MINUTES
JOINT MEETING
SENATE FINANCE COMMITTEE
SENATE STATE AFFAIRS COMMITTEE
April 06, 2004
9:04 AM

TAPES

SFC-04 # 71, Side A
SFC 04 # 71, Side B
SFC 04 # 72, Side A

CALL TO ORDER

Co-Chair Gary Wilken convened the meeting at approximately 9:04 AM.

PRESENT

Finance Committee Members

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice Chair
Senator Ben Stevens
Senator Lyman Hoffman
Senator Donny Olson
Senator Fred Dyson

State Affairs Committee Members

Senator Gary Stevens, Chair
Senator John Cowdery
Senator Bert Stedman
Senator Lyman Hoffman

Also Attending: MELANIE MILHORN, Director, Division of Retirement and Benefits, Department of Administration; BOB REYNOLDS, Mercer Human Consulting; GEORGE SULLIVAN, Chair, PERS Board; ANSLEM STAACK, Chief Financial Officer, Division of Retirement and Benefits, Department of Administration;

Attending via Teleconference: There were no teleconference participants.

SUMMARY INFORMATION

Actuarial Valuation Report
By Bob Reynolds, Mercer Human Consulting

Co-Chair Wilken introduced former Anchorage Mayor and current Chair of the Public Employees Retirement (PERS) Board, George Sullivan

MELANIE MILHORN, Director, Division of Retirement and Benefits, Department of Administration, noted that Mercer Human Consulting has been advising the Division for approximately 12 years and she introduced Bob Reynolds.

BOB REYNOLDS, Mercer Human Consulting, testified that each year an actuarial of systems is undertaken, which is an evaluation of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS) to determine the amounts necessary to fund the programs. He noted the consulting firm analyzes the liability of the systems, but is not involved in investment of the funds, nor gives advice on the investment of those funds. He stated the Alaska State Pension Investment Board undertakes the investment activities.

Mr. Reynolds informed that the actuarial valuation was presented to the PERS/TRS board with information current as of June 30, 2003. He referenced a handout prepared by Mercer Human Resource Consulting for the March 24, 2004 PERS and TRS Board meeting, titled, "State of Alaska, Public Employees' Retirement System and Teachers' Retirement System Actuarial Valuations as of June 30, 2003" [copy on file.]

> Page 2
> [Flow chart showing that Provisions, Data and Assets, as of June 30, 2003, and Assumptions and Methods revised in January 2003 are input into the Actuarial Valuation, which produces Contribution Rate and Funding Ratio.]

Mr. Reynolds defined the data and assets as the "hard data", to which the assumptions and methods are applied. He qualified that many unknown factors are involved, including investment returns, mortality rates, pay raises, etc., and that the consulting firm makes estimates based on the information available. He expressed the intent that the program contains adequate funds for each member's benefits during that member's working lifetime.

Mr. Reynolds stated that the funding ratio is a measure of the assets compared to the liabilities of the system. The intent is that the funding ration is 100 percent, i.e. the exact amount of

assets in the system necessary to pay the benefits the membership has earned. The funding ratio is used to calculate the actuarial contribution rate.

Mr. Reynolds defined the actuarial contribution rate as the rate necessary to pay into the system to arrive at a funding ration of 100 percent after a 25-year period. He listed two components of the contribution rate, one being the rate intended to pay the benefits that members are currently earning. This is referred to as the normal cost rate. The second component is the past service cost, which is related to the funding ratio. If at any time the program is not 100 percent funded, the unfunded liability is amortized with the intent to pay off in 25 years, similar to a mortgage.

Mr. Reynolds summarized the cost of benefits currently earned and catch up rate, which is the amortization of the unfunded liability.

Page 3
PERS Key Results

Average Contribution Rate:	
FY 05	24.91%
FY 06	25.63%
Board Adopted Rate:	
FY 05	11.77%
FY 06	TBD
Funding Ratio:	
Non-Medical Benefits	
June 30, 2002	120.9%
June 30, 2003	121.4%
Total Benefits	
June 30, 2002	75.2%
June 30, 2003	72.8%

Mr. Reynolds stated that at June 30 2002, assets were approximately three-quarters of the liability of the system. The PERS and TRS systems provide both retirement and medical benefits, although many state systems do not pre-fund for medical benefits; Alaska's system is one of only eight that do, while approximately 100 systems do not. Alaska's systems are pre-funded actuarially.

Senator Dyson asked the definition of average contribution rate.

Mr. Reynolds answered this is the percentage of payroll of the system membership for 25 years.

Senator Dyson clarified this is 25 percent of each employee's

paycheck.

Mr. Reynolds affirmed this is necessary to fund the system at 100 percent.

Senator Dyson asked if this amount is paid entirely by the employee or whether the employer contributes a portion.

Mr. Reynolds responded this pertains to the employer contribution, as the employee contribution is already taken into account.

Senator Bunde clarified that the Board had adopted an 11.77 percent increase to the employer contribution, although actuaries recommended 24.91 percent.

GEORGE SULLIVAN, Chair, PERS Board, replied that the PERS Board is only authorized to adopt a five percent increase each year. The TRS Board has no limitation in the amount of authorized increases.

Mr. Reynolds furthered that the Board increased the contribution a full five percent, although the amount remains below the actuarial rate.

Co-Chair Green clarified that the five percent limitation is specified in regulation not in statute. She asked the reason of the limitation.

Ms. Milhorn affirmed the five percent restriction is contained in regulation. She was unsure the reason for the limitation, which only applies to PERS contributions. The Board adopts regulations for both the PERS and TRS systems.

Mr. Sullivan was new to the Board and requested the Board discuss this matter at its meeting later in the week.

Co-Chair Green wanted clarification that the limitation is a regulatory requirement.

Senator Bunde noted the limitation does not apply to TRS members and that TRS contributions could be increased to any amount.

Page 4
TRS - Key Results

Total Contribution Rate:
FY 05 35.57%
FY 06 38.85%
Board Adopted Rate:

FY 05 16%
FY 06 TBD

Funding Ratio:
Non-Medical Benefits:
June 30, 2002 93.2%
June 30, 2003 89.5%
Total Benefits:
June 30, 2002 68.2%
June 30, 2003 64.3%

Mr. Reynolds outlined this page.

Mr. Reynolds noted the Board considers this information plus other factors to determine the actual rate.

Page 5
Funding Ratio History
[Bar Graph showing the percentages for PERS and TRS for the years 1979 through 2003.]

Mr. Reynolds indicated this graph provides a comparison of the two systems. In many years, the funding has been below 100 percent. The last two years has had a significant decline for two primary reasons. One is a market correction as the result of "soft" market performance for two years that has decreased the value of investments. Also, the cost of medical care is in significant excess of the anticipated costs.

Senator Bunde understood the intent that years in which the system was funded more than 100 percent would "average out" the years in which funding was less than 100 percent. However, the system has been fully funded only eight of the previous 25 years.

Page 11
Monthly Blended Premium per Retiree for Health Coverage
[Graph showing comparison of the actual premium amount to the assumed premium for the years 1995 through 2004.]

Mr. Reynolds explained this graph shows the history of the costs of medical care provided by the system since 1995. The methodology of actuarially attempts to mitigate a portion of the volatility. He noted the amount of volatility of the annual cost of medical care over time. It has been difficult to therefore calculate liability.

Mr. Reynolds pointed out that during the middle 1990s, the costs of medical care appeared to be "under control". However, the trend appeared to reverse itself with an escalating cost of medical care.

In the years 2001 and 2002 actuaries have "fallen behind" in predicting accurate liability. After three years, it has been determined this is more than simple routine volatility, and the consultants and the Board decided to adjust to the abnormal increases. This is one factor contributing to the funding ratio.

Page 14
Health Cost Trend Assumption
[Bar Graph showing the percentage of the rates, as revised in 2003, would vary in the years FY 03 through FY 18.]

Mr. Reynolds explained this graph shows the current expectation of costs into the future. Its expected that medical costs would increase in "double digits" over the next several years, at approximately 12 percent per year for FY 04 and FY 05, then gradually decline over time at about one-half percent per year. Inflation is calculated to be 3.5 percent, which is higher than the current inflation rate. It is anticipated that medical care costs would "settle into" a rate higher than inflation, which has been the trend.

Page 26
Market Return versus Actuarial Return on Assets
[Graph listing the percentages of: Market Return, Actuarial Return PERS, and Actuarial Return TRS, for the fiscal years ending 1995 through 2003.]

Mr. Reynolds pointed out that investment performance in the middle and late 1990s was very good, then poor in the years 2002 and 2003. One assumption was that investments would earn 8.25 percent per year. However, the earnings were negative eight percent for the past three years. This translated to a 33 percent loss to the cost to the system.

Page 23
PERS Reconciliation of Average Contribution Rate for Fiscal Year 2006
[Bar graph listing the following:

Contribution rate FY 05	24.91%
Elimination of 102%	0.90%
Resetting assumed medical Premium	0.00%
Health cost trend	0.00%
System benefit changes (including PRPA)	0.00%
Salary increases	-0.19%
Contribution shortfall	1.10%
Demographic experience	0.40%

Investment experience 0.31%
Contribution rate FY 06 25.63%]

Mr. Reynolds informed this exercise is undertaken each year.

Mr. Reynolds noted the contribution shortfall of 1.1 percent of the 24.91 percent originally calculated as the amount necessary to contribute to the system. Shortfalls result in future liabilities

Page 24
[Bar graph indicating the following:
Contribution rate FY 05 35.57%
Resetting assumed medical Premium 0.00%
Health cost trend 0.00%
System benefit changes (including PRPA) 0.00%
Salary increases 0.10%
Contribution shortfall 1.40%
Demographic experience 1.35%
Investment experience 0.43%
Contribution rate FY 06 38.85%]

Mr. Reynolds overviewed this graph.

Senator Bunde noted that shortfalls are amortized over 25 years. He asked if the significant shortfalls of the last two years would remain apparent over 25 years.

Mr. Reynolds replied that the information presented so far, is an evaluation of the situation as of June 30, 2003, and that he would begin to address the projection of the system in the future.

Page 28
Projections at Calculated Rate - Key Assumptions

- Three active populations scenarios:
  - 0% growth
  - 1% growth
  - 2% growth
- New entrants brought in to replace members assumed to die, terminate, retire, or become disabled
- New entrant profiles based on average new entrant profiles from the prior 3 years
- Future liabilities and asset returns are calculated at 8.25%, except
  - 17% investment return for FY 04
- Actuarially calculated contribution rate is adopted

each year, beginning in FY 06, but rate cannot increase by more than 5% per year for PERS.

Mr. Reynolds defined growth as membership.

Mr. Reynolds noted the 17 percent investment return for FY 04 reflects the actual rate of return and have exceeded assumptions.

Senator Hoffman asked if the 8.25 percent return on assets calculation is realistic over the long term.

Mr. Reynolds answered yes based on analysis of capital market returns and the asset allocation. He told of an investment-consulting group that assisted in making this calculation. The State Pension Investment Board undertakes a similar calculation of expected returns, although those calculations utilize a shorter timeframe of five years. The projections presented at this hearing extend 30 to 40 years into the future to determine an average over a long period of time.

Page 33
PERS Projections at Calculated Rate - Observations

- Calculated rates increase under all population scenarios
- Calculated rates begin to decline towards end of the projection period under the 1% and 2% scenarios
- Over the past 9 years, the average annual population increase for the PERS has been 1.1%
- Calculated rates increase to above 30% under the 1% population increase scenario
- Factors contributing to the projected rate increases are:
  - Contributions are less than the actuarially calculated rate for the first 5 years of the projection
  - New entrants enter the System at lower pay levels than the exiting members they are replacing, generating losses and diluting the pay-off of unfunded liabilities
- Funding ratios are at least 96% by the end of the 25-year period, under all 3 population scenarios

Mr. Reynolds qualified that the calculated 1.1 percent growth is an estimate and the actual rate is unknown.

Mr. Reynolds explained that contributions into the system for new employees hired at a lower pay are less than the contributions for current employees because contributions are calculated as a percentage of payroll. Contributions therefore decline over time.

Senator Bunde commented that proposals for early retirement are marketed as positive actions because payroll would be lower; however, the retirement benefit costs are not reduced because a certain level of contributions must be maintained.

Mr. Reynolds agreed.

Page 34
TRS Projections at Calculated Rate - Observations

- Calculated rates increase under all population scenarios
- Calculated rates begin to decline towards the end of the projection period under the 1% and 2% scenarios
- Calculated rates increase to 42% even under the 2% population increase scenario
- Factors contribution to the projected rate increases are:
  - Contributions are less than the actuarially calculated rated for the first 2 years of the projection
  - After the first 2 years, there is still a 2-year lag before calculated rates actually enter the System
  - New entrants enter the System at lower pay levels than the exiting members they are replacing, generating losses and diluting the pay-off of unfunded liabilities
- Funding ratios are at least 96% by the end of the 25-year period, under all 3 population scenarios

Mr. Reynolds pointed out that the TRS calculated increase is higher than that for PERS. He stated that the TRS Board does not have same constraint in increasing the contribution percentage.

Senator Dyson questioned the 1.1 percent growth rate cited on page 33, noting the State population is only projected to increase one-percent.

Mr. Reynolds clarified the 1.1 percent figure is rounded from the 1.06 estimate projected for the State.

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Mr. Reynolds added that the growth rate for TRS was approximately 0.6 percent, which is actually lower than the PERS growth rate over the last nine years.

Mr. Reynolds continued that the factors that contributed to rate increases for TRS is similar to the factors influencing the PERS rate increases. The funding ratios for the two systems would both be approximately 96 percent at the end of the 25-year projection period.

Senator Bunde asked why the funding ratio over the next 25 years would not reach 100 percent.

Mr. Reynolds replied that contributions into the system are less because new employees entering the system are earning lower pay levels than those employees leaving the system.

Mr. Sullivan furthered that retired TRS teachers returning to work under contract are not paying into the TRS system.

Mr. Reynolds specified this is an influence on what has happened in the past, and is not included in the calculations.

Page 35
PERS Projections at Calculated Rates
Contribution Rates
[Bar graph projecting the Contribution Rate percentage for the fiscal years 2004 through 2028 for Population Increase 2%, Population Increase 1%, and Population Increase 0%.]

Page 36
TRS Projections at Calculated Rate
Contribution Rates
[Bar graph projecting the Contribution Rate percentage for the fiscal years 2004 through 2028 for Population Increase 2%, Population Increase 1%, and Population Increase 0%.]

Mr. Reynolds stated these graphs demonstrate the previous point in detail.

Page 37
PERS Projections at Calculated Rate
Funding Ratios
[Bar graph projecting the Funding Ratio percentage on June 30 of the years 2003 through 2028 for Population Increase 0%, Population Increase 1%, and Population Increase 2%.]

Page 38
TRS Projections at Calculated Rate
Funding Ratios
[Bar graph projecting the Funding Ratio percentage on June 30

of the years 2003 through 2028 for Population Increase 0%, Population Increase 1%, and Population Increase 2%.]

Mr. Reynolds pointed out these graphs indicate the funding ratios would increase to almost 100 percent at end of the projection period.

Mr. Reynolds stressed the "most powerful influence" on these assumptions is the assumption that the boards are adopting the calculated rate, to the best of their ability, to the maximum amount possible. He explained that this assumption assumes that the actuarial calculated rates are the rates that the boards would be adopting. According to this assumption, the funding ratio reaches almost 100 percent at the end of the 25-year period. However, the rates currently entering the system are not the actuarial calculated rates.

Page 39
Projections at Current Rate - Key Assumptions

- Three active population scenarios:
  - 0% growth
  - 1% growth
  - 2% growth
- New entrants brought in to replace members assumed to die, terminate, retire, or become disabled
- New entrant profiles based on average new entrant profiles from the prior 3 years
- Future liabilities and asset returns are calculated at 8.25%, except:
  - 17% investment return for FY 04
- Adopted contribution rate is maintained at the FY 05 level for all future years

Mr. Reynolds explained the results if current contribution rates were maintained and not increased.

Page 40
Projections at Current Rate - Observations
PERS Observations

- System funding deteriorates under all three population scenarios
- Actuarially calculated rates escalate under all population scenarios
- Assuming 1% population growth, actuarially calculated rates increase to more than 75%, while funding ratio decreases to 20% by the end of the projection period.

TRS Observations

- System funding deteriorates under all three population scenarios
- Actuarially calculated rates escalate to 90% or more, depending upon the population scenario
- Assuming 1% population growth, actuarially calculated rates increase to more than 100%, while the funding ratio decreases to 0% by the end of the projection period.

Mr. Reynolds outlined this page.

Senator Bunde asked if the contribution rate were 100 percent, contributions to the retirement system would be equal to the amount of the employee's salary.

Co-Chair Wilken clarified this would occur if the current contribution rate were maintained.

Mr. Reynolds compared this to credit card debt, explaining that if monthly payments were less than the interest rate, the debt would increase over time.

Page 41
PERS Projections at Current Rate
Contribution Rates
[Bar graph estimating the Contribution Rate percentages for the fiscal years ending 2004 through 2028 for Population Increase 2%, Population Increase 1%, and Population Increase 0%.]

Mr. Reynolds noted this graph assumes that the contribution rate increases for FY 05 then remains the same for 25 years.

Page 4
TRS Projections at Current Rate
Contribution Rates
[Bar graph estimating the Contribution Rate percentages for the fiscal years ending 2004 through 2028 for Population Increase 2%, Population Increase 1%, and Population Increase 0%.]

Mr. Reynolds pointed out the situation is the same for the TRS system.

Page 43
PERS Projections at Current Rate
Funding Ratios

[Bar graph estimating the Funding Ratio percentages for the fiscal years ending 2004 through 2028 for Population Increase 0%, Population Increase 1%, and Population Increase 2%.]

Page 44
TRS Projections at Current Rate
Funding Ratios
[Bar graph estimating the Funding Ratio percentages for the fiscal years ending 2004 through 2028 for Population Increase 0%, Population Increase 1%, and Population Increase 2%.]

Mr. Reynolds noted that the decline occurs much sooner, and with no funds to pay benefits monies must be appropriated from general revenues.

Page 45
Projections Under Different Economic Scenarios - Key Assumptions

- All assumptions and methods are the same as Section 1.5(a) except:
  - Results are shown only under the 1% population growth scenario
  - The actuarially calculated contribution rate is adopted in each year, beginning in FY 06
  - Investment returns are assumed as follows:
    [Table indicating the Total Portfolio Investment Return Under Each Scenario of each of the fiscal years 2004 through 2010 and beyond, showing the Base Case, Growth, and Prolonged Recession percentages.]

Mr. Reynolds outlined this page.

Mr. Reynolds noted this demonstrates prolonged unfunded liability, "a.k.a. double-dipped".

Page 46
PERS Economic Scenarios - Projected Contribution Rates
Annual Population Increase 1%
[Line Graph showing the Contribution Rate percentages of the fiscal years 1004 through 2028 for Prolonged Recession, Base Case, and Growth.]

Page 47
TRS Economic Scenarios - Projected Contribution Rates
Annual Population Increase 1%
[Line graph showing the projected Contribution Rate percentages of the fiscal years 1004 through 2028 for

Prolonged Recession, Base Case, and Growth.]

Mr. Reynolds explained these results for calculated rates.

Page 48
PERS Economic Scenarios - Projected Funding Ratios
Annual Population Increase 1%
[Line graph showing the projected Funding Ratio percentages of the fiscal years 2003 through 2028 for Prolonged Recession, Base Case and Growth.]

Page 49
TRS Economic Scenarios - Projected Funding Ratios
Annual Population Increase 1%
[Line graph showing the projected Funding Ratio percentages of the fiscal years 2003 through 2028 for Prolonged Recession, Base Case and Growth.]

Mr. Reynolds noted this indicates the results for funding ratios.

Mr. Reynolds informed that a prolonged recession would result in contribution rates significantly higher than current calculations. This is an optimistic scenario, but would realize modest benefits.

Mr. Reynolds stated the results for the TRS System are similar in that the projections assume calculated rates enter the System and the Boards adopt the full rate increase.

Mr. Sullivan commented that at the request of employers, the five-percent annual increase limit was adopted to prevent large increases in any one year.

Senator Bunde noted that in FY 05 the legislature would appropriate $41 million to the education foundation funding formula to address the TRS deficit. He asked if a similar deficit should be expected for the next 25 years.

Mr. Reynolds clarified the $40 million is necessary to account for the rate increase from 12 to 16 percent. The 16 percent rate is still 22 percent less than the 38 percent necessary to fully fund the system. Five times the $40 million amount is required to eliminate the unfunded liability.

Co-Chair Green stressed the importance that the five percent limit is not statutory, but rather a regulation the Board adopted for itself.

Co-Chair Wilken reiterated this was done at the request of

municipalities.

Ms. Milhorn explained the process in which the Board made the determination of the five percent annual limit. She indicated the matter would be brought back before the Board for reconsideration.

Co-Chair Green recommended this be done.

Senator Stedman identified two issues: "Where we are today and how to get out of it", and policy failure. He recommended the 3.5 percent inflation rate must be modified to determine a positive affect on the under-funding. He furthered that the Board made several policy decision, most of which escalated the under funding status. One of those decisions relates to the market loss and adjustments to account for that loss. He requested future explanation of these policy decisions. He indicated less concern with policy decisions relating to liability, as the actuaries could only provide estimates. The policies relating to management of assets should be examined. The risk levels of the State and municipalities may not be accurately reflected in the actions of the Board. He intended to review the Board's interactions with consultant actuaries. The comparisons with other states are not accurate because most other states do no pre-fund medical benefits. He supported pre-funding medical benefits. The issue of the asset strategy recommended by the consultant, and that implemented by the Board, as well as the levels of risk within those different strategies is a concern.

Mr. Reynolds stressed that inflation is only one aspect affecting actuarial assumptions; other factors include investment returns, salary increases and medical cost increases. If inflation were less than 3.5 percent, other assumptions would also be reduced by one percent. Salaries less than expected and lower medical expenses would benefit the systems, but poor investment returns would increase the liability of the systems.

Senator Stedman argued that inflation has historically been 3.1 percent and he predicted that over the next 30 to 40 years, inflation would average three to 3.1 percent. He noted the cost of health care should be calculated separately.

Mr. Reynolds replied that this is considered in the assumptions.

Senator Stedman commented that if inflation averages 3.5 percent in the future, the liability of the systems would be greater than anticipated and the problem would be more serious than currently estimated.

Mr. Reynolds responded that 3.5 percent was intended to be the best estimate at the time of the latest actuarial assumption. The consulting group formally reviews the assumptions every five years and results are audited by an independent actuarial firm. When last preformed and "layered", the expectations arrived at a rate of return on investments of approximately 8.6 percent. It is common to factor in conservatives, which was done in this instance and the resulting rate of return prediction was 8.25 percent. The amounts are factored conservatively, partly in the event inflation is lower than anticipated.

Senator Stedman asked the percentage of error.

Mr. Reynolds did not have the information immediately available, although the data does exist.

Senator B. Stevens asked how long Mercer Human Consulting has been the State's advisor.

Mr. Reynolds answered 12 years.

Senator B. Stevens asked how the contribution is based.

Mr. Reynolds replied the fiscal year contribution is based on calculations of the two previous years.

Senator B. Stevens wanted justification of why the Board chose reductions from 12.8 percent to six percent. He asked if this was because the projections indicated the system would be fully funded into the future. He asked why the calculations would decrease.

Mr. Reynolds explained how projections appear at each point in time. Projections start with the amount available. The contribution rate is two parts: the amount required to meet the current need and the amount necessary to pay debt. At that time the debt was very low. The risk factor is borne by the employer and includes investment of assets. The largest contributor to the system is the financial market, which is volatile. This is the starting point for determining necessary contribution rates.

Senator B. Stevens cited information provided by the Department indicates a projected reduction. He asked if that reduction was approved at a meeting after the original rate had been approved.

ANSLEM STAACK, Chief Financial Officer, Division of Retirement and Benefits, Department of Administration, testified that the Board has always followed the recommendations of the actuary in setting rates. The Board has never taken independent actions in this,

except in 1997 when adjustments were made to offset the first drop of four percent; however the recommendation was made two years prior.

Senator B. Stevens remarked on the matter that if emergency action could be taken to reduce the contribution rate, is there ability to take immediate action to increase the rate.

Mr. Staak assumed this could be done if regulation did not prevent such increases.

Senator B. Stevens asked if any pending legislation was before the legislature that would enhance the State's ability to manage pensions.

Mr. Reynolds responded that this situation is not unique and is due to national and international factors, investment returns and cost of medical care. The funding status of all systems has declined dramatically over the last few years. Several other public employee retirement systems are attempting to address the unfunded liabilities. In some states, like Alaska, the invest risk resides with employers. Other programs are defined as a contribution program, commonly known as a 401k in the private sector, where the employee assumes the risks. Some states have adopted an employee risk method or a hybrid of both.

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Mr. Reynolds continued that some states allow the employee to make a selection between programs. These are policy issues. Many systems are experiencing these risk challenges for the first time as a result of poor investment market returns of the last couple of years. During the 1990s risk was actually a "reward" because investment returns were so high.

Senator B. Stevens repeated his question regarding any pending legislation to address this matter.

Mr. Sullivan replied that HB 329 and HB 321, would significantly impact the retirements systems.

Mr. Reynolds clarified this legislation would enhance benefits for certain members of the system. The consulting group has commented on these bills and the boards have appointed committees to explore the issue and make recommendations.

Ms. Milhorn detailed memberships of the boards and the active pursuit of this matter to obtain information, perform analysis and make recommendations for a tier "redesign". This would include recruitment and retention issues as well.

Co-Chair Wilken asked when this report would be complete.

Ms. Milhorn replied the report is due to be submitted to the legislature in February 2005.

Senator B. Stevens asked for clarification that the pending legislation would have a three-percent impact across the entire payroll or just the payrolls that involve those individuals.

Mr. Staak explained that the provisions of HB 91 would change benefits to police and fire employees. It would incur an additional cost per year of approximately $5 million per year to be paid over time. HB 329 relates to early retirement incentives and would cost an estimated $5 billion if every employee who qualified for the early retirement chose to retire.

Co-Chair Wilken interjected these bills would have negative impacts to the PERS and TRS systems.

Senator B. Stevens furthered the legislation would affect a certain employee base, but would impact all members of the system.

Mr. Reynolds affirmed that a segment of the members would be affected.

Senator Dyson appreciated that the Murkowski Administration is making an effort to define clear missions and goals. He assumed that the mission of the benefits and retirements system is to be viable and not encounter these issues in the future. When the matter was brought before the Senate Finance budget subcommittee, the subcommittee was told, "we only manage the fund and others do [the] actuarial [assessments]" He suggested the functions should be combined.

Senator Dyson also wanted discussion of options to implement at times the system is under-funded, including which portion of the risk or burden is incurred by the employees' direct contribution. He wanted to know the benefits and limitations of this.

Ms. Milhorn assured that the Division is dedicated to finding ways to ensure the solvency of the System. The TRS committee is investigating employee contributions.

AT EASE 10:49 AM / 10:49 AM

Senator Bunde requested the actuarial information relating to HB 91. He then expressed concern about information released by the Department of Labor and Workforce Development indicating that the majority of the current population is of a "working age", but that in about ten years, the working age segment would decrease by as much as 50 percent. This would impact the PERS/TRS system. He asked if this has been factored into the consultant's assessments. He also asked if the variables could be altered and employment increased.

Mr. Reynolds replied that the Group has periodically studied the retirement patterns of the system membership. A large number of employees in the PERS/TRS system would likely retire in ten to 15 years. Replacement employees would hired be at lower pay levels. This has been factored into the assessments.

Senator Bunde surmised that fewer PERS and TRS employees would increase the "burden" on taxpayers, and that a smaller percentage of the population would be taxpayers carrying that burden.

Senator Stedman remarked, "Portfolios refer to strategy". An active management strategy is not the only option available. This is a policy issue with the Board setting the policy for those carrying the liability. He asked the level of interaction between the consultant and the Board, as he ascertained the two entities assessed different funding levels and risk levels.

Mr. Reynolds responded that expectation of higher earnings through an equity portfolio over longer term has a tradeoff of greater volatility. The alternative is a more conservative investment policy in bonds, which has less volatility, but incurs a higher long-term cost, because of the lower returns.

Mr. Reynolds agreed the concern regarding the "mismatch of assets and liabilities" is common within the private sector, because of the requirement that corporations values their liability at current income investment rates. As a result, the liabilities have been driven upward dramatically by decreases in the rates available while the value of the assets backing those liabilities have been reduced because those assets are invested in the stock market. This is a worldwide issue. Some European companies are currently invested exclusively in bonds to ensure that assets match liabilities; this has not been done in the United States because the accounting rules are different.

Mr. Staak furthered that the PERS and TRS boards meet on a regular

basis with the Alaska State Pension Investment Board (ASPIB), and are aware of the information input to the actuarial valuation. Regarding the structuring of some investments, he noted that over the past ten years, both boards have not done as well as a single investment category of the State Supplemental Benefits (SBS) plan. The SBS plan has outperformed both the Alaska Permanent Fund and the ASPIB. This is not a fair comparison because each of the entities has a different "stream" of assets and liabilities it is trying to match. Matching the assets and liabilities of a pension plan is difficult, because of the regular "stream of expenditures" for pensions and health care costs, and given the smaller fund amount. A pension plan always is expected to earn over 8.25 percent. A single negative year has a dramatic affect because of the additional loss of the expected earnings as well as the actual loss. For example a year with a loss of five percent results in an actual loss of 13 percent because of the anticipated 8 percent earnings that were not realized but accounted for.

Senator Stedman agreed with the comments on the difficulty of matching assets and liabilities 100 percent given the ongoing expenditures. However, he wanted to know why policy decisions did not control the risk.

Senator Stedman questioned the policy call of lowering the funding from 12 percent to less than seven percent. He understood the political pressures and the municipalities' and the State's efforts to reduce expenses from the general funds. However, most employees understand the necessity to save at least ten percent of their salary for retirement. The reduction therefore appeared to be contrary to general retirement savings plans. This is without considering actuarial assumptions.

Mr. Reynolds responded that the calculated contribution rates are based on payment of benefits that the active members are earning, and payment on the unfunded liability. The payment required for payment of benefits for each of the systems is approximately 13 to 14 percent for the employer portion. Including the employee contribution, the rate is approximately 22 percent of each member's annual salary.

Co-Chair Green pointed out that many of the decisions were made through regulations. In the event that other changes are deemed necessary, the boards or the Department must request statutory changes. No such statutory changes have been recommended to the legislation. She asked how this situation could be remedied.

Mr. Reynolds listed one option is to deposit the calculated rate into the systems for the next 25 years. If 39 percent of pay is

contributed to the TRS system for the next 25 years, the contributions could revert to the payment for the active memberships' benefits, which would be approximately 14 percent. This ignores any future volatility within the system, which is projected to be neutral over time. A second option, which ignores any potential constraints, is to contribute $5 billion to both funds immediately. This is the amount the two systems are currently underfunded. The contribution rates could then be decreased to 12 percent. Another option would be a reduction in the benefits provided to members. However, courts have ruled that benefits are contractual and therefore could only be reduced for future employees. Any benefits from this option would not be realized until the future.

Page 26
Market Return versus Actuarial Return on Assets
[Line chart showing the percentages of Market Return, Actuarial Return PERS, and Actuarial Return TRS for the fiscal years 1995 through 2003.]

Co-Chair Wilken understood that the impact of two to three years of low performance has resulted in this situation.

Mr. Staak affirmed the implications have been cumulative, because instead of realizing earnings during those years, earnings went down. Although earnings increased somewhat, only one-third of the loss has been recovered. The difference must be made up.

Mr. Reynolds gave an example of a beginning balance of $10 billion three years prior with an expected annual earning of 8.25 percent. The projected rate of return after three years would increase the fund to $12.5 billion. If instead, the fund lost eight percent, the balance of the fund would be $9.2 billion and the fund would be underfunded $3.3 billion.

Co-Chair Wilken asked why the System is in the current situation given that earnings were higher than expected for 1995 though 1999.

Mr. Reynolds replied that the PERS system was funded more than 100 percent, but not much more. Some savings were passed on to employers during that time and also enhancements were made to the program since that time.

Page 46
PERS Economic Scenarios - Projected Contribution Rates
Annual Population Increase 1%
[Line Graph showing the Contribution Rate percentages of the fiscal years 1004 through 2028 for Prolonged Recession, Base

Case, and Growth.]

Page 47
TRS Economic Scenarios - Projected Contribution Rates
Annual Population Increase 1%
[Line graph showing the projected Contribution Rate percentages of the fiscal years 1004 through 2028 for Prolonged Recession, Base Case, and Growth.]

Co-Chair Wilken asked if rates must increase from approximately eight percent for PERS and 11 percent for TRS to 30 and 40 percent for the next 25 years.

Mr. Reynolds affirmed.

Co-Chair Wilken requested a compilation of the savings returned to employers. And an accounting of the amount the State would be expected to fund each year.

ADJOURNMENT

Co-Chair Gary Wilken adjourned the meeting at 11:17 AM