

MINUTES
SENATE FINANCE COMMITTEE
February 20, 2007
8:33 a.m.

CALL TO ORDER

Co-Chair Bert Stedman convened the meeting at approximately [8:33:34 AM](#).

PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Charlie Huggins, Vice Chair
Senator Kim Elton
Senator Donny Olson
Senator Joe Thomas
Senator Fred Dyson

Also Attending: DAVID TEAL, Director, Legislative Finance Division, Legislative Agencies & Offices

Attending via Teleconference: There were no teleconference participants

SUMMARY INFORMATION

^PERS/TRS Funding Status & Review

PERS/TRS Funding Status & Review

[8:33:39 AM](#)

Co-Chair Stedman stated that the information presented today would assist the effort to address continuing issues pertaining to Employer Contribution Rate levels and the unfunded liabilities of the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS), and their impact on the operating budgets of the State, municipalities, school districts, and the University of Alaska. The "asset/liability mismatch" would be one of the key elements addressed today.

AT EASE [8:35:40 AM](#) / [8:36:48 AM](#)

DAVID TEAL, Director, Legislative Finance Division, Legislative Agencies & Offices, noted that many of the items slated for discussion were previously addressed in the "PERS and TRS Funding Status and Review" presentation conducted for the Committee on February 15th by Melanie Millhorn, Director, Division of Retirement & Benefits, Department of Administration.

Mr. Teal directed his remarks to the Legislative Finance handout titled "PERS & TRS Funding" [copy on file] dated February 20, 2007.

[8:37:47 AM](#)

Page 2

Liability/Asset Gap

PERS/TRS Funding Ratio

[Chart comparing the Accrued Liability of the PERS/TRS systems to its Assets. The references to FY 97 through FY 05 below the chart indicate the data year. The Rate Years FY 05 through FY 08, inside the chart, reflect the year impacted by that data. For example, data from FY 02 impacted the Rate Year FY 05.]

Mr. Teal explained that, as depicted on the chart, the PERS and TRS systems' assets and liabilities were in alignment during data years FY 1997 (FY 97) through FY 2001 (FY 01). However, when data was updated in FY 01 and factored into Rate Year FY 04, the scenario changed. The discrepancy between the two has continued to increase and a \$6.9 billion gap is projected for Rate Year FY 08. Thus, what was not an issue of concern four years ago, has now become a major concern to the State and local governments.

Mr. Teal stated that the retirement systems must forecast for the long-term "because it has to look at people's entire working lives and then their retirement as well". A minimum 50-year time horizon is the norm.

Mr. Teal communicated that the systems are "supposed to be self-adjusting" in that assets should increase in step with liabilities. Such things as growth in the wage base and/or an increase in the contribution rate level would increase the asset base. To that point, he noted that the contribution rate levels "are calculated by actuaries and adjusted each year".

Mr. Teal asserted that the self-adjusting system worked well until "suddenly, the system exploded and opened a gap" between the systems' liabilities and assets. That gap is referred to as the "unfunded liability of the system ... it went from virtually zero to five million dollars in one year."

8:40:54 AM

Mr. Teal pointed out that the systems' unfunded liabilities were increasing faster than their assets. This is evidenced by the fact that the upward slope of the accrued liability line on the chart was steeper than the growth slope of the assets line.

Mr. Teal advised that because the systems' self-adjusting mechanism was designed to address "drifts" rather than "explosions", there is a question of whether that mechanism could address the level of unfunded liabilities being experienced.

Mr. Teal expressed that such things as the downturn in the financial market in 2001 attributed to the decline in assets. The actuary credited increasing medical costs and longer life expectancy as factors increasing liabilities. Changes in the actuarial assumptions also were a factor.

8:42:32 AM

Mr. Teal reiterated that the systems might have reached a point beyond that which could be addressed by the self-adjusting mechanism. This is one of the reasons this discussion "is so important". A deep understanding and review of the details is paramount.

Mr. Teal contended that a minimum of one piece of new legislation would be required "to adjust the system" as simply adjusting the contribution rates would not be sufficient.

8:43:10 AM

Questions

1. What Does the Unfunded Liability Mean?

- To Retirees - Not Much. Benefits cannot be reduced. There is no cash flow problem.
- To Employees - No direct impact; employee contribution rates cannot be increased unilaterally. But there may be indirect costs associated with higher benefit costs.
- To Employers - Higher Contribution rates in the absence of other cash infusions.

Mr. Teal reviewed how the unfunded liability issue might affect PERS and TRS retirees, employees, and employers. Retirees would experience little impact as their benefits could not be reduced. While there would be no direct impact on employee's contribution rates since those rates are fixed, indirect impacts such as restrictions on future employment opportunities and salaries could be experienced as employers absorb additional system costs.

Mr. Teal explained that the unfunded liability would have the most impact on employers as their contribution rates would continue to increase, absent some "major cash infusion" by the State.

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Questions

2. Can the gap close as quickly as it opened?

Don't count on it. (But note TRS 91-98)

3. If rate increases close the gap, are we looking for a solution when no problem exists?

Ask municipalities if contribution rate increases is a crisis.

4. What is the State's role in fixing the system?

That depends on the system.

Mr. Teal questioned whether the system's self-adjusting mechanism "on its own" would be able to close the unfunded liability gap without increasing employer's contributions rates to unreasonable levels.

Mr. Teal directed attention to the chart titled "Board Adopted Employer Contribution Rates - FY '90 thru FY '08", page 16, of the aforementioned February 15th Department of Administration Division of Retirement & Benefits' presentation [copy on file]. As depicted on that chart, the TRS adopted Employer Contribution rates were lower than the actuarial recommended rates for eight years. "What that would normally mean is that the system is being under-funded" and a gap between the assets and liabilities would occur. The fact that the Actuarial recommended rate lowered after those eight years indicates that "the system fixed itself. It can happen, but I think it could only happen when you catch it quick enough and it's sort of a drift rather than a major shift in what happened."

Mr. Teal identified this as being an issue in the lawsuit the State is contemplating against the State's former actuarial, Mercer Human Resources Consulting. "Although it's a self-adjusting system and we could have or should have been paying more into it, we didn't."

Mr. Teal contended that the level of the unfunded liability exceeds the system's ability to self-adjust. "The actuarial assumptions that were used may be responsible for opening up that system to the point where the system cannot fix itself."

[8:46:38 AM](#)

Mr. Teal assured the Committee that the gap between liabilities and assets would close; however, it would not "close quickly" as the "rate increases are designed to close the gap over a 25 year period."

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Mr. Teal addressed the question of whether there "really was a problem" if the gap could be "closed by itself in 25 years". He could not definitively counsel the Legislature in respect to whether we might be "looking for a solution" to a non-existent problem, but he did suggest that Legislators "ask the municipalities if the current contribution rates are a crisis in

their eyes". He believed their response would be that "they simply can't afford the high rates." A determination must be made as to what role the State should take in "fixing the system".

[8:47:54 AM](#)

Page 5

State Financial Support

- The state fully paid cost increases in the TRS system.
- The state fully paid cost increases for its own employees.
- The state paid a portion of cost increases for local governments, despite the fact that it has no legal responsibility to pay these costs.

Mr. Teal reviewed the State's financial support efforts since 2004. There is a question as to whether the portion of the costs paid by the State for local governments was enough as the State simply picked up the annual increases in costs.

[8:48:30 AM](#)

Page 6

Financial Contributions (%)

[Bar graph depicting the level of the State and Local Contribution Rates to Local PERS for FY 2004 through FY 2008:

FY 2004:	State 0.0%,	Local 7%
FY 2005:	State 5%,	Local 7%
FY 2006:	State 5%,	Local 12%
FY 2007:	State 5%,	Local 17%
FY 2008:	State 18%,	Local 22%

Mr. Teal addressed the question of whether the State had truly picked up the increase in costs since the percentages paid by municipalities increased from seven percent in FY 04 and FY 05 to 12 percent in FY 06, to 17 percent in FY 07, and to 22 percent in FY 08 while the State's percent remained constant at five percent until it increased to 18 percent in FY 08. The

percents depicted for municipalities were averages as rates varied from one municipality to another.

Page 7

Financial Contributions (\$ Mill)

State and Local Contributions to Local PERS

[Bar graph depicting the level of State and Local monetary contributions to Local PERS for FY 2004 through FY 2008:

FY 2004: State \$ 0.0, Local \$30.0
FY 2005: State \$21.4, Local \$30.0
FY 2006: State \$21.4, Local \$51.4
FY 2007: State \$21.4, Local \$72.8
FY 2008: State \$77.0, Local \$94.2]

Mr. Teal stated that the State/municipality contribution percents on page 6 are depicted in terms of dollars on page 7. "The State has picked up the annual increases from the prior year, but not cumulative increases." Thus, local contributions increased from \$30 million in FY 04 to \$94 million in FY 08.

[8:50:18 AM](#)

Mr. Teal advised that municipalities' contribution levels would continue "growing rapidly" absent a change in the State's current practice. Municipalities' costs could increase to \$170 million in FY 09.

[8:50:35 AM](#)

Page 8

Going Forward

But paying the bill is not the same as fixing the system.

There are several issues the legislature may wish to address:

- Discriminatory hiring
- Allocation of costs
- Affordability
- Unfunded liability

- Other technical items

A Possible Fix? - Make PERS a "Cost Share Plan" like TRS.

Mr. Teal stressed that the State's simply "paying the bill" would not fix the system. The issues depicted on this page as well as consideration of making PERS a cost-sharing system like TRS should be included in the discussion. He characterized the retirement system as having "some broken pieces" as opposed to being "dysfunctional."

Mr. Teal, in concluding his remarks, specified that Co-Chair Stedman had requested him to focus today's discussion on issues and costs being experienced by the systems. He also noted that the PERS and TRS' Alaska Management Retirement Board (AMRB) recently passed a resolution urging implementation of a cost sharing system for PERS. He understood that Governor Sarah Palin intended to introduce a bill to that effect soon. The discussion regarding how to fix the system would occur after that.

[8:52:01 AM](#)

In response to a question from Senator Dyson about the Financial Contribution bar graph on page 6, Mr. Teal explained that the lower portion of the bar graphs on the horizontal axis represented the municipal employer contribution percent level; the upper portion represented the percent paid by the State that year.

Mr. Teal further explained that the percents depicted on the vertical axis represented percent of payroll. For example, the total employer and State contribution to the retirement system for an employee earning \$100,000 would be \$45,000.

[8:53:11 AM](#)

Mr. Teal stated that the percent of payroll rates are "expected to climb" under the current system. The PERS rate in 12 to 15 years would exceed 100 percent and the TRS rate would exceed 200 percent.

Senator Dyson exclaimed "wow!"

Mr. Teal communicated that the TRS retirement costs for a teacher earning \$50,000 a year could eventually be \$100,000.

8:54:05 AM

Senator Elton referred to the list of issues depicted on page 8; specifically the unfunded liability issue. To that point, he asked whether an analysis had been conducted on the affect an "extraordinary deposit" to the PERS/TRS retirement system from the State, \$250 million for several years for example, might have on future contribution rates.

8:55:02 AM

Mr. Teal divulged that the Division of Retirement and Benefits had conducted an analysis based on a \$500 million deposit. That information could be provided. He was surprised to find that a \$500 million contribution would have "minimal impact" on contribution rates: instead of anticipated contribution rates of 100 percent for PERS and 200 percent for TRS, the rates would be 95 or 180 percent, respectfully.

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Co-Chair Stedman noted that a variety of dollar infusion levels toward the unfunded liability have been discussed. He had also been surprised at the minimal impact the infusions would have on employer contribution rates.

8:56:26 AM

Co-Chair Stedman identified the unfunded liability as "the issue of most concern in the immediate future" in the effort to reduce employer contribution rates.

Co-Chair Hoffman noted that Governor Palin had included \$77 million in her FY08 budget proposal to assist local governments. While the Governor had identified this as "a one-time approach", his concern was that this effort might result in increasing local government dependence on the State "to pick up those dollars". Such a commitment would be difficult to continue under current State revenue parameters.

Co-Chair Hoffman asked whether a level of support from the State for the long term had been identified.

8:57:42 AM

Mr. Teal disclosed that a spreadsheet (copy not provided) had been developed that depicted State funding support options for the long term. This "is a decision that's completely up to the Legislature."

Mr. Teal referred to the FY08 local contribution level of \$94 million depicted on page 7, and noted that even were a one-time infusion of \$77 million made in FY08, the local contribution rate would continue to increase by \$77 million every year thereafter. He noted however, that local contribution rates would not continue the dramatic increases experienced between FY04 and FY08, and would level out over time. Regardless, municipalities' contribution obligations would be a hardship "given tax caps, given revenues at the local level."

[8:59:09 AM](#)

Co-Chair Hoffman calculated from the data on page 7 that were the State to continue picking up the difference between the rates of one year and the next, the local government contribution base rate in FY09 would be \$171 million. Thus the problem: local governments would be unable to pick up those additional costs. "If we don't do something the municipalities are going to end up bankrupt."

[9:00:10 AM](#)

Senator Olson asked for examples of "other technical items" as specified in the list of issues on page 8.

Mr. Teal considered that to be a question best answered by the Legislature.

Senator Olson questioned whether the solutions being considered to address the PERS and TRS issues were "obtainable" and something municipalities could "live with".

[9:00:48 AM](#)

Co-Chair Stedman stated that the purpose of hearings such as this was to glean a better understanding of the issues being experienced by the retirement systems. The effort would benefit the Committee when they address legislation being developed by the Administration that would "move the PERS system closer to

the TRS" system in that it would pool communities' contribution obligations together instead of each community having "an identified liability".

Co-Chair Stedman stated that in addition to pooling liabilities and infusing money, the effort must include providing affordability and "predictability to the municipalities on their general fund and also K-12 education" obligations.

Co-Chair Stedman specified that the \$6.9 billion gap between assets and accrued liabilities was based on June 2005 data. Current data would indicate that gap to range between \$8.5 and \$10 billion today.

Co-Chair Stedman stressed that the State must get ahead of the issue rather than basing its actions on data that is two years old. The desire would be for the Committee to address this issue before legislation on the proposed gasline is referred to the Committee.

Senator Olson asked for further information about the "discriminatory hiring" issue also identified on page 8. He understood that the State has experienced "an alarming" increase in the number of employees over the past few years, and to that point, he asked whether that has affected the PERS and TRS unfunded liability gap. If so, he questioned whether one of the solutions would be to utilize "contract" employees who would be outside the PERS and TRS systems.

[9:04:09 AM](#)

Co-Chair Stedman qualified that that sort of action should be avoided. When there is a job opening, the cost per applicant "should be equal regardless of what tier structure they're in". The endeavor must avoid allowing "one applicant [to] have a substantially lower cost to the employer" as an employer might include in their budget the highest per employee cost but hire "the lower cost employee; thereby imbedding a spread within his budgetary process in his department." The effort should also allow employees to change positions with their employer regardless of tier status. These issues would be included in the Administration's forthcoming bill.

Senator Huggins understood the term "pooling" to refer to a cost share plan.

Co-Chair Stedman affirmed.

9:06:13 AM

Co-Chair Stedman asked that the charts on page 6 and 7 be revised to include an additional line reflecting the actuarial recommended rate in addition to the State and Local contribution rates.

Mr. Teal confirmed that would be done.

Co-Chair Stedman stated that this would further clarify the discrepancy between the rates adopted by the PERS Board and those recommended by the actuary.

9:07:28 AM

Senator Thomas asked for confirmation that the employer contribution rate for a \$50,000 employee could be \$100,000 in the future.

Mr. Teal affirmed that was correct.

Mr. Teal advised that this would relate to the discrimination issue raised by Senator Olson. Contribution rates would continue to grow were the status quo system left unchanged. This is because "there's a declining wage base" in that the defined benefit (DB) system is closed to additional people. Persons hired after June 30, 2006 would be enrolled in the new Defined Contribution Retirement plan, and thus, do not contribute to the DB plan's unfunded liability.

Mr. Teal specified that "the unfunded liability is a fixed amount" similar to "a mortgage" to which an annual payment of \$657 million is due. Different rates would result were that amount split among all employees rather than just those hired prior to July 1, 2006. The rate would continue to climb as more employees were added to the DCR plan. And thus while "the cost pretty much remains the same... the rate goes up".

Mr. Teal exemplified how this might affect employees: were a person hired prior to July 1, 2006 to compete for a job paying \$100,000 per year against someone subject to the DCR plan, the retirement benefits' cost to the employer for the DB employee would amount

to approximately \$44,000 as compared to \$11,000 for the DCR employee. While this would be "an easy decision for the employer", it would be detrimental to the career opportunities of the DB employee. This problem would continue to escalate as contribution rates increased.

[9:11:02 AM](#)

Senator Thomas acknowledged.

Senator Thomas asked whether the chart provided by the Division of Retirement & Benefits on February 15th, amortized the unfunded liability over a particular time period.

Mr. Teal explained that the unfunded liability amount would continue to increase approximately another two or three years and would "likely flatten out and then decline as retirees die". Any monetary infusion by the State made in FY 08 would not be reflected until FY 2011, due to the lag time in data and applicability.

Mr. Teal reiterated that liabilities would decline over time to zero as beneficiaries die. Assets would, over time, meet the declining liability line "and then track the line down to zero". He estimated that this process could take 60 years, as some of the people in the DB plan are only in their twenties.

The discussion concluded.

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[9:13:18 AM](#)

Co-Chair Stedman reviewed the upcoming general Committee hearing schedule.

ADJOURNMENT

Co-Chair Bert Stedman adjourned the meeting at [9:14:11 AM](#)