A Discussion of Retirement Systems in Alaska

Senate Finance Committee
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Are Alaska's Public Employee Retirement Systems Healthy?

If not, what can be done about it?

System Health refers to the likelihood that promised benefits will be paid when due.

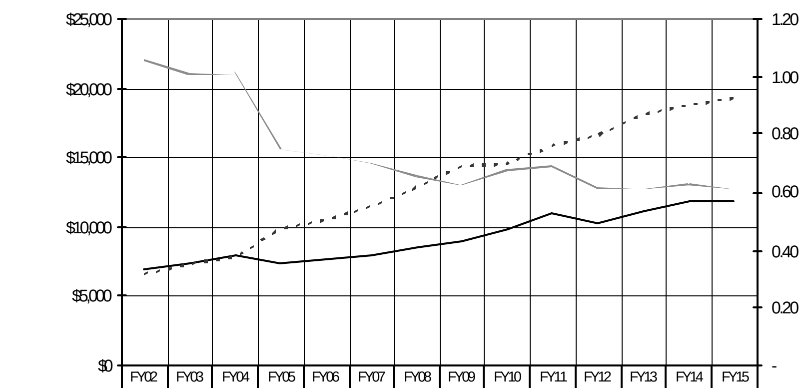
- **Defined Contribution (DC) Plans**
  - No promised benefit level
  - So no measure of health required

- **Defined Benefits (DB) Plans**
  - Promised benefits (pensions)
  - So it is it critical to track and maintain system health

Measuring the Health of a Retirement System

1. **Funding Ratio = Assets/Liabilities.**
2. **Unfunded Liability—just a dollar amount; not a relative measure.**
3. Are employers paying the actuarially required contribution (ARC)?
4. Are contributions causing financial stress?

PERS Assets and Liabilities

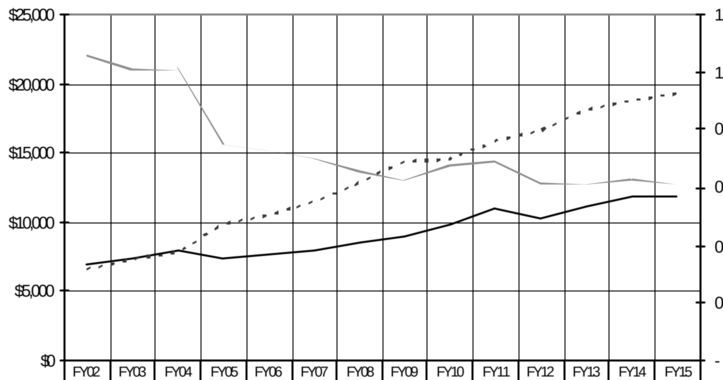


	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15
Assets	7,016	7,455	7,942	7,413	7,687	8,030	8,443	9,041	9,901	11,040	10,243	11,157	11,814	11,832
Liabilities	6,649	7,377	7,869	9,860	10,562	11,444	12,845	14,388	14,571	15,888	16,579	18,132	18,741	19,292
Funding Ratio	1.06	1.01	1.01	0.75	0.73	0.70	0.66	0.63	0.68	0.69	0.62	0.62	0.63	0.61

Unfunded Liability is the Consequence of Assumptions that Fail to Materialize

- **Benefits may exceed expectations**. (Liability increases)
- **Contributions or earnings may be less than anticipated**. (Assets fail to increase as expected)

PERS Assets and Liabilities



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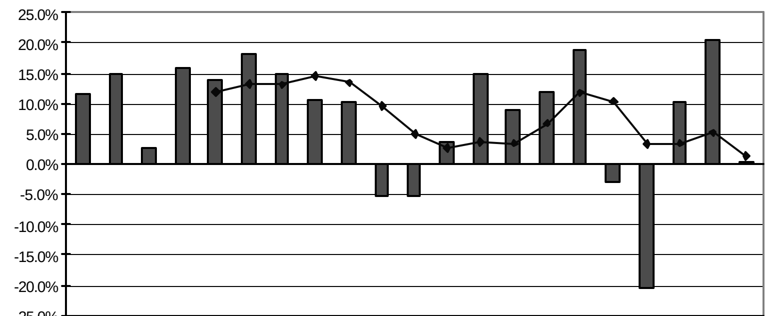
How Volatility of Investment Returns Affects Unfunded Liability

		Assets	Liability	Unfunded Liability	Funding Ratio	Contribution Rate
Year 1 Start		$ 12,000	$ 12,000	$ -	100.0%	
Benefits Payments		$ (1,000)	$ (1,000)			
Net		$ 11,000	$ 11,000			
Accrued Liability			$ 1,350			
Earnings	8.0%	$ 920				
Contributions (set in advance)		$ 430				17.9%
Year 1 End		$ 12,350	$ 12,350	$ -	100.0%	
Year 2 Start		$ 12,350	$ 12,350	$ -	100.0%	
Benefits Payments		$ (1,000)	$ (1,000)			
Net		$ 11,350	$ 11,350			
Accrued Liability			$ 1,378			
Earnings	8.0%	$ 948				
Normal Contributions		$ 430				17.9%
Past Service Contributions		$ -				0.0%
Year 2 End		$ 12,728	$ 12,728	$ -	100.0%	17.9%
Change in UL				$ -		

Rates of Return on PERS Investments



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Annual Rate of Return	11.6%	15.0%	2.7%	16.0%	14.0%	18.2%	14.7%	10.6%	10.2%	-5.4%	-5.5%	3.7%	15.1%	9.0%	11.7%	18.9%	-3.1%	-20.5	10.2%	20.4%	0.2%
5-Year Average Return					11.9%	13.2%	13.1%	14.7%	13.5%	9.7%	4.9%	2.7%	3.6%	3.4%	6.8%	11.7%	10.3%	3.2%	3.4%	5.2%	1.4%

Take-away Points Regarding Earnings

1. Earnings are volatile and unpredictable.
2. Small variations can be addressed by smoothing, amortization and good fortune.
3. When variations are small, unfunded liability is a soft liability that can be repaid with earnings (rather than contributions).
4. The road to recovery from large losses can be very long—so long that the system may appear to be broken.
5. The system is unlikely to stay broken in the long-run.
6. If you pay what you owe, the system will fix itself.
7. As time passes, assumptions are replaced with reality.

Measuring the Health of a Retirement System

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ARM Board Proposals

- Cash infusion of $1 billion to PERS and $1 billion to TRS.
- Adopt the level dollar amortization method in order to accelerate contributions.

Amortization Methods

- ***Level percent of pay*** amortization applies a constant contribution rate over the amortization period. Use of this method is near universal and is currently used in Alaska.

- ***Level dollar*** amortization splits unfunded liability into equal payments over the amortization period, much as for a standard home mortgage. Relative to the level percent method, payments to eliminate unfunded liability will be higher in the early years, and contribution rates required to generate level dollar payments will decline over time. Because the level dollar method has larger payments in the early years, it is sometimes referred to as "front loading."

The ARMB Proposals: Questions to Consider

1. Are the proposals necessary?
2. Does the path to full funding matter?
3. Are the proposals affordable?

Annual State Assistance Savings from $2 Billion Cash Injection (vs. Status Quo) (PERS Only)
(in $000)

Discount Rate: 0%

Years From Present	Year	Baseline State Assistance (Level Dollar and 8% Return)	Discount Multiplier	Discounted Baseline Assistance	State Assistance (Baseline plus $250 million in FY14-FY17)	Savings over Baseline Scenario	Cumulative Savings over Baseline Scenario
0	FY14	319,456	1.00	319,456	569,456	(250,000)	(250,000)
1	FY15	519,676	1.00	519,676	769,676	(250,000)	(500,000)
2	FY16	572,439	1.00	572,439	815,639	(243,200)	(743,200)
3	FY17	576,925	1.00	576,925	787,294	(210,369)	(953,569)
4	FY18	563,734	1.00	563,734	486,636	77,098	(876,471)
5	FY19	566,220	1.00	566,220	446,414	119,806	(756,665)
6	FY20	549,597	1.00	549,597	397,960	151,637	(605,028)
7	FY21	530,984	1.00	530,984	372,455	158,529	(446,499)
8	FY22	511,130	1.00	511,130	348,993	162,137	(284,362)
9	FY23	490,148	1.00	490,148	327,713	162,435	(121,927)
10	FY24	469,924	1.00	469,924	307,485	162,439	40,512
11	FY25	449,483	1.00	449,483	287,253	162,230	202,742
12	FY26	429,310	1.00	429,310	267,492	161,818	364,560
13	FY27	407,509	1.00	407,509	245,981	161,528	526,088
14	FY28	384,751	1.00	384,751	224,501	160,250	686,338
15	FY29	360,954	1.00	360,954	201,123	159,831	846,169
16	FY30	10,870	1.00	10,870	-	10,870	857,039
17	FY31	-	1.00	-	-	-	857,039
18	FY32	-	1.00	-	-	-	857,039

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What Fiscal Stress???

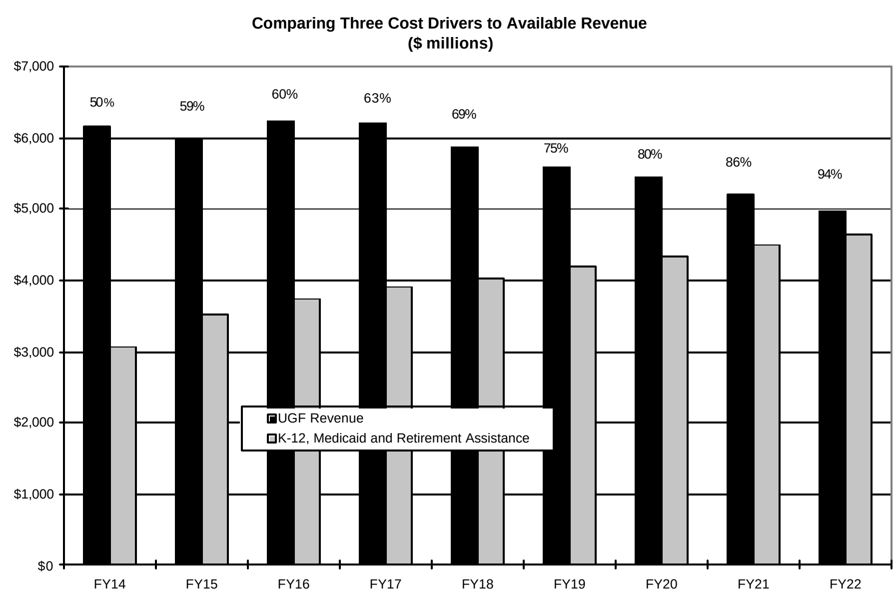
- The state may be paying too much into retirement plans, but it is better to choose to pay when we can afford it than be forced to pay when we cannot afford it.
- When budget surpluses turn into deficits, we can work to reduce state costs.
- Until then, state contributions reduce the magnitude of the future fiscal problem.

Books, Bonds and Budgets

- **Accountants**: Must report net pension liability on the balance sheet.
- **Rating Agencies**: Use a common set of assumptions to make system health comparable.
- **Legislators**: GASB no longer provides guidance.

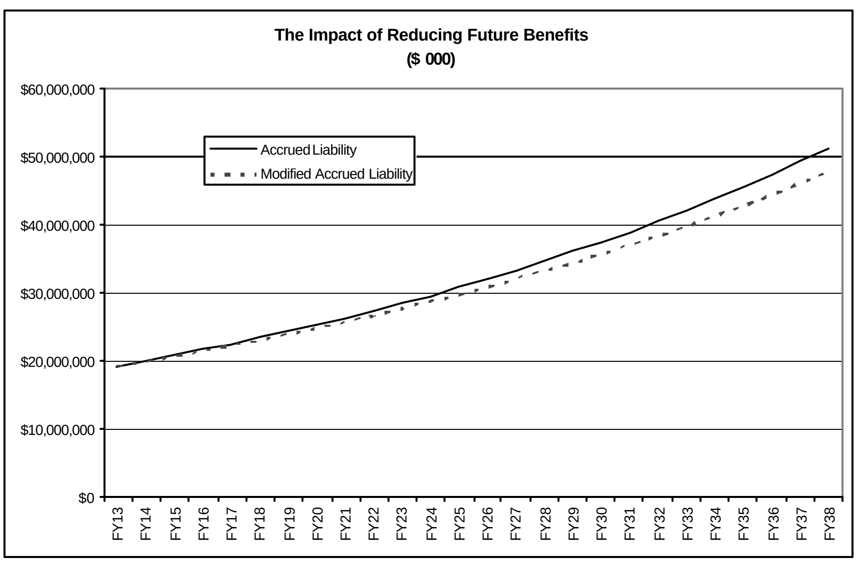
Advice from a National Pension Funding Task Force

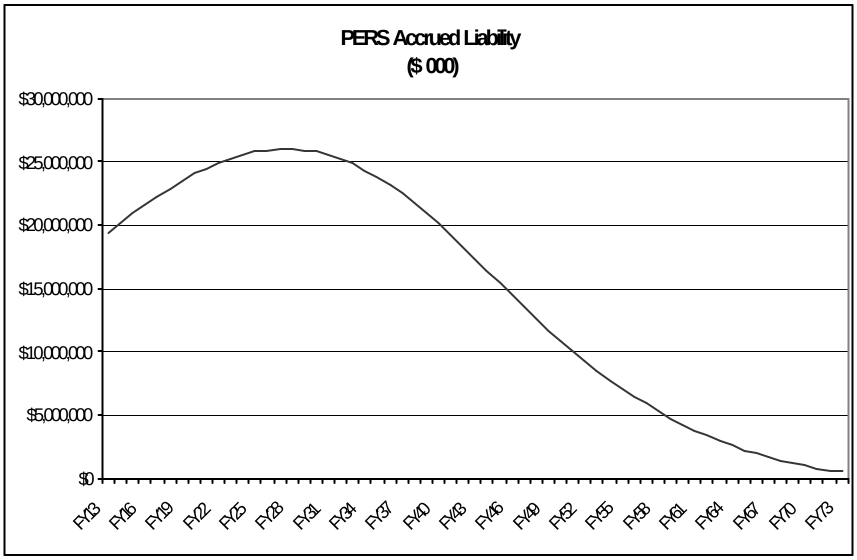
- **Put funding guidelines in statute.** Describe computation of the ARC (Annual Required Contribution). Show the plan to bring the system to full funding.
- The numeric approach offers sound guidance, but the funding ratio and other actuarial measures are not the most important measure of system health. **What really matters is what is affordable.**



What Other States Have Done to Improve Retirement System Health

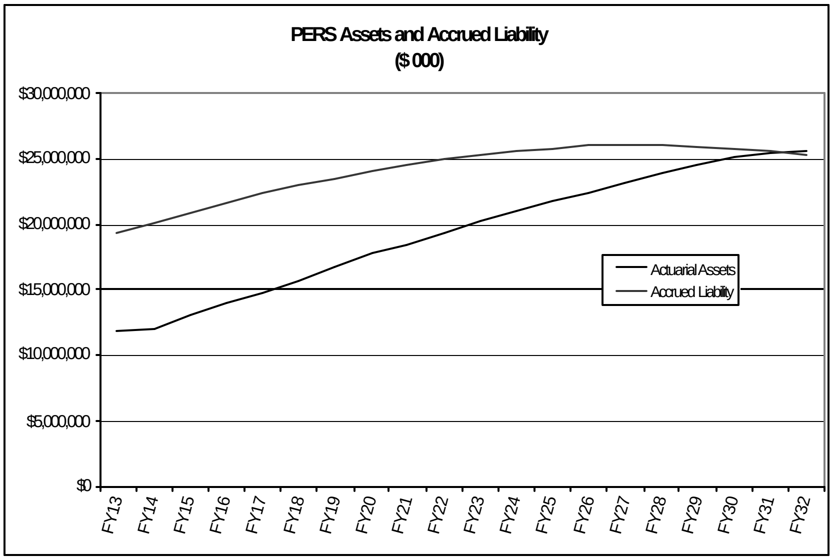
1. Increase Assets
   - Increase employee contributions
2. Reduce Benefits
   - Raise the retirement age
   - Increase service requirements
   - Reduce post-retirement adjustments
   - Adopt hybrid plans





A National Task Force Recommends that Pension Funding Policies:

1. Be based on actuarially determined contribution rates—and the calculation of rates should be in statute so the plan is clear to employees, retirees, administrators, boards, and legislators.
2. Collect a consistent percentage of payroll—use the Level Percent of Pay amortization method.
3. Be disciplined—to ensure that promised benefits can be paid (i.e., pay the ARC).
4. Maintain intergenerational equity (i.e., the cost of benefits should be paid by the generation of taxpayers that were served by the employees who earned those benefits).
5. Require clear reporting to show how and when plans will be fully funded and the progress toward that goal.

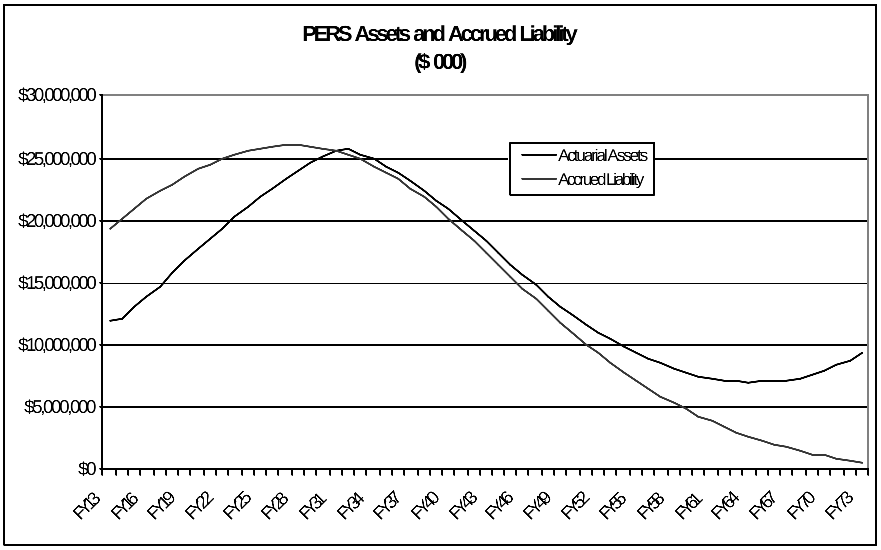


What is the Goal?

and

What Options Might Achieve It?

Goal: a healthy system—meaning a system with a plan to eliminate unfunded liability in a reasonable time at an affordable cost.



Recommendation: Reconsider an Approach like that in SB 187

- A cash infusion sufficient to maintain system health while capping employer contributions at 22%.
- No more state assistance—saving approximately $500 million annually for 15 years.