

HOUSE FINANCE COMMITTEE
January 27, 2014
1:36 p.m.

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CALL TO ORDER

Co-Chair Austerman called the House Finance Committee meeting to order at 1:36 p.m.

MEMBERS PRESENT

Representative Alan Austerman, Co-Chair
Representative Bill Stoltze, Co-Chair
Representative Mark Neuman, Vice-Chair
Representative Mia Costello
Representative Bryce Edgmon
Representative Les Gara
Representative David Guttenberg
Representative Cathy Munoz
Representative Steve Thompson
Representative Tammie Wilson

MEMBERS ABSENT

Representative Lindsey Holmes

ALSO PRESENT

David Teal, Director, Legislative Finance Division;
Representative Jonathan Kreiss-Tomkins.

SUMMARY

^PRESENTATION: PERS/TRS: HISTORY AND CURRENT SITUATION:
LEGISLATIVE FINANCE DIVISION

[1:37:23 PM](#)

Co-Chair Austerman discussed the agenda. He stated that the goal was to gain a baseline understanding of why the state's unfunded retirement liability had gotten to its current level.

DAVID TEAL, DIRECTOR, LEGISLATIVE FINANCE DIVISION, provided a PowerPoint presentation titled "A discussion of Retirement Systems in Alaska" (copy on file). He noted that the slides had been prepared for the Senate Finance Committee over the prior interim. The focus was on the health of Alaska's retirement systems; the presentation was an assessment of the situation aimed at helping people to decide whether action was necessary. He detailed that the presentation was the second of a three part series on retirement issues; the first part related to an in depth history of the issue and the third part pertained to the discussion of options. The discussion of options would be left for a future meeting. He pointed to the complexity of the issue and recognized that members' understanding of the issue varied. He explained that much of the later material built upon the earlier material. He remarked that Pete Ecklund, staff to Representative Alan Austerman was a significant benefit to the committee because he had been involved in changes to the system that had occurred more than five years earlier.

[1:41:04 PM](#)

Mr. Teal pointed to slide 2 and addressed the questions "Are Alaska's Public Employee Retirement Systems Healthy?" and "If not, what can be done about it?"

Mr. Teal communicated that the answer to the first question was no. He shared that the presentation would detail what had led him to the conclusion. He planned to talk about actuarial concepts and policy guidelines. The focus was on the Public Employees' Retirement System (PERS), but much of the information applied to the Teachers' Retirement System (TRS), and the Judicial Retirement System (JRS). The discussion would be limited to the Defined Benefit (DB) plans.

Representative Edgmon addressed the first question on slide 2 and agreed that the retirement system was unhealthy. However, he believed it bore comparison to some of the worst case scenarios around the country (e.g. Illinois, Detroit, and other) where pension shortfalls were beyond the reach of the local economies. He remarked on the state's AAA bond rating. He noted that although the liability was around \$11 billion to \$13 billion, it could be argued that it was still in the state's reach to correct

over time; whereas other states may not have the same option.

Mr. Teal answered that the assessment was accurate. He elaborated that some systems throughout the U.S. were healthier than Alaska's and some were less healthy. The current liability was quite high; however, it was advantageous that Alaska had closed its DB system and that it was no longer accruing unfunded liability on what was becoming a larger and larger share of the state's payroll. He detailed that Defined Contribution (DC) employees currently accounted for approximately 30 percent or one-third of the payroll.

Mr. Teal addressed slide 3 titled "System health refers to the likelihood that the promised benefits will be paid when due" [Note: slide 3 is missing from the presentation's electronic document]:

- Defined Contribution (DC) Plans
 - o No promised benefit level
 - o So not measure of health required
- Defined Benefits (Mr. Boyle) Plans
 - o Promised benefits (pensions)
 - o So it is critical to track and maintain system health

Mr. Teal expounded that under DC plans the employer paid a percentage of payroll into an individual retirement account-type setup. The employer made no promises about what the accounts would be worth in future years; the employee bore the risk that the account would have the ability to provide sufficient income for retirement. He stated that because system health referred to the likelihood that money would be on hand to pay promised benefits, it did not make sense to discuss the health of DC plans, given that there was no risk that the system would be unable to pay promised benefits.

Mr. Teal relayed that under the DB plan employers typically contributed a percentage of payroll and often the costs were similar to the time when contributions were made. He discussed that the defining attribute of the DB plan was that the employer promised to pay retirees a pension. The employer bore the risk and responsibility of ensuring that benefits could be paid when due.

[1:46:37 PM](#)

Mr. Teal addressed slide 4 titled "Measuring the Health of a Retirement System":

1. Funding Ratio = Assets/Liabilities.
2. Unfunded Liability--just a dollar amount; not a relative measure.
3. Are employers paying the actuarially required contribution (ARC)?
4. Are the contributions causing financial stress?

Mr. Teal explained that measuring the health of a retirement system used to be easy. Employees accrued pension benefits as they worked and accrued benefits were an accounting liability to the system. He detailed that when the funding ratio (assets/liabilities) was 100 percent or more the system was fully funded, meaning there were sufficient assets on hand to pay all anticipated future benefits. The funding ratio was measured at a specific point in time (typically annually) and was a common way of measuring health and comparing systems.

Mr. Teal addressed the second measure on slide 4: unfunded liability. The unfunded liability was the dollar amount owed; whereas the funding ratio provided the number in a percentage (the terms were almost interchangeable). He relayed that the state had an unfunded liability of approximately \$7.5 billion or approximately 61 percent of the assets required to pay benefits in PERS.

Representative Gara understood that under the Alaska Constitution the state could not change benefits for DB retirees. He shared that he was a Tier II employee and wondered whether there was an option for changing the ratio for what he and the state paid towards retirement. He asked if the change would not be allowed because benefits would be impacted.

Mr. Teal replied that many other states were facing problems paying their benefits. One solution to the problem was to change the level of benefits. He relayed that in most states, including Alaska, the issue was constitutional and the state was not allowed to reduce benefits unilaterally. He elaborated that some states had tried reducing benefits, but most had moved forward with the implementation of a new tier that applied to employees

hired after a set date. Alaska had switched to a DC plan; therefore it did not have many options for new tiers for the DB plans. He reiterated his earlier testimony that the state was not allowing any additional people into the DB system; therefore there was no reason to implement a new tier that would change the benefits people receive.

Representative Costello noted that the unfunded liability was usually discussed as \$12 billion. She asked if the \$7.5 billion figure used in the presentation was limited to PERS. Mr. Teal replied in the affirmative.

Representative Munoz stated that the unfunded liability had "exploded" since the implementation of the DC plan. She asked for underlying factors contributing to the dramatic increase since 2006. Mr. Teal replied that much of his presentation focused on providing factors contributing to the liability. He would address the items throughout the presentation.

[1:51:13 PM](#)

Representative Guttenberg asked if anyone was tracking health care for the new DC system. Mr. Teal replied in the affirmative. He stated that there was no reason to track an individual retirement account; however, there was technically a hybrid plan for health care. He detailed that the health portion of the DC plan was actually a DB plan; employees were promised health benefits regardless of the cost or cost change. The presentation simplified the issue and referred only to the retirement portion of benefits.

Representative Guttenberg was concerned that a future legislature may try to look back for information that had not been tracked.

Co-Chair Stoltze remarked that the Alaska Supreme Court had interpreted that the Alaska Constitution prohibits a change to benefits. He stated that that the court ruling was broad and he could not find a section on pensions and benefits. He was interested in obtaining more information on the topic in order to better explain it. He believed the legislature had relied on the court ruling, but the legislature could not expect the Alaska Court System to come explain it. He remarked that the legislature only heard from the court system once a year. He opined that it was difficult to have a conversation about how the state

got to the specific place. He did not have a clean understanding of the court case. He discussed that Lieutenant Governor Treadwell had tossed out an initiative related to appropriation on the advice of an assistant attorney general. He observed that the Alaska Supreme Court was allowed to appropriate all of the time. He stated that the constitution was explicit on appropriation powers. He made a remark about a fishing issue. He believed the courts had been very aggressive in directing appropriations.

[1:55:21 PM](#)

Co-Chair Stoltze noted that it would be much easier talking to constituents if the legislature had a better understanding of what the Alaska Supreme Court was directing.

Mr. Teal agreed that the topic was not simple. He referred to other states that had tried to reduce benefits on constitutional grounds; some had won and others had lost. He discussed Alaska's Supreme Court ruling that made it clearer but, there were issues related to how much money a state had and whether it could continue to pay benefits.

Co-Chair Stoltze remarked that he had been told the Alaska Supreme Court made political decisions occasionally.

Representative Gara pointed to Article 12, Section 7 of the Alaska Constitution and read that "accrued benefits to these systems shall not be diminished or impaired."

Co-Chair Austerman asked for the page number. Representative Gara referred to page 37, Article 12, Section 7 under Retirement Systems.

Mr. Teal added that the definition of "accrued" was not provided. He stated that different definitions of the term would provide for different outcomes; the issue had been decided differently in various states.

Mr. Teal continued to address slide 4. He relayed that a funding ratio of 100 percent did not provide a guarantee of long-term health. He elaborated that most systems had a funding ratios near, at, or above 100 percent during the 1990s due to a decade of relatively high interest rates resulting in solid asset growth. He detailed that low contribution rates played a part in the situation in the

1990s. He elaborated that in many cases when systems were healthy the response was an expansion of benefits. He stated that fortunately for the treasury, Alaska did not expand benefits when it had experienced funding ratios at 100 percent. Alaska had reduced benefits when other states had been expanding them. He would address the third and fourth measures of health shown on slide 4 later in the presentation.

[1:59:24 PM](#)

Mr. Teal moved to slide 5 "PERS Assets and Liabilities." The graph showed assets and liabilities in the funding ratio beginning in 2002. He noted that the graph's dark line represented assets, the dotted line represented liabilities and the blue line represented the funding ratio. The state had been at a 100 percent funding ratio for a lengthy period of time; however, a \$2.5 billion gap occurred in 2005. The gap caused the funding ratio to fall from 100 percent to 75 percent in one year's time. He did not have concern about the upward trend in liability. He explained that an upward trend was expected because there were typically more workers earning more money and accumulating more health and pension benefits as time passed. He reiterated that Alaska had not increased benefits when the funding ratios were high and its benefits were not extraordinarily generous. He pointed out that Alaska was one of three states that included health costs in its unfunded liability funding-ratio calculation. The state was relatively better off than numbers showed. He stressed that investments must perform as expected for the system to function optimally.

Mr. Teal relayed that slightly over one-third of the state's unfunded liability was due to health costs. He advised against making a comparison to other systems. He communicated that the health costs should be included in computations if the state expected to pay them. The purpose of measuring system health was to obtain an honest assessment of the situation, not to make a system look better in comparison to others. Alaska did include the health costs in the calculation. He reiterated that the state should not be concerned with the upward trend of the liability curve. The problem was that assets were supposed to keep pace with the liability curve; however, that had not been occurring. He shared that it could be read as the funding ratio declining or as an increasing gap. He relayed

that issue was not typically a problem because as payroll and benefit accrual increased so did contributions (with little or no change in rates). He emphasized that everything was fine in a DB system as long as investments performed as expected. He stated that the pertinent question related to how the systems in Alaska and most other states had become so unhealthy in such a short time period.

[2:03:41 PM](#)

Mr. Teal shared that the answer was that unfunded liability was the consequence of assumptions that failed to materialize (slide 6). He referred to the defining attribute of a DB plan that employers bore the risk of system health. He detailed that unfunded liability was a consequence of risk becoming reality. There was trouble when earnings did not meet assumptions. He reiterated that in one year the state had gone from a funding ratio of 100 percent down to 75 percent and a \$2.5 billion unfunded liability. There were two sides to the risk. First, liability was a moving target. If any circumstance increased benefits to a greater than expected value (e.g. life expectancy or health care costs), the funding ratio declined and unfunded liability appeared. He noted that the state's legal case against its former actuary Mercer represented an example of utilizing outdated assumptions that had understated the state's accrued liability. With the adoption of better assumptions, the accrued liability increased.

Mr. Teal moved to a chart on slide 7 that showed a sudden increase in accrued liability. He explained that approximately half of the gap was due to an understatement of the state's accrued liability. The state had sued Mercer and had received a \$0.5 million settlement; consequently the assumptions had been fixed. He stressed that assets could fail to keep pace with liabilities even if benefits followed assumptions; this had occurred at the same time that benefit assumptions were revised. Half of the \$2.5 billion gap was due to incorrect assumptions and half was due to investment losses.

[2:06:55 PM](#)

Representative Gara mentioned how the system had been designed. He pointed to skyrocketing healthcare cost

increases and wondered if the state would be close to fully funded in the absence of such significant healthcare costs. Mr. Teal answered that healthcare costs accounted for approximately one-third of the unfunded liability because assumptions had been inaccurate. However, it was difficult to separate healthcare costs from life expectancy and other assumptions that had understated liability. He agreed that the unfunded liability would have been lower if healthcare costs had not increased; however, DB systems were designed to automatically fill the gap over an amortization period. The gap was filled by making small adjustments to rates; the strategy had always worked in the past. He explained that actuaries calculated health care costs, the amount of benefits expected to be earned, and the total expected to be paid in benefits for the upcoming year. He expounded that assuming the goal was to remain at a funding ratio of 100 percent, assets would need to increase by the same amount as the change in accrued liability.

2:10:01 PM

Mr. Teal moved to an Excel spreadsheet shown on slide 8, related to how volatility of investment returns affects unfunded liability. The spreadsheet included a simplified actuarial model that assumed beginning assets of \$12 billion and \$12 billion in liabilities, which meant a funding ratio of 100 percent (the retirement funding ratio had been at 100 percent in 2004). He walked through the scenario and discussed how accrued benefits liabilities, earnings, and employee contributions impacted the assets and liabilities. The trouble is that contributions were determined based on an earnings estimate that was assumed in advance. He provided another example with lower earnings and the same contribution rate, which resulted in an unfunded liability. He elaborated that the liability was not a significant problem if returns were higher some years and lower others. He pointed to the normal contributions rate that generated sufficient assets provided that assumptions come true; unfunded liability was generated when the assumptions did not come true. He shared that an unfunded liability could be covered through past service costs; a sum was recovered during an amortization period of 25 years. He added that the liability did not necessarily need to be recovered over the 25-year period because the unfunded liability could go away if a higher return was earned; as long as there was a fairly narrow band of

earnings the system recovered on its own with small changes in contribution rates.

2:15:06 PM

Mr. Teal continued with slide 8. He discussed the impact of volatility on interest rates. He discussed years with interest earnings of 6 percent and years of earnings at 10 percent, with an average rate of 8 percent. Under the years earning 6 percent the unfunded liability increased; however, the years earning 10 percent mostly recovered the lost earnings. He stated that increased volatility could generate greater unfunded liability and an inability to pay the amount off in the following year.

Mr. Teal looked at a historical chart showing interest earnings on slide 9. Some years had seen returns at 15 percent or more and others had seen losses of up to 20 percent. The average rate of return over the past five years had been 1.4 percent. Losing 21 percent would create a huge unfunded liability; if the average rate of return was kept at 8 percent it would be necessary to earn 37 percent the following year, but there would still be an unfunded liability. He explained that it would be necessary to earn over 50 percent to offset the one year of a 21 percent loss. He communicated that the system never anticipated such significant earnings volatility; it was designed to look at stable bond returns where contribution rates would remain fairly stable and the unfunded liability would take care of itself. He relayed that the system could take care of itself if volatility was small; however, volatility had not been small.

2:18:44 PM

Mr. Teal turned to slide 10 titled "Take-away Points Regarding Earnings":

1. Earnings are volatile and unpredictable
2. Small variations can be addressed by smoothing, amortization and good fortune
3. When variations are small unfunded liability is a soft liability that can be repaid with earnings (rather than contributions).
4. The road to recovery from large losses can be very long - so long that the system may appear to be broken

Mr. Teal expounded that earnings were volatile and unpredictable; small variations could be addressed by smoothing (a 5-year moving average), amortization, and good fortune; and when variations are small there may not be need to fund an unfunded liability through contributions. Many states had mistakenly assumed that the unfunded liability gap was soft and that raising contribution rates was unnecessary. He relayed that states were in trouble because the soft liability continued to grow and became firmer and firmer. He stated that Alaska could no longer count on high earnings to close the gap; it had turned into a debt that the state needed to pay.

Representative Costello asked for verification that the state paid above 22.5 percent for PERS and above 12.5 percent for TRS. She surmised that raising rates in the past would have resulted in increased cost to the state anyway. Mr. Teal answered that because employer rates were capped any increase in the rate showed up as additional state assistance.

[2:21:03 PM](#)

Representative Costello stated that the CBR had one account that was more aggressively invested and one account that had a more conservative long-term approach. She wondered whether investment philosophies were the same.

Mr. Teal replied in the negative. He relayed that time horizon and investment objectives definitely influenced the rate of return. The 8 percent rate of return was based on the idea that assets were invested for the long-term. Annual contributions provided the state with cash flow to pay benefits, which meant the state did not need to worry about spinning off cash flow to make benefit payments; as long as this was true perhaps 8 percent earnings were attainable. He relayed that the Permanent Fund had lowered its earnings target. The aggressive CBR account earned close to 8 percent and the shorter-term main account earned half the amount. He stressed that as the state's system changed he did not believe it was possible to continue to make 8 percent because of liquidity concerns. He wondered where the cash would come from to make benefit payments when contributions went away. He would discuss the issue further at a future meeting.

Mr. Teal continued to address slide 10:

5. The system is unlikely to stay broken in the long-run
6. If you pay what you owe, the system will fix itself
7. As time passes, assumptions are replaced with reality

Mr. Teal elaborated on slide 10. He addressed that investment losses could be so large that there were not enough assets on hand to recover even with very high interest rates; however, the system was unlikely to stay broken in the long-term. The system would fix itself if the debt was paid. He stressed that investment projection models were helpful, but they were only models; as time passed model assumptions would be replaced with actual earnings. Unfunded liability would result if a model's earning rate was too high; subsequently contribution rates would increase. Employers would not pay the additional contribution rate, but the state would. He communicated that paying debt exhibits to credit raters the willingness to pay other liabilities including bonds. The debt calculation was complex and controversial because determining what was owed was a matter of choice to some degree. Different interest and amortization rates would provide great differences in the unfunded liability and required contribution rate. Credit raters had discovered that models used by various states were not useful due to the multitude of assumptions used; therefore, raters had developed a common set of assumptions they could use to compare systems.

[2:27:23 PM](#)

Mr. Teal continued to discuss measuring the health of a retirement system on slide 11. He opined that the state ought to focus on its own unfunded liability rather than compare itself to other states with similar issues. He relayed that the cost of paying benefits was identical under any option as long as a model's assumptions were accepted and benefits did not change. He did not believe the state was looking at changing benefits. He compared the options to those facing a person buying a home; the goal was to find the most affordable option.

Mr. Teal turned to slide 12 and addressed the fourth measure of a retirement system health: "Are contributions

causing financial stress?" The measure was the least technical and played a significant role in discussions that had resulted in the adoption of a DC plan. He communicated that losses in 2005 opened many legislators' eyes to the financial risk of the DB plan. Subsequently, the legislature adopted the DC plan for PERS and TRS; the change had not been made for JRS. He noted that the legislature may want to consider making the change to JRS. The DB plan was the ultimate pay as you go plan; money was put money in and would never be owed. The DC plan affected only new employees; therefore; it was necessary to determine what to do with the existing DB plans and the massive debt that had been incurred. He informed the committee that amortizing the unfunded liability over 25 years would have resulted in some employers paying extremely high contribution rates. He recalled a Fairbanks rate at 180 percent of payroll; a rate that high would not be feasible for an employer.

[2:31:00 PM](#)

Mr. Teal continued providing a historical perspective. He relayed that many employers faced rates they could not pay prior to 2008 (before more money was lost in 2008 and 2009). He noted that the state had accounting difficulties during the time. He provided a hypothetical example of a person who had worked for the school board for ten years at \$150 per month and transitioned to two other positions that paid more for 10 years each. With 30 years of service the employee would retire with about two-thirds of their pay earned at the last position; each employer would be responsible for one-third of the amount. The school district had reserved funds to pay its portion of the employee's retirement at the \$150 per month rate; however, they were not able to pay one-third of the rate earned at the last high paying position. When the issue occurred it created an accounting problem that had resulted in individual employer rates with significant variability. He detailed that some lawsuits had been threatened. He noted that the new law made the issue moot as it offered a shared cost proposal; liabilities were pooled and employers paid the same blended rate.

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Mr. Teal continued that most employers had paid a higher rate than the state in earlier years; therefore, going to a

blended rate was advantageous to them. Those municipalities without higher rates were held harmless and the new blended rate was phased in. He elaborated that even the blended rates had been problematic; the recommended rate for FY 08 was close to 40 percent of payroll and was expected to increase for several years even under the best circumstances. Municipalities had requested rates that were stable, predictable and affordable. The 22 percent PERS and 12.5 percent TRS employer contribution caps were a solution the state and municipalities agreed upon because the state understood that municipalities could not pay 40 percent rates without going bankrupt. He had recently reviewed a presentation he had made in April 2007; his conclusion at the time was that the rate caps were stable and predictable.

Mr. Teal relayed that the 22 percent cap was intended to go through the early to mid-2030s until the last DB employee retired. The model prepared by the actuary at the time showed that the state would pay approximately \$50 million on behalf of employers in 2008; the amount would peak at approximately \$70 million in 2010 and would steadily decline below \$30 million in 2017. There had been a state surplus at the time. The solution had looked affordable for the long-term; particularly when recognizing that the state was also an employer capped at 22 percent and had about 60 percent of the payroll. Approximately 40 percent of the state assistance went to municipalities; whereas the remainder went to the state's own bill.

[2:37:34 PM](#)

Mr. Teal advised that perhaps the lesson was to take actuarial models with a grain of salt. Instead of fading away, state assistance had grown to \$700 million in the current year; it was heading for over \$1 billion annually. Addressing the issue had not been critical when there had been a budget surplus.

Co-Chair Austerman pointed to the 22 percent cap versus a 40 percent that had been proposed in the past. Over the years the state continued to provide revenue sharing to municipalities to cover the cost of their employees' retirements. He asked for verification that the above 22 percent paid by the state was the same 22 percent that began in 2007.

Mr. Teal replied in the affirmative. The 22 percent rate had been set in statute; however, the state's share (everything above 22 percent) had continued to increase. He reminded the committee that 20 percent of the state's retirement portfolio had been lost. He pointed to the expectation that funds would earn 8 percent annually or \$800 million on a \$10 billion portfolio. He elaborated that a 20 percent loss equated to a loss of \$20 million, putting the state \$2.8 million behind its expected earnings. The losses need to be recovered, but the employers continue to pay the same 22 percent; the state picked up all of the additional unfunded liability.

Mr. Teal discussed the thinking behind the failure to address the issue earlier on slide 13 titled "What is Fiscal Stress???":

- The state may be paying too much into retirement plans, but it is better to choose to pay when we can afford it than be forced to pay when we cannot afford it.
- When budget surpluses turn into deficits, we can work to reduce state costs.
- Until then, state contributions reduce the magnitude of the future fiscal problem.

Mr. Teal elaborated that two years earlier concern had developed about the state's ability to pay the current and projected level of state assistance. He relayed that in response SB 187 had been introduced, calling for a cash infusion and reduced state assistance in the future; both the governor and the Alaska Retirement Management Board (ARMB) had opposed the legislation and it did not move forward. The concern about a deficit had become a reality; the state was now concerned about fiscal stress or affordability. He relayed that it had become evident at a recent National Conference of State Legislatures (NCSL) Pension Task Force meeting that he was not alone in thinking that fiscal stress was an important measure of system health. He noted that there were a multitude of things happening with retirement systems nationally including revised Governmental Accounting Standards Board (GASB) rules. The board had changed pension accounting rules; there were new computations by Moody's and other bond raters. He elaborated that there was now a separation between pension accounting and pension funding. The task force had been concerned that the standards and

calculations would be confusing to the public and legislators. Until the present year, GASB standards had been used for accounting, for bond rating, and for funding decisions made by legislators; there were now separate calculations for each.

[2:43:46 PM](#)

Mr. Teal turned to slide 14 titled "Books, Bonds, and Budgets." Accountants now had to report net pension liability on balance sheets. He explained that previously if a debt was paid on time it was not reported on a balance sheet. He compared the prior method to not factoring in money owed on a mortgage when determining a person's net worth. Ratings agencies used common set of assumptions in order to make system health comparable, which had resulted in some downgrades in bond ratings. He had spoken with a Moody's rater who had shared that Alaska had not been downgraded because it had closed its retirement system, which was a fiscally responsible step. The state was paying what it was supposed to pay and pensions only accounted for a portion of the rating agency's model. Additionally, the state had large financial reserves.

Mr. Teal addressed that GASB no longer provided guidance to legislators. He shared that previously there had been a model showing that states were required to pay the actuarially required contributions. He did not know why GASB had discontinued funding guidance. The state no longer had any rules that it was required to follow when paying off its unfunded liability.

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Representative Gara had a couple of questions related to the governor's proposal. Mr. Teal replied that he would hold off on a discussion of options until the following week.

Co-Chair Stoltze wondered how critical the premise of an 8 percent investment return was. He asked about the sensitivity of dependence and dangers of relying on the 8 percent. Mr. Teal answered the issue was "absolutely critical" to the system. He detailed that billions would be added to the unfunded liability if 8 percent was not earned and the interest rate assumption was changed by a full percentage point.

Co-Chair Stoltze remarked that the payout would not need to be the same as a trust, which was indefinite by nature. He observed that at some point the system would run out of beneficiaries. He wondered if that was the reason for using a higher investment return target instead of a more sustainable target. He expressed confusion on the issue.

Mr. Teal believed it would be easier to answer the questions later. He believed the issue addressed by Co-Chair Stoltze represented what was wrong with the current way the state was approaching the problem: trying to build up a significant balance and coast.

Co-Chair Stoltze asked for verification about the premise the state was operating under. Mr. Teal replied that the premise was that the state would build up enough money in the fund so that contributions would fall to zero in the mid-2030s and that from that point on the state would rely on earnings from assets to pay benefits for the following 40 years. He relayed that there was a major problem with the premise if the state was not going to earn 8 percent; without any contributions if the state did not earn the 8 percent return it would mean a difference of billions of dollars over a 40-year period.

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Mr. Teal continued to address a question by Co-Chair Stoltze. He believed the state would be responsible for paying the difference if 8 percent was not earned.

Co-Chair Austerman agreed that the state would be responsible. He believed the entire legislature needed to have an in depth discussion on the issue. He remarked that the state could use its entire savings to pay off the unfunded liability and in the future it could be right back in the same situation if there were years that experienced significant losses. He stated that the whole system was off kilter.

Co-Chair Stoltze believed the legislature needed to be cautious and to be better educated on the subject prior to making a decision on how to proceed.

Representative Gara was concerned that the state could not make the [investment] returns that individuals could

because it had to be more cautious with the money. He discussed that paying a cash infusion would limit the risk exposure. He remarked that he and Representative Guttenberg had proposed a similar solution in the past. He compared the issue to paying down a mortgage to reduce the amount of money owed over the long-term. He recognized that there would be large swings in the stock market, but if the amount owed was minimized the large swings would hurt less.

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Mr. Teal turned to slide 15 that included advice from the National Pension Funding Task Force:

- Put funding guidelines in statute. Describe computation of the Annual Required Contribution. Show the plan to bring the system to full funding
- The numeric approach offers sound guidance, but the funding ratio and other actuarial measures are not the most important measure of system health. What really matters is what is affordable.

Mr. Teal elaborated that two years earlier there had been large budget surpluses and state assistance had represented just one more large appropriation; there had been sufficient funds to cover the appropriation and the state had still been saving money. He explained that the funding ratio had not changed since that time. He stated that two years earlier the systems had been healthy by definition. Currently with a funding ratio at the same level, the health of the systems had deteriorated substantially because the state treasury could no longer afford the current path or a path with increased payments.

Mr. Teal moved to slide 16. The slide showed a graph comparing three cost drivers of available revenue. Cost drivers including K-12, Medicaid, and retirement assistance required over 62 percent of the state's available revenue. He expounded that if revenue forecasts and growth assumptions in the three cost drivers both held true the drivers would take 99 percent of the state's available revenue by FY 22. The mismatch between revenue and expenditure was unsustainable. He surmised the legislature may want to know how to address the issue if it was accepted that the state could not afford the projected retirement payments under the current path.

He turned to slide 17 titled "What Other States Have Done to Improve Retirement System Health":

- Increase assets
 - Increase employee contributions
- Reduce benefits
 - Raise the retirement age
 - Increase service requirements
 - Reduce post-retirement adjustments
 - Adopt hybrid plans

Mr. Teal elaborated on slide 17. States were trying to change the path of the liability curve. He stated that states could try to increase assets, but the only way to increase assets was to increase earnings. He noted that earnings assumptions were already fairly high. Other states wanted to increase employer contributions, but employers could not afford it; therefore, they were turning to employees. He elaborated that sometimes it related to future employees and sometimes it also included current employees. He relayed none of the forms of benefit reductions made by other states made much more than a small but growing change over a long period of time. He acknowledged that the changes could amount to billions of dollars over a long time period and that states had few other options. He had not heard of any proposals to tweak Alaska's benefits system; Alaska was still ahead of other states because it had acted early.

Mr. Teal looked at how reducing future benefits would impact the state's liability curve in a graph on slide 18. A reduction in benefits resulted in a small change to the liability curve that would continue to trend upward. He moved to slide 19 related to PERS accrued liability. Alaska's closure of the DB system to new entrants resulted in a radical [downward] change in the benefit curve shown on slide 19. The state would continue to accrue more benefits while DB employees continued working; however, by FY 30 benefits would peak and begin to decline through FY 70 or FY 80. He noted that the downward trend allowed the state to move away from the standard actuarial approach in which assets had to chase the liability curve upward. He asked how else the liability gap would be closed when liabilities were set by statute.

[3:02:59 PM](#)

Mr. Teal continued to discuss slide 19. The state had approximately \$15 billion in assets; the current plan gave the state 25 years to close the gap. The goal should be to pay all benefits when due and to end up with no money left when the curve reached zero. He addressed why the state wanted to build its assets up until it reached the liability curve at its peak and why it could not go straight across or head straight for the bottom of the curve. He noted that a large balance was not needed; the only reason for a large balance was so contributions could go to zero and the state could coast on interest earnings. He intended to address the questions the following week.

Mr. Teal directed attention to slide 20 titled "A National Task Force Recommends that Pension Funding Policies":

1. Be based on actuarially determined contribution rates - and the calculation of rates should be in statute so the plan is clear to employees, retirees, administrators, boards, and legislators
2. Collect a consistent percentage of payroll - use the Level Percent of Pay amortization method
3. Be disciplined - to ensure that promised benefits can be paid (i.e., pay the ARC)
4. Maintain intergenerational equity (i.e. the cost of benefits should be paid by the generation of taxpayers that were served by the employees who earned those benefits)
5. Require clear reporting to show how and when plans will be fully funded and the progress toward that goal

Mr. Teal expounded on slide 20. He believed item number one was doable once a plan was agreed upon. He remarked that a slight conflict existed with item two because ARMB recommended changing amortization methods. He did not believe it was necessary to discuss amortization methods because the board had supported the governor's proposal; therefore he did not believe the level dollar would be discussed as an option any longer. He continued that the method for setting the actuarial contribution rate was designed for open systems where new entrants were joining regularly; the system required the percent of pay method. He addressed item number 3, which entailed putting a plan in statute and following it. He believed the item was achievable if the plan was affordable. The fourth recommendation stipulated that debt should not be moved

forward to be paid by the next generation. The fifth item recommended that clear reporting should be required to show how and when plans would be fully funded and progress towards the goal. He did not include unfunded liability in the normal cost category that he defined as what it took to pay an employee's benefits supposing all assumptions came true.

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Mr. Teal agreed with intergenerational equity when it came to paying the pension what a model projected would be owed; however, unfunded liability was not a normal cost and it could not be paid in a way that maintained intergenerational equity. He provided an example of a person who retired in 2004 when the unfunded liability was zero; expected benefits were all paid for by his generation and money was on hand to pay all of the expected benefits. However, unanticipated losses occurred in 2005 and an unfunded liability was created; contribution rates had to rise in order to fill the gap, which meant that the next generation would pay. Under a DB system the employer took the risk and had to pay when an unfunded liability gap opened; it did not matter who the liability was attributed to.

Mr. Teal relayed that the Buck Consultants' (the state's actuary) actuarial model showed that unfunded liability was fully paid by the 2030s because existing unfunded liability was fully amortized by that time and the model never developed any new unfunded liability; the reason was because earnings assumptions were always met under the actuarial model.

Mr. Teal turned to a chart on slide 21 titled "PERS Assets and Accrued Liability." The actuarial projection was shown in black and depicted liabilities as increasing, peaking, and slowly decreasing. The model showed that contributions would be necessary until a trust fund of \$25 billion was reached; when the \$25 billion was reached the plan was 100 percent funded and contributions would stop. However, if earnings ever fell below 8 percent, new unfunded liability would occur. He concluded that costs could and probably would continue long after the last DB plan employee retired and that the state would pay for any costs that may open up. He believed obsession with intergenerational equity could lead to overly restrictive policy decisions. The

concept did not apply to unfunded liability and a DC plan would be required if intergenerational equity was desired.

3:12:07 PM

Mr. Teal communicated that the ARMB sideboards regarding intergenerational equity and shifting costs from the state to the municipalities could not be followed by ARMB proposals. He did not believe the legislature should be held to the ARMB sideboards if the entity's models could not comply.

Mr. Teal did not object to a cash infusion; he noted he had worked on a cash infusion model over two years earlier. He addressed the questions "What is the Goal?" and "What Options Might Achieve it?" on slide 22:

Goal: a healthy system—meaning a system with a plan to eliminate unfunded liability in a reasonable time at an affordable cost.

Mr. Teal elaborated that the goal was also to pay benefits when due. He relayed that several things could be done. The state could re-amortize its unfunded liability, which would reduce state assistance in the short-term, but would not save money. He compared the option to refinancing a home longer-term without a change in interest rates. Another option would be to change the model assumptions, but it was reality that mattered; if the model was not the best reflection of expectations it would not have value. A third option would be to eliminate healthcare from the unfunded liability calculation; however, those costs were real and if the state was going to continue to pay them they should be included. The state could also look for more workable options that did not rely on the assumptions that no additional unfunded liability would open up or that the state would continue to earn 8 percent returns.

3:15:12 PM

Mr. Teal provided a wrap up. He stressed that action on funding was not imperative. The state was on a track to reach full funding; the primary issue was the affordability of staying on the present track. He provided concluding advice on slide 23:

- Outline your plan in statute.

- Avoid paying less than the plan.
- Avoid paying more than we can afford.

Mr. Teal expounded that the plan should be outlined in statute and the state should not merely appropriate money annually. The state should also avoid paying less than the plan or more than it could afford.

Co-Chair Austerman requested information showing the different potential liabilities for municipalities. He stated that if the state's real share was 60 percent it left 40 percent for other employers. He noted that the state had been paying over 22 percent since 2007. Additionally, he wondered what the state's total bill had been since 2007 for costs that would have been paid by the municipalities if a 22 percent cap had not been implemented.

Mr. Teal replied that he would follow up with the information. He used Anchorage as an example and shared that its payroll was \$25 million annually. He addressed the first portion with an Excel spreadsheet titled "December 2013 Retirement Assistance by Employer" (copy not on file) and relayed that the Anchorage municipality's percentage of payroll was 8.2 percent; its share of the unfunded liability was \$650 million. He remarked that the state could choose to pay its share in a lump sum and to ask municipalities to do the same or to pay the amount over a period of time; he did not think it was a serious option. He explained that the idea would not work because Anchorage's bill would be \$60 million per year or 32 percent of its payroll on top of the normal contributions if it opted to make the payment over a 25-year period.

[3:19:29 PM](#)

Co-Chair Austerman reiterated his request for information showing the different potential liabilities for municipalities. He wanted an apples-to-apples conversation, which he did not believe was occurring at present.

Representative Munoz asked for verification that the state paid 100 percent of past obligations prior to 2007. Mr. Teal replied in the negative. He communicated that the obligation was recomputed annually.

Representative Munoz asked what the breakdown had been for local governments and the state prior to 2007.

Mr. Teal replied that the payment portions had all been even; everyone had paid a rate and there had been no state assistance. He elaborated that because it had not been a shared system that communities had different rates. For example, rates may have been 17 percent for Juneau, 12 percent for Anchorage, and 21 percent for North Slope. When the system became shared it meant that all communities paid the same blended rate based on the shared liability of the system and payroll. The rate had been about 40 percent, but it had been determined that municipalities could not pay that amount, as a result the cap had been set at 22 percent.

Representative Costello observed that the unfunded liability was not the only problem facing the state. The committee had learned earlier in the day that by 2022 the state would have a \$7 billion Medicaid bill. She surmised that if the state was going to consider all of its problems that it was important to factor in when cash would be needed the most. She saw it as a delicate timing issue that was not isolated to the pension problems. She believed that the state wanted to reduce its annual payment in order to free up money to fund state services.

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Mr. Teal had not meant to imply that addressing retirement issues would take care of the other issues. He believed all of the issues were related and it was important to think about them together. He detailed that in 2007 education, retirement, and revenue sharing had all been tied together and solved as a common solution. He agreed that under the current plan the savings to employers did not occur until 20 years in the future, but the state was facing fiscal problems much sooner than 20 years out. However, if the state was to address retirement it would free up a substantial amount of money to focus on health, education, and municipal revenue sharing issues. He added that the gap would not be filled, but it would help.

Representative Costello remarked that earlier in his testimony Mr. Teal had been somewhat dismissive of the bond raters' view on how Alaska should handle the issue. She asked for comment on the value of the state's bond rating

and how the legislature's action or inaction could impact it.

Mr. Teal answered that he had not meant to dismiss the bond raters. He believed the rating was important and allowed the state to borrow money at a lower rate. He clarified that he had been dismissing the role of pension debt in determining the bond rating. The bond rater had communicated that Alaska had large reserves and that it could choose to pay off the debt. There were many factors included in bond ratings and he did not believe the pension debt was a critical component. Raters also factored in that the state had closed its DB system. He relayed that bonds were rated for 20 years in the future, not for the next year.

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Representative Guttenberg referred to shared plans and blended rates. He wondered whether it was still possible to break out the different rates by community. Mr. Teal answered that he was not able to calculate the data. He thought that the Division of Retirement and Benefits may have the information that would allow for a computation of the data. He did not know if the division had the data in a format that would allow for the computation currently; the whole point of going to a shared cost system was that the breakout did not need to occur any longer.

Representative Guttenberg referred to Mr. Teal's earlier testimony that used Anchorage as an example. He thought the example had provided a breakout of information for the municipality.

Mr. Teal replied in the negative and explained that the issues were separate. One of the issues pertained to the way individual employers used to be responsible for individual employees' benefits. The state had moved away from the format and currently the system was blended; no matter where an employee worked they received the same benefits depending on pay and time of service. Employees were paid out of one large pool. The second issue pertained to taking the unfunded liability and breaking out a municipality's share of the debt. He explained that if money was spent on a capital project paid for with municipal bonds there would be something to show for it.

There was nothing to show for unfunded liability, the money was just lost.

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Representative Guttenberg agreed; however, he provided a scenario in which an employee worked for the City of Saint Paul and had subsequently worked in Anchorage and Petersburg. He surmised that all of the communities would claim that the liability was not theirs. He stated that municipalities could no longer calculate the portion of the money they owed. He believed the issue would be a sticking point.

Mr. Teal stressed that the state did not care where anyone worked anymore. The assignment of liability had nothing to do with the time served or money made by employees. He elaborated that the assignment to employers had nothing to do with the employees. Money had been lost and municipalities were all responsible for their share.

Co-Chair Austerman remarked that the question had been raised in 2006 and 2007, which had prompted moving to a shared system. He added that the state had been unable to answer the question at that time as well.

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ADJOURNMENT

[3:33:25 PM](#)

The meeting was adjourned at 3:33 p.m.