# SB 141 White Paper

## Senate Finance Committee

Alaska Public Employee's Retirement System and Teacher's Retirement System: Problems and Solutions for the Alaska Public Pension Plans

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# Introduction

Nationwide there are significant funding problems with pension plans both in the public and private sector. Numerous solutions are being proposed and undertaken to resolve the underfunded status of pension systems in order to prevent their collapse.

Three primary factors have contributed to national funding problems: (1) ***declining interest rates***—plan liabilities are calculated as the present value of future plan obligations. The discount rate used in this calculation is linked to market yields on various fixed income securities. As interest rates have fallen, so have yields, resulting in higher plan liabilities. (2) ***Negative equity returns***—From the beginning of 2000 through the end of 2002, the U.S. stock market, as measured by the Wilshire 5000 Total Market Index, returned a cumulative –37%. Even after the market rebound of 2003, the Wilshire 5000 Index had a –17% cumulative return for the four previous years ending on December 31. Most pension plans hold 60% to 65% of their assets in stocks, so they have seen both their returns and their asset base shrink significantly. (3) ***Less-favorable demographics***—the aging of both pension plans and their beneficiaries translates into an increase in the cash obligations coming due within a relatively short span of time. For employees in their 20s, benefits may not be due for 35 years. In contrast, liabilities for those approaching retirement are more near-term. Near-term liabilities are discounted over a short time horizon and are, therefore, worth more in current dollars than those discounted over a long time horizon. Increasing near-term liabilities results in increasing total liabilities and lower funding ratios.[1]

For pension plans, a catastrophic event would be the inability to pay the benefits promised to participants. This is not the situation faced today. The degree to which a plan is underfunded—meaning that its assets are less than its projected benefit obligation—is the degree to which the plan falls short of its obligation to pay in the present all of its projected liabilities. Unless a plan is terminated, however, pension liabilities are not due today—an important fact to keep in mind when evaluating pension plan health. Participants should look to the long term in considering the health of pension plans.[2]

Even if the situation is not as bad as it first appears, there are legitimate concerns about the current level of pension plan funding. The most direct way for a plan sponsor to improve the funding level is to make new contributions. A healthy plan should expect its annual contributions to equal plan service costs, the amount of benefit payments accruing for the current year. Investment returns as well as annual contributions are expected to fund future benefit payments. On average, benefits paid rose (along with plan assets) in the 1979-1998 period. One would expect average contributions to increase proportionally—larger plans should make larger contributions to cover larger service costs. This did not occur. As a result, contributions as a percentage of assets or of benefits paid declined in the 1979-1998 period. If funding levels are to improve, a critical consideration is whether employers can afford to make higher contributions

[1] The Vanguard Group Investmend Counseling & Research/Analysis "Corporate Pension Funding" Kimberly A. Stockton, June 2004.
[2] Watson Wyatt-Insider, "The Changing Nature of Defined Benefits Plans" February 2005.
Watson Wyatt-Insider, "Pensions in Crisis" September 2003. Available On-Line http://www.watsonwyatt.com

than they have in the past ten years. The ratio of unfunded liabilities to assets is a good indicator of the potential impact on employers.

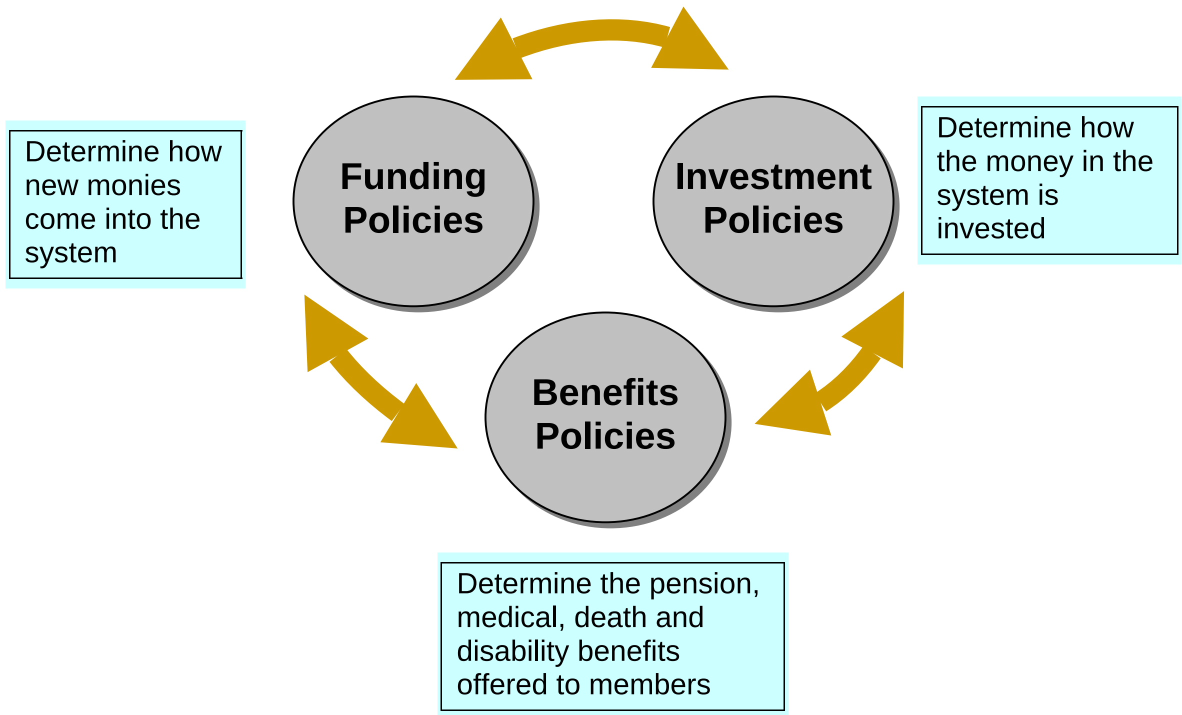
To forecast how long pension plans will take to reestablish healthy funding levels, it is necessary to make assumptions about the future. A long-term historical perspective suggests some reasonable expectations. One is that the extreme market conditions experienced in the 2000-2002 period are unlikely to be repeated soon.[3] Between 1926 and 2002, equity markets and interest rates declined together in only 15 of the 77 years. Before the 2000-2002 period, there was no three-year period during which both declined. If history is a guide, it seems likely that the economic and financial environment will be better for pension plans in the near future. Indeed, 2003 saw U.S. stocks on the upswing.

No one should be surprised if funding levels take some time to recover. If this happens, it will likely not be because of a deteriorating economy but because of the smoothing of asset returns permitted in both financial reporting and calculations of funding.[4] For example, financial accounting rules permit smoothing of asset values over a 5-year period. Thus, reported asset values in 2004 will reflect not only the higher equity returns of 1999 and 2003, but also the lower returns of 2000-2002. In other words, the dismal performance of the equity markets from 2000 through 2002 will drag down calculated asset levels in the future. Lower asset levels means lower funding levels. Thus, because of accounting rules, recovery from low funding levels could take some time.

[3] Manhattan Institute: Civic Report "Defusing the Pension Bomb: How to Curb Public Retirement Costs in NY State." E. J. McMahon and Peter Ferrara, November 2003. Available On-Line http://www.manhattan-institute.org/html/cr_40.htm

[4] Milliman USA: Multiemployer Review "Multiemployer Pension Plan Funding Problems." Spring 2003. Available On-Line http://www.milliman.com

# Funding Retirement Systems




The most recognized measure of a public retirement plan's health is its actuarial funding level—the ratio of assets to liabilities for benefits accrued to-date.[5] A pension plan whose assets equal its liabilities is funded at 100% and is considered fully funded; any shortfall of assets is an unfunded liability, and a plan with an unfunded liability is considered underfunded.

Underfunded normally does not mean that a plan is unable to pay the benefits for which it is presently obligated—in fact, substantially all underfunded public pension plans are able to meet their current obligations. Fully funded can mistakenly be interpreted to mean that no future contributions to the plan will be required. In fact, fully funded means that the actuarial valuation of assets on hand equal the plan's actuarial accrued liabilities, contributions and investment earnings still will be required to cover the benefit obligations as they accrue going forward.

All plans, underfunded and fully funded alike, that are open to newly hired workers, rely on future contributions and investment returns. A key difference between underfunded and fully funded plans is that underfunded plans require contributions both to finance benefits currently being accrued as well as to eliminate the shortfall between their assets and their accrued liabilities. Because fully funded plans have no such shortfall, they require contributions only to finance the benefits currently being accrued.

[5] NASRA Public Fund Survey Summary of Findings FY 2003
Keith Brainard, September 2004. Available On-Line http://www.publicfundsurvey.org/SurveyFindingsFY03.pdf

# Alaska Pension System Summary

The Alaska Public Employees' and Teachers' Retirement Systems (PERS/TRS) are Defined Benefit (DB) plans. The Division of Retirement and Benefits administers the plans with oversight provided by the PERS Board and TRS Board. The PERS Board is composed of five members—two board members are elected by the PERS membership, and three are governor appointed. The TRS Board is composed of five governor-appointed members-- one of whom must be a resident receiving retirement benefits under this chapter.

The Alaska State Pension Investment Board (ASPIB)—an organization that consists of eight trustees, carries out the investment functions of Alaska's retirement systems. ASPIB is made up of the Commissioner of the Department of Revenue, three trustees are appointed by the governor, and four trustees elected by the general memberships of PERS and the TRS.

Review of the boards for other state retirement systems finds wide variety in the composition, structure, and duties of boards of public retirement systems. While many such boards oversee one of several retirement systems (as in Alaska, where separate boards oversee PERS and TRS), there are boards that oversee several systems. Many of the boards also function as investment managers, although that is not clear in every case. Evidence, or the lack thereof, of the presence of additional boards that take on investment duties leads to the reasonable belief that many of the boards either do so, or have subcommittees or other organizations that advise them on such matters.

In a DB plan the benefit paid to an employee is based upon a formula set in law and is not determined by the account balance. Future benefit payments are not affected by plan funding methods or funding level of the plan, market gains or losses, or expenses. If a member decides to cash-out the employee account, the employee only receives the employee's contributions and fixed interest on the account. Employer contributions and actual investment earnings stay with the retirement system.

An actuarial valuation is performed each year to obtain a total accrued liability for the entire system. Actuarial valuations use assumptions to determine what the total cost will be over the life of the system. These assumptions reflect major variables that will affect the total system costs and the cost of any one individual. The overall objective of a pension fund is to accumulate sufficient funds to meet all expected future financial obligations to participants. An actuarial valuation determines the expected future obligation.

In a DB plan, the system does not know how long you will actually live, how many payments you will actually get after retirement, how much Cost Of Living Adjustment (COLA) you will actually be paid, how much your post retirement pension adjustments will be, or how much future health care costs will be. Assumptions are used to make a reasonable estimate of what the costs might be. The funding level is determined based on these assumptions.

The purpose of actuarial methods is to fund a member's retirement benefits over the member's working lifetime. The total expected liability for each member is broken down into two parts—the past service liability and future normal costs. The past service liability is the portion attributable to prior service and is expected to have already been funded for. Future normal costs are the annual amounts expected to be earned in the future and to be paid for by future members and employer contributions. To the extent that system assets are less than the past service liability, the “unfunded liability” is amortized over 25 years and a past service rate is combined with normal cost rate in calculating employer contributions. Mercer’s actuarial valuations of the systems are based on member and asset information provided by the Division of Retirement and Benefits and plan provisions as described in the Actuarial Valuation Reports. The actuarial methods and assumptions are also described in the Actuarial Valuation Reports.

The expected system liability is the value in today’s dollars of all the expected future benefit payments to all of the system members. There is uncertainty as to both the amount and the timing of future benefit payments. Thus, determining system liabilities requires making assumptions regarding future events. In setting each assumption, appropriate consideration is given to historical observations as well as to expectations for the future. Professional standards require that each assumption represent Mercer’s best estimate at the time of anticipated future experience. Therefore, it would not be appropriate to characterize any of the assumptions as “conservative” or “aggressive” but rather to characterize each assumption as Mercer’s best estimate based on information available at the time. Several of the key actuarial assumptions are as follows: investment return, health cost trend, future inflation, mortality rates, future salary increases, and retirement/termination rates. While each assumption is the best estimate of future experience based on information available at a given point in time, changes can occur which lead to revisions in actuarial assumptions. Among others, such changes can include longevity increases, lowered expectations regarding future inflation, and increased expectations regarding future healthcare cost increases. Assumption changes cause increases or decreases in system liabilities, which are amortized over 25 years through past service rate.

The PERS and TRS Boards approve actuarial assumptions after recommendations by and discussion with the actuary. Formal assumption reviews are conducted every five years. The results of the most recent review of actuarial assumptions were presented to the Boards in October 2000. Detailed analysis of each assumption can be found in the Public Employees’ Retirement System Analysis Study of Actuarial Assumptions and the Teachers’ Retirement System Analysis Study of Actuarial Assumptions. In addition, an independent actuarial consulting firm performs periodic audits of actuary’s assumptions and methods. Milliman, USA, performed the most recent audit with results presented to the Boards in October 2002.

The investment return assumption represents the average long-term rate of return expected to be realized on the system portfolio over the system’s future lifetime. It is used to discount future benefit payments to the valuation date when calculating liabilities. Because it represents expected future earnings to provide for benefits, raising or lowering the return assumptions causes liabilities to move in the opposite direction. Lowering the return assumption to 7.25% would increase system liabilities; raising the discount rate to 9.25% would reduce system liabilities. The National Association of State Retirement Administrators survey of investment return assumptions as of June 30, 2003 produces a median rate of return assumption of 8%, with 39 funds using return assumptions of 8.25% or higher.

The annual investment return is comprised of three major components: the increase in overall productivity, the risk premium associated with each investment class, and inflation. The first two of these represent the "real" rate of return. Since 1996, the real rate of return implicit in the investment rate has been 4.25% for PERS.[6] The real rate of return expected on investments is a function of the time period over which results are measured and the types of investments chosen.

| Measurement Period | National CPI | Approximate Rate on Market Value of Assets |
|---|---|---|
| FY 99 | 2.2% | 10.3% |
| FY 98 | 1.6% | 12.8% |
| FY 97 | 2.3% | 17.9% |
| FY 96 | 3.0% | 13.6% |
| FY 95 | 2.8% | 15.3% |

Actuarial calculated contribution rates for PERS and TRS indicate the need for higher contributions in order to eventually achieve 100 percent funding ratios. In theory, higher funding ratios could also be achieved through increasing the level of investment earnings. However, higher levels of investment earnings can generally be achieved only by taking on higher levels of risk, which may mean both increasing year-to-year volatility and increasing the likelihood of failure to meet long-term investment objectives.

Both the funding and investment policies can be thought of as "adding assets to the plan." The remaining "lever" available towards improving the fiscal condition is the benefits policy. Over the long term, the systems' fiscal condition could be improved by providing lower benefits.

In the U.S., three legal rules govern the activities of pension plan administrators, who have the legal status of fiduciaries. The three rules are the exclusive purpose rule, the prudent man rule and the diversification rule. The first obligates fiduciaries to act in the best interest of the plan's participants and beneficiaries. The second rule requires the fiduciary to act with the same care, skill, prudence and diligence that a prudent person would take. The third rule requires the fiduciary to diversify the plan's investment by type, geographic area, maturity and industrial classification to minimize the risk of losses.

Experience in recent years, with the sharp drop in the stock market, suggests that the prudent man rule might need to be interpreted to require that underfunded plans more closely match asset and liability durations and that asset characteristics should be more closely aligned with the fixed dollar nature of pension liabilities.

[6] Alaska Division of Retirement and Benefits: Alaska Legislative Report, "Response to Questions from House State Affairs on the Public Employees' Retirement Systems and the Teachers' Retirement System." February 2005. Available On-Line: http://www.state.ak.us/local/akpages/ADMIN/drb/home.htm

# Defined Contribution Plan

A defined contribution retirement plan provides members with individual retirement accounts. Usually both members and employers make annual contributions. Many programs allow members to perform their own asset allocations to funds selected in advance by the program administrator.[7]

***Advantages for Workers***

**Portability**. The clearest advantage for workers of the defined contribution plan is portability. The funds would be paid directly into each individual worker's own account and immediately become the worker's direct property. When a worker leaves state employment for another job, he or she can then take this individual retirement account with them. This account would include all past employer and employee contribution plus full market investment returns. Consequently, the defined contribution plan provides for full portability.

The current defined benefit plan, by contrast, has no real portability. When a worker leaves, he or she can take with them only their own past contributions plus fixed interest. They must give up the employer contributions for all of their years of work, all investment returns on those contributions, and the full market investment returns on their own contribution in excess of the fixed interest they can withdraw. This lack of portability is highly damaging to shorter term and younger workers.[8] The system is skewed to favor the longer-term workers.

The defined contribution plan solves these problems with full and immediate portability. Under this plan, 100% of workers would get retirement benefits for the years they worked for state or local government. And they would take those benefits with them wherever they go. This would be highly beneficial for younger and shorter-term employees, which probably constitutes the majority of people who work for state or local government.

**Vesting**. The defined contribution plan also eliminates any vesting requirement. The funds paid into the worker's account immediately become the property of the worker and remain fully available to pay future retirement benefits. This includes the employer as well as employee contributions and all investment returns on those contributions. Under the current defined benefit system, by contrast, the 5-year vesting requirement eliminates any real benefit for workers who stay less than 5 years.

The defined contribution plan is consequently highly beneficial for these shortest term workers. A vesting requirement in a defined benefit plan makes sense to eliminate small and relatively inconsequential benefit payments to numerous short-term employees, and the burden of keeping

[7] The Federal Reserve Bank of St. Louis, "The Role of Self-Regulation and Voluntary Compliance Incentives in the Design of Pension System." William Poole, September 25, 2003. Federal Reserve Bank of St. Louis, Available On-Line http://www.stlouisfed.com/news/speeches/2003/9_25_03.html).

[8] Philadelphia Business Journal, In Depth: Human Resources, "Gen Y in search of flexibility." September 22, 2003. Available On-Line http://philadelphia.bizjournals.com/philadelphia/stories/2003/09/22/focus1.html

track of the financing and payment of such benefits. But in a defined contribution plan, the government simply pays a proportion of the worker's salary into the worker's own account and leaves it to the worker after that. Eliminating any vesting requirement here would allow all workers to receive retirement contributions for the years they worked for the government employer, without any significant administrative burden on the system.

**Fair Benefits**. Under traditional defined benefit plans, benefits are skewed to favor the longer term and oldest workers and disadvantage the younger and shorter-term workers. First, of course, the vesting requirements eliminate benefits for those working less than 5 years, with the funds devoted to benefits for those working longer term. Secondly, the benefits are a percentage of final salary, which tends to be much higher for those have worked the longest, and for older workers. Thirdly, granting the same percentage of final salary for each year worked, does not give the full value to younger workers of the contributions made for them. The contributions paid into the system during years of employment, including the worker’s own contributions, continue to earn investment returns for many years after the worker leaves government employment, but the worker will get nothing for all the years of investment returns on his contributions after he leaves employment. These returns will be redistributed to finance the higher benefits of older and longer-term workers.

Inflation makes the problem even worse. Salary increases over the years usually incorporate compensation for inflation. When benefits are calculated based on salary, they will incorporate the compensation for inflation included in the salary increases over the worker's career. But for younger, shorter-term workers, this inflation compensation stops when they leave government employment, as the salary used for their benefit calculations is fixed at that age. The value of the worker's benefits will consequently be depreciated by such inflation as well. By contrast, the longer term and older workers will be fully compensated for inflation through their salary increases over working years.

None of these distortions occur in the defined contribution plan. The contributions to the worker's account immediately vest as the property of the worker, so the worker gets to keep those contributions in any event. Each worker also gets the full market investment returns on the contributions for every year thereafter, giving him the full value of those contributions, rather than redistributing some to others based on a calculated percentage of final salary. Finally, those investment returns over the years will also include an inflation compensation component; again giving the worker compensation for inflation for each year after the contribution is made.

Consequently, the defined contribution plan gives fair, undistorted benefits to each and every worker. Those who work longer get proportionally higher benefits to the extent they worked longer. But they do not get disproportionally higher benefits, skewed to favor them over other workers, and effectively redistributing funds from these workers to them.

**Personal Control**. In the defined contribution plan, the retirement funds for each worker are under the direct ownership of the worker in his or her own individual account. Workers can pick the private investments that will best serve them in the private competitive market. They consequently no longer have to worry about adverse changes in their retirement plan or politicians failing to make good on their promises, at least for the years already worked, as the contributions for those years already belong to them in full.

**Better Benefits**. Younger and shorter term workers who work roughly 20 years or less in government employment would generally get much better benefits from the defined contribution plan, because of the all the factors discussed above. Even the long-term workers can achieve benefits from the defined contribution plan.

Take the example of a worker who earns $30,000 per year over his career after inflation. Assume the same 6% of salary is paid into the defined contribution plan each year as paid currently into the defined benefit plan. After 40 years of work, this worker would retire with a fund of about $250,000 in today's dollars. Assuming retirement at the normal Social Security retirement age, that fund would finance an annuity paying the worker almost $35,000 per year each year for the rest of his life, or about 116% of preretirement income. The defined benefit plan would pay the worker 80% of final salary, or $24,000 per year. So the defined contribution plan would actually pay the worker about 45% more.[9]

***Advantage for Taxpayers***

**No Investment Risk**. The most obvious advantage for taxpayers of the defined contribution plan is that it eliminates investment risk for them.[10] With the government managing a common pool of investment funds under a defined benefit plan the taxpayers bear the complete risk of poor investment performance. If poor performance leaves the pool unable to pay the promised defined benefits, then the taxpayers will have to make up the difference.

Under the defined contribution plan, however, the taxpayers simply make a specific contribution to the accounts of the workers each month. The government then is not liable for investment performance.

**No Political Risk**. Defined contribution plans greatly reduce another set of risks that are usually overlooked- political risks. With the government specifying benefits far in the future, as under a defined benefit plan there is always a strong danger of political giveaways by shortsighted politicians. These politicians can promise higher retirement benefits, while leaving future officials and taxpayers to pay for them. Under a defined contribution plan, where the government does not specify future benefits but only makes regular investment contributions, this risk is eliminated.

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[9] Americans for Tax Reform: Policy Briefs: "Pension Liberation for Arizona." Peter J. Ferrara. Available On-Line: http://www.atr.org/policybriefs/010799pb_az.html

[10] Cascade Policy Institute, "Pension liberation for Oregon. A proposal to reform PERS." Peter J. Ferrara, J.D., May 2001. (See pages 11-17). Available On-Line: http://www.cascadepolicy.org/pdf/fiscal/I_117.pdf

**Also see**: American Legislative Exchange Council, "Pension Liberation: A proactive Solution for the Nation's Public Pensions Systems." Peter J. Ferrara, August 1997. Available On-Line: http://www.heartland.org/pdf/22664b.pdf

Moreover, a large government investment pool, as under a defined benefit plan, is always subject to the danger of political interference that could raise costs. Political favoritism may influence investment policy, prohibiting some investments and forcing the fund into others. By taking the focus off of simply maximizing investment returns, such political favoritism will reduce investment returns and increase the cost of funding the specified defined benefits.

Politicians may seek to raid the large, tempting investment pool in other ways as well. They may seek to draw supposedly excess funds out of the pool in one way or another, perhaps by replacing an overfunded plan with a new one, or reducing the government's contributions. Or they may try to use the funds for short-term added benefits. Politicians and bureaucrats in other states have been known to siphon funds out of these plans improperly or illegally. These actions would again raise costs for taxpayers.

Government management of the funds also creates the risk of mishandling the funds by bureaucrats who lack the incentives, competitive pressures, and expertise of private investment managers. Attempts to insulate the funds from bureaucratic control by contracting out to private investment managers may not be entirely successful.

Even where there has been a good record of avoiding these abuses in the past, the danger is always present. However, none of these risks arising from a large government investment pool exist in a defined contribution plan, where the government does not maintain such a pool.

**No Unfunded Liability**. The defined contribution plan eliminates the danger of any unfunded liability, from any source, that must be covered by taxpayers. Under a defined benefit plan, the taxpayers, regardless of the cause of the shortfall, must cover any shortfall in the common investment pool that leaves the pool unable to pay the promised benefits, creating an unfunded liability. In the defined contribution plan, where the government does not maintain a common investment pool but only pays a specified amount to each worker's individual account each month, with these funds financing each worker's future benefits, there is no possibility of an unfunded liability that taxpayers would have to cover.

**Greater Control Over Costs**. The defined contribution plan provides the government and taxpayers greater control over costs. Costs under a defined benefit plan, where the government has pledged to provide a certain benefit amount regardless of cost, can vary greatly, depending on a wide range of factors outside the government's control. Retirees can live longer, greatly increasing costs. More workers may stay with the government employer long term, increasing costs. Interest rates or the stock market may decline, requiring increased contributions to make up the difference.

With the defined contribution plan, by contrast, the government is responsible only for a specified contribution each year. This contribution is completely dependent only on what the government agrees with workers or their union to pay. This means in turn greater certainty and predictability in budgeting. There is no possibility that taxpayers will be surprised with a large, unexpected unfunded liability that will require increased taxes or other funding measures.

**Reduced Costs**. A defined contribution plan will also significantly reduce costs. Defined benefit plans have large administrative costs for the government employer. The government must maintain and pay for the management of the large common pool of assets. It must also administer the benefits, determining eligibility and making payments.

With a defined contribution plan, by contrast, administrative costs for the government employer are negligible. The government simply pays an amount into each employee's own account as part of payroll processing. The worker takes over administration of the account after that.

***What are the criticisms of a defined contribution plan?***

**Unsophisticated Workers**

One of the major criticisms of defined contribution plans is that most workers are too unsophisticated about investing to handle the responsibility of directing their own retirement investments. This underestimates the capabilities of working people. The proposed plan is carefully structured to avoid this problem. Under the plan, workers would simply pick from a wide range of sophisticated, highly reliable investments.

**Investment Risk**

Probably the main criticism of defined contribution plans is that they shift investment risk from the employer to the worker. In a defined benefit plan, the worker receives the specified benefits regardless of investment performance, so the worker bears no investment risk. In a defined contribution plan, the worker's benefits depend entirely on the investment performance of his retirement account, so the worker bears full investment risk. Poor investment performance leads directly to lower benefits.

What is not widely recognized is that while defined contribution plans leave workers subject to investment risk, defined benefit plans without inflation adjustments leave workers subject to inflation risk. As inflation rises, the specified benefit in an unadjusted defined benefit plan is worth less and less. Under a defined contribution plan, by contrast, the worker's investments would rise along with inflation over the long run, providing a real, above inflation, market rate of return. This would tend to keep prospective long run benefits rising with inflation.

Also not sufficiently appreciated is that workers can fully handle the investment risk posed by defined contribution plans, for several reasons. First, retirement investments are very long term. The worker is investing not only for his entire career, but, indeed, for his entire life, as the remaining retirement fund will continue to be invested to support benefits throughout retirement. With such a long term investment horizon, perhaps 60 years or more, workers can weather many ups and downs in investment performance, with the average return on a diversified portfolio very likely over the long run to close in on the average long term market return.

Secondly, workers can easily invest in simple, widely available, highly diversified pools of stocks, bonds and other investments, through mutual funds and other vehicles. Such diversified pools will track the general market investment returns discussed above over the long run. Indeed, with a sufficiently broad based investment pool, the worker would basically own a piece of the economy as a whole. If the entire economy collapses, state and local governments will not be able to support defined benefit plan promises either.

Thirdly, with professional investment managers handling the specific investments for workers, investment risk can be minimized in a sophisticated and reliable manner through diversification and other market strategies.

Workers, indeed, may be able to handle this investment risk better than state and local governments. For they can do so without all of the political risks discussed above.

**Transition Issues**

Another argument is that the transition to a defined contribution plan will be costly because the government will have to pay the workers leaving the defined benefit plan their share of accumulated funds to take to the new plan. But if the defined benefit plan is fully funded, then it will have the money to pay the departing workers saved in its common trust fund. If the defined benefit plan is not fully funded, as is the case with Alaska’s defined benefit plan, then it needs to be in any event, and the government will have to bear that cost anyway.

# Senate Bill 141

Alaska's retirement systems currently suffer from a $5 Billion deficit, meaning that if all liabilities came due today we would not be able to pay for them. A combination of factors contributed to the problem: a three-year bear market, declining interest rates, failure to realize negative returns, legislation that increased benefits, artificially low contribution rates, under stated system liabilities, and rising health care costs. Although this may be characterized as a "perfect storm" it is a perfect storm that may reoccur in the future. Many of these factors are beyond our control, which makes it difficult to predict and manage future costs. We cannot create a law that can fix the significantly underfunded status of the defined benefit plans. What we can do is implement management changes to the existing system and structural changes for new employees in order to move toward greater cost control and a fully funded retirement system. Movement to a defined contribution plan will remove the volatility that currently confronts employers. This will provide the employers with stable and predictable contribution costs going forward for new members.

SB 141 contains the tools to make those changes. The bill also has a fiscal patch. The fiscal note for the legislation includes a $108 million deposit into the retirement trust for every participating employer. The $108 million will address the 5% increase in PERS/TRS costs for FY 2006 and temporarily relieve the financial burden on political subdivisions and school districts.

**Management changes to the existing system**

The proposed bill streamlines the administration of the retirement systems by establishing the Alaska Retirement Management Board (ARMB) to replace the Alaska State Pension Investment Board (ASPIB), the Teacher's Retirement System (TRS) Board, and the Public Employees' Retirement System (PERS) Board. The new board will be more experienced with financial and pension matters than the current boards require, and will be charged with greater emphasis of its fiduciary role.

The ARMB will examine assets and liabilities in tandem in order to identify and address potential system problems in a timely fashion. Under the current structure the assets are housed in the Department of Revenue and invested by the ASPIB, while the liabilities are recorded in the Department of Administration. Accordingly, annual reports by each separate entity do not adequately put system assets and system liabilities side-by-side for a thorough analysis of the fiscal health of the entire system. SB 141 contains provisions that require greater coordination and communication between these two entities. The ARMB will have the capacity and the duty of compiling thorough system analyses, coordinating with the retirement system administrator to take into account all the system assets, liabilities and potential changes.

The ARMB will consist of nine trustees: the Commissioner of Revenue, the Commissioner of Administration, and seven appointed trustees with professional credentials or recognized competence in investment management, finance, banking, economics, accounting, pension administration or actuarial analysis. Of these seven appointed trustees, three will be members of the public, one will be a finance officer for a political subdivision in TRS, one will be a finance officer for a political subdivision in PERS, one will be a member of PERS, and one will be a member of TRS.

The ARMB will have responsibility for setting the annual employer contribution rates and the annual interest rates credited to employee accounts for the existing PERS/TRS defined benefit plans. Tighter statutory language in this bill will prevent the Board from setting employer contribution rates below the actuarially computed normal cost rate and ensure that if the normal cost rate begins to climb, employees and employers will share in absorbing those costs. (The normal cost rate is the actuarially determined amount needed to pay for benefits expected to be earned by active members during the fiscal year.)

SB 141 also moves the responsibility for hearing benefit appeals to the Office of Administrative Hearings. By transferring this function to an administrative law judge, the bill offers assurance that appeal matters will be handled consistently, professionally and by unbiased adjudicators specially trained to handle the questions presented. Additionally, it will allow the Board to focus its attention and expertise in carrying out its fiscal responsibilities.

**Structural changes for a new system that will eliminate volatility**

The objective of SB 141 is to improve the long-term health and security of Alaska's retirement system. This bill starts with the research and conclusions in the Tier Redesign Initiative completed by the Alaska Division of Retirement and Benefits. This study is the result of the work of a taskforce formed at the request of the Commissioner of Administration in September of 2003 to study and evaluate new Tier proposals. The Tier Sub-Committee was comprised of two PERS Board members and two TRS Board members. Based on the findings of the task force, including support from employer groups, this legislation offers a new comprehensive retirement system based on a fundamental change from a defined benefit to a defined contribution plan. This will bring predictability to employer contributions and financial stability to the system while at the same time maintaining the attractiveness of public sector employment.

The bill establishes a defined contribution (DC) retirement plan for new employees that addresses the changing nature of today's workforce. National trends show that the overall workforce is aging while at the same time the likelihood of workers remaining with a single employer over their entire career is declining.[11] The DC plan presents the ability to accrue a meaningful benefit early in a career. In the DC plan, employees will have a retirement plan that is portable from job to job. Employees will have the ability to direct the investment of their retirement money. There will be contribution equity among employees and the contribution amount calculation is clear and easy to understand. This plan will provide the opportunity for non-career employees to realize greater retirement income and for all employees to obtain higher retirement benefits based on the financial experience of their account.[12]

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[11] American Water Works Association (AWWA), E-MainStream, "Resources for recruiting employees." October 1999. Available On-Line: http://www.awwa.org/communications/mainstream/archives/1999/October/msfocus1.cfm

[12] Watson Wyatt-Insider, "The Changing Nature of Defined Benefits Plans" February 2005.
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SB 141 also continues the tradition of offering insurability for all employees by providing access to major medical insurance. The bill addresses rising health care costs by both decreasing employer costs associated with providing medical coverage and providing an additional savings mechanism to assist retirees with their medical expenses. This mechanism is a Health Reimbursement Arrangement (HRA). An HRA is solely employer funded and reimburses retirees for qualified medical expenses up to a maximum dollar amount for a defined coverage period. The HRA is a new benefit, funded through the working lifetime of the employee, that provides the retiree the benefit of having money available for medical expenses that is nontaxable and interest bearing.

## Defined Contribution (DC) Retirement Plan Elements

### Individual Accounts

Each member will have an individual account into which both the employee and the employer will contribute a percentage of the employee's compensation, pre-tax. The rate of employee contribution to this account is a mandatory 8 percent with a mandatory employer contribution of 3.5 percent.

An employee may elect to contribute additional pre-tax earnings not to exceed the limits established by the Internal Revenue Code.

All members of the DC plan immediately vest in their own contributions and related earnings. Members gradually vest in the employer contributions and related earnings on the following schedule:

25% after two years;
50% after three years;
75% after four years;
100% after five years.

Employees can take their individual account with them when they leave employment and can "roll" in other qualified funds when they are hired. Employees will direct the investment of the funds in their individual account based on a range of investment options provided by the ARMB.

### Medical Benefits

Employees will be eligible for major medical insurance and will have access to a Health Reimbursement Arrangement if the employee retires directly from the plan. An employee is eligible for retirement from the plan if: (1) the employee is at least 65 with 10 years of service; or (2) is a peace officer/firefighter with 25 years of service; or (3) has 30 years of service; and (4) has been an active member of the plan for at least a year prior to retirement.

Employees will have access to major medical insurance coverage. "Access" means that an eligible person may not be denied insurance coverage except for failure to pay the required premium. Retirees with 25 or 30 years of service, but who are less than Medicare age eligible (currently 65), must pay the full premium to receive coverage. There is one premium per retiree, and different premiums will be calculated for single retirees versus retirees with a spouse and/or dependent children.

The defined contribution system contains shared health insurance premium payment provisions. The employer will contribute 3.75 percent of an employee's compensation to the group health insurance trust fund.

Once the retiree becomes Medicare eligible, the monthly medical premium is shared with the employer and coordinated with Medicare. The retiree's share depends on years of service:

+ 10-14 years = 30%
+ 15-19 years = 25 %
+ 20-24 years = 20%
+ 25-29 years = 15%
+ 30+ years = 10%

The employer will contribute 1% of the average annual employer group compensation, to a maximum of $500, to an HRA trust fund per member per year. The contribution is recorded in both an individual employee record of account and an employer record. Interest (the rate to be determined by the ARMB) on this account is posted to individual records annually. Contributions and interest accumulate over the working lifetime of employees.

The HRA Trust is an employer owned fund. Individual accounts of record are maintained for five years after an employee terminates without retiring. Terminated employee accounts revert to the employer unless the individual returns to work within the five-year period. A person who returns to work within the five-year period is attributed the account balance recorded in their name on the date of termination. Employers may use surplus funds held in the trust to credit individual employee records with the annual contributions owed by the employer.

Members who retire directly from the system (as well as their spouse and dependent children) are eligible for withdrawals from the HRA. The member's spouse and children remain eligible even if the retiree dies. Dependent children remain eligible even if the member and spouse die.

The HRA Trust can be used for reimbursements for qualified medical expenses under IRC 213(d), including medical premium payments. The total reimbursement is limited to the account balance recorded for the individual. There are no set limits for appropriate reimbursement other than exhaustion of the account balance.

Contributions by the employer are non-taxable when made and are non-taxable upon distribution. There are no IRS limits on reimbursement. Unused funds will rollover year-to-year, including annual interest.

**Changes to the Defined Benefits Plans**

SB 141 addresses contribution rates in the existing defined benefit plan by changing contribution calculations. The employee contribution rate is changed to the greater of: (1) the amount set in statute prior to enactment of this bill; or (2) one-half of the normal cost rate as determined by the ARMB. The employer contribution rate is changed so that it may not be less than the difference between the employee contribution and the normal cost rate that is set by the ARMB.

This bill also addresses the reinstatement of indebtedness provisions. It repeals the window for reinstatement effective June 30, 2010. This relieves the "off books" liability of hundreds of millions of dollars represented by more than 10,000 people who have refunded out of the State's retirement system but who could return to work and be restored to the tier status they held prior to termination by repaying the amount refunded plus interest. In medical premiums alone, this amount stands at greater than $107 million for one year in today's dollars.

Finally, this bill addresses the cost of living adjustment (COLA) that is given only to retirees at least 65 years old, or persons receiving a disability benefit, who reside in Alaska. The 10% COLA is removed from the statutes.

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