

HOUSE FINANCE COMMITTEE
January 22, 2004
2:26 PM

TAPE HFC 04 - 11, Side A

CALL TO ORDER

Co-Chair Williams called the House Finance Committee meeting to order at 2:26 P.M.

MEMBERS PRESENT

Representative John Harris, Co-Chair
Representative Bill Williams, Co-Chair
Representative Kevin Meyer, Vice-Chair
Representative Mike Chenault
Representative Eric Croft
Representative Hugh Fate
Representative Richard Foster
Representative Mike Hawker
Representative Reggie Joule
Representative Carl Moses
Representative Bill Stoltze

MEMBERS ABSENT

None

ALSO PRESENT

Melanie Millhorn, Director, Division of Retirement and Benefits, Department of Administration; Anselm Staack, Chief Financial Officer, Department of Administration; Ray Matiashowski, Deputy Commissioner, Department of Administration.

PRESENT VIA TELECONFERENCE

Robert Reynolds, Actuarial Consultant, Mercer

GENERAL SUBJECT(S):

The following overview was taken in log note format. Tapes and handouts will be on file with the House Finance Committee through the 23rd Legislative Session, contact 465-2156. After the 23rd Legislative Session they will be available through the Legislative Library at 465-3808.

OVERVIEW: Increased Costs of PERS AND TRS

LOG	SPEAKER	DISCUSSION
	TAPE HFC 04 - 11 SIDE A	
000	Co-Chair Harris	Convened the House Finance Committee meeting at 2:26 p.m.
		Increased Costs of PERS and TRS
103	MELANIE MILLHORN, DIRECTOR, RETIREMENT and BENEFITS, DEPARTMENT OF ADMINISTRATION	Introduced the other speakers including Mr. Reynolds, an actuarial consultant for Mercer. Explained that an actuarial does projections based on cost.
205	ROBERT REYNOLDS, ACTUARIAL CONSULTANT, MERCER	Clarified that an actuarial is an economic forecaster in specific circumstances.
407	Ms. Millhorn	Referred to "Public Employees' Retirement System; Teachers' Retirement System" publication (copy on file.) Explained that the discussion would cover the funding status and the two primary factors driving it: the increase in health costs and the loss of investment earnings. Discussion would also center on FY 01 through FY 05 Employer Rates, and Employer Contribution Rates from FY 98 through FY 04. A subcommittee has been formed to address possible tier redesign: Tier IV for PERS and Tier III for TRS.
0548	Ms. Millhorn	Referred to the 8-page White Paper (copy on file) summarizing major concerns. Explained that both PERS and TRS are defined benefit plans for the State.
656	Ms. Millhorn	Referred to equation on "Background," page 2.
750	Co-Chair Harris	Asked the percentage of administrative expenses.
804	Ms. Millhorn	Replied that administrative expenses appear on page 2 of 8.
4059	Co-Chair Harris	Asked if there is a maximum that can be spent on administrative costs. Ms. Millhorn replied no. Alaska is currently at 1.2% for PERS and 0.8% for TRS.
830	Representative Croft	Asked if those figures are close to the national average.
842	Ms. Millhorn	Offered to research the question.
911	Ms. Millhorn	Referred to page 3 and explained "over time" is defined as a 25-year amortization schedule for PERS and TRS, which by statute can go up to 40 years. The FY 05 Employer Rates are the result of the most recent evaluation for PERS and TRS on June 30, 2002. The Employer Rate setting is two years ahead based on

		evaluation reporting due to the budgeting process. This is standard for most public pension plans.
1003	Representative Croft	Noted that there have been dramatic changes in the stock market since 2002 and asked the effect of the Employer Rate being only as current as June 2002.
1018	Ms. Millhorn	Responded that the June 30, 2003 rate is expected in March 2004 to set rates for FY 06. The specific time period lags two years. Agreed with Representative Croft that there is "smoothing," and said that Mr. Reynolds could address the actuarial assumption.
1148	ANSELM STAACK, CHIEF FINANCIAL OFFICER, DEPARTMENT OF ADMINISTRATION	Explained that for FY 03, the amount of earnings was 3.7% for the entire fund, compared to the actuarial assumed rate of 8.25%.
1321	Representative Croft	Referred to page 1, Defined Benefits, that describes an early cash-out with the employee receiving only employee contributions and fixed interest. Observed that employee early cash-outs leave a lot of money in the system.
1407	Mr. Staack	Responded that the only way to get an actuarial gain from early cash-outs is if the member doesn't take his benefit. Explained that if a member cashes out their account early and takes the employee contributions and 4.5% interest earnings by statute, it is only 20-30% of the actual value of their benefit.
1507	Representative Croft	Asserted that it would be in the fund's interest, not the individual's, though not many people cash out early.
1528	Mr. Reynolds	Explained that if a member leaves before vesting, he forfeits the employer contributions made on his behalf during that time period; therefore, the fund becomes more solvent if people leave before becoming vested. Assumptions are made when doing valuations about the rate at which people leave, but for the system to become more solvent, people would need to leave at a greater rate than is currently assumed. In TRS, the assumption is that 10% will leave during the first year. Mr. Reynolds pointed out that the majority of the systems liabilities are not attributable to unvested members, but rather to retired members, surviving

		spouses, terminated members who are already vested, and active members who are already vested. He said that even if all non-vested liabilities were eliminated, the systems still wouldn't be 100% funded because non-vested members represent a small portion.
1712	Representative Croft	Asked what would happen if a vested member cashed out his contributions.
1727	Mr. Staack	Replied that the vested member would receive only the contributions and the earnings on those contributions; the fund retains the rest. Mr. Staack stated that cashing out happens more often than one might think.
1834	Representative Croft	Asked if there has ever been an incentive encouraging members to cash out before becoming vested.
1901	Mr. Reynolds	Replied that there has not, and added that there would be legal constraints. In single employer corporate plans, for example, the employer can't discriminate or take an action in order to prevent an employee from becoming vested.
1947	Representative Croft	Commented that another way to make the fund solvent would be to create a bigger pool of people.
2010	Ms. Millhorn	Explained that the fund looks at a 25-year period, with stock market performance playing a large role. The objective over time is to regain the funding status at the targeted rate.
2114	Ms. Millhorn	Noted that the next valuation report will be completed by the end of March 2004. The PERS, TRS, and Alaska State Pension Investment Board will discuss the results of the valuation report of June 30, 2003 and adopt the actuarial assumptions underlying the Employer Rates. In April 2004, PERS and TRS will meet separately to determine the Employer Rates for FY 06.
2215	Ms. Millhorn	Referred to page 4, "System Funding Goals," and discussed the four points.
2325	Vice-Chair Meyer	Asked how Alaska compares to other state pension systems and targeted funding ratios.
2402	Mr. Reynolds	Responded that it is difficult to compare PERS and TRS with other systems because PERS and TRS fund to a much higher target, including pre-funding retiree medical benefits whereas most systems treat medical benefits as a pay-as-you-go

		expense. The funding ratios of Alaska compare well with other states, as neither the highest nor the lowest.
2500	Representative Hawker	Asked Mr. Reynolds the risks of setting a funding ratio of less than 100% with a covered employee base that is stable or declining over time.
2557	Mr. Reynolds	Explained that with a less than 100% funding target over a 25-year median period, the funding of the systems would pass beyond the current workforce to a future generation. With a declining workforce, the state would accept the risk of not being able to ever fully fund the systems.
2812	Ms. Millhorn	Referred to page 5, "Data, Assumptions and Methods" and pointed out that all reports are available online with the Division of Retirement & Benefits. The current issues challenging the systems are the financial market performance and the rising cost of medical care, page 6.
2930	Ms. Millhorn	Referred to pages 6-7, Employer Rates in FY 04 and FY 05 and reviewed the average employer contribution rate.
3129	Representative Croft	Asked if it is a unified pool with every employer having a different rate.
3141	Ms. Millhorn	Responded that is correct.
3150	Representative Croft	Asked about the advantage and legality of pooling.
3221	Mr. Reynolds	Replied that in the TRS system each employer shares in the experience of the whole system. By not pooling the employer rates, the employer assumes the liability for granted past service.
3327	Representative Hawker	Asked if there was a change in methods or actuarial assumptions between FY 04 and FY 05.
3423	Mr. Reynolds	Responded that the primary drivers for the change in the rates for PERS and TRS were the investment performance and the increases in healthcare costs. These led to revising some assumptions and methods.
3634	Mr. Reynolds	Continued, that it takes several years to recognize a trend and draw conclusions, and it's normal for investment experience to be down in any one year.
3736	Representative Stoltze	Asked if Mr. Reynolds could offer any cautionary advice on the retirement legislation.

3758	RAY MATIASHOWSKI, DEPUTY COMMISSIONER, DEPARTMENT OF ADMINISTRATION	Stated that the department would evaluate bills on a case- by- case basis. He observed that they are in an "under funding" status. He anticipated that the market would return to the pre-1990 rates. Alaska is one of the few states that pre-funds medical liabilities.
3950	Representative Croft	Asked the result of funding a target of less than 100%, for example a target of 98%.
4012	Mr. Reynolds	Responded that the target of 98% would not have a large effect on calculating the contribution rate. He cautioned that, over time, 100% should be the target; he advised to avoid adopting rates significantly below the calculated contribution rates for extended periods of time.
4209	Representative Croft	Noted that the up market was smoothed but now the down market is not, and he questioned the result.
4245	Mr. Reynolds	Disagreed with Representative Croft's conclusion. He pointed out that there were three significant down years, where it made sense not to continue to smooth. He maintained that they would smooth down years in the future. He clarified that for the FY 05 evaluation based on FY 02, market results were not smoothed because it was felt that it was better to recognize what had occurred.
4416	Representative Croft	Noted that big market years were smoothed, but that the FY 05 was taken straight. He questioned what would have occurred if it were smoothed.
4526	Mr. Reynolds	Observed that the first two years were good and the next three were extremely bad; if they had smoothed, the valuation would have been low. The expectation is that with an absence of poor performance the rates would be higher.
4633	Representative Croft	Referred to smoothing assumptions.
	TAPE CHANGE HFC 04-11, SIDE B	
4551	Ms. Millhorn	Spoke to the result of early retirement in education.
4521	Vice-Chair Meyer	Questioned if the stock market is the best place to invest.
4452	Ms. Millhorn	Could not respond to the issue.
4432	Vice-Chair Meyer	Stressed the difficulty of budgeting for school districts when funding levels are unknown.

4400	Ms. Millhorn	Spoke to the PERS results and noted that without the medical portion, 143.7% was funded in FY 04. The PERS is funded at 120.9% in FY 05 without medical expenses. She continued to review the TRS rates over time. For FY 05, Mercer's recommendation was that the employer rate be at 35.57%. The Board adopted a 16 % rate. There is not a cap on TRS.
4153	Ms. Millhorn	For FY 05, TRS is at 68.2% with total benefits.
4113	Ms. Millhorn	Reviewed employer rates and savings contained in "Employer Savings FY 98-FY 04." The rate was 12.8% in FY 98. There was almost \$360 million in savings from FY 96 - FY 05.
3923	Ms. Millhorn	Reviewed the estimated change in employer contributions for FY 05 (copy on file.)
3757	Ms. Millhorn	Discussed retiree medical insurance cost increases. The monthly premium in 1977 was \$34.75. In December 2003, the cost of the monthly premium was \$720.00. There has been a large amount of volatility. Health costs for PERS are approximately 30%; TRS is approximately 20%.
3631	Ms. Millhorn	Noted that the investment experience is a major factor. The total investment loss was 5.25% in FY 01; FY 03 was a 3.67% gain.
3634	Ms. Millhorn	If the investment earnings are less than the 8.25% actuarial earning rate, the plan's targeted funding ratio is significantly impacted.
3454	Ms. Millhorn	Reviewed the PERS employer rate change for the last five years. She observed that there are a number of variables that impact the recommendations (copy on file.)
3406	Ms. Millhorn	Reviewed the TRS employer rate change for the last five years. The TRS rate has been more stable than has PERS.
3332	Mr. Reynolds	In response to a question by Representative Croft, Mr. Reynolds explained that the assumption is that the premium will increase at the assumed rate. The previous years are compared to the assumed rate. Adjustments are only made if there is a significant deviation. In FY 02, the decision was made to use the actual premium due to the amount of variation.
3133	Representative Croft	Concluded that the rate had settled down to 10%.

3111	Mr. Reynolds	Agreed, but added that recent experience shows greater than 10%. Increases escalated in the late 1990's and beyond. He emphasized the difficulty of estimating health care costs. The assumption is that health care will increase at a rate of about 12% over the next three years.
2943	Representative Hawker	Observed that changes have manifested in the most recent evaluation process. He questioned where the decision to reflect changes is made.
2855	Mr. Reynolds	Explained that actuaries have professional standards, but that the TRS and PERS Boards have the authority to adopt the recommendations. The Board can modify the recommendations during two steps in the process.
2738	Representative Hawker	Noted that contributions numbers were stable until the last year. He questioned if recommendations were not followed this past year.
2698	Mr. Reynolds	Explained that calculated rates were not substantially different from the adopted rates.
2622	Representative Hawker	Observed the change made between FY 01 and FY 02 from 6.77 to 24.9.
2533	Mr. Reynolds	Clarified that the medical and investment experiences occurred in FY 02.
2455	Mr. Reynolds	Reviewed a summary of benefits paid by PERS, page 13 (copy on file.) The COLA was collapsed into the service area in 1997. There was \$451 million paid out in PERS benefits. She gave examples of payout ratios.
2234	Ms. Millhorn	Continued to review the PERS chart (copy on file.) She noted that there was an early retirement option (RIP) from 1997 - 1999.
2137	Ms. Millhorn	Observed that a newsletter would be sent to members to solicit input regarding tier redesign.
1951	Representative Hawker	Questioned if input would be solicited from non-state employees.
1816	Ms. Millhorn	Stated that they would be open to more input; however, there is no intent to actively solicit recommendations outside of the employee base.
1725	Ms. Millhorn	Observed that there are only 8 of 123 health care pension plans that pre-fund health care. Many plans only report liabilities on a one-year plan.

1554	Representative Croft	Questioned the effect of not pre-funding.
1528	Mr. Reynolds	Observed that the calculated contribution rate would be reduced from 25% to 10% - 12% if pre-funding of medical benefit were eliminated for PERS. The same effect would occur in TRS. If medical benefits had not been pre-funded there would be fewer assets in the system. The system is where it is today due to the practice of pre-funding medical benefits in the past.
1315	Mr. Matiashowski	In response to a question by Representative Stoltze, noted that there have been two committees formed to look at redesigning the TRS and PERS systems.
1212	Ms. Millhorn	Noted that the survey was created to start a dialog about the variables involved in redesigning the tiers.
1142	Mr. Reynolds	In response to a question by Representative Hawker, observed that states that do not pre-fund are paying for medical expenses as they occur, from general revenues. These states are not looking very far into the future to assess their ability to meet that obligation.
954	Representative Hawker	Observed that the risk is exposure to a more volatile situation.
929	Mr. Reynolds	Agreed, and added that large-scale demographic changes, such as the retiring "baby boomer" population, could result in exposure.
	<u>ADJOURNMENT</u>	The meeting was adjourned at 3:54 PM.