

**MINUTES**  
**SENATE FINANCE COMMITTEE**  
**March 16, 2005**  
**9:16 a.m.**

**CALL TO ORDER**

Co-Chair Green convened the meeting at approximately [9:16:48 AM](#).

**PRESENT**

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

**Also Attending:** SENATOR JOHNNY ELLIS; SENATOR GARY STEVENS;  
REPRESENTATIVE PAUL SEATON; MILES BAKER, Staff to Senator Stedman

**Attending via Teleconference:** There were no teleconference participants.

**SUMMARY INFORMATION**

SB 141-PUBLIC EMPLOYEE/TEACHER RETIREMENT

The Committee heard from the sponsor and the bill was held in Committee.

HB 1-INCREASE AMT OF BASE STUDENT ALLOCATION

The Committee adopted a committee substitute and the bill was reported from Committee.

#SB141

SENATE BILL NO. 141

"An Act relating to the teachers' and public employees' retirement systems and creating defined contribution and health reimbursement plans for members of the teachers' retirement system and the public employees' retirement system who are first hired after July 1, 2005; establishing the Alaska Retirement Management Board to replace the Alaska State

Pension Investment Board, the Alaska Teachers' Retirement Board, and the Public Employees' Retirement Board; adding appeals of the decisions of the administrator of the teachers' and public employees' retirement systems to the jurisdiction of the office of administrative hearings; and providing for an effective date."

This was the first hearing for this bill in the Senate Finance Committee.

Co-Chair Green commented on the significant effort invested in preparing this legislation.

Senator Stedman stated this bill proposes a reconstruction of the retirement system for the state of Alaska. Over the past couple years, difficulties with the existing system have become apparent. Because of the complex mathematical models involved, it is difficult to determine the actual liability of the retirement fund.

Senator Stedman noted his presentation would be given in two parts utilizing a handout titled, "Retirement Security Act, SB 141, March 16, 2005" [copy on file]. The portion addressed at this meeting would focus on the past and current situation. The next meeting would address the specific proposals of SB 141.

[9:20:29 AM](#)

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#### Presentation Outline

- How a retirement system works
- What is the current status of Alaska's system?
- What went wrong?
- SB 141 Overview
- SB 141 Walk-through (March 17, 2005)
- Appendices

Senator Stedman overviewed the presentation.

[9:20:47 AM](#)

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How a retirement system works

[Flow chart containing three interrelated components of a

Secure and Sustainable Retirement System:

- Funding Policies-Determine how new monies come into the system
- Investment Policies-Determine how the money in the system is invested
- Benefits Policies-Determine the retirement, medical and death benefits offered to members]

All Three System Components Must be Working in Balance

Senator Stedman noted that the responsibility of the investment policy is to ensure that benefit policy liabilities are met. It is the responsibility of the funding policy to ensure that adequate revenue is collected. The system works in balance over years, although some fluctuation in overvalue and undervalue is expected. Each area must be aware of the activities of the other two areas since the actions of each area impact all areas. For example, when the legislature changes the benefit policy, the other two policies are affected as well.

[9:22:18 AM](#)

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How a retirement system works

[Drawing of a fuel barrel labeled Net System Assets, and pipes depicting the following:

Driven by Funding Policies

Employer Contributions- input to the fuel can

Member Contributions- input to the fuel can

Driven by Investment Policies

Investment Gains - input to the fuel can

Investment Losses - output from the fuel can

Driven by Benefits Policies

Admin & Investment Expenses - output from the fuel can

Benefits & Refunds Paid - output from the fuel can]

Net System Assets Must Be Sufficient to Pay Future Benefits

Senator Stedman remarked the intent is that the fuel can reservoir never run dry. He qualified that for the purpose of this presentation he would refer to the State of Alaska as the employer, noting that municipalities and school districts are also employers in the retirement systems. Currently different groups control the three policies, Funding, Investment and Benefit. He questioned the abilities of these entities to communicate with each other.

[9:24:55 AM](#)

Co-Chair Wilken asked if the barrel depicted in the drawing represents the same fund that is currently under-funded.

Senator Stedman affirmed and indicated he would provide further explanation.

[9:25:17 AM](#)

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What is the [status] of Alaska's system?

[Drawing of fuel barrel labeled with data specific to the Alaska system based on 2003 Actuarial Valuation. The barrel lists \$11.4 billion Net System Assets (Combined PERS & TRS Actuarial Asset Values) and \$16.4 billion Assets Needed to Meet Accrued Liabilities, with a difference of \$5.0 billion. Pipes attached to the barrel are labeled as follows.

Employer Contributions: \$162.1 million  
Member Contributions: \$167.9 million  
Investment Results: \$373.1 million  
Admin & Investment Expenses: -\$32.6 million  
Benefits & Refunds Paid: -\$778.3 million

PERS & TRS Have A Combined \$5.0 Billion Unfunded Liability

Senator Stedman noted the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS) are combined in this demonstration. Individual data is available for each system.

Senator Stedman noted this depiction includes benefits due in different years. If payout of all benefits were required immediately, the funds would be \$5 billion short.

Senator Stedman commented that this information could be viewed as a glass half empty or half full. He stressed however that the situation is not to the extent as to "cripple or derail" the State's fiscal position. The State is able to meet the benefit obligations for retired and future retired employees.

[9:28:45 AM](#)

Senator Dyson clarified that \$16.4 billion is the amount of assets required if all the benefits were paid out.

Senator Stedman affirmed that if the plan were "shut down" and a targeted earnings rate of 8.25 percent were achieved, \$16.4 billion would be needed to meet all obligations.

Senator Dyson clarified that if the system "cashed out" every member immediately, more than \$16.4 would be required.

[9:29:43 AM](#)

Senator Bunde understood the intent to fund future medical expenses, the amounts being uncertain. He asked if this method is common or whether other plans fund actual expenses, rather than attempt to project accrued liabilities. He asked if the State should consider this option.

Senator Stedman appreciated the observation. Alaska is one of four states that pre-fund medical benefits. Although the unfunded liability position is undesirable, Alaska is in a better situation than most states. Other states have substantially greater challenges. The Alaska system should not be in its current situation because medical benefits are pre-funded, however, the situation could be significantly worse. Alaska employees should not be concerned that their benefits would not be paid.

[9:32:08 AM](#)

Senator Bunde indicated a preference to have the funds available, rather than delay action on addressing the situation. He spoke to the "incredible speed" of medical advancements and subsequent cost increases. Pre-funding medical funding is a "moving and very difficult target" to match. The medical benefits could never be pre-funded with certainty, as the amount is approximate and changes frequently.

Senator Stedman agreed the amounts are not "cast in stone". It is easier to ascertain the amount of the plan's assets than project the liabilities. The estimate of the liability is approximately \$6.4 billion depending on the timing of the calculation. This matter would be addressed further as the risk level is considered.

[9:33:44 AM](#)

Senator Olson noted the \$110 million difference between input and outflow and asked how long this has been occurring.

Senator Stedman replied that negative flow demonstrated on the barrel drawing represents FY 03. He expected the difference for FY 04 to be a positive flow due to the improved performance of the

fund portfolio. Market fluctuations would cause years with more cash paid from the system than deposited into it, although more years would realize positive cash flow. He stressed that "the driver that pays the benefits" helps the employer and employee contributions, but the major driver is the fund portfolio. The earnings of the asset base would pay the majority of the funds paid out in benefits.

[9:34:52 AM](#)

Senator Olson asked if Senator Stedman supported elimination of pre-funding medical benefits.

Senator Stedman answered no. Alaska is "on the right track" by pre-funding medical benefits, despite occasional hardship in estimating costs. Alaska is in a better situation than other states that do not pre-fund medical benefits.

[9:35:15 AM](#)

Co-Chair Green requested members hold questions to the next hearing.

Senator Bunde asked Senator Stedman to reemphasize that those currently in the system would not lose their retirement benefits.

Senator Stedman affirmed current and retired employees "are not at risk at all".

Senator Bunde received an email from a public employee that read "This afternoon I was notified by an employee association representative that the legislature is about to vote tomorrow on SB 141 that would without consent, take cash from my paycheck, reduce my retirement income and reduce retirement health benefits I've already paid for with my labor." Senator Bunde asserted that misinformation is being distributed.

Co-Chair Green had heard the same.

[9:37:43 AM](#)

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What is the [status] of Alaska's system?

[Line graph showing Historical PERS & TRS Funding Ratios for each year from 1975 through 2003. The PERS ratio is 72.8 percent and the TRS ratio is 64.3 percent for 2003. Other

information reads:

1975 System Population		
Active:		19,998
Retire:		1,734
2004 System Population		
Active:		43,300
Retire:		28,279
Terminated (Vested)		6,689
Terminated (Non-Vested)		14,606]

Senator Stedman noted the desired target is assets and liabilities in the same amount. He overviewed this graph.

[9:39:24 AM](#)

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What went wrong?

[Line graph showing Combined PERS & TRS Actuarial Valuations (2003): Accrued Liabilities, Actuarial Value Assets, and Market Value Assets for the years 1994 through 2003. The data for 2003 is as follows.

Accrued Liabilities:	\$16,397,262
Actuarial Value Assets*	11,439,566
Market Value Assets:	10,994,074

\*Asset Market Value is adjusted by the actuary in an effort to bring more order and predictability to the employer contribution rate and to smooth out year to year market fluctuations. Prior to 2002, Mercer used a "corridor method". Beginning in 2002 they switched to a 5-year "smoothing method".]

We Have Been Understating Our Liabilities For the Past Several Years

Senator Stedman noted this graph details the valuations beginning in 1994, well before the current situation developed. Economic growth in the capital markets occurred in the late 1990s and assets had "the opportunity to participate in". An adjustment was made in 2002 that substantially adjusted the calculation of the assets. This was done to avoid an impression of substantially over-funded in the timeline of the retirement plan during the "bubble" in the equity market, which would provide an artificial representation of the funding ratio.

Senator Stedman informed that an actuarial audit was done in FY 02 and adjustments were made as a result. The liabilities

substantially increased in FY 02 and reached \$16 billion in FY 03.

[9:41:26 AM](#)

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What went wrong?

[Line graph showing Accrued Liabilities, Actuarial Value Assets, and Market Value Assets for the years 1994 through 2003. The years 1996 through 2002 are highlighted "What happened in the last several years?"]

Clearly Something Changed Since 2000.

Senator Stedman pointed out that the calculations of liabilities contained in reports issued to the legislature before the year 2002 were inaccurate and too low. The impression was given that the assets appeared to be at a high value, when in reality, the liabilities were understated. This practice continued for several years and lead to erroneous decisions by the boards involved in managing the retirement system, which exaggerated the problem. After the audit was released in 2002 and adjustments were made, the liabilities increased greatly and at the same time the equity markets "were having their difficulty" and the portfolio decreased in value and a widening of the unfunded liability began.

[9:42:38 AM](#)

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Same as above with the addition of a line showing multiple years of compounded errors.

Senator Stedman informed that actuarial analysis is difficult and time consuming with the "numbers constantly in motion". However, "when the rubber hits the road, we need an accurate number."

[9:43:48 AM](#)

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What went wrong?

[Bar graph showing PERS/TRS Projected system Liabilities (\$Millions) for the years 1994 through 2003. This information differentiates: Forecasting error and 2003 Proj. Liability, and the error percentage between the two amounts.]

Why Have Liabilities Grown at 9.27 % vs. A Projected Growth of 5.60%?

Senator Stedman outlined this graph. The liability of the fund in FY 03 is \$16.4 billion, which is approximately one-third of the fund total. These are "huge spreads" and the variance must be minimized regarding expected liabilities actual liabilities.

[9:45:00 AM](#)

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What went wrong?

- Inaccurate assumptions
- Historical understatement of system liabilities
- Rising health costs
- 3-yr bear market
- Declining interest rates
- Unfavorable demographic changes
- Timing of the recognition of market losses
- Artificially low contribution rates in good times
- Legislation that has increased benefits
- Awarding of Post Pension Retirement Adjustments

A Combination of Factors Created Our Present Situation

Senator Stedman explained that inaccurate assumptions made during the 1990s led to the historical understatement of liabilities.

Senator Stedman commented that the legislature had insufficient and inaccurate information when decisions were made to increase benefits.

[9:46:14 AM](#)

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What went wrong?

[Bar graph showing Factors Contributing to PERS Employer Rate Increase\* (% of Cumulative 1998 to 2003 Rate Increase Attributed to Each Factor) as follows:

Actuarial Loss (Increased Employer Rate)	
Assumption Changes	-34.19%
Investment Experience	-11.62%**

Health Experience	-11.28%
Demographic Experience	-8.89%
Asset Valuation Method	-4.42%**
Contri Shortfall Due to	
2 Year Calculated Rate	-3.37%
102% Funding Ratio	
Adjustments	-2.02%
Ad hoc PRPA	-1.56%
System Benefit Changes	-0.64%
Actuarial Gain (Decreased Employer Rate)	
Salary Experience	6.47%
Past Service Amortization	
Change	15.52%
*PERS Employer Rate increased 18.3% form 7.36% in 1998 to 25.63% in 2003	
**Total Asset Side Impact of 16.04%	

#### A Combination of Factors Created Our Present Situation

Senator Stedman explained this graph includes all factors involved in the increased employer contribution rate utilizing an absolute value to total 100 percent. The most significant factor was Assumption Changes. Investment Experience and Health Experience also contributed. Some of the health care assumption changes were imbedded in the Assumption Changes factor. A more detailed breakdown of each factor is available. Clearly, one factor is not solely responsible for the situation

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What went wrong?

[Flow chart showing three interrelated components noted as Difficult to Control System Drivers:

- Funding Drivers
  - o Retiree Medical Costs
  - o Mortality Rates
  - o Retirement/Turnover Rates
  - o Past Service Liabilities
- Investment Drivers
  - o Inflation
  - o Market Performance
  - o Economic Performance
  - o Risk Tolerance
- Benefit Drivers
  - o New Legislation

- o Salary Increases
- o Recruitment & Retention Goals
- o Age of Workforce
- o COLAs

The center of the flow chart lists the following:

- Constraints
  - o Statutory Provisions
  - o Alaska Constitution
  - o System Cash Requirements
  - o Federal Regulations
  - o Bargaining Agreements
  - o Size of Asset Pool]

Financial & Economic Drivers are Hard To Predict and Difficult to Control

Senator Stedman opined, "Therein lies the risk that we face." He overviewed the items in the three drivers and the main constraints.

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What went wrong?

[Flow chart showing three interrelated components noted as Difficult to Manageable System Drivers:

- Funding Drivers
  - o Targeted Funding Ratio
  - o Employer Contribution Rates
  - o Actuarial Assumptions
- Investment Drivers
  - o Asset Allocation Policy
  - o Asset/Liability Equation
  - o Investment Expenses
- Benefit Drivers
  - o New Legislation
  - o Waivers & Appeals
  - o Normal System Costs

The center of the flow chart lists the following:

- Manageable Controls
  - o Retirement Boards
  - o Statutory Provisions
  - o Plan Provisions
  - o Existing Tiers
  - o Department Regulations
  - o Management Structure

Senator Stedman highlighted the drivers and the controls. He noted

the factors are interdependent. These factors must be more closely monitored to control liability exposure.

[9:50:34 AM](#)

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What went wrong?

[Drawing of fuel barrel titled "PERS/TRS Control & Oversight" containing Net System Assets. Pipes attached to the barrel are as follows:

Input:

Employer Contributions - PERS & TRS Boards

Member Contributions - Tier Structure & Statutes

Investment Gains - ASPIB

Outflow:

Investment Losses - ASPIB

Admin & Investment Expenses - ASPIB & Div of Retirement/Benefits

Benefits & Refunds Paid - Tier Structure, Legislature & Statutes

Responsibility & Oversight is Fragmented Among Different Entities

Senator Stedman remarked that different groups are "watching the gauges and adjusting the valves" of the PERS/TRS Control & Oversight fuel barrel, and these groups do not communicate with each other effectively. When the legislature asks a group questions about the operation and status of the fund, it does not receive answers, but rather it told that the responsibility lies with another group.

[9:51:48 AM](#)

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What went wrong?

[Flow chart showing the interrelation between Funding Policies and Investment Policies; and the cancelled interrelation between these policies and Benefits Policies. Notations indicate: Higher Employer and Employee Contributions Alone Can't Solve Our Problem; and, Investment Returns Alone Can't Solve Our Problem. The center of the flow chart reads: Unfunded Liability PERS \$2.9 billion, TRS \$2.1 billion.]

## Current Funding & Investment Policies Can't Support Our Benefits Policy

Senator Stedman noted the "breakdown" of the system and lack of fluency. Rather than allow the current dysfunction to continue, policy decisions should be corrected now and the unfunded liability addressed afterward.

[9:52:47 AM](#)

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### Important Conclusions

- System assets and liabilities must be jointly managed
- System volatility needs to be reduced
- Cost predictability and controls must be improved
- Employer contribution rates must be stabilized
- Sources of new liability must be eliminated
- Liability growth must be contained
- Existing liability must be reduced

Senator Stedman overviewed these items.

Senator Stedman attributed system volatility in part to the existence of separate boards overseeing the plan. SB 141 proposes one board to manage the entire system. This entity would be responsible for achieving balance and controlling volatility.

[9:54:33 AM](#)

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### SB 141 Overview

Senator Stedman stated that the aforementioned information generated the proposed Retirement Security Act.

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### SB 141 Overview

The Retirement Security Act will

- Strengthen Management & Fiduciary Oversight

- Improve Our Ability to Predict and Control Costs
- Constrain the Growth of the Unfunded Liability
- Provide Near Term Financial Relief to Employers
- Pave the Way For Developing a Long-Term Financial Fix

While still maintaining our principle objectives of

- Ensuring the Solvency of Alaska's Retirement System
- Maintaining the Attractiveness of Public Sector Employment
- Recruiting and Retaining Talent

RSA Improves the Long-term Health and Security of Our Retirement System

Senator Stedman commented on the challenge to address the problems with the system. He was determined to retain good employees as well as attract new quality employees. Competition for these employees is not only within Alaska, but includes the entire Pacific Northwest. Parody is also necessary between existing and new employees. Employees performing the same job should not be compensated differently. This is detrimental for moral.

[9:57:48 AM](#)

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SB 141 Overview

SB 141 - Key Elements:

- Establishes a Defined Contribution (DC) Plan, Retiree Medical Benefit and Health Reimbursement arrangement for new employees
- Replaces the existing boards (PERS, TRS, ASPIB) with a new 9-member Alaska Retirement Management Board (ARMB)
- Establishes ARMB's role to balance system assets with liabilities
- Transfers the quasi-judicial responsibility for hearing appeals to the Office of Administrative Hearings
- Transfers to the Commissioner of Administration responsibility for hearing appeals to the Office of Administrative Hearings
- Transfers to the Commissioner of Administration responsibility for adopting system regulations and reviewing requests
- Sets the actuarially computed Normal Cost Rate as the

floor for annual employer contribution rates

Senator Stedman indicated he would go into more detail on the key elements in future hearings on this bill. The defined contribution plan would be significantly different from the current defined benefit system. The retiree medical benefit plan would be changed and a health reimbursement arrangement would be offered for new employees to assist with insurance deductibles and health care costs.

Senator Stedman characterized the replacement of the existing boards as the most important element of this legislation. One entity would oversee both assets and liabilities and communicate with the legislature. This would eliminate "buck passing".

Senator Stedman stated that the balance of assets and liabilities by the ARMB would be a different process than current practice. If assets and liabilities were balanced, most of the existing concerns of funding shortfalls would diminish.

Senator Stedman continued that the appeals process is currently a function of the PERS and TRS boards.

Senator Stedman defined the actuarially computed Normal Cost Rate as the "annual contribution for today's benefits being accrued".

[10:01:09 AM](#)

Senator Stedman commented that the current system is operated as a fractional organization with different groups overseeing and controlling different aspects of the plan. A consolidation must be undertaken and one group must be in control of the entity.

Senator Stedman informed that significant detail information would be presented later.

Co-Chair Green ordered the bill HELD in Committee.

AT EASE [10:02:53 AM/10:12:00 AM](#)

Co-Chair Green made an announcement regarding congressional action relating to the Arctic National Wildlife Refuge.

#HB1

[10:12:35 AM](#)

CS FOR HOUSE BILL NO. 1(HES)

"An Act relating to the base student allocation used in the formula for state funding of public education; and providing for an effective date."

This was the second hearing for this bill in the Senate Finance Committee.

Co-Chair Wilken moved for adoption of SCS CS HB 1, 24-LS0001\S as a working document.

Senator Hoffman objected for an explanation of the changes.

Co-Chair Wilken explained that the total effect of the committee substitute adds \$70 million to the education foundation funding formula. This amount is divided into \$32 million for the classroom and \$38 million for Public Employees Retirement System (PERS) and Teachers Retirement System (TRS) expenses. The \$32 million is contingent on the passage of HB 1. The \$38 million provision is contingent upon passage of a retirement reform bill, perhaps in the form of SB 141.

Co-Chair Wilken calculated passage of this legislation would result in a funding increase of \$343 per student.

Co-Chair Green remarked on the need to reform the PERS and TRS, which is a priority. This is part of the effort to assist school districts, boroughs, etc. in funding education.

Senator Hoffman asked the consequences for this legislation if SB 141 does not pass.

Senator Hoffman pointed out that the fiscal note amount is different than that stated by Co-Chair Wilken. The fiscal note indicates the total funding per student would be \$4,733 rather than \$4,919.

[10:15:00 AM](#)

Co-Chair Wilken clarified that the increase of \$32 million would increase the per student allocation by \$157 totaling \$4,733. If PERS and TRS reform is passed the per student allocation would be increased an additional \$186 to be \$4,919. The total of the committee substitute is the same as the bill passed by the House of Representatives.

Senator Hoffman removed his objection and the committee substitute

was ADOPTED as a working document.

Co-Chair Wilken offered a motion to report SCS CS HB 1, 24-LS0001\S from Committee with individual recommendations and a new fiscal note.

There was no objection and SCS CS HB 1 (FIN) MOVED from Committee with a fiscal note prepared by the Senate Finance Committee dated 3/16/05 for the Department of Education and Early Development in the amount of \$32,018,600.

**ADJOURNMENT**

Co-Chair Green adjourned the meeting at 10:16 AM