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Ginny Austerman

From: Sujit CanagaRetna [scanagaretna@csg.org]
Sent: Friday, July 08, 2005 6:46 AM
To: Ginny Austerman
Subject: Implementation Status of Statement No. 45



Governmental Accounting Standards Board

Summaries / Status

Status of Statement No. 45

Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

Status

Issued: June 2004

Effective Date:

The requirements of this Statement are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999:

- Governments that were phase 1 governments for the purpose of implementation of Statement 34—those with annual revenues of \$100 million or more—are required to implement this Statement in financial statements for periods beginning after December 15, 2006.
- Governments that were phase 2 governments for the purpose of implementation of Statement 34—those with total annual revenues of \$10 million or more but less than \$100 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2007.
- Governments that were phase 3 governments for the purpose of implementation of Statement 34—those with total annual revenues of less than \$10 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2008.

Earlier application of this Statement is encouraged. All component units should implement the requirements of this Statement no later than the same year as their primary government.

Affects:

- Will supersede GASBS 12; GASBS 27, ¶24
- Will amend NCGAI 6, ¶5; GASBS 10, ¶2; GASBS 16, fn6 and fn7; GASBS 27, ¶6, ¶7, and ¶39; and GASBI 6, ¶7

Affected by: No other pronouncements

Primary Codification Section Reference: Will be codified in P50

Abbreviations for Accounting Pronouncements

GASBS - GASB Statements	NCGAS - NCGA Statements
GASBCS - GASB Concepts	NCGAI - NCGA Interpretations
GASBI - GASB Interpretations	SOP - AICPA Statements of Position
GASBTB - GASB Technical Bulletins	ASLGU - AICPA Audit Guide
BFC - Basis For Conclusions	

Systems in Stress

Public retirement systems are challenged by shrinking assets and growing liabilities

By Sujit M. CanagaRetna

As federal officials debate how much tinkering they need to do to keep Social Security solvent, policy-makers in the states are searching for solutions to shore up weaknesses in public retirement systems.

In many cases, these public retirement systems are underfunded at a time when the first wave of the nation's baby boomers is rapidly approaching retirement.

The problem is underscored in the results of a survey conducted by The Council of State Governments' Southern Office, the Southern Legislative Conference. Data from the nationwide survey showed that liabilities exceeded assets in 73 percent of the plans that responded.

Those survey results are among the findings in a comprehensive report, *America's Public Retirement Systems: Stresses in the System*, released by CSG's Southern office in Atlanta.

Federal data on all 2,670 state and local retirement systems plus survey results from 105 state retirement plans in 46 states are used in the report to provide analysis for policy-makers on the status and trends in the nation's public retirement systems.

Other findings in the report show that:

- Nationally, public retirement systems' payments to retirees are climbing while assets are dropping. Between 1993 and 2002, annual receipts for public retirement systems plunged from \$125.9 billion annually to an aggregate deficit of \$6.1 billion because of earnings losses on investments. Meanwhile during the same period, payments to retirees more than doubled from \$52.6 billion annually to \$122 billion.
- Liabilities are rising at a faster rate than assets. Between the fiscal years 2001 and 2002, the assets of public retirement systems increased by 3 percent while liabilities increased at a more rapid rate of 8.1 percent.
- States are responding to the challenge by refinancing funds through bond sales, calling for changes in qualifications to earn full retirement benefits, and monitoring more closely the performance and management of the nation's 219 state retirement funds.

Retirement Infrastructure Fragile

The report highlights that in addition to weaknesses in these public retirement systems, other elements of the nation's retirement architecture, vital to financing the retirement of millions of Americans in the future, remain extremely tenuous as well.

Specifically, the report notes the precarious financial position of corporate pension plans and the federal Pension Benefit Guaranty Corporation (PBGC); the looming shortfalls expected in the Social Security and Medicare programs in coming decades; and the low personal savings rates of most Americans, coupled with the high rates of consumer and household debt.

A variety of interest groups and concerned citizens have emphasized that policy-makers at all levels of government need

to initiate concrete steps to prepare for the "graying" of America and the expected huge increase in retirees. In fact, the number of people in the United States 65 years and older is forecast to grow from about 13 percent of the total population in 2000 to 20 percent in 2030, and to remain above 20 percent for at least several decades thereafter. In this context, there is growing concern that more attention needs to be directed toward retirement planning and developing a retirement infrastructure that has the capacity to absorb the retirement needs of all Americans.

In recent years, public retirement funds have attracted a great deal of attention, sometimes because of their shrinking asset base and sometimes for a variety of other reasons. Nationally, there are 2,670 state and local government pension plans. By the end of fiscal year 2002, those retirement systems contained \$2.2 trillion in cash and investment holdings for more than 17.3 million total members. These pension funds made payments to more than 6.2 million beneficiaries during this period.

Funding Levels Plunging

Various studies show, however, that funding levels for public pension funds are plunging. For instance, according to a study by the National Association of State Retirement Administrators, the assets of public retirement systems increased by 3 percent between fiscal years 2001 and 2002 while liabilities increased by 8.1 percent. Then, a study by Wilshire Associates shows that the ratio of state pension assets to liabilities declined from 106 percent in 2001 to 82 percent in 2003. Finally, the majority of plans that responded to the CSG Southern office's survey revealed that a majority of the plans that responded were underfunded with liabilities exceeding assets in 68 of the 93 plans.

There is a great deal of variation among public pension plans and replicating the performance of one state's success with a particular approach may not always be possible in another state given its unique circumstances. Nevertheless, the report documents specific strategies adopted by a number of public retirement plans to improve and bolster their financial positions.

- **Alabama**—The Retirement System of Alabama (RSA) has gained national attention due to its "unorthodox" investments from the recent acquisition of US Airways to investments in the Robert Trent Jones Golf Trail to financing the restoration of portions of downtown Mobile to real estate investments in New York City. RSA's assets ballooned from \$500 million in 1973 to \$26.2 billion in the space of three decades. (For more information on RSA, see accompanying article in this month's *State News* on page 21.)
- **California**—The nation's largest public pension plan, the California Public Employees' Retirement System (CalPERS), voted to oust 38 hospitals from its Blue Shield HMO network in 2004 because they were deemed too expensive, a move that will save the giant pension plan \$50 million annually.
- **Kansas**—In 2004, the governor and legislative leaders agreed on a strategy to borrow \$500 million to buttress the state's beleaguered Public Employees Retirement System

Nationally, public retirement systems' payments to retirees are climbing while assets are dropping. Between 1993 and 2002, annual receipts for public retirement systems plunged from \$125.9 billion annually to an aggregate deficit of \$6.1 billion because of earnings losses on investments.

At the federal level, most of the debate about the financial underpinnings for future retirees has centered on Social Security and Medicare. It is time for the plight of the PBGC to be added to that debate.

(KPERS). Kansas' strategy was one adopted by a number of states as they sought to reinforce their enfeebled retirement systems.

- *Maine*—In a contrarian approach, hailed by *The New York Times* as the first pension fund in the United States to do so, Maine has adopted a strategy known as matching, i.e., deliberately aiming for low but guaranteed investment income to pay for the retirement benefits of its workers.

Options for Improvement

To bolster the shaky pillars of America's current retirement system, *America's Public Retirement Systems: Stresses in the System* offers options for policy-makers to consider.

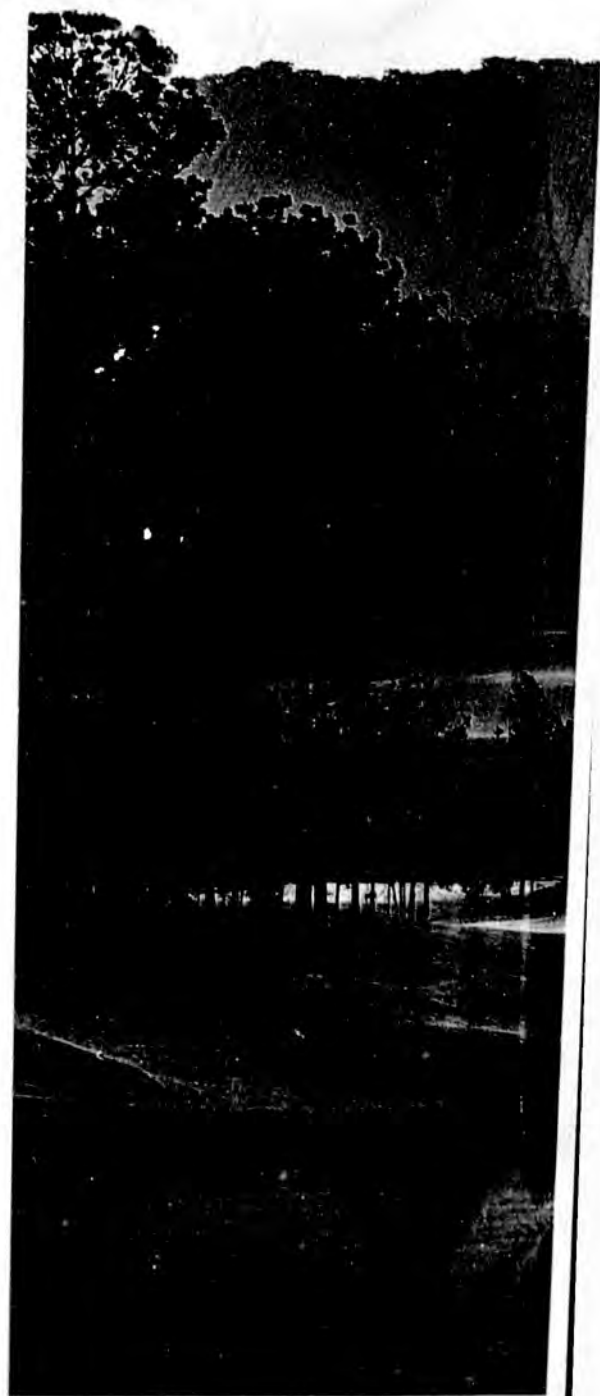
To overcome financial problems associated with a low savings rate, policy-makers at all levels of government should begin an assortment of educational and incentive programs to instill the importance of savings. The United States has a household savings ratio of 2 percent compared with 15 percent in Europe and 6.5 percent in Japan.

At the federal level, most of the debate about the financial underpinnings for future retirees has centered on Social Security and Medicare. It is time for the plight of the PBGC to be added to that debate. The PBGC, mandated to protect the pensions of bankrupt and failing corporations, is severely underfunded. Cumulatively, the level of pension underfunding could possibly eclipse the magnitude of the federal government's bailout of the savings and loan industry in the 1980s.

Finally, state policy-makers should pay more attention to the management of pension fund assets, the investment choices made by fund managers, and the practice of deferring contributions to retirement funds to offset budget shortfalls.

Ensuring both the short-term and long-term financial viability of America's public and private retirement systems is a challenge and a responsibility for policy-makers at every level of government—federal, state and local. In fact, resuscitating and then sustaining the financial health of our different retirement income flows provides the underpinnings for the foundation of the United States as an economic, political and military powerhouse in the global context. Consequently, it is imperative that policy-makers and citizens alike initiate efforts now to bolster the shaky pillars of America's current retirement system to minimize the costs of making these fundamental reforms in the future.

—Sujit M. CanagaRetna is senior fiscal analyst with The Council of State Governments' Southern Office, the Southern Legislative Conference. CanagaRetna's entire report is available online at slcatlanta.org.



Number, Membership, and Monthly Benefit Payments of State-Administered Employee Retirement Systems: 1993-2003

Item	2003	1998	1993
Number of systems	218	214	190
Membership last month of fiscal year			
Total membership	21,209,882	18,792,096	15,206,551
Active members	12,538,604	11,358,499	10,224,417
Inactive members	3,250,341	3,009,997	1,430,369
Percent distribution	100.0	100.0	100.0
Active members	59.1	60.4	67.2
Other	40.9	39.6	32.8
Beneficiaries receiving periodic benefits			
Total number retired or survivors	5,420,937	4,423,600	3,551,765
Former active members, retired service	4,642,902	3,798,600	3,099,491
Former active members, retired disability	342,286	254,718	187,795
Survivors of former active members	435,749	370,282	264,479
Percent distribution	100.0	100.0	100.0
Percent former active members, retired service	85.6	85.9	87.3
Percent former active members, retired disability	6.3	5.8	5.3
Percent survivors of former active members	8.0	8.4	7.4
Recurrent benefit payments for last month of fiscal year			
Total amount of benefit for retired/survivors	\$7,852,487,401	\$4,638,426,325	\$2,823,434,232
Amount former active members, retired service	\$7,013,919,983	\$4,167,810,596	\$2,525,531,815
Amount former active members, retired disability	\$462,604,657	\$257,442,309	\$161,872,035
Amount survivors of former active members	\$375,962,761	\$213,173,420	\$136,030,332
Percent distribution	100.0	100.0	100.0
Percent former active members, retired service	89.3	89.9	89.4
Percent former active members, retired disability	5.9	5.6	5.7
Percent survivors of former active members	4.8	4.6	4.8
Average monthly payment for beneficiaries			
Average for all beneficiaries	\$1,449	\$1,049	\$795
For former active members, retired service	\$1,511	\$1,097	\$815
For former active members, retired disability	\$1,352	\$1,011	\$862
For survivors of former active members	\$863	\$576	\$514

Source: U.S. Department of Commerce, U.S. Census Bureau, December 2004
Detail may not add to totals due to rounding.



Alabama's Ace Investments

Out-of-the-ordinary investments pay off for Alabama's retirement system

By Jenny Price

One of the largest office buildings on the isle of Manhattan—55 Water Street—doesn't belong to Donald Trump or any other larger-than-life New York City real estate mogul.

The 54-story tower near Wall Street is the property of the Retirement Systems of Alabama, the pension fund for nearly 300,000 public workers and retirees. RSA bought the building at a fire sale price a decade ago; today it's worth more than \$800 million.

The unorthodox investment for Alabama's pensioners is part of a strategy that has not only made a name for its leader, David Bronner, but also increased the fund's assets from \$500 million to more than \$26 billion during the past 30 years.

Bronner said he had to go beyond traditional money management of the retirement funds when he took over RSA in 1973. The fund did not have the money it needed to meet its future obligations and the state of Alabama, which he said owed RSA more than \$1 billion, was struggling economically and was not a prime destination for travelers or big business.

"I had a quarter for every dollar I owed people," Bronner said.

Since then, the retirement system has actively invested in developing Alabama's economy, including a statewide system of public golf courses, a cruise ship terminal in Mobile and major office buildings in Montgomery, the capital city.

The Renaissance Ross Bridge Golf Resort and Spa in Birmingham, Alabama, the newest addition to the Robert Trent Jones Golf Trail, will open this summer.
Photograph by Lawrence Michael Clemmer

"I had to have a different philosophy. The stronger I can make the state of Alabama, the stronger I can make the pension fund."

—David Bronner

First Stop: New York City

When Bronner took over the fund, he turned his attention to managing its stocks and bonds but also looked for other ways to bolster its assets so he could use the retirement system as a tool to impact Alabama's economy.

"I had to have a different philosophy," Bronner said. "The stronger I can make the state of Alabama, the stronger I can make the pension fund."

That meant looking outside Alabama for investments that would allow the retirement system to buy in for a cheaper price with the potential for a larger payoff. RSA started by investing in Consolidated Edison bonds in 1975, when New York City was on the verge of a financial collapse, which led the pension fund to become the utility's largest investor.

During a financial crisis in the late 1980s, RSA stepped in again to buy \$200 million in New York City bonds. And later, the system was able to buy the Water Street building for "29 cents on the dollar," Bronner said.

"It's just phenomenal, the returns we've gotten off that," he said.

Focusing On Alabama

While Alabama's retirement system has made investments away from home, the fund has also made significant efforts to build up the state through projects that promote tourism and other economic development.

In the 1980s, RSA funded a \$12 million Wal-Mart distribution center in 1985 in northern Alabama and financed a \$48 million state complex building project.

In 1996, the retirement system spent \$2.5 billion to purchase Raycom Media, which owns about three dozen television stations in 19 states and Puerto Rico and now has headquarters in Montgomery, Ala. One year later, RSA invested \$1.8 billion in Community Newspaper Holdings, which publishes 295 daily, weekly and semi-weekly newspapers.

Once the retirement system had control of the newspaper company, it moved its headquarters from Kentucky to Birmingham, Ala.

Bronner said he looked to protected industries, such as newspapers and television, which had large cash flows "instead of having

everything subject to being beat up on Wall Street." He said those purchases also provided a vehicle to promote the state through millions of dollars in free advertising.

Build It, People Will Come

RSA continued Bronner's mission to raise Alabama's profile by looking to another surprising venture: golf courses.

The retirement system invested \$180 million in a chain of two dozen golf courses designed by renowned architect Robert Trent Jones. A half-million people a year play the golf trail, which is named for Jones. The New York Times called the trail "some of the best public golf on Earth" and Golf Digest ranked Alabama as one of the "Top 10 States" for 2002-2003.

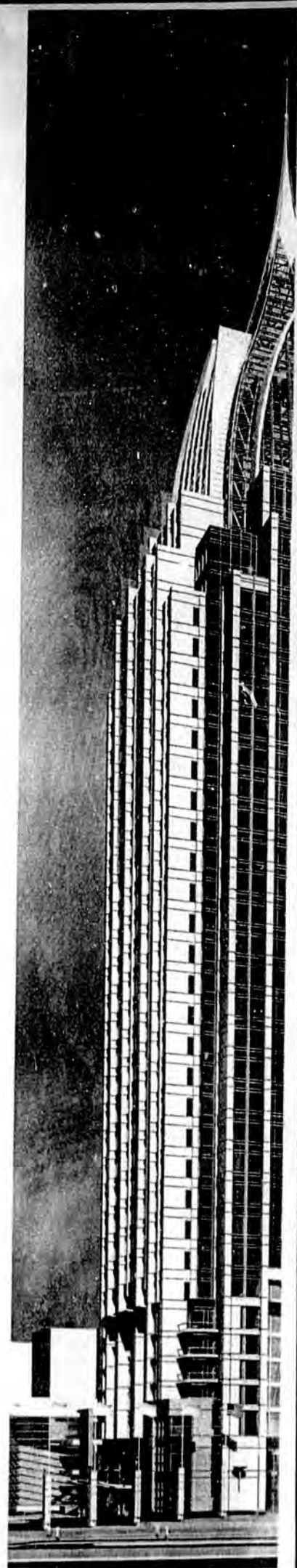
In 2003, the golf trail provided RSA with a 14 percent return on its investment, a rate that dropped to 4 percent last year due to construction of two additional courses. Tourism now produces more than \$6.8 billion in revenue for the state of Alabama, compared with the \$1.8 billion it brought in before the trail was built, according to RSA's 2004 annual report.

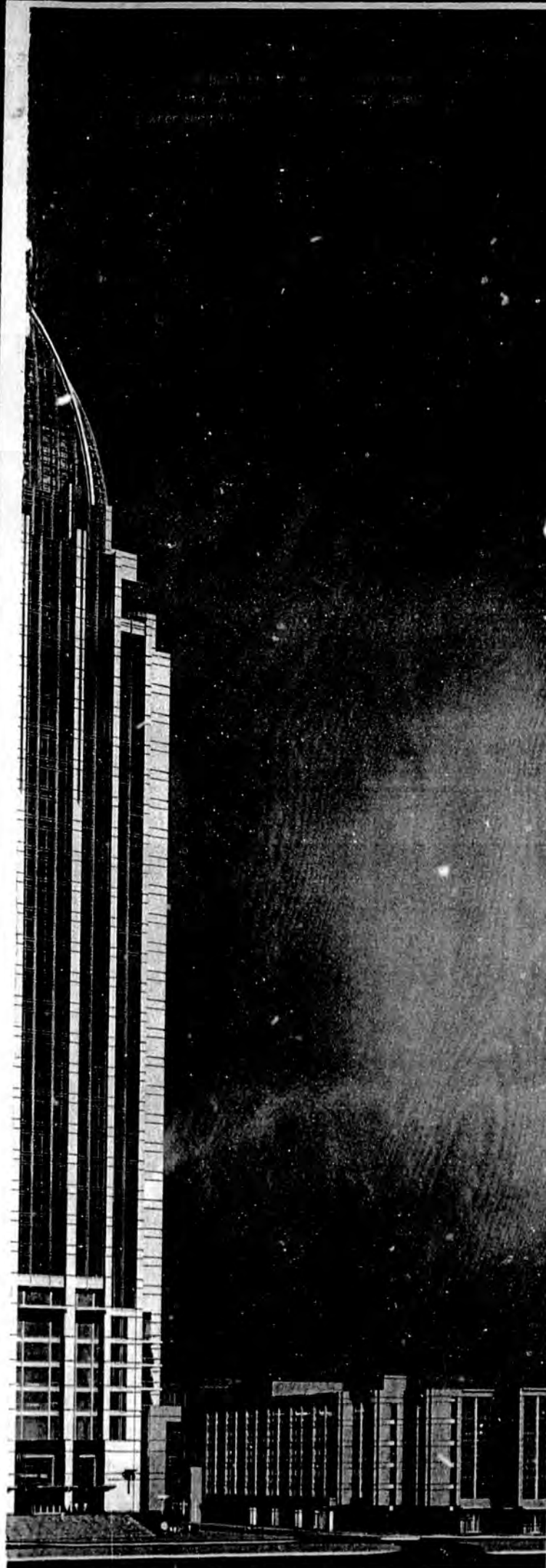
Lee Sentell, head of the Alabama Bureau of Tourism and Travel, said "people laughed" when RSA first announced plans for the courses, but the project has had a major impact on the state's image. When Sentell attended a travel trade show in London several years ago, people walked by, saw the Alabama sign and tried to think of what they knew about the state.

"Their reaction was usually 'George Wallace,'" he said. "The last time I did the show people walked by, saw the Alabama sign and said, 'Golf. Robert Trent Jones.'"

Along with the golf courses, RSA has invested in hotels and two upscale retirement communities, to try to attract retirees from other states and keep Alabama seniors from moving elsewhere.

Bronner and golf trail officials also contend the courses, which began opening in 1992, made a difference in helping convince Mercedes, Honda and Hyundai to locate new plants in Alabama. The state is projected to produce 760,000 vehicles in 2005, with auto companies





and their suppliers employing nearly 40,000 workers, according to the Alabama Automotive Manufacturers Association.

Governors from other states have sought Bronner out to learn more about what the retirement system has done in Alabama, but he said he stresses to them that results take time.

"Lots of things that I've done have taken me a decade to do. You—as a politician—you want to do it tomorrow," he said. "It's very difficult to do huge, long-term things."

Not Without a Fight

Bronner's office is filled with editorial cartoons critical of his efforts to move ahead with nontraditional investments for the retirement system's funds. Over the years, he said newspaper publishers have tried "to have my head roll."

"We had tons of legislative battles and special sessions to reform," Bronner recalled. "We just kept moving and we obviously moved in the right direction and got there."

The retirement system's members support the decisions and investments Bronner has made, said Mac McArthur, executive director of the Alabama State Employees Association since 1998. McArthur gave Bronner and RSA "high marks" and said pensioners are comfortable with the retirement system using a small part of the funds for unusual and creative investments.

"They are aggressive. It's a very small part of their portfolio, but they are aggressive," McArthur said.

McArthur also credited RSA for obtaining a \$111 million settlement for losses from its investments in WorldCom, which collapsed two years ago after an \$11 billion accounting scandal.

The settlement amount was 90 percent of what RSA was suing to collect; Bronner noted in the retirement system's 2004 annual report that the "normal settlement" in such cases is usually five to 10 cents on the dollar.

Owning US Airways

Some investment experts began to question RSA's methods when in 2002 it offered a \$240 million investment and \$500 million in financing to keep struggling US Airways afloat. RSA also agreed to slash payments for leases the fund already held on \$340 million worth of US Airways aircraft. The deal made the retirement system majority shareholder in 2003 and Bronner the airline's chairman.

"It's not a whole lot different than when I bought New York City real estate," Bronner said. "We often go into an industry when we think they're pretty well beat up. This one got a little more beat up because of oil (prices)."

In September 2004, US Airways filed for bankruptcy protection for the second time, posing a threat to the retirement system's investment. More recently, Air Wisconsin Airlines has offered to loan the airline \$125 million, about half of what US Airways has said it needs to get out of Chapter 11 status.

"Even though we haven't bailed out on them, we're looking at them," Bronner said. "We're going to have to make a decision in the next few months whether we put in more money or what we're going to do with the thing."



David Bronner

Approximately **36 percent** of the retirement system's investments are in **domestic stock** and another 36 percent are in **domestic fixed income bonds**. The rest are in **international securities and bonds**, **real estate** and **other investments**.

Still, Bronner said RSA remained on solid ground because the money the fund had invested in the airline was less than 1 percent of its total assets.

He also said the state and the fund benefited from RSA's interest in US Airways because it led to more airplanes being serviced in Alabama and provided an avenue for cross-promoting the airline with the state's tourism destinations, such as the Robert Trent Jones Golf Trail.

The RSA's Web site also urges state employees and retirees to take advantage of exclusive discounts on airfares.

The State Of RSA

Despite US Airway's financial woes, RSA's net investment earnings totaled \$5.3 billion over the last two fiscal years and the system is about 95 percent funded.

Approximately 36 percent of the retirement system's investments are in domestic stock and another 36 percent are in domestic fixed income bonds. The rest are in international securities and bonds, real estate and other investments.

Norman Stein, a law professor at the University of Alabama who studies employee benefits and is a member of RSA, said it's important to consider Bronner's more unusual undertakings in the context of the whole portfolio.

"Some people may believe you shouldn't commit even a small percentage of the portfolio to high risk, potentially high return, investments and I think he's shown you can do that if you do it cautiously and conservatively," Stein said.

Looking Ahead

RSA isn't slowing down when it comes to buildings projects in the state.

In October 2004, Carnival Cruise Lines began porting one of its ships, "The Holiday," at a terminal the retirement system built in Mobile. RSA also pledged several million dollars in marketing each year to support the terminal.

The retirement system also is investing \$162 million to build the RSA Battle House Tower in Mobile, which at 35 stories will be

the tallest building in the state and will feature a lighted crown visible from 30 miles away, according to the project's architect. The project also includes renovating the adjacent 250-room Battle House Hotel, a historic landmark.

In Montgomery, RSA is partnering with the city to build a four-star hotel and convention center that is expected to anchor a revitalized downtown and Riverfront District in Alabama's capital city.

"It's something that, honestly, I don't believe that we would have been able to achieve very rapidly from the private sector alone," said Randy George, president of Montgomery's Chamber of Commerce.

—Jenny Price is a former Associated Press statehouse reporter. She is now a freelance writer based in Madison, Wis.



Photo courtesy of the Retirement Systems of Alabama

In 2003, Alabama's retirement system became the majority shareholder of US Airways and RSA's David Bronner became the airline's chairman.

Membership and Benefits of State-Administered Employee Retirement Systems (March 2003)

State	Total membership	Total active members	Total inactive members	Beneficiaries receiving periodic benefit payments	Average monthly benefit payment
United States	21,209,882	12,538,604	3,250,341	5,420,937	\$1,449
Alabama	326,639	214,895	25,360	86,384	1,329
Alaska	94,676	46,526	20,924	27,226	1,720
Arizona	433,703	229,744	124,702	79,257	1,421
Arkansas	166,596	109,633	16,051	40,912	1,326
California	2,397,755	1,377,772	332,300	687,683	1,551
Colorado	357,275	191,332	99,681	66,262	2,055
Connecticut	190,727	119,381	9,819	61,527	2,112
Delaware	58,344	38,498	984	18,862	1,084
Florida	891,754	620,163	64,912	206,679	1,065
Georgia	602,377	357,142	142,530	102,705	1,801
Hawaii	97,831	62,292	4,150	31,389	1,516
Idaho	96,025	62,490	7,906	25,629	982
Illinois	932,817	463,965	236,088	232,764	1,550
Indiana	367,980	229,110	47,701	91,169	827
Iowa	281,651	163,971	39,444	78,236	846
Kansas	248,881	147,294	40,404	61,183	822
Kentucky	370,132	219,349	55,446	95,337	1,462
Louisiana	370,998	216,526	44,600	109,872	1,623
Maine	87,678	51,848	5,056	30,774	1,129
Maryland	330,647	192,836	45,990	91,821	1,126
Massachusetts	305,623	206,502	7,270	91,851	1,558
Michigan	623,561	395,379	27,625	200,557	1,470
Minnesota	586,357	280,450	185,835	120,072	1,580
Mississippi	328,419	155,590	112,698	60,131	950
Missouri	383,112	262,223	26,701	94,188	1,424
Montana	103,820	53,387	23,679	26,754	936
Nebraska	71,133	45,149	14,301	11,683	1,130
Nevada	112,623	77,610	7,701	27,312	1,852
New Hampshire	74,484	50,910	6,569	17,005	1,204
New Jersey	705,187	440,615	63,468	201,104	1,763
New Mexico	188,306	120,955	25,134	42,217	1,556
New York	1,333,418	782,538	118,976	431,904	1,510
North Carolina	697,775	454,249	80,793	162,733	1,267
North Dakota	43,447	27,207	5,567	10,673	927
Ohio	1,531,223	734,148	464,477	332,598	1,548
Oklahoma	224,470	143,008	10,080	71,382	1,220
Oregon	310,268	159,769	53,815	96,684	1,909
Pennsylvania	682,299	367,315	75,770	239,214	1,296
Rhode Island	51,818	28,505	3,965	19,348	1,861
South Carolina	442,717	219,006	130,720	92,991	1,292
South Dakota	63,934	35,114	12,379	16,441	972
Tennessee	304,196	198,917	22,158	83,121	923
Texas	1,635,614	1,176,389	134,880	324,345	1,531
Utah	150,095	94,833	23,280	31,982	1,323
Vermont	41,035	23,837	7,683	9,515	930
Virginia	504,796	311,811	84,227	108,758	1,216
Washington	356,359	216,709	29,545	110,105	1,347
West Virginia	107,171	64,319	14,436	28,416	1,322
Wisconsin	486,819	263,500	107,032	116,287	2,075
Wyoming	55,317	33,893	5,529	15,895	968

Source: U.S. Department of Commerce, U.S. Census Bureau, December 2004.

Fixing the Problem

Illinois is among the states considering new pension-reform plans

By Tim Anderson



Concerns over unfunded pension liabilities and the budgetary impact of state retirement plans are pushing lawmakers to seek changes that ensure the systems' solvency and prevent runaway costs. In recent years, a number of ideas have been considered in states around the country, such as the sale of pension-obligation bonds, switching to defined contribution plans, increasing contribution levels and reducing benefits.

The focus on reforming state retirement systems is continuing this year. In Minnesota, for instance, legislation has been introduced to increase pension contribution levels by public workers as well as by cities and counties. Another proposal would cap annual pension-benefit increases in the state's post-retirement investment fund to 5 percent—an attempt to avoid a recurrence of the asset deficit that the fund now faces. In the absence of the cap, double-digit benefit increases had been provided during the unprecedented market growth of the 1990s. But when the market slumped, the fund was left with a permanent liability that cut deeply into its reserves.

Minnesota's situation—recent investment losses, a rise in unfunded pension liabilities and tight fiscal conditions—is

emblematic of what has occurred across the country. In addition, longer-term trends, such as the fact that states will have more retirees living longer in the future, mean reform likely will be a priority in the years, and decades, ahead.

Illinois: 'Facing a Crisis'

More so than in any other Midwestern state, pension reform has become a highly publicized issue in Illinois this legislative session, for several reasons. First, an overhaul of the system is part of Gov. Rod Blagojevich's plan to balance the state budget. Second, earlier this year, a commission appointed by the governor released an extensive list of reform ideas for legislators to consider. Third, the state's five retirement systems are in particularly poor financial health. Illinois has the largest unfunded pension liability among the 50 states (\$43 billion in 2003).

"There is a consensus that we are facing a crisis, and that it is a complicated and complex issue that must be dealt with," said Illinois Rep. Rich Bradley of Chicago.

Rep. Mark Beaubien Jr. of Barrington agrees, adding that "virtually all members of the Legislature believe some changes ought to occur."

But while most agree on the need for reform, finding consensus on the details of any proposed changes may be difficult.

"The numbers, the unfunded liabilities, speak for themselves," Bradley said. "The dire economic situation of the state also is obvious. Those elements have brought us to a point where people have to go behind closed doors and negotiate an agreement."

Many factors have contributed to the crisis in Illinois. First and foremost, according to Bradley, is the fact that the state has consistently funded pensions below necessary contribution levels over the past 30 years. Beaubien said that the state missed a golden opportunity to begin fixing the system during the latter half of the 1990s.

"We were averaging a billion dollars in new revenue, and some of that should have gone into the pension system," he said. "Instead, when times were good, we passed a lot of benefit enhancements without any funding source."

Then, after these benefits were put in place, the pension systems' earnings declined as a result of the economic downturn, leaving an already underfunded system with a worse financial outlook.

Bradley says one of this year's goals is to make sure future state legislatures do not repeat past mistakes. One idea suggested by the gubernatorial commission—of which Bradley and Beaubien were members—and included in Blagojevich's proposal is a requirement that any new pension benefit be accompanied by a specific revenue stream to pay for it. That and other pieces of the governor's plan will be the starting point for what are expected to be months-long negotiations in the Capitol. The Illinois Constitution prevents any reduction in benefits to existing employees. As a result, most changes would affect only new hires. Blagojevich's proposal includes:

- *An adjustment in the age at which employees are paid full benefits*—Currently, someone who has worked at least eight years for the state can retire with full benefits at age 60. The governor wants to raise the age to 65. Similarly, his plan would change the age at which 35-year employees of the state can retire with full benefits (from 60 to 65).
- *A change in determining pension increases*—The governor says annual increases in retirees' pensions should be tied to cost-of-living increases (based on the Consumer Price Index). Currently, retired workers receive an automatic 3 percent increase, regardless of cost-of-living increases or market performance.
- *A cap on end-of-career salary increases*—This reform targets the large boost in pay that school districts often provide teachers and administrators before their retirement. Because these employees' benefits are based on salaries during their final four years on the job, the large pay increases mean the state has to pay more in benefits. Blagojevich's proposal would cap end-of-career raises at an annual rate of 3 percent; school districts would assume the costs for salary increases above that amount.

These and other pension reforms could save the state \$55 billion over the next 40 years. Because of those long-term savings, Blagojevich says, the state can reduce its contributions to the retirement systems by more than \$700 million this year, helping balance the budget in the process.

Many lawmakers, while praising Blagojevich for tackling the pension issue, are wary about tying a budget fix to these long-term savings.

"Most of these are prospective reforms, and taking the money up front won't work," Beaubien said.

Some of the specific proposals may be a tough sell as well. The cap on end-of-career salary increases would impact two important constituencies: teachers and local school districts. Either districts will have to come up with the extra money, or teachers' pay raises will be curtailed. Beaubien predicts some kind of cap will be enacted, but that it will not apply to existing school contracts.

Other parts of the pension reform proposal may be challenged on legal grounds. For instance, members of the State



"There is a consensus that we are facing a crisis, and that it is a complicated and complex issue that must be dealt with."

—Illinois Rep. Rich Bradley

University Retirement System (SURS) have the option to take part in a plan in which they are guaranteed an average interest rate of 9 percent. Participants in the other four state systems receive 6 percent. Any law that puts SURS' interest rate in line with the other systems will be challenged as unconstitutional for diminishing current employees' benefits, Beaubien said.

But despite obstacles like these, both he and Bradley expect the General Assembly to move forward with some version of pension reform.

"There are many stakeholders to consider in this process," Bradley said. "We're doing a thorough job in analyzing all of the possible scenarios, and eventually I think we'll have a plan that addresses the unfunded liabilities we have."

—Tim Anderson is publications manager for the Midwestern Office of The Council of State Governments. This article originally appeared in *Stateline Midwest*, a publication of CSG-Midwest.



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State Pension Funds Feel Age Wave's Stresses

By Jack Penchoff

The safety of Social Security and public employee pension funds is the type of issue where policy-makers earn their keep. There is general agreement on the problem—our aging population is producing an increasing number of retirees who are tapping into retirement funds that have shrinking assets. The solutions are not as easy to define.

At the federal level, leaders generally agree Social Security needs fixing. The extent of those repairs has produced the “paralysis by analysis” that sometimes plagues decision makers.

States, meanwhile, are forging ahead with a host of solutions in efforts to shore up weakening state and local pension plans. **Sujit CanagaRetna**, senior fiscal analyst with CSG's Southern Legislative Conference in Atlanta, has written a 100-page report on the issue. This month *State News* provides a summary of CanagaRetna's findings in his report, *America's Public Retirement Plans: Stresses in the System*. The report outlines the problems and offers examples of what states are doing to meet the challenge.

One state that has had success in sustaining a healthy public retirement system is Alabama. Freelance writer **Jenny Price** examines the Retirement Systems of Alabama. Price also interviewed the architect of Alabama's pension plan, David Bronner, who has helped the state's retirement system build a portfolio that includes Manhattan real estate, US Airways, 295 newspapers and the famous Robert Trent Golf trail, which *The New York Times* has hailed as “some of the best public golf on Earth.”

Illinois is considering pension reform plans that are not quite as glitzy as Alabama's efforts. **Tim Anderson**, publications manager for CSG's Midwest office, writes about Gov. Rod Blagojevich's proposals to restore the financial health of Illinois' underfunded pension liability that in 2003 amounted to \$43 billion.

In other news this month, Dr. Carolyn Orr, CSG's chief agriculture and rural policy analyst, reports on the 2005 Legislative Agriculture Chairs Summit held in Memphis, where the discussion centered on rural development strategies.

And **Dan Lorentz**, a CSG health policy analyst, writes about how some states are taking a comprehensive approach to battling cancer by making sure all of a state's anti-cancer resources are working together to fight the disease on all fronts, from prevention and early detection to treatment, rehabilitation and end-of-life care.

—Jack Penchoff is senior editor of *State News*.



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Panelists Discuss Benefits and Pitfalls of Issuing Bonds for Pension Funds

Posted 06/27/05

By Elizabeth Albanese

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SAN ANTONIO — Pension bonds can be useful tools in assisting governments to reduce unfunded liabilities in their pension funds, but such debt issues must be structured with future debt burdens and benefit requirements in mind, said panelists speaking Sunday at the 99th annual Government Finance Officers Association conference.

An unfunded liability in a pension plan represents the difference between the present

value of all benefits expected to be paid to plan members and the actuarial value of the plan assets available to pay those benefits, meeting moderator Ted Alexiades said.

Alexiades, the finance director for Hingham, Mass., said unfunded liabilities can occur if the investment performance of assets in a pension fund does not meet established targets.

"Unfunded liabilities can also occur is if there is an expansion of benefits," he said. "A fully funded pension system is ripe for demands by unions to expand benefits."

Illinois director of debt management David Abel said

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unfunded liabilities are cropping up increasingly now because of a number of factors. His state issued \$10 billion of pension obligation bonds in 2003.

"Historically, workers worked more years and had a shorter life expectancy," Abel said. "There were also more people in the work force than receiving benefits. That type of system worked on a pay-as-you-go basis. Today, however, people's life expectancy is much higher — 15 to 20 years after retirement. We also have a pool of retirees that outnumbers the number of people in the work force."

Alexiades said his town rejected a number of proposed transaction structures that would have back-loaded the debt but given the town's budget an immediate boost.

"We tossed aside more than a few plans that would have drastically reduced the amount of our annual payments into our pension system," he said. "However, those plans tend to be a boon to the current administration — back-loading the bonds creates big savings in the first few years, so current administrations tend to embrace those deals because they provide budget flexibility in the short term. However, those deals can also create enormous budget risk for future administrations."

Abel said that in structuring pension obligation bond deals, finance officials also need to be cognizant that pension systems will receive a very large one-time cash infusion but lowered annual payments thereafter.

He said such deals must be structured conservatively up front, because call features on such issues are far more expensive than they would be on traditional tax-exempt bond deals. In addition, the taxable status of the debt increases the cost of borrowing.

"Those call features are much more expensive to obtain in these deals," Abel said. "We found that call features required about a 50 basis point increase in cost, while lowering the market interest in the transaction."

He also said POB issues are, in fact, arbitrage financings because they result in a pool of cash that is not immediately spent down on projects.

Moody's Investors Service vice president Doug Benton said that from a rating perspective, his agency looks at

POBs on a corporate equivalent scale.

Red flags for ratings include possible expansion of benefits.

"We like to check to see that there are provisions in place that this won't happen," he said.

Other rating concerns, according to Benton, are declining fund status of pension plans and increased future funding requirements.

However, he said such issues could also provide a municipal issuer with new investors.

"There is a lot of interest in this market from the international capital markets," Benton said.



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By Andrew Ackerman

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WASHINGTON

— West Virginia's plan to issue as much as \$5.5 billion in taxable pension obligation bonds to shore up its underfunded pension system for teachers, judges, and state police officers is dead for now

after voters in a special election Saturday rejected the proposal, which would have authorized the state to issue the debt.

The referendum failed with 86,657, or 54% of voters, opposing it, and 73,872, or 45%, voting in favor.

After the results were tallied, Gov. Joe Manchin 3d said he is abandoning the proposal so he can move on to other issues, leaving the state's pension problems to future administrations.

"Now that the voters have spoken, it's time to move on," Manchin said in a statement that distanced himself from his first major legislative defeat since becoming governor in January. "It will be up to future governors and legislators to address this further down the road."

The state planned to repay the general obligation bonds by setting aside fixed payments of \$350 million a year from its general revenue, assuming it could sell the bonds with a coupon rate of 5.5%.

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Because voters rejected the bonding proposal, the state will stick to the current system, which calls for payments to retirees' pensions to increase by about \$20 million a year for the next six years, ballooning to more than \$700 million in 2034. In fiscal year 2005, payments totaled about \$350 million.

Analysts reiterated yesterday what they've said in the past: The state has significant outstanding pension liabilities.

"Over time, the projections are that increased amounts of state general revenue will be needed, and over time, the state will have to figure out a plan for how to do that," said Jason Dickerson, an analyst with Fitch Ratings, which rates the state AA-minus. Standard & Poor's gives the state the same rating, and Moody's Investors Service rates it Aa3.

Critics of the proposed bond issue had derided the plan as too risky and a windfall to bankers and lawyers on Wall Street who would have made millions in underwriting fees. Some urged the state to make fixed payments from excess general revenue without the perceived investment risks that come with servicing bonds.

"What I'm dealing with is a bunch of politicians in this state, about the poorest state per capita in the country, and they don't want to cut services; they don't want to raise taxes; they don't want to do anything that makes anyone unhappy," said Thornton Cooper, a lawyer who paid about \$500 for radio ads that attacked the bond amendment on a Charleston station for five days last week. "They just want to put off all of these problems and I'm not convinced it's safe."

Cooper's ads — and those paid for by Don Blankenship, a wealthy energy mogul, saturated airwaves for the last two weeks — and may have confused voters. For instance, one of Cooper's ads argued that the state does not currently pay interest on the pension debt. Only the bonds, the ad said, would require interest payments.

But supporters argued that the state must service its outstanding liabilities with ever-increasing annual payments under the current system.

"It's such a complicated issue — pension funding versus

bonding versus what the risks are, the investment return and everything else — that the average voter isn't going to understand," said Harry Mandel, actuary for the state's Consolidated Public Retirement Board. "And so the attempt was to tell people that we're trying to refinance at a lower interest rate to save the state money, and then you have the one negative ad that comes out and says, well, you pay zero interest currently, so you're not reducing the interest rate — in fact you're creating interest — which is totally false. But again the average voter is going to believe that."

Voters' rejection of the proposal brings to an end, at least for now, a controversial seven-year-old idea that led state Treasurer John Purdue and state auditor Glen B. Gainer into a legal battle with then-Gov. Bob Wise over issuing a proposed \$3.9 billion in pension bonds. It culminated last year, when the state's Supreme Court of Appeals ruled in December that the state's constitution required that any GO bond sale required voter approval.

The Legislature approved an \$8.5 billion debt plan in January that called for a constitutional amendment that would allow voters to decide whether the state should sell the \$5.5 billion in GO pension bonds and authorized the state to issue \$3 billion in revenue bonds that did not require voter approval.

The state still plans to issue between \$1 billion and \$1.5 billion in special revenue bonds for its workers' compensation liabilities.



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STATE OF ALASKA

DEPARTMENT OF ADMINISTRATION

DIVISION OF RETIREMENT AND BENEFITS

June 22, 2005

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The Honorable Bruce Weyhrauch
Chair Special Committee on Ways and Means
House of Representatives
State Capitol, Room 421
Juneau, Alaska 99801

JUN 27 2005

Re: Assessment of the PERS / TRS Funding Matter

Dear Representative Weyhrauch:

I am confirming receipt of your letter faxed on June 17, 2005, advising that the Special Committee on Ways and Means would be meeting to discuss the PERS and TRS underfunding matter. I appreciate you taking up this important discussion. In that regard, could you please advise what role you envision the Division of Retirement and Benefits playing in the upcoming meetings.

Also, as a related matter, I would like to know what kind of resources will be needed to support the efforts of the Special Committee on Ways and Means. The purpose of this inquiry is to determine and plan for your resource needs and ensure that any additional costs are identified appropriately for budgetary purposes. For example, it would be good to know if the Special Committee on Ways and Means will have inquiries from the Division's actuarial consultant or need additional work to be performed by the actuary.

In closing, I wanted to share with you an article titled "Sinkhole - how public pension promises are draining state and city budgets" that was published in Business Week Magazine on June 14, 2005, that you may find of interest. I look forward to hearing from you and working with the Special Committee on Ways and Means on this important initiative. Please let me know if you have any questions about this correspondence.

Sincerely,



Melanie Millhorn
Director

Enclosure

cc: Members of Special Committee on Ways and Means

Ray Matiasowski, Commissioner
Department of Administration

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Sinkhole!

How public pension promises are draining state and city budgets

The public schools in Jenison, Mich., are real gems: Test scores are well above the national average, its autism and special-education program is recognized around the country, and the music program has been honored by the group that hands out the Grammy Awards.



INTERACTIVE MAP

The 4,800-student district averages close to 100% attendance at parent-teacher conferences, and on Friday nights in the fall families crowd the high school stadium's bleachers to watch football. Parents have moved to this idyll on the west side of the state from as far away as Kentucky, Texas, and New Jersey just to get their kids enrolled. Over 500 students from nearby districts attend Jenison by choice.

But underneath all that success is a looming fiscal crisis. In the past three years, Superintendent Thomas M. TenBrink has surgically cut \$4.2 million out of his \$39 million budget in a quest to keep Jenison the fiscally responsible district it has long been. He has instituted fees for participating in after-school sports and field trips. He eliminated 30 teaching spots, leaving the district with 287. He hasn't bought a new textbook in three years. He saved \$550,000 by turning an elementary school into a self-financing preschool and day-care center. But TenBrink is running out of options. "It's getting to the point where it will start affecting the children," says Lauralee Ryan, the parent of a first-grader and an active supporter of the schools.

Jenison is caught in a financial vise. School funds from the state are capped by law at \$6,700 per student, a figure that has been frozen for the past three years, but costs are zooming. The fastest-growing outlay of all: contributions to pensions and retiree health care. This year the bill is \$1 million. Next year it will jump to \$1.5 million. An expense that for years hovered at 12.99% of payroll is now eating up 14.87% of it, and state finance experts predict it will hit 20% within three years. "That is just draining our budgets," TenBrink says.

TenBrink's daily struggle to provide vital community services while meeting retirement promises mirrors the battle playing out across Michigan and the entire country. It's not just school districts that are being squeezed. State and local governments, hard hit by the economic downturn of 2001, find themselves in a financial bind. While sharp anti-tax sentiment constrains revenue and governments face new outlays for everything from homeland security to No Child Left Behind, there's a growing feeling that the retirement promises made to everyone from office workers and state patrols to firefighters and legislators may simply be unbearable. For some of the worst-off states, like Illinois, there is a long history of failure to fund pensions, which have snowballed into multibillion-dollar shortfall. For others, the depth of the problem is new, the result of poor investment returns and overly generous promises made when funds were flush in the late '90s.

The result: Essential services like education are being squeezed. States have only slowly recovered from the economic recession and revenue drops of as much as

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40% in 2001 and 2002. Nicholas W. Jenny, a senior policy analyst at the Nelson A. Rockefeller Institute of Government, says that while taxes have begun to rise slightly, hikes have been more modest than they were in previous downturns, including the early 1990s, something he attributes to a political climate that's "very tax-increase averse." Recent anecdotal evidence shows that many towns and cities have bumped up taxes over the past few years as state and federal governments have pushed unfunded requirements like No Child Left Behind and other costs down the ladder.

How long that can continue without voter backlash is unclear, however. Meanwhile the cost of retirement has continued its steady climb. According to the U.S. Census Bureau, major public pension plans paid out \$78.5 billion in the 12 months ended Sept. 30, 2000. By the comparable period in 2004, that had grown to \$117.8 billion, a 50% climb in five years. Beyond hiking taxes and cutting costs, governments have few ways to meet this bill. One option that many fiscal conservatives find troubling is pension obligation bonds. They are, essentially, an arbitrage bet in which governments borrow at relatively low municipal rates, invest the money, and hope they make enough to cover pension payments and earn a bit on the top. But they can lose money if the market goes south, a situation that New Jersey, which issued \$2.7 billion in bonds in 1997, now finds itself in. Over the past decade state and local governments have borrowed approximately \$30 billion this way.

Don't expect that flood of debt to slow, because there's little relief in sight. Excluding federal workers, more than 14 million public servants and 6 million retirees are owed \$2.37 trillion by more than 2,000 different states, cities, and agencies, according to recent studies. In 2003 alone, states and municipalities poured some \$46.2 billion into these plans, according to the National Association of State Retirement Administrators, a 19% jump from the year before. Excluding federally funded programs, pensions went from 2.15% of all state and local spending in 2002 to approximately 2.44% in 2003. But the largest state and city funds were still short \$278 billion in 2003 -- approximately 20% of state and municipal revenue excluding federal funds. That's twice the \$123 billion pension hole Wilshire Associates found at the companies in the Standard & Poor's (MHP) 500-stock index that year.

As much as states are throwing into pensions, they may owe even more. Despite a 2004 stock market rise that should narrow some of the gap, pension experts at Barclays Global Investors (BCS) say that if public plans calculated their obligations using the more conservative math that private funds do, they would not be \$278 billion under, but more than \$700 billion in the red. "It's just ruining the financial picture for states and municipalities," says Matthew H. Scanlan, managing director of Barclays, one of the largest managers of pension-fund investments. "You're looking at a taxpayer bailout of this pension crisis at some point."

There's more bad news. One major category of cost isn't disclosed at all: how much retiree health care has been promised to public retirees. No one can estimate how much these promises will add up to, but they're sure to be in the tens of billions, and only some states seem to have put aside reserves for them, according to bond analysts. That's chilling, given how quickly medical costs are rising. After a pitched battle, the Governmental Accounting Standards Board (GASB), the independent accounting standards-setter for state and local governments, has finally begun to require states to disclose these liabilities. Numerous unions and state government representatives objected to the change, says GASB member Cynthia B. Green, "not because [unions and states] didn't think these were important, but because they thought once the governments did their studies and found what the price tag was, they would be concerned or, if not concerned, staggered." The requirement will be phased in beginning in late 2006.

If these costs aren't brought under control, rising taxes could prove unavoidable -- and a competitive problem for the states in the worst shape as well as for the country. Stephen D'Arcy, a professor at the University of Illinois at Urbana-Champaign's College of Business who has studied public pensions, worries that if states like Illinois have to sharply hike taxes to pay for benefits earned decades ago, companies -- and even citizens -- could end up moving to states in better fiscal shape. "You could see it turning into an economic desert in certain states," he warns. Combined with the national retirement issues

surrounding Social Security, these plans contribute to a depressing outlook for U.S. competitiveness overall.

RUDE AWAKENING

Even states with well-funded plans are struggling to meet their current obligations. For years, New York State enjoyed low pension payments, thanks to strong investment returns and fully funded plans, but in 2004 cities and counties across the state got a rude awakening. Pension contributions jumped as much as 248% in one year. "It was the equivalent of what I call a fiscal atom bomb," says Richard A. Bucci, mayor of Binghamton, a city in the center of the state, with a metro-area population of 250,000. In 2004, Bucci's pension bill jumped from \$1.6 million to \$4.2 million, forcing him to both cut back services and raise taxes. Homeowners saw property taxes jump 7% last year, half of which went to pensions, and another 7% hike is coming this year for the same reason.

Just a few years ago funds across the country were in much better shape. "Five years ago we were starting to feel pretty good about pension funds not being a credit issue," says Parry Young, a pension expert at S&P, "but now they're back on the plate." In 2000, Wilshire Associates found the largest state funds were overfunded -- boasting assets equal to 109% of liabilities. By last year that had dropped to 83%.

One reason for the drop was unavoidable: The impact of the bear market of 2000-2002 on the value of these fund investments was severe. The other reason was just foolishness: a lathering on of billions of dollars worth of new promises to workers in flush days. It was a familiar mistake: Public-pension provisions are determined by elected officials, and civil servants vote. Legislators have a long history of making such expensive upgrades to already generous plans.

Some of these giveaways are truly spectacular. In 1998 the city of Houston instituted a deferred-retirement option plan, or DROP, that would allow workers to in effect take their retirement when they became eligible for it but continue to work at their salary. The retirement income was put in a side account where it earned an attractive rate of return, and the employee could later have his pension adjusted upward to a higher level. The DROP, along with other pension improvements, drove the city's pension plan down from 91%-funded in 2000 to just 60% two years later. Houston had gone from contributing 9.5% of payroll toward pensions to more than 32%. Joseph Esuchanko, a Michigan actuary brought in to study the problem, discovered that things would only get worse. According to his calculations, it was possible for employees to become millionaires thanks to the system. Under one scenario, a lifelong city employee retiring with a salary of \$92,000 could get \$420,000 a year in pension benefits. The citizens of Houston agreed with Esuchanko's conclusion that the system was a "win-win for the employee and a lose-lose for the employer." Last May they voted to end the benefits.

Little wonder, since even bare-bones guaranteed retirements are increasingly rare in the rest of the economy. According to the Census Bureau, 90% of state and local workers have a defined-benefit pension with a guaranteed payout. But only 24% of people employed in the private sector have such plans. (Most public-sector employees contribute along with employers to their pensions, unlike private-sector workers.) And more of the companies that once offered these benefits -- places like Motorola (**MOT**), IBM (**IBM**), and Delta Air Lines (**DAL**) -- are dropping them for new workers in favor of 401(k)s. Health-care coverage for retirees, a costly perk that companies have been shedding at lightning speed, also remains common in the public realm.

It has long been accepted as truth that government workers get good benefits and job security in lieu of high salaries, but over the years the gap between public and private employee paychecks seems to have narrowed. It's hard to come by perfect comparisons, since government numbers for the private sector include lower-wage industries like retailing, which pull down the averages, but overall, public-sector workers look to be getting a pretty good deal. In 2004 average salary for a public worker was \$49,275 compared with \$34,461 for everyone else, according to the Employee Benefit Research Institute (EBRI).

Even white-collar workers are better off in the public sphere. According to the U.S. Labor Dept., state and local government managers and professional staff earned \$42.87 an hour last year, while their private-sector counterparts earned \$41.52.

One big reason: government workers get \$2.62 an hour in retirement benefits; everyone else gets \$1.63.

States pay more for public retirees too. According to the EBRI, the average public-plan retiree got \$16,188 a year in 2003, far more than the \$7,200 their private company counterparts could expect. One reason for that big split is that some public retirees do not get Social Security. But that too is changing. Since 1983 most public workers have been part of that system too, so in the future the disparity could well widen. All in all, EBRI concludes, state and local government wage and salary costs are 40% higher than the private sector's; its employee benefit costs are 60% higher.

Workers naturally fight any changes hard, and they can be a very sympathetic group. In California, Governor Arnold Schwarzenegger came up against the political challenges of taking on public pensions this spring after he declared his support for a radical solution: ending the state's traditional pensions for new hires instituting a 401(k)-style system instead. (The norm in the private sector, such defined-contribution plans are rare in government.) Schwarzenegger spent February and March campaigning for a resolution to be put on the ballot possibly this coming fall. He collected signatures personally. He raised money for a series of radio ads. But by Apr. 8, the "Governator" had been felled by public campaigns arguing his plan would cut survivor benefits for police and firefighters. "What we really need is a discussion about what kind of society we want to be," says J.J. Jelincic, president of the 140,000-member California State Employees Assn. "What does it take to get there and how do we fund it."

EXTREME BENEFITS

To Jelincic, the answer is to raise taxes, but though Schwarzenegger lost the first round he hasn't warmed to that idea and has vowed he won't give up. The state's pensions hit the news last year with revelations of a crippling \$1.4 billion deficit in San Diego's municipal pension fund. The city's mayor, Richard Murphy, announced on Apr. 25 he would resign on July 15 after facing a continuing debate over how to solve the problem and probes by the Securities & Exchange Commission, FBI, and the U.S. Attorney for the Southern District of California's office into securities fraud and public corruption in connection with the fund.

But San Diego is only the beginning. Citizens of Salinas, Calif., where pension costs are up and revenue is down, are facing the possibility that their public libraries will close this year. Orange County, Los Angeles County, and many other California counties have significant pension deficits. The state itself will pay \$3.5 billion into pension and health benefits for retirees this year, almost triple what it paid just three years ago. And California's Legislative Analyst's Office (LAO) expects that to climb another \$1.1 billion over the next five years.

Moving all new California employees to a 401(k)-style plan wouldn't eliminate the bill already due, but it would slow the pace at which the pension deficit grows. Although there would still be a cost to this plan, it would be more predictable and lower than what the state is currently paying. Over many decades, California's pension costs would shrink as high-cost employees are replaced.

California's pension benefits are extreme. In 1999 and again in 2001, a time when the pension plans were flush with strong investment gains and state contributions were low, the state legislature upped the benefits to levels far beyond even the most generous public plans. A recent analysis by the LAO notes that for longer-term and some local employees, it's quite possible to receive more annual income in retirement than when a worker was employed.

This tendency to dole out goodies in fat times is the core moral hazard of public-pension plans. Politicians like to reward voters when they can, and public workers vote. It wasn't only in California that benefits crept up during the end of the bull market. Public employees saw benefit enhancements in New York, Colorado, Illinois, New Jersey, and many other states. "That was the mirage of cost-free benefits," says S&P's Young. "Nobody pays, nobody gets hurt." Not all of California's sudden pension bill is due to this; much comes from falling stock prices. But the LAO calculates that \$600 million, or almost 25%, of the \$2.6 billion contributed to state pensions in 2004-2005 resulted from these benefit increases. And unlike the investment performance, there is no hope for relief from this new, more expensive set of pension promises.

A plan's downturn can be tough to predict. Just five years ago, the city of New York was expecting its fiscal 2004 pension bill to total \$650 million. Instead, it came in at four times that much, \$2.46 billion, or 8% of the city's \$29.7 billion budget. Half of that \$1.8 billion surprise came from benefit improvements, including \$251 million in cost-of-living adjustments. By fiscal 2007, the Independent Budget Office of the City of New York projects pension contributions to hit \$4.9 billion, 12% of the \$40.5 billion budget.

REVERSE COMPOUNDING

But states have also voluntarily heightened their own exposure to this risk. Rosalind M. Hewsenian, managing director of Wilshire Associates, says the biggest cause of the sharp drop in funding levels at public plans over the past few years was a drop in employer funding and a reliance instead on investment gains to make up the difference.

Take Illinois. The fifth-wealthiest state in total income, Illinois nevertheless has a 30-year history of shirking its pension promises. According to an analysis by the Civic Federation, a Chicago research group sponsored by the business community, since 1970 Illinois has not once paid its annual pension bill in full. Over the next 40 years the state will have to contribute \$275.1 billion if it is to reach its goal of 90% funding -- and that's presuming no benefit changes are made. Through bull markets, bear markets, and sideways markets, the state has consistently lagged, and over time those delays have become more and more expensive. The culprit: reverse compounding. A pension plan's obligations are determined in part by the expected investment return on its assets. In the case of Illinois, that is 8%. So for every dollar not added to assets in time, the state is effectively borrowing from the pension plan at 8% interest. That's a high price in today's market, where municipal bonds typically pay closer to 6%. Illinois Governor Rod R. Blagojevich says that if the state follows its current spending plan, it will have paid \$220 billion in interest before it fills the hole.

After 30 years of the state's procrastination, the pension burden has grown backbreaking. Illinois' five pension funds are \$35 billion in the red, a serious shortfall for a state with a general operating budget of \$43 billion this year. Illinois owes \$2.6 billion this year, and within five years that will reach \$4 billion annually. By comparison the state will spend \$5.9 billion total on kindergarten through 12th-grade education next year. "If we were a business we wouldn't be in Chapter 11, we'd be in Chapter 13," says Ralph M. Martire, executive director of the Center for Tax & Budget Accountability, a Chicago-based nonprofit think tank. "We'd have to liquidate." Illinois is not a fast-growing state that can hope that future population and tax growth will bail it out. D'Arcy of the University of Illinois calculates that Illinois should be 97%-funded based on the rate of its income growth. Instead, retirement funds are 62%-funded.

The challenge to fixing the state's pension mess is, again, politics. Right now the halls of the state legislature in Springfield are a lobbying battleground between proponents of a plan proposed by the governor to cut benefits for new workers and union-led forces opposed to such a two-tier system. In many ways, the union argument is quite persuasive: State workers in Illinois have perks that are generally in line with or even a bit below those of other state's civil servants. Workers have consistently made their contributions to the pensions -- it's the state that has failed to pay its share. And Illinois has an antiquated tax system that probably is holding revenue down.

Over the years, even as the state failed to pay for existing pension promises, the Springfield politicians have added more. In the past 10 years benefit sweeteners have added \$5.8 billion in new benefits, largely through early retirement inducements. And there has been a general creep up in the level of promises made. Today, one-third of Illinois state employees get hazard rates of pension payments originally intended only for state police, according to the governor.

Elected officials are hesitant to ask the rest of their voters to pay for these promises through higher taxes. One primary reason: Outside of government workers, very few employees have these kinds of deals anymore. "Our people at 55 years of age can get 75% to 80% of their salary [as pension], and it's a pretty nice salary," says Illinois State Representative Robert S. Molaro, a member of a commission convened by the governor to make recommendations for fixing the pension system. "It will be hard for us to go to the taxpayers and ask them to pay

for our pensions with benefits you in the private sector couldn't even dream of."

FREE FROM SCRUTINY

Given this divide, it's reasonable to wonder why there hasn't been more debate about these plans already. They've been protected from scrutiny for a number of reasons. The public-pension systems lack the regulatory system governing corporate pension plans. Corporations have to disclose timely, detailed information about their pensions to investors and the SEC. Rating agencies focus on them, too. In combination, these groups can pressure companies to be more conservative in their fund management. Devereaux A. Clifford, managing director of pension consultants Greenwich Associates, says it was pressure from these watchdogs that forced corporations to lower unrealistic investment return assumptions, from 8.9% in 2002 to 8.3% in 2004.

The public world has far less scrutiny. Nor do these plans have an equivalent to the Pension Benefit Guaranty Corp., the government-sponsored insurer of corporate plans. They have to conform to the funding requirements or accounting demands of the Employee Retirement Income Security Act, the federal law passed in 1974 to monitor private pensions. And public fund reporting lags corporate reporting by at least six months. Important factors like the performance and cost of bonds issued to cover pension obligations are even harder to suss out.

That's bad news. Understanding the depth of these retiree problems seems especially important for state and local governments because of their limited financial options. Unlike the federal government, which can always print money, and private companies, which might sell more widgets and make more profits to fund their pensions, and whose pensions are guaranteed by a government-backed insurer, local government basically has only one way of meeting those promises: your taxes. Public-pension experts note that these obligations must be paid. Public-sector retirement benefits are generally guaranteed by state constitution. Even in the throes of New York City's fiscal meltdown in the 1970s, while services were being cut and emergency bonds were being issued to keep the city afloat, cutting existing pensions was never even discussed.

Don't expect much help from the stock market, either. Much of what fueled big gains in state assets in the '80s and '90s was a shift from investing primarily in bonds to higher-returning equities. Meredith Williams, executive director of Colorado's public employee retirement system, says that by 2000, his funds were 90%-invested in equities and real estate investment trusts. The bear market took Colorado's plan from 105%-funded to only 76%. That prompted Williams to cut stocks to something closer to 60% of total holdings. "You live by that sword, you die by that sword," he says. Neither would it be smart for state and local governments to continue borrowing to pay down pension liabilities, a move that not only can backfire if investments are weak but also saddles future generations with debt.

The more likely answer is the most painful: Taxes will keep going up and benefits will be cut for future public employees. Both are unpopular. The debate is just starting to be heard.

By Nanette Byrnes, with Christopher Palmeri in Los Angeles

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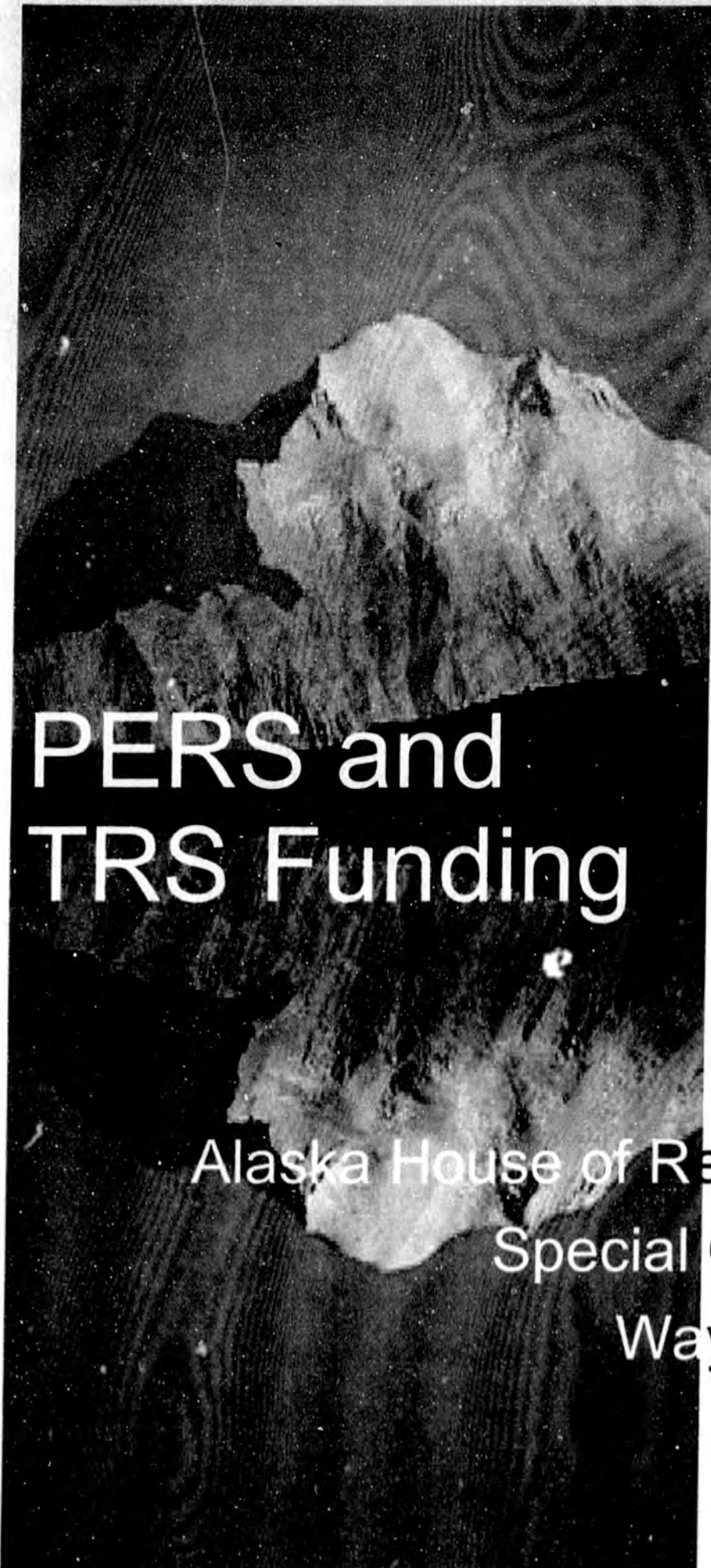
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PERS and TRS Funding

Report to the
Alaska House of Representatives
Special Committee on
Ways and Means
July 14, 2005



Alaska Public Employees' and Teachers' Retirement System

Earnings – Actuarial Rate – Employer Rates – Funding Ratios

Public Employees' Retirement System

Measurement Year	FY 01	FY 02	FY 03	FY 04
Employer Rate Year	<u>FY 04</u>	<u>FY 05</u>	<u>FY 06</u>	<u>FY 07</u>
Actual Investment Return	(5.25%)	(5.48%)	3.67%	15.08%
<u>Actuarial</u> Investment Return	8.25%	8.25%	8.25%	8.25%
Cumulative Dollar Shortfall, <u>in billions</u> (in billions, market value)	(\$1.2)	(\$2.4)	(\$2.9)	(\$3.4)
Average Calculated Rate	6.77%	24.91%	25.63%	28.19%
Board Adopted Rate	6.77%	11.77%	16.77%	TBD
Funding Ratio – Assets \ Liabilities Total Benefits	100.9%	75.2%	72.8%	70.2% (Draft Valuation)

Teachers' Retirement System

Measurement Year	FY 01	FY 02	FY 03	FY 04
Employer Rate Year	<u>FY 04</u>	<u>FY 05</u>	<u>FY 06</u>	<u>FY 07</u>
Actual Investment Return	(5.35%)	(5.49%)	3.68%	15.08%
<u>Actuarial</u> Investment Return	8.25%	8.25%	8.25%	8.25%
Cumulative Dollar Shortfall, <u>in billions</u> (in billions, market value)	(\$0.6)	(\$1.1)	(\$2.1)	(\$2.3)
Average Calculated Rate	14.44%	35.57%	38.85%	41.78%
Board Adopted Rate	12.00%	16.00%	21.00%	TBD
Funding Ratio – Assets \ Liabilities Total Benefits	95.0%	68.2%	64.3%	62.8% (Draft Valuation)

How Did the PERS and TRS Systems End Up With a Deficit?

- Rising Health Care Costs
- Loss of Investment Income
- Change in Assumptions



Public Employees' Retirement System

Actuarial Valuation June 30, 2002



Analysis of Valuation--June 30, 2002

Summary

The following table summarizes the sources of change in the average employer contribution rate:

1.	Last year's average employer contribution rate	6.77%
2.	Change due to:	
a.	Resetting FY03 assumed total blended medical premium	3.68%
b.	Health Cost trend assumption change	6.98%
c.	Asset methodology change - immediate recognition of deferred losses	7.24%
d.	Asset methodology change - elimination of corridor adjustments	4.11%
e.	System benefit changes	0.04%
f.	Ad hoc PRPA	0.14%
g.	Salary increases	(0.20%)
h.	Demographic experience	1.21%
i.	Past service amortization change	(5.06%)
3.	Average employer contribution rate this year	24.91%



Analysis of Valuation (Continued)--June 30, 2002

As shown in the Highlights section of the report, the funding ratio as of June 30, 2002 has decreased from 100.9% to 75.2%, a decrease of 25.7%. The average calculated employer contribution rate has increased from 6.77% of payroll for FY04 to 24.91% for FY05, an increase of 18.14% of payroll. The reasons for the change in the funded status and average contribution rate are explained below.

(1) Retiree Medical Insurance

The following table summarizes the monthly premium per benefit recipient since retiree medical benefits have been provided under PERS and TRS.

Time Period	Monthly Premium Per Retiree For Health Coverage	Annual Percentage Change	Average Compound Annual Increase Since FY78
2/1/76-1/31/77	\$ 34.75	--	--
2/1/77-1/31/78	57.64	66%	--
2/1/78-1/31/79	69.10	20%	20%
2/1/79-1/31/80	64.70	-6%	6%
2/1/80-1/31/81	96.34	49%	19%
2/1/81-1/31/82	96.34	0%	14%
2/1/82-1/31/83	115.61	20%	15%
2/1/83-1/31/84	156.07	35%	18%
2/1/84-1/31/85	191.85	23%	19%
2/1/85-1/31/86	168.25	-12%	14%
2/1/86-1/31/87	165.00	-2%	12%
2/1/87-1/31/88	140.25	-15%	9%
2/1/88-1/31/89	211.22	51%	13%
2/1/89-1/31/90	252.83	20%	13%
2/1/90-1/31/91	243.98	-4%	12%
2/1/91-1/31/92	243.98	0%	11%
2/1/92-1/31/93	226.90	-7%	10%
2/1/93-1/31/94	309.72	37%	11%
2/1/94-1/31/95	336.05	9%	11%
2/1/95-1/31/96	350.50	4%	11%
2/1/96-1/31/97	350.50	0%	10%
2/1/97-1/31/98	368.00	5%	10%
2/1/98-12/31/98	368.00	0%	9%
1/1/99-12/31/99	442.00	20%	10%
1/1/00-12/31/00	530.00	20%	10%
1/1/01-12/31/01	610.00	15%	10%
1/1/02-12/31/02	668.00	10%	10%
1/1/03-12/31/03	720.00	8%	10%

As you can see from the above table, the monthly retiree medical premium for the January 1, 2003 to December 31, 2003 time period has increased to \$720.00. Over the last 10 years, annual premium rate changes have ranged from no change to up 37%, but the average compound annual increase has been about 9%.



Analysis of Valuation (*continued*)--June 30, 2002

Effective June 30, 2002, the Board adopted a health cost trend assumption which varies by year, declining to an ultimate rate equal to inflation plus 1.5%, or 5.0% for FY17 and later. If the long-term assumption remains reasonable, short-term gains and losses from the annually determined medical premium rate will offset each other over time.

To help avoid the volatility in the funding and solvency of the System from bringing large health-related gains and losses into the System every year, we have been using the health cost trend assumption to determine actuarial liabilities for retiree medical benefits.

On June 30, 2002, the assumed total blended premium was reset to the actual total blended premium for FY03. The difference between the assumed rate and the actual rate will be tracked annually and reduced if the gap becomes too wide. Also, adjustments will be made, if necessary, to the assumed medical premium rate whenever experience and current trends indicate a change is appropriate. The resetting of the assumed total blended premium decreased the funding ratio by 3.4% and increased the average employer contribution rate by 3.68%.

The average employer contribution rate increased by 6.98% of payroll due to the change in the health cost trend assumption and the funded ratio decreased by 6.4%.

(2) Investment Experience

The approximate FY02 investment return based on market values was (5.69%). Due to the change in the asset valuation method, all prior investment gains and losses were recognized at June 30, 2002. This produced a loss of approximately \$1.020 billion to the system from investment experience, which decreased the funding ratio by 10.3% and increased the average employer contribution rate by 7.24%.

(3) Past Service Amortization

As a result of the Actuarial Audit performed in 2002, effective June 30, 2002, the Board adopted a 25-year fixed period level percentage of pay amortization of the Unfunded (Surplus) Target Accrued Liability. This change is consistent with the 5-year recognition of gains or losses used in the new asset valuation method [item (4) below].

The change in the Past Service Amortization methodology decreased the average employer contribution rate by 5.06%.



Analysis of Valuation (*continued*)--June 30, 2002

(4) Asset Valuation Method

As a result of the Actuarial Audit performed in 2002, effective June 30, 2002, the Board adopted an asset valuation method that recognizes 20% of the investment gain or loss in each of the current and preceding four years. This method will be phased in over the next five years.

Due to this change, the accumulated corridor adjustment from the prior method is now included in the amortization of the unfunded liability. Elimination of the corridor adjustment increased the average employer contribution rate by 4.11%.

(5) Salary Increase

During the period from June 30, 2001, to June 30, 2002, salary increases were less than anticipated in the valuation assumptions. Salary experience resulted in an actuarial gain which increased the funding ratio by 0.2% and lowered the total employer contribution rate by 0.20% of the total payroll.

(6) Employee Data

Section 2.2 provides statistics on active participants. The number of active participants increased 2.5%, from 32,441 at June 30, 2001 to 33,242 at June 30, 2002. The average age of active participants increased from 43.75 to 43.99 and average credited service decreased from 8.49 to 8.47 years.

The number of benefit recipients increased 5.8%, from 16,274 to 17,215, and their average age increased from 64.55 to 64.70. There was a 7.8% decrease in the number of vested terminated participants, from 6,187 to 5,702. Their average age increased from 47.54 to 47.86.

The overall effect of these participant data changes and methodology adjustments prompted by the actuarial audit was an actuarial loss to the System, resulting in an increase in the average employer contribution rate equal to 1.21% of total payroll.

(7) Ad hoc PRPA

An ad hoc Post Retirement Pension Adjustment (PRPA) was granted during FY02. This increased benefit payments to many Tier I (hired before July 1, 1986) retirees. This action produced a loss to the system of approximately \$20,105,000.

The overall effect of the ad hoc PRPA was an actuarial loss to the System which decreased the funding ratio by 0.3% and increased the average employer contribution rate by 0.14% of total payroll.



Analysis of Valuation (*continued*)--June 30, 2002

(8) System Benefit Changes

The following enhancements were effective June 30, 2002:

- For all Police/Fire members, the number of years for calculation of average monthly compensation is now three years.
- The occupational death benefit for survivors of Police/Fire members is now the greater of 50 percent of the member's final salary or 75% of the normal retirement benefit the member would have earned had the member survived to normal retirement age.
- Upon reaching normal retirement age, a disabled Police/Fire member now receives the greater of his/her disability benefit or his/her normal retirement benefit.

These System benefit enhancements increased the average employer contribution rate by 0.04%.

(9) Actuarial Projections

At the Fall 1991 Board Meetings, the PERS Board approved the use of an enhanced actuarial projection system. The same actuarial cost method is used, but the enhanced system projects population growth patterns and their associated liabilities 20 years into the future. By also projecting plan assets, this report in effect produces an actuarial valuation for each of the next 20 years. Section 1.5, Actuarial Projections, contains the results of this analysis.

This type of information can be especially useful to multi-tiered systems, such as PERS. All of the projected new entrants will be covered under the provisions of the current tier so that the ultimate effect on plan liabilities can be anticipated. As you can see in Section 1.5, based on the actuarial assumptions and asset valuation method, future contribution rates are expected to increase in the immediate future and then remain fairly stable.



Teachers' Retirement System

Actuarial Valuation June 30, 2002



Analysis of Valuation--June 30, 2002

Summary

The following table summarizes the sources of change in the total employer contribution rate:

1.	Last year's total employer contribution rate	14.44%
2.	Change due to:	
	a. Resetting FY03 assumed total blended medical premium	3.85%
	b. Health cost trend assumption change	6.84%
	c. Asset methodology change – immediate recognition of deferred losses	15.03%
	d. Asset methodology change – elimination of corridor adjustment	0.03%
	e. Salary increases	(0.11%)
	f. Demographic experience	4.21%
	g. Ad hoc PRPA	0.36%
	h. Past service amortization change	(9.08%)
3.	Total employer contribution rate this year	35.57%



Analysis of Valuation (*continued*)--June 30, 2002

As shown in the Highlights section of the report, the funding ratio as of June 30, 2002 has decreased from 95.0% to 68.2%, a decrease of 26.8%. The total calculated employer contribution rate has increased from 14.44% of payroll for FY04 to 35.57% for FY05, an increase of 21.13%. The reasons for the change in the funded status and calculated contribution rate are explained below.

(1) Retiree Medical Insurance

The following table summarizes the monthly premium per benefit recipient since retiree medical benefits have been provided under PERS and TRS.

Time Period	Monthly Premium Per Retiree For Health Coverage	Annual Percentage Change	Average Compound Annual Increase Since FY78
2/1/76-1/31/77	\$ 34.75	--	--
2/1/77-1/31/78	57.64	66%	--
2/1/78-1/31/79	69.10	20%	20%
2/1/79-1/31/80	64.70	-6%	6%
2/1/80-1/31/81	96.34	49%	19%
2/1/81-1/31/82	96.34	0%	14%
2/1/82-1/31/83	115.61	20%	15%
2/1/83-1/31/84	156.07	35%	18%
2/1/84-1/31/85	191.85	23%	19%
2/1/85-1/31/86	168.25	-12%	14%
2/1/86-1/31/87	165.00	-2%	12%
2/1/87-1/31/88	140.25	-15%	9%
2/1/88-1/31/89	211.22	51%	13%
2/1/89-1/31/90	252.83	20%	13%
2/1/90-1/31/91	243.98	-4%	12%
2/1/91-1/31/92	243.98	0%	11%
2/1/92-1/31/93	226.90	-7%	10%
2/1/93-1/31/94	309.72	37%	11%
2/1/94-1/31/95	336.05	9%	11%
2/1/95-1/31/96	350.50	4%	11%
2/1/96-1/31/97	350.50	0%	10%
2/1/97-1/31/98	368.00	5%	10%
2/1/98-12/31/98	368.00	0%	9%
1/1/99-12/31/99	442.00	20%	10%
1/1/00-12/31/00	530.00	20%	10%
1/1/01-12/31/01	610.00	15%	10%
1/1/02-12/31/02	668.00	10%	10%
1/1/03-12/31/03	720.00	8%	10%

As you can see from the above table, the monthly retiree medical premium for the January 1, 2003 to December 31, 2003 time period has increased to \$720.00. Over the last 10 years, annual premium rate changes have ranged from no change to up 37%, but the average compound annual increase has been about 9%.



Analysis of Valuation (*continued*)--June 30, 2002

Effective June 30, 2000, the Board adopted a health cost trend assumption which varies by year, declining to an ultimate rate equal to inflation plus 1.5%, or 5.0% for FY17 and later. If the long-term assumption remains reasonable, short-term gains and losses from the annually-determined medical premium rate will offset each other over time.

To help avoid the volatility in the funding and solvency of the System from bringing large health-related gains and losses into the System every year, we have been using the health cost trend assumption to determine actuarial liabilities for retiree medical benefits.

On June 30, 2002, the assumed total blended premium was reset to the actual total blended premium for FY03. The difference between the assumed rate and the actual rate will be tracked annually and reduced if the gap becomes too wide. Also, adjustments will be made, if necessary, to the assumed medical premium rate whenever experience and current trends indicate a change is appropriate. The resetting of the assumed total blended premium decreased the funding ratio by 2.1% and increased the total employer contribution rate by 3.85%.

The average employer contribution rate increased by 6.84% of payroll due to the change in the health cost trend assumption and the funded ratio decreased by 3.6%.

(2) Investment Experience

The approximate FY02 investment return based on market value was (5.68%). Due to the change in the asset valuation method, all prior investment gains and losses were recognized at June 30, 2002. This produced a loss of approximately \$866 million to the system from investment experience, which decreased the funding ratio by 16.0% and increased the average employer contribution rate by 15.03%.

(3) Past Service Amortization

As a result of the Actuarial Audit performed in 2002, effective June 30, 2002, the Board adopted a 25-year fixed period level percentage of pay amortization of the Unfunded (Surplus) Accrued Liability. This change is consistent with the 5-year recognition of gains or losses used in the new asset valuation method [item (4) below].

The change in the Past Service Amortization methodology decreased the average employer contribution rate by 9.08%.



Analysis of Valuation (*continued*)--June 30, 2002

(4) Asset Valuation Method

As a result of the Actuarial Audit performed in 2002, effective June 30, 2002, the Board adopted an asset valuation method that recognizes 20% of the investment gain or loss in each of the current and preceding four years. This method will be phased in over the next five years.

Due to this change, the accumulated corridor adjustment from the prior method is now included in the amortization of the unfunded liability. Elimination of the corridor adjustment increased the average employer contribution rate by 0.03%.

(5) Salary Increase

During the period from June 30, 2001, to June 30, 2002, salary increases were less than anticipated in the valuation assumptions. Salary experience resulted in an actuarial gain which increased the funding ratio by 0.2% and lowered the total employer contribution rate by 0.11% of total payroll.

(6) Employee Data

Section 2.2 provides statistics on active and inactive participants. The number of active participants decreased 1.3% from 9,815 at June 30, 2001 to 9,690 at June 30, 2002. The average age of active participants decreased from 44.19 to 44.15 and average credited service decreased from 10.62 to 10.33 years.

The number of retirees and beneficiaries increased 6.4% from 7,333 to 7,804, and their average age increased from 63.17 to 63.30. There was a 2.1% increase in the number of vested terminated participants from 767 to 783. Their average age decreased from 49.15 to 48.97.

The overall effect of these participant data changes and methodology adjustments prompted by the actuarial audit was an actuarial loss to the System, resulting in an increase in the total employer contribution rate equal to 4.21% of total payroll.

(7) Ad hoc PRPA

An ad hoc Post Retirement Pension Adjustment (PRPA) was granted during FY02. This increased benefit payments to many Tier I (hired before July 1, 1990) retirees.

The overall effect of the ad hoc PRPA was an actuarial loss to the System of approximately \$19,456,000 which lowered the funding ratio by 0.4% and increased the total employer contribution rate by 0.36% of total payroll.



Analysis of Valuation (*continued*)--June 30, 2002

(8) Actuarial Projections

At the Fall 1991 Board Meetings, the TRS Board approved the use of an enhanced actuarial projection system in the valuation report. The same actuarial cost method is used, but the enhanced system projects population growth patterns and their associated liabilities 20 years into the future. By also projecting plan assets, this report in effect produces an actuarial valuation for each of the next 20 years. Section 1.5, Actuarial Projections, contains the results of this analysis.

This type of information can be especially useful to multi-tiered systems, such as TRS. All of the projected new entrants will be covered under the provisions of the current tier, so that the ultimate effect on plan liabilities can be anticipated. As you can see in Section 1.5, based on the actuarial assumptions and asset valuation method, future contribution rates are expected to increase in the immediate future and then remain fairly stable.

MERCER

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January 3, 2005

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Department of Administration
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Juneau, AK 99811-0203

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JAN 06 2005

Div. of Ret. & Benefits

Subject:

Changes in Funded Status - PERS and TRS

Dear Melanie:

Part of our December 1 presentation to the Alaska State Pension Investment Board (ASPIB) focused on changes in the funded percentages for PERS and TRS. From July 1, 1992 to June 30, 2003, the funded percentage for the PERS declined from 92.3% to 70.0%, based on the market value of assets. The funded percentage for TRS declined from 91.0% to 61.7%. The dollar amount increases in the unfunded accrued liabilities (UAL) were \$3.2 billion for PERS and \$2.2 billion for TRS. We found that the total change in funded status for the PERS and TRS from July 1, 1992 to June 30, 2003 was due to asset and liability sources as follows:

	PERS		TRS	
	Change in Funded Status	Increase in UAL (billions)	Change in Funded Status	Increase in UAL (billions)
Change due to assets	(3.8)%	\$1.1	(2.7)%	\$0.6
Change due to liabilities	(18.5)	2.1	(26.6)	1.6
Total	(22.3)%	\$3.2	(29.3)%	\$2.2

This letter provides further breakdown of the changes in funded status attributable to liabilities. The percentages have been revised slightly from those quoted in the ASPIB meeting based on further research on the effect of the various factors.

	PERS		TRS	
	Change in Funded Status	Increase in UAL (billions)	Change in Funded Status	Increase in UAL (billions)
Health experience	(6.9)%	\$0.6	(3.0)%	\$0.2
Health assumption changes	(12.5)	1.1	(4.7)	0.3
Plan changes	(4.7)	0.3	(5.3)	0.2
Demographic experience	5.4	(0.1)	(6.8)	0.5
Non-health assumption changes	0.2	0.2	(6.8)	0.4
Total change due to liabilities	(18.5)%	\$2.1	(26.6)%	\$1.6

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Page 2

January 3, 2005

Ms. Melanie Millhorn

State of Alaska

Health experience and changes in health assumptions were relatively large contributors to the decline in funded status. Benefit improvements also contributed to the decline. For both Systems, plan changes include benefit improvements enacted by the legislature, as well as ad-hoc Post-Retirement Pension Adjustments (PRPAs).

I hope this information is helpful. Please call or email if you have questions or need additional information.

Sincerely,



Robert M. Reynolds, ASA, MAAA

RMR/DK/ws

Copy:

Anselm Staack

Chris Byrnes

Marcia Chapman

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State of Alaska
Public Employees' Retirement System

Funded Status Analysis
Conclusions and Recommendations

*Actuarial Service Company, P.C.
May 6, 2005*

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Executive Summary

Approach to this analysis

In order to gain an understanding of the current funded status of the Alaska Public Employees' Retirement System (PERS), we first studied the actuarial valuations published by Mercer for the years ended June 30, 1999 through 2004. From this we were able to gain an understanding of the System's benefit structure and the actuarial methods and assumptions used to value the assets and liabilities. We traced the history of funding over the period covered by these valuations. We were able to identify the benefits, methods and assumptions that were the major contributors to the current funded status.

We were able to understand the current funded status as determined by Mercer. We were also able to suggest changes in methods and assumptions which may refine the calculation of the funded status.

Summary of findings

1. Non-medical pension benefits are in the average range when compared to similar state sponsored plans. They are considered adequate to meet the needs of retirees.
2. PERS retiree health premiums have grown at an alarming rate. If this continues, System liabilities will continue to grow at a much higher rate than previously anticipated.
3. The actuarial method used to value liabilities is one used by only 16% of major public employee retirement systems.
4. The health cost trend rate assumed by Mercer is comparable to assumptions used by other actuaries valuing other public systems.
5. The substantial increase in the average contribution rate over the period covered in our analysis is due largely to increases in the cost of retiree medical benefits and poor investment performance.
6. The normal cost as percent of payroll increased dramatically for retiree health benefits while the normal cost as percent of payroll for pension benefits remained generally level.
7. The actuarial accrued liability for retiree medical benefits increased at almost three times the rate for pension benefits.
8. The unfunded actuarial accrued liability increase was due largely to increases in the cost of retiree medical benefits and poor investment performance.

9. Since 1999, the System's funded status went from a position of overfunded by \$262,000,000 to a position of underfunded by \$3,414,000,000.
10. Average annual return on investments over the past ten years has been in line with actuarial assumptions, although the past five years performance has been poor.

Recommended changes

The second phase of this engagement will deal with recommendations. Those will be primarily in the following areas:

1. Reconsider the actuarial method used to compute liabilities and normal cost.
2. Consider changes in the health cost trend rate being assumed.
3. Develop ways to increase return on investments without substantially increasing risk.
4. Evaluate alternate plan designs for future hires.
5. Develop ways to indirectly reduce benefits for retirees.
6. Develop ways to better manage health care costs.

Pension Benefits

Police and fire members of the Retirement System receive a benefit equal to 2% of a three year final average compensation (FAC) (five year if hired after June 30, 1996) times the first ten years of service plus 2.5% of FAC for service over 10 years. Other members receive 2% of FAC for the first 10 years of service 2.25% for the next 10 years and 2.5% for all service in excess of ten years. All service earned before July 1, 1986 is covered by a 2% multiplier. Police and fire members are eligible for normal retirement after 20 years of service regardless of age, and other members are eligible to retire after 30 years of service regardless of age. All members are eligible at age 60 with minimum service. Members participating before July 1, 1986 are eligible for normal retirement at age 55.

When an individual retires, his/her retirement income will generally come from three sources: Social Security, personal savings and pension plans. This is referred to as the "Three-Legged Stool." Although PERS members may be eligible for benefits from other Pension Systems, those benefits are beyond the scope of our study. PERS members are not eligible for social security through their employment with PERS employers, but may become eligible through employment elsewhere. Understanding how the three sources of retirement income work together can help determine the adequacy of PERS benefits.

A retiree's "replacement ratio" is the percentage of his/her current income just before retirement that is available from Social Security, personal savings and employer provided retirement programs. According to the *Replacement Ratio Study* prepared by Aon Corporation and Georgia State University and presented at the April 2005 Enrolled Actuaries Meeting in Washington DC, an employee retiring with an annual income of \$60,000 needs to generate about 75% of their preretirement income in order to maintain their same standard of living in retirement. A PERS member retiring with 30 years of service will receive a benefit equal to 67.5% (70% for police and fire members) of pay. Retirement Benefits are protected against inflation due to the Post Retirement Pension Adjustments (PRPAs) and Alaska Cost of Living Allowance (COLA) which are available. With the addition of social security (if available from other sources), other pensions which might be payable and personal savings, a retiring PERS participant should have adequate income in retirement.

In December 2003, the Wisconsin Legislative Council published the *2002 Comparative Study of Major Public Employee Retirement Systems*. Of the 85 plans studied, participants of 17 were not covered by Social Security. These 17 plans had an average formula multiplier of 2.39%. A 30 year participant in PERS will have an average formula multiplier of 2.25% (2.33% for police and fire members).

Pension benefits for Alaska PERS are in the average range for major Pension Systems in the Country. It also appears that they are adequate to ensure a reasonable standard of living in retirement for PERS members.

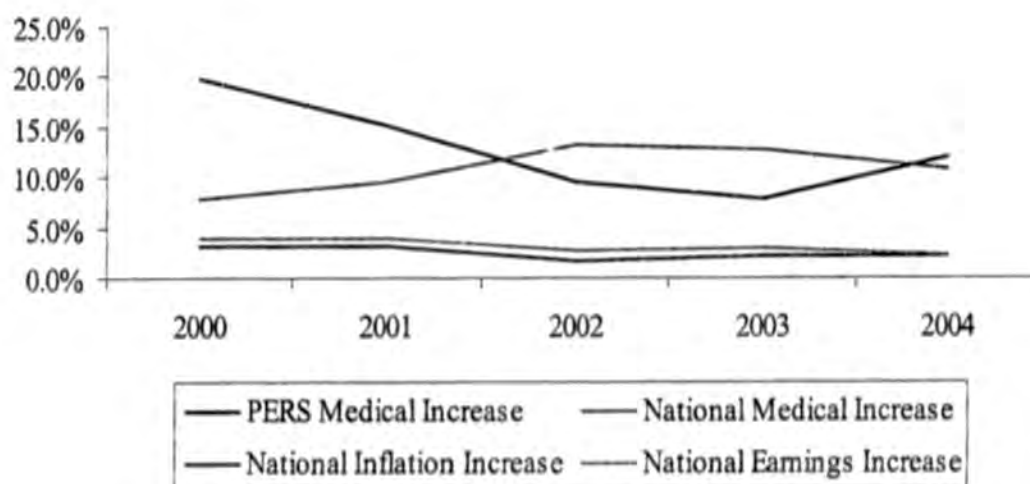
Postretirement Medical Benefits

In order to minimize volatility in the contribution rate, the calculation of the average employer contribution rate has not included actual changes in medical premiums. Rather, the health cost trend assumption has been used to determine the liabilities. For the June 30, 2002 valuation, the actuarially determined assumed premium which was being used for funding was reset to the actual premium. This resulted in an increase in the average employer contribution rate of 3.68% of payroll. Additionally, assumptions regarding future increases in the premium rate were updated for both the June 30, 2002 and June 30, 2004 valuations resulting in additional increases in the average employer contribution rate of 8.01% of payroll. These adjustments to the contribution rate appear to be actuarially sound and are more indicative of future liabilities.

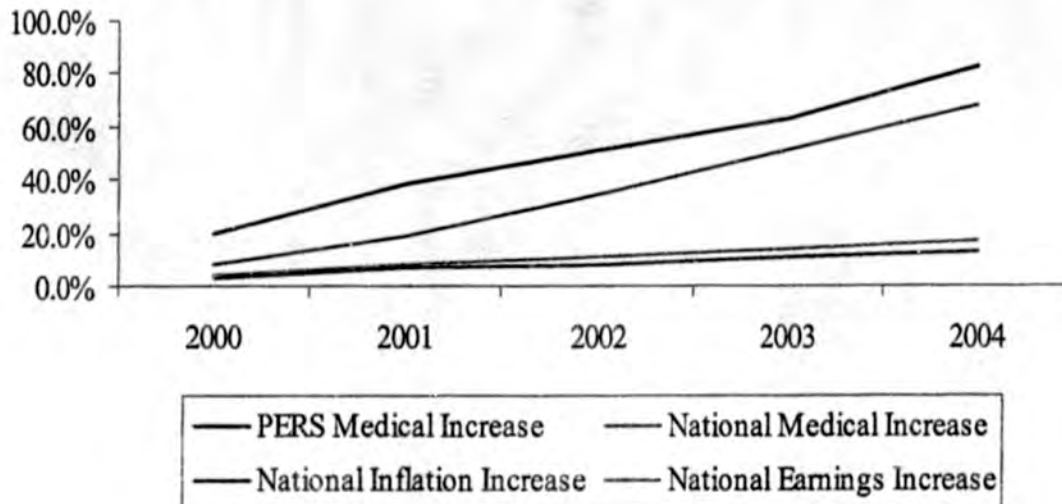
The 2004 Annual Employer Health Benefits Survey, released by the Kaiser Family Foundation and Health Research and Educational Trust, reports that over the five year period 1999 through 2004, inflation increased 13.1% nationally. Over the same period, workers' earnings increased 16.7%. The increase in health insurance premiums for state and local government covered workers increased 67.5%, far out distancing both indicators.

PERS retiree health premiums increased 82.4% from 1999 through 2004. Although the 2005 increase in premiums for PERS was only 5.5%, the record shows that the average annual PERS increase for the past six years has been 11.5%. If this trend continues, the liabilities associated with medical benefits are going to increase at an alarming rate.

Annual Increases in Medical Premiums Compared to Other Indicators



Cumulative Increases in Medical Premiums Compared to Other Indicators



The Kaiser Family Foundation and Health Research and Educational Trust survey was conducted between January and May of 2004 and included 3,017 randomly selected public and private firms with three or more employees.

As reported in the November 10, 2004 Winston-Salem Journal, Aon, an international insurance brokerage firm, projects national health care costs for employers will increase 13.5% in 2005. This does not include the costs for prescription drug coverage.

On October 11, 2004, Hewitt, an international human resource consulting firm, projected a 2005 decrease in health care costs from 12.3% in 2004 to 11.3%. Hewitt's study included more than 2,000 health plans in 139 U.S. markets.

Mercer, a human resource consulting firm, reported on November 18, 2004, that employers predict a 2005 increase of 10% for their current medical plan with their current vendor.

While there are many sources of future projections, the universal opinion is that health care costs will continue to grow at a much faster rate than inflation and will grow as a proportion of gross domestic product.

In their June 30, 2004 actuarial valuation, Mercer used a health cost trend for the future, illustrated on the next page:

	<u>Medical</u>	<u>Prescription Drugs</u>
FY05	9.5%	14%
FY06	9.0%	13%
FY07	8.5%	12%
FY08	8.0%	11%
FY09	7.5%	10%
FY10	7.0%	9%
FY11	6.5%	8%
FY12	6.0%	7%
FY13	5.5%	6%
FY14 and later	5.0%	5%

Our experience has shown that a trend which is just 1% higher for each year results in a corresponding increase in the actuarial accrued liability of from 8% to 12%. Most actuaries use trend assumptions that decrease with time down to the 5% range. However, the PERS average composite increase for the past five years has been 9.9%, for the past ten years 9.7% and for the past fifteen years 8.4%. Although some years have been less than the average, it seems worth questioning whether the actual experience will match the trend assumed.

Actuarial Methods

Actuarial Cost Method

Liabilities and contributions for the State of Alaska Public Employees' Retirement System are computed using the projected unit credit cost method. Under this method, the actuarial accrued liability is set equal to the present value of the projected accrued benefit which has accrued through the valuation date, and the normal cost is set equal to the present value of the projected benefits that are expected to accrue during the valuation year.

The projected unit credit method is one of several acceptable actuarial methods. Only 16% of the plans surveyed in the *2002 Comparative Study of Major Public Employee Retirement Systems* published by the Wisconsin Legislative Council utilized the projected unit credit cost method to determine employer contributions. 76% used the entry age normal cost method. Both methods are designed to reach the goal of fully funding the pension obligations. They will result in different normal cost patterns and actuarial accrued liabilities and thus funding ratios. In most cases, the entry age normal method will result in a higher normal cost and lower actuarial accrued liability than the projected unit credit cost method. This will give the impression of a better funded status.

Actuarial Value of Assets

Alaska PERS utilizes a smoothing method in order to derive an actuarial value of assets. Under the method, gains and losses in the market value of assets, based on the difference between the actual rate of return and the assumed rate of return, are smoothed over five years. This actuarial value of assets method was first used for the June 30, 2003 actuarial valuation.

This method of smoothing is commonly used and is an acceptable method. By smoothing gains and losses, large fluctuations in assets, and thus actuarially determined contribution rates, are minimized. If the market value of assets earns the assumed rate of interest for every year in the future, the actuarial value of assets will be equal to the market value of assets at the end of the smoothing period.

Actuarial Assumptions

We have reviewed the actuarial assumptions used by Mercer in their June 30, 2004 draft actuarial valuation. We have also reviewed Mercer's most recent analysis of actuarial assumptions and Milliman's 2002 actuarial audit of TRS & PERS.

Based on our review, we believe the actuarial assumptions currently in use by Mercer, with the exception of the health cost trend, are used to determine a reasonable estimate of the funded status of PERS. While Mercer's health cost trend assumption is well within the range of acceptable assumptions commonly in use by actuaries in general, it is quite possible that it is not conservative enough. A sensitivity calculation to determine the effect of a 1% increase in the trend rates would be most helpful in studying the funded status of the System.

If the trend rates were 1% higher, the actuarial accrued liability attributable to retiree medical costs might be as much as 8% to 12% higher. If that were so, the unfunded actuarial accrued liability would increase by as much as \$375,000,000 to \$575,000,000. Consequently, the funded ratio, reported to be 70.2%, would decrease to between 66.8% and 67.9%.

Change in Average Employer Contribution Rate

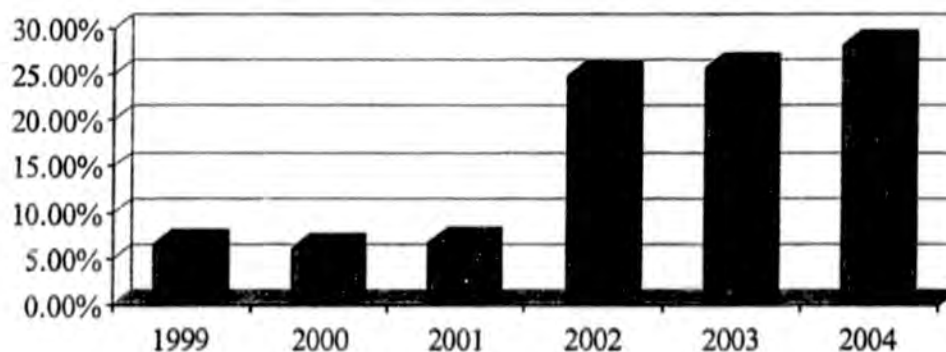
The average employer contribution rate at June 30, 1999 was 6.56%. By June 30, 2004, the average employer contribution rate had skyrocketed to 28.19%. The Annual Actuarial Valuation Reports summarize various reasons for the increase in the contribution rate. The chart below itemizes the change in the contribution rate by cause:

Average Employer Contribution Rate at June 30, 1999	6.56%
Change Due to Medical Benefits	11.69%
Change Due to Investments	9.00%
Change Due to Funding Methods	-5.39%
Change Due to Demographics	3.86%
Change Due to Contribution Shortfall	1.99%
Change Due to Changes in Benefits	<u>0.48%</u>
Average Employer Contribution Rate at June 30, 2004	28.19%

The substantial increase in the average contribution rate is due predominantly to large increases in the cost of the postretirement medical benefits and the area of investments.

The following graph shows the trend in the average employer contribution rate over the past five years:

Average Employer Contribution Rate



The jump in the contribution rate in 2002 of 18.14% of payroll was due mainly to changes made in methods and assumptions. These changes were necessary in order to better reflect anticipated future experience. Additionally, the medical premium was increased to the actual premium rather than an assumed premium and deferred investment losses were recognized immediately. The assumed premium and deferred investment losses resulted in a much lower contribution rate for the June 30, 2001 actuarial valuation as compared to the June 30, 2002 actuarial valuation.

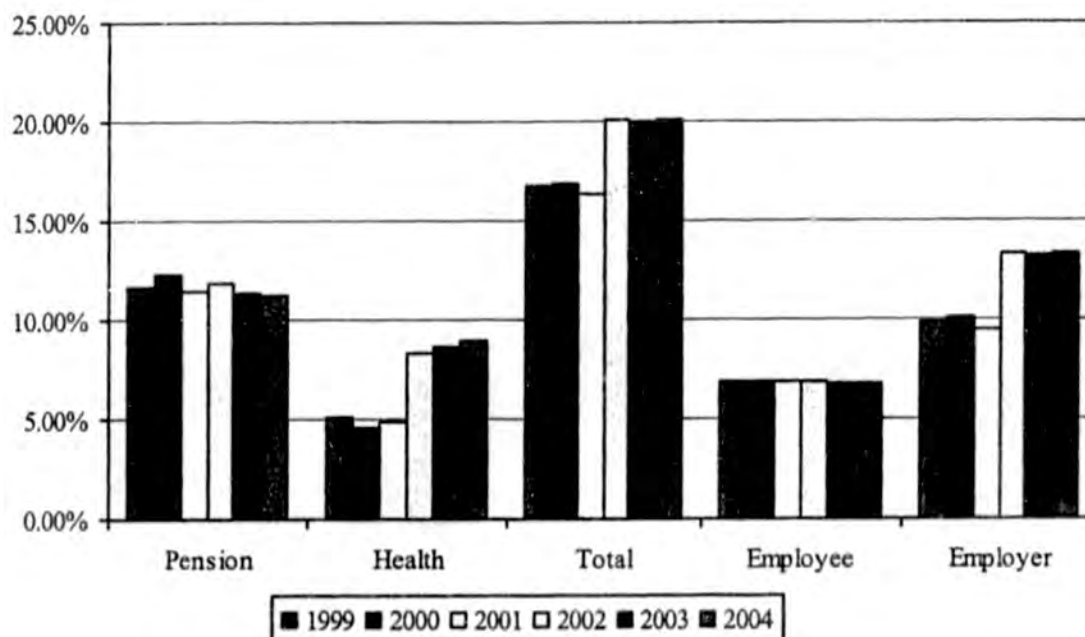
Components of Employer Contribution Rate

The average contribution rate is made up of two pieces. The normal cost is equal to the cost of benefits which are accruing during the year for active employees. The past service rate equals the actuarial accrued liability, or the liability for benefits which have already accrued before the valuation date, less the actuarial value of assets, amortized over a predetermined period.

Normal Cost

The following chart shows actuarially derived normal costs since 1999 as a percent of payroll.

Normal Cost as a Percent of Payroll

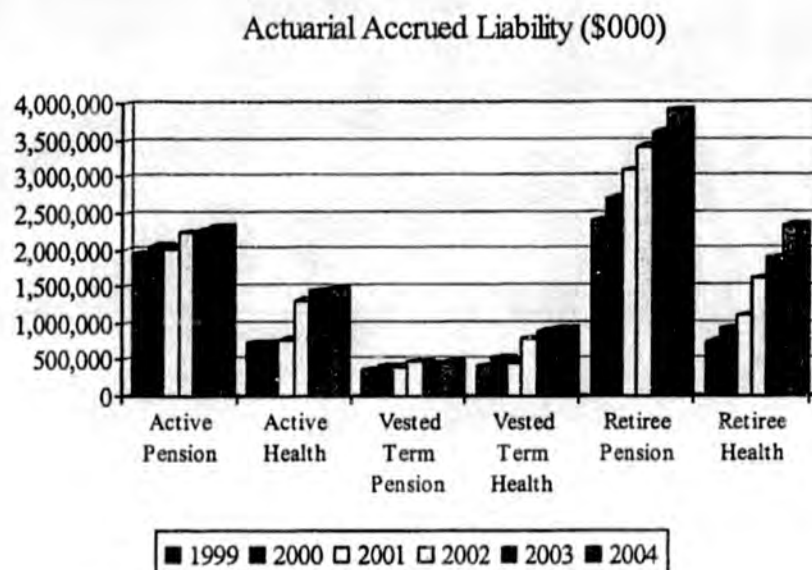


As you can see by the graph, although the normal cost as a percent of payroll for pension benefits has remained generally level since 1999, the normal cost as a percent of payroll for postretirement health benefits has increased by 75% since 1999. Since employee contributions have not been increased, the entire increase in the cost of postretirement health benefits has been allocated to the employer normal cost.

Actuarial Accrued Liability

The actuarial accrued liability (AAL) is computed separately for actives, vested terminations and retirees. The AAL is expected to increase each year by an amount equal to the normal cost for the prior year less benefit payments plus interest. The AAL's for

Alaska PERS, as illustrated in the following graph, increased at rates in excess of expectations.



Over the past five years, the AAL has increased by an average of 11.5%. The average annual increase in AAL for postretirement health was 19.8% compared to an average annual increase in AAL for pension benefits of 7.2%. The retired group saw the largest increase in liability. This is to be expected because of the relatively young age of the group. During this period, the number of retirees receiving benefits increased from 14,185 to 19,572, an average increase of 6.7% per year. Annual pension benefits payable to retirees increased by an average of 9.2% per year, resulting in an average annual increase in the AAL for retirees of 10.1%. However, during this same period, health liabilities for the retirees increased by an average of 25.7% per year. The average increase in pension liability per retiree was 3.3% per year compared to an average increase per retiree in the cost of retiree health of 17.8% per year.

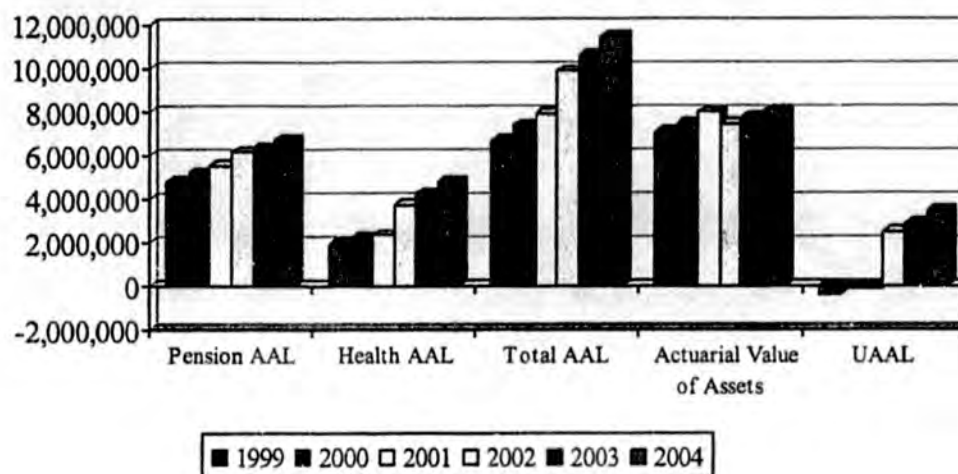
As of June 30, 1999, the AAL for postretirement health was less than 30% of the total AAL. By June 30, 2004, postretirement health accounted for over 40% of the AAL. Without a corresponding increase in the actuarial value of assets, the increase in liability resulted in an increase in the unfunded actuarial accrued liability.

Unfunded Actuarial Accrued Liability

The unfunded actuarial accrued liability (UAAL) is equal to the difference between the AAL and the actuarial value of assets. If all experience is exactly as assumed, the UAAL is expected to approach zero as contributions are made toward the underfunding. The UAAL is affected by actuarial gains and losses, method changes, assumption changes and changes in benefits.

Over the past five years there has been a significant increase in the UAAL as both the AAL and the assets have been negatively affected by experience and changes in valuation methods and assumptions.

Unfunded Actuarial Accrued Liability (\$000)



Although the System was fully funded before the June 30, 2002 actuarial valuation, the changes in methods and assumptions combined with the loss on investments resulted in a significant underfunding for the June 30, 2002 valuation which has worsened in the two years since then.

According to the 2004 *Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* pension assets fell 1% for the 2003 fiscal year while liabilities grew 5% for the 64 state retirement systems studied. The funding ratio for these plans declined from 78% in 2002 to 74% in 2003. The median funding ratio was 76%. 97% of these systems were underfunded. Based on most recent data available when the Report was published, the UAAL for Alaska PERS was smaller than 60% of the other state plans and their funded ratio was higher than 70% of the other systems. When reviewing these statistics, it is important to remember that Alaska PERS has decided to prefund their retiree health benefits and the AAL reported for the System includes these benefits. It is not clear how many other Systems in the study include liabilities for postretirement health benefits in their numbers.

Past Service Rate (Amortization of Unfunded Actuarial Accrued Liability)

The initial UAAL as of June 30, 2002 and future gains and losses are currently being amortized over a fixed 25 year period as a level percentage of pay. Before June 30, 2002 the UAAL was amortized over a rolling 25 year period as a level dollar. This change resulted in a decrease in the contribution rate of 5.06% of payroll for the June 30, 2002 valuation.

Funded Status

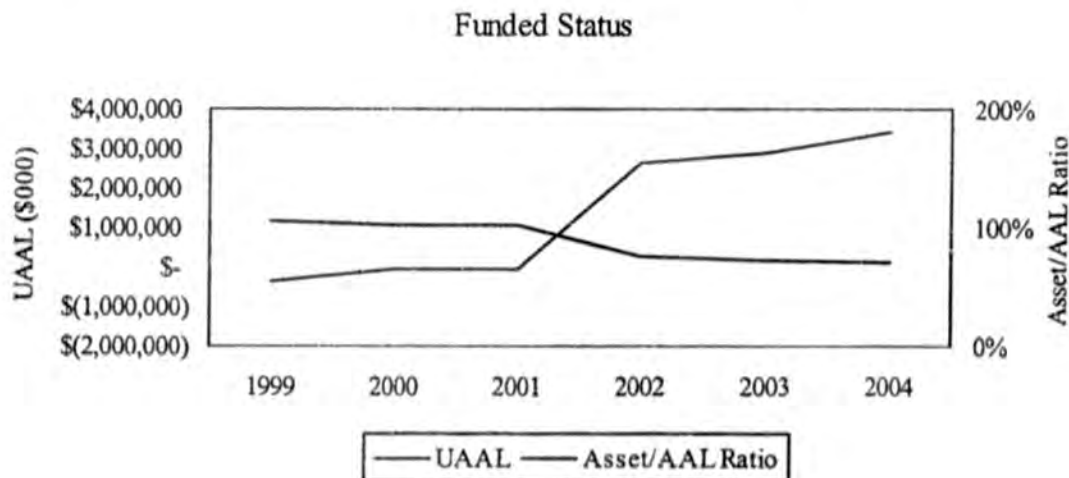
The unfunded actuarial accrued liability (UAAL) is one measure of a retirement system's funded status. The UAAL is calculated by subtracting the actuarial value of assets from the actuarial accrued liability (AAL) using the System's valuation assumptions and methods.

The AAL for the plan is the sum of each participant's individual AAL. Each individual AAL is the present value of the projected accrued benefit which has accrued as of the valuation date assuming investment returns of 8.25% in the future. Other assumptions with respect to salaries, withdrawals, retirement, etc. are also made. The actuarial value of assets is related to the market value using a smoothing technique to avoid peaks and valleys.

If the difference between the AAL and the actuarial value of assets is positive, the system is underfunded. A surplus exists if the opposite is true. The system is precisely funded according to this method if the actuarial value of assets equals the AAL.

Various factors cause the UAAL to change from year-to-year. These are changes due to normal operation of the plan, actual experience and changes in actuarial assumptions, actuarial methods and provisions.

Since 1999, the System has gone from an overfunding of \$262,000,000 to an underfunding of \$3,414,000,000. At June 30, 1999, the actuarial value of assets was 105.5% of the AAL. That same ratio at June 30, 2004 was 70.2%. See the pattern below.



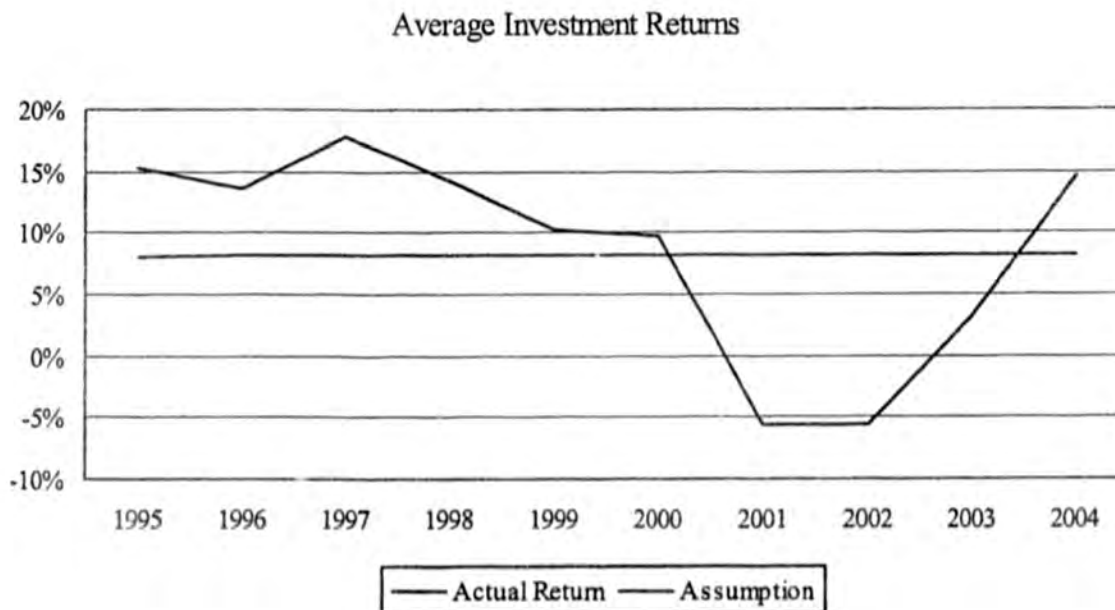
The decrease in the funded status of the plan was due chiefly to the increasing cost of retiree medical benefits and investment losses.

Investments

Before the June 30, 2002 actuarial valuation, the actuarial value of assets was set equal to the expected value based on an 8.25% investment return. The difference between market value and a 5% corridor around valuation assets was amortized as a level percent of pay over 20 years. Effective with the June 30, 2002 valuation, a new method to compute actuarial assets was adopted. Under this method, gains and losses are recognized over a five year period. Immediately recognizing investment losses from before June 30, 2002 and the adoption of the new method increased the contribution rate by 11.35% of payroll. Investment gains from prior years that were recognized for the June 30, 1999 and June 30, 2000 valuations decreased the contribution rate by 3.16% of payroll.

Although investment returns on the market value of assets over the past ten years averaged 8.44%, investment returns only averaged 2.94% over the past five years. This resulted in significant losses for the Retirement System and a corresponding increase in contribution rates.

Average investment returns on the market value of assets are compared to the investment assumption on the following graph.



The Next Step

In the first part of this engagement we have looked at the PERS benefit structure, the actuarial methods and assumptions being used by Mercer, the funding history and the magnitude of the underfunding. It still remains to project the funding status out into the future and offer suggestions as to various approaches to reversing the trend.

Among the things we will look at are possible alternatives to the actuarial methods and assumptions being used. However, it must be remembered that true decreases in cost can only be achieved by some combination of three means, which are:

1. Decrease operating expenses
2. Decrease benefits paid
3. Increase return on investments

Operating expenses currently exceed \$5,000,000 per year. While it may be difficult to significantly reduce this amount, careful study of expenditures should be undertaken.

State law prohibits a decrease in benefit structure for current plan participants. However, it is possible to change the benefit structure for future hires, either through the defined benefit plan or through the creation of a defined contribution plan. We will look at the alternatives of each and offer estimates as to the cost savings potential inherent in such changes.

It is also possible to indirectly reduce benefits for current participants through a program of cost containment initiatives in the area of health care spending. Health care costs continue to rise at an alarming rate because people want the best care available and the health care industry continues to develop newer and more costly means of treatment, including prescription drugs. PERS must educate retirees to the relative prices of alternative health care choices.

If not being done already, PERS must monitor very closely the small percentage of cases with significantly high cost. The State can also sponsor programs to encourage employees to delay retirement. This would reduce the cost of both health care benefits and non-health care benefits.

Return on investments over the past ten years has averaged slightly over 8.25%, the rate assumed by Mercer. It may be possible to increase return without a corresponding increase in risk. Very careful asset management may be able to accomplish this.

We hope to complete our work on this by May 6th. After completion we will present a final report for legislative council.

Ways and Means – July 14, 2005

From: Joseph
Esuchanko

1. UAAL

A. 6/30/2004

- I. 6/30/2004 draft valuation - \$5.7 billion
- II. 6/30/2003 valuation - \$5.5 billion
- III. 6/30/2002 valuation - \$5.0 billion

B. 6/30/2005

- I. 6/30/2002 valuation - \$5.1 billion
- II. 6/30/2003 valuation - \$5.9 billion
- III. 6/30/2004 draft valuation – 6.2 billion
- IV. My estimate - \$6.6 billion
 - a. Range - \$6.5 to \$6.6 billion

C. 6/30/2006

- I. 6/30/2002 valuation - \$5.1 billion
- II. 6/30/2003 valuation - \$6.1 billion
- III. 6/30/2004 draft valuation – 6.7 billion
- IV. My estimate - \$7.7 billion
 - a. Range - \$6.9 to \$7.7 billion

2. Alternative calculation methods vs PUC

A. EAN

I. 11% use PUC while 75% use EAN

II. Better comparison to other systems

B. PVAB

I. Shows whether accrued benefits are funded

C. AGG

I. No UAAL, but good calculation of funding requirements

3. Future trend

A. UAAL will increase over near future, then level out (possible small decline), then decline after UAAL fully amortized

4. Medical benefits

A. 28% of payments to retirees

B. 38% of AAL

C. 43% of normal cost

D. Increases 1999-2004

I. Inflation – 13.1%

II. Wages – 16.7%

III. Average medical premiums – 67.5%

IV. PERS/TRS medical premiums – 82.4%

V. Medical growth much > inflation and a larger portion of GNP

5. Recommendations

A. Perform full actuarial valuation as of June 30, 2005 ASAP

I. Determine UAAL

a. Identify sources

i. By Tier

ii. By benefit

II. Perform marginal (sensitivity) analyses

a. Health trend – 8%-12% per 1% change

b. Inflation

c. Investment return

d. Salary increases

III. Look at alternative actuarial funding methods and assumptions

B. Develop strategic plan

I. Operating expenses

II. Net return on investments

III. Medical cost savings

IV. Reduce future pension payments



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July 11, 2005

Representative Bruce Weyrauch, Chair
House Ways and Means Committee
State Capitol
Juneau, AK 99811

Dear Representative Weyrauch,

Thank you and the rest of the legislature for your support of the appropriation to many municipalities and all school districts to offset the FY 2006 PERS and TRS increases of 5% of total salaries. This one year funding offset has been especially helpful to local taxpayers in light of the other extraordinary local cost increases municipalities and school districts are also facing from:

- The increased cost of fuel and related increases in the cost of transportation and goods;
- Increased employee health insurance, property, liability and other municipal insurance cost increases;
- Continuing impacts of the loss of revenue sharing, the growing unfunded State mandate for the State's senior citizen/disabled veteran property tax exemption; etc.

The issue of how to permanently "fix" the approximately \$6 Billion PERS/TRS deficit is a critical financial concern to every local taxpayer, local government, and school district. If nothing else is done to fix the problem, over half of the cost of the approximately \$6 billion liability falls directly to local taxpayers. Many smaller communities will simply be financially unable to survive, while few, if any, communities will realistically be able to afford the full bill for the retirement program without assistance from the State government. The survival of small local governments and the possible inability of local economies to absorb the cost of the State retirement program is truly a statewide and State government concern.

Even though the PERS/TRS funds from the State this year will help, it appears that the actual costs to local taxpayers are largely hidden by deferring costs to the future. This happens because cities, boroughs and school districts "own" over 50% of the PERS liability and therefore now own nearly a \$3 billion debt that the State increases annually by 8.25% as the "lost opportunity on investments", as it was explained by the Mercer Consultants. That means that this year, while the State provided approximately \$55 million of funding to schools and municipalities, the State added approximately \$240 million to the PERS/TRS debt of schools and municipalities to represent the "lost

investment opportunity" of 8.25% on nearly the \$3 billion. In other words, last year alone nearly \$400 in debt that must be paid in the future was added for every person in Alaska. Because each individual participating municipality is a separate entity in the PERS system with its own "PERS liability" and different PERS rate, the overall liability is growing rampantly for all while some individual municipalities are being impacted much more severely.

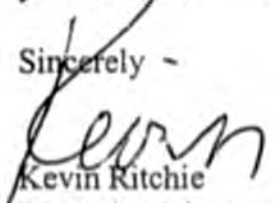
Getting out of PERS is not a realistic option for most communities as this would require the immediate payment of, perhaps, many millions of dollars. The State statutes governing exiting from the PERS system also need to be examined because in instances where it has been done, the exiting municipality often receives a financially damaging final accounting after the municipality is forced to make an irrevocable decision to exit. For example, this year the City of St. Mary's was given information indicating that they could expect a \$140,000 to \$160,000 final accounting when they decided to exit the PERS system. After they exited, they were told the final payment was actually \$540,000, which is beyond the means of St. Mary's to repay.

The options identified so far to "fix" the PERS/TRS funding shortfall include:

- A large cash infusion into the PERS/TRS Fund.
- Discussion of the impact of the artificial 5% rate increase cap. The 5% cap accelerates increases in future liability to employers due to the 8.25% "lost investment opportunity". "Lost investment opportunity" costs to employers currently adds about \$500 million per year to the current estimated \$5.7 Billion PERS/TRS liability.
- Allow municipalities and school districts to finance their PERS liability using "pension obligation bonds" to reduce the current State 8.25% "interest" rate on the individual municipal or school PERS/TRS liability to 5.5% or 6%.
- Re-examine the assumptions used in calculating the future PERS/TRS funding shortfall.
- Re-instate some form of sharing state revenue to allow municipalities and school districts to absorb higher PERS/TRS rates each year without overburdening local taxpayers or forcing small cities to close their doors.

As we have been doing for well over a year, cities and boroughs and school districts will provide support for your efforts to resolve the issue of the PERS/TRS liability. Thank you for the efforts of the House Ways and Means Committee to address this critical issue.

Sincerely -


Kevin Ritchie
Executive Director

ACTUARIAL UNFUNDED ACCRUED LIABILITIES AND FUNDING RATIOS

Report Date	AAL	Actuarial Value of Assets	UAAL	Funded Ratio	Report Date	AAL	Actuarial Value of Assets	UAAL	Funded Ratio	Report Date	AAL	Actuarial Value of Assets	UAAL	Funded Ratio
PERS at 6/30/2004					TRS at 6/30/2004					Total at 6/30/2004				
6/30/2002	11,026,585	8,041,361	2,985,224	72.9%	6/30/2002	5,821,396	3,822,510	1,998,886	65.7%	6/30/2002	16,847,981	11,863,871	4,984,110	70.4%
6/30/2003	11,220,156	8,008,101	3,212,055	71.4%	6/30/2003	6,089,875	3,822,351	2,267,524	62.8%	6/30/2003	17,310,031	11,830,452	5,479,579	68.3%
6/30/2004	11,443,916	8,030,414	3,413,502	70.2%	6/30/2004	6,123,600	3,845,370	2,278,230	62.8%	6/30/2004	17,567,516	11,875,784	5,691,732	
PERS at 6/30/2005					TRS at 6/30/2005					Total at 6/30/2005				
6/30/2002	11,664,233	8,623,761	3,040,472	73.9%	6/30/2002	6,030,178	4,001,080	2,029,098	66.4%	6/30/2002	17,694,411	12,624,841	5,069,570	71.3%
6/30/2003	11,898,173	8,448,481	3,449,692	71.0%	6/30/2003	6,334,769	3,921,125	2,413,644	61.9%	6/30/2003	18,232,942	12,369,606	5,863,336	67.8%
6/30/2004	12,122,784	8,381,478	3,741,306	69.1%	6/30/2004	6,420,995	3,913,785	2,507,210	61.0%	6/30/2004	18,543,779	12,295,263	6,248,516	66.3%
6/30/2005	12,329,000	8,329,000	4,000,000	67.6%	6/30/2005	6,514,000	3,895,000	2,619,000	59.8%	6/30/2005	18,843,000	12,224,000	6,619,000	
PERS at 6/30/2006					TRS at 6/30/2006					Total at 6/30/2006				
6/30/2002	12,279,740	9,258,908	3,020,832	75.4%	6/30/2002	6,243,640	4,196,723	2,046,917	67.2%	6/30/2002	18,523,380	13,455,631	5,067,749	72.6%
6/30/2003	12,591,977	8,960,569	3,631,408	71.2%	6/30/2003	6,579,652	4,141,473	2,438,179	62.9%	6/30/2003	19,171,629	13,102,042	6,069,587	68.3%
6/30/2004	12,821,289	8,790,346	4,030,943	68.6%	6/30/2004	6,678,661	3,993,189	2,685,472	59.8%	6/30/2004	19,499,950	12,783,535	6,716,415	65.6%
6/30/2005	13,283,000	8,612,000	4,671,000	64.8%	6/30/2005	6,929,000	3,944,000	2,985,000	56.9%	6/30/2005	20,212,000	12,556,000	7,656,000	

Note: Amounts for Report Date 6/30/2005 are rough estimates using statistical projections.
They do not represent precise amounts, which can only be determined through a complete actuarial valuation.

TESTIMONY ON PERS/TRS ISSUES
HOUSE WAYS + MEANS COMMITTEE
JOHN ALCANTRA, GR DIRECTOR, NEA-ALASKA
JULY 14, 2005

Good afternoon, Chairman Weyhrauch and members of the House Ways + Means committee. My name is John Alcantra and I serve as the Government Relations Director for NEA-Alaska. NEA-Alaska represents more than 12,800 public school employees throughout Alaska. I would like to thank the committee for taking their valuable time during another glorious Alaska summer to have this and subsequent meetings on the PERS and TRS issue.

This afternoon, I will be a listening participant to the invited testimony of experts. I trust the presentations may answer some of the questions and address some of the suggestions I will put forth in this public testimony.

I will try to remain cognizant to the scope of this meeting, and not dwell on the pitfalls and problems of the legislation passed during special session (Senate Bill 141). With that in mind I offer the following suggestions:

Calculate past service cost of each tier:

Where is the true liability? Common sense suggests the benefits provided in PERS and TRS tier 1 may produce the majority of the liability. If you separate the tiers and calculate past service costs independently for each tier, is there still liability in the PERS tier 3 and TRS tier 2 retirement packages?

Determine pension versus medical costs:

NEA-Alaska believes that up to 70% of the liability rests in health care and skyrocketing medical costs. Is it factual that Alaska can't afford to pay its public employees a defined benefit pension or is it the health insurance component that is unaffordable?

Look closely at the actuarial assumptions:

It is worth noting that Mercer is using a methodology that only 11-16% of public systems utilize to determine liability of the systems. Of further note is the fact that the method being used leads to higher liability costs.

It has been NEA-Alaska's request since May 2004, that the assumptions being used match the experience in Alaska.

Mercer's Assumptions

Inflation will be 3.5%
Wage Growth 3.75-4.5%
Investment return 8.25%
Health Care Costs 12.5% - 5%

Alaska's Experience

2.6% over any ten year period; PF uses 3%.
1.36%
9% over any ten-year period
8% (7.5% according to Esuchanko)

Assumptions attached to Alaska's reality could definitely lead to a different liability amount.

If you address inflation, Mercer assumes a 3.5% inflation rate. Alaska's experience is 2.6% over any 10 year period in our state's 46 year history. The Alaska Permanent Fund, one of the most respected funds in the world, currently valued at over \$31 Billion dollars, uses the more accepted 3% inflation figure. So what is a ½ percent? Over 20 years it is \$800 million dollars! Over a 30 year spectrum (to match retirement eligibility) it is well over a billion dollars!

How about wage growth? Mercer uses a 3.75 to 4.5% figure. How our members wish this was true. Since 1989 teacher salaries have grown by 1.36% per year and the largest growth in the past seventeen years was the 3.23% wage increase obtained this past year. How much does this assumption change the unfunded liability?

Process Recommendations:

NEA-Alaska strongly recommends the state procure the services of an independent actuary. Advice provided by Mercer brought Alaska's retirement system from over funded three years ago to a liability of about \$5.7 billion today! We can't revise the current system until we have confidence that the actuarial assumptions are valid.

Indeed, NEA-Alaska believes the State should research whether Mercer owns part of the liability.

A final recommendation would be a request that a group of stakeholders be brought together to review and analyze data provided by an independent actuary. This analysis would assist the Ways + Means committee on a final work product.

Again I appreciate the opportunity to provide this testimony. NEA-Alaska and our members look forward to future opportunities to participate.

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OPINION

Fairbanks Daily News-Miner, Saturday, June 18, 2005

Retirement revisited

The special session of the Alaska Legislature last month did produce a bill that aims to help stabilize the finances of the state-run Public Employees' Retirement System and the Teachers' Retirement System. The two systems combined have an estimated \$5.7 billion unfunded liability, which became the cornerstone of rough debate throughout much of the work in Juneau.

While the debate did lead to legislation, it nevertheless left people with many questions and a confused understanding—if they were able to assemble one at all—of the scale of the problem, how it came into being and what solutions might be best.

With that much muddiness in the public's perception of the issue, it is good to hear that the House Special Committee on Ways and Means Committee will hold meetings throughout the summer to, in the words of the official announcement Thursday, "assess the implications of the unfunded liability ... and potential legislative measures to address that liability." The committee plans to meet in Juneau, Anchorage and Fairbanks.

Legislation passed at the end of the contentious special session, which ended in late May, will only affect new employees and therefore will do nothing about the billions in unfunded liability that burden participating government employers—namely the state of Alaska, the University of Alaska and many local governments such as the Fairbanks North Star Borough and its school district.

The House Ways and Means Committee's chairman, Republican Rep. Bruce Weyhrauch of Juneau, said the committee will work to present legislation in 2006 that will address the current liability of the retirement systems for existing employees so that the rising mandatory payments don't take money from other state programs.

Alaska has the money, of course, via the Alaska Permanent Fund to pay the entire retirement obligation if it really wanted to, but that is neither a real political option nor an appropriate option. And besides, such a course should never be allowed without answers to tough questions, and that's another important component of the Ways and Means Committee's undertaking. The committee wants to examine how the problem came into being and determine the role of PRS/TRS management in arriving at the shortfall.

The debating about the retirement systems has been loud, unruly by some, and full of misunderstanding by others. If the House Special Committee on Ways and Means can present a clear picture to the public, future discussion on the topic could be well served.

SCOMM

142.10

TRADITIONAL DEFINED BENEFIT PENSION PLANS:

A Tried and True System That Benefits Taxpayers

The traditional public pension system is the best way to ensure taxpayers can reliably receive vital services. It's a cost-effective, proven and stable method to attract and retain qualified people to perform critical public sector work.

Dismantling and replacing the traditional pension system with new private accounts will result in higher costs for taxpayers and bureaucratic chaos.

The traditional pension system works - and has for more than 100 years. It is flexible and provides vital services to taxpayers at a low cost. Further, it provides a modest and stable retirement income for workers who have dedicated their career to serving the public.

FACTS ABOUT PUBLIC PENSIONS

The public pension system safeguards the delivery of vital taxpayer services.

Taxpayers will pay MORE to move to millions of private accounts.

The traditional public pension system is sound.

Funding shortfalls can be avoided.

The traditional public pension system is a vital stimulus to the economy.

States that have attempted a radical reform of public pensions have failed.

Taxpayers will foot the bill for workers who outlive inadequate, unstable retirement income.

The Disadvantages of Replacing Defined Benefit Plans with Defined Contribution Plans for State and Local Governments, Their Employees and Taxpayers

Legislation has been proposed in several states to replace state and local government defined benefit (DB) retirement plans with 401(k)-type retirement accounts called defined contribution (DC) plans. The issue is not whether state and local employees should have access to DC plans – most already do in conjunction with their DB plans or else through DC-type plans,¹ which play a useful role in providing supplemental, tax-deferred retirement savings. Rather the question is whether defined benefit plans should be eliminated and replaced with defined contribution plans.

While recognizing defined contribution plans are useful in providing supplemental retirement benefits, there are distinct advantages of maintaining state and local DB plans and disadvantages against replacing them with DC plans. Eliminating a DB plan and switching to a DC plan is a lose-lose situation for governments, their employees, and taxpayers for the reasons listed below.

1. Switching to a DC plan will cost state and local governments more over the short-term. Long-term cost savings are uncertain at best.
2. Almost all state and local DB plans provide disability and survivor benefits as well as retirement income. Switching to a DC plan would require employers to obtain these benefits from another source, and at a higher cost.
3. DB plans enhance the ability of state and local governments to attract qualified employees and retain them throughout their careers. Switching to a DC plan would limit this ability, possibly producing or exacerbating labor shortages in key service areas by increasing employee turnover rates. Higher turnover rates result in increased training costs and lower levels of productivity that can, in turn, result in the need for a larger total workforce.
4. DB plans help state and local governments manage their labor force by providing flexible incentives that encourage employees to work longer or retire earlier, depending on the circumstances. Switching to a DC plan would limit this flexibility and make these incentives more expensive for the employer.
5. DB plans lower overall retirement benefit costs by pooling the risks of outliving retirement benefits and of investment losses over a relatively large number of participants. Switching to a DC plan would require each individual to bear these risks alone, consequently requiring higher contributions than if the risks were pooled.

¹ Examples of DC-type plans available to state and local employees include 457 governmental deferred compensation plans and 403(b) annuities. In addition, some state and local employees are also covered by 401(k) plans, if the plans were established before May 6, 1986. According to testimony by the National Association of Government Defined Contribution Administrators before the U.S. House Ways and Means Oversight Subcommittee on March 23, 1999, 48 states and over 5,000 local governments have 457 plans, through which an estimated 8 million employees save for retirement. This is over 40 percent of the nation's state and local government employees.

6. DB plans earn higher investment returns and pay lower investment management fees than DC plans. Switching to a DC plan is likely to lower investment earnings used to finance retirement benefits and increase management costs, to the detriment of plan members.
7. DB plan investment earnings reduce future employer contributions. Switching to a DC plan would prevent state and local governments from reducing employer contributions through investment earnings, which currently fund over two-thirds of public retirement benefits.
8. DB plans provide secure retirement benefits based on a person's salary and period of service. Switching to a DC plan result in lower and less secure retirement benefits for many long-term governmental employees, including teachers, police officers, and firefighters, who constitute over half of state and local government workers.² State and local employees who are without Social Security coverage would be put at even greater risk.
9. DB plans help sustain state and local economies by providing adequate retirement benefits for a significant portion of the workforce. Switching to a DC plan may slow state and local economies, since a large number of retirees would likely receive lower retirement benefits.
10. Switching to a DC plan is likely to result in pressure on state and local governments to increase DC plan benefits and provide additional financial assistance for public sector retirees.

² U.S. Department of Commerce, U.S. Census Bureau, *Statistical Abstract of the United States 2004-2005* (Washington, DC: U.S. Government Printing Office, 2004), Table No. 454. Teachers, school employees, police officers, and firefighters constitute approximately 60 percent of state and local government employees.

BACKGROUND

State and local government retirement plans in the United States cover 14 million active employees (about 10 percent of the U.S. labor force) and 6 million retirees,³ including teachers, police officers, firefighters, legislators, judges, and general employees. In 2003, state and local retirement plans had over \$2 trillion in assets and paid annual benefits of \$122 billion, averaging about \$18,500 per retiree.⁴ Ninety percent of state and local governmental employees are covered by defined benefit retirement plans.⁵ Approximately 25 percent are not covered by Social Security, including close to half of public school teachers and three-quarters of police officers and firefighters.⁶

Since the mid-1990s, legislation has been proposed in several states to replace state and local DB plans with DC plans. Over the last two years, the pace of these proposals has increased, due to downturns in the investment markets and resulting higher contribution rates for many DB plans. Proponents of the change argue that switching to a DC plan would lower the government's cost of providing retirement benefits, thereby reducing state and local taxes. They also argue that DC plans would benefit public employees by giving them higher benefits through DC plan investment earnings and by making it easier for employees to take their benefits with them when they change jobs.

As this paper shows, it is likely that switching to a DC plan would increase a government's retirement costs over the short-term, and possibly over the long-term as well. In addition, recent studies indicate that retirement benefits provided through DC plans are, on average, significantly lower than those provided through DB plans. Moreover, while DC plans are useful for providing supplemental, tax-deferred retirement savings, replacing DB plans with DC plans could cause severe, unintended consequences:

- Governments could lose a valuable tool for attracting and retaining qualified employees;
- Public employees could lose a significant amount of retirement income, potentially affecting state and local economies; and
- Legislators could face additional pressure to increase DC retirement benefits and provide additional financial assistance for public sector retirees.

³ U.S. Department of Commerce, U.S. Census Bureau, *2003 State and Local Government Public Employee Retirement System Survey*, Table 5.

⁴ Ibid. Table 1. Average benefit calculated by the author and rounded to the nearest thousand dollars.

⁵ U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, DC: U.S. Government Printing Office, 2000), p. 5.

⁶ Keith Brainard, *Public Fund Survey, Summary of Findings, FY 2003*, September 2004. The Public Fund Survey is sponsored by the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR). Respondents represent over 80 percent of U.S. state and local retirement system assets and covered membership.

HOW DEFINED BENEFIT PLANS WORK

In a typical DB plan, employers promise to pay retirement benefits based on an employee's period of service and final average salary. A typical benefit formula for state and local general employees is 2 percent times final average salary times years of service.⁷ Under this formula, an employee who works 20 years and retires with a final average salary of \$40,000 would earn an annual benefit of \$16,000.

Eligibility for the benefit (i.e., vesting) usually requires employees to work for a minimum period of time, typically 5 years.⁸ Upon retirement, the benefit is provided as a series of monthly payments over the retiree's lifetime (and the surviving spouse's lifetime if this option is selected by the member who, in return, receives a reduced benefit). Most state and local employees are in DB plans that provide cost-of-living adjustments as protection against inflation. In addition, most state and local DB plans provide disability and pre-retirement death benefits.

DB plan benefits are financed by contributions from the employer (and most often from employees as well) and investment income. Employee contributions are usually established at a fixed rate of pay (e.g., 5 percent). Employer contributions are calculated so that, over the long-run (50 years or more), annual contributions plus expected investment earnings are enough to pay the promised benefits plus administrative expenses. The calculations are done by actuaries and designed to maintain employer contribution rates at a level percent of payroll, by smoothing short-term investment fluctuations and using other actuarial techniques.⁹ Plan assets are invested in professionally managed, broadly diversified portfolios, with investment fees paid by the plan or employer. Retirement benefits are paid from accumulated contributions and investment earnings.

For employers, a key advantage of DB plans is that investment earnings reduce future employer contributions. In other words, employer and employee contributions generate investment earnings that, in turn, are used to pay benefits that would otherwise have to be paid from future employer contributions. From 1983 through 2002, state and local DB plan investments earned \$1.65 trillion, reducing the need for additional employer contributions and taxpayer revenues.¹⁰

A potential disadvantage of DB plans is that when investment earnings are less than expected, additional employer contributions are required. However, it should be noted that the \$1.65 trillion earned by state and local investments over the past 20 years includes investment losses that occurred in 2000 through 2002, as well as in 1987 and 1994.

⁷ The "2 percent" portion of this benefit formula is referred to as the "benefit multiplier." Benefit multipliers vary, depending on occupation and Social Security coverage. According to the NASRA/NCTR 2003 Public Fund Survey, the median benefit multiplier is 1.85 percent for state and local employees covered by Social Security and 2.20 percent for those not covered by Social Security.

⁸ National Education Association, *Characteristics of Large Public Education Pension Plans* (Washington, DC: National Education Association, 2004). The 88 statewide plans surveyed cover 9.4 million active workers. Fifty-seven percent of the plans had vesting periods of five years.

⁹ These smoothing techniques work well when investment fluctuations are moderate and short-lived.

¹⁰ U.S. Department of Commerce, U.S. Census Bureau, *State and Local Government Public Employee Retirement System Survey, 1983 to 2002*.

For employees, a key advantage of DB plans is that they provide secure and predictable retirement income over their lifetimes based on pre-retirement earnings. A key disadvantage is that employees who do not remain employed long enough to become vested often lose their DB plan benefits, although employee contributions are usually returned with interest.

HOW DEFINED CONTRIBUTION PLANS WORK

In a DC plan, employers provide employees with individual investment accounts and promise to contribute a certain amount to the accounts (e.g., 4 percent to 8 percent of salary) while the employee is employed. Employees can also contribute to their accounts and decide how the assets are invested, choosing from a number of funds representing major investment categories. Investment management fees are paid from the employee's account, reducing the funds available to pay benefits. At retirement, the employee's benefit is paid solely from the contributions and investment earnings that have accumulated in the individual's account.

For employers, one advantage of DC plans is that the employer's contribution rate is fixed and unaffected by downturns in investment markets. Moreover, the employer has no financial liability for the employees after they retire, even if the DC accounts are insufficient to provide an adequate retirement benefit. (While this may be an advantage for the employer, it is a disadvantage for taxpayers who may have to pay increased public financial assistance as a result.)

A disadvantage for employers is that DC plans may not be a strong incentive for attracting and retaining qualified employees, especially if competing employers are offering DB plans. Moreover, if employees' account balances are inadequate to provide retirement benefits when the employees intend to retire, employers can end up with a number of active employees who are not performing at peak productivity (also known as being "retired in place"). Another disadvantage is that, since the employer's contribution rate is fixed in a DC plan, upturns in the investment markets do not reduce the employer's contribution rate, as they do in DB plans.

For employees, one advantage of DC plans is that the vesting period is typically shorter than for DB plans. Six months to two years is typical. Moreover, DC accounts are easier to transfer if employees change jobs. A major disadvantage is that DC accounts are subject to investment risk and may not be enough to sustain employees throughout their retirement. Another disadvantage is that a high percentage of employees cash-out and spend some or all of their DC accounts when they change jobs, significantly reducing the amounts available to pay retirement benefits.¹¹

The remainder of this paper describes the issues and problems involved with replacing DB plans with DC plans.

¹¹ This is surprising since the cashed-out amounts are subject to income taxes. In many cases they are also subject to a 10% penalty tax on early distributions.