

SENATE FINANCE COMMITTEE
February 24, 2011
9:06 a.m.

[9:06:16 AM](#)

CALL TO ORDER

Co-Chair Stedman called the Senate Finance Committee meeting to order at 9:06 a.m.

MEMBERS PRESENT

Senator Lyman Hoffman, Co-Chair
Senator Bert Stedman, Co-Chair
Senator Lesil McGuire, Vice-Chair
Senator Johnny Ellis
Senator Dennis Egan
Senator Donny Olson
Senator Joe Thomas

MEMBERS ABSENT

None

ALSO PRESENT

Mike Barnhill, Deputy Commissioner, Department of Administration; Gary Bader, Chief Investment Officer, Department of Revenue.

SUMMARY

^Public Employee Retirement System (PERS) and Teachers Retirement System (TRS) Update.

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Co-Chair Stedman discussed the financial overview of the PERS and TERS retirement systems. He mentioned that the Permanent Fund Dividend (PFD) would be discussed in a future meeting.

MIKE BARNHILL, DEPUTY COMMISSIONER, DEPARTMENT OF ADMINISTRATION introduced himself.

GARY BADER, CHIEF INVESTMENT OFFICER, DEPARTMENT OF REVENUE introduced the PowerPoint presentation "Public Employee Retirement System (PERS) and Teachers Retirement System (TRS) (copy on file)."

Mr. Barnhill discussed Slide 2: "PERS/TRS Update."

- I. Basic Facts
- II. Investments
- III. Recent Assumption Changes
- IV. SB 125 State Assistance
- V. Future
- VI. Other Issues

Mr. Barnhill detailed Slide 4: "PERS/TERS Basic Facts."

- A. Membership
- B. Organization
- C. Balance Sheet
- D. Health Cost Trends
- E. Funding Ratio History
- F. Employer Contribution Rates

Mr. Barnhill discussed Slide 5: "Basic Facts-Membership-PERS."

160	Member Employers
3	Defined Benefit (DB) Tiers
25,015	retirees
6,566	terminated members entitled to future benefits
<u>27,565</u>	actives (74.55%)
59,146	total members
1	Defined Contribution (DC) Tier
0	retirees
304	terminated members entitled to future benefits
<u>9,412</u>	actives (25.45%)
9,716	total members

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Mr. Barnhill discussed Slide 6: "Basic Facts-Membership-TRS."

TRS:

58	Member Employers
2	Defined Benefit (DB) Tiers
10,255	retirees
884	terminated members entitled to future benefits
<u>8,226</u>	actives (78.4%)
19,365	total members

1 Defined Contribution (DC) Tier
0 retirees
394 terminated members entitled to future
benefits
2,269 actives (21.6%)
2,663 total members

884 terminated members entitled to future
benefits
8,226 actives (78.4%)
19,365 total members

1 Defined Contribution (DC) Tier
0 retirees
394 terminated members entitled to future
benefits
2,269 actives (21.6%)
2,663 total members

Co-Chair Stedman elaborated that TRS included teachers and PERS was comprised of municipalities and state employees.

Mr. Barnhill added that the PERS included 160 member employers, the largest of which is the state comprising 50 percent of the workforce and contributions. The remaining 159 employers are municipalities, school districts and other small organizations.

Co-Chair Stedman asked if every school district and municipality was included. Mr. Barnhill concurred.

Senator McGuire asked about the smaller organizations. She requested a list of organizations. Mr. Barnhill responded that a small number of organizations are members of PERS. He offered to provide a complete list.

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Senator Egan asked how many retirees were entitled to future benefits. He wondered how many retirees were not entitled to future benefits. Mr. Barnhill responded that PERS included the category termed "inactive non-vested" including people who cashed out contributions to the system. He noted that PERS had 14,600 people in the category. He stated that the deadline for re-vesting has already expired.

Senator Egan asked if the 14,600 people were not eligible for reentry to the system. Mr. Barnhill concurred.

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Mr. Barnhill detailed Slide 7: "Basic Facts-Organization." He explained that the organization of the system is divided into three primary entities, the Department of Revenue (DOR), the Alaska Retirement Management Board (ARMB) and the

Department of Administration (DOA). Each entity has separate functions with respect to the system. The DOR through the treasury division is the investment manager of the trust fund assets. The department hires investment managers and consultants. The ARMB is the fiduciary of the trust fund assets. The ARMB sets the rates and the investment policy, which the division of treasury carries out.

Mr. Barnhill continued that DOA handles the liability issues. The department has staff to serve the ARMB. The department also has a contract with the actuary, which serves the needs of the Division of Retirement and Benefits (DRB) and ARMB.

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Mr. Barnhill detailed Slide 8: "Basic Facts-Balance Sheet."

PERS DB:

Assets (Mkt. Value, 12/31/10)	\$10,901,792,145
Accrued Liabilities (Net Present Value 6/30/2010)	
	<u>17,190,284,000</u>
	Unfunded Liability
	\$6,288,491,855
Funding Ratio	63.42%

TRS DB:

Assets (Mkt. Value, 12/31/10)	\$4,603,709,667
Accrued Liabilities (Net Present Value 6/30/2010)	
	<u>8,449,650,000</u>
	Unfunded Liability
	\$3,845,940,333
Funding Ratio	54.48%

Mr. Barnhill stated that the figures differ from the assets that the actuary reports in its most recent evaluation. He mentioned that Buck Associates is the state's actuary. An update is expected in April.

Co-Chair Stedman asked about the trust's litigation. Mr. Barnhill replied that the topic is covered on Slide 31: "Other Issues-Mercer Settlement." He noted that the Department of Law (DOL) on behalf of ARMB settled the lawsuit against the system's former actuary Mercer for \$500 million in June 2010. The system netted \$402 million from the settlement. The \$402 million was allocated between PERS and TRS.

Co-Chair Stedman asked if the balance reflected in Slide 8 accounted for the contribution of the settlement. Mr. Barnhill responded yes, in addition to recent investment gains in the market.

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Mr. Barnhill continued that the unfunded liabilities listed are estimations and Bach Consultants is working on its 2010 evaluation. He expected the figures to change somewhat.

Co-Chair Hoffman asked how the funding ratios for defined benefits under PERS compare to other defined benefits in the nation. Mr. Barnhill replied that Alaska's funding ratio is low in comparison with other systems in the nation. Co-Chair Hoffman asked for a percentage in comparison with other defined benefit contributions. Mr. Barnhill replied that some systems have approximately 100 percent funding ratios. Other systems have less than 50 percent funding ratios. He stated that various estimates are used by actuaries to gauge the health of a system. He opined that a healthy system showed ranges of 70 to 80 percent. He added that PERS is 63 percent and TRS is closer to 50 percent. The percentages are indicative of a poorly funded system.

Co-Chair Stedman asked about and the pension site without the health insurance. Mr. Barnhill stated that Alaska is one of four states that forward funds health care.

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Co-Chair Stedman clarified that benefit programs are not at risk. He stated the goal to shrink the balance. Mr. Barnhill appreciated the point and highlighted the constitutional requirement.

Co-Chair Stedman pointed out that Alaska includes the prefunding of health insurance. Mr. Barnhill noted that Alaska was one of four states that prefunded health care. The funding ratio for both pension benefits and health benefits is equal.

Co-Chair Stedman pointed out the negative \$10 billion balance. He did not want the public to assume that the benefit payments were at risk. He stated that the goal is to shrink the negative \$10 billion imbalance between assets and liabilities. Mr. Barnhill agreed and added that everyone working on the problem is committed to one goal ensuring that all benefits are paid when due. He agreed that many challenges exist to bring the system back into a status of full funding.

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Mr. Barnhill discussed Slide 9: "Basic Facts-Health Cost Trends." He noted that the slide is derived from the actuarial evaluation released by Buck Consultants. The slide depicts the last 30 years during which Alaska experienced 9 percent inflation in its health care costs. The number demonstrates that Alaska has been unable to control health cost growth over the long term. Medical costs increased in

excess of the rate of inflation in Alaska. The actuary must recognize the trend adequately in the rates set for the system. The rates produced less than adequate contributions by employers, which was the basis of the Mercer law suit. The DOR is reviewing the situation carefully with consideration of a variety of initiatives designed to change the trend.

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Mr. Barnhill discussed Slides 10 and 11: "Basic Facts-Funding Ratio History-PERS." He noted that the relative funding of the systems in 1979 is similar to present times. The state achieved 100 percent funding in the mid 1980s.

Mr. Barnhill discussed Slide 12: "Contribution Rates." He noted that rates are board adopted. The board adopted rates in the early 2000s are low reflecting the oversight of the actuaries. He recalled that the teacher's retirement board had a policy of flat rates in the 1990s, which eliminated rate volatility for school districts. In 2002, the systems received an actuarial audit and the oversights by Mercer were first detected. The actuary rates spiked after the audit, but the boards pursued a policy of increasing rates by 5 percent per year. He noted that 2004 through 2007 show an incline of contribution rates. He recalled SB 141 passing in 2005, which sunset the Teacher's Retirement board and the Public Employees Retirement board and replaced them with the current ARMB. The ARMB set the rates at the actuarial rate creating the spike seen in 2007 and 2008. He mentioned considerable concern about the impact of 50 plus percent contribution rates in school districts. The legislature took measures by appropriation and passed SB 125, which set, by statute the employee contribution rate for TRS at 12.5 percent and for PERS at 22 percent.

Co-Chair Stedman clarified percent of payroll. Mr. Barnhill concurred. He described the breakdown of the rates illustrated.

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Mr. Barnhill continued that the initial spike trended down through 2009 and 2010, which reflected investment gains and actuarial gains. The great recession in 2008 and 2009 caused rates to spike again. The actuarial rates are projected at 50 percent for TRS and 30 percent for PERS. He noted that SB 125 allows the state to cover the difference and the funding is appropriated in the operating budget.

Co-Chair Stedman added that the state could fund 14 percent of payroll without the unfunded liability.

Mr. Barnhill added that rates are high and expected to rise. Municipal employers will continue to pay 22 percent of their total payroll. School districts will pay only 12.5 percent of the total payroll. The state picks up the remainder under SB 125.

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Mr. Bader discussed Slide 14: "Investments-ARMB Assets Under Management." He stated that DOR manages \$18 billion of non-retirement funds and another \$19 billion of funds that are part of the retirement system now subject to the fiduciary oversight of the ARMB. He mentioned 14 different funds associated with the defined benefit retirement account. He quoted that the PERS trust was at \$6 billion, the PERS health trust at \$4.8 billion, the TRS retirement trust at \$3 billion and the TRS health trust at \$1.5 billion. The ARMB is responsible for oversight of the supplemental annuity plan which is in deferred comp and totals approximately \$3 billion. He explained that the retirement accounts must be managed separately according to the advice of tax council.

Mr. Bader discussed Slide 15: "Investment-Asset Allocation." He mentioned that the asset allocation is currently active for all defined benefit plans except the military retirement plan. The target allocation has 29 percent of assets invested in domestic equities, 23 percent in global equities, 7 percent in private equity, 16 percent in real assets, 5 percent in absolute return, 19 percent in fixed income, and 1 percent in cash. The board adopts bands around which staff is permitted to allow the investment mix to change.

Mr. Bader discussed Slide 16: "Investments- US Stock Market Historical Returns." He commented on the pictorial view of the history of equity markets. The example shows that 29 percent of the yearly returns are negative.

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Mr. Bader discussed Slide 17: "Investments-Fiscal Year Returns." He explained that returns of the PERS and TRS are similar to those of the permanent fund. He added that an eighteen year period shows that the PERS and TRS were very close to the returns of the permanent fund. Co-Chair Stedman asked why the five and eighteen year periods were selected for the illustration. Mr. Bader responded that the ten year comparison was not favorable.

Co-Chair Stedman requested the measurement periods for one, three, five, and ten year returns.

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Senator Egan asked about returns before 1993. Mr. Bader responded that Callan Associates had the requested figures. He offered to provide the returns to the committee.

Mr. Barnhill added that eighteen years was reflective of the two board's fiduciary responsibility over the assets. He stated that a 30 year annualized return is 8.7 percent, which is much higher due to extraordinary returns in the early 1980s. Mr. Bader added that the five year return corresponds to the length of period that the ARMB has had fiduciary responsibility.

Co-Chair Stedman added that some historic data is available in his office. He noted that the history occurs in a wide range of annual books addressing stocks, bonds, and other asset classes.

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Mr. Bader mentioned Slide 18: "Investments-Cumulative Returns." He noted that the lines shown represent the returns provided. The red line shows the cumulative total return of the fund over the past 18 or 19 years. The blue line represents how the fund would perform at its target asset allocation using index returns. The curvilinear line represents that which the fund would have earned cumulatively had it earned the 8.25 percent, or the assumed rate of return.

Senator McGuire asked about health costs and the consideration of their percentage of growth. Mr. Bader responded that the health costs manifest themselves in the calculated contribution rate. The investments intended to return a certain amount.

Senator McGuire opined that with an unachieved target of 8.5 percent, the legislature must have future conversations about the actual costs associated with paying benefits to beneficiaries including percentages earned.

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Mr. Barnhill agreed.

Co-Chair Stedman agreed that a similar chart led to finance member confusion in the past when the committee was told that no problem existed. The committee's request was to take the targeted 8.25 percent and "shoot it forward." The data is conceptually difficult for some members. He requested that the asset value for June 30 with a target of 8.25, with a new growth line for each year.

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Senator McGuire added that the health care costs should be located in the chart as well. Co-Chair Stedman noted that the health care costs fall back to an increasing contribution rate.

Co-Chair Stedman stated that a higher targeted rate would be unattainable. He noted the need for prudence in an attainable target. The ARMB is required by statute to match assets and liabilities.

Mr. Barnhill mentioned a contemporary conversation regarding the issue of appropriately matching assets with liabilities. He mentioned that the investment return assumption of systems like PERS and TRS should be reduced to a riskless rate of return like 5 percent, which is something that Alaska has not embraced. The choice would double the unfunded liability for Alaska, which would increase employer contribution rates. The historic rates of return are closer to the rate of return. Alaska, the ARMB, and most pension boards around the country are not embracing the notion of a riskless rate of return.

Co-Chair Stedman commented that data from the last 15 years with a targeted rate of return would be helpful.

Mr. Barnhill offered to portray the numbers in any way needed by the committee.

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Mr. Bader described Slide 20: "Recent Assumption Changes."

- AS 37.10.220(a)(9) requires a review of actuarial assumptions every four years
- Buck Consultants performed the experience study
- Gabriel Roeder Smith & Co. reviewed and certified the Buck experience study
- Based on the Buck and GRS reports, the ARM Board modified some of its actuarial assumptions

Mr. Bader discussed Slide 21: "Recent Assumption Changes-Investment Returns."

- Investment Return Assumption reduced from 8.25% to 8.00%
 - 4.88% real return assumption
 - 3.12% inflation assumption

Senator Thomas referred to Slide 17. He asked why the proposed investment return assumption is reduced by one quarter of a percent. Mr. Bader responded that the board lowered the percentage to 8 percent to remain competitive with other funds.

Senator Thomas thought that the state's experience and the performance of the permanent fund might affect the investment return assumption.

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Mr. Barnhill responded that the country saw a gradual reduction from investment returns in the 8.5 percent range down to 8 percent and lower. Pension systems are resisting the notion of percentages lower than 7.5.

Co-Chair Stedman stated that the finance committee has expressed concern that 8.25 is a high target, which artificially suppresses the liability. He wished to view a better estimate of the liability and asset spread. He asked why the asset allocation is so similar to that of the permanent fund when the objectives appear to be different. He encouraged additional opinions. He discussed the state's liquidity position. He expected the finance committee to request additional consultants to provide varying opinions.

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Co-Chair Stedman appreciated the lower target. Mr. Barnhill replied that the lower rate will have a future impact. Whenever the investment return assumption is lowered, some impact will exist for the unfunded liability. He predicted a modest increase in the unfunded liability and the total employer contribution rate. He added that the permanent fund changed its asset allocation and adopted different asset categories. The similarity in returns for the funds is a result of exposure to equities.

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Mr. Bader discussed Slide 22: "Recent Assumption Changes- Contribution Rate Impact."

	<u>PERS</u>	<u>TRS</u>
FY 2012 Employer Contribution Rate	30.76%	42.61%
Change in Demographics (net) (post termination mortality)	1.25%	5.55%
Change in Earnings Assumption	1.53%	1.77%
Total Change in Employer Contribution	2.78%	7.32%
FY2012 Employer Contribution Rate - Revised	33.54%	49.93%

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Co-Chair Stedman asked about excess contributions made by the state.

Mr. Barnhill discussed Slides 23 and 24: "SB 125 State Assistance." The slides depict the payments made by the state historically and the projected amounts. He mentioned 2009; the first year that SB 125 took affect when the state paid \$400 million. He mentioned that prior to the enactment of SB 125, the state made a similar payment to buy down the rate for the year. He stated that the governor has proposed amounts of approximately \$470 million in the operating budget for the FY 12 payment amount. The proposed state assisted amount under SB 125 will climb steeply and will crest over \$1 billion in ten years on its way to \$1.4 billion in 2029. He explained the sharp drop in 2029 because the initial unfunded liability, which was the product of the actuarial audit in 2002 equaling \$4.4 billion, will be fully amortized under a 25 year amortization. Once fully amortized, the state assistance will drop considerably under SB 125.

Senator McGuire asked to see pre SB 125 and post SB 125 data regarding state contribution to PERS and TRS.

Co-Chair Stedman offered to provide the information to Senator McGuire.

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Mr. Barnhill stated that the legislature contributes considerable funding to the system. He noted further contributions from the employers.

Co-Chair Stedman mentioned the judiciary retirement plan. Mr. Barnhill added that the contribution to the judicial retirement system was considerably smaller with a funding hole of \$10 or \$20 million. The proposition of fully funding the judicial retirement system is an easy prospect in comparison to that of PERS and TRS.

[10:11:22 AM](#)

Mr. Barnhill discussed Slide 26: "PERS/TRS Future."

- ARM Board held work session in September 2010 at the request of legislative finance.
 - Discussed how to best address unfunded liability
 - Modeled different approaches and scenarios
 - Discussion and modeling is ongoing

Mr. Barnhill discussed Slide 27: "PERS TERS Future." He informed that unfunded liability is referred to as soft liability and equals roughly \$10 billion. The legislature and ARMB determine the payment of the liability. The policy concern is whether to pay more now or later. He stressed that the actual benefit payments were not a soft liability. The payments will exist until 2080 or 2090 when the last defined benefit member passes away. A long term view of the benefit payments was projected by Buck Consultants and depicted on the slide. The projected benefit payments will crest over \$3 billion per year for a 20 year period beginning in 2028.

Mr. Barnhill detailed Slide 28: "Future."

Long term observations:

- Sharply declining petroleum revenues post-2030
- Other obligations (schools and Medicaid) will compound fiscal situation - paying now versus paying more later is in sharp tension
- Paying more now and reducing state savings accounts could reduce budgeting flexibility post-2030 at a time when state savings account may be necessary to "keep the lights on"
- Paying less now increases expenses in the long term
- More critical thinking and discussion about a global approach to structuring state finances and budgeting including a long term plan for PERS/TRS funding is needed

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Mr. Barnhill discussed Slide 30: "PERS/TRS Other Issues-Termination Studies." He informed that the PERS statute states that when an employer either terminates completely from PERS, or terminates a classification of employees from PERS, a termination study is required. The additional cost of the study will be billed to the employer. The actuaries report that when a class of employees is terminated, changes in retirement behavior occur. When an employee retires earlier than anticipated, an unfunded liability is established in the system. The termination study ensures that the system remains whole as a result of changes caused by a particular employer. Co-Chair Stedman added that the liability would fall to the state. He did not want the liability to shift. Mr. Barnhill agreed.

Mr. Barnhill added that he requested that Buck Associates summarize the termination studies that occurred in 2010. The studies are depicted on Slide 30. Each study cost a total of \$25 hundred and produced a onetime termination ranging from \$10 thousand to \$21 thousand. The statute allows the division of Retirement and Benefits to have a payment plan

with the municipality allowing the cost to be spread over time to reduce the impact on finances. He opined that the statute was fair. One issue raised regarded the production of unfair double counting. He mentioned current work with the Department of Law (DOL) with the objective of the elimination of unfair double counting.

Co-Chair Stedman mentioned Fairbanks and a similar issue. The risk is that multiple municipalities will go broke. He stressed that shifting liability presents a large issue. He wished to see the contribution rate drop to 14 percent.

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Mr. Barnhill mentioned Slide 32: "PERS/TRS Other Issues-PERS Payroll." The information was requested by the Legislative Finance division. The defined benefit portion of the declining payrolls is illustrated in the slide.

Mr. Barnhill noted Slides 34 and 35: "PERS/TRS." The slides illustrate the employee contribution rates in PERS and TRS including the adoptive rate, the board rate, and the SB 125 rate.

Co-Chair Stedman offered to work with the department on the regulatory issue of the termination study. He explained that some municipalities feel that they are not treated fairly. Mr. Barnhill understood and welcomed the collaboration. He offered to provide information from the DOL regarding the reported double counting.

Co-Chair Stedman expected to have additional information from Buck Associates regarding the payment structure. He wished to avoid the payment of \$1.4 billion per year.

ADJOURNMENT

[10:25:41 AM](#)

The meeting was adjourned at 10:26 AM.