

LFD Informational Paper 21-2: Alaska's Public Retirement Systems

A Legislative Research/Legislative Finance Collaboration

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Overview

The State of Alaska provides [several retirement programs](#) to distinct groups of state and local employees and retirees. The Teachers' Retirement System (TRS) and Public Employees' Retirement System (PERS), enacted in statute in 1955 and 1960 respectively, are by far the largest. Collectively, over 87,000 employees and retirees of participating [municipalities](#), public K-12 [school districts](#), and the [University of Alaska](#) were members of these systems at the onset of fiscal year (FY) 2019. Since 2005, the [Alaska Retirement Management Board](#) (ARM Board) has served as the fiduciary of the State's retirement plans and controls investment of their considerable assets.

Pursuant to Article XII, Section 7 of the Alaska Constitution, membership by state and municipal employees in a retirement system is a contractual relationship and "accrued benefits" of these systems cannot be "diminished or impaired." The Alaska Supreme Court has interpreted this provision to mean that reductions to retirement benefits impact only employees hired after the effective date of the change (*Hammond v. Hoffbeck*, 1981). As a result, the benefits offered to an individual on the date of hire are protected barring a constitutional amendment.

Retirement Plan "Tiers"

Legislatures have reacted to increases in numbers of participating employees and retirees, and higher costs for services due to inflation and other factors, by creating new cohort groups, or "tiers" that changed formulas for calculating pensions, increased normal retirement ages, altered retiree medical

coverage, and other adjustments aimed at reducing costs. Anyone hired by a participating employer after the effective date of a new tier is locked into that benefit for the duration of program membership.

There are currently [four tiers of PERS](#) and [three tiers of TRS](#), with effective dates as follows:

<u>PERS</u>		<u>TRS</u>	
Tier I	January 1, 1961 - June 30, 1986	Tier I	July 1, 1955 - June 30, 1990
Tier II	Enrolled after June 30, 1986	Tier II	Enrolled after June 30, 1990
Tier III	Enrolled after June 30, 1996	Tier III	Enrolled after June 30, 2006
Tiers IV	Enrolled after June 30, 2006		

The retirement tiers in place through FY 2006 differed from predecessors in substantive ways; however, each offered a “defined benefit” (DB) income stream. That is, a traditional pension in which both employer and employee contribute a specified amount, which is pooled and invested on behalf of all employees in the plan. Regardless of the return on that investment, the employee is guaranteed a monthly pension upon retirement based on a formula that multiplies a percentage of average salary over a specified period by the number of years of total service. In this system, the employer bears the risk of investment returns being insufficient to cover benefits. Further, in Alaska’s DB plans, the State’s health plan premiums are covered for vested retirees that meet age and years of service requirements.

Implemented in 2006, Tier IV of PERS and Tier III of TRS represented a fundamental shift from previous benefits plans. In these “defined contribution” (DC) models, employer and employee contributions are pooled in participant-directed, 401k-style investment accounts in which the employee bears the risk of insufficient investment return and there is no guaranteed retirement income. Although common in the private sector—just 16 percent of full-time privately employed Americans had access to a DB plan in 2018—DC plans are rare for state and local government employees, over 90 percent of whom are covered by DB plans. (Alaska and Michigan are currently the only two states that mandate DC plans for all new employees.) The change to a DC model [reduced employers’ contribution rates](#) for new employees but was primarily meant to arrest the growth of future pension obligations by eliminating the defined benefit for new hires.

Supplemental Benefits and Social Security

The [Supplemental Benefits System](#) (SBS) is a defined contribution, tax-advantaged plan under section 401(a) of the Internal Revenue Service code that exists in tandem with the state’s retirement systems. A pre-tax contribution of 6.13 percent is automatically deducted from employees’ salaries and matched by a contribution from employers, for a total of 12.26 percent of salary. Investments are administered by a third-party firm with allocation options among several mutual funds and other investment vehicles directed and managed by the employee. Terms of contribution limits, withdrawal, taxation, and penalty are akin to 401(k) plans offered in the private sector. The state also offers an IRS section 457 [deferred compensation](#) plan that allows participants to save part of their pre-tax income.

Non-Participation in Social Security Insurance

Throughout the 1970s several local governments in Alaska ceased participation in the federal Social Security System. In 1978, employees of the state voted to rescind SSI coverage and therefore lost access to the monthly retirement income that is its main benefit (officially known as “Old-Age, Survivors, and Disability Insurance [OASDI]”). On January 1, 1980, the SBS was established by the state to replace OASDI benefits. Although the concept of saving funds by returning public employees in Alaska to the Social Security System and eliminating the SBS has been raised, the process is complicated, requires approval of employees, and is otherwise [highly unlikely to succeed](#).

Employer Contribution Rates and Unfunded Pension Liabilities

In the late 1990s and early 2000s, poor and negative investment returns along with rapidly increasing medical costs and other factors combined to require dramatically increased contributions rates, which varied among employers under Alaska law. In 2006 alone, rates for some non-state PERS and TRS employers more than doubled as a percentage of payroll, threatening serious impacts to the fiscal operations of municipalities and school districts. In response, [SB 125 was enacted](#) in FY 2008 setting respective contribution rates for PERS and TRS employers at 22 percent and 12.56 percent of payroll. Total annual contributions required to maintain the plans’ service liability are calculated by the ARM Board. Pursuant to SB 25 (AS 14.25.085, specifically), the State is required to meet its employer obligation and to contribute any amount of obligations from other employers exceeding 22 percent of payroll. For example, the employers’ [contribution rate for FY 21](#) is set at 30.85 percent. As such, the State of Alaska is obligated to make the 30.85 percent contribution for its own employees plus an amount totaling 8.85 percent of every other participating employers’ payrolls.

Many of the same issues that led to dramatically increased costs for employers contributed to a [pension funding shortfall](#) that came to light in 2003. In addition to those factors, serious errors by the retirement system’s actuary were identified that year through an audit. In late 2002, actuarial reports showed that PERS was more than 100 percent funded and TRS was at 95 percent. Following the audit, fiscal year-end (June 20, 2003) reports put actual funding levels for PERS and TRS at 75.2 percent and 68.2 percent of future obligations, respectively, raising concerns about the solvency of the systems.

Table 1: PERS - Actuarial and Employer Rates

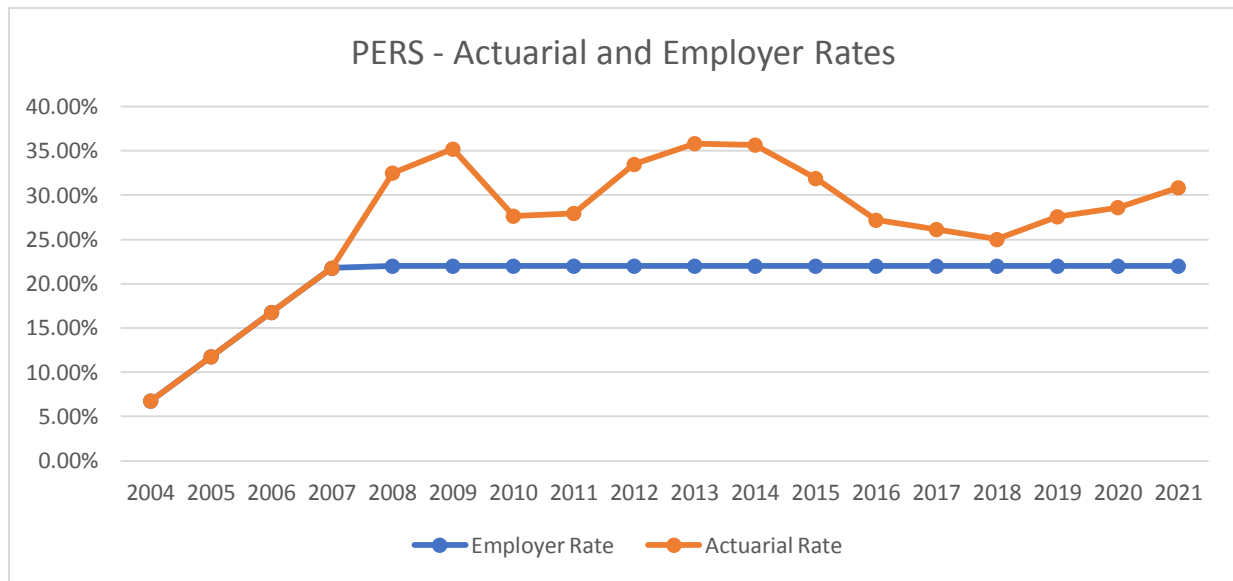
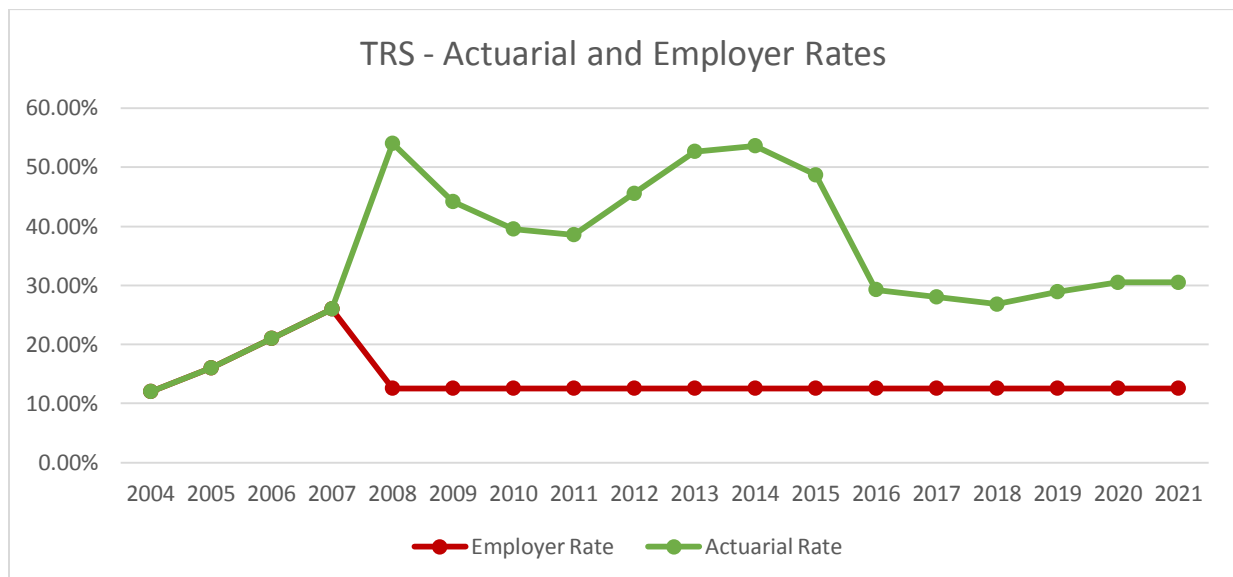
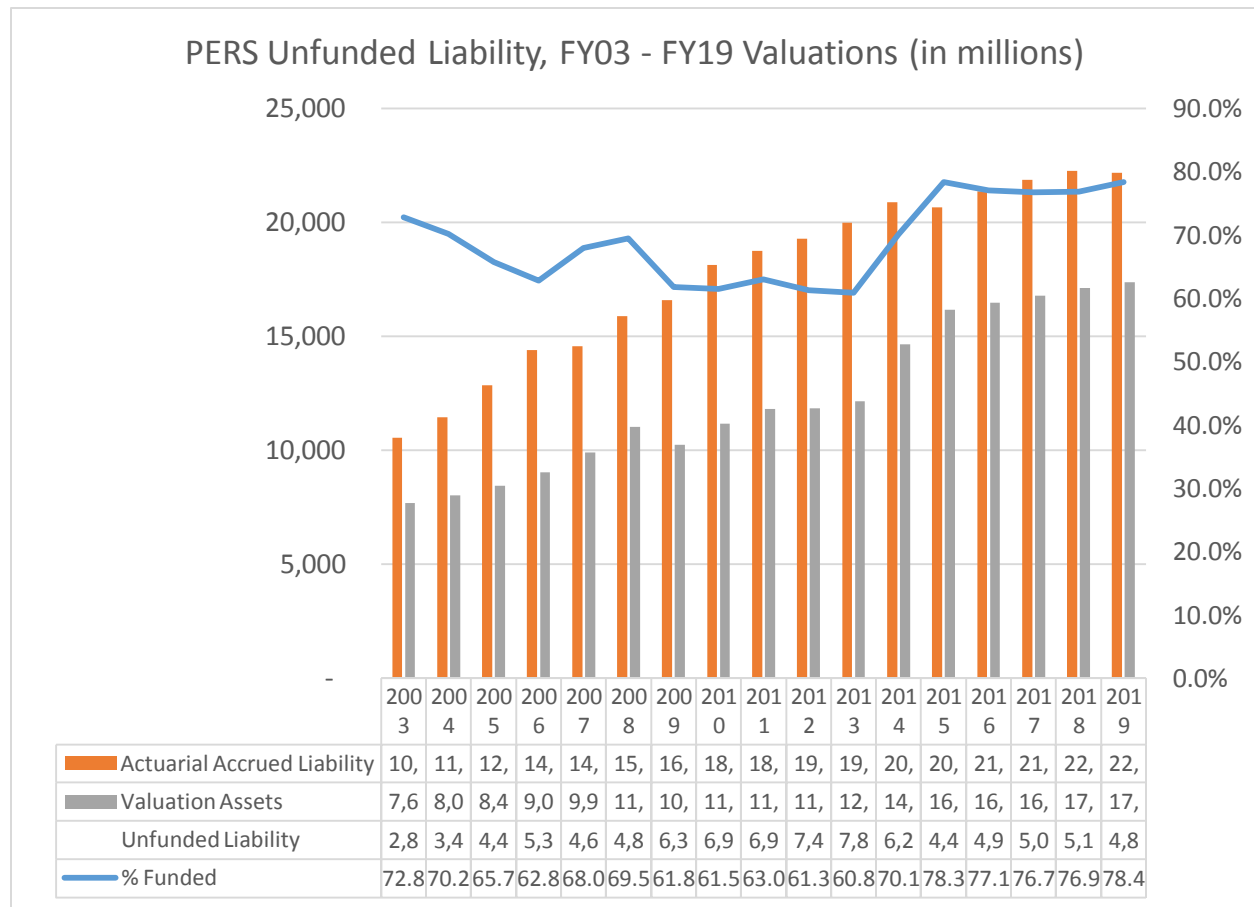


Table 2: TRS Actuarial and Employer Rates



Fallout from the funding crisis included the creation of the defined contribution plans discussed above. In addition, the State brought a \$2.8 billion lawsuit against its former actuary, Mercer Consultants, for malpractice, breach of contract, and unfair trade practices. The [suit was settled](#) in 2010 with Mercer agreeing to pay the state \$500 million, about one-fifth of which went toward attorney's fees.

Table 3: PERS Unfunded Liability, FY 2003 - FY 2019 Valuations (in millions)



Despite changes to the retirements systems, pension shortfalls continued to grow. Although estimates varied, reports of unfunded liabilities up to \$12 billion motivated special appropriations in the FY 2015 [operating budget](#) totaling \$2 billion to PERS and \$1 billion to TRS (see Table 4). These appropriations included \$700 million required for current year obligations. Subsequently, the State enacted a 25-year amortization plan to eliminate the pension liability in 2039 (See Table 5). The plan calls for increasing annual payments that, combined, will total \$10.815 billion over time.

Table 4: Impact of FY 15 Lump Sum Appropriation to Cost of State Retirement Assistance (FY 2006 – FY 2021)

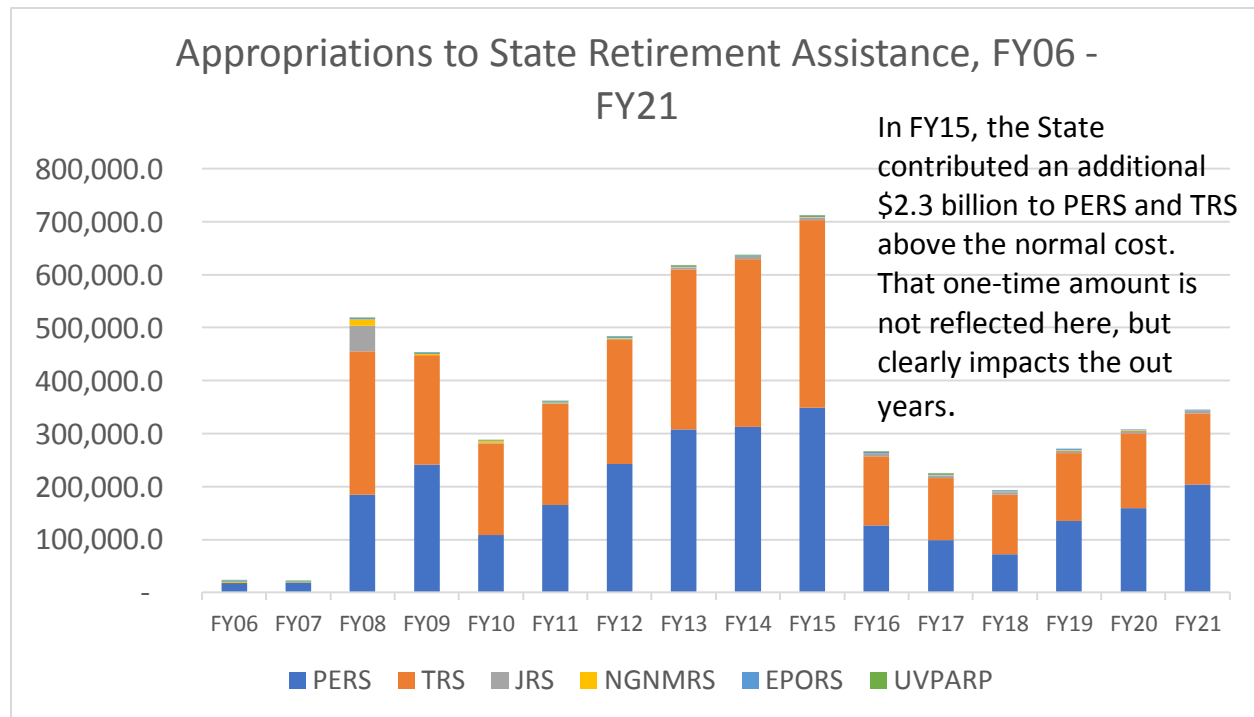
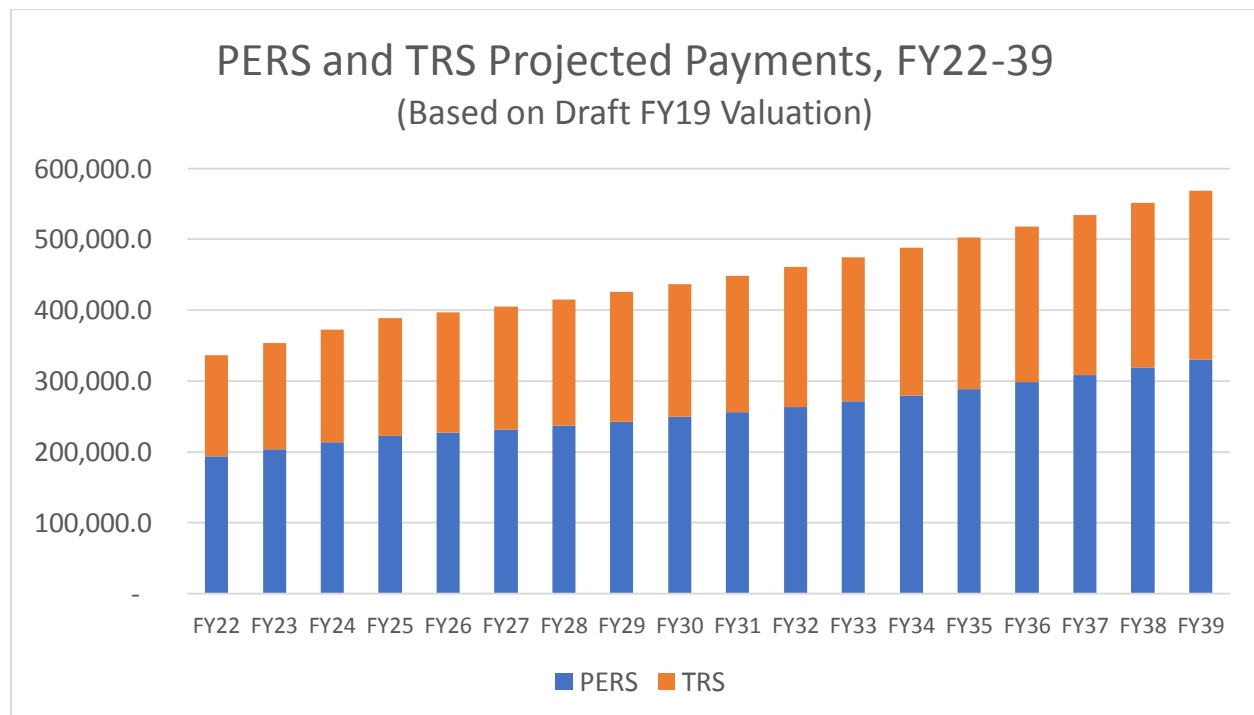


Table 5: PERS and TRS Projected Payments (FY 2022 - FY 2039) Based on Draft FY19 Valuation



Past and Projected State Contribution

Since capping the employer rates in FY08, Alaska's state assistance to retirement payments has become a significant item in the operating budget. In FY21, the \$345.6 million payment comprised approximately 7% of the UGF operating budget. According to a [report by the Equable institute](#), this is proximate to the national median.

The unfunded liability is calculated by comparing the retirement system's current assets to the projected system costs. Since PERS and TRS are "closed" systems (new employees are not enrolled in the defined pension program), the assets need to last as long as the last beneficiary is still receiving benefits. The State's actuary makes assumptions regarding investment returns, inflation, health care cost increases, and the lifespan of beneficiaries. As of 2020, the ARM Board assumes investment returns of 7.38% and inflation of 2.50%, for a "real" return of 4.88%. This assumption is in line with [the national median assumption](#) of 7.25%, but this is a source of controversy in many states. Adopting a lower return assumption results in higher payments in the short-term, but reduces the risk of a spike in payments due to underperforming investments.

Since the passage of HB 385 in 2014, the State's annual payment for PERS and TRS is calculated using a formula that is designed to avoid large annual swings in payments. The payments are "smoothed" using a five-year average of past investment returns to determine the unfunded liability for each fiscal year. This is then amortized over a closed term of 25 years, meaning the period starting in 2014 and ending in 2039. The annual payment is calculated by the ARM Board and adopted annually. Since this methodology was adopted, the State has made the recommended payment each year.

One potential risk with this methodology is that even with smoothing, the payments may become increasingly volatile as we approach the end of the 25-year amortization period because there would be fewer remaining payments to spread any changes. To address this, in 2017 the ARM Board adopted a "layering" approach. With this approach, the original 2014 unfunded liability will be paid off by 2039, but any further increases to the unfunded liability due to actuarial changes (such as investment underperformance) would be paid off over a new 25-year period. This will prevent wild swings in payments as we approach 2039.

Options to Manage Payments

Alaska has several options to reduce contributions to the retirement in response to fiscal pressures, though the impacts must be considered carefully. Any changes to the pension system must be designed to avoid diminishment lawsuits or other unintended consequences. Furthermore, a few options that were viable in the past are no-longer viable.

Options that May Not Be Viable

One option that the State has already leveraged is the reduction of benefits. Alaska's constitution prohibits the reduction of benefits for current or past employees, so benefit reductions have been accomplished through the creation of additional tiers for new employees. New PERS and TRS employees do not pay into the pension system at all, so an additional tier with reduced benefits would not create additional savings. The only way to further reduce benefits would be through a Constitutional amendment.

Another option that is unlikely to be viable is [pension obligation bonds](#). These bonds are a form of arbitrage, in which the State issues bonds at a low rate and invests the proceeds at a higher rate. The difference between these two would be a savings to the State. Alaska has an existing statute allowing the Executive Branch to issue up to \$1.5 billion of pension obligation bonds, although the legislature would need to authorize debt service on these bonds. Given the favorable interest rate environment in 2020, pension obligation bonds may seem to be a viable option to reduce total costs to the State, albeit at the cost of increased investment risk. However, the Supreme Court's decision in [Forrer v. Alaska](#) casts doubt on the constitutionality of this statute. This decision ruled that Alaska's statute allowing the issuance of bonds to purchase oil and gas tax credits is unconstitutional. Pension obligation bonds fall into a similar category of debt as the oil tax bonds, so at a minimum there remains significant doubt about this statute. Should the State choose to proceed, bond-buyers' concern about the viability of the financing mechanism could cause the rate to rise and the spread between the bond proceeds and earnings to shrink.

Refinancing Options

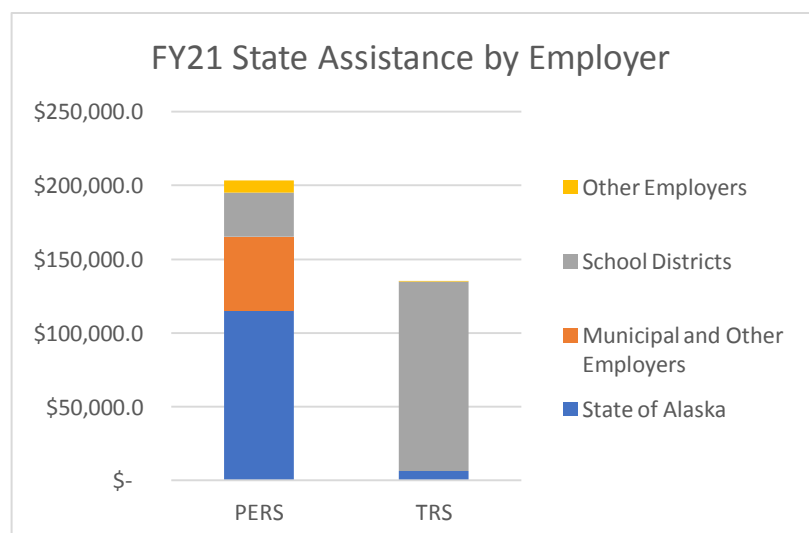
Another option the State has already taken advantage of is refinancing the debt. In FY 2015, the State transferred \$3 billion from the Constitutional Budget Reserve to the PERS and TRS trusts. \$700 million of this was needed for the current-year cost, and the remaining \$2.3 billion was an additional contribution. At the same time, the State extended the time to repay the unfunded liability by 25 years, to FY2039. The lump-sum payment reduced Alaska's unfunded ratio substantially, so this refinancing was not perceived as an attempt to underfund the pension system.

The State could again extend the repayment timeline, which would reduce present costs. However, this would not result in a long-term savings to the State. The overall cost would increase over time due to foregone investment earnings on the smaller payments. States that have underfunded pension systems and attempted this approach, such as Illinois and New Jersey, have ultimately faced a crisis later and serve as a cautionary tale.

The CBR no-longer contains sufficient funds to make a substantial dent in the unfunded liability with an additional one-time transfer. The only fund source with a large enough balance to make a significant transfer is the Permanent Fund Earnings Reserve Account (ERA). This would not be a true savings, however, because the ERA earns a similar investment return rate as the pension trust funds – in effect, all this transfer would do is lock the funds away from legislative control.

Cost shift

PERS and TRS are shared systems that serve employees both within State government and outside it. TRS employees are almost entirely school district employees, but a few State employees are also covered by TRS (primarily teachers at Mount Edgecumbe High School). The State is the largest PERS employer at 57% of payroll in FY21, with 43% coming from



other employers (primarily municipal governments and school districts).

Increasing the employer contribution rate would increase costs for all plan employers, including the State, but the primary impact would be to effectively shift the cost of pension payments to municipal governments and school districts. The State's higher employer contribution could be met by increased funding in agency budgets, partially offsetting the reduced contributions. Municipalities may respond by raising local property or sales taxes. School districts, however, are unable to raise revenues, so a cost shift to school districts would almost certainly result in reductions to other areas of spending.

A 1% increase in the PERS employer rate from 22% to 23% would decrease the State assistance payment by about \$23 million but would result in an additional \$13 million of costs to the State as a PERS employer. A 1% increase in the TRS employer rate from 12.56% would decrease the state assistance payment by about \$7.5 million, only \$350 thousand of which would be felt by the State as an employer.

Governor Dunleavy's FY22 budget [included a proposal](#) to split the PERS rate so that the State of Alaska pays the actuarial rate and other PERS employers continue paying 22%. This would allow increased cost shifting to non-UGF fund sources, saving an estimated \$43 million per year of UGF. The administration anticipates that much of the increased payments would be absorbed by federal fund sources. Additional details on the administration's proposal will be included in corresponding fiscal notes.

Pension buyout

Some states, such as Missouri and Illinois, have sought to reduce pension system payments by offering voluntary buyouts to certain employees. Missouri, for example, made a one-time offer in 2017 to former employees who were not yet retired: forego monthly retirement checks and instead receive a lump-sum check worth 60% of their normal annuity. Over [3,700 former employees](#) chose to take the lump-sum payment, resulting in an estimate savings of about \$90 million to the pension fund over the long term. The savings is attributable to reductions in benefits and administrative expenses from only having to send a single check. Critics of this system argued that this buyout took advantage of short-term thinking to offer a deal that makes former employees worse off over the long term.

In Alaska, a voluntary buyout program would likely not be considered a diminishment and could be allowed. Further analysis would be needed to see how many former employees would be eligible in Alaska to see the potential of a buyout proposal. However, it is unlikely to result in major annual savings. The benefit of a buyout also depends on how good of a "deal" the State is offering – the higher the offer, the less savings for the State.

Reduced health care costs

Both PERS and TRS offer health benefits to retirees in addition to pensions. Retirees are enrolled in AlaskaCare, the same health care system as some active employees (primarily non-unionized employees). The Department of Administration, which administers this plan, has implemented several changes to benefits since 2017 to reduce costs without running afoul of diminishment concerns for retirees. For example, in 2019 the department implemented an enhanced Medicare Part D Employer Group Waiver Plan for prescription drugs, which is estimated to save \$32.9 million annually to the retirement trust. The savings from this measure alone reduced the unfunded liability by about \$1 billion and decreased state retirement assistance payments by \$60 million across all plans. This sort of administrative change can make a significant impact, and generally does not require legislative action.

One way it may be possible to realize further savings is to expand AlaskaCare to additional active employees, which would spread administrative costs over more policies and enhance the system's purchasing power. Most State, municipal, and school district employees receive health insurance through union health trusts. Some municipal and school district employers self-insure. Depending on the specific health and demographic profile of the new cohort, bringing more of these employees into AlaskaCare may reduce costs for retiree health care, driving down the State's retirement assistance payment. However, the full consequences of expanding AlaskaCare to cover more employees is a complex topic that requires analysis that is beyond the scope of this paper.

Glossary of Terms

Excerpt from Alaska Department of Administration

Division of Retirement and Benefits

Accessed on 10/28/2020 at:

<http://doa.alaska.gov/drb/help/glossary.html#.X5nBCS2z10t>

Actuarial Accrued Liability (Past Service Cost)

The excess of the present value of a pension fund's total liability for future benefits and fund administrative expenses over the present value of the normal cost of those benefits as accrued for the current year.

Actuarial Adjustment (PERS)

Equality in value of the aggregate expected payments under two different forms of pension payments, considering expected mortality and interest earnings on the basis of tables adopted from time to time by the Public Employees' Retirement Board.

Actuarial Assumptions

Factors which actuaries use in estimating the cost of funding a defined benefit pension plan. Examples include: the rate of return on plan investments; mortality rates; and the rates at which plan participants are expected to leave the system because of retirement, disability, termination, etc.

Actuarially Determined Contribution (ADC)

The ADC is equal to the sum of (1) the employer's "normal cost" of retirement benefits earned by employees in the current year plus administrative expenses expected to be paid from the trust in the upcoming year, and (2) the amount needed to amortize any existing unfunded accrued liability over a period of 25 years.

Alaska Deferred Compensation Plan

The Alaska Deferred Compensation Plan allows you to voluntarily set aside a portion of your income before it is taxed. The amount set aside, plus any change in value (interest, gains and losses), is payable to you or your beneficiary at a future date. Upon becoming eligible to participate in the Plan, you may elect to defer your income on a pre-tax basis. By doing so, you agree to reduce your salary by an agreed-upon amount. This amount may not exceed certain requirements.

Alaska Retirement Management Board (ARMB)

The Alaska Retirement Management Board serves as the trustee of the assets of the state's retirement systems, the State of Alaska Supplemental Annuity Plan and the deferred compensation program for state employees. The board manages and invests fund assets in a manner that is sufficient to meet the liabilities and the pension obligations of the system.

Alaska Supplemental Annuity Plan

The Alaska Supplemental Annuity Plan (SBS-AP) is a defined contribution plan governed by section 401(a) of the Internal Revenue Code. A portion of your wages and a matching employer contribution are made pre-tax to this plan instead of contributions to Social Security. These contributions plus any change in value (interest, gains and losses), is payable to you or your beneficiary at a future date.

Deferred Compensation Plan

The Deferred Compensation Plan allows you to voluntarily set aside a portion of your income before it is taxed. The amount set aside, plus any change in value (interest, gains and losses), is payable to you or your beneficiary at a future date. Upon becoming eligible to participate in the Plan, you may elect to defer your income on a pre-tax basis. By doing so, you agree to reduce your salary by an agreed-upon amount. This amount may not exceed certain requirements.

Defined Benefit Plans

Pensions based on years of service and salaries. Retirees receive a defined monthly check, with the employer taking on the investment risk of the retirement funds. Many state, municipal and school employees around the nation once belonged to such plans.

Defined Contribution Plans

Retirement savings accounts based on employee and matching employer contributions. If the employee's investment choices perform poorly, or if the employee contributes little to the account, the employee receives less money at retirement. More employers are switching to defined contribution plans to lessen their financial risk and to allow their workers to take the money with them when they change jobs.

Employer (TRS)

A public school district, the Board of Regents of the University of Alaska, the Department of Education and Early Development, the National Education Association of Alaska, the Regional

Resource Centers, or the state legislature with respect to a state legislator who elects membership under AS 14.25.040(b).

Employer (PERS)

- The State of Alaska;
- A nonprofit regional corporation, but only with respect to village public safety officers employed by the corporation who have not terminated participation in the system; or
- A political subdivision or public organization of the state that participates in the system.

Funded Ratio

The ratio of a plan's current assets to the present value of earned pensions. There are several acceptable methods of measuring a plan's assets and liabilities. In financial reporting of public pension plans, funded status is reported using consistent measures by all governmental entities. According to the Government Accounting Standards Board (GASB), the funded ratio equals the market value of assets divided by the actuarial accrued liability calculated under the Entry Age Normal cost method.

Normal Cost

The normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year. The employer normal cost equals the total normal cost of the plan reduced by employee contributions.

Public Employees' Retirement System (PERS)

The Public Employees' Retirement System (PERS) includes a defined benefit plan that is for government employees first hired on or before June 30, 2006 and a hybrid defined contribution plan that has some defined benefit components for employees first hired on or after July 1, 2006

On January 1, 1961, the Alaska legislature established the Public Employees' Retirement System (PERS) to attract and retain qualified people into public service employment. The PERS offers a variety of benefits to its members and their survivors. These benefits, when combined with other income, are designed to provide members with financial security during their retirement years. For more information read the [Public Employees' Retirement System Information Handbook](#).

SB 141 (2005)

Closed the defined benefit plans and created a new retirement and retiree health plan. Signed into law July 27, 2005 Chapter 9 FSSLA 05.

SB 123 (2007)

Technical correction bill. Allowed the Alaska Retirement Management Board to apply the percent of pay past service cost against both defined benefit and defined contribution salaries. Signed into law June 6, 2007 Chapter 20 SLA 07.

SB 125 (2008)

Changed the PERS to a cost-share plan and set the employer rate at 22%. Established that the State will pay the difference between the 22% and the actuarially determined rate. Signed into law April 8, 2008 Chapter 13 SLA 08

Supplemental Annuity Plan

The Alaska Supplemental Annuity Plan (SBS-AP) is a defined contribution plan governed by section 401(a) of the Internal Revenue Code. A portion of your wages and a matching employer contribution are made pre-tax to this plan instead of contributions to Social Security. These contributions plus any change in value (interest, gains and losses), is payable to you or your beneficiary at a future date.

Supplemental Benefits System (SBS)

SBS includes the following:

- Life insurance
- Accidental Death and Dismemberment coverage
- Survivor benefits
- Disability benefits (short term and long term disability plans)
- Dependent Care Assistance Plan

Supplemental Contribution Account (TRS)

The account maintained by the system to record the supplemental contributions of each member, including interest and adjustments to the account.

Teachers' Retirement System

On July 1, 1955, the Alaska legislature established the Teachers' Retirement System (TRS) to attract qualified people into public service employment. The TRS offers a variety of benefits to its members and their survivors. These benefits, when combined with other income, are designed to provide members with financial security during their retirement years. For more information read the [Teachers' Retirement System Information Handbook](#).

The Teachers' Retirement System (TRS) includes a defined benefit plan that is for government employees first hired on or before June 30, 2006 and a hybrid defined contribution plan that has some defined benefit components for employees first hired on or after July 1, 2006.

Unfunded Actuarial Accrued Liability (UAAL)

The excess, if any, of the Actuarial Accrued Liability over the Actuarial Value of Assets. In other words, the present value of benefits earned to date that are not covered by current plan assets.