GRS

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Ms. Laura Pierre
Chief of Staff
Office of Senator Anna Fairclough
Alaska State Legislature
907.465.6456 office | 907.465.2819 fax
Alaska State Capitol
Juneau, AK 99801

Re: Actuarial Review of Alaska TRS Funding Options, as prepared by Mr. David Teal

Dear Ms. Pierre:

Per your request we have reviewed the model developed by Mr. Teal. Based on this review, and our conversations with Mr. Teal, we concur that the model adequately represents the possible outcomes regarding the funding of the PERS and TERS plans. We note, however, that our agreement with the accuracy of the model is not an agreement with the funding plan. The proposed plan adds risk to the pension systems and is counter to actuarial standards regarding the funding of the pension plans. We understand that the legislature is weighing these risks against the larger risk framework facing the state.

We were able to spend time with Mr. Teal reviewing these models in detail; his time is greatly appreciated.

We have not performed any review of the Governor's proposal.

OPENING COMMENTS

The models prepared by Mr. Teal adequately represents the future outcomes described in his proposal. The models do show a cost for proposed delayed funding. Costs are increased by billions of dollars in order to save on funding today. The model shows employers in debt until at least 2073 for the liabilities of the closed TRS and PERS pension systems. We have made tweaks to the models, but it does not have an impact on the overall outcome suggested by the models.

The proposed plans decrease the amount of funding in early years into TRS and PERS by extended the length of time for contributions to be made to the trust. Projections of Employer/State contribution rates to TRS, as shown in the Buck presentation dated February 7, 2014, show state contributions ending around 2030 and employer contributions ended by 2042. Projections of Employer/State contribution rates to PERS show state contributions ending around 2029 and employer contributions ended by 2037. Under the model proposed by Mr. Teal, employer contributions will continue until at least 2073 (and these employer contributions include the State pass through amounts for TRS).

One of the key issues that Mr. Teal states, and for which we would recommend further exploration, is the comment that "the total cost of every option is identical-each ensures that all future benefits are paid when due". We concur that the benefit payments are the same, but the total future contributions can vary significantly depending on the timing of payments and subsequent investment earnings. Because the Teal proposal stretches out employer payments over the next 60 years, the actual dollar amount needed is greater. As shown in the Total Contributions and Affordability sections, the total Employer/State contributions needed through 2073 for TRS increase from $8.9 billion for the current funding policy for TRS to $24.3 billion under the proposal. For PERS, the total Employer/State contributions needed through 2073 increase from $15.0 billion for the current funding policy to $42.3 billion under the proposal.

Any time that funding is decreased to a pension system, that pension system is introduced to greater risk - namely, the risk that a volatile event could quickly deplete the funds within the trust.

To the extent that the debt is extended and costs are increased, the pension trusts is put at greater risk for asset depletion. In fact, in those later years, employers will be assessed charges for the pension system when they no longer have active members participating in the system. If the only issue under consideration were the TRS and PERS funds, the answer would be that there is not a positive benefit to this course of action; we realize, however, that issues are being considered beyond the pension trust. It is our understanding that the legislature is weighing the risks and benefits of a variety of issues and those considerations extend beyond the scope of this review.

The models are based on only one set of future events. Since volatility is such a critical issue to the pension trusts, we would recommend that a variety of return scenarios be analyzed so the legislature may better assess whether the State has the capability to withstand such fiscally stressful events. For example, if the TRS trust only earns 7% in the first 12 years, the assets are completely depleted around 2040. We feel it would be useful for the State to see what happens to contribution requirements if the earnings are less than assumed (i.e.1% less in all years) and if the payroll does not grow as anticipated. That way the State would not be surprised if the costs for TRS escalate rapidly during a downturn in the economy.

PROPOSED POLICY - TRS

Our understanding of the proposed funding policy is as follows:

- The State would contribute $1.45 billion during fiscal year 2015 at which time direct State assistance would cease
  - $1.35 billion would be deposited into the Defined Benefit trust
  - $0.10 billion would be deposited into a reserve account
- Employers would continue to contribute at the 12.56% of payroll during fiscal year 2014, then 32.56% of payroll thereafter. The state will enact a “pass through” transaction, where the additional required funding will move from the state to each employer so that employer may make the 32.56% contribution.

The proposed funding policy, although it does cease State contributions, continues employer contributions at the 32.56% of payroll rate for an extended period of time. It also establishes a “pass through” mechanism whereby the State is remitting a portion of the pension contribution to the employer for its contribution to the pension trust. In essence, this plan saves money in the near future only to increase costs over time.

Total Contributions and Affordability

Funding Policy	Employer contributions*	State Assistance*	Description of the Funding Policy	Modeled by
Base or Current Policy	$.8 billion**	$8.1 billion**	State assistance to cover actuarial rate beyond 12.56% employer rate	Buck
Governor’s Proposal	$.9 billion**	$8.7 billion**	$1.12 billion in FY 2015 plus $343 million per year for 20 years; $118 million in the 21st year	Buck
Teal Proposal	22.2 billion***	$2.1 billion***	$1.35 billion in FY 2015 plus $0.1 billion to reserve; Increase employer contributions to 32.56% of pay through “pass-through”	Teal

**All funding policies were evaluated using an investment return of 8.0% per year for comparability.*
***From Buck projection model presented February 7, 2014.*
**** From Mr. Teal’s projection model as referenced at the start of this report; $22.2 billion is the comprised of $1.7 billion from the amounts available to the Defined Benefit Plan and $20.5 billion from “pass through” from the state. The $2.1 billion is the direct state assistance in 2013, 2014 and 2015.*

PROPOSED POLICY - PERS

Our understanding of the proposed funding policy is as follows:

- The State would contribute $1.45 billion during fiscal year 2015 at which time State assistance would cease
  - $1.00 billion would be deposited into the Defined Benefit trust
  - $0.45 billion would be deposited into a reserve account
- Employers would continue to contribute at the 22% of payroll rate (with 22% going into the Defined Benefit trust for Defined Benefit payroll and approximately 12% going into the Defined Benefit trust for DCR payroll-since 10% of DCR payroll goes into the Defined Contribution Plan) for an extended period of time to account for the reduced State contributions.

Total Contributions and Affordability

Funding Policy	Employer contributions*	State Assistance*	Description of the Funding Policy	Modeled by
Base or Current Policy	$7.8 billion**	$7.2 billion**	State assistance to cover actuarial rate beyond 22% employer rate	Buck
Governor's Proposal	$11.4 billion**	$5.7 billion**	$1.88 billion in FY 2015 plus $157 million per year for 20 years	Buck
Teal Proposal	$40.2 billion***	$2.1 billion***	$1.00 billion in FY 2015 plus $0.45 billion to reserve	Teal

**All funding policies were evaluated using an investment return of 8.0% per year for comparability.*
****From Buck projection model presented February 7, 2014.*
***** From Mr. Teal's projection model as referenced at the start of this report.*

REVIEW OF SUPPORTING CALCULATIONS

Budget alignment

One item for the State to consider is the extent to which a proposal "aligns" with future budget projections. It may be preferable to support a pension funding policy that does not create "budget encroachment" in the later years. Based on our understanding of the future revenue projections for the State (i.e. the "Prudhoe Curve") we note that future revenues are expected to decline. Thus, this model, which increases costs in later years, runs counter to a policy of "budget alignment".

Market Value for Projecting Assets

The Teal model projection was starting with the projected actuarial value of assets from Buck as of June 30, 2014 to project forward. We have projected forward using the market value of assets as of June 30, 2013, not the actuarial value of assets since the market value is the amount invested and earning returns. This correction to the model does not make a substantial difference to the outcome.

POLICY CONCERNS

Implications of a Closed Plan

Closed plans have liability characteristics quite different from "open" plans. There will come a day in the closed plan when the accrued liability starts to decline and finally, a day when there is no more liability in the plan. New member positive cash flows are a stabilizing force in times of adverse experience for an open plan, and an open plan that does not target full funding can be sustainable. Closed plans such as the Alaska defined benefit plans, however, must reach full funding by the time the last benefit is paid. Generally, best practice, from an actuarial standpoint, is to accelerate funding to a closed plan to achieve full funding during the working lifetimes of the active members. Recommendations from both GASB and GFOA are to use an actuarial funding method that uses a closed, level dollar amortization.

Once plans close they continue to lose political capital. In reality, this translates into a difficulty to obtain funding when needed. Legislatures with tight budgets would be asked to allocate funds to an enterprise with no active members. It becomes more difficult to find a "champion" for these closed funds, considering all the other revenue constraints being faced at the time. In order to minimize this risk, funds may seek to become fully funded at the time of the cessation of the active workforce.

The proposed funding policy pushes out the date of full funding as long as possible and does not address potential interim volatility or adverse deviation. If the Plan does not earn the expected returns, or has adverse demographic deviation (such as low payroll growth), the only adjustment under the proposed funding policy is to further extend the 32.56% payment by the TRS employers and the 22.00% payment by the PERS employers. In those later years, the employers' payroll will have a much greater proportion of its employees in the defined contribution plan. As the payroll covered under the DCR payroll increases, the amount allocated to the Defined Benefit Trust decreases, thereby creating a need for additional funding.

Accounting, bond ratings and reporting under GASB-impact to the State's cost of capital

The Governmental Accounting Standards Board dictates how pension liabilities are to be expensed (not how they are to be funded). Recent changes, which will become effective within the next couple of years, require that the unfunded accrued liability be placed on the balance sheets of the plan sponsors. In addition, for plans that are not and will not be fully funded, the standard requires the use of an assumed rate of return lower than that used for funding. [Please note that under the proposed model, because State contributions will cease to TRS in 2015, it is possible under the new accounting standards that the liabilities for TRS will be spread among all employers, thereby mitigating this concern for the State and transferring it to the employers. Auditors would need to opine whether the State or the employers would be responsible for the liability given the contribution pass-through.]

Adopting this proposal for delayed funding will impact the amount of liability that will be placed on the balance sheet for the state. This, in turn, could affect the bond ratings for the State, thereby affecting issues such as the cost of capital and loan covenants. These issues are well beyond the scope of this assignment; however, we raise them so that you can have the opportunity to review any potential impacts with your auditors and legal counsel.

In analyzing the cost for this issue, it may be worthwhile to determine up front whether there could be a change in the State's cost of capital and thus create a much higher cost for capital improvement costs in the future. That is, for example, if you want to save $1 billion over the near term, yet the cost for capital improvements increases $2 billion, then would the State feel it had made the optimal decision?

The model does not address the accounting issues (nor could it). The answer would rest with the State's auditors, bond counsel, and any other parties who work in the arena of ratings and bonds.

Summary of concerns with the model

- The model illustrates only one possible future; prepare scenarios with different rates of return and different payroll growth rates
- The model does not align with budget projections (it produces higher costs in later years);
- The model is sensitive to adverse experience; it would not take much adverse experience to create a situation where the 32.5% and 22.0% employer limits would need to be violated in order to make benefit payments.

ADDITIONAL COMMENTS

If you have any questions concerning our review, please call Leslie at (720) 274-7271.

Sincerely,

Gabriel, Roeder, Smith & Company

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