

Alaskan Public Pension Coalition

White Paper

Returning Alaska to a Defined Benefit System:
A Benefit for Alaskans and a Savings for the State



February 2010

Table of Contents

Executive Summary	2
Introduction.....	4
The Alaskan Public Pension Coalition	5
Historical Perspective	5
Underfunding Becomes an Issue	7
How Mercer Consulting Created the Problem.....	8
Privatization Pushed.....	8
Alaska Strips New Public Employees of Retirement Security	10
Managing the Unfunded Liability.....	10
Defined Contribution Plans – What’s the Problem?.....	12
Retention Issues	13
Cost of Training	13
Health Reimbursement Accounts	14
Cost of Living Adjustments (COLA)	15
A Defined Benefit System Costs Less Than a Defined Contribution Plan.....	16
It’s All about Economics: Nebraska’s Experience	18
Keeping Two Systems	19
The Importance of Defined Benefit Systems to Alaska’s Economy	20
Conclusion	20
Appendix.....	22
Endnotes.....	23

Table of Figures

Figure 1: How Alaska's Unfunded Pension Liability was Illustrated in 2005.....	6
Figure 2: White House letter to Alaska Senate President Ben Stevens	16
Figure 3: Value of Employer-Paid Benefits (31-year old new employee)	17



Executive Summary

Returning Alaska to a Defined Benefit System: A Benefit for Alaskans and a Savings for the State

February 2010

The Alaskan Public Pension Coalition (APPC) with more than 30 members representing more than 70,000 working families and 97,000 individual Alaskans is proud to produce this white paper on a critical issue for Alaska: Retirement insecurity in the Great Land.

The APPC was formed to review the impact of the 2005 changes and determine if the State of Alaska would be better served by a return to a Defined Benefit system for public employees. The passage of Senate Bill 141, which eliminated the guaranteed Defined Benefit pension system, was conceived to address the so-called unfunded liability. Unfortunately for Alaska and her employees, the passage of Senate Bill 141 has not produced the desired results and has set in motion a different set of events that will impact the way all Alaskans will live in the future.

The Elimination of Defined Benefit Pensions

- Does not save the state any money
- Impacts recruitment and retention
- Does not address the unfunded liability
- Exposes employers to higher Defined Benefit funding costs in future years
- Will substantially reduce the amount of money future retirees will likely spend in Alaska—if they can afford to retire here
- Will introduce more volatility in Alaska during down markets
- Will result in less cash in the Alaskan economy because retirees will not have cost of living adjustments to help keep pace with inflation
- Will eliminate some of the high rates of return options in the retiree funds, resulting in a lower rate of return in the Defined Contribution plans
- Reduces the benefit of a more diversified, stable, and expanded Alaska economy
- Exposes the state to costs in the future through increased use of social services by retired public employees who have run out of money

Facts Regarding the Unfunded Liability

The unfunded liability is the result of inaccurate actuarial advice given to the state over many years, not the result of generous pensions and health care. The unfunded liability is not the fault of the employees or employers in the system who paid what they were instructed. A lawsuit against the former actuary currently in the courts may recover a portion of the funds needed to make up the unfunded liability.

The unfunded liability has a repayment plan in place through the passage of Senate Bill 125.

Employer payments for past debt, contributions from the state to make up the difference and well managed funds are the tools already in place to address the state's unfunded liability. In addition we have the option of issuing pension obligation bonds if we desire as a result of House Bill 13.

The unfunded liability represents the total obligation the state would have if all debts were payable today- the good news is that it is not payable today. We have a window of 25 years to manage and correct the problem.

A Guaranteed Pension Does Not Cost the State More Than a 401(k)-Style Savings Account

In contrast to widely held notions, the state's actuaries agree that current Tier III PERS and Tier II TRS Defined Benefit employees do not cost the state any more in today's dollars than employees in the far inferior Tier IV PERS and Tier III TRS.

The return on investment for the same dollar invested in a Defined Contribution plan provides inadequate resources for retirees, an inferior health care plan in retirement, disenfranchises spouses and dependents and exposes the state to additional costs in training, recruitment and retention.

The Defined Benefit systems provide stable, predictable income for retirees and the entire Alaska economy. Also since Alaska's public employees have no Social Security, the Defined Benefit system represented the *only* stability for their retirement.

Other States Have Migrated Back to Defined Benefit

After discovering that the change to a Defined Contribution system did not solve the problems of on-going costs or unfunded liabilities and created new and equally complicated problems, most jurisdictions have abandoned the Defined Contribution experiment.

Alaska Will Pay the Price

Inadequately funded retirements and poor health care funding will endanger the retiring worker, and will also expose the State of Alaska to more financial risk. Studies show that poorly funded 401(k)s caused a significant increase in use of social services among the retired. In addition to dependency on government for services, the amount of money moving in the economy will be less as retirees have less overall disposable income. In addition to retirees' having less to spend overall, the lack of a predictable monthly payment leads retirees to spend less when the economy is in trouble. This compounds the boom and bust cycle of the Alaska economy and diverts resources to unnecessary expenses at the cost of needed economic projects.

Traditional pensions are cost effective, result in keeping the best and brightest employees, provide better health care, result in increased and more predictable money circulating in the economy and represent the best return on the state's investment dollar.

Introduction

During a politically charged special session in 2005, the Alaska Legislature, under pressure from the Murkowski Administration, dismantled the public employee retirement pension and health care systems. These were replaced with a Defined Contribution savings account, and an expensive and possibly non-existent retiree health plan. Overnight, Alaska went from having a secure retirement system to having one of the worst in the country. Alaska is one of only 12 states in the nation that does not offer Social Security to its public employees. Social Security is a pension and offers a retirement benefit which cannot be outlived. Without Social Security or a Defined Benefit pension, there is no retirement security for retirees.

The State of Alaska cannot afford to become the training ground for the Lower 48. Without the retirement incentive to stay and build a life in Alaska, we are spending limited state monies to train new employees, only for them to move outside where most public employees have a pension. In light of volatile oil revenues, spending on training new employees is a gamble the State of Alaska can ill afford.

The U.S. Department of Labor estimates recruitment and training costs to be approximately one third to one half of an employee's annual salary. For public safety the numbers are much higher. Alaska-based police and fire fighters report recruitment and training costs in excess of \$100,000 per employee. The portability provision in the Defined Contribution retirement plan encourages trained and experienced public employees to leave Alaska once they are vested.

In addition to retention issues and training costs, the State of Alaska will pay for the change to Defined Contribution accounts in the long run with less disposable, stable income in the economy. In 2006, retiree pensions contributed more than \$1.46 billion to the Alaskan economy, which generated 11,700 jobs. Without the predictable income that pensions provide, many retirees will leave the state, and Alaska's economy will suffer.

For all of the bad things the new Defined Contribution plan created, it doesn't do the two things it was supposed to do: save money and reduce the unfunded liability. The State of Alaska's own actuaries report that there is almost no cost difference between the new Defined Contribution plan and the Defined Benefit system. Since the costs between the two programs are no different, then its proposed ability to reduce the unfunded liability is also overstated.

For Alaskans who spend a lifetime in public service, the new Defined Contribution savings account causes retirement insecurity. Not eligible to participate in Social Security, these retirees will likely outlive what little they have in their Defined Contribution plans and eventually end up on public assistance.

The Defined Contribution plan represents a poor return on the state's investment. It creates higher training costs, turnover, inadequate health care coverage, and a system that gives Alaska's public servants a far inferior outcome for the same amount of money.

The Alaskan Public Pension Coalition

The Alaskan Public Pension Coalition (APPC) was formed in 2007 to review the changes to determine whether they were in the best interest of the State of Alaska. If not, the APPC would educate the decision makers and the public about the true costs of the Defined Benefit system and the Defined Contribution plan. The Alaskan Public Pension Coalition is a partnership of public employee unions and member organizations.¹ The goal of the coalition is to keep Alaska strong by restoring a secure retirement for Alaska's fire fighters, police officers, teachers, and other public employees. The coalition represents more than 70,000 working families and 97,000 individual Alaskans.

APPC is particularly concerned with the affect on employees hired after July 1, 2006 who fall into Tier IV for PERS and Tier III for TRS, the Defined Contribution retirement plan. A Defined Contribution plan provides little retirement security and discourages new employees from making a career in public service or teaching in Alaska. As most of these employees are not allowed to participate in Social Security, Alaska's public employees and teachers are left with no retirement safety net. This situation will have a dramatic impact on the ability of public employers and school districts to recruit and retain the highest quality employees and teachers once the recession subsides.

Historical Perspective

Since statehood Alaska provided a Defined Benefit system with a guaranteed amount of pension in retirement based upon years of service. PERS/TRS also provided guaranteed and adequate health insurance coverage and spousal and dependant coverage, continued pension to a surviving spouse and coverage for any beneficiary who becomes disabled for any reason.

On July 1, 2006, the retirement system for newly hired public employees changed radically. When these Alaskans sign up for local or state employment, they are automatically placed into the Defined Contribution retirement plan for Tier IV Public Employees Retirement System (PERS) or Tier III for teachers the Teachers Retirement System (TRS). In this new plan employees have only the money in the 401(k)-type investments to provide retirement income. There is limited coverage for health insurance which can be terminated on short notice and there is no disability benefit for employees injured off the job.

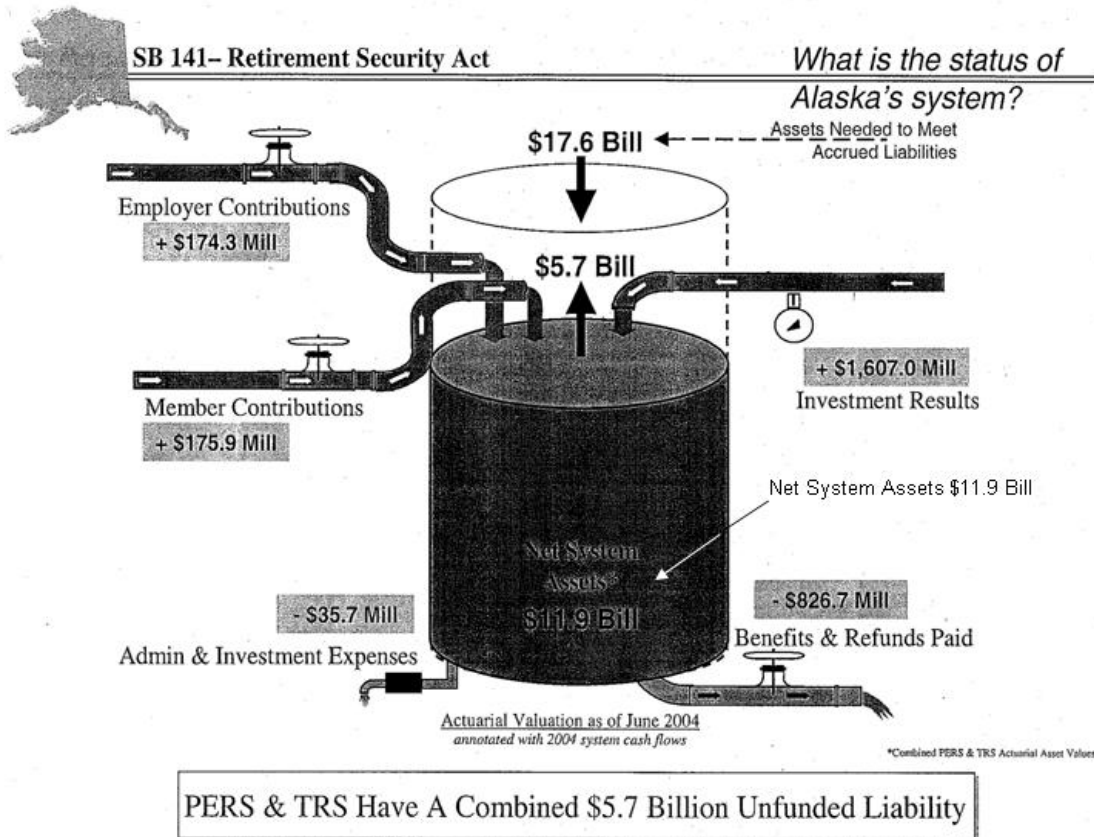
During a special session in 2005, the Alaska State Senate passed Senate Bill 141. The measure ultimately passed the Alaska House of Representatives by a single vote. SB 141 changed the type of retirement offered to public employees from a Defined Benefit system (a pension) to a Defined Contribution plan, or 401(k). This bill was passed under the false premise that the current retirement system (PERS/TRS) was in deep financial trouble and that the Defined Contribution plan would remedy the problem. The argument used to support the change to a 401(k) type retirement plan was the so called "unfunded liability" of the PERS/TRS programs.

¹ See page 22 for a full listing of APPC member organizations.

The debate was contentious. The legislature relied on the advice of Murkowski Administration officials who were advocating the change to Defined Contribution retirement. During that debate the legislature gave little weight to many relevant points, the most important being that we had the ability to “weather the storm.” The situation was not in fact as dire as the administration was predicting. There was \$12.89 billion (net system assets + investment results + member contributions + employer contributions) held in trust accounts for the benefit of employees in the retirement systems (PERS/TRS). Actuaries hired to predict the systems’ costs and earnings estimated that in 30 years, \$17.6 billion would be needed in trust accounts if employers were required to pay all future obligations of the fund today (see graph below). Naturally over that 30 year period investment values would fluctuate up and down and the trust accounts could have grown out of this deficit. Sixty-five to seventy percent of the cost of Defined Benefits comes from investment returns, not from employer or employee contributions. Because of political pressure, the legislature did not comprehend that the retirement trust funds were reasonably healthy and did not need to be radically adjusted.

The following is a graph created and distributed by Senate Finance during the SB 141 debate. These numbers were as of 2005.

Figure 1: How Alaska's Unfunded Pension Liability was Illustrated in 2005



By: The Senate Finance Committee
Date: April 23rd, 2005

Underfunding Becomes an Issue

In 2005, it was reported that the PERS/TRS Trust accounts were underfunded. Retirement system “unfunded liability” in its simplest terms, is defined as holdings in investment trusts in some amount less than 100% of the money that could be needed to cover expected liabilities if future benefits had to be paid in full today. Mercer Consulting, the state’s actuary, provided the state with estimates on future liabilities, but failed to accurately adjust the expected liability through analysis of future needs. Through 2003, Mercer Consulting had not appropriately advised the state to increase employer contribution rates to the trust accounts.² The failure to make the necessary contributions created an unfunded liability. Once the mistake was realized, the State of Alaska’s Division of Retirement and Benefits determined that the PERS/TRS system was \$5.7 billion short of meeting all expected future needs.

However, as late as November 2004, the State of Alaska said on the state web page in their official position paper that through wise investment, PERS/TRS could grow its way out of the deficit and “weather the storm.”³ Drastically changing the retirement system was an overreaction.

This initial episode of common sense may have resulted from reviewing PERS/TRS history and remembering that the pension funds had overcome similar funding ratio problems in the 1980s after just a few years. But the idea that we would weather the storm was abandoned and the Governor and members of the Alaska Legislature began working on a plan to deal with the unfunded liability by privatizing Alaska’s pension system.

The current unfunded liability was a result of bad actuarial advice to the employers. Individual employees contribute at a fixed rate, which has never gone down. The rate for most employees in PERS is 6.75%. The rate is 8.25% for those public employees in the 20 year retirement program designed for high risk and high stress occupations such as police officers. The rate for teachers in TRS is 8.65%. Employees pay their share regardless of changes in value in the PERS/TRS accounts. The employers’ contribution rates, however, was variable based upon investment performance.

Employers were allowed to take advantage of market gains to reduce their contribution rates. As a result of this flexible employer contribution rate, employer rates varied over time. At some point in the 1990s investment performance was so strong that public employers, including the State of Alaska, made minimal contributions to the system. Rising stock prices and increasing property values meant that market gains realized from growth reduced the need for employer contributions. Unfortunately, failure to make full regular and needed contributions by employers to the system created an “unfunded liability” in the trust accounts needed for future retirees. Employer contribution rates were not adjusted upward from the time period of 2000-2005 because of inaccurate actuarial advice and failure to update mortality tables. Therefore, the

² Complaint Case No. 1JU-07-974 CI in Superior Court for the State of Alaska, Alaska Retirement Management Board on behalf of State of Alaska Public Employees’ Retirement System and State of Alaska Teachers’ Retirement System, Plaintiff v. Mercer (US), Inc.

³ Office of the Commissioner, Public Employees’ Retirement System, Teachers’ Retirement System Communication Policy, November 5, 2004.

system could not compensate for rising health care costs and increasing life expectancy. In practice, the longer people live, the more money is needed to be available in the trust accounts. This failure to adjust contribution rates, coupled with a short term downturn in the stock market from 2000-2002 compounded over time created an unfunded liability problem. Employers not investing adequately in the system harmed employees and their dependants and beneficiaries.

How Mercer Consulting Created the Problem

Mercer Consulting worked as the State of Alaska actuary for the PERS/TRS funds for over two decades. In the early 2000s, when their calculations showed PERS dropped from over 100% funded to just 75% funded in one year, many questions were asked. The State of Alaska wisely hired another actuarial firm, Milliman, to do an audit of Mercer's work. Milliman found Mercer made significant mistakes. Besides mathematical errors, Milliman found other troubling practices, including using outdated mortality tables, outdated health care assumptions, incorrect salary assumptions, etc. Mercer Consulting also used some methods in their calculations not used by many actuaries around the U.S. Making these corrections and moving to the new assumptions became part of the underfunding calculation.

After complaints were made about Mercer's work, the Alaska Attorney General's Office and the Alaska Retirement Management (ARM) Board did a careful review of Mercer's work. In May 2009 the ARM Board consulted with respected, specialized outside counsel, who hired the services of expert actuarial and other financial experts. After reviewing the information gathered from this effort, the ARM Board determined there was a very strong basis to believe Mercer Consulting breached its fiduciary duty to the state. A lawsuit was filed and depositions were taken by both parties. Based upon evidence uncovered in deposition, the ARM Board filed an amended complaint alleging actual damages of \$2.8 billion for breach of contract, professional negligence and fraud. Punitive damages and treble damages could potentially raise this figure. The case is set for trial in mid-2010.⁴

Privatization Pushed

In early March 2005, the Murkowski Administration unveiled a plan to dismantle the pension retirement system in Alaska in favor of a Defined Contribution plan. They argued that this change would shift all future risk of loss onto the new employees and the state would not be responsible for any further unfunded liability. This was part of a national effort to "privatize" public pension systems. At the same time Alaska faced this issue, President George W. Bush was advocating the same change for federal Social Security as Gov. Arnold Schwarzenegger pushed the "privatization" plan in California. With urging from the Murkowski Administration, Alaska Senate President Ben Stevens and national interest groups, Alaska became the only entity to switch from Defined Benefit to Defined Contribution retirement during this nationwide privatization effort.

⁴ Complaint Case No. 1JU-07-974 CI, op. cit.

On May 7, 2005, Ruben Barrales, Deputy Assistant to the President and Director of the Office of Intergovernmental Affairs faxed a letter to Alaska Senate President Ben Stevens, urging privatization of Alaska's pension system. Following is a copy of that letter.

Figure 2: White House letter to Alaska Senate President Ben Stevens

THE WHITE HOUSE

WASHINGTON

May 7, 2005

Dear Senator Stevens,

On behalf of the President, thank you for your letter regarding your efforts to improve the Public Employee Retirement System for future public employees in Alaska. As you are aware, the President is also working to strengthen the nation's retirement system -- Social Security -- for future generations of Americans.

According to recent reports, Alaska's retirement system could be more than \$5 billion short of meeting its long-term obligations. Like with the current Alaska state plan, the federal government has made promises it cannot afford to pay with the current system.

I understand that your proposal would provide individual savings accounts for new state employees. Likewise, the President believes that a strengthened Social Security system should include personal savings accounts.

As a former governor, the President understands the challenges facing state government. Just as you are finding with your state system, if we do not act to fix Social Security now, the only solutions will be dramatically higher taxes, massive new borrowing or sudden and severe cuts in benefits or other government programs.

The President continues to meet with state and local officials to highlight the need for reform. Last month the President addressed a joint session of the South Carolina legislature, and he also met with public employees in Galveston County, Texas. All full-time public employees of Galveston County, including elected officials, pay into personal accounts. And, Galveston public employees enjoy higher rates of return than they would under Social Security.

Just like the challenges you are facing with your state system, President Bush understands that reforms will not be easy. But he believes that if we approach these debates with courage and honesty, we will succeed. As you understand, our children's and future workers' retirement security is more important than politics.

Sincerely,



Ruben Barrales

Deputy Assistant to the President

Director of Intergovernmental Affairs

Ben Stevens
Senate President
Alaska State Legislature
State Capitol
Juneau, AK 99801-1182

Alaska Strips New Public Employees of Retirement Security

Meanwhile, the Murkowski Administration presented a Defined Contribution retirement plan as a solution to the underfunding dilemma. This same Defined Contribution plan had been reviewed and rejected by the Public Employees and Teacher Retirement Boards which at that time managed PERS/TRS accounts. They believed other options to dealing with the unfunded liability needed to be explored.

There was a national effort to move retirement fund management away from elected beneficiary representatives. The mission of these interest groups was to gain control of pension board management decisions. This mission was the number one priority for corporations and private stock brokers. Corporations did not want pension investment boards influencing corporate investment decisions. Stock brokers were looking to privatize retirement assets so they could manage these billions of dollars in funds and obtain lucrative management fees. Passage of Senate Bill 141 gave these powerful entities what they were looking for in management of Alaska's retirement system. Larger efforts in Washington, D.C. and California were soundly rejected. In rejecting Defined Contribution retirement plans, these jurisdictions affirmed that a secure pension, partially controlled by the beneficiaries themselves, is the best form of retirement security.

Managing the Unfunded Liability

Complicating matters, participating employers in PERS made contributions prior to 2008 at rates that varied depending on such factors as the number and experience of employees and whether the employer would recognize the employees' past service. The rates were wide-ranging depending on the community and employer and were difficult to project. When SB 141 removed the 5% contribution cap on employer contributions, rates went up to substantially. Municipal finance officers and school district officials were shocked and predicted fewer city services. The municipalities and school districts that had been underfunding based on inaccurate actuarial advice were facing huge increases in their costs to cover the unfunded liability and bring the participating groups current with their obligations. It was clear that the participants in the PERS/TRS system would not be able to sustain large increases in their rates all at one time and a method to manage the debt of the unfunded liability was designed.

The passage of SB 125 in 2008 changed the Defined Benefit payment schedule of the PERS into an employer cost-sharing program similar to the teachers' retirement system (TRS) Defined Benefit system in which all employers make contributions at one uniform rate.⁵ As a result, the covered employee, departments, groups, or other classifications within the Defined Benefit system remains fixed at 22% with the State of Alaska paying the remaining balance. The bill established one integrated system of accounting for all employers which is uniform, predictable and uncomplicated.

⁵ Minutes of Special Teleconference Meeting of the Alaska Retirement Management Board, State of Alaska, May 2, 2007.

SB 125 created not only a stable rate of pay for employers it created a mortgage payment of sorts for PERS/TRS participants so they could begin paying their portion of the unfunded liability. Now participants will pay the normal service rate for active members and the 'past service cost rate' which is their payments on the unfunded liability. In addition the state agreed to be the source of funds to pay the difference between the new cost rate to employers and the actual amount due the system.

Right after the passage of SB 125 the state appropriated \$500 million to the unfunded liability. In future years the amount appropriated would dwindle and become subject to the budgeting pressures. The amount the state contributes to the Defined Contribution unfunded liability has been reduced over the past few years and failed to meet the needed repayment schedule of the unfunded liability.

In an attempt to fix the unfunded liability by using new tools the Alaska State Legislature in 2008 passed House Bill 13, an act relating to the Retirement System Liability and the Alaska Pension Obligation Bond Corporation. Sponsored by Rep. Mike Hawker (R-Anchorage), HB 13 was seen as a management tool for the state that would provide government employers the opportunity to utilize a financial mechanism to help reduce the cost of satisfying the unfunded liability of the retirement systems. By borrowing money at lower interest rates and investing it to earn higher returns, funds are provided to prepay the unfunded accrued actuarial liabilities.

According to testimony during committee hearings and analysis provided by Goldman Sachs and Callan and Associates, potential savings to the State of Alaska from pension obligation bonds are significant, possibly as much as \$384.2 million in savings and up to \$626.6 million in savings depending on the amount of money borrowed.⁶

Pension Obligation Bonds permit more stable budget planning for all participants in PERS and TRS. Officials from the Department of Revenue lent support to the bill which passed with no dissenting votes. HB 13 was signed into law on May 22, 2008.

Today, the tools created to manage the unfunded liability are being used in part. The employers continue to pay the amount designated by SB 125 and are meeting their obligations. The State of Alaska has a mixed record of appropriating the funds required by SB 125 to address the unfunded liability. Pension obligation bonds at this writing have never been issued due to the down turn in the market.

The unfunded liability remains the primary reason given for the failure of any forward movement on returning to a Defined Benefit. Ironically, the Defined Contribution plan has done little to diminish the unfunded liability and may in fact exacerbate the problem. By eliminating contributions to the Defined Benefit system by future employees, and the failure of the state to make up the difference between what it owes and what it charges the participants, the unfunded liability will continue to grow. Alaska's unfunded liability is a real problem with a real solution in place. We simply have lacked the will to follow our own plan and our employees are paying the price. Alaska will pay the price at some point in the future.

⁶ Testimony before the Alaska Senate Finance Committee, February 29, 2008, <http://bit.ly/aKcb6r>

Defined Contribution Plans – What’s the Problem?

For the new employees in Defined Contribution plans, the retirement they receive as part of working in public service jobs is a private investment account similar to a 401(k) plan. These plans are often used by private employers to supplement federal Social Security. Because most Alaska public employees who work for the State of Alaska, municipalities, school districts or other entities under the PERS/TRS system are not eligible to participate in federal Social Security, new employees have no safety net in retirement. If the individual investment accounts don’t perform well, new public employees will be left with little retirement. In Alaska in 2008, the worst investment year since the Great Depression, Defined Benefit plans lost more than 22% while Defined Contribution plans lost an average of 36%.⁷

This failure to save enough money can be the result of many factors. Employees, however, often do not follow or even get the best expert advice when it comes to saving and investing for retirement. Too many workers fail to contribute sufficient amounts to the plans, and individuals’ lack of expertise in making investment decisions can subject individual accounts to extremely unbalanced portfolios with too little or too much invested in one particular asset, such as stocks, bonds, or cash. For example, one study found that more than half of all Defined Contribution plan participants had either no funds invested in stocks—which exposes them to very low investment returns—or had almost all their assets allocated to stocks, making for a much more volatile portfolio.⁸ Another important difference between Defined Contribution plans and defined benefit systems becomes apparent at retirement. Unlike in Defined Benefit systems, where workers are entitled to receive regular, monthly pension payments, in Defined Contribution plans it is typically left to the retiree to decide how to spend one’s retirement savings. Research suggests that many individuals struggle with this task, either drawing down funds too quickly and running out of money, or holding on to funds too tightly which produces a lower standard of living. In theory, employers that offer Defined Contribution plans could provide annuity payout options, but in practice they *rarely* do.

Defined Contribution plans don’t offer adequate income for retirement:

- Retirement incomes under the previous Defined Benefit pension system were modest, averaging only a little more than \$20,000 per year. Under the new Defined Contribution system, retirees will average about half of that amount.
- According to a national study, when retirees change jobs, more than 2/3 of them with 401(k)-type savings accounts cash them out, leaving them with little economic security during retirement. Of those that keep their savings accounts, they average only \$400 per month to live on throughout their retirement.⁹

⁷ See page 14, State of Alaska Division of Retirement and Benefits presentation to the House Finance Committee on PERS/TRS 2009

⁸ Ilana Boivie and Beth Almeida, “Patience is a Virtue: Asset Allocation Patterns in DB and DC Plans,” *National Institute on Retirement Security*, July 2008.

⁹ Gary W. Anderson and Keith Brainard, “Profitable Prudence: The Case for Public Employer Defined Benefit Plans,” *Pension Research Council*, The Wharton School, University of Pennsylvania, 2004.

- Retirees in other states have Social Security as a safety net to supplement the average income of \$400 per month. Most of Alaska's public employee retirees do not receive a federal Social Security benefit.¹⁰

Under a Defined Contribution plan workers bear all the risk. No matter how much money an employee contributes, they have a high degree of uncertainty of how much money they will have available during retirement. This is particularly true if their investments do poorly. The “cash out” Defined Contribution program also forces a retiree to estimate how long they expect to live past retirement age so they can plan accordingly. If they live approximately 10 to 15 years post-retirement, they are likely to outlive their 401(k) funds.

In planning for retirement, a Defined Contribution plays a role; but it should play only a supporting role. A good retirement plan should consist of a Defined Benefit or pension plan, Social Security, and retirement savings, such as a 401(k). This is what is referred to as the “three-legged” retirement stool. Under Alaska's Defined Contribution plan, there is only one leg remaining -- the 401(k) savings account. Sadly for Alaska's public employees, they have no opportunity to achieve this ‘three-legged’ retirement stool.

Retention Issues

Since the passage of SB 141, there no longer exists a 20 year retirement program for high risk or high stress jobs. For those employees hired after July 1, 2006, this important recruitment and retention tool for police officers and fire fighters was lost. Additionally, the vesting requirement of the PERS/TRS system has been set aside. Vesting encourages employees to make a career out of public employment. After five years of public employment, Defined Contribution employees can take all money in their accounts with them when they leave. This also includes all employer contributions. There is no encouragement to make a career of public employment since Defined Contribution plans are completely portable. These transient employees take their portable Defined Contribution plans and leave Alaska for a more secure retirement elsewhere.

Beyond state employees, Tier IV PERS/Tier III TRS impacts local municipalities and school districts that are no longer able to offer an attractive retirement for new employees. Without this recruitment and retention tool, these entities are finding it difficult in the long term to retain teachers for our schools or fire fighters or police to protect us. These problems will become more dramatic as current PERS/TRS members move toward retirement, the recession subsides, and new highly qualified employees cannot be found to replace current public employees.

Cost of Training

Increased training costs as a result of higher turnover are important when looking at the costs of remaining with a Defined Contribution plan. And nowhere are the costs more evident than in the area of public safety. According to Anchorage Police Department Employees Association

¹⁰ Alaskan Public Pension Coalition, “*Secure the Future for Alaska's Families: Know the Facts,*” 2008.

(APDEA), the total cost to hire one police recruit until he or she takes his or her first shift as a police officer is estimated at over \$100,000. In this pre-certification training, recruits undergo a series of written, physical, psychological, polygraph, and medical exams as well as passing a succession of rigorous interviews. The investment made recruiting and training recruits is one of the highest training costs in the state. In addition to high training costs, the Anchorage Police Department spends up to \$400,000 a year on recruiting costs.

A young police officer hired under Tier IV will quickly learn that police departments in the Lower 48 have Defined Benefit systems. The training he or she has received in Alaska can be easily transferred to another jurisdiction. With the portability of Defined Contribution accounts, there exists no incentive to remain in Alaska. Employees become transient.

Training costs are also a significant expenditure for state and local governmental agencies. A recent federal Department of Labor study shows that turnover costs one-third to one-half of the annual salary of the employee, not including productivity loss. This does not refer to the costs of training specialized positions such as state troopers, correctional officers, probation officers, where the costs run into the tens of thousands to even a hundred thousand dollars.

In the end, these highly trained employees will leave Alaska with both new skills and all funds in their Defined Contribution accounts.

Health Reimbursement Accounts

Another major concern with the Defined Contribution plan is the woefully inadequate health care component. Alaska's Defined Contribution plan provides Health Reimbursement Accounts (HRA) to help pay for health care needs for retirees upon retirement. These extremely limited funds are only available to those who retire directly from the public employer. Because of the specific new requirements in the new Defined Contribution law, many employees will likely be ineligible to retire under the Defined Contribution plan so will have no medical benefit. It is anticipated that the HRA funds will not amount to much money. Once the HRA funds are expended, Defined Contribution plan retirees must purchase their health insurance. Defined Contribution plans limit access to state offered health insurance to only those employees who retire directly from a public employer covered by the plan. In the near future Defined Contribution plan employees will begin to move elsewhere to find a more secure retirement program with guaranteed health insurance. Any benefit they accrued working in the State of Alaska through the HRA will be lost as these employees leave Alaska.

Guaranteed health insurance, spousal survivor benefit and disability benefits are not part of a Defined Contribution plan. The longer the retiree lives after retirement, the greater chance that the retiree will end up on public assistance, which is a future and yet unrecognized cost of the current inadequate Defined Contribution plan.

A 2008 study by the National Institute for Retirement Security determined that there would be annual *savings* of an estimated \$7.3 billion in public assistance, attributed to retirees' receipt of

Defined Benefit pension income.¹¹ The estimated \$7.3 billion in savings represents 8.5% of all public assistance received by American households in 2006 for the same benefit programs.¹²

In another study by the National Institute for Retirement Security, it is estimated that without current Defined Benefit income, there would be a 40% increase in the number of older American households receiving public assistance.

The possibility of Defined Contribution plan retirees ending up on public assistance in Alaska is valid, given the growth rate of Alaskans age 65 and older. According to a study by the University of Alaska's Institute of Social and Economic Research (ISER), between 1990 and 2000 the number of Alaskans age 65 and older increased by 60%.¹³ Similar growth is expected in this decade and the next. That's four to five times faster than the U.S. average.

Households receiving Defined Benefit pension income are much less reliant on public assistance than households without pension income. Of those households that did not receive any pension income, 16.6% received public assistance in 2006, which was more than *triple* the 4.6% for households that received a Defined Benefit pension income.¹⁴

Cost of Living Adjustments (COLA)

With a Defined Contribution plan, there is no pension and therefore no cost of living adjustment (COLA) increases to help buying power stay closer to inflation. Although the COLA provided under the Alaska Defined Benefit system was modest, $\frac{1}{2}$ to $\frac{3}{4}$ of the Consumer Price Index increase, it provides some buffer. Without inflation indexing, the resulting loss of buying power of Defined Contribution plan retirees will add up to 40% over time.

Pensions are economic stabilizers; retirees with a reliable pension continue to spend on basic needs, providing important stimulus during tough economic times. In supplying a stable source of income to retirees, state and local pension plans support the national economy as well as local economies throughout the country with jobs, incomes and tax revenues. Especially in these times of financial crisis and economic instability, public pension plans play an important role in providing a stable, reliable source of income not just for retired public servants, but also for the local economies in which their pension checks are spent – and therefore the national economy as well.

¹¹ Beth Almeida and William B. Forna, "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans," *National Institute for Retirement Security*, August 2008.

¹² Frank Porell, Ph.D. and Beth Almeida, "The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships," *National Institute on Retirement Security*, July 2009.

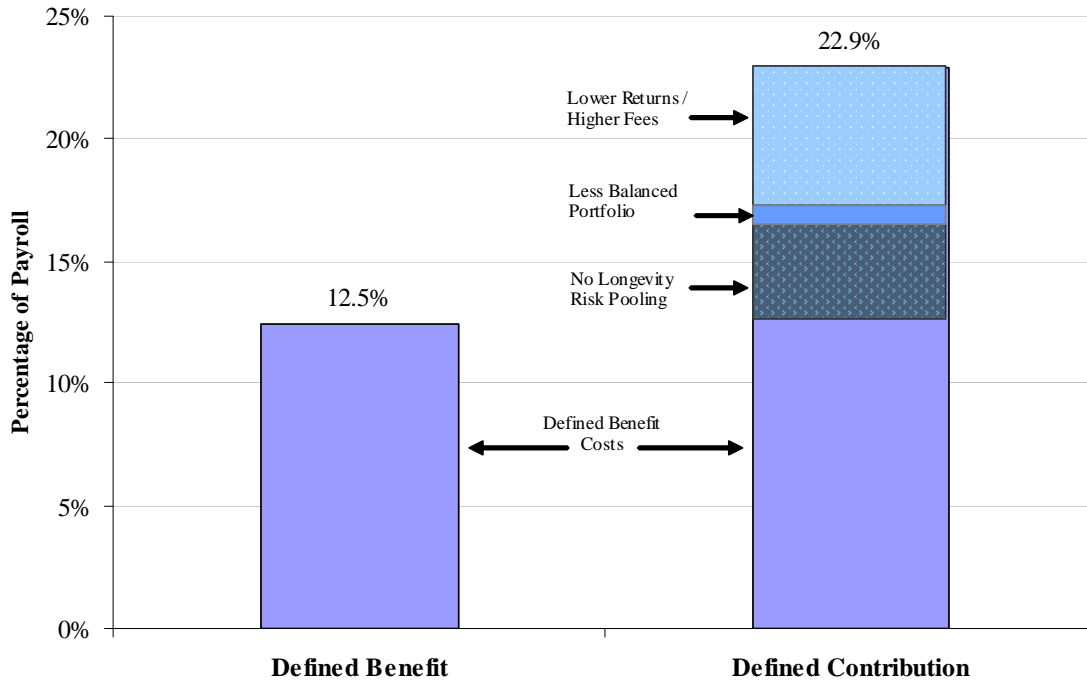
¹³ Scott Goldsmith and Jane Angvik, "\$1.5 Billion A Year and Growing: Economic Contribution of Older Alaskans," *UA Research Summary No. 7*, Institute of Social and Economic Research, University of Alaska Anchorage, September 2006.

¹⁴ Porell, op. cit.

A Defined Benefit System Costs Less Than a Defined Contribution Plan

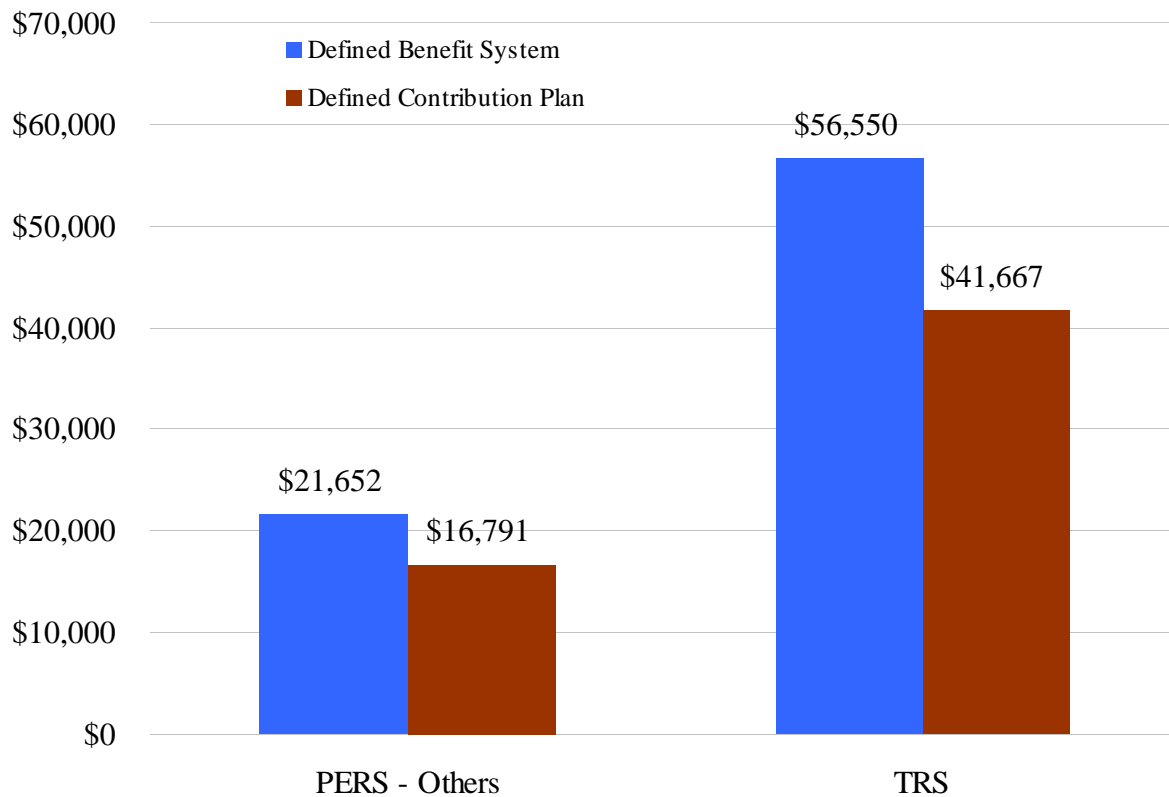
For any given level of benefit, a Defined Benefit system costs less than a Defined Contribution plan. This makes Defined Benefit systems, in the language of economists, more efficient since they stretch taxpayer, employer or employee dollars further in achieving any given level of retirement income.

Figure 3:
Cost of Defined Benefit Systems and Defined Contribution Plans as a Percentage of Payroll



Source: *National Institute on Retirement Security, A Better Bang for the Buck* (August 2008)

Figure 4: Value of Employer-Paid Benefits (31-year old new employee)



Based on data provided by Buck Consultants, letter dated May 4, 2006
Assumes a married member with a starting salary of \$35,500/year

There are three primary reasons behind Defined Benefit systems' cost advantage:¹⁵

1. As Defined Benefit systems pool the longevity risks of large numbers of individuals, they avoid the “over-saving” dilemma inherent in Defined Contribution plans. Defined Benefit systems need only accumulate enough funds to provide benefits for the average life expectancy of the group.

In contrast, individuals in Defined Contribution plans need to set aside enough funds to last for the “maximum” life expectancy if they want to avoid the risk of running out of money in retirement. Since the maximum life expectancy can be substantially greater than the average life expectancy, a Defined Contribution plan will have to set aside a lot more money than a Defined Benefit system to achieve the same level of monthly retirement income.

2. Defined Benefit systems do not age, unlike the individuals in them, and they are able to take advantage of the enhanced investment returns that come from a balanced portfolio

¹⁵ See page 4, Almeida and Fornia, op. cit.

over long periods of time. For instance, ongoing Defined Benefit systems generally include individuals with a range of ages. As older workers retire, younger workers enter the same system. As a result, the average age of the group in a mature Defined Benefit system does not change much. This means Defined Benefit systems can ride out bear markets and take advantage of the buying opportunities that they present without having to worry about converting all of their money into cash for benefits in the near future.

By contrast, individuals in Defined Contribution plans must gradually shift to a more conservative asset allocation as they age, in order to protect against financial market shocks later in life. This process can sacrifice investment returns because people may have to sell assets when they are worth too little due to market fluctuations coinciding with retirement timing. Moreover, they are not able to take advantage of higher expected returns associated with a balanced portfolio. By their nature, Defined Contribution plans are portable and liquid and cannot access some of the large, long term investments that have traditionally contributed the most to Defined Benefit plan returns, such as private equity, commercial real estate, and other alternative investments.

3. Defined Benefit systems achieve greater investment returns as compared with Defined Contribution plans based on individual accounts. Superior returns can be attributed partly to lower fees that stem from pooled assets and economies of scale. Also, because of professional management of assets, access to a broader range of and longer term investments, Defined Benefit systems achieve superior investment performance as compared to the Defined Contribution plans or the average individual investor.

Moving away from traditional Defined Benefit systems in favor of individual retirement savings accounts, including those in Defined Contribution plans, has left Alaskans especially vulnerable to the volatility in financial markets.

It's All about Economics: Nebraska's Experience

In 1964, Nebraska switched from a Defined Benefit system to a Defined Contribution plan for state and county government workers. Immediately, the state noted it was paying higher administrative costs for its new Defined Contribution plan program. With time, the State of Nebraska discovered that, compared to a Defined Benefit system, its new Defined Contribution plan program cost the state considerably more in record-keeping fees, investment management fees, educational programs and other administrative line item fees.

By 1999, the State of Nebraska found the expenses of its Defined Contribution plan program were double the cost of its Defined Benefit system. It also found that when employees hired under the Defined Contribution plan managed their own investments, investment returns were lower than under a Defined Benefit system. In fact, the state found that under a Defined Contribution plan, a retiree with 30 years of service and an average annual salary of \$30,000 had about \$11,230 annually in retirement benefits, which is \$2,460 less than the poverty level for a family of two.

Participants in the state's Defined Benefit system with similar pay and service credit, meanwhile, had an annual retirement benefit of \$16,797, which is \$3,100 more than the poverty level for a family of two.

Faced with hard data that retirees from the state's Defined Contribution plan would eventually end up on public assistance, Nebraska's Legislature changed back to a Defined Benefit system in 2002.¹⁶

Keeping Two Systems

Ilana Boivie and Beth Almeida of the National Institute on Retirement Security studied the consequences of moving from a Defined Benefit system to a Defined Contribution plan in a 2008 study *Look Before You Leap: The Unintended Consequences of Pension Freezes*.¹⁷

Key findings from freezing a Defined Benefit system include:

- Freezing a Defined Benefit system and moving to a Defined Contribution plan can increase costs to the employer/taxpayer at exactly the wrong time. This is because:
 - Maintaining two plans is more costly than operating just one;
 - Foregoing and undermining the economic efficiencies of Defined Benefit system drive up retirement plan costs; and
 - Accounting rules can require pension costs to accelerate in the wake of a freeze.
- Freezing a Defined Benefit system and moving to a Defined Contribution plan can worsen retirement insecurity, potentially damaging recruitment and retention efforts. Because of this, most states that have studied whether to freeze a Defined Benefit and switch to a Defined Contribution plan have found continuation of the Defined Benefit plan to be in the best interests of employers/taxpayers and employees.

While the Alaska Defined Contribution plan has many problems, it also causes problems for the state's existing Defined Benefit system. As fewer people remain in the Defined Benefit system, the costs to public employers will increase. This is because new hires will be contributing to their individual accounts and not to the Defined Benefit system. Existing Defined Benefit employees add to the trust account at a fixed rate of contribution (6.75%, 8.25%, or 8.65%).

The employer's contribution rate is variable, and the Alaska State Constitution (Article 12, Section 7) requires the state to maintain accrued benefits. With a smaller pool of money and a larger percentage of funds being moved into cash to pay benefits, the rate of return will have to be reduced, requiring larger employer payments. The changes will force a change in investment strategy and increase the unfunded liability.

¹⁶ Rachel Quinn, in correspondence prepared for APEA/AFT by AFT Research Department.

¹⁷ Ilana Boivie and Beth Almeida, "Look Before You Leap: The Unintended Consequences of Pension Freezes," *National Institute on Retirement Security*, 2008.

The Importance of Defined Benefit Systems to Alaska's Economy

A 2006 study by the Institute of Social and Economic Research reported that Alaska's retirees bring \$1.46 billion a year into the state's economy. The source of 75% of the estimated \$1.46 billion is pensions and Social Security.¹⁸ The impact of retirees' cash flow on the state's economy is tremendous: 11,700 jobs are generated and income is spent locally. Other benefits include:

- A variety of jobs are created, from trade jobs to health care jobs
- Jobs that are created are year-round jobs, not just seasonal
- Jobs are created around the state
- The state's economy is diversified, stabilized, and expanded
- Volunteer opportunities, both formal and informal, are expanded with an estimated value of between \$13 million to \$52 million annually
- Home and Community Based Services (care giving) is expanded at a value of \$47 million annually

Pensions are a steady, predictable income stream for the recipients but also for our economy. People with pensions act as stabilizers in difficult financial times. Because they know the check will come every month they are less likely to constrict spending in the current recession. Conversely, people with 401(k) style savings accounts are more likely to reduce spending sharply as they see their balances decline. This may not be a huge factor in this downturn, but in 20 years when everyone has only a 401(k), the lack of secure pensions will likely exacerbate the boom bust nature of the Alaska economy.

Conclusion

Changing to a Defined Contribution plan was an overreaction to a perceived crisis. The unfunded liability issue gave individuals interested in privatizing the retirement system a handy reason to move forward with their plan. At the time, many thought privatization would be the answer to all of this country's economic ills, but time has since proven otherwise. As we have outlined in this paper, the current Defined Contribution plan is a terrible return on investment for the State of Alaska.

The Defined Contribution plan does not rectify the unfunded liability, it costs more. Defined Contribution exposes public employers to recruitment and retention problem, has inadequate health care for retirees, and will likely result in many Alaskans outliving their savings and finding themselves depending on public assistance.

It is time to reverse the damage done by passage of Senate Bill 141. It is time for the Alaska Legislature to return all public employees to a retirement system that offers every employee the security of knowing that they will be provided for in their retirement years. The longer we wait, the worse the problem will become.

¹⁸ Goldsmith and Angvik, op. cit.

With undependable and inadequate Defined Contribution plans, many public employee retirees will simply not be able to afford to stay in Alaska, spend their retirement funds here, and make the many other contributions to Alaska communities. In recent years two thirds of public employee retirees have remained in Alaska. If the state remains with Defined Contribution plans, a much larger percentage of employees and retirees are expected to move to the Lower 48. Medical costs outside of Alaska continue to be about 40% lower and other living costs are also much less.

For those who are accountable to the people of the State of Alaska and its financial future, we must return our state to a Defined Benefit system. The last five years have shown this entire country that a successful financial retirement for America's retirees rests in guaranteed pension income, not volatile and uncertain Defined Contribution funds.

Many other states have learned their lesson and have returned to a Defined Benefit system. It is time for the State of Alaska to do the same.

Appendix

¹ APPC member organizations.

² Complaint Case No. 1JU-07-974 CI in Superior Court for the State of Alaska, Alaska Retirement Management Board on behalf of State of Alaska Public Employees' Retirement System and State of Alaska Teachers' Retirement System, Plaintiff v. Mercer (US), Inc.

³ Office of the Commissioner, Public Employees' Retirement System, Teachers' Retirement System Communication Policy, November 5, 2004.

⁴ Complaint Case No. 1JU-07-974 CI, op. cit.

⁵ Minutes of Special Teleconference Meeting of the Alaska Retirement Management Board, State of Alaska, May 2, 2007.

⁶ Testimony before the Alaska Senate Finance Committee, February 29, 2008, <http://bit.ly/aKcb6r>

⁷ See page 14, State of Alaska Division of Retirement and Benefits presentation to the House Finance Committee on PERS/TRS 2009

⁸ Ilana Boivie and Beth Almeida, "Patience is a Virtue: Asset Allocation Patterns in DB and DC Plans," *National Institute on Retirement Security*, July 2008.

⁹ Gary W. Anderson and Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Plans," *Pension Research Council*, The Wharton School, University of Pennsylvania, 2004.

¹⁰ Alaskan Public Pension Coalition, "*Secure the Future for Alaska's Families: Know the Facts*," 2008.

¹¹ Beth Almeida and William B. Forna, "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans," *National Institute for Retirement Security*, August 2008.

¹² Frank Porell, Ph.D. and Beth Almeida, "The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships," *National Institute on Retirement Security*, July 2009.

¹³ Scott Goldsmith and Jane Angvik, "\$1.5 Billion A Year and Growing: Economic Contribution of Older Alaskans," *UA Research Summary No. 7*, Institute of Social and Economic Research, University of Alaska Anchorage, September 2006.

¹⁴ Porell, op. cit.

¹⁵ See page 4, Almeida and Forna, op. cit.

¹⁶ Rachel Quinn, in correspondence prepared for APEA/AFT by AFT Research Department.

¹⁷ Ilana Boivie and Beth Almeida, "Look Before You Leap: The Unintended Consequences of Pension Freezes," *National Institute on Retirement Security*, 2008.

¹⁸ Goldsmith and Angvik, op. cit.

Endnotes

¹ **Member organizations of the Alaskan Public Pension Coalition:**

- NEA-Alaska
- Alaska State Employees Association/American Federation of State, County and Municipal Employees, Local 52 (ASEA/AFSCME)
- Alaska Public Employees Association/American Federation of Teachers (APEA/AFT)
- Anchorage Police Department Employees Association (APDEA)
- Alaska AFL/CIO
- AARP Alaska
- National Public Pension Coalition (NPPC)
- Anchorage Fire Fighters Union, Local 1264 (AFF Local 1264)
- International Brotherhood of Electrical Workers, Local 1547 (IBEW 1547)
- Alaska Professional Fire Fighters Association
- Public Employees, Local 71
- Public Safety Employees Association/American Federation of State, County and Municipal Employees, Local 803 (PSEA/AFSCME)
- Alaska Retired Educators Association (AK-REA)
- Anchorage Education Association (AEA)
- NEA-Alaska/Retired
- Retired Public Employees of Alaska (RPEA)
- Teamsters, Local 959
- Alaska AFSCME Retiree Chapter 52
- Mat-Su Education Association (MSEA)
- Fairbanks Education Association (FEA)
- Mat-Su Classified Employees Association (MSCEA)
- Alaska Center for Public Policy