

Unfunded Liability in Alaska's Retirement Systems

Where It Came From and How to Eliminate It

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The purposes of this paper are to increase the understanding of Alaska's public retirement systems and to prompt discussion that will fill in the details of a plan to eliminate unfunded liability without paying hundreds of millions of dollars in annual state assistance. The paper begins with a description of Alaska's retirement systems (focusing on fiscal issues), and then presents a series of questions and answers that are intended to provide the background and options necessary to prompt discussion of how to best resolve the situation.

Alaska's two major government sector retirement systems—the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS)—have total unfunded liabilities in excess of \$11 billion¹. In simple terms, unfunded liability means that projected benefit payments are expected to exceed the level of assets required to pay those benefits. To give unfunded liability perspective and measure the health of retirement systems, actuaries use the ratio of system assets to system liabilities. A funding ratio of 100% means a system is fully funded—that is, it has no unfunded liability. The funding ratios for PERS and TRS are 62% and 54%, respectively. In short, standard measures of the health of Alaska's retirement systems show them to be woefully under-funded.

Unlike government in general, retirement systems have limited options to reduce expenditures. Because retirement benefits cannot be quickly or easily reduced, increasing assets of retirement systems is often seen as the only viable option for closing a funding gap.²

The standard actuarial method to increase assets is to increase employer contribution rates. Multiplying the annual contribution rate by an employer's payroll determines the amount of contributions each employer will pay, so higher rates bring in more contributions. Annual contribution rates are typically calculated in a way designed to make the system fully funded after a long period (25 years in Alaska).

As a consequence of unfunded liability, employer contribution rates in Alaska are very high and are projected to remain high for many years. The “normal” employer contribution rate—which is the rate that would be required to fund a retirement system in

¹ The \$11 billion figure is based on the actuarial value of assets; using the market value of assets increases the unfunded liability to about \$13.4 billion. Actuarial value is typically used to present and compare data on the soundness of retirement systems.

² Courts have ruled that employees have a constitutional right to accrued benefits. While benefits can be reduced—or employee contribution rates increased—for future employees, it takes several years for such changes to have a significant fiscal impact.

the absence of unfunded liability—is about 10% of payroll. For FY13, projected employer contribution rates are 35.84% and 52.67% for PERS and TRS, respectively.

Fortunately for employers, Alaska law caps PERS employer contribution rates at 22% and TRS rates at 12.56%. Unfortunately for the state treasury, Alaska pays the difference between the rate cap and the full actuarial rate. For example, for every \$100,000 paid to PERS employees eligible for a pension, the employer will pay \$22,000 (22%) to PERS, and the state will pay \$13,840 (35.84%-22%).

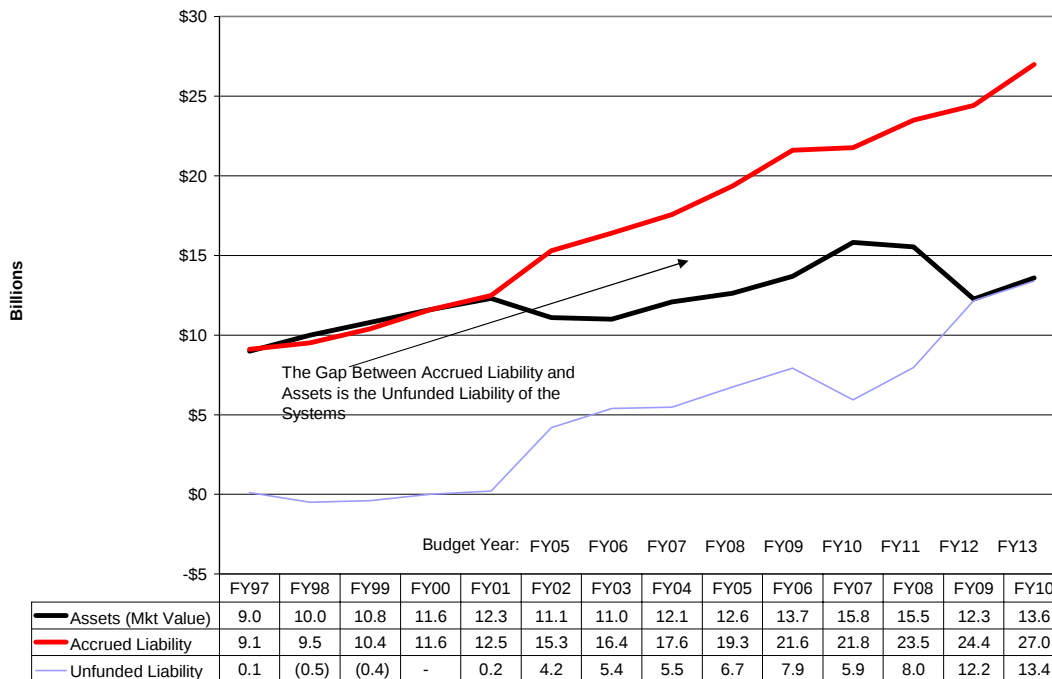
As payroll grows—both by the addition of employees and by higher salaries to individual employees—employer and state costs will increase. State assistance to retirement systems has grown from \$285 million in FY10 to \$358 million in FY11 to \$480 million in FY12. FY13 costs are expected to be \$610 million. The cost of state assistance is projected to continue to escalate—reaching a peak of \$1.2 billion annually before turning downward near FY30 as the number of beneficiaries declines. If the projections are accurate, annual state assistance to retirement systems will exceed Medicaid costs and may rival the cost of K-12 education.

The consensus opinion of government budget/policy staff is that Alaska cannot afford the projected level of state assistance. Even if oil prices remain high, production declines are likely to reduce state revenue in the future. The projected level of state assistance to retirement may leave us with little flexibility to meet other budget needs. The following questions and answers are intended to provide the background and options necessary to prompt discussion of how to best resolve the situation.

Who is responsible for the poor financial condition of Alaska's retirement systems?

The short answer is “no one—the problem is attributable primarily to investment losses and to revisions of actuarial assumptions.” A bit of history may help here. Until FY05, the state's actuaries claimed that Alaska's retirement systems were 100% funded. As shown in figure 1, the onset of unfunded liability was both sudden and profound. It occurred when a review of actuarial assumptions found that Mercer (former actuaries for Alaska's retirement systems) had been using outdated information to determine the condition of the retirement systems.

Figure 1. PERS/TRS Assets and Liabilities



So Mercer is to blame?

The role of actuaries in retirement system planning is critical. Actuaries integrate assumptions regarding rates of return, inflation, mortality, and numerous other variables into a model that projects the assets and liabilities of a retirement system. The model is used to determine the contribution rates required to keep the system healthy. Mercer's actions *hid* the problem, but they are not the primary *cause* of the problem. More accurately, we would still have a large unfunded liability even if Mercer had been more attentive.

Figure 1 offers a simple explanation of the developing fiscal problem. Replacing Mercer's assumptions regarding future benefit costs caused liabilities to increase by about \$2 billion in FY05, which is roughly half the unfunded liability gap that opened in that year.³ The remaining \$2 billion of the gap was due a decline in the value of assets—also caused in part by a revision of actuarial assumptions. If the condition of the retirement systems had been more accurately depicted, contribution rates in prior years

³ The funding gap actually opened in FY02. However, there is a three-year lag between events and reaction in Alaska's retirement systems. The financial condition of the systems at the end of FY02 determined contribution rates for FY05, which is when the budding fiscal problem first received widespread attention. As an example of the time lag, note that the financial market slide of 2008 and 2009 (as indicated by the downturn in the value of assets) affected rate calculations in FY11 and FY12. In this paper, references to years refer to the year for which rates are calculated (i.e., the budget year) rather than to the actuarial valuation year.

would have been higher (and the FY05 unfunded liability reduced). Note, however, that market losses in FY08 and FY09 account for at least \$5 billion of the unfunded liability gap (compared to what the gap would have been if assets had continued an upward trend).

While some argue that earnings on prior contributions (had Mercer's rate calculations called for them) would have narrowed the gap, there are a few points to consider:

- Mercer's actions caused a change in the timing of employer contributions but not necessarily a significant change in the amount of contributions—Mercer took no money from the systems.
- The impact of additional contributions (and earnings on them) would have been partially offset by additional losses in the market crash of FY08 and FY09.
- A statutory cap on rate increases prevented rates (in FY05 through FY07) from being set as high as actuarial calculations recommended.

Does the State—or the Alaska Retirement Management Board (ARMB)—bear some responsibility?

Neither the State nor the ARMB have contributed significantly to the fiscal problems of Alaska's retirement systems. In fact, Alaska's many positive actions include:

- Reflecting health care costs in the funding ratio. Although Alaska's retirement systems rank near the bottom in a nationwide list of funding adequacy, Alaska is one of the few states that include projected health care costs in benefit projections. Most other states overstate the funding adequacy of their public retirement systems by excluding health care costs.
- Holding the line on benefit increases. During periods of strong performance in financial markets, retirement systems often reach or exceed 100% funding ratios. Many states reacted to high funding ratios in the 1990s by increasing retiree benefits. Alaska did not increase benefits—we created a new, lower cost tier for PERS employees new to the system after 1996.
- Eliminating a statutory cap on annual increases in employer contribution rates soon after the cap began to limit rate increases.
- Paying the full contribution rates recommended by the state's actuaries. Several states reduced contributions as the recession strained budgets.
- Adopting realistic actuarial assumptions. It is tempting to make retirement systems appear to be healthier by modifying assumptions regarding rates of return, discount rates, inflation rates, life expectancy and many other variables that affect the calculation of funding ratios. The ARMB should be applauded for recently adopting a set of more realistic assumptions. These assumptions increased the calculated amount of unfunded liability by about \$2 billion.
- Replacing defined benefit plans with defined contribution plans. The primary difference between defined benefit (DB) and defined contribution (DC) retirement plans is assignment of risk. In a DB plan, the employer offers a defined level of benefits (typically a monthly pension) and absorbs the risk that deviations from actuarial assumptions—like lower-than-expected return on investment and longer-

than-expected payout streams—may increase the cost of providing the defined benefit. In a DC plan, the employer agrees to contribute a defined amount (typically a percentage of earnings) to individual retirement accounts and the *employee* absorbs all risk that his account balance will not be sufficient to provide the expected retirement benefits. Each type of plan has advantages and disadvantages to employees and employers, but there can be no debate that unfunded liability would be higher in FY12 if the State had not adopted DC plans. In essence, DC employees bore the brunt of market losses in FY08 and FY09. If those employees had been in a DB plan, system liabilities would be higher and *employers* would be responsible for replacing market losses.

Who is responsible for paying the unfunded liability?

The short answer is “employers.” But again, the answer is not as simple as one might think. Until the reforms of FY08, Alaska’s public employers (as in many states) had individual contribution rates that were based on the experience of each employer. Without legislative action, the average PERS contribution rate would have been over 32% for FY08, and some municipal contributions would have been more than 100% of their payrolls. To make matters worse, there was consensus that rates would go higher before beginning a downward trend and that rates would not go below 23% before FY30. With severe fiscal pressure—even bankruptcy—on the horizon, municipalities (and the State) wanted to make PERS contribution rates stable, predictable and affordable.

The solution involved three steps:

1. Adopting a shared cost system—meaning that liabilities, assets and payrolls were pooled and every participating employer paid a single contribution rate based on the blended experience of all participating employers.
2. Setting employer contribution rates at no more than 22% of payroll.
3. Shifting costs (in excess of those covered by the 22% rate) to the State.

These actions did not reduce the total cost of PERS, they simply provided financial assistance to political subdivisions. The State (as administrator of the retirement system) has no moral or legal obligation to provide assistance to municipalities (or other employers) for PERS costs; all participating employers are responsible for paying system costs.

Then why did the State agree to pay costs over 22% of payroll?

State actions were intended primarily to rescue political subdivisions from the brink of disaster. There were several factors involved in the decision:

1. The State was in a better fiscal position than local governments to address the problem.

- At the time, high oil prices provided surplus revenue to the treasury while increasing the costs of local government. PERS assistance was a way to share revenue with political subdivisions.
 - The magnitude of the problem appeared much less daunting than it does now. Actuarial projections showed the annual cost of PERS assistance would reach about \$70 million per year before falling to \$20 million by FY20 and to zero by FY30.
2. Actuarial models produced fund balances that were much higher than needed to pay benefits in the long term. This indicated that contribution rates were higher than necessary and that the true costs of state assistance might be lower than actuarial projections.
 3. There would be opportunities to revise actuarial methods to reduce or eliminate state assistance in the future if the cost of state assistance became unaffordable.

Those original projections of state assistance trending downward from \$70 million per year bear little resemblance to reality or to the revised outlook for continued escalation. Recall the discussion from page two—state assistance to retirement systems has grown from \$285 million in FY10 to \$358 million in FY11 to \$480 million in FY12. FY13 costs are expected to be \$610 million. The cost of state assistance is projected to continue to escalate—reaching a peak of \$1.2 billion annually before turning downward as the number of beneficiaries declines. The original projections did not anticipate billions of dollars of investment losses or the adoption (beginning FY13) of revised actuarial assumptions that increased the unfunded liability by another \$2 billion.

The revised outlook for costs of state assistance changes the entire landscape; because the State cannot afford the multi-billion cash outlay that is now projected, we must look for ways to reduce or eliminate annual state assistance.

Can the State simply stop paying annual state assistance?

Yes, under conditions outlined later in this paper.

There are two seemingly contradictory truths about retirement system funding:

1. Unfunded liability is a debt to the system.
2. Unfunded liability is a “soft liability” that can be extinguished in ways other than paying it off.

Those who take a hard line approach to retirement funding believe the debt must be paid, preferably as soon as possible because delays add interest costs to the existing debt. This approach implies contribution rates must remain at the actuarially recommended rate. Others argue that higher-than-expected earnings are just as effective as contributions when it comes to reducing the unfunded liability, and that overreaction to poor short-term investment returns is unwarranted. Several states have adopted this line of reasoning and have opted to pay less than the actuarial rate to their retirement systems.

But arguing about precisely how or when to close an unfunded liability gap misses the point. The underlying reason Alaska can stop making annual state assistance payments is that the legislature closed Alaska's defined benefit retirement plans to new employees.

Why does closing a retirement system allow us to ignore traditional rate calculations designed to pay off the unfunded liability?

In a typical defined benefit retirement plan, the actuarial objective is to maintain assets equal to accrued liability. In a typical defined benefit retirement plan, accrued liabilities increase every year. The upward trend is a function of:

1. the life history of employees—how many there are, how long they work, how much they earn, when they retire and when they die,
2. pension and health care formulas/agreements, and
3. inflation, which affects future salaries (which, in turn, affects benefits) and post retirement pension adjustments.

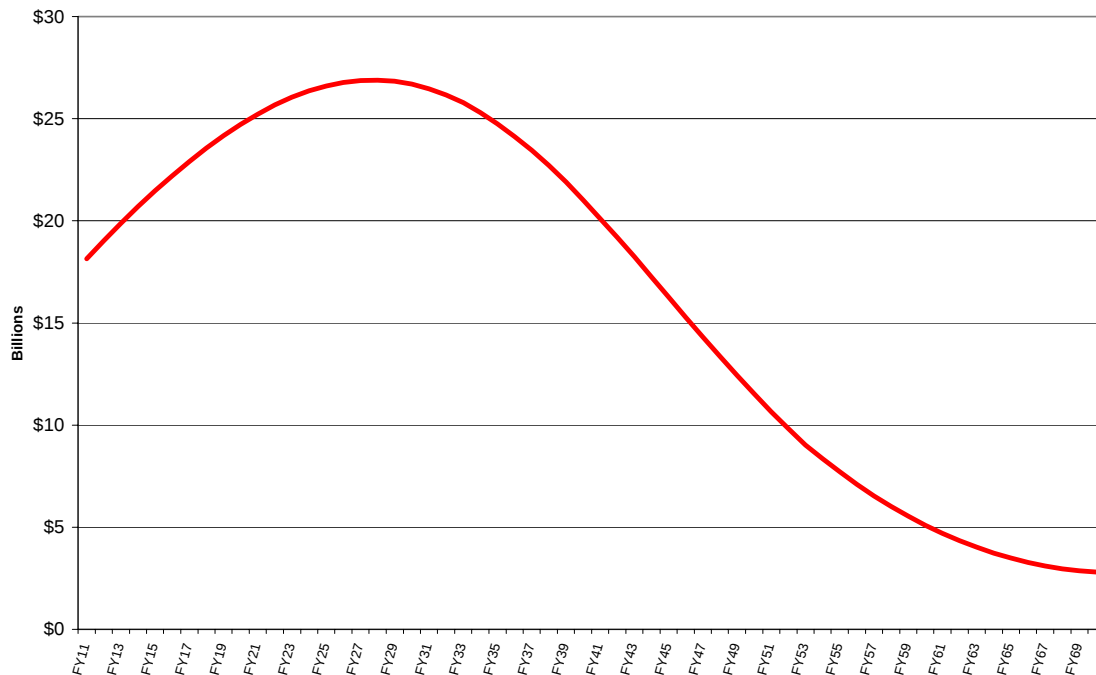
Once an employee is hired, there is little that can be done to control the accrual of benefits for that person. In attempting to match assets and liabilities, actuaries effectively take liabilities as a given; they focus on increasing assets to reach an ever-increasing level of accrued liabilities. Benefit payments (and investment losses) reduce assets, and the following items increase assets:

1. Earnings—but return on investment is typically an input of a model (and manipulating projections of asset values by using overly optimistic assumptions regarding earnings is not in anyone's best interest).
2. Employee contributions—but this rate is not typically subject to change due to constitutional provisions protecting accrued benefits.
3. Employer contributions—this is the primary variable used to generate asset growth.

The key to the ability to modify actuarial objectives is that Alaska does not have a typical retirement system. The traditional actuarial approach works well when liabilities are ever-increasing, as they are under an open system. Because Alaska closed PERS and TRS defined benefit plans to new entrants, a plotted line of liability will turn downward in the future. The lack of new entrants constrains the accrual of additional liability, and liability associated with those already in a defined benefit plan declines as retirees die.

The downturn can be seen (beginning near 2030) in figure 2, which shows projections for the accrued liability of the PERS system through 2070 (the last defined benefit plan employee is projected to retire in the early 2040s).

**Figure 2. Projected PERS Liabilities
Buck Baseline Scenario**



The year in which the downturn begins and the speed of the decline depend on assumptions built into the model. The exact location of the peak and the year in which liability reaches zero are not particularly important; the point is that the liability curve *will* turn downward and *will* reach zero when the last pensioner dies.

But doesn't closing a retirement plan to new entrants also mean that contributions will fade away as the number of participating employees declines?

Not in Alaska. *Another key point is that PERS and TRS employers pay contributions based on their full payroll, not just on the payroll of employees participating in defined benefit plans.*

For employees in PERS or TRS defined benefit plans, the full amount of employer contributions goes to retirement trust accounts from which benefits are paid. This is typical of retirement plans. For participants in PERS and TRS defined contribution plans, the employer contributes the normal cost—meaning a rate that does not include repayment of unfunded liability—to each employee's individual retirement account and to the shared health care trust. The remainder of employer contributions—the difference between the full employer rate (22% for PERS and 12.56% for TRS) and the normal cost of the defined contribution plan—goes to the retirement trusts to pay defined benefits. State assistance payments also go to trust accounts and reduce unfunded liability.

In short, contributions to the retirement trust funds need not fade away as defined benefit employees are replaced with defined contribution employees.

The situation doesn't sound fair—why do the trust funds get contributions for employees who are ineligible for pensions?

First, let's be perfectly clear that defined contribution *employees* do not contribute to defined benefit trust funds. It is *employers* that contribute, and those contributions are not made on behalf of particular employees, they are simply a way of paying the bill that employers owe. Payroll is just a way of allocating costs among employers. Using the full payroll reduces contribution rates. The potential distortion caused by using full payroll to allocate costs was considered to be insignificant relative to the employment discrimination that could have resulted if employer contribution rates varied for each tier that employees were in.⁴

But benefits outlays don't start to decline for almost 20 years. If there is no more state assistance, won't PERS employer contributions be fixed at 22% longer than they would be under the current approach? Won't that mean employers pay more than they should?

There is no question that reducing state assistance will keep employer contribution rates at 22% for a longer period. As an example of the impact of stopping state assistance, a test scenario with a \$2 billion deposit of state funds in FY13 extended the 22% rate by two years.

In fairness, the extension of the 22% rate does accurately portray the degree of cost shifting (from the State to employers) that could occur if annual state assistance is ended. Employer contribution rates drop from 22% to (near) zero in just two years under the baseline scenario. Under the \$2 billion deposit scenario, that rate cliff would be replaced with a more gradual decline. Because there are several factors that could affect how gradual that decline might be, no sample graph is included here.

The point to keep in mind is that the State is not responsible for paying off the unfunded liability—employers are.

⁴ Consider the example of a DB employee—with a retirement cost of 22%—competing for a job against a new employee for whom retirement contributions were only half as much.

If the state no longer provides annual assistance of hundreds of millions of dollars, how do we guarantee there will be enough money on hand to pay benefits when they are due?

There are no guarantees when it comes to making long-term projections involving many complicated variables. The best we can do is to have actuaries create a scenario in which there is no annual state assistance. Buck prepared such a scenario for both PERS and TRS. The models used to create the scenarios incorporate the assumptions recently adopted by the ARMB. The following discussion is limited to the PERS scenario.

A test scenario with employer rates capped at 22% and no annual state assistance indicated the PERS trust fund will be empty near 2040. But that is not an indication of failure of the concept. The purpose of the test scenario was to determine how large a one-time addition of money would be required to replace annual state assistance. As a starting point, Buck ran a scenario with a \$2 billion deposit in FY13. The results in figure 3 indicate that a \$2 billion deposit will be sufficient to pay benefits when due.

**Figure 3. Projected PERS Assets and Liabilities
with a \$2 billion Deposit in FY13**

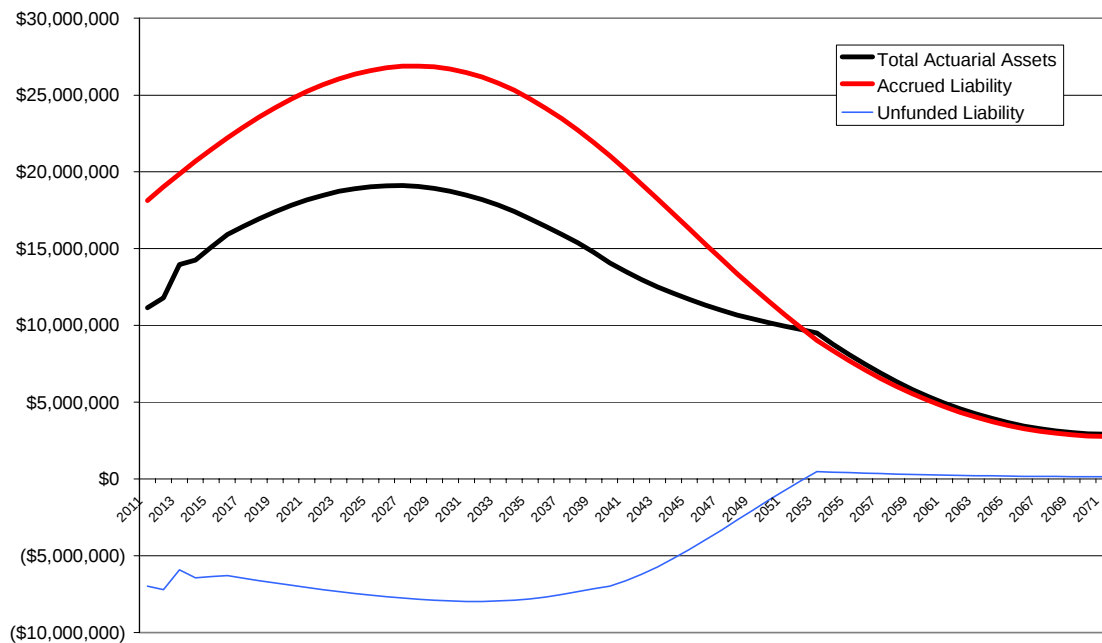


Figure 3 indicates that a \$2 billion deposit in FY13 would bring the funding ratio—the ratio of assets to liabilities—to 100% in the early 2050s. Put another way, the unfunded liability would be eliminated in the early 2050s. What figure 3 does not show is that the result is achieved with no employer contributions to the trust fund after the early 2050s; annual investment returns would be sufficient to pay annual benefits.

Need Buck to run scenarios with various up-front payments and various triggers for transfer from reserves to the trust. The easiest trigger is likely the funding ratio—money would transfer from reserves to keep the ratio above an arbitrary minimum. Money cannot be transferred from the trust to reserves, nor can contributions go to the reserve account. A secondary trigger to transfer from reserves to the CBRF would allow the state to recover the deposit and would keep rates above zero. All this stuff is needed to flesh out options and needs to be done before releasing this paper.

Why is a one-time deposit better than annual payments?

A one-time deposit isn't necessarily better; it is just more expedient:

- There is no guarantee that money will be available in the future (after operating and capital budgets) to make large projected annual payments, or that the legislature will vote to use any surplus revenue to pay down the unfunded liability.
- We currently have sufficient reserves to solve the problem with a single vote.

Wouldn't a one-time deposit deplete all reserves outside the Constitutional Budget Reserve Fund, particularly if there is a similar plan for TRS?

While one could argue that the source of money is unimportant from a technical perspective, the source *is* important from a political perspective. Without going into detail, let's assume that legislative leadership wants to adopt annual budgets without obtaining the supermajority vote required to access the Constitutional Budget Reserve Fund (CBRF). If we use non-CBRF reserves for retirement systems, a future reduction in revenue could quickly exhaust the remaining non-CBRF reserves, thus forcing annual supermajority votes to get a budget through the legislature.

For those who want to avoid annual supermajority votes, the better option is to make a single transfer from the CBRF to retirement systems.

But that would mean reopening a liability to the CBRF. Wouldn't that mean a return to the days sweeping available general funds into the CBRF at the end of each year, with an annual supermajority vote required to reverse the sweep?

Any withdrawal from the CBRF must be repaid (per Article IX, Section 17(d) of the State Constitution), and available general funds must be swept into the CBRF at the end of each year until the liability is repaid. But a supermajority vote limited to reversing the sweep has not been a political problem in the past and there are ways to minimize the impact of a sweep. Those actions include transferring balances subject to the sweep—

including the statutory budget reserve fund—to a non-sweepable fund such as the Alaska Housing Capital Corporation account. Necessary transfers can be made with a simple majority vote in any appropriation bill.

Is there a chance that we can recover the money from retirement trust accounts to repay the CBRF?

Once money is deposited to the trust accounts, it can be used only to pay benefits. But there is an option that avoids this problem. Rather than depositing money in the retirement trust accounts, we could create a reserve account from which money could be transferred to the trust accounts only as needed.

What are the advantages of a reserve account versus deposits to trust accounts?

When it comes to the ability to pay benefits when due, there is no difference between having a single account or two accounts. The primary advantage of the reserve account is that the reserve balance would be recoverable. We would have the flexibility to withdraw funds during a budget crisis or, in what appears to be a likely scenario, when benefit outlays decline to the point that reserves are no longer necessary.

Determining who “owns” the “leftover” money in a trust account is problematic. It is likely that a surplus balance in the trust would go the federal government as well as to state and local government employers.⁵ That is, it is more likely that the State could recover state assistance payments made to a reserve account than to a trust account.

The potential for recovery may be a critical factor in deciding where a one-time deposit should go. Modeling efforts show that the PERS trust may have “too much” money once benefit outlays begin to decline near 2040 (as evidenced by a very rapid decline in contribution rates once the system is fully funded). That problem would be exacerbated if a deposit to the trust account were followed by higher-than-projected earnings.

There are several options for setting up transfers from the reserve account to the trust account. Perhaps the simplest is to establish a statutory minimum funding ratio and make automatic transfers from reserves to the trust to maintain that ratio. For example, each year actuaries would compare assets in the trust to system liabilities, and if that ratio fell below 40%, the amount required to bring the ratio to 40% would be transferred from reserves to the trust. More sophisticated triggers could be developed as part of a legislative package, or the issue can be left for others to address in the future.

⁵ A federal claim to leftover trust funds would be based on the proportion of payroll paid with federal receipts. In response to an inquiry, the Department of Administration said that the federal government not only could, but assuredly would, expect recovery of a share of the trust when it was no longer required to pay retirement benefits.

Wouldn't the reserve account be subject to the annual sweep of available funds to the CBRF?

The reserve account would not be subject to the CBRF sweep if transfers from reserves to the trust did not require appropriation. This condition could be met with a trigger mechanism that transferred money under specified conditions, such as the funding ratio of the system.

What are the disadvantages of a reserve account versus deposits to trust accounts?

Deposits to the trust offer certainty that cannot be matched by annual state assistance payments or by a reserve account. For those seeking a guarantee of sufficient balances to pay future benefits, the flexibility offered by a reserve account will be seen as a disadvantage. Future legislatures could appropriate the reserve balance for purposes other than payment of benefits. This may appear to be a fatal flaw in the reserve account approach, but there is little practical difference between recapturing money from reserves and failing to pay state assistance.

Because reserve account balances are not dedicated to the payment of benefits, actuaries will exclude the balance from the calculation of “official” funding ratios. This will make the retirement system appear to be in poorer fiscal condition than it is, thereby potentially affecting state bond ratings. Again, this is not necessarily a fatal flaw.

- Actuaries can compute the funding ratio with and without reserves. While the former method does not conform to GASB (Government Accounting Standards Board) rules, those rules affect only the reporting of information—they are not standards of behavior.
- The approach can be explained to rating agencies, who may agree that the official numbers do not tell the complete story and conclude that establishing a defined contribution system and a reserve account are preferable (in that they put the state in a healthier fiscal position) to the significant annual state assistance payments that will be required if we do not address the problem.

What about earnings on reserve fund balances—where would they go?

The reserve fund would be invested by the ARMB and earnings would accumulate in the reserve fund, just as earnings on trust fund balances accumulate in the trust fund.

Earnings are a key component of the ability to pay benefits when due. Earnings on money transferred from the CBRF would be used to pay benefits (as necessary). Any balance not needed to pay benefits can be used to repay the liability to the CBRF or go to the general

fund. Because the liability to the CBRF is limited to the amount of principal withdrawn, the transfer to a retirement reserve fund is effectively a zero-interest loan.

Can we get by with a transfer of less than \$2 billion to PERS?

As noted earlier, peering 30 years into the future is not an exact science. A model scenario with no annual state assistance and \$2 billion deposit in FY13 shows that:

- employer contribution rates fall below 22% by 2040 and
- the total funding ratio—the ratio of trust fund assets plus reserve fund assets to system liabilities—hovers near 70% until about 2045, and then turns upward to reach 100% by the early 2050s.⁶ The current funding ratio is 62%.

These are indicators that \$2 billion is more than sufficient to maintain a healthy retirement system while eliminating state assistance. But the projections are very sensitive to investment returns—for example, the FY11 return of 20% generated about \$1.2 billion more than anticipated under an assumption of an 8% return. The higher-than-expected return is fiscally identical to a deposit paying off \$1.2 billion in unfunded liability.

In short, a few bad years of investment returns can make a \$2 billion deposit insufficient to keep the system healthy, while a few good years could make a \$2 billion deposit far larger than necessary to accomplish the goal of paying benefits when due without relying on state assistance. This variability underscores the advantage of establishing a reserve account. The \$2 billion figure is an arbitrary amount that allows for a little misfortune; if the deposit turns out to be more than required, surplus reserve balances can be returned to the CBRF or go to the treasury.

Why the focus on PERS—What about TRS?

PERS is far more complex than TRS. TRS is inherently simpler because the State is effectively the only employer. The cost to the State would be the same whether school district retirement costs were paid through the K-12 foundation formula or by paying state assistance directly to the trust fund.

It is important to understand that stopping PERS assistance could shift future costs from the state treasury to employers (including the state itself). Stopping TRS assistance would shift the timing of state contributions without shifting costs away from the state.

In determining whether to make a one-time deposit to TRS, there are several issues to consider:

⁶ Ideally, scenarios testing the sensitivity of results to deposit amount, rate of return and other variables would be available. We have not yet requested additional model runs.

1. If the objective is to reduce annual assistance payments, then the concept is as relevant to TRS as it is to PERS.
2. There will be a constituency that will have difficulty understanding why the legislature would address problems in only one of the two retirement systems.
3. The costs of funding the TRS system will be paid by the State, now or in the future. Other than waiting for high investment returns to fix the problem of high contribution rates—which is unlikely because employer contributions will decline as DC payroll replaces DB payroll—there is little reason not to follow the approach proposed for PERS.
4. The statutory employer rate for TRS (12.56%) provides very little headroom between normal rates (about 10.5%) and the statutory rate—meaning that employer contributions will decline significantly as the DB payroll fades away. The DC payroll under PERS will continue to generate money as the PERS DB payroll declines because the statutory (maximum) employer contribution rate of 22% is much higher than the normal rate.
5. Increasing the statutory TRS rate will not reduce state costs—it will simply move the costs from direct state assistance to state assistance through the K-12 formula (assuming that school districts are not expected to absorb the higher costs).
6. Even though TRS is roughly half the size of PERS, TRS would require a deposit of about \$4 billion to put the system on sound financial footing in the absence of annual state assistance.
7. As an alternative to making a deposit sufficient to eliminate annual TRS assistance, a cap on the actuarial rate (perhaps linked to the funding ratio) could be used to reduce payments.

Can this discussion be condensed to a step-by-step plan?

Assuming the goal is to replace annual state assistance with a one-time payment that is sufficient to ensure that future benefits can be paid when due, there are too many options to permit development of a firm plan at this time. A general outline—with some of the many variables and alternatives highlighted—follows:

1. Amend Alaska statutes to accomplish the following:
 - a. Establish a retirement reserve fund.
 - A single fund to address PERS? Should TRS be addressed? If so, are separate funds better than a combined fund?
 - Alternative: no reserve fund(s) required—deposit money directly to the trust fund(s).
 - b. Eliminate requirements for state assistance payable when actuarial rates exceed statutory rate caps.
 - c. Establish a trigger to transfer from reserves to the trust fund.
 - A more conservative trigger—meaning one that makes the system appear healthier by GASB standards—requires a larger deposit.
 - d. Establish a trigger to recover money from the reserve fund.

- Is there a desire to recapture any of the deposit? Only the original deposit? Earnings on the deposit?
- 2. Appropriate money from the CBRF to the reserve fund (supermajority vote required).
 - How much money?
 - Use savings other than the CBRF?
- 3. Transfer non-CBRF savings balances to nonsweepable accounts in order to minimize the impact of supermajority votes associated with an outstanding liability to the CBRF.

The outline is not intended to be comprehensive—its purposes is to prompt discussion that will fill in the details of a plan to eliminate unfunded liability without paying hundreds of millions of dollars in annual state assistance.

What about other options to reduce unfunded liability and/or state assistance?

When exploring options to solve a problem, it is useful to specify goals so that options can be evaluated in terms of their potential for meeting those goals. Agreeing on goals is not always an easy task—goals differ in priority from person to person, and some goals may not be shared by all parties involved in finding a solution. As a starting point, options are evaluated based on their potential for meeting the following goals:

1. Ensure that PERS can pay all benefits when due.
2. Retain the “22% deal” that makes municipal contribution rates as stable and affordable as possible.
3. Minimize annual state assistance costs.

To simplify the discussion, let’s assume that goals 1 and 2 are met so that we can focus on goal 3. Options that make progress toward goal 3 fall under one of three approaches:

1. Do nothing

This is a viable option. A few years of 20% investment returns—as occurred in FY11—would reduce annual assistance by reducing the unfunded liability. Even if investment returns on retirement trust funds are near the 8% projected, the State could use earnings on savings accounts or other revenue to continue to pay escalating costs of state assistance. Of course, doing so would not reduce budgetary pressure caused by a drop in revenue. In short, doing nothing works well as long as state revenue remains strong.

The reserve account approach outlined in this paper may appear to be a variation of the “do nothing” option because it relies on earnings from a savings account to eliminate state assistance. The key difference from the “do nothing” approach is that earnings on the CBRF are not currently part of the available revenue stream. By using a “new” source of revenue to fund state assistance, a reserve account created with a

transfer from the CBRF reduces potential budgetary pressure.⁷ Of course, reduced earnings in the CBRF would reduce the period that reserves could be used to balance the budget.

2. Accelerate the reduction of unfunded liability

For those who accept model output as our future reality, making higher near-term contributions is the only viable method to significantly reduce annual state assistance in the future. Unfortunately, any action that increases actuarial contribution rates is contradictory to the goal of reducing annual state assistance, assuming the state continues to absorb the cost of any rate above 22%. Raising employer contribution rates, making a one-time deposit or a series of smaller deposits are simply variations of the theme. It takes additional money to reduce unfunded liability.

The reserve account approach outlined in this paper adds money to the system. As discussed, the primary advantage of a reserve account (over deposits to the PERS and/or TRS trust accounts) is that it permits the State to recover the deposits if they turn out to be too large.

A **cash-out plan** is an alternative method to reduce unfunded liability. Instead of aiming to increase assets, such a plan is intended to reduce future liabilities. Under such a plan, retirees and/or beneficiaries would be offered a choice to receive a lump-sum payment in lieu of future pension and health care benefits. Because the lump-sum would be less than the present value of benefits, the unfunded liability would be reduced whenever a person chose the lump-sum option. The reduction of unfunded liability would depend primarily on:

- The discount from actuarial value—paying 99% of the present value of benefits would save little, if any, money, while paying 50% of value could result in substantial savings (if anyone chose an option with such a steep discount).
- The number of people that chose the lump-sum option—the participation rate would likely decrease as the discount from present value increased.
- Adverse selection—which is the tendency for those who expect a long retirement period to select a pension and those who expect a short retirement period to select the lump-sum. Couples with dual retiree health benefits might also tend to select the lump-sum option for one spouse.

Buck's analysis of the plan concludes that it could reduce unfunded PERS liability by \$91 million to \$485 million—which translates to reductions of annual state assistance of \$6 million to \$30 million. The analysis comes with the caveat that results are highly dependent on assumptions.

⁷ Use of general funds or money from savings accounts would not have the same effect as using “new” money from the CBRF; earnings from those sources are currently part of the available revenue stream.

Note that a cash-out plan—which addresses the liability side of the unfunded liability issue—is compatible with plans that work to increase system assets. There is little reason to focus on only one side of the issue.

3. Revise actuarial methods or assumptions in order to restate the magnitude of the problem.

Closing retirement systems to new entrants allows—but does not force—a reassessment of actuarial methods. Changing methods or assumptions in response to changes in retirement systems would be valid; changes made with the intent to hide the magnitude of a problem should be avoided. As noted in this paper, the ARMB recently adopted a set of assumptions that *increases* the calculated amount of unfunded liability.

The reserve account approach outlined in this paper does not revise actuarial methods or assumptions, other than changes associated with tracking money that is part of the system—reserve fund balances—but is outside the trust fund. Several changes in methodology—including shortening the amortization period in years when unfunded liability is paid down, refinancing outstanding unfunded liability, adopting a rolling amortization period, and redefining funding targets—that might reduce state assistance were discarded. They were discarded not because they are ineffective tools to reduce state assistance, but because retaining a common set of assumptions and methods facilitates the comparison of various options.