

# ALASKA STATE LEGISLATURE

## LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



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SUMMARY OF: A Special Report on the Departments of Administration and Revenue, Public Employees' Retirement System, Teachers' Retirement System, and Alaska State Pension Investment Board, Selected Issues.

### PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted an audit of selected issues related to the Public Employees' Retirement System (PERS) and the Teachers' Retirement System (TRS) and their respective former oversight boards. In addition, our audit included selected issues regarding the Alaska State Pension Investment Board (ASPIB).

The purpose of this audit was to review and assess the fiscal history of the state-administered PERS and TRS (Plans). Both plans currently face significant projected unfunded liabilities. Our primary objective was to review the past decisions made by the PERS board, the TRS board, and the ASPIB to assess to what extent, if any, the boards' decisions contributed to the plans' current unfunded liabilities.

### SCOPE

The scope of the audit varied depending on the audit objective.

- PERS and TRS employer contribution rate decisions – Adopted rates for FY 90 to FY 06 were reviewed for consistency with the consulting actuary's calculations and advice.
- ASPIB asset allocation decisions – Adopted asset allocations for FY 99 to FY 05 were reviewed for consistency with the Treasury staff and investment consultants' advice.
- PERS and TRS funding ratios – Funding ratios from July 1, 1992 through June 30, 2000 were reviewed to determine the internal and external factors causing the changes in ratios with a focus on the period July 1, 1999 through June 30, 2004.
- Other state public pension plans – Five public employees' pension plans and five teachers' retirement plans were selected from 127 public pension plans

surveyed by the National Association of State Retirement Administrators in 2004.

## REPORT CONCLUSIONS

A summary of the conclusions follows:

- It is unclear if state law mandates that retirement funds maintain funding ratios of 100 percent.
- Decreases in funding ratios were primarily due to investment losses and rising medical costs.
- Rate-setting decisions had a small impact on each Plan's declining funding ratios. In three instances, the PERS board set rates below the former consulting actuary's calculated rates.
- TRS did not adopt the annual actuarially-calculated employer contribution rate, but rather set a level rate as recommended by the consulting actuary.
- Administrative decisions of oversight boards had limited impact on the Plans' liabilities.
- Regulations with financial effect need to be updated.
- Asset allocations were more conservative, but investment returns were consistent with those of comparable retirement plans in other states.
- An administrative two-year lag between determining the contribution rates and using them has contributed slightly to the Plans' declining funding ratios.
- Recent state appropriations partially offset higher contribution rates faced by participating employers.

## FINDINGS AND RECOMMENDATIONS

The director of the Division of Retirement and Benefits (DRB) should review and update the Public Employees' Retirement System's and the Teachers' Retirement System's (Plans) regulations.

Certain regulations that financially affect the Plans have not been updated for a number of years. According to the DRB staff, the division has contracted with a former assistant attorney general to review the existing Plans' statutes and regulations and provide potential revisions to the commissioner of the Department of Administration early in 2006. We recommend that certain regulations be considered for change under this review.

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January 25, 2006

Members of the Legislative Budget  
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

#### DEPARTMENTS OF ADMINISTRATION AND REVENUE PUBLIC EMPLOYEES' RETIREMENT SYSTEM, TEACHERS' RETIREMENT SYSTEM, AND ALASKA STATE PENSION INVESTMENT BOARD

#### SELECTED ISSUES

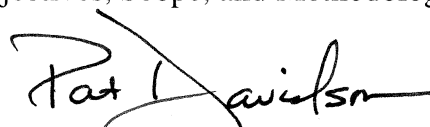
December 30, 2005

Audit Control Number

02-30037-06

The purpose of this audit was to review and assess the fiscal history of the state-administered Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS). Both plans currently face significant projected unfunded liabilities. Our primary objective was to review the past decisions made by the PERS board, the TRS board, and the Alaska State Pension Investment Board to assess to what extent, if any, the boards' decisions contributed to the plans' current unfunded liabilities.

The audit was conducted in accordance with generally accepted government audit standards. Fieldwork procedures utilized in the course of developing the findings and discussion presented in this report are discussed in the Objectives, Scope, and Methodology.

  
Pat Davidson CPA  
Legislative Auditor



# TABLE OF CONTENTS

	<u>Page</u>
Objectives, Scope, and Methodology.....	1
Organization and Function .....	5
Background Information .....	9
Report Conclusions .....	15
Findings and Recommendations .....	27
Appendices	
Appendix A – Legislation Affecting the PERS Plan, For the Period 1986 through 2004.....	31
Appendix B – Legislation Affecting the TRS Plan, For the Period 1986 through 2004 .....	33
Appendix C – Comparison of the State of Alaska Public Employees’ Retirement System with Other Pension Funds.....	35
Appendix D – Comparison of the State of Alaska Teachers’ Retirement System with Other Pension Funds.....	39
Agency Responses	
Department of Administration .....	43
Department of Revenue.....	47
Alaska Retirement Board .....	49
Legislative Auditor’s Additional Comments .....	51



# OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted an audit of selected issues related to the Public Employees' Retirement System (PERS) and Teachers' Retirement System (TRS) administered by the Department of Administration (DOA), Division of Retirement and Benefits (DRB). We also reviewed certain actions of the PERS and TRS oversight boards and the Alaska State Pension Investment Board (ASPIB).<sup>1</sup>

## Objectives

Specific objectives of this audit were:

- To review the legal implications of maintaining underfunded state pension plans.
- To review the fiscal history and current funding status of PERS and TRS (Plans), including determination of the internal and external factors that contributed to the Plans' current underfunded status. To compare the Plans' funded status with other state public pension plans.
- To determine whether the PERS and TRS boards' rate-setting decisions were consistent with their consulting actuary's calculations and advice.
- To ascertain to what extent, if any, the actions of the PERS and TRS oversight boards contributed to the Plans' decline.
- To determine the extent that ASPIB followed their advisors' recommendations in adopting the Plans' asset allocations. Also, to compare the Plans' asset allocations and investment returns to other state public pension plans.
- To review state funding appropriated to participating employers to alleviate recent increases in employer contribution rates.

## Scope

The scope of the audit includes varied time periods depending on the audit objective.

- PERS and TRS employer contribution rate decisions – Adopted rates for FY 90 to FY 06 were reviewed for consistency with the consulting actuary's calculations and advice.

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<sup>1</sup> All three boards were abolished effective July 1, 2005 and replaced by the Alaska Retirement Management Board, effective October 1, 2005.

- ASPIB asset allocation decisions – Adopted asset allocations for FY 99 to FY 05 were reviewed for consistency with the Treasury staff and investment consultants’ advice.
- PERS and TRS funding ratios – Funding ratios from July 1, 1992 through June 30, 2004 were reviewed to determine the internal and external factors causing the changes in ratios with a focus on the period July 1, 1999 through June 30, 2004.
- Other state public pension plans – Five public employees’ pension plans<sup>2</sup> and five teachers’ retirement plans<sup>3</sup> were selected from 127 public pension plans surveyed by the National Association of State Retirement Administrators (NASRA) in 2004. Our selection was based on similar asset size, covered employee group(s), and plan management type (agent multiple-employer plan or cost-sharing multiple-employer plan) as those of the Plans.

### Methodology

We obtained and reviewed the former DRB consulting actuary’s<sup>4</sup> calculations of changes in funding ratios and funding net shortfalls due to differences between calculated employer rates and adopted rates. In addition, we obtained the annual valuation reports prepared by the former consulting actuary for the Plans. We determined the reasonableness of assumptions and methodologies used in developing the annual actuarial valuation by:

- comparing the inflation factors with the applicable Consumer Price Index,
- making a comparison of the assumed rate of return with other state public pension plans, and
- reviewing actuarial audit reports of the former consulting actuary’s valuation reports.

Although we reviewed the assumptions and methodologies of the calculations for the valuation reports, we did not re-perform them.

We determined the variances between the consulting actuary’s calculated employer contribution rates and the rates adopted by the Plans’ oversight boards and the causes for such variances. The Plans’ asset allocations were analyzed to determine if they were consistent with the advice of ASPIB’s advisors. We compared the Plans’ funding ratios, asset

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<sup>2</sup> Arizona Public Safety Personnel Retirement System, Illinois State Employees’ Retirement System, Louisiana State Employees’ Retirement System, Michigan State Employees’ Retirement System, and Virginia Retirement System. Although much larger than the other plans, Virginia Retirement System was included as part of the audit request.

<sup>3</sup> Arkansas Teachers’ Retirement System, Kentucky Teachers’ Retirement System, Montana Teachers’ Retirement System, North Dakota Teachers’ Fund for Retirement, and Oklahoma Teachers’ Retirement System.

<sup>4</sup> Mercer Human Resource Consulting, LLC was the actuary for both Plans since at least 1976. Available records indicate that the contract was competitively bid in 1986, 1994, and 1999 with Mercer being awarded the contract. In 2005, DRB solicited bids for the contract and awarded it to Buck Consultants, LLC. The contract period is from October 1, 2005 to June 30, 2009, with five one-year renewal options.



allocations, and investment returns with those of the selected ten other state public pension plans as reported by NASRA and the states' financial reports. These comparisons were augmented by reviews of available information on the ten plans' websites and interviews of the plan administrators. Medical cost-saving initiatives of DRB and the Plans' boards were reviewed and discussed with DRB staff.

The following documents were also reviewed:

#### Laws and Regulations:

- Alaska Statutes including AS 14.25, AS 37.10.210 to 37.10.390, and AS 39.35.
- Regulations including 2 AAC Chapter 35 and 2 AAC Chapter 36.
- Session laws including Chapter 9, FSSLA 2005; Chapter 3, FSSLA 2005; Chapter 159, SLA 2004; Chapter 57, SLA 2001; Chapter 4, FSSLA 1996; Chapter 97, SLA 1990; and Chapter 82, SLA 1986.

#### Reports and Publications:

- 1993 performance audit by the Division of Legislative Audit of TRS.
- PERS and TRS comprehensive annual financial reports (financial and actuarial sections) for fiscal years 1990 to 2005.
- PERS and TRS actuarial valuation reports for June 30, 1990 to June 30, 2004 and PERS valuation supplements for June 30, 1995 to June 30, 2003.
- *Employee Benefits and Retirement System Funding White Paper*. A 2003 paper authored by DRB Chief Financial Officer.
- *Employers' Edge*. Newsletters published by DRB for calendar years 1998 to 2005.
- *PERS Newsbreak* and *TRS Newsbreak*. Newsletters published by DRB for calendar years 1996 to 2005.
- *Actuarial Audit of State of Alaska TRS & PERS*. A 2002 audit conducted by Milliman USA.
- *Actuarial Audit of the Public Employees' and Teachers' Retirement Systems*. A 1995 audit conducted by A. Foster Higgins & Co., Inc.
- *State of Alaska Public Employees' Retirement System Funded Study Analysis*. A 2005 report prepared by Actuarial Service Company, P.C.
- *Findings and Analysis Regarding Alaska State Pension Investment Board's Investment Program*. A 2003 audit performed by Independent Fiduciary Services, Inc.
- 1991, 1996, and 2000 actuarial assumption studies for PERS and TRS.

- 1994 inflation component of economic assumption study for PERS and TRS.
- *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards*. A 2004 report prepared by Workplace Economics for the American Association of Retired Persons.
- *Public Fund Survey Summary of Findings for FY 2004*. A report prepared by NASRA.

Other Documents:

- Relevant PERS board, TRS board, and ASPIB minutes and resolutions.
- DRB director correspondence files for calendar years 1997 to 2005.
- Pertinent correspondence between DRB and Mercer Human Resource Consulting, LLC; Milliman USA; and Deloitte Consulting, LLP for calendar years 2001 to 2005.
- ASPIB Investment Policy and Procedure Manual.
- Relevant legislative committee minutes.
- 2003 and 2004 public fund surveys conducted by NASRA and National Council on Teacher Retirement.
- Financial statements and websites of other state pension plans.
- Department of Law legal representation letters to the Plans' public accounting firm for the FY 05 financial audit.
- DRB reports regarding appeals to the court from 1997 to April 2005 of the Plans' administrative board decisions and related Alaska Supreme Court opinions.
- Other DRB documents concerning the Plans.

We also interviewed the following individuals:

- DOA and DOR deputy commissioners, DRB director and staff, and Treasury Division staff.
- Former board members.
- The Plans' former consulting actuary.
- DRB's lead assistant attorney general and the Plans' board attorney.
- Plan administrators of other state public pension plans.

# ORGANIZATION AND FUNCTION

## Public Employees' Retirement System

Established in 1961 under AS 39.35.010, the Public Employees' Retirement System (PERS) was created to provide "*for the payment of retirement, disability, and death benefits to or on behalf of*" employees of the State, political subdivisions, and public organizations.<sup>5</sup> Many school districts and the University of Alaska (UA) also participate in PERS to provide benefits to personnel without academic standing.

PERS is administered by the Department of Administration (DOA), Division of Retirement and Benefits (DRB). The delegated plan administrator<sup>6</sup> is responsible for managing the accounts of employer and employee contributions and the payment of benefits to retirees and beneficiaries. PERS is a defined benefit plan, paying benefits based on a formula set in law, rather than the retiree's account balance. Currently, there are three tiers of benefits under PERS. (See Appendix A) However, SB 141 (Chapter 9, FSSLA 2005) created a defined contribution plan, adding a fourth tier to PERS effective July 1, 2006.

As an agent multiple-employer plan, PERS is essentially an aggregate of single-employer plans that pools assets and shares administrative costs, but maintains separate liabilities. A contribution rate is calculated for each employer. In addition to the State, currently there are 159 political subdivisions and public organizations that participate in the plan. As of June 30, 2005, there were 73,725 PERS participants: 33,732 active members; 20,703 retirees and beneficiaries; 6,517 vested terminations; and 12,773 non-vested terminations with account balances.

## Teachers' Retirement System

The Teachers' Retirement System (TRS) was established in 1955 under AS 14.25.010, effective July 1, 1955, to provide "*for the payment of retirement, disability, and death benefits to or on behalf of*" certified teachers, university teaching staff, and other employees with academic standing in the State.

As with PERS, TRS is administered by DRB with the delegated plan administrator managing the accounts of employer and employee contributions and the payment of benefits to retirees and beneficiaries. Also like PERS, TRS is a defined benefit plan, providing formula-driven,

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<sup>5</sup> The term public organization refers to government-affiliated entities such as the Alaska Housing Finance Corporation, the Anchorage Parking Authority, and the Cook Inlet Housing Authority.

<sup>6</sup> The delegated plan administrator is the director of DRB.

lifetime payments to the retiree or beneficiary. Currently, there are two tiers of benefits under TRS. (See Appendix B) However, Chapter 9, FSSLA 2005 also created a defined contribution plan for TRS, adding a third tier effective July 1, 2006.

In contrast to PERS, TRS is a cost-sharing, multiple-employer plan, under which multiple employers share assets, costs, and liabilities. All employers pay the same employer contribution rate. School districts, UA, regional resource centers, and the State participate in TRS. Currently, there are 58 employers participating in TRS. As of June 30, 2005, there were 22,323 TRS participants: 9,786 active members; 9,018 retirees and beneficiaries; 750 vested terminations; and 2,769 non-vested terminations with account balances.

### PERS Board

Organizationally under DOA, the PERS board provided regulatory and technical oversight of PERS until the board was abolished effective July 1, 2005. The powers and duties of the board included adopting PERS regulations and resolutions, acting as an appeals board, setting the employer contribution rate based on an actuarial valuation, and other duties enumerated under state law (AS 39.35.040). The board was composed of two PERS members elected by the PERS membership and three public members appointed by the governor. For the sole purpose of hearing disability benefit appeals, the board included two governor-appointed, state-certified physicians and two alternates.

### TRS Board

The TRS board provided regulatory and technical oversight of TRS under DOA until the board was abolished effective July 1, 2005. The powers and duties of the board included adopting TRS regulations and resolutions, acting as an appeals board, recommending to the plan administrator<sup>7</sup> the employer contribution rate based on an actuarial valuation, and other duties enumerated under state law (AS 14.25.035). The board was composed of five members appointed by the governor, at least one of whom was a state resident receiving TRS benefits. For the sole purpose of hearing disability benefit appeals, the board included two governor-appointed, state-certified physicians and two alternates.

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<sup>7</sup> Prior to October 2005, the employer contribution rates for PERS were set annually by its oversight board. In contrast, the TRS oversight board's authority was not as extensive – the board could recommend what the rates should be for employers; however, the final authority rested with DOA. This notwithstanding, the TRS board, rather than the commissioner, traditionally set the employer contribution rates. Under recently revised legislation, the newly constituted Alaska Retirement Management Board sets employer contribution rates for both PERS and TRS defined benefit plans.

### Alaska State Pension Investment Board

In 1993, state law (AS 37.10.210) established the Alaska State Pension Investment Board (ASPIB) within the Department of Revenue (DOR). Assuming the fiduciary role previously held by the commissioner of DOR, ASPIB was responsible for the prudent management and investment of state pension plan assets until it was abolished July 1, 2005.

ASPIB's powers and duties included establishing investment policies, selecting and retaining the funds' external investment managers, reviewing and reporting on the funds' performance, meeting annually with the PERS and TRS boards, and other duties enumerated under state law (AS 37.10.220).

The board was composed of eight trustees: two PERS members elected by the PERS membership, two TRS members elected by the TRS membership, three governor-appointed trustees, and the commissioner of DOR. The board had three investment advisors: a contracted external investment consultant, the board-appointed investment advisory council, and DOR, Division of Treasury staff.

### Alaska Retirement Management Board

Established under Chapter 9, FSSLA 2005, the Alaska Retirement Management Board (ARMB) replaced the PERS and TRS boards, and ASPIB, assuming oversight and management of the retirement funds, effective October 1, 2005. Organizationally in DOR and staffed by the Division of Treasury, ARMB is composed of nine trustees appointed by the governor: a finance officer, two members of the general public, two trustees selected from four PERS bargaining unit nominees, two trustees selected from four TRS bargaining unit nominees, and the commissioners of DOA and DOR. Like ASPIB, ARMB has an external investment consultant and an investment advisory council.

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## BACKGROUND INFORMATION

Retirement plans can be divided into two broad classifications – defined benefit plans and defined contribution plans. A defined benefit plan pays an eligible participant benefits determined by an established formula. These benefits are not necessarily tied to, or limited by, the financial contributions made into the plan by a given participant and the participant’s employer(s). By contrast, a defined contribution plan bases payments on the financial contributions made on behalf of or by each participant: the more money individuals have credited to their accounts, the more in benefit payments they can expect to receive.

### State administered retirement programs have historically been defined benefit plans

Historically, both the Public Employees’ Retirement System (PERS) and the Teachers’ Retirement System (TRS) have been defined benefit pension plans<sup>8</sup> (Plans). The calculation of benefits paid under each Plan is set in state law. State law also sets what percentage of income each participating employee is to pay into the Plans. The amount paid by participating employers is based on rates that are either set, or recommended, by the Plans’ oversight boards.

### Funding rates for employers are based on an annual assessment of each Plan’s liabilities

PERS and TRS have three sources of revenue: contributions from employee participants, contributions from participating employers, and return on investments of the Plans’ assets. The employee contribution rate is set in state law, while the return on investments is determined by investment strategy and market conditions. The primary factor controlled by the respective plan oversight boards is the employer contribution rate.

Each year both Plans’ oversight boards receive an assessment, termed a “valuation,” from a consulting actuarial firm. This annual valuation assesses the prospective liability stemming from the projected cost of each Plan’s defined benefits. The valuation plays a central role in the rates charged to employers who participate in TRS and PERS. The actuary’s calculated rate serves as the primary guideline used by each oversight board in setting employer rates.

In estimating the liabilities of each Plan, the actuary makes informed assumptions about demographic and economic variables, such as investment return, salary increases, mortality rates for participants, and the likely increase in medical costs. The valuation projects how much each participating employer should contribute in order for the Plan to meet prospective

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<sup>8</sup> Effective for new hires on or after July 1, 2006 under both Plans, employees will be under a defined contribution plan.

benefit payment liabilities. The valuation estimates how much each employer should contribute, in terms of the percentage of their employees' payroll, in order to fund the associated benefit obligation.

Projected rates are made up of two parts – past service costs and current “normal” costs

When determining what rates are necessary to meet liabilities, the actuary calculates two separate costs:

1. Past service costs. These are costs for each employer that have carried over from past assessments. Typically, they stem from situations where the established contribution rate proves not to be high enough to cover the costs of benefits or where there is an increase in benefits for retiree participants (who are no longer paying into the system) or where the new participants are allowed to purchase past service years from a prior position with a nonparticipating employer. The past service rate is the part of the overall rate dedicated to covering any accumulated, unfunded liability.
2. Current or “normal” costs. This element represents each participating employer's cost of benefits earned by active members during the current plan year.

The actuary applies these cost factors differently when calculating the rate each participating employer should pay. The Plans differ as follows:

1. PERS employers pay an “individual” cost rate. All employers pay the same rate to cover normal costs, but pay a specific past-service cost rate reflecting the costs associated with their retired beneficiaries. Accordingly, employers participating in PERS pay differing blended rates. For FY 06, the highest calculated rate was 110.24 percent, the lowest was zero percent,<sup>9</sup> with the average being 25.63 percent.
2. TRS employers all pay the same rate. TRS has one employer contribution rate that consists of one rate to cover normal costs and past service costs for all employers. For FY 06, the calculated employer contribution rate was 38.85 percent.

Past legislative action to decrease pension costs was diminished by later legislation

In an effort to lower pension and medical benefit costs, the legislature created a PERS Tier II in 1986<sup>10</sup> for employees first hired after June 30, 1986 and a Tier III in 1996<sup>11</sup> for employees first hired after June 30, 1996.

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<sup>9</sup> A zero contribution rate occurs when the employer's assets exceed the liabilities by an amount that is equal to or greater than the employer's normal cost.

<sup>10</sup> Chapter 82, SLA 1986.

<sup>11</sup> Chapter 4, FSSLA 1996.



PERS Tier II increased the normal retirement age from 55 years to 60 years of age and the early retirement age from 50 years to 55 years of age. These actions decreased future pension benefit payments by delaying the age of retirement. In addition, Tier II lowered retiree medical coverage costs by requiring a retiree under the age of 60 years to pay the full premium and retirees 60 years old but under 65 years to pay one-half the premium for the benefit. (Prior to Tier II, all retirees received medical coverage with full system-paid premiums.)

Tier III further restricted system-paid medical premiums for retirees by requiring them to have at least ten years credited service to be eligible for the benefit. Other changes were made that had the effect of increasing or decreasing retiree pension costs.

Then in 1990, the legislature created a TRS Tier II for employees first hired after June 30, 1990.<sup>12</sup> As with PERS Tier II, the 1990 legislation<sup>13</sup> lowered retiree medical coverage costs by requiring a retiree under the age of 60 years to pay the full premium and retirees 60 years old but under 65 years to pay one-half the premium for the benefit.<sup>14</sup> The legislation also made other changes affecting the retiree pension costs.

With the enactment of Chapter 57, SLA 2001, more retirees who were first hired on or after July 1, 1986 for PERS or July 1, 1990 for TRS received system-paid premiums by lowering the age requirements. (See Appendix A and B for additional details concerning these legislative changes to both Plans)

In addition, while retiree costs have been on the rise and employer contributions have increased, the participants' contributions have remained the same for PERS since 1987 and for TRS since 1991.

#### Funding ratio provides measure of each Plan's solvency

The oversight boards consider the Plans' funding ratios when setting employer contribution rates. The funding ratio is the ratio of assets to projected liabilities of the fund as determined by the actuarial valuation. It is a measure of the pension plan's financial condition. When the estimated future assets of the fund exceed the projected liabilities, the funding ratio is above 100 percent. When projected accrued liabilities exceed estimated future assets, the funding

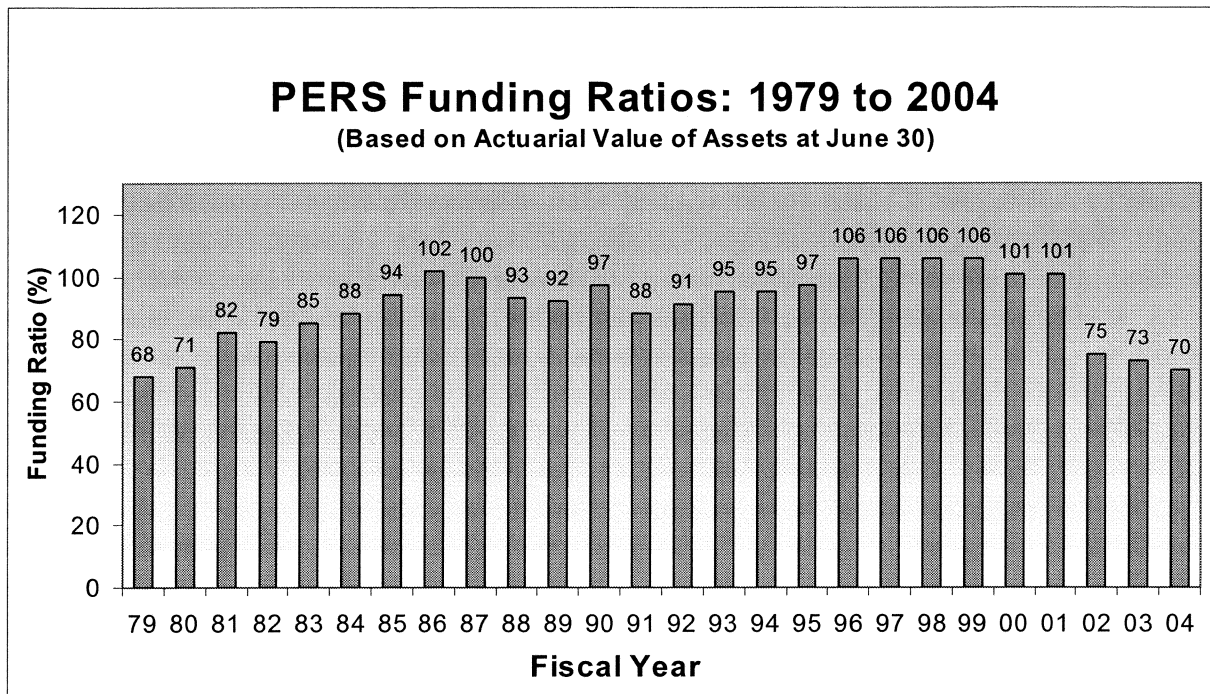
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<sup>12</sup> Chapter 97, SLA 1990.

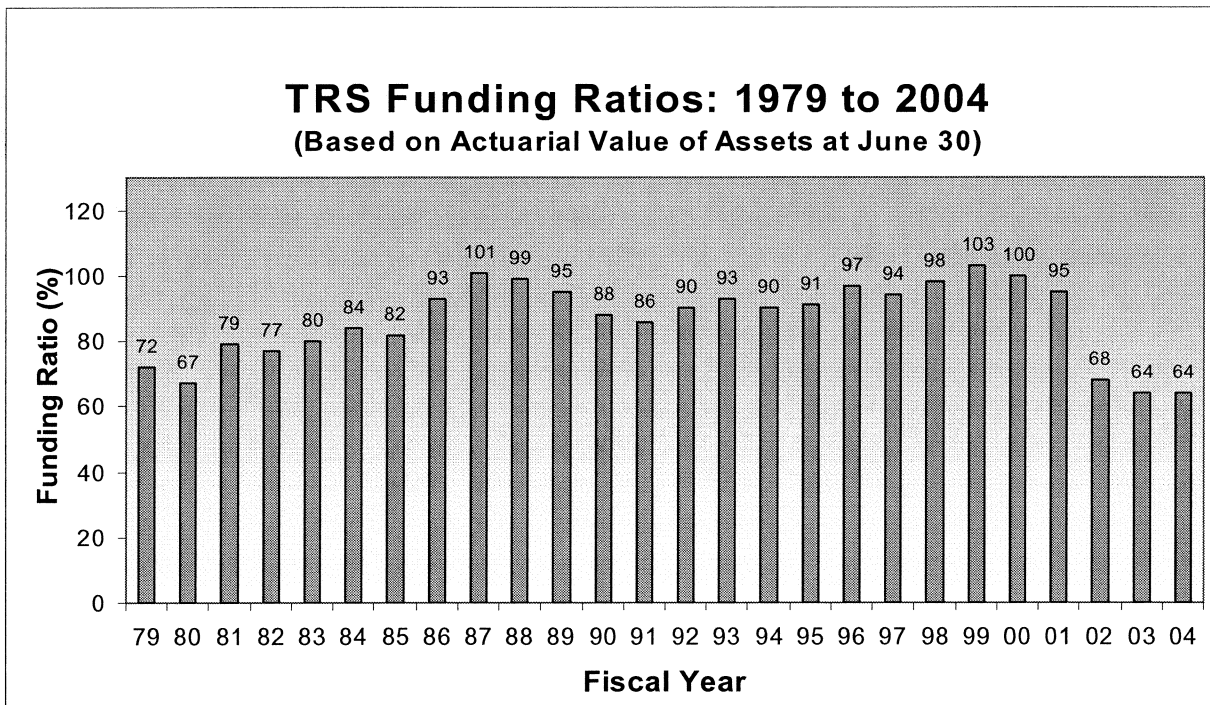
<sup>13</sup> Due to the Alaska Constitution, Article XII, Section 7 requirement to not "*diminish or impair*" benefits of previously hired and employed participants, various "tiers" of public employees have been established. These tiers are based on the hire date of the employees in order to change ages for retirement, periods necessary for vesting, post-employment medical eligibility, etc.

<sup>14</sup> Prior to the establishment of TRS Tier II, like PERS, retirees received system-paid premium medical coverage.

**Exhibit 1**



**Exhibit 2**



ratio falls below 100 percent. This difference between the accrued liabilities and the assets represents what is termed the plan's unfunded actuarial accrued liability.

From FY 01 to FY 02, both Plans experienced dramatic declines in their funding ratios. The PERS' funding ratio dropped from 101 percent to 75 percent and was most recently calculated to be 70 percent. Over the same period, the ratio for TRS declined from 95 percent to 68 percent, currently sitting at 63 percent.<sup>15</sup> The current funding ratios are similar to the ones experienced in FY 79 when PERS was funded at 68 percent and TRS was funded at 72 percent. (See Exhibit 1<sup>16</sup> and Exhibit 2<sup>17</sup> on the opposite page)

### Retiree healthcare is administered by the State through self-insurance program

Beginning in FY 98, the State opted to provide health care benefits to retirees through self-insurance. The State created a separate trust fund, labeled the Retiree Health Fund (RHF), to keep track of funding and expenditures. RHF was designed to provide funding necessary to meet current and future medical costs for retirees.<sup>18</sup>

Each month the premium for each retiree's health care benefits<sup>19</sup> is transferred from PERS and TRS to RHF. The amount of the premiums is based on consultant calculations that try to anticipate future claims and the estimated administrative costs. Besides these premium transfers, RHF is also credited with the investment earnings generated by any balance of transferred funds.

During FY 04, DOA determined that RHF had an excess balance.<sup>20</sup> A \$20 million transfer was made from RHF back to the state's retirement systems.<sup>21</sup> Since the retirement plans have a potential for a higher rate of return on investments than RHF, DOA management believed it was prudent to transfer the funds back to the respective retirement plan. Such reviews of fund balances are done periodically to determine that the RHF reserves are adequate, but not

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<sup>15</sup> As of the most recent valuation report dated June 30, 2004.

<sup>16</sup> Mercer Human Resource Consulting, LLC, *State of Alaska Public Employees' Retirement System Actuarial Valuation Report as of June 30, 2004 As Approved by the Alaska Retirement Management Board on October 12, 2005*, p. 2.

<sup>17</sup> Mercer Human Resource Consulting, LLC, *State of Alaska Teachers' Retirement System Actuarial Valuation Report as of June 30, 2004 As Approved by the Alaska Retirement Management Board on October 12, 2005*, p. 2.

<sup>18</sup> Major medical plan (premiums mostly paid by funds transferred from the respective retirement fund), the dental-vision-audio (DVA) plan, and the long-term care (LTC) plan (premiums for both of the latter are paid for, fully, by the retiree).

<sup>19</sup> The medical premium for calendar year 2006 has been calculated at \$875, up from \$850 for 2005.

<sup>20</sup> Excess reserves are the result of a number of factors, such as, claim experience was less than anticipated, more generic prescriptions were purchased lowering the Plans' drug costs, higher utilization of in-network providers with negotiated reduced cost, etc.

<sup>21</sup> PERS received \$13.7 million, TRS received \$6.2 million, the Judicial Retirement System received \$50,000, and the Elected Public Officials Retirement System received \$26 thousand.

excessive. DRB is considering a similar transfer during FY 06 based on the *State of Alaska, 2006 Retiree Benefits Renewal Report, October 31, 2005*.

New Medicare Part D prescription program will reduce costs of the Plans

Medicare Part D is the new prescription drug plan offered to eligible Medicare beneficiaries beginning in 2006. However, the prescription drug benefits offered under both the PERS and TRS plans are better than the benefits offered under Medicare Part D. Therefore, retirees are encouraged not to enroll in Medicare Part D; in order to avoid incurring any unnecessary premium and deductible costs. The Medicare Part D program still pays for some of the prescription drugs purchased by retirees through a direct subsidy to the Plans. The total annual subsidy for both Plans is estimated to be approximately \$7 million. These funds will be deposited into RHF to offset retiree medical coverage costs.

## REPORT CONCLUSIONS

We were directed to review and assess the fiscal history of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS) (Plans). Both Plans are facing significant, projected, unfunded liabilities. Our primary objective was to review the past decisions made by each of the Plans' oversight boards and the Alaska State Pension Investment Board (ASPIB)<sup>22</sup> and to assess to what extent, if any, the boards' decisions contributed to the current unfunded liability for each Plan.

As discussed further in this section, we have developed the following conclusions:

- It is unclear if state law mandates that retirement funds maintain funding ratios of 100 percent.
- Decreases in funding ratios were primarily due to investment losses and rising medical costs.
- Rate-setting decisions had a small impact on each Plan's declining funding ratios. In three instances, the PERS board set rates below the consulting actuary's calculated rates.
- TRS did not adopt the annual actuarially-calculated employer contribution rate, but rather set a level rate as recommended by the consulting actuary.
- Administrative decisions of oversight boards had limited impact on the Plans' liabilities.
- Regulations with financial effect need to be updated.
- Asset allocations were more conservative, but investment returns were consistent with those of comparable retirement plans in other states.
- An administrative two-year lag between determining the contribution rates and using them has contributed slightly to the Plans' declining funding ratios.
- Recent state appropriations partially offset higher contribution rates faced by participating employers.

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<sup>22</sup> The Alaska Retirement Management Board replaced the Plans' boards and ASPIB on October 1, 2005.

It is unclear if state law mandates retirement funds maintain funding ratios of 100 percent

Policy decisions related to the administration of retirement plans for public employees are, and have been, shaped by Alaska's constitution. Article XII, Section 7 prohibits accrued benefits from being "*diminished or impaired.*"<sup>23</sup> It has been suggested that when funding ratios for PERS and TRS fall below 100 percent, the accrued benefits of participants have been diminished or impaired. From our reading of the legal analysis provided to date, absent any specific ruling from the state courts, we do not believe maintaining the funding ratio at this target level is necessarily required.

In 1992, the Department of Law (DOLaw) addressed an inquiry as to whether the governor is constitutionally or statutorily mandated to include employer contributions in the budget to keep the retirement funds actuarially sound. DOLaw noted that while the state Supreme Court had not specifically addressed the issue, there was a

*...strong probability that the Alaska courts would find a diversion of retirement funds to be violative of the Alaska constitution and would in addition find the governor bound by statute to include employer contributions in his budget.*<sup>24</sup>

DOLaw summarizes its perspective in the 1992 memorandum with the comment that it was likely "*...an Alaska court would hold that **adequate funding** of the state retirement funds is constitutionally required...*" [Emphasis added] Further, in a 2005 memorandum of advice, DOLaw more explicitly comments that "*State law requires employer contribution rates be calculated in amounts sufficient, when combined with employee contributions, **'to provide the benefits earned'** ....*" [Emphasis added]

Not specifically addressed by these analyses is whether allowing the funds to fall below a 100 percent funding ratio amounts to, either, inadequate funding or a situation that deprives participants of earned benefits. In the context of these analyses, we believe the retirement oversight boards have a responsibility to set employer contribution rates and take other actions to maintain the actuarial soundness of each retirement Plan. Optimally, maintaining the funding ratios at or above 100 percent maximizes actuarial soundness.

Accordingly, it would seem that at a minimum, contribution rates should not be lowered when the actuarial valuation indicates that rates should be increased. However, under the

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<sup>23</sup> As discussed in Background Information, because of this requirement, new "tiers" of employees have had to be created whenever retirement benefits have been restructured to be less generous. The restructured, lesser benefits involved with each new classification tier are applied to all employees first hired after a specified date by participating employers.

<sup>24</sup> In the memorandum, the DOLaw adds that it is also addressing the issue as to whether the legislature is "*...constitutionally mandated to appropriate, those employer contributions that are prescribed by the boards of the various retirement systems to keep the system funds actuarially sound.*"

existing legal interpretation and advice, it does not appear, at least in the short term, the oversight boards must necessarily set rates at such a level as to make it fiscally impractical for employers to participate.

Decreases in funding ratios were primarily due to investment losses and rising medical costs

Between FY 00 and FY 04, the unfunded actuarial accrued liabilities (UAAL) increased to approximately \$3.4 billion and \$2.3 billion for PERS and TRS, respectively. Based on an analysis prepared by the Plans' actuary,<sup>25</sup> updated to include FY 04, the following factors affected the UAAL for each Plan.

PERS's actuarial funding ratio declined from 106 percent to 70 percent. Investment losses accounted for about a third of the decline. Changes in participants' death rate assumption,<sup>26</sup> medical premiums, and legislative expansion<sup>27</sup> of system-paid medical benefits for Tier II and Tier III participants accounted for about a quarter of the decline. Just over a quarter of the drop (28 percent) was attributable to the change in the asset valuation method adopted in 2002.<sup>28</sup> The remaining 14 percent of the decline was due to actual Plan experiences related to the participant population, adoption of new economic and demographic assumptions, and two ad hoc post-retirement pension adjustments (PRPAs)<sup>29</sup> approved by the PERS board.

During the same period, TRS' actuarial funding ratio declined from 103 percent to 63 percent. Investment losses accounted for about 28 percent of the decline. Changes in participants' death rate assumption, medical premiums, and legislative expansion of system-paid medical benefits, for Tier II participants, accounted for approximately another 12 percent. About 40 percent of the decline was attributable to the change in the asset valuation method adopted in 2002. The remaining 20 percent of the decline was due to actual Plan experiences related to the participant population, data corrections on participants, adoption of new economic and demographic assumptions, and three ad hoc PRPAs approved

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<sup>25</sup> The former actuary, Mercer Human Resource Consulting, LLC, prepared a letter to the director of the Division of Retirement and Benefits, dated January 23, 2005. The letter delineates the causes of changes in the UAAL from July 1, 1992 to June 30, 2003, using the fiscal year-end market values of net assets.

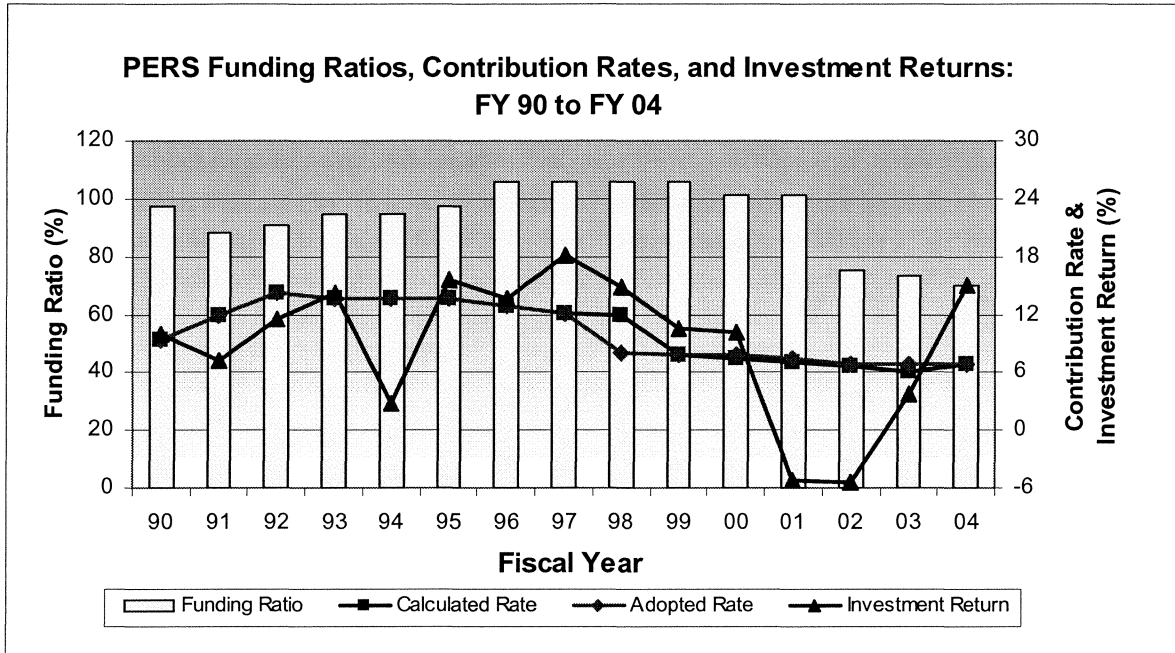
<sup>26</sup> The 1984 Unisex Pension Mortality Table was replaced with the 1994 Group Annuity Mortality Basic Table, resulting in increased estimated lives for participants to accrue and receive retirement plan benefits.

<sup>27</sup> Chapter 57, SLA 2001 for both PERS and TRS.

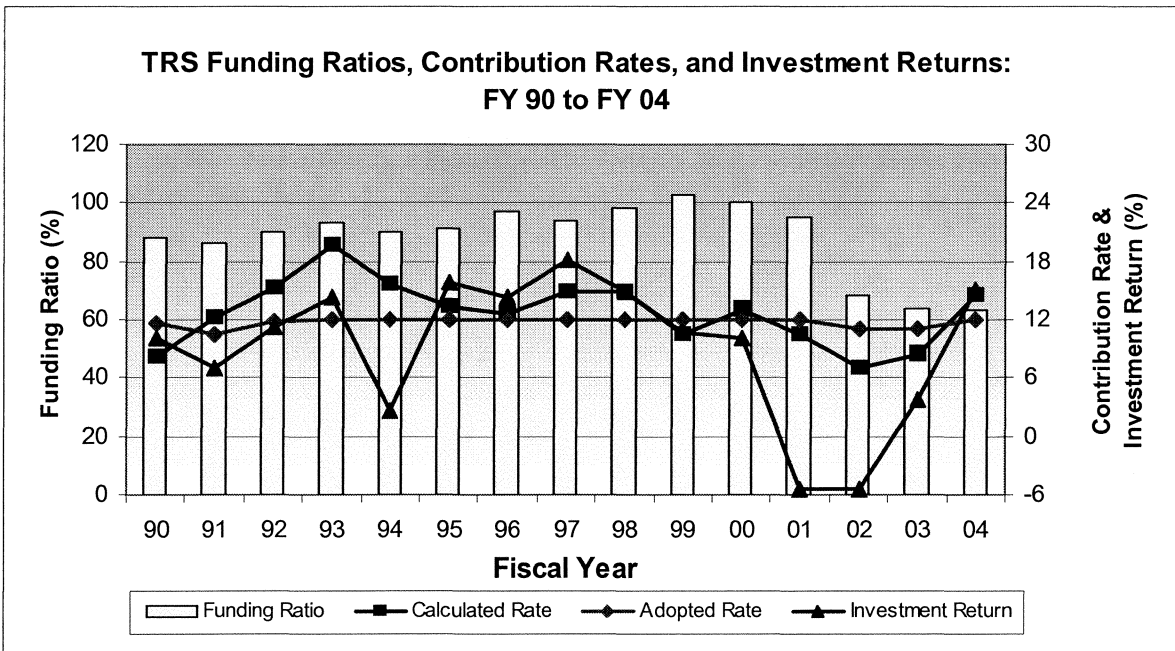
<sup>28</sup> As a result of the actuarial audit performed in 2002, effective June 30, 2002, both Plans' boards adopted an asset valuation method that recognizes 20 percent of the investment gain or loss in each of the current and preceding four years. Previously, gains or losses were recognized under the "corridor" method. The actuarial value of assets, as of June 30, 2002, was written down to market value in conjunction with the valuation methodology change.

<sup>29</sup> Since 1986 for PERS and 1990 for TRS, the Plans provide for an automatic actuarially-funded PRPA based on the *Consumer Price Index for Urban Wage Earners and Clerical Workers* in Anchorage. Those retirees who were first hired before 1986 for PERS and 1990 for TRS may receive either the automatic PRPA or an ad hoc PRPA approved by the PERS board or the commissioner of the Department of Administration, in the case of TRS. The qualifying retiree receives the PRPA that is greater in value.

**Exhibit 3**



**Exhibit 4**





## Exhibit 5

by the TRS board. For both TRS and PERS, the apparent over-funding in FY 04 of the state RHF self-insurance account had an immaterial impact on each of the Plans' diminishing funding ratios.

Exhibits 3 and 4 on the opposite page show the funding ratios, employer contribution rates, and investment returns of each Plan for fiscal years 1990 through 2004. They illustrate how the 2001 and 2002 downturn in the stock market resulted in a drastic drop in investment returns. This drop and the recognition of all net investment losses as of June 30, 2002 were the main factors in the decline in the funding ratios.

Both Plans also experienced significant increases in retiree medical costs that contributed to the decline in the funding ratios. The DRB director and both Plans' boards have worked to identify ways to reduce retiree medical costs. (See Exhibit 5)

We compared PERS and TRS funding ratios, with ten (five for each category) other state plans generally of similar asset size. Since these other state plans fund medical benefits on a "pay-as-you-go" basis we have excluded, for PERS and TRS, any medical-benefit related assets or liabilities.<sup>30</sup> Exhibit 6 on the next page shows the results of the comparisons.

The State's lower funding ratios, in large part, result from Alaska's PERS and TRS recognizing all the net investment losses at the end of FY 02. By contrast, the other states are spreading those investment losses over multiple years. As discussed earlier, the recognition of those investment losses by PERS and TRS contributed significantly to the funding ratio dropping below 100 percent.

### Division and Boards Take Action to Contain Retiree Medical Costs

Rising at rates higher than wage growth and inflation, the cost of medical care is a major driver in the funding ratios' decline. To reduce such costs, the division and boards have taken various measures. Some of these initiatives, and their actual or potential savings according to management and consultants, include:

Positive Open Enrollment – Identification of individuals ineligible for medical benefits is projected to save \$16 million annually.

Generic Prescription Drugs – Since its inception, the generic drug education program has increased generic drug use by approximately 11 percent. A one percent increase in use equals approximately \$1.2 million savings annually.

Medicare Part D – Encouraging eligible retirees, who already have comprehensive drug coverage under AlaskaCare, to not enroll in the new federal drug program is expected to result in an annual estimated federal subsidy of \$7 million.

<sup>30</sup> According to a report published by the American Association of Retired Persons (AARP) Public Policy Institute, of the 41 states that reported providing some retiree health insurance, Alaska was one of only 11 that pre-funded such benefits. Other states may provide medical benefits, but fund them on an annual basis, referred to as a "pay-as-you-go" basis. (Stan Wisniewski, Ph.D. J.D. and Lorel Wisniewski, Ph.D., Workplace Economics, Inc., *State Government Retiree Health Benefits: Current Status and Potential Impact of New Accounting Standards*, AARP Public Policy Institute, Washington, DC, July 2004.)

As seen in Exhibit 6, the average drop in funding ratios between FY 02 and FY 04 for the states in the PERS comparison group was over 11 percent and almost 8 percent for the TRS comparison group. In contrast, the drop in Alaska’s funding ratio for PERS was less than 1 percent while for TRS it was less than 2 percent. Because these other states are spreading their investment losses into subsequent years those losses will continue to have a negative effect on the funding ratios into the future. (See Appendix C and D<sup>31</sup>)

**Exhibit 6**

Funding Ratios (%)		
Plan	FY 02	FY 04
PERS Comparison Group		
Arizona	113.0	92.4
Virginia	101.8	90.3
Michigan	98.7	84.5
<b>Alaska – PERS*</b>	<b>86.8</b>	<b>86.0</b>
Louisiana	70.2	59.3
Illinois	53.7	54.2
TRS Comparison Group		
Arkansas	91.9	83.8
North Dakota	91.6	80.3
Kentucky	86.6	80.9
Montana	83.4	74.0
<b>Alaska – TRS*</b>	<b>75.4</b>	<b>73.8</b>
Oklahoma	51.4	47.3
* excludes medical benefit related assets and liabilities		

Rate-setting decisions had a small impact on each Plan’s declining funding ratios

- In three instances, the PERS board set rates below actuary’s calculated rates

For the 17-year period from FY 90 through FY 06, the PERS board set employer contribution rates equal to or slightly higher than the actuary’s calculated rates, with three exceptions. The FY 98 and more recently the FY 05 and 06 rates were set below those calculated by the actuary, although for different reasons. (See Exhibit 7)

For FY 98, the PERS board initially adopted the calculated rate of 11.90 percent and then lowered it to 8 percent the following year.<sup>32</sup> At the time, PERS had a projected funding ratio of 106 percent and the board saw lowering the rate as a way to reduce volatility in the rates.<sup>33</sup> In making their decision, the board sought and followed the advice of their consulting actuary.<sup>34</sup>

This action contributed minimally to PERS’ underfunded status. Lowering the FY 98 rate resulted in a shortfall of approximately \$56 million as of June 30, 2003. This shortfall was partially offset by the board’s adoption of rates slightly higher than the actuarial rates four times – FY 00 through FY 03.

<sup>31</sup> The Illinois State Employees Retirement System and the Kentucky Teachers’ Retirement System were not included in the Appendix because the additional information was not readily available.

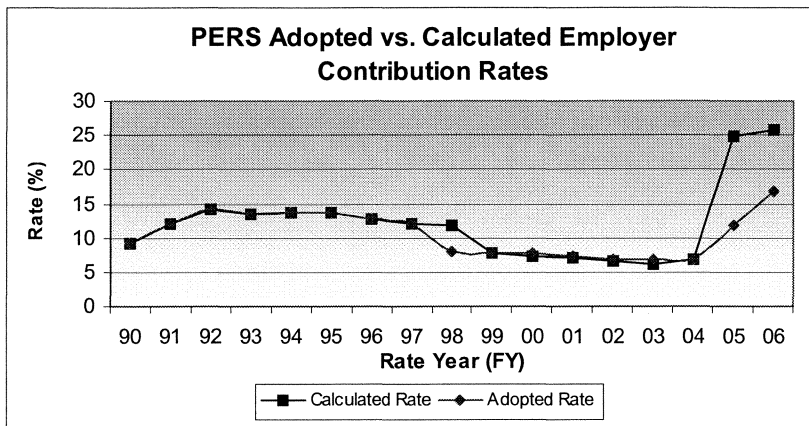
<sup>32</sup> Although the PERS board decreased the employer contribution rate for FY 98 in FY 99, due to the budget process requiring approval by the legislature or the respective local government oversight body, it would have been difficult to increase the rate after it had been adopted by the PERS board and the employers had included it in their approved budget.

<sup>33</sup> Without the reduction, the contribution rates would have been 11.90 percent in FY 98, falling sharply to 4.30 percent in FY 99, and rising to 7.74 percent in FY 00. Lowering the FY 98 rate smoothed the contributions to 8 percent, 7.74 percent, and 7.74 percent.

<sup>34</sup> According to the former consulting actuary, lowering the rate was “*preferable*” to keeping it at 11.90 percent (March 20-21, 1997 PERS Spring Board Meeting minutes).

These higher rates represented an increase in the fund of \$21 million as of June 30, 2003 with a net effect of a \$35 million shortfall, or 0.2 percent decline, in funded status as of June 30, 2003.<sup>35</sup>

**Exhibit 7**



As reflected by the graph in Exhibit 7, the calculated employer rates rose dramatically after FY 04. The PERS board responded

by substantially increasing the adopted employer rate, going from 6.77 to 11.77 percent for FY 05 and on to 16.77 percent for FY 06. While the increases represented more than a doubling over the two years, the calculated rate was approximately 25 percent each year. Although considerably less than the calculated rate, the rates adopted for both years were the maximum allowed by regulation.<sup>36</sup>

- TRS did not adopt the annual actuarially calculated employer contribution, instead a level rate was set as recommended by the consulting actuary

The PERS and TRS boards historically employed different strategies in adopting annual employer contribution rates. The PERS board typically adopted rates equal to or slightly higher than the actuary’s calculated rate, subject to the annual five percent regulatory restriction. In contrast, until recent years, the TRS board sought to maintain a level, long-term contribution rate of 12 percent for participating employers.<sup>37</sup> Such a strategy resulted in the board often adopting rates lower than the actuarial calculated rates.

This approach was endorsed by the TRS Plan’s actuary.<sup>38</sup> In 1991, the consulting actuary stated,

<sup>35</sup> This analysis was provided to DRB by Mercer in a memo dated February 14, 2005.

<sup>36</sup> Regulation 2 AAC 35.900, effective May 17, 1991, states: “The maximum change in the contribution rate for an employer from one year to the next shall be no more than five percentage points, as actuarially calculated, whether the change is an increase or a decrease.” Enactment of Chapter 9, FSSLA 2005 preempted this regulation.

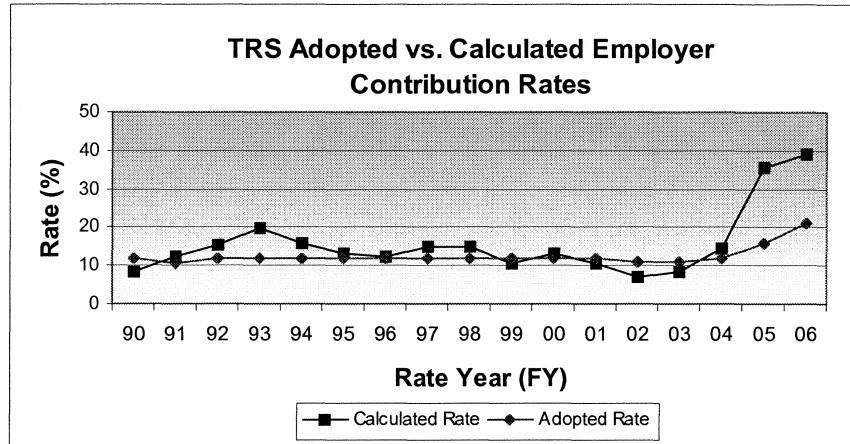
<sup>37</sup> The TRS board adopted this strategy in 1991 for rate years beginning with FY 93. Prior to this, TRS’ policy was to adjust contribution rates for plan changes (e.g. new legislation, ad hoc PRPAs) that occurred during the two-year period between rate adoption and rate implementation. This former practice resulted in “actual” contribution rates, differing from “actuarial” contribution rates, as reflected by the FY 90 through FY 92 rates in Exhibit 8.

<sup>38</sup> Beginning with the July 1, 1991 valuation report through the June 30, 1998 report, the consulting actuary explicitly recommended the level contribution rate of 12 percent for FY 94 through FY 01. Then, in the June 30, 1999 valuation report the 11 percent rate for FY 02 was explicitly recommended by the consulting actuary.

*We are proposing to the Board that sound actuarial principles would support leveling out this [employer] contribution pattern to anticipate the second tier provisions coming into effect. In this way, a more stable contribution pattern could be adopted to help State and school districts better budget retirement expenses.*

**Exhibit 8**

For most years between FY 93 through FY 04, the TRS board maintained the contribution rate at 12 percent.<sup>39</sup> Although the board had no restriction on how much it could change rates, the board opted to limit the increase for FY 05 to 4 percent (raising the total contribution rate to 16 percent) and for FY 06 to 5 percent (making the employer contribution rate 21 percent).



As reflected by the graph in Exhibit 8, above, the actuarial calculated rate for those years exceeded 35 percent. As such, the FY 05 and FY 06 adopted rates covered the Plan’s normal cost projections, with only one-tenth and one-third of the rate contributing to the unfunded liability in FY 05 and FY 06, respectively.

For the 14 years between FY 90 through FY 03, the TRS board adopted rates lower than the actuary’s calculated rates nine times. Such action resulted in an accumulated shortfall of approximately \$242 million. Conversely, the board adopted rates above the calculated rates five times, resulting in an accumulated surplus of \$97 million. The net effect was a \$145 million shortfall as of June 30, 2003 or 2.5 percent decline in the Plan’s funding ratio.<sup>40</sup>

While the TRS board’s level-rate strategy contributed more to the decline in the Plan’s funding ratio than the PERS’ board policy, neither board’s rate-setting decisions – for years prior to FY 05 – played a major role in each Plan’s declining ratios.

<sup>39</sup> As of June 30, 1999 and 2000, the funding ratio had risen to 103 percent and 100 percent and the calculated rates for FY 02 and FY 03 had fallen to 7.09 percent and 8.29 percent, respectively. Given the Plan’s healthy status and the significantly lower calculated rates, the board lowered the adopted rates for FY 02 and FY 03 to 11 percent.

<sup>40</sup> This analysis was provided to DRB by their former actuarial consultant, Mercer, in a memo dated February 14, 2005.

Administrative decisions of oversight boards have had limited impact on Plans' liabilities

In past years, if retirement-plan participants believed they had not received a benefit to which they were due under the terms of their plan, they could appeal to the respective oversight board for redress. The boards, after reviewing the complaint, could reverse a decision made by state agency administrators responsible for TRS and PERS.

In general, we determined that the boards were fiscally conservative in the nature of decisions they reversed – most typically overruling administrative agency decisions related to disability determinations. These rulings were limited to facts of the complaint for the individual involved and had little appreciable impact on subsequent decisions. Such circumscribed decisions limited the exposure of the respective Plan to pay out benefits in situations not originally contemplated when the programs were designed.

Unplanned financial liability to the Plans currently stems from two cases with recent or pending state Supreme Court rulings. The first is the recent court ruling that requires the State to provide benefits to same sex partners of eligible participants in the same manner as is now done for spouses of participants. The court made the ruling on the basis of the equal protection provisions of the state constitution. The ruling has the effect of establishing a new group of prospective beneficiaries to both Plans that were not originally contemplated when the retirement Plans were established. The oversight boards had made no decision in the disputes that served as a basis for this court decision.

The second case involves whether PERS should count the value of personal leave cashed-in when calculating the basis on which benefits are paid. The compensation of the highest three or highest five (depending on the “tier” classification of the retiree) years serves as the basis for calculating retirement benefits. The PERS board ruled that proceeds an individual receives, as payout for unused personal leave, should not be counted in determining annual compensation. The individual, involved, appealed the PERS board’s ruling to the Superior Court, which ruled in favor of the board. The individual is now appealing the case to the state Supreme Court.<sup>41</sup>

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<sup>41</sup> The case, titled *McMullen v. Bell* (State of Alaska), was originally decided by the PERS board in favor of the plaintiff, McMullen. The State appealed and the Superior Court remanded the decision to the PERS board for further fact finding. On remand, the PERS board reversed its earlier decision and ruled against McMullen’s position. McMullen then appealed to the Superior Court, which affirmed the second PERS board decision. McMullen has now appealed to the Alaska Supreme Court. The case has been fully briefed and argued, and is pending decision by the Supreme Court. The case was originally brought as a class action suit in Superior Court. The court declined to certify the class. Instead, the court granted the State’s motion to stay all proceedings pending the outcome of *McMullen v. Bell*. According to DOLaw, in all likelihood, the decision in *McMullen v. Bell* will determine the outcome of the class action.

Regulations with financial effect need to be updated

Certain regulations that financially affect the Plans have not been updated for a number of years. We recommend that the Division of Retirement and Benefits (DRB) review and, as necessary, update the regulations related to both Plans. (See Recommendation No. 1)

Asset allocations more conservative, but investment returns were consistent with other plans

A fundamental responsibility of ASPIB was to annually review the allocation of assets among various investment options in order to maximize return while minimizing risk. To assist with their financial decision making, the investment board worked with three advisors: (1) an external investment consultant – Callan Associates, Inc., (2) the Investment Advisory Council,<sup>42</sup> and (3) Department of Revenue’s Treasury Division staff.

**Exhibit 9**

	Year	Average of 10 Comparable Funds	PERS	TRS
<b>Asset Allocation to Equity</b>	FY 02	58.6%	56.6%	56.5%
	FY 04	63.5%	58.3%	58.1%
<b>Asset Allocation to Fixed Income</b>	FY 02	30.7%	35.5%	35.7%
	FY 04	22.9%	30.7%	30.9%
<b>Return on Assets</b>	FY 02	-7.0%	-5.5%	-5.5%
	FY 04	16.0%	15.1%	15.1%

We reviewed ASPIB’s asset allocation decisions for FY 99 to FY 05. The board consistently adopted the asset allocation recommended by their advisors.

We also compared the equity and fixed income allocations and investment returns of the PERS and TRS to the average of ten other public pension plans of similar asset size. Comparisons were made of the asset allocations and returns during the most recent “bear” market (reflected in FY 02 returns) and during the recovery period (reflected in FY 04 returns).

As reflected in Exhibit 9, PERS and TRS equity allocations were more conservative than the average of the ten comparable plans in our analysis. The boards were also more conservative in investing in fixed income securities. PERS and TRS showed investment returns comparable to the other plans. Most notably, during the substantial FY 02 downturn, both PERS and TRS actually performed slightly better at retaining value compared to the other plans in our group. In FY 04, however, the ten comparable plans slightly outperformed PERS and TRS.

<sup>42</sup> AS 37.10.270 sets up an advisory council made up of between three and five individuals that have “*experience and expertise in financial investments and management of investment portfolios for public, corporate, or union pension benefit funds, foundations, or endowments.*” This council reviews the investments made by ASPIB, makes recommendations concerning investment policy and procedures, advises the board on selection of performance consultants, and provides other advice as requested by the board.

## Two-year lag in setting contribution rates has contributed slightly to unfunded liability

Both TRS and PERS have a two-year lag from the time the actuarial valuation is completed to the time the new rates, based on the valuation, are effective. For example, rates based on the valuation as of June 30, 2004 will not be effective until July 1, 2006. This lag can have a negative impact on each Plan's funding ratio because market conditions or costs may change so quickly, making the contribution rates too low to cover these increasing costs.

A lag exists for public pension plans because rates must be available to allow sufficient time to prepare the budget. In the state government's case, TRS and PERS boards' approved rates must be submitted to the state's Office of Management and Budget by the end of September, in any given year, to be integrated into the budget. This allows only three months to collect and review employer data, complete the valuation, and adopt contribution rates – a process that takes nine months.

According to the Plans' former actuary, a one-to-two year lag is common among public pension plans and 18 months is the most prevalent. In our review of ten state pension plans, we found that half of the plans had rates set by statute. Of the five that did not, three had a one-year lag, one had a two-year lag, and one that set rates for a two-year period had both a one-year and two-year lag.

## Recent state appropriations offset higher contribution rates faced by participating employers

In recent years, the legislature has made appropriations to help employers pay for contribution rate increases. Most significantly, the legislature increased school foundation payments by 18 percent, in large part to compensate for higher TRS and PERS contribution rates faced by school districts.<sup>43</sup> This increase, estimated at over \$70 million for the two years (FY 05 and FY 06), when added to a \$18 million appropriation for local governments<sup>44</sup> and \$15 million in appropriations to the University of Alaska sums to more than \$100 million in state funding provided to help employers pay for the large increases in employer rates.

Essentially, by making such appropriations, the legislature was holding nonstate employers harmless, to some extent, for the higher rates. Although these participating employers are receiving offsetting funding now, it should be noted they also received significant cost savings in previous years when the PERS board cut employer rates substantially. The board cut the FY 98 rate by more than four percent and actuarial rates stayed relatively low for the

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<sup>43</sup> The increase shows up in the higher base student allocation within the foundation formula, which drives state funding for public education. From FY 04 to FY 06, the base student allocation rose 18 percent from \$4,169 to \$4,919. Contained in this increase was more than \$70 million to offset higher contribution rates faced by local school districts for PERS and TRS personnel.

<sup>44</sup> Chapter 3, FSSLA 2005

next seven years through FY 04.<sup>45</sup> These lower rates resulted in cost savings of more than \$232 million for these nonstate government participating employers.

The appropriation methods used by the legislature varied depending on the type of participating employer.

- To assist school districts, the base student allocation for the school foundation formula was raised.
- To assist the University, additional funding was provided through two appropriations that were combined with other budget request items.
- To assist local governments, a direct appropriation to DOA, DRB, was made on their behalf.

Given the relatively volatile nature of the employer contribution rates, the legislature should consider using separate appropriations or allocations when contributing to the nonstate government participating employers. This would allow the legislature to better track supplemental amounts appropriated for the recently rising contribution rates. This type of tracking is beneficial because, in the long run, employer contribution rates will both rise and fall.

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<sup>45</sup> For FY 98, the PERS board lowered the average employer rate from the FY 97 rate of 12.1 percent to 8 percent. The board lowered the rate again for FY 99 to 7.74 percent, for FY 01 to 7.4 percent, then to 6.75 percent for FY 02 through FY 04.



# FINDINGS AND RECOMMENDATIONS

## Recommendation No. 1

The director of the Division of Retirement and Benefits (DRB) should review and update the Public Employees' Retirement System's and the Teachers' Retirement System's (Plans) regulations.

Certain regulations that financially affect the Plans have not been updated for a number of years. According to DRB staff, the division has contracted with a former assistant attorney general to review the existing Plans' statutes and regulations and provide potential revisions to the commissioner of the Department of Administration early in 2006. We recommend that this review includes the following:

- The mortality table, used to factor the amount of reduction in an employee's monthly retirement to provide a surviving spouse or dependent with a continued monthly benefit, has not been updated to a newer table. Currently, the regulations for both Plans use the outdated 1984 UP84 Unisex Pension Mortality Table rather than the 1994 Group Annuity Mortality Basic Table adopted in 2002 to calculate the Plans' liabilities. The effect of not updating the regulation has increased liabilities by paying too high of retirement benefits to employees who have chosen an option to provide benefits to a spouse or dependent in the event of the retiree's death.
- Interest paid on employee contribution accounts under the Plans was last set at 4.5 percent in 1974. This amount of interest has been paid to the employee contribution accounts even when both Plans' rates of return on investments were negative.
- Repayment of indebtedness on an employee's contribution account includes interest paid by the employee. Both Plans have had the interest rate on indebtedness set at seven percent since 1974.

In order to limit the liabilities of the Plans and to maintain the actuarial soundness of each retirement Plan, regulations should be reviewed and, as necessary, updated at least annually.

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# **APPENDICES**

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## APPENDIX A

### Legislation Affecting the PERS Plan For the Period 1986 through 2004

#### Chapter 82, SLA 1986 – Creates PERS Tier II and makes other changes

Tier II changes applied to new hires on or after July 1, 1986:

- Normal retirement age increased from 55 to 60 years of age and early retirement age increased from 50 to 55 years of age. This delayed the start of pension benefits by five years, thus decreasing pension costs.
- Retirees under 60 years old must pay full premium of medical coverage; 60 years old but under 65 years of age must pay one-half of the premium; and those retirees 65 years or older or disabled members received system-paid premium medical coverage. (Previously all retirees' medical premiums were system-paid.)

Changes made to retirement plan that *increased costs*:

- Automatic post pension retirement adjustments added to the plan. (Previously, only ad hoc post pension retirement adjustments were included.)
- Benefit calculation formula for service years earned after July 1, 1986 increased retiree benefits by raising percentage for second 10 years of service to 2.25 percent and 2.50 percent for all years earned thereafter. (Previously, all service years were calculated at 2 percent.)

Change made to retirement plan that *decreased costs*:

- Age requirement to receive Alaska cost-of-living adjustment restricted to retirees 65 years or older or disabled members regardless of age. (Previously, all retirees who remained domiciled in Alaska received the Alaska cost-of-living adjustment, regardless of age.)

Change made to retirement plan that *increased contributions*:

- Employees' contribution rates increased by 2.5 percent for police and fire and other employees, school district employee contribution rate increased by 5.35 percent.

## APPENDIX A

### Legislation Affecting the PERS Plan For the Period 1986 through 2004 (continued)

#### Chapter 4, FSSLA 1996 – Creates PERS Tier III

Tier III changes applied to: Retirement benefit recipients whose benefits were based on membership beginning after July 1, 1996:

- Retirees, except for disabled retirees, with less than 10 years of service, regardless of age, were required to pay the full premium for medical coverage. This decreased medical costs to the Plan by restricting system-paid medical premiums to those with 10 years or more of credited service.

Changes made to retirement plan that *decreased costs*:

- Benefit calculation formula's average salary basis changed from high consecutive three years to high consecutive five years for all retirees first hired on or after July 1, 1996.
- Actuarial adjustment for early retirement defined in statute as one-half of one percent per month every month retiree is less than normal retirement age.

#### Chapter 57, SLA 2001 – Expands system-paid medical coverage *increasing costs*

Change applied to new hires on or after July 1, 1986 but before July 1, 1996:

- Retirees 60 years of age or older or any age with 25 years (fire and peace officers) or 30 years of credited service received system-paid premium medical coverage. This provided system-paid medical coverage five years earlier.

Change applied to new hires on or after July 1, 1996:

- Retirees 60 years of age or older with at least 10 years of credited service or any age with 25 years (fire and peace officers) or 30 years of credited service received system-paid premium medical coverage. This provided system-paid medical coverage five years earlier.

#### Chapter 59, SLA 2002

Change in the average salary of peace officers and fire fighters *increases costs*:

- Benefit calculation formula's average salary basis changed from high consecutive five years for all retirees first hired on or after July 1, 1996 to high consecutive three years, regardless of hire date.

## APPENDIX B

### Legislation Affecting the TRS Plan For the Period 1986 through 2004

#### Chapter 97, SLA 1990 - Creates Tier II and makes other changes

Tier II changes applied to new hires on or after July 1, 1990:

- Normal retirement age increased from 55 to 60 years of age and early retirement age increased from 50 to 55 years of age. This delayed the start of pension benefits by five years, thus decreasing pension costs.
- Retirees under 60 years old must pay full premium of medical coverage; 60 years old but under 65 years of age must pay one-half of the premium; and those retirees 65 years or older or disabled members received system-paid premium medical coverage. (Previously all retirees' medical premiums were system-paid.)

Changes made to retirement plan that *increased costs*:

- Automatic post-pension retirement adjustments added to the plan. (Previously only ad hoc post-pension retirement adjustments were included.)
- Benefit calculation formula for service years earned after June 30, 1990 and that are more than 20 years of total credited service increased retiree benefits by increasing the percentage for those years of service greater than 20 years to 2.5 percent. (Previously all service years were calculated at 2 percent.)

Change made to retirement plan that *decreased costs*:

- Age requirement to receive Alaska cost-of-living adjustment restricted to retirees 65 years or older or disabled members domiciled in Alaska regardless of age. (Previously all retirees received the Alaska cost-of-living adjustment regardless of age.)

Change made to retirement plan that *increased contributions*:

- Employees' contribution rates increased by 1.65 percent beginning January 1, 1991.

#### Chapter 57, SLA 2001 – Expands system-paid medical coverage *increasing costs*

Retirees 60 years of age or older or any age with 25 years of credited service received system-paid premium medical coverage. This provided system-paid medical coverage five years earlier for retirees.

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Appendix C  
Comparison of the State of Alaska Public Employees' Retirement System with Other Pension Plans

Plan Description	Funding Method
<p>State of Alaska Public Employees' Retirement System (PERS) is an agent, multiple-employer public employee retirement system established under Title 39.35 of the Alaska Statutes.</p> <ul style="list-style-type: none"> <li>• Members are state and local government employees (including peace officer and fire employees and excluding teacher or other certified academic employees). As of June 30, 2004 there were 71,009 members.</li> <li>• PERS' consulting actuary is Mercer Human Resource Consulting, Inc.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 7.5% for peace officer and fire employees and 6.75% for all other employees. (AS 39.35.160)</li> <li>2. Employer contribution rate is actuarially determined for both normal and past service costs.</li> <li>3. Assumed investment rate of return is 8.25% per annum for actuarial projections.</li> </ol>
<p>The Arizona Public Safety Personnel Retirement System (PSPRS) is an agent multiple-employer public employee retirement system established by Title 39, chapter 5, article 4 of the Arizona Revised Statutes.</p> <ul style="list-style-type: none"> <li>• Members are public safety employees of certain state and local governments. As of June 30, 2004 there were 23,584 members.</li> <li>• PSPRS' consulting actuary is Rodwan Consulting Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 7.65% of compensation. (A.R.S. 38-843 C)</li> <li>2. Employer contribution rate is actuarially determined for both normal and past service costs with a statutory floor set at 2%. (Floor increased to 5% with session law 2005, Chap. 208 effective July 1, 2006)</li> <li>3. Assumed investment rate of return of 9.00% per annum is for actuarial projections. (Rate decreased July 1, 2004 to 8.75% with subsequent annual reductions of .25 % until the rate is reduced to 8.00%)</li> </ol>
<p>Virginia Retirement System (VRS) is a mixed agent and cost-sharing, multiple-employer retirement plan.</p> <ul style="list-style-type: none"> <li>• Members are state employees, teachers and public school board employees, employees of participating political subdivisions, and other qualifying employees. As of June 30, 2004 there were a total of 305,477 members.</li> <li>• VRS' consulting actuary is Gabriel, Roeder, Smith &amp; Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 5.0% of compensation. (COV 51.1 – 144)</li> <li>2. Employer contribution rate is actuarially determined for both normal and past service costs.</li> <li>3. Assumed investment rate of return is 8.00% per annum for actuarial projections.</li> </ol>

Appendix C  
Comparison of the State of Alaska Public Employees' Retirement System with Other Pension Plans

<p>Michigan State Employees Retirement System (MSERS) is a cost sharing, multiple-employer, statewide, defined benefit plan.</p> <ul style="list-style-type: none"> <li>• Members are state (civil) employees as well as appointed officials of the executive branch of state government and employees of both the legislative and judicial branches of state government. As of September 30, 2004 there were a total of 80,395 members. MSERS is a closed plan. All employees hired on or after March 31, 1997 are enrolled in a 401(k) defined contribution plan. During FY 98, the Michigan State Employees' Retirement Act provided members an opportunity to transfer to the defined contribution plan. This was a one-time opportunity and the decision was irrevocable. The transfer had to be completed by September 30, 1998.</li> <li>• MSERS' consulting actuary is The Segal Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employees do not contribute to the defined benefit retirement plan except for purchase of past service credit.</li> <li>2. Employer contribution rate is actuarially determined in accordance with the actuarial reserve funding provisions of the Michigan Compiled Law 38.1 et seq.</li> <li>3. Assumed investment rate of return is 8.00% per annum for actuarial projections.</li> </ol>
<p>Louisiana State Employees' Retirement System (LASERS) is a single employer defined benefit pension plan.</p> <ul style="list-style-type: none"> <li>• Members are state officers and employees. As of June 30, 2004 there were a total of 137,719 members.</li> <li>• LASERS' consulting actuary is Hall Actuarial Associates.</li> </ul>	<ol style="list-style-type: none"> <li>1. Louisiana Revised Statute (RS), Title 11.62 sets the employee contribution rates from 7.5% to 9.5% depending on the covered group of employees.</li> <li>2. Louisiana RS 11.102 provides that for each fiscal year, commencing with FY 90, for each of the public retirement systems, the legislature shall set the required employer contribution rate equal to the actuarially required employer contribution.</li> <li>3. Assumed investment rate return is 8.25% per annum for actuarial projections.</li> </ol>

Appendix C  
Comparison of the State of Alaska Public Employees' Retirement System with Other Pension Plans

State/ Plan Name	2001 and 2002 Investment Losses	Asset Valuation Method	As of June 30, 2004			Amortization Method of UAAL
			Market Value of Plan Net Assets	Actuarial Value of Plan Net Assets	Unfunded Actuarial Accrued Liability (UAAL)	
Alaska PERS <sup>46</sup>	\$659 million	5-year smoothing <sup>47</sup>	\$5.9 billion	\$5.8 billion	\$940 million	25-year fixed period as a level percentage of pay
Arizona PSPRS	\$1.6 billion	Rolling 7-year average	\$4.3 billion	\$4.8 billion	\$393 million (increased to \$1.1 billion as of June 30, 2005)	Rolling 20-year period as a percentage of pay
Virginia VRS	\$5.6 billion	5-year smoothing	\$37.8 billion	\$39.7 billion	\$4.3 billion	Closed 30-year as a level percentage of pay
Michigan MSERS	\$2.3 billion	5-year smoothing	\$9.4 billion	\$10.2 billion	\$1.9 billion	32-year period as a percentage of pay (decreased to a 31-year period for 2005 valuation)
Louisiana LASERS	\$748 million	4-year weighted average	\$6.6 billion	\$6.1 billion	\$4.1 billion	Set by law – remaining years of amortization 25 years (Legislation effective July 2004 increased remaining years between 24 and 30 years.)

<sup>46</sup> The amounts reported for PERS excludes health care assets and liabilities.

<sup>47</sup> All net investment losses accumulated as of June 30, 2002 were recognized, the actuarial value of assets was decreased and the unfunded liability increased, and the asset valuation methodology was changed to a 5-year smoothing methodology beginning with the June 30, 2003 valuation.

Appendix C

Comparison of the State of Alaska Public Employees' Retirement System with Other Pension Plans

**Comparison of Funding Ratio**

Fiscal Year	State of Alaska PERS System Funding Ratios <sup>48</sup>			Comparable State's Pension Only Funding Ratios			
	Total PERS Funding Ratio	PERS Health Care Ratio	PERS Pension	Arizona Pension	Virginia Pension	Michigan Pension	Louisiana Pension
2000	101.1%	96.8%	102.8%	124.7%	105.4%	109.1%	74.7%
2001	100.9%	96.0%	103.0%	126.9%	107.3%	107.6%	74.2%
2002	75.2%	56.1%	86.8%	113.0%	101.8%	98.7%	70.2%
2003	72.8%	50.9%	87.4%	93.6%	96.4%	84.5%	66.2%
2004	70.2%	47.7%	86.0%	92.4%	90.3%	84.5%	59.3%

**Comparison of Employer Rates**

Fiscal Year	State of Alaska PERS System Employer Rates <sup>49</sup>			Comparable State's Pension Only Employer Rates			
	Total PERS Employer Rate	PERS Health Care	PERS Pension	Arizona Pension	Virginia Pension	Michigan Pension	Louisiana Pension
2000	7.74%	2.11%	5.63%	5.21%	12.2%	5.4%	12.3%
2001	7.40%	2.12%	5.28%	5.21%	10.7%	5.2%	13.0%
2002	6.75%	1.94%	4.81%	4.21%	8.0%	4.1%	13.0%
2003	6.75%	2.00%	4.75%	3.75%	7.7%	4.3%	14.1%
2004	6.77%	2.01%	4.76%	7.66%	8.8%	5.5%	15.8%

<sup>48</sup> The allocation of the funding ratio between the actuarial value of pension assets and healthcare assets is the same proportion as the market values of those assets as presented in the actuarial valuations.

<sup>49</sup> The allocation of the employers' contribution rate between the pension costs and healthcare is the same proportion of actuarial accrued liabilities for each category as presented in the actuarial valuations which established the rate for the particular fiscal year.

Appendix D  
Comparison of the State of Alaska Teachers' Retirement System with Other Pension Plans

Plan Description	Funding Method
<p>State of Alaska Teachers' Retirement System (TRS) is a cost-sharing, multiple-employer public employee retirement system established under AS 14.25.</p> <ul style="list-style-type: none"> <li>• Members are certified teachers, university teaching staff, and other employees with academic standing in the State. As of June 30, 2004, there were 19,119 members.</li> <li>• TRS' consulting actuary for the June 30, 2004 actuarial valuation was Mercer Human Resource Consulting, Inc.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 8.65% of base salaries. (AS 14.25.050)</li> <li>2. Employer contribution rate is actuarially determined for both normal and past service costs. (AS 14.25.070)</li> <li>3. Assumed investment rate of return is 8.25% per annum for actuarial projections.</li> </ol>
<p>The Arkansas Teacher Retirement System (ATRS) is a cost-sharing, multiple-employer, combination contributory/non-contributory defined benefit pension plan established under Arkansas Code (ARC) Chapter 24.</p> <ul style="list-style-type: none"> <li>• Members are teachers and other educationally related employees as defined by ACT 427 of 1973, as amended. As of June 30, 2004, there were 108,316 members.</li> <li>• ATRS' consulting actuary is Gabriel, Roeder, Smith &amp; Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 6% of gross earnings or \$7,800, whichever applies. Members' contributions before July 1, 1969 shall be in accordance with the provisions in force before July 1, 1969. (ARC 24-7-406(b)(2), (3) and (4))</li> <li>2. Employer contribution rate is actuarially determined for both normal and past service costs with statutory ceilings for FY 06 and FY 07 of 14% and 15%, respectively. (ARC 24-7-401)</li> <li>3. Assumed investment rate of return is 8.00% per annum for actuarial projections.</li> </ol>
<p>The North Dakota Teachers' Fund for Retirement (TFFR) is a cost-sharing, multiple-employer defined benefit pension plan established under North Dakota Century Code (NDCC) chapter 15.39.</p> <ul style="list-style-type: none"> <li>• Members are all public teachers and certain other teachers who meet various membership requirements. As of June 30, 2004, there were 16,720 members.</li> <li>• TFFR's consulting actuary is Gabriel, Roeder, Smith &amp; Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 7.75% of gross earnings. (NDCC chapter 15-39.1-09)</li> <li>2. Employer contribution rate is set by law at 7.75% of member's gross earnings. (NDCC chapter 15-39.1-09)</li> <li>3. Assumed investment rate of return is 8.00% per annum for actuarial projections.</li> </ol>

Appendix D  
Comparison of the State of Alaska Teachers' Retirement System with Other Pension Plans

<p>Montana Teachers' Retirement System (MTRS) is a mandatory multiple-employer, cost-sharing defined benefit pension plan established under Montana Code Annotated (MCA) Title 19, chapter 20.</p> <ul style="list-style-type: none"> <li>• Members are persons employed in Montana as teachers or professional staff of any public elementary or secondary school, community college or unit of the university system. As of June 30, 2004, there were 30,246 members.</li> <li>• MTRS' consulting actuary is Milliman Consultants and Actuaries.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 7.15% of the member's annual compensation. Employers shall pick-up and pay member contributions. (MCA, Title 19, chapter 20-602)</li> <li>2. Employer contribution rate is set by law at 7.47% of member's annual compensation. (MCA, Title 19, chapter 20-605)</li> <li>3. Assumed investment rate of return is 7.75% per annum for actuarial projections.</li> </ol>
<p>OKTRS is a mandatory/nonmandatory multiple-employer, cost-sharing defined benefit pension plan established under Oklahoma Statutes (OS) Title 70.</p> <ul style="list-style-type: none"> <li>• Members are persons employed by state-supported education institutions. As of June 30, 2004, there were 134,728 members.</li> <li>• OKTRS' consulting actuary is Gabriel, Roeder, Smith &amp; Company.</li> </ul>	<ol style="list-style-type: none"> <li>1. Employee contribution rate is set by law at 7.00% of the member's annual compensation. (OS Title 70)</li> <li>2. Employer contribution rate is set by law (OS Title 70, sect.17-108-1 ) as follows: <ul style="list-style-type: none"> <li>▪ July 1, 1999 through June 30, 2000 4.8%</li> <li>▪ July 1, 2000 through June 30, 2001 5.8%</li> <li>▪ July 1, 2001 through June 30, 2002 6.8%</li> <li>▪ July 1, 2002 through June 30, 2003 7.05%</li> <li>▪ For each year after June 30, 2003 7.05%</li> </ul> </li> <li>3. The state contributes from its General Fund an amount equal to 3.25% of dedicated taxes beginning in 2000 and increases to 3.5% for each year thereafter.</li> <li>4. Assumed investment rate of return is set by law at 7.5% per annum for actuarial projections</li> </ol>

Appendix D  
Comparison of the State of Alaska Teachers' Retirement System with Other Pension Plans

State/ Plan Name	2001 and 2002 Investment Losses	Asset Valuation Method	Market Value of Plan Net Assets	As of June 30, 2004		Amortization Method of UAAL
				Actuarial Value of Plan Net Assets	Unfunded Actuarial Accrued Liability (UAAL)	
Alaska TRS <sup>50</sup>	\$384 million	5-year smoothing <sup>51</sup>	\$3.2 billion	\$3.1 billion	\$1.1 billion	25-year fixed period as a level percentage of pay
Arkansas ATRS	\$677 million	4-year smoothed market with 80%/120% corridor	\$8.1 billion	\$8.4 billion	\$1.6 billion	31-year level percentage of pay
North Dakota TFFR	\$217 million	5-year smoothing	\$1.4 billion	\$1.5 billion	\$354.8 million	20-year level percentage of pay <sup>52</sup>
Montana MTRS	\$279 million	5-year smoothing	\$2.4 billion	\$2.5 billion	\$873.5 million <sup>53</sup>	Infinite <sup>54</sup>
Oklahoma OKTRS	\$470 million	5-year smoothing	\$7.0 billion	\$6.7 billion	\$7.4 billion	Infinite <sup>55</sup>

<sup>50</sup> The amounts reported for TRS excludes health care assets and liabilities.

<sup>51</sup> All net investment losses accumulated as of June 30, 2002 were recognized, the actuarial value of assets was decreased and the unfunded liability increased, and the asset valuation methodology was changed to a 5-year smoothing methodology beginning with the June 30, 2003 valuation.

<sup>52</sup> Beginning with FY 05 the UAAL amortization period was increased by the board to a 30-year period.

<sup>53</sup> The UAAL as of June 30, 2005 increased to \$1.0 billion.

<sup>54</sup> An increase in the ECR of 2.87% would need to be implemented to maintain an amortization period of 30-years.

<sup>55</sup> Current employer rates set by statute do not provide sufficient contributions to amortize the UAAL within the statutory requirement of 30-years.

Appendix D  
Comparison of the State of Alaska Teachers' Retirement System with Other Pension Plans

**Comparison of Funding Ratio**

Fiscal Year	State of Alaska TRS System Funding Ratio <sup>56</sup>			Comparable State's Pension Only Funding Ratio			
	Total TRS Funding Ratio	TRS Health Care Ratio	TRS Pension Ratio	Arkansas Pension	North Dakota Pension	Montana Pension	Oklahoma Pension
2000	99.6%	94.2%	115.9%	96.7%	101.6%	84.7%	53.7%
2001	95.0%	88.2%	96.7%	95.4%	96.4%	N/A <sup>57</sup>	51.4%
2002	68.2%	48.5%	75.4%	91.9%	91.6%	83.4%	51.4%
2003	64.3%	43.3%	72.5%	85.9%	85.1%	N/A	54.0%
2004	63.9%	38.5%	73.8%	83.8%	80.3%	74.0%	47.3%

**Comparison of Employer Rates**

Fiscal Year	State of Alaska TRS System Employer Rates <sup>58</sup>			Comparable State's Pension Only Employer Rates			
	Total TRS Employer Rate	TRS Health Care Rate	TRS Pension Rate	Arkansas Pension	North Dakota Pension	Montana Pension	Oklahoma <sup>59</sup> Pension
2000	12.0%	2.1%	9.9%	12%	7.75%	7.58%	4.8%
2001	12.0%	2.2%	9.8%	12%	7.75%	7.58%	5.8%
2002	11.0%	2.0%	9.0%	12%	7.75%	7.58%	6.8%
2003	11.0%	2.2%	8.8%	12%	7.75%	7.58%	7.05%
2004	12.0%	2.5%	9.5%	13%	7.75%	7.58%	7.05%

<sup>56</sup> The allocation of the funding ratio between the actuarial value of pension assets and healthcare assets is the same proportion as the market values of those assets as presented in the actuarial valuations.

<sup>57</sup> Prior to FY 04, Montana's actuarial valuations were done biannually.

<sup>58</sup> The allocation of the employers' contribution rate between the pension costs and healthcare is the same proportion of actuarial accrued liabilities for each category as presented in the actuarial valuations which established the rate for the particular fiscal year.

<sup>59</sup> The Oklahoma Teachers' Retirement System is one of the five worst funded pension plans. The state legislature recognized this problem in 1998 and passed SB 1037 requiring the state to contribute 3.25% of dedicated taxes in 2000 and 3.5% for the years thereafter to the plan. Between FY 00 and FY 04 the state contributed approximately \$932 million in addition to the employees' and employers' contributions.



# STATE OF ALASKA

FRANK H. MURKOWSKI, GOVERNOR

## DEPARTMENT OF ADMINISTRATION

OFFICE OF THE COMMISSIONER

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April 26, 2006

Pat Davidson  
Legislative Auditor  
Division of Legislative Audit  
P. O. Box 113300  
Juneau, AK 99811-3300

RECEIVED  
APR 26 2006  
LEGISLATIVE AUDIT

Dear Ms. Davidson:

Re: Departments of Administration and Revenue Public Employee's Retirement System,  
Teachers' Retirement System, and Alaska State Pension Investment Board

Thank you for the opportunity to provide the following response to the recommendation in the preliminary audit report referenced above.

### Recommendation No. 1

The director of the Division of Retirement and Benefits should review and update the Plans' regulations.

On November 9, 2005, the Division began the aforementioned process. The Division hired a former attorney general to review all of the PERS and TRS regulations and to draft new regulations for the defined contribution plans for PERS and TRS in accordance with SB 141 enacted by the 24<sup>th</sup> Legislature.

It was recommended that regulations for PERS and TRS be reviewed annually. Three specific regulations were identified in the audit report and are listed below with a response from the Division noted thereafter.

1. The mortality table used to factor the amount of reduction in an employee's monthly retirement to provide a surviving spouse or dependent with a continued monthly benefit has not been updated to a newer table. Currently, the regulations for both Plans use the outdated 1984 UP84 Unisex Pension Mortality Table rather than the 1994 Group Annuity Mortality Basic Table adopted in 2002 to calculate the Plans' liabilities. The effect of not updating the regulation has increased liabilities by paying too high of retirement benefits to employees who have chosen an option to provide benefits to a spouse or dependent in the event of the retiree's death.



The Division concurs with the recommendation and will take action to revise this regulation. However, it is important to note that the changes can only be made to members' benefits prospectively in accordance with the Alaska Supreme Court case noted below.

The PERS and TRS are constrained by Article XII, sec. 7 of the Alaska Constitution from making changes to existing plan provisions that would diminish or impair member benefits. The article provides:

***Retirement Systems.** Membership in employee retirement systems of the State or its political subdivisions shall constitute a contractual relationship. Accrued benefits of these systems shall not be diminished or impaired.*

The Alaska Supreme Court has held in *Hammond v. Hoffbeck*, 627 P.2d 1052 Alaska 1981, that rights under the state's retirement systems vest on employment and enrollment in the system. They reasoned that retirement benefits are an element of the bargained-for consideration given to an employee in exchange for the employee's assumption and performance of employment.

In *Sheffield v. APEA* 732 P.2d 1083 Alaska 1987 the Alaska Supreme Court determined an application of different actuarial factors that resulted in lower final benefit calculations was a diminishment of benefits as defined by *Hammond v. Hoffbeck*. As a result, members are entitled to the best set of factors that have been in effect during their membership in the retirement systems.

With the constitutional constraint, changes as proposed in the report recommendations that may act to reduce benefits can only be applied to members of the retirement systems who enter on or after the effective date of the change.

2. Interest paid on employee contribution accounts under the Plans was last set at 4.5 percent in 1974. This amount of interest has been paid to the employee contribution accounts even when both Plans' rate of return on investments was negative.

The interest setting function has been moved in SB 141 from the ASPIB Board (dissolved) to the newly created Alaska Retirement Management (ARM) Board effective October 1, 2005. The recommended interest paid on member contribution accounts governed under regulations 2 AAC 35.820 (PERS) and 2 AAC 36.150 (TRS), to reflect changes in the Plans rate of return on investment shall be forwarded to the ARM Board for consideration.

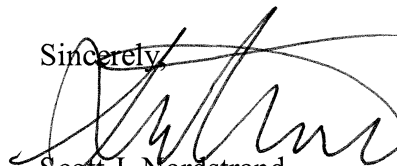
3. Repayment of indebtedness on an employee's contribution account includes interest paid by the employee. Both Plans have had the interest rate on indebtedness set at 7 percent since 1974.

The Division concurs with the recommendation and will take action to revise this regulation. However, it is important to note that the Alaska Supreme Court case noted above may affect

the Division's ability to change the interest rate on indebtedness balances established prior to the change.

Thank you again for the opportunity to respond to your recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read "Scott J. Nordstrand", written over the word "Sincerely,".

Scott J. Nordstrand  
Commissioner

cc: Kevin Brooks  
Deputy Commissioner

Eric Swanson, Director  
Division of Administrative Services

Melanie Millhorn, Director  
Division of Retirement and Benefits

Tom Boutin, Deputy Commissioner  
Division of Treasury  
Department of Revenue

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# STATE OF ALASKA

## DEPARTMENT OF REVENUE

OFFICE of the COMMISSIONER

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April 25, 2006

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MAY - 1 2006

LEGISLATIVE AUDIT

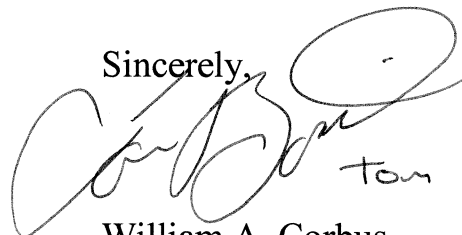
Danna Moser  
In-Charge Auditor  
Legislative Budget and Audit Committee  
Division of Legislative Audit  
P.O. Box 113300  
Juneau, AK 99811-3300

Dear Ms. Moser:

RE: April 5, 2006 confidential preliminary audit report on Department of Administration and Revenue, Public Employees' Retirement System, Teachers' Retirement System, and Alaska State Pension Investment Board, Selected Issues, December 30, 2005

I can find no material differences of fact in your preliminary audit report. We have no facts or background which are substantively different from your discovery and conclusions. Everyone in state government will have better facts as new information, including updated actuarial information from new actuaries and reflecting SB 141, becomes available. Thank you for a very thorough look at this matter.

Sincerely,



William A. Corbus  
Commissioner of Revenue

Tom Bostin for  
Bill Corbus

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# Alaska Retirement Management Board

P.O. Box 110405  
Juneau, Alaska 999811-0405  
(907) 465-3749

May 18, 2006

RECEIVED  
MAY 18 2006  
LEGISLATIVE AUDIT

Pat Davidson, Legislative Auditor  
Legislative Budget & Audit Committee  
Division of Legislative Audit  
PO Box 113300  
Juneau, AK 99811-3300

Dear Ms. Davidson:

As Chair of the Alaska Retirement Management Board (ARMB), I am responding to your letter of April 5, 2006 requesting a written and electronic response to the preliminary audit report on: *Departments of Administration and Revenue, Public Employees' Retirement System, Teachers' Retirement System, and Alaska State Pension Investment Board, Selected Issues, December 30, 2005*. The ARMB's response to the report is set forth below.

(1) Recommendation No. 1: The director of the Division of Retirement and Benefits (DRB) should review and update the Public Employees' Retirement System's and the Teachers' Retirement System's (Plans) regulations. The ARMB has been advised by DRB and its contract attorney that a complete review of regulations in light of the passage of SB141 is underway. This legislation also assigned regulatory authority to ARMB, and the board and its staff have worked in conjunction with DRB staff to ensure that all regulations are in place as required.

(2) Recommendation No. 1, second bullet point: Interest paid on employee contribution accounts under the Plans was last set at 4.5 percent in 1974. This amount of interest has been paid to the employee contribution accounts even when both Plans' rates of return on investments were negative. At its June 14-15, 2006 meeting, the ARMB will review and set the interest rate on employee contribution accounts. Under SB141, this interest rate is set by the board, not by regulation.

(3) Report Conclusions: Decreases in funding ratios were primarily due to investment losses and rising medical costs. The board respectfully disagrees with this statement. This phrase reflects unfairly on the prior board and staff by highlighting investment returns during a four-year period and ignoring investment performance that over the long run exceeded the actuarially required rate. Further, the information set forth on page 17 in support of the conclusion shows that in fact investment losses accounted for 33% of the decline for PERS and 28% for TRS. Medical costs, assumption changes, asset valuation changes and plan experience contributed 67% and 72% of the decline respectively. Neither the ARMB nor the prior board had any control over those contributing factors.

The ARMB appreciates the opportunity to comment on this preliminary audit report.

Sincerely,



Gail R. Schubert, Chair



# ALASKA STATE LEGISLATURE

## LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



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May 19, 2006

Members of the Legislative Budget  
and Audit Committee

We have reviewed the responses to our preliminary audit report. Nothing contained in these responses gives us cause to reconsider the report conclusions or findings. However, we want to clarify a part of the report referred to in the response from the Alaska Retirement Management Board (ARMB).

The board, in its response, took exception to our conclusion that "Decreases in funding ratios were primarily due to investment losses and rising medical costs." The board believes this statement reflects unfairly on the performance of the prior board members of the Alaska Pension Investment Board and the Department of Revenue staff. We disagree.

The objectives of this report regarding ASPIB were limited to determining the extent to which they followed their advisors' recommendations in adopting the Plans' asset allocation. Also, to compare the Plans' asset allocations and investment returns to other state public pension plans. Our conclusions regarding those objectives are reported on page 24.

Actual investment gains and losses result from multiple factors, including such items as general stock market fluctuations, changing interest rates, and investment strategies. However, we did no analysis and drew no conclusions regarding any individual causal factor of investment losses.

Sincerely,

A handwritten signature in black ink that reads "Pat Davidson". The signature is fluid and cursive, with a long horizontal stroke at the end.

Pat Davidson  
Legislative Auditor