

MINUTES
SENATE FINANCE COMMITTEE
January 27, 2005
9:31 a.m.

CALL TO ORDER

Co-Chair Green convened the meeting at approximately [9:31:59 AM](#).

PRESENT

Senator Lyda Green, Co-Chair
Senator Gary Wilken, Co-Chair
Senator Con Bunde, Vice-Chair
Senator Bert Stedman
Senator Donny Olson
Senator Fred Dyson

Also Attending: SENATOR GARY STEVENS; BILL CORBUS, Commissioner, Department of Revenue; TOM BOUTIN, Deputy Commissioner, Department of Revenue; GARY BADER, Chief Investment Officer, Treasury Division, Department of Revenue; MELANIE MILLHORN, Director, Division of Administrative Services, Department of Administration

Attending via Teleconference: From offnet locations: SENATOR LYMAN HOFFMAN; BOB REYNOLDS, Senior Actuarial Consultant, Mercer Human Resource Consulting

SUMMARY INFORMATION

Department of Revenue: Roles of ASPIB & Treasury Division

The Committee heard a report from the Department of Revenue Treasury Division's regarding the Alaska State Pension Investment Board and the Public Employees Retirement System and the Teachers Retirement System.

Department of Administration: Tier Redesign Project Report

The Committee heard from the Department of Administration regarding the Tier Redesign Project.

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Department of Revenue:
Roles of ASPIB & Treasury Division

Co-Chair Green announced that, in order to allow time for thorough presentations, Members' questions would be entertained following the conclusion of today's presentations. Were it deemed necessary, the hearing would continue tomorrow.

BILL CORBUS, Commissioner, Department of Revenue, stated that the presentation would address four issues: the structure of the Department of Revenue Treasury Division; a review of the Division's investment funds that have "a role in managing" investments; the relationship of the Alaska State Pension Investment Board's (ASPIB) investment policy to the Public Employees Retirement System (PERS) and the Teachers Retirement System (TERS) actuarial assumptions; and the ASPIB investment process.

Commissioner Corbus stated that the Missions and Measures of the Treasury Division specify that it is the Division's responsibility "to collect and invest the State's money." This would include cash management functions and insuring that established guidelines are followed. An investment staff of financial analysts conduct the "most difficult and challenging" responsibility which is that of investing approximately four billion dollars of State funds as well as managing the investments of ASPIB. The Commissioner has fiduciary responsibility for the State's money and, as an ASPIB board member, has equal responsibility to that of the other seven Board members.

TOM BOUTIN, Deputy Commissioner, Treasury Division, Department of Revenue, commented that in 2004, the Treasury Division managed and invested approximately \$20.5 billion of State money as reflected on the Department's handout titled "Combined Schedule of Invested Assets at Fair Value December 31, 2004" [copy on file] which depicts the money "by fiduciary and within those headings, by beneficiary group or agency." Updated information could be located on the Division's website each month. The Division manages money on behalf of "ASPIB for four defined benefits programs and two participant-directed plans." The Division manages money for four State agencies and 27 other funds that the Commissioner has fiduciary responsibility for. Cash flows, cash needs, liquidity and investment restrictions associated with such things as proceeds from tax exempt bonds that vary by fund.

Mr. Boutin stated that today's presentation would be limited to the activities of the Treasury Division and ASPIB, which was established by legislation in 1992. The Treasury Division was charged with exercising "the investment, custodial and depository powers or duties, the Fiduciary of a State fund shall apply the

prudent investor rule and exercise a fiduciary duty in the sole financial best interest of the Fund. Treasury further refines the prudent investor rule to the standards of: 1) an institutional investor; 2) a professional; and 3) an investor managing large investments. While some funds managed by Treasury and entrusted to the Commissioner of Revenue are Trust funds, such as the Public School Trust Fund and the Children's Trust, Treasury uses the same investment process and standards for all funds." In regards to procedures, "Treasury prepares written investment policies and documents investment processes. Each fund has missions and objectives that lead to an appropriate asset allocation strategy and establishment of specific investment policy. Investment managers are selected for each fund to implement the investment policy." Approximately four billion dollars of fixed income management is conducted internally with the balance of the fund being conducted by external investment managers. "Performance of managers is strictly monitored, evaluated, and documented" and ASPIB and the Commissioner of Revenue hold formal meetings to monitor performance and asset allocations. Results are reported quarterly and independent audits are conducted annually.

Mr. Boutin reported that the Division is allowed by State Statute to establish investment pools and benchmarks. Policies are maintained and available for viewing on the Department's website. Formal processes exist for asset allocation and asset classes, expected returns, risks, time and time horizons, risk tolerance and liquidity, and "the evaluation and hiring and firing of money managers". The fiscal year 2004 Rate of Return on Investments for PERS and TRS was 15.08 percent and 15.09, respectfully. These returns exceeded the actuarial assumptions as well as the medium return for public funds, as reported by Callan & Associates. He referenced the Department's handout titled "Cumulative Performance Relative to Target" [copy on file] whose "Cumulative Returns Actual vs Target" chart depicts the Fund's rates of returns experienced since 1991 to the national actuarial expected returns. The handout's chart titled "Thirteen Year Annualized Risk vs Return" portrays the Fund's rate of return to a larger universe of comparable funds.

GARY BADER, Chief Investment Officer, Alaska State Pension Investment Board and Treasury Division, Department of Revenue, pointed out that State Statutes specify that the PERS and TRS Board would establish their actuarial rates of return after the receipt of advice from the Division of Retirement and Benefits and the Actuary. The Actuary, whose investment horizon is approximately 25 to 30 years, determines the assumptions and then applies the assumption and develops "the estimated contribution rates required of the employers in the system." The Actuarial information is

presented annually, in a joint meeting, to the Boards. The ASPIB Board is "acutely aware" that PERS/TRS are anticipating "an 8.25 percent rate of return over a long period of time." Following the Actuarial presentation and the PERS/TRS adoption of their actuarial rates of return, ASPIB would establish "its target earnings for the coming year."

Mr. Bader continued that the process leading up to the point of how ASPIB establishes its earning assumptions each year, including how to deploy the assets, is further explained in the Department's packet titled "Alaska State Pension Investment Board Presentation to the Senate Finance Committee: The Role of ASPIB and the Treasury Division" [copy on file], dated January 27, 2005. This packet contains an abbreviated version of what the Board considers in the process "of setting its asset allocations."

Mr. Bader reviewed the packet's presentation as follows.

Page two

Agenda

- * Present reasoning behind capital market projection process
 - economic background
 - specific projections
- * Discuss implications generally
- * Outline next steps

Mr. Bader stated that page two outlines the process undertaken by the Division's financial consultant, Callan Associates Inc. regarding capital market assumptions as to how the stock market would perform over the next five years for such things as fixed income and other asset allocation classes.

Page four

Callan's Capital Market Projection Process

Economic Outlook Drives Our Projections

- * Evaluate the current environment and economic outlook for the U.S. and other major industrial countries:
 - Business cycles, relative growth, inflation.
- * Examine the relationships between the economy and asset class performance patterns.
- * Examine recent and long-run trends in asset class performance.
- * Apply market insight:
 - Consultant experience - Plan Sponsor, Manager Search, Specialty
 - Industry consensus
 - Client Policy Review Committee
- * Test the projections for reasonable results.

Mr. Bader stated that page four is the first of several pages that demonstrate the types of evaluations Callan considers in developing their assumptions.

Page five

2004 Capital Market Projections

Guiding Objectives

*Our best thinking regarding the 5-year outlook, recognizing our median projections represent the midpoint of a range, rather than a specific number.

*Results that are readily defensible both for individual asset classes and for total portfolios.

*Conscious of the level of change suggested in strategic allocations for DB, DC and foundation/endowment clients.

*Reflect common sense and recent market developments.

*Balance conflicting goals and conflicting opinions.

Mr. Bader read the information on page five. The information on page six is a reflection on recent years' asset returns. In the year 2000, the Russell 3000's return of a negative 7.46 percent is an indicator of how the stock market performed in general. In contrast, the Leman Brothers Aggregate reflected a positive 11.63 percent that year. "This demonstrates one of the basic tenants of investment management," which is that of having "a number of asset classes that have rates of return that are not necessarily correlated with one another." When possible, asset allocations should be made according to those principals.

Mr. Bader stated that page seven depicts global perspectives considered by Callan Associates. Page eight considers information regarding the United States economy. He highlighted information on page eight regarding interest rates as follows.

* Interest rates are still extraordinarily low:

- Treasury bonds yields were at their lowest in 40-years, due to

*Aggressive Fed action to lower interest rates

*Investors, afraid of equity, favoring bonds and driving yields lower.

Mr. Bader stated that this information is being factored into the assumptions about "how committed we should be regarding fixed income in the coming time period."

Mr. Bader continued that page nine addresses expectations. He highlighted the section on that page as follows.

*Callan's outlook in a nutshell: expect a low inflation, low interest rate, single digit return environment.

Mr. Bader noted that the graph on page ten depicts the historical relationship between earnings to price and the Standard & Poor (S&P) 500 returns.

Mr. Bader expressed that the graph on page eleven depicts the historical relationship between the S&P 500 Earnings Yield and the 10-Year Treasury Bond Yield from 1981 through 2003.

Mr. Bader stated that in regard to Domestic Fixed Income, the graph on page 12 reflects that current yield is an indicator of the future returns of bonds. "There is relatively close tracking between the return on bonds five years out and what their yield to worst is today."

Mr. Bader stated that page 13 is a thumbnail explanation of the rationale for the 2004 capital market assumptions, presented on page fourteen, that Callan Associates presented to ASPIB. The Projected Standard Deviation (Risk) factor is a measure of "how likely that return might vary from the prediction."

Mr. Bader noted that page 15 depicts the 2004 Correlation Coefficient Matrix. He reiterated that the investment policy supports holding a variety of different assets classes, studying their variations, and then determining how they move in relation to one another. Were something "to move in step" with another asset class, the correlation factor would be one; were it to move in the exact opposite direction, such as stocks going up and bonds going down "in exactly the same proportions to one another" the correlation factor would be minus one. The correlation factor would be zero were there no correlation at all.

Mr. Bader stated that pages 16 and 17 provide additional information that ASPIB would be considering at the upcoming March meeting at which the asset allocation would be established. He noted that ASPIB and its consultant, Callan Associates, do not work independently in setting asset allocations, as Statutes require that ASPIB have an Investment Advisory Committee (IAC), with a minimum of three members. He reviewed the current membership and shared that IAC, during a recent telephonically conducted meeting, proposed to ASPIB and Callan Associates that the asset allocation target rate of return be 7.84 percent as reflected in the gray column depicted on the Efficient Frontier Segment chart on page 19, with a standard deviation of 11.81 percent over time.

Mr. Bader stated that page 20 presents the previous page's

Efficient Frontier information in graph form. "The basic tenant is that the higher return you expect to get, the more volatility of returns" might be experienced in achieving it. "Volatility is considered a measure of risk." He noted that Callan's capital market target rate of return was 7.60 percent based on a five-year projection, whereas PERS/TRS were seeking a target return of 8.25 percent. He pointed out that the actuarial assumptions for PERS/TRS are based on a thirty-year horizon, whereas Callan Associates utilizes a five-year projection. "The difference between the two is what is assumed in the inflation adjustment between the two assumptions. Callan had an inflation assumption of 2.6 percent. The attempt here is to get a five percent real rate of return. If you put into 2.6 percent inflation, that brings the ASPIB to 7.6 percent. Mercer is also trying in their assumptions to get a five percent real rate of return. Their inflation assumption over a 30-year period is greater than Callan's is over the five. That is why there is a disconnect between the earnings assumption of PERS/TRS and the target rate of return for ASPIB."

Mr. Bader continued that pages 22 through 24 depict "graphical representations of the probability of return." The expected likelihood of getting the target rate of return is approximately "50/50" on the chart titled "1-Year Range of Return Comparison" on page 22. The likelihood of exceeding the target rate of return is depicted in the column titled "Proposed". For example there is a ten-percent probability of earning 23.94 percent or greater. Were the ten-year Range of Return chart of page 24 compared to the one-year chart on page 22, "the likelihood of obtaining the targeted range of return" is the relatively the same, the likelihood of differing from that rate of return is diminished as exemplified by there being only a ten-percent probability of earning 12.69 percent or higher over the ten-year period. Therefore, the longer something is invested, the more likely the possibility of obtaining the target.

Mr. Bader informed that, with the exception of pages 25 and 27, the information in the packet was provided by Callan Associates. The information on page 25 was provided by Mercer Human Resource Consulting in response to the question, "how have the funds impacted the funding ratios of the retirement system." As depicted, the "rate of return exceeded what the actuarial rate of return actually turned out to be", as reflected on the chart. "There were a number of years in which the ASPIB and PERS/TRS funds earned higher rates of returns" than expected. He noted that the aggregate of all the investment returns impacted the 2003 funding ratio for PERS, as depicted in the chart on page 25, but only accounted for a negative 3.8 percent decline in the funding ratio. Were the 2004 investment returns, which were in the 15.1 percentage, taken into

consideration, the funds would reflect a positive investment return over the period since 1993.

Mr. Bader stated that the "Cumulative Returns Actual vs. Target" chart on page 26 depicts the Actuarial Assumption and the returns of the PERS/TRS funds as provided by Callan Associates.

Mr. Bader stated that page 27 contains a copy of the January 3, 2005 letter from Mercer Human Resource Consulting to Melanie Millhorn, Director of the Department of Administration, that presents that the change in the funded status of the funds, "while slightly impacted by investment returns ... is the result of changes in the liabilities of the funds."

Mr. Bader concluded the Division of Treasury's ASPIB presentation.

AT EASE [9:59:58 AM](#) / [10:00:22 AM](#)

Co-Chair Green noted that, in addition to this meeting being teleconferenced with the Anchorage and Fairbanks Legislative Information Offices (LIO), the Kenai LIO is also participating.

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TIER REDESIGN PROJECT REPORT
DEPARTMENT OF ADMINISTRATION

MELANIE MILLHORN, Director, Division of Retirement & Benefits, Department of Administration, explained that "the catalyst behind" the tier redesign project that began in January 2004, was the Commissioner of the Department of Administration who tasked members of the PERS/TRS Board with developing new tier redesigns to address two areas: the short-funded status for the systems and rising employer contribution rates. The information being presented today includes information that was discussed during the Tier Redesign Project meetings conducted in Anchorage and Fairbanks over a nine-month period. The "State of Alaska PERS & TRS Tier Proposals Senate Finance" Report [copy on file] was prepared by the actuarial firm, Mercer Human Resource Consulting, and is a compilation of the information discussed during those meetings. The meetings were advertised and numerous employers and interested parties participated in the discussions. In November 2004 the Tier Project Review Subcommittee, which consisted of two PERS and two TRS Board members, finalized their work on this project and presented two alternative tier proposals, referred to as Alternative 1 and Alternative 2, to the full PERS/TRS Boards. While the Subcommittee favored Alternative 1, the full PERS/TRS Boards did not approve

either of the Tier Redesign alternatives, and as a result, no recommendation was furthered to the Department of Administration Commissioner, Ray Matiashowski. The Tier Review Subcommittee is no longer active as their task has been completed. She noted that there was "significant participation" by the employers, who are the stakeholders of this system," at the November 2004 PERS/TRS Board meeting. It should also be noted that "all of the employers who testified and participated in that meeting which was the culmination of all of that analysis, benchmarking," and survey results, "advocated for new tier alternatives."

BOB REYNOLDS, Senior Actuarial Consultant, Mercer Human Resource Consulting, testified via teleconference from an offnet site and stated that Mercer is the actuary for the State of Alaska's retirement systems, the PERS/TRS systems in particular. Mercer's role with the Tier Redesign Project subcommittee was to facilitate, gather information, and provide cost alternatives for tier alternatives being considered.

Mr. Reynolds turned his remarks to the aforementioned handout and stated that Slide One on page one indicates that the Retirement Program Financial Management is influenced by how the Benefit Policies, Funding Policies, and the Investment Policy interact.

Mr. Reynolds reviewed the contents of the Report as follows.

Slide 2, page 1

Financial Summary

Employer Contribution Rates - PERS

	<u>FY05</u>	<u>FY06</u>
Normal Cost Rate:	13.31%	13.24%
Average Past Service Rate:	11.60%	12.39%
Average Contribution Rate:	24.91%	25.63%
Board Adopted Rate:	11.77%	16.77%

*The normal cost rate provides for benefits expected to be earned by active members during the fiscal year

*The past service rate is the part of the contribution that is intended to pay the unfunded liability (over 25 years)

Slide 3, page 2

Financial Summary

Employer Contribution Rates - TRS

	<u>FY05</u>	<u>FY06</u>
Normal Cost Rate:	14.76%	14.28%
Past Service Rate:	20.81%	24.57%
Total Contribution Rate:	35.57%	38.85%
Board Adopted Rate:	16.00%	21.00%

*The normal cost rate provides for benefits expected to be earned by active members during the fiscal year

*The past service rate is the part of the contribution that is intended to pay off the unfunded liability (over 25 years)

Mr. Reynolds stated that the intention of Slide 2 regarding the PERS system and Slide 3 regarding the TRS system, is to provide background information pertinent to the "financial implications of the new tiers." Mercer's FY 06 actuarial calculated rate for the PERS system is 25.63 percent as denoted as the Average Contribution Rate on Slide 2 and 38.85 percent as denoted by the Total Contribution Rate for TRS on Slide 3. While both of these rates are comprised of the same two components, the Normal Cost Rate and the Past Service Rate, they are labeled differently because the PERS system employers "are each charged their own separate rate calculation relative to their own circumstances." Therefore the rate reflects the "average contribution system" for PERS "as a whole." The TRS employer contribution rate is referred to as the Total Contribution Rate because a single calculation rate would apply to all employers in the system. The definitions of normal cost rate and past service rate are depicted at the bottom of Slides 2 and 3. "The normal cost rate is the cost of the benefits that the members who are actively employed within the system are earning during that year." "In any situation where the funding is less than 100 percent" according to Mercer's calculations, in that there are less assets than there is "accrued liability in the system, that deficit is called the unfunded liability and it is amortized over 25 years, similar to a mortgage, except that it is amortized as a level percentage of payroll."

Mr. Reynolds continued that for FY 06, the PERS Average Past Service Rate of 12.39 percent is the amount that would be required to pay off the unfunded liability over 25 years. The Normal Cost Rate for FY 06 is 13.24 percent. Therefore the Average Contribution Rate is 25.63 percent.

Mr. Reynolds declared that, by regulation, the PERS employer contribution could only decrease or increase by five percent per year. Thus, while the FY 06 Average Contribution Rate is 25.63 percent, the Board Adopted Rate is 16.77 percent.

Mr. Reynolds noted that the FY 06 Normal Cost Rate is 14.28 percent and the Past Service Rate is 24.57 percent, for a Total Contribution Rate of 38.85 percent. "The largest portion of the Total Contribution Rate is actually the part that is required to pay off the unfunded liability." The TRS Board has "recommended" a rate of 21.00 percent for FY 06.

Mr. Reynolds pointed out that absent any unfunded liability, "if the systems were 100 percent funded," the calculated rate for the PERS system would be 13.24 percent and the calculated rate for the TRS would be 14.28 percent. Therefore, "were the systems fully funded at this time", the systems' rates would range between 13 and 14 percent.

Slide 4, page 2

- *Rising contribution levels
- *Volatile investment returns
 - =investment uncertainty
- *Rising medical costs

Mr. Reynolds stated that Slide 4 further describes some of the financial concerns of the Tier study.

Slide 5, page 3

Overview

Key Information

Key information gathered and analyzed

- * Employer survey
- * Member focus groups
- * Benchmarking
- * Benefit levels
- * Demographic projections
- * Implications of Medicare changes
- * Trends, issues and alternatives
- * Cost analysis and projections

Mr. Reynolds stated that Slide 5 depicts some of the key information utilized by the subcommittee in determining its Tier alternatives. "An extensive body of information was gathered, discussed, and analyzed over the course of the ten to eleven month period." Much of this information is available on the Department of Administration website. "One key finding of the benchmarking activity that was conducted was that the medical program through the PERS/TRS systems was considerably richer than programs offered in similar states."

Ms. Millhorn informed the Committee that the PERS and TRS employers' survey results are located on pages 30 through 57 of the Report. The survey was very important as it set the framework for gathering information. Employers' input alerted the subcommittee as to which benefits are valued. 89 PERS employers responded and ten others replied that they choose not to participate. 36 of 57 TRS employers responded. Surveys were also distributed to 11 collective

bargaining unions; only one responded. Employer input was a valued component of this process.

Slide 6, page 3

Employer Survey - PERS

Important Conclusions

- * Employers want the retirement program to continue to provide medical coverage
- * Many employers open to the possibility of providing differing levels of medical coverage based on service or having members share in the cost of coverage
- * Other potential cost savings areas that some employers seem open to:
 - Lowering the post-retirement cost-of-living adjustment
 - Not providing medical coverage to vested terminated members
- * Some responses seem to favor continuing a defined benefit approach
 - Reward long service
- * However, responses leaned towards shifting investment risk to members

Slide 7, page 4

Employer Survey - TRS

Important Conclusions

- * Employers want the retirement program to continue to provide medical coverage
- * Many employers, particularly the largest employers, open to the possibility of providing differing levels of medical coverage based on service or having members share in the cost of coverage
- * Other potential cost savings areas that some employers seem open to:
 - Lowering the post-retirement cost-of-living adjustment
 - Not providing medical coverage to vested terminated members
- * Some responses seem to favor continuing a defined benefit approach
 - Reward long service
- * However, responses leaned towards shifting investment risk to members

Mr. Reynolds stated that Slides 6 and 7 depict "the important conclusions that were drawn from the Employers' surveys. Slide 6 reflects the conclusions for PERS employers and Slide 7 depicts the conclusions for TRS employers. "The conclusions were essentially identical". He reviewed the conclusions and noted that "vested

terminated members are members who leave the system prior to reaching eligibility for retirement, but who are entitled nevertheless to receive a benefit from the State once they reach retirement age." The benchmarking activity that was undertaken in the Tier Review revealed that, "very few, if any, other system provides medical coverage to vested terminated members."

Slide 8, page 4

Overview

System Objectives and Constraints

Based on information gathered and stakeholder feedback, the Tier Committee drafted the following objectives:

- * The System should provide medical benefits to retirees
 - Members should bear a greater share of the cost
 - Members should have to retire from the System to be eligible
- * Benefits should favor longer-service members
- * Employer contributions should be more predictable and stable
- * Investment risk should be shared by employers and members
- * Healthcare inflation risk should be shared by employers and members

Slide 9, page 5

Overview

System Objectives and Constraints

Based on information gathered and stakeholder feedback, the Tier Committee drafted the following constraints:

- * Non-medical benefits must be sufficient to satisfy minimum requirements for employers who do not participate in Social Security
- * Benefit changes must take the form of new "tiers"
- * Annual cost of benefits should be less than the current Systems' normal cost rates

Mr. Reynolds stated that the employers' survey combined with other information gathered by the subcommittee "led to the drafting objectives and constraints for the retirement system that are reflected on Slides 8 and 9. The information on Slides 8 and 9 provide the framework for what the subcommittee "was aiming at in arriving at the proposed alternatives."

Slide 10, page 5

Trends and Alternatives

Defined Benefit Observations

- * Plans have experienced higher cost levels and greater cost volatility
- * Funded status has declined in last 3 years

- * Advantages (to employer) of defined benefit plans
 - Retention incentives, lower turnover cost
 - Workforce management
 - Cost allocated to longer-service employees

Slide 11, page 6

Trends and Alternatives

Defined Benefit Observations (*continued*)

- * Advantages (to employee) of defined benefit plans
 - Pooling of longevity risk
 - In most cases, employer bears investment risk
 - Predictable, stable retirement income
- * Challenges (for employer) of defined benefit plans
 - Investment risk
 - Cost volatility

Slide 12, page 6

Trends and Alternatives

Defined Contribution Observations

- * Advantages (to employer) of defined contribution plans
 - Predictable cost
 - Stable cost
 - Employee assumes investment risk
 - No long-term administrative commitment
 - Contribution equity among employees
- * Advantages (to employee) of defined contribution plans
 - Portability
 - Ability to direct investments
 - Contribution equity among employees

Slide 13, page 7

Trends and Alternatives

Defined Contribution Observations (*continued*)

- * Challenges for defined contribution plans
 - More difficult to manage workforce
 - Employee directed money often earns less
 - Amount needed at retirement is often underestimated
 - Employees need to contribute in excess of 10 percent, but most do not
 - Retirees generally not equipped to transform lump sum into monthly payments that last for a lifetime (difficult to manage longevity risk)

Mr. Reynolds stated that Slides 10 through 13 describe trends and alternatives in retirement programs nationwide. He read the information on the slides and stated that one outcome of this benchmarking activity was the realization that retirement systems around the country "have experienced or would experience changes to

their programs." Therefore, comparing Alaska's retirement programs to others is difficult as programs nationwide are in a state of flux. An alternative retirement program is a defined contribution retirement plan such as a 401K plan, which is the type of program being proposed for the federal Social Security program. "A Defined contribution plan is an account that is typically invested at the employee's discretion in the marketplace... in mutual funds or stock funds." The advantages of a defined contribution plan to an employer and an employee are depicted on Slide 12. The challenges of these plans are depicted on Slide 13.

Slide 15, page 8
Proposed Alternatives
Overview

- * Two alternatives are being presented to the PERS and TRS Boards, with the Tier Committee recommending Alternative 1
- * Components of Alternative 1
 - defined benefit
 - defined contribution
 - medical
 - health reimbursement account (HRA)
- * Components of Alternative 2
 - defined contribution
 - medical
 - health reimbursement account (HRA)
- * Member contributions under both alternatives are higher than the current tiers
- * Contribution rates for the defined contribution component are higher for Alternative 2
- * Post-retirement medical program is the same for both alternatives

Mr. Reynolds stated that the Subcommittee proposed two alternatives, Alternative 1 and Alternative 2, as described on Slide 15. The health reimbursement account (HRA) which is the medical component being proposed for both alternatives "is a vehicle similar to a defined contribution account but with the purpose of setting aside and building a fund to pay for medical expenses in retirement." Therefore, the HRA plan would be different from the current plan.

Mr. Reynolds stated that the difference in the two Alternatives is that the defined benefit portion of the retirement program was eliminated in Alternative 2, "and the costs that would have been directed to the defined benefit program in Alternative 1 were instead directed to the defined contribution part of Alternative 2 so that Alternative 2 has a larger defined contribution component

than Alternative 1 does and no defined benefits portion." The Member contribution in both Alternatives would be higher than current tiers' levels. While the Subcommittee supported Alternative 1, the overall PERS/TRS Boards did not approve it.

Slide 16, page 8

Proposed Alternatives

Defined Benefit Alternative

Key features of Alternative 1 defined benefit program

- * 1 percent of career average pay
- * Pay is indexed from year received to year preceding retirement (or termination) based on the Anchorage CPI
 - for example, 1997 pay for a member retiring on December 31, 2009 would be increased at Anchorage CPI for 12 years
- * Base pay only
- * Normal retirement at the earlier of
 - (1) age 60 with 5 years of service (8 years for TRS),
or
 - (2) 25 years of service (30 years for PERS "others")
- * Post-retirement pension adjustments similar to current tiers
- * No 10 percent Alaska cost-of-living adjustment (COLA)

Slide 17, page 9

Defined Contribution Alternatives

Key features of defined contribution components

- * Individual accounts are maintained for each member
- * Contributions are a percentage of base pay
- * Various investment options (member-directed)
- * 100% vested
- * Terminating or retiring member takes account (eligible for rollover)

Mr. Reynolds stated that Slides 16 through 19, on pages eight and ten, provide details of the defined benefit and defined contribution components of the programs. The graph on Slide 18, on page nine, compares the value of the TRS Non-Medical benefits of the current plan at various ages to the projected values of the two proposed Alternatives. The graph on Slide 19 reflects these values for PERS. The TRS chart depicted on Slide 18 indicates that Tier 2 members who retire from the current system at age 60 would receive higher benefit levels than either Alternative; however, the proposed Alternatives would provide that person higher benefits were they to retire at an earlier age. On average, the benefit levels of the Alternatives would provide similar values to those of current Tier 2 employees. A PERS Tier 2 60-year old retiree's current benefit levels would be similar to those of Alternative 1. Prior to that age, Alternative 1's value exceeds that of

Alternative 2 or the current PERS Tier program.

Mr. Reynolds characterized the proposed Alternatives' Non-medical benefit components as being "risk-shifting" rather than being a cost-reduction. The benefit levels were designed to be roughly similar to the current programs with some of the investment risks shifting from the employer to the employee. The level of shifting is what differs in the two proposed alternatives. "Alternative 1 shifts some of the risks from employers to members and Alternative 2 shifts" the entirety of the investment risk from the employer to the members in regards to non-medical benefits.

Mr. Reynolds stated that key aspects of the proposed Medical programs are described on Slides 20 through 28, pages ten through 14.

Slide 20, page 10

Proposed Medical Program

Key Features

Key features of post-retirement medical program

- * Members must retire directly from the System to be eligible
- * System sponsored health plan with varying levels of subsidy or cost to members
- * Early retirees get "access only" prior to normal retirement eligibility
- * Defined dollar benefit from normal retirement to Medicare eligibility (currently age 65)
- * Defined health benefit after Medicare eligibility, similar to the current program with the following key exceptions:
 - Method of coordination with Medicare
 - Retired members will share in the cost through premium contributions

Slide 21, page 11

Proposed Medical Program

System Sponsored Health Care Plan

- * System sponsored health plan available to all eligible retirees, but with varying levels of subsidy
- * Basic plan design elements

	<u>Current Plan</u>	<u>Alternate Plan</u>
Medical		
*Coordination with Medicare	Total Allowance	Maintenance of Benefits
*Deductible	\$150/person, \$450/family	\$250/person, \$750/family
*Out of Pocket	\$800	\$2,500
*Outpatient Surgery Coinsurance	100%	80%

Prescription Drug

*Retail	90 day supply	30 day supply
-Generic	\$4	\$5
-Brand Formulary	\$8	\$15
-Brand Non-Formulary	\$8	\$30
*Mail Order	90 day supply	90 day supply
-Generic	\$0	\$5
-Brand Formulary	\$0	\$15
-Brand Non-Formulary	\$0	\$30
Dental, Vision, Audio	No change	

Slide 22, page 11

Proposed Medical Program

Eligibility

*Normal retirement eligibility for medical benefits will be defined as the earlier of

- (1) age 60 with 10 years of service
- (2) 25 years of service (30 years for PERS "others" retirees).

* Disabled participants will be eligible

* Terminated vested participants are not eligible. A member must retire directly from active service in order to receive coverage

Slide 23, page 12

Proposed Medical Program

Early Retirement

* Early retirees who have not reached normal retirement eligibility

- Receive "access only" plan
- Will not be eligible for subsidized retiree health plan costs
- Pay 100% of the pre-Medicare eligible (currently pre-age 65) per member per year (PMPY) claim costs

* Dependent spouses of early retirees will pay 100% of the appropriate pre-Medicare or Medicare eligible PMPY claim cost

Slide 24, page 12

Proposed Medical Program

Normal Retirement to Medicare Eligibility

* Members who retire directly from the Systems will be eligible for a "defined dollar" benefit upon reaching eligibility for normal retirement

* Fixed dollar subsidy toward system sponsored health coverage

* Access to system sponsored retiree medical plan as outlined above

* Subsidy amount is based on length of service

* Subsidy amount indexed each year by healthcare inflation up to a maximum of 5 percent (with a "catch-up" provision based on years when healthcare inflation is less than 5%)

Slide 25, page 13

Proposed Medical Program

Normal Retirement to Medicare Eligibility

* Upon becoming eligible for Medicare, such members will become eligible for the "defined health" benefit

* Pre-Medicare dependent spouse is eligible for the same subsidy as retiree

* Medicare eligible dependent spouse is eligible for the Medicare eligible benefit level, with contribution percentage based on retiree length of service

Slide 26, page 13

Proposed Medical Program

Normal Retirement to Medicare Eligibility

* Apply percentages to the applicable subsidy base to arrive at the appropriate subsidy amount.

* Defined Dollar Subsidy Base Annual PMPY for fiscal year 2004:

Pre Medicare \$5,962*

* Subsidy Percentage

<u>Service (yrs)</u>	<u>Subsidy %</u>
10-14	30%
15-19	45%
20-24	60%
25-29	75%
30+	90%

* Member contributions are determined by subtracting the annual subsidy amount from the annual claims cost for a given year.

*Equivalent to FY2004 pre-Medicare projected claim cost.

Slide 27, page 14

Proposed Medical Program

After Medicare Eligibility

* Defined health benefit similar to current program

* Retirees who were previously eligible for 100% subsidy of retiree health plan costs will now participate in the premium cost.

* Contributions are per covered individual

* Pre-Medicare dependent spouses are eligible to receive a defined dollar subsidy with percentage based on retiree length of service

* Medicare eligible dependent spouses are eligible to receive the same defined health benefits as the retiree and pay the same contributions

Slide 28, page 14

Proposed Medical Program

After Medicare Eligibility

*Contribution Base PMPY for fiscal year 2004:

Medicare Eligible \$2,667

* Contribution Percentage

<u>Service (yrs)</u>	<u>Contribution %</u>
10-14	30%
15-19	25%
20-24	20%
25-29	15%
30+	10%

* Apply percentages to the contribution base to arrive at the applicable contribution

Mr. Reynolds stated that Slides 20 through Slide 28 describe the key aspects of the proposed medical program. He communicated that under the proposed alternatives, terminated vested members who leave prior to retirement would not be eligible for medical benefits. The components of Slide 20 were reviewed. The System sponsored health plan would provide varying levels of subsidy or costs to the members. The medical benefits program would be divided into three phases over a member's retirement including: Phase 1 is early retirement in which a member who retires prior to normal retirement "would get access to the program but would need essentially to pay their own way"; Phase 2 would be from a member's normal retirement age to reaching eligibility age for Medicare which is currently age 65; and Phase 3 which is once a member reaches Medicare eligibility. Phase 2's Defined Dollar Benefit means that "the system would provide money that the member would use to help pay for medical care but the member would be responsible for the difference between what the system provides and the actual cost of the medical care. Phase 3 would be similar to the current program with the exception being the method through which "the program coordinates with Medicare and a greater degree of cost sharing with the members through premium contributions." The Health Reimbursement Account (HRA) is intended to assist members with setting aside money "to help pay for some of the cost sharing elements in the proposed program." He recommended that the Committee Members independently review the Medical component Slides.

Mr. Reynolds informed the Committee that more information regarding the HRA account is provided on Slides 29 through 38, pages 15

through 19. HRA have been in existence for several years and recent federal legislation "is making them more common and more attractive." While HRA accounts are similar to defined contribution plans, the key point here is that HRA "is simply an account that helps accumulate money toward health expenses in retirement."

Mr. Reynolds stated that the financial implications of the alternatives are depicted beginning with Slide 39 on page 20. It provides the normal cost rates of Alternative 1 as compared to the current system for both PERS and TRS. He reminded that the current system's normal cost rates were depicted in Slides 2 and 3. "The normal cost rate is the cost of the benefit that the members are expected to earn in any given year. It does not consider any unfunded liability that might need to be paid off. It's a fresh start look at the cost of the retirement system." It would be "expected that on average the Alternative 1 program would cost 18.75 percent." The numbers in parenthesis reflect the comparable cost for the current TRS system. The current projected cost would total 22.97 percent. Alternative 1 would result in approximately a four-percent savings. One of the Tier Redesign subcommittee's objections was to reduce costs of the system. Currently, members' share of the program cost is 8.69 percent; under the new system members' share would increase to 10.0 percent. Employers' costs would be reduced by approximately 5.5 percent. The PERS cost rates are also depicted on Slide 39.

Mr. Reynolds explained that Slide 40 on page ten depicts similar information regarding Alternative 2. The overall costs of Alternative 2 were designed to be similar to Alternative 1. The difference is that the defined benefit program is eliminated and the defined contribution rate is higher. He reviewed the PERS and TRS normal cost rates for members and employers as proposed by Alternative 2.

Mr. Reynolds concluded that both Alternatives "were designed to have similar overall long term cost implications both to members and employers." The differences "include the levels of cost volatility that could be expected from year to year." Alternative 1 has more volatility because it has retained the defined benefit component". Alternative 2 would have "considerably less volatility but would continue to have some cost volatility associated with the medical component."

Ms. Millhorn explained that page 21 depicts the historical PERS and TRS Normal Cost Rates as compared to the Actuarial Computed Rates for the years FY 1983 through FY 2006. She noted that the benefits from higher investment earnings are reflected in the lower cost rates for the years 1999 through 2002.

Mr. Reynolds stated that pages 22 through 25 portray the Key Assumptions utilized for the Actuarial Projections into the future for the current PERS and TRS systems. The assumptions on page 22 project that there would be a population growth rate of one percent; the PERS Board would adopt the Actuarial recommended rate with the provision that, as established in State Regulation, the rate could not increase by more than five-percent per year; and the utilization of "three different possible economic futures" including one labeled "Base Rate" in which it is anticipated that the fund would earn on average 8.25 percent per year; one labeled "Growth" which "is a little more optimistic with higher returns in the next few years, leveling out to the Actuarial assumption in the future"; and a "pessimistic economic scenario labeled Prolonged Recession with very poor investment returns for the first few years rebounding to a higher level but a level that is still lower than the 8.25 percent assumption." The known actual returns for the year 2004 have been factored in. These three scenarios and their projected contributions rates are depicted, in graph form, on page 23. He stated that the graph depicts that the unfunded liability would be paid off in 25 years. The contribution rates could increase to as much as 30-percent under the Base Case scenario before declining.

Co-Chair Green understood that this information was provided in the Department's January 26 presentation.

Mr. Reynolds affirmed, and noted that this information continues for the TRS system on pages 24 and 25. The TRS system's contributions could increase to approximately 55-percent before the unfunded liability is paid off. He reiterated that the TRS Board is not bound by the five-percent constraint.

Mr. Reynolds stated that the PERS/TRS scenarios for the new tiers, as compared to the current program are depicted on Slides 41 and 42 on page 26, respectfully. He clarified that because no one in the current system would be subject to the new tier provisions, a few years would pass before the savings affects of the new tier would be realized. It is anticipated that "significant cost savings" amounting to approximately six or seven percent could result at the end of the 25-year period for the PERS system, as reflected on Slide 41. Similar savings are projected for the TRS system as depicted on Slide 42.

Mr. Reynolds and Ms. Millhorn concluded their remarks.

Senator Bunde understood that a significant number of employees would be retiring from the PERS/TRS systems over the next few

years. Therefore, implementation of a new tier within the next four or five years would be the most effective action.

Ms. Millhorn deferred to Mr. Reynolds, as her Division had not conducted an analysis in this regard.

Mr. Reynolds responded that while he could not provide "a numerical answer to the question", during the initial stages of the tier redesign project, Mercer had conducted population projections for both the PERS and TRS systems for the next five to ten years. The projections included expected retirements and the areas of the system that would require personnel replacements. This information is available on the Department of Administration's website. The projections portrayed on page 26 of the Report reflect "the affect of the new tier were it to be implemented in the very near future," either today or in the next one to two years. Projections were not undertaken that would reflect the affects of a new tier occurring five years out. While those projections are unavailable, "clearly it does defer by five years any savings that a new tier might bring into the system." He agreed that were "a bubble of people" retiring over the next few years, delaying the implementation of a new tier could be characterized as "some opportunity lost in terms of replacing current membership with new tier members."

Co-Chair Wilken chaired the following portion of the meeting.

Senator Bunde stated that he would defer the decision to the Co-chairs as to whether development of a chart depicting the forecasted retirement scenario might be helpful to the discussions. Continuing, he asked for further information regarding the projected one-percent population growth.

Mr. Reynolds clarified that, based on "recent historical analyses," a one-percent population growth is forecast in regards to the growth of members in the two systems: active membership in PERS has grown 1.1 percent per year on average over the past five years as compared to .6 percent per year growth for TRS. He clarified however, that "it is not Mercer's attempt to predict" what might occur in the State.

Senator Bunde stated that it would be interesting to compare this information to the projections developed by the Department of Labor and Workforce Development.

Senator Bunde asked regarding "the cost of money" in that would the State be able to save a substantial amount of money were it able to pay off the outstanding debt early, similar to how an individual might save money were their 30-year loan paid off prior to its

termination date.

Senator Green assumed Chair of the meeting.

Mr. Reynolds responded, "that the time value of money is factored into all these calculations." Paying off a mortgage early would save nominal dollars. However, were that money invested at the mortgage interest rate, it would not result in significant savings as tax incentives and other elements would not be applicable. The Department has requested Mercer to determine the affect of paying off a portion of the unfunded liability early. This information is being compiled. He referred the Committee to the right hand column of figures on aforementioned Slides 2 and 3 which indicate that, were each systems' entire unfunded balance paid off, the cost rate would decrease from 25.63 percent to 13.24 percent and from 38.85 percent to 14.28 percent for PERS and TRS respectfully. "That would be the savings realized from paying off the entire unfunded portions of the unfunded...." Were half of it paid off, "the past service rate would decrease by half."

Co-Chair Green announced that, due to time constraints, Members' questions pertinent to these issues would continue during the Friday, January 28, 2005 meeting.

ADJOURNMENT

Co-Chair Green adjourned the meeting at 11:01 AM