska public servants not covered by Social Security

Why DB option? – Secure Retirement Benefit

- Because DB plans “define” the “benefit” received by retirees, they can ensure appropriate benefit levels
- Individuals do not need to be concerned with investment volatility under DB plans
- Individuals do not need to be concerned with outliving their savings under DB plans
- Because DC returns tend to be lower, greater contributions would be required to attain same benefit level as DB

Benefits Available from DCR Program are Substantially Lower than from Latest DB Tier

	Teachers	Police & Fire	Other PERS
Hire Age	34	31	37
Retirement Age	59	56	60
Years of Service	25	25	23
DB Benefit as Percent of Final Average Compensation (defined under the terms of the plan)	58%	63%	55%
DCR Benefit as Percent of Final Average Compensation (calculated based on assumptions above)	34%	30%	30%
Reduction of Benefit % due to DCR program	24%	33%	25%

Illustration of Hypothetical Teacher Benefits - \$50,000 Final Average Salary



Why DB option? – Economic Impact

- Pensions account for more than \$1 billion in Alaskan economy
- Retirement System provides health care benefits
- DB option can provide inflation protection
- Provide benefits consistent with objective of worker retention and job stability
- DB Plan eliminates the risk of destitute former employee citizens becoming a burden on the State, as “Payer of Last Resort”

DB Plans Provide a “Better Bang for the Buck”

- The DB approach saves money compared to the DC approach. Three reasons ...
 1. DB pension plans pool “longevity risks”
 2. DB pension plans can maintain a better diversified portfolio because, unlike individuals, they do not age
 3. DB pension plans achieve better investment returns because of professional asset management and lower fees

Why DB? – More Economically Efficient

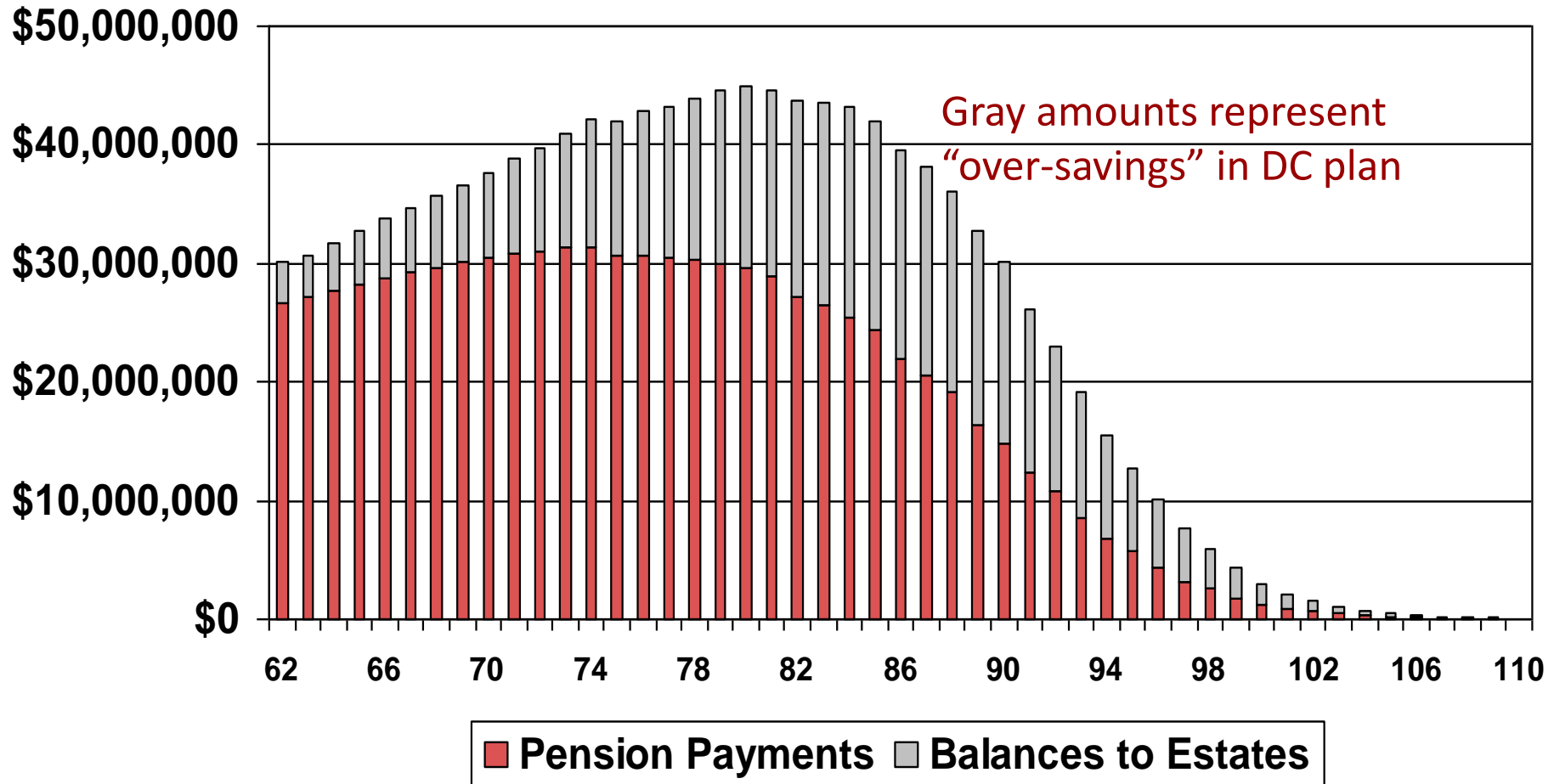
- ***Longevity Risk Pooling***
 - DB plans better manage longevity risk, or the chance of running out of money in retirement
 - DB plans avoid the “over-saving” dilemma and do more with less
- ***Maintenance of Portfolio Diversification***
 - DB plans are able to take advantage of the enhanced investment returns that come from a balanced portfolio throughout an individual’s lifetime
- ***Superior Returns***
 - DB plans, which are professionally managed, achieve greater investment returns versus those of individual accounts

1st Strength of DB Plans

Longevity Risk Pooling

- Because they cover large numbers of retirees, DB plans can pay out over the *average* life expectancy, not *maximum* life expectancy
- An individual under a DC plan will want to avoid the risk of running out of money if they live a long life
- Because individuals must plan for a maximum life expectancy, much more money must be accumulated in a DC plan, compared to a DB plan

Under a DC Plan 24% of Assets Are Not Used for Retirement – 1,000 Sample Teachers

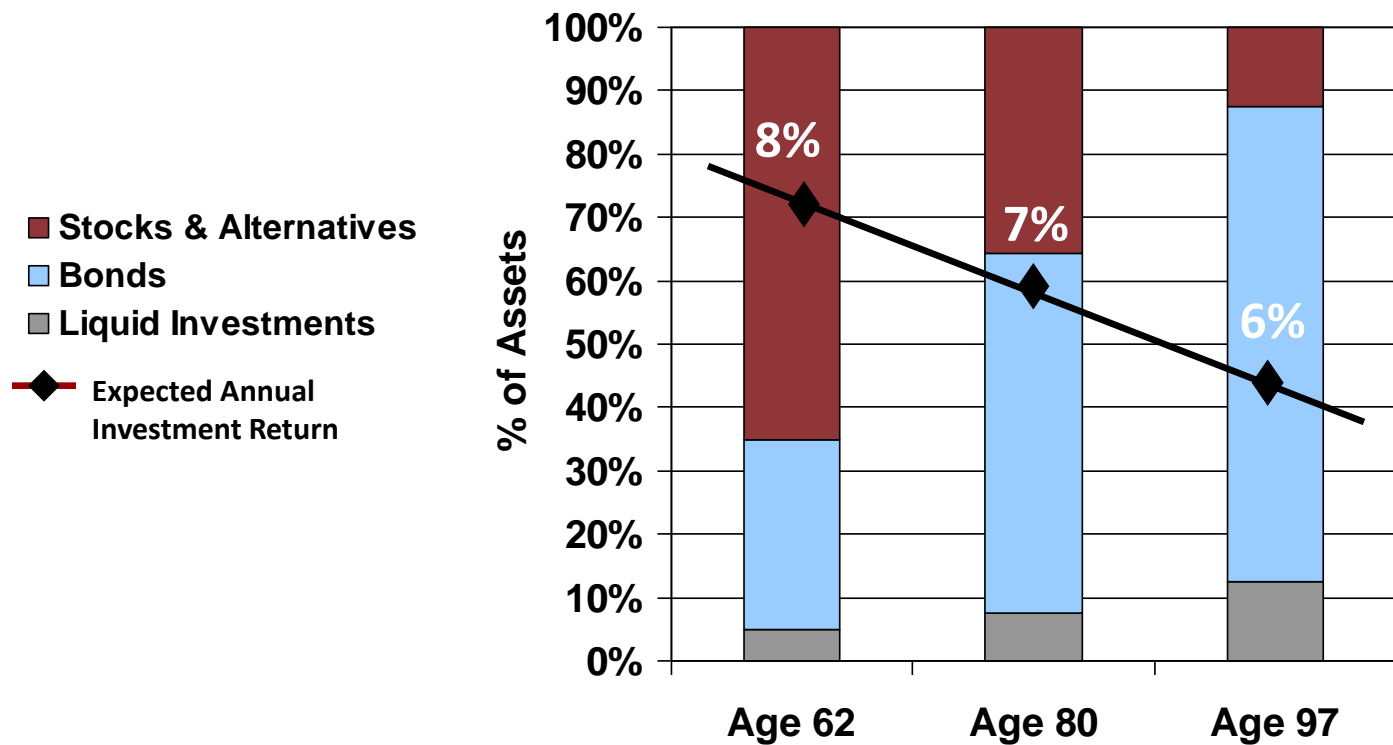


2nd Strength of DB Pension Plans

More Effective Portfolio Diversification

- DB plans can maintain a well diversified portfolio over time – unlike individuals, DB plans do not age
- To protect against market shocks, individuals in DC plans are advised to shift toward more conservative investments as they age, sacrificing some expected return
- Lower returns mean more money must be contributed to deliver the same level of benefits

As Individuals Shift DC Portfolio Allocation, Expected Return Reduced



3rd Strength of DB Pension Plans

Pooled, Professionally-Managed Assets

- Assets in DB plans are professionally managed. Despite their best efforts, individuals tend to underperform when it comes to investing in DC plans
- Pooled investments in DB plans can lower expenses
 - Large group pricing negotiation
 - Avoid expenses of individual recordkeeping, investment education, investment transactions
- Studies generally have shown that DB plan returns outperform DC plans by at least 1% annually
 - Towers Watson 1995-2008 large plans 1.27% outperformance
 - CEM Benchmarking 1998-2005 found 1.80% difference
 - Recent Alaska experience shows even larger DC shortfall
 - Even a mere 1% differential generates tremendous efficiencies – more than 20%

What about Unfunded Liabilities?

- Unfunded Liability has grown by more than \$5 billion since 2005
 - “Unfunded Liability” is attributable to prior benefits, not future benefits
 - SB 141 DC approach was not designed to solve unfunded liability
 - Several safeguards have been introduced to manage unfunded liability
- Addition of DB option not anticipated to increase unfunded liabilities
 - To the extent that actuarial assumptions’ conservatism is borne out, would actually decrease unfunded liabilities
- DB systems are advance funded, not left to future generations

Findings

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 - DB more efficient
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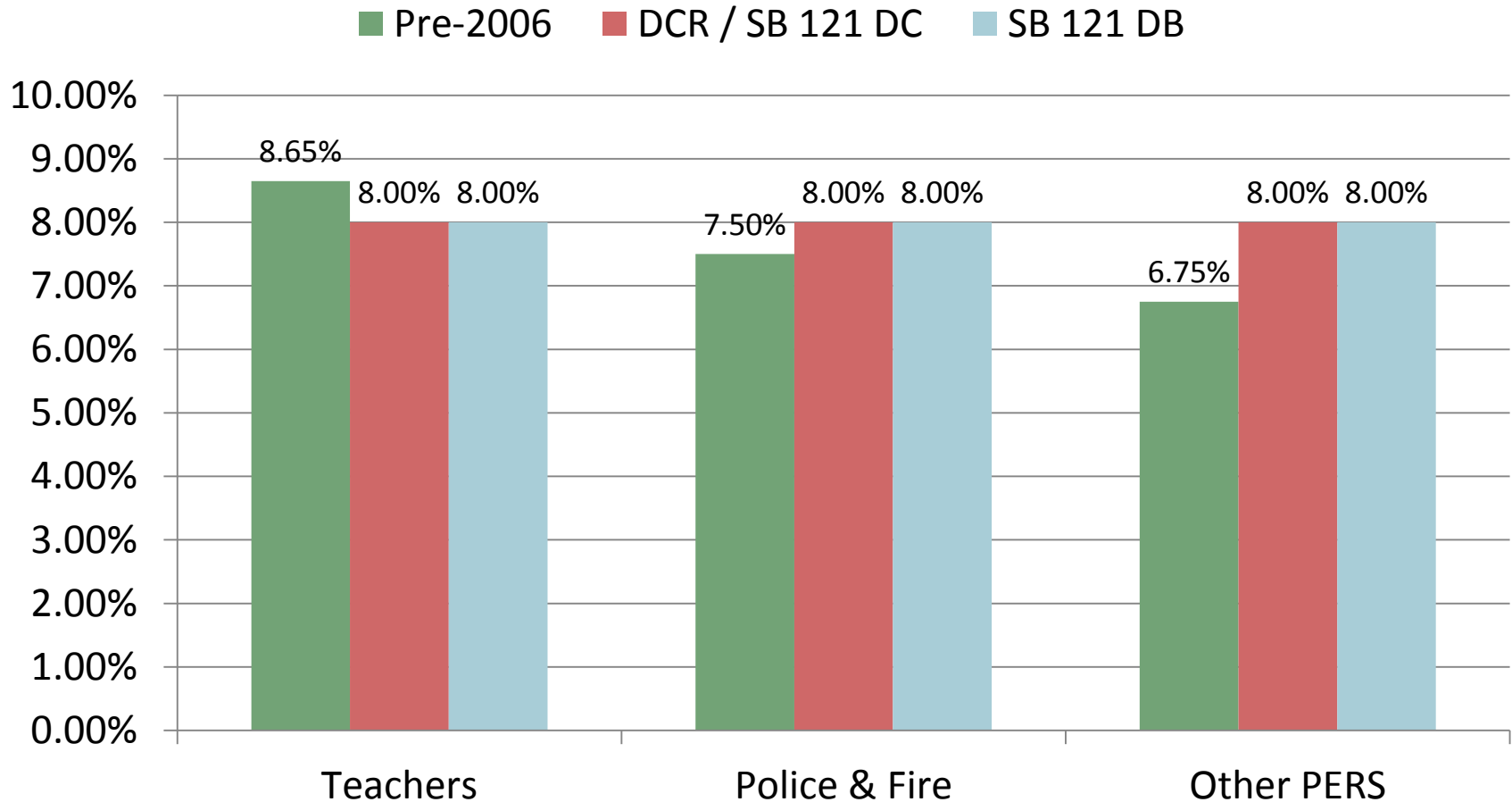
Challenge is to Design DB Option at Costs Comparable to DC Plan

- The actuary for the Alaska Department of Administration Division of Retirement Benefits regularly reports on the financial condition of the Alaska Public Employees' Retirement System (PERS) and Alaska Teachers' Retirement System (TRS).
- These analyses are conducted primarily through an “actuarial valuation”, which calculates the plans costs and liabilities.
- The actuary has calculated the Normal Cost under both the prior tier DB plans as well as under the DCR program.
 - “Normal Costs” are the cost of ongoing future benefits, not including cost to pay off “Unfunded Liability”
 - “Unfunded Liability” is attributable to prior benefits, not future benefits
- SB 121 has been modified to address initial cost concerns

Major implications of the proposal for those who elect DB

- Pension benefits will be the same as the prior defined benefit plan tiers for those hired prior to July 1, 2006
 - The tiers which were reduced in the 1990's
- Retiree DB health benefits will be stronger than those under DCR, but not as strong as those provided under the latest tier DB plans.

Contributions for Various Members



Retiree Medical Coverage

- Retirees eligible to receive retiree major medical coverage with subsidized premiums, under the following conditions:
 - Retired teachers are eligible with 25 years of service or at the age of Medicare eligibility [65] with at least 10 years of service.
 - Retired peace officers and firefighters are eligible with 25 years of service or at the age of Medicare eligibility [65] with at least 10 years of service.
 - Other PERS retirees are eligible with 30 years of service or at the age of Medicare eligibility [65] with at least 10 years of service.
- Retiree share of premiums range from 10% to 30% based on service at retirement
 - This range may increase or decrease in future based on experience

Cost Comparison Estimates - Teachers

Teachers Retirement System	DB Plan Tier 2	DCR Plan Tier 3	Proposed Tier 4
Total Retirement Normal Cost (including refunds)	11.39%	NA	10.84%
Member Contributions	(8.65%)	(8.00%)	(8.00%)
Net Employer Retirement Normal Cost	2.74%	NA	2.84%
DC Employer Contribution Rate	NA	7.00%*	NA
Medical Normal Cost Rate	5.33%	0.49%	6.39%
HRA Contribution Rate	NA	3.00%	NA
Total Employer Cost	8.07%	10.49%	9.23%
DCR Payroll during FY 2015	NA	\$116,432,000	\$116,432,000
Total Employer Cost on FY 2015 Basis	NA	\$12,213,000	\$10,748,000
Cost difference vs. DCR	NA		Saves \$1,465,000

* Includes DCR Occupational Death and Disability

Cost Comparisons – PERS Police Officers and Firefighters

Public Employees Retirement System – Peace Officers & Firefighters	DB Plan Tier 3	DCR Plan Tier 4	Proposed Tier 5
Total Retirement Normal Cost (including refunds)	12.30%	NA	12.08%
Member Contributions	(7.50%)	(8.00%)	(8.00%)
Net Employer Retirement Normal Cost	4.80%	NA	4.08%
DC Employer Contribution Rate	NA	5.22%*	NA
Medical Normal Cost Rate	5.90%	0.48%	6.00%
HRA Contribution Rate	NA	3.00%	NA
Total Employer Cost	10.70%	8.70%	10.08%
DCR Payroll during FY 2015	NA	\$35,710,000	\$35,710,000
Total Employer Cost on FY 2015 Basis	NA	\$3,107,000	\$3,598,000
Cost difference vs. DCR	NA		Costs \$491,000

* Includes DCR Occupational Death and Disability

Cost Comparisons – Other PERS Members

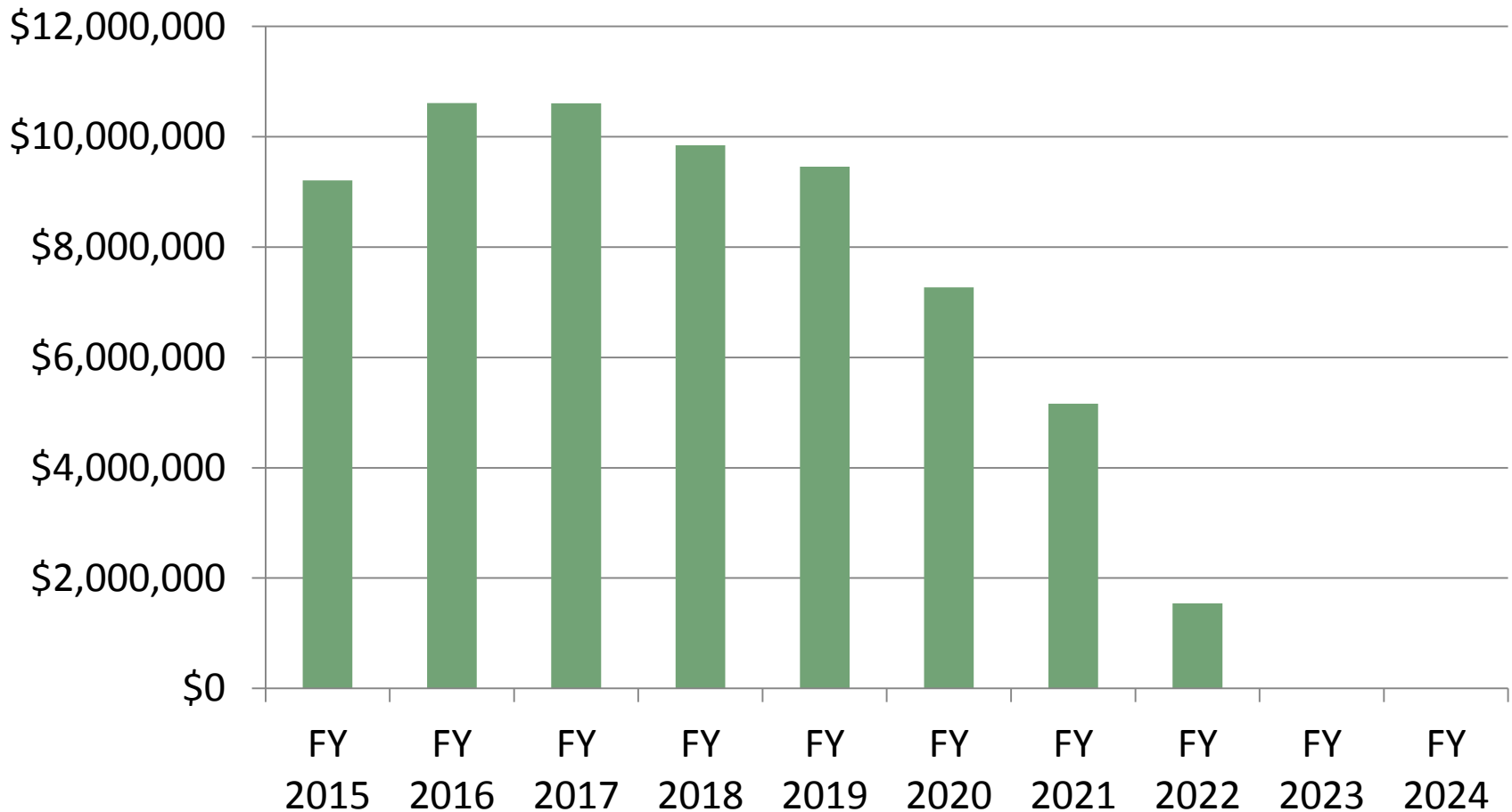
Other Public Employees Retirement System Members	DB Plan Tier 3	DCR Plan Tier 4	Proposed Tier 5
Total Retirement Normal Cost (including refunds)	9.58%	NA	9.45%
Member Contributions	(6.75%)	(8.00%)	(8.00%)
Net Employer Retirement Normal Cost	2.83%	NA	1.45%
DC Employer Contribution Rate	NA	5.22%*	NA
Medical Normal Cost Rate	7.00%	0.48%	5.06%
HRA Contribution Rate	NA	3.00%	NA
Total Employer Cost	9.83%	8.70%	6.51%
DCR Payroll during FY 2015	NA	\$374,608,000	\$374,608,000
Total Employer Cost on FY 2015 Basis	NA	\$32,591,000	\$24,355,000
Cost difference vs. DCR	NA	NA	Saves \$8,236,000

* Includes DCR Occupational Death and Disability

Results from Cost Comparison

- Stronger pension benefits through a Defined Benefit option for members hired since 2006.
- It would provide improved health care plan benefits, but no future HRA contributions.
- In total, 2015 employer costs would fall by about \$9 million.
 - More than \$60 million over eight years

Total savings anticipated of more than \$60 million over eight years

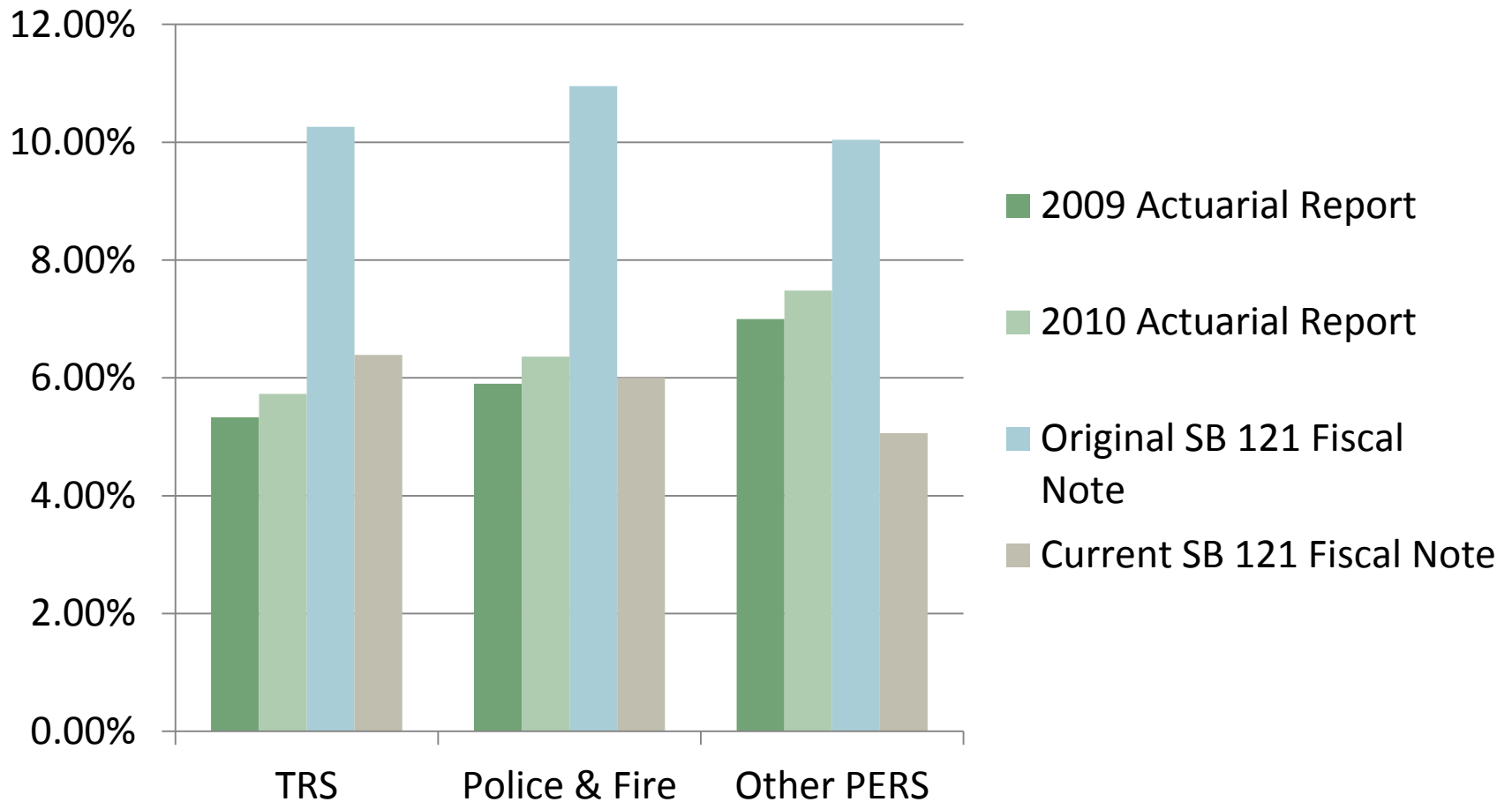


By 2023, based on fiscal note estimates, healthcare will decrease to maintain cost neutrality

Summary of Revisions to SB121

- Initial SB 121 essentially was return to prior tier
 - But with choice
 - Members could trade DCR accounts to get prior DB service
 - Future pension costs were neutral
 - But some past pension costs due to transition
 - And health costs were not neutral due to anticipated rapid increase in health care costs
- Revisions include
 - DB prior service can be purchased only, if DCR accounts not adequate, service limited
 - Increased worker contributions
 - Reduced healthcare benefits
 - premium share rather than full premium paid
 - only for full career retirees or post-Medicare
 - if normal costs increase, sharing would be reduced

Comparison of Healthcare Normal Costs



Conclusions

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