Response to GRS Review of a Pay-Go Approach to Retirement Funding

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The April 3, 2014 GRS review of the pay-go retirement funding proposal contained several statements that I responded to on the same date. Given the limited time I was given to provide a response, my April 3 comments simply rebutted some minor issues of presentation.

At this point, the reaction to pay-go from the Governor, the press and the legislature makes it apparent that getting into the weeds cannot contribute to a solution. The points below are not so much a direct response to the GRS review as an explanation of the broader issues of retirement funding.

The central points of the report were:

1. The model is computationally accurate;
2. The projections show that all benefits would be paid when due under a pay-go approach; and
3. The model is a departure from standard actuarial practice.

The conclusions are no surprise, but the conclusions offer insufficient guidance regarding what, if anything, to do about retirement funding. The following points are intended to help legislators understand and evaluate retirement funding options:

1. A computationally accurate exit strategy is unlikely to appease credit raters. Raters use models of their own design to compare plans in various jurisdictions. They will not readily accept proposals that do not comply with standard actuarial assumptions that apply to open systems (despite the fact that Alaska's defined benefit plans are closed to new entrants). There is little doubt that our closed retirement systems will adopt pay-go by 2070, but that decision can be left for future legislatures.

2. The Governor's plan fails to meet the contribution levels specified in statute, and has drawn concern from credit raters. That can be (at least partially) addressed via statutory redefinition of the ARC—the contribution rate recommended by actuaries—but even then the proposal
    a. may be of concern to raters who evaluate retirement systems in a standard way and
    b. will not significantly improve our fiscal situation through FY24.

3. The situation should come as no surprise to anyone who has tried wishing away debt. There are two ways to eliminate our unfunded liability:
    a. Pay the debt and/or
    b. Be fortunate enough to experience market conditions that help us earn our way out of debt.

4. We have limited control over market conditions, and any action that increases our upside potential generally increases downside risk. Even a cash infusion sufficient to eliminate unfunded

liability offers no guarantee that the system will remain fully funded. New unfunded liability will appear whenever earnings are less than projected or benefits are greater than projected.

5. An uncertain future exposes the state to significant risk of unexpected contributions in the future. That is the nature of a defined benefits system. The risk of unexpected state contributions is increased once employer contributions cease because
    a. the standard means to eliminate unfunded liability—increasing employer contribution rates—is no longer a practical option and
    b. the lack of cash inflow from contributions means that benefits must be paid from earnings, and the need to spin off cash earnings is likely to reduce investment returns.

6. If credit ratings are of great concern—and they should be (but note that unfunded liability makes up only 10% of rating criteria)—then we must abandon non-standard approaches to funding our retirement systems.

7. This conclusion does not imply that there are no alternatives to continuing on our current path. Mathematically, our annual payments to a retirement system are determined by the following equation:

    State contributions = ARC – money from other sources

8. The equation leaves us with two options to reduce annual payments:
    a. Reduce the ARC or
    b. Increase cash flow from sources other than the state.

9. The Governor calls for a cash infusion, which reduces the ARC. The Governor also apparently intends—but has not yet submitted a bill—to redefine the ARC. The revised statute would allow a fixed payment (of less than the amount calculated under the standard ARC) for a variable term. I cannot say how raters will view this non-standard approach.

10. A cash infusion is the cheapest means to eliminate unfunded liability. Anyone familiar with a mortgage knows there are only a few levers to pull when it comes to paying a debt:
    a. More cash up-front reduces annual payments, other things being equal;
    b. Higher annual payments reduce the term of the payments; and
    c. A longer term generally means higher interest costs.

11. The cheapest solution to a paying a debt is not necessarily the best solution. Few people can afford to pay cash for a home, so they must opt for a mortgage as a more affordable solution. For some, the advantages of a longer term loan make that option preferable to a short-term, cheaper mortgage. The right choice depends on expectations of future income and expenses and many other variables that are difficult to predict.

12. The state has sufficient reserves to eliminate unfunded liability. Arguably, affordability is not an issue. But other issues have been raised:

a. A cash infusion from state reserves would reduce flexibility to use those reserves for other purposes. It is true that reserves transferred to retirement trust funds cannot be retrieved. But if we expect to pay the debt to retirement systems, our reserve balances are not really flexible—if we continue to face both annual deficits and large payments to retirement systems, reserve balances will be used to make annual payments to reduce unfunded liability.
b. A cash infusion will not significantly improve our reserve balance position in the next 10 years. True, a cash infusion will reduce annual contributions to retirement, but those annual reductions will be offset not only by the transfer of reserve balances, but also by the loss of earnings on the reserves that are transferred to retirement funds. Any net gain in reserve position will be attributable to the difference in returns on reserve funds versus retirement trusts.
c. Although a cash infusion would improve the health of retirement systems—perhaps erasing a black mark by credit raters—unfunded liability is only 10% of credit raters' criteria. Higher reserve balances may be more important to our credit rating than healthier retirement systems.
d. A cash infusion to PERS is complicated by the fact that the state is responsible for about 60% of the system's unfunded liability but would pay 100% of the cash infusion. A cash infusion to PERS is a form of revenue sharing. Although the revenue sharing aspect of a cash infusion could be offset by an increase in the employer contribution rates or a reduction in appropriations for revenue sharing, these options involve technical and political considerations that could take some time to resolve.

13. A cash infusion is not the only way to reduce the ARC. It is possible to reduce the ARC by terminating prefunding of health care costs, increasing the projected rate of return on investments, lengthening the amortization schedule and making other changes to actuarial assumptions that would make our retirement systems look healthier. These games should be avoided—they would mislead legislators and are unlikely to improve our credit rating or have any other positive impact.

14. However, refinancing our unfunded liability is an action that could extend the life of reserves in a way that is easy to understand. Just as a person whose economic future has taken a turn for the worse could benefit from converting his mortgage with 14 years remaining to a new 30-year loan—knowing that the lower payments come at the price of an extended term—the state could benefit from rolling all outstanding unfunded liability into new 25-year amortization schedule. In combination with a cash infusion, refinancing could make annual retirement costs more affordable.

15. The other option to reduce annual state assistance payments (see #8 above) is to increase employer contribution rates.
    a. Under PERS, a rate increase would bring in money from non-state employers, thereby reducing state retirement assistance payments. The linkages between revenue sharing, required local funding of schools, local property taxes, and retirement assistance should be recognized, but splitting the retirement cost burden between the state and municipalities is primarily a political decision involving many stakeholders.

b. Under TRS, the state is effectively the only payer; general funds pay both the employer rate and state assistance. Raising the TRS employer contribution rate may be an effective strategy (from a political as well as a credit rating perspective) because it emphasizes that TRS spending is for education rather than to support a troubled retirement system, but it would not change the sum of state expenditures for K-12 and TRS.

16. Although resolution of PERS funding issues may not be achievable before session-end, there is no window of opportunity that will close. The "do nothing" option may be the most practical solution. That option requires only an appropriation of about $350 million to the PERS trust fund in order to meet the ARC.

17. TRS funding is perhaps easier to resolve. One scenario is to
    a. Increase the employer rate, with a mechanism to pay school districts the amount of the cost increase. This requires statutory change and has a net zero cost to the state and to school districts.
    b. Reset the amortization period for all outstanding liability to 25 years. This does not require statutory change (unless the ARM Board proves uncooperative) and should result in lower payments that extend until 2040. The change would not have a great impact intergenerational equity
    c. Appropriate $1 billion to the trust fund to bring the funding ratio comfortably above 60% (about 10 points higher than the current funding ratio). This requires an appropriation.
    d. Recompute the ARC for FY15 based on the revised amortization schedule and the reduction of unfunded liability, and continue to pay state assistance as required by current statute.