Date: July 18, 2018
Prepared By: Joseph W. Simon
Purpose: Review pension sustainability initiatives in New Mexico and other states.
Witness: Jan Goodwin, Executive Director, Educational Retirement Board
Expected Outcome: Awareness of a range of policy options to examine when considering pension sustainability legislation.

Pension Sustainability Legislation in New Mexico and Other States

Introduction

In April 2017, the New Mexico Educational Retirement Board (ERB) received the recommendations from a biennial study of how the pension fund's actuarial assumptions have compared with the actual experience of the fund. The study, conducted by ERB's independent actuaries at Gabriel, Roeder, Smith & Company (GRS), recommended the board reduce the assumed rate of inflation from 3 percent to 2.5 percent. As a result, the actuary recommended the plan assume:

- Average investment returns of 7.25 percent, down from 7.75 percent;
- Average wage inflation of 3.25 percent, down from 3.75 percent;
- Average growth in overall payroll of 3 percent, down from 3.5 percent; and
- Average annual cost-of-living adjustments of 1.9 percent, down from 2 percent.

ERB accepted the actuary's recommendations in October 2017.

While the Government Finance Officers Association recommends pension plans perform an experience study at least once every five years, to stay on top of demographic and economic trends, ERB conducts an experience study every two years. The actuary conducts a valuation "snapshot" at the end of each fiscal year, in accordance with GASB standards.

These assumption changes have a negative impact on the funding status of New Mexico's educational retirement system. ERB's actuaries estimated the cost of funding the benefits earned in the current year rose from 13 percent of covered payroll to 13.6 percent of covered payroll. However, the total cost of the pension system includes not only the cost of benefits earned in the current year, but also costs associated with the systems unfunded liability, or the costs of benefits earned in previous years that have not been covered with contributions or investment returns. As of June 30, 2016 prior to the assumption changes, ERB's actuaries estimated the unfunded liability at $6.6 billion, with fund assets covering about 64.2 percent of total liabilities. With the revised assumptions, GRS estimated the unfunded liability at $7.4 billion, with assets at 61.5 percent of total liabilities. Most significantly, the system's funding period — the number of years the actuary estimates it will take to fully pay down the system's unfunded liability — increased from 46 years to 84 years. Strong investment returns in FY17 helped to narrow that time period to 61 years; however, this remains longer than the 30 year standard adopted by the Government Accounting Standards Board (GASB) and ERB's actuary recently told the board that the fund was only one modest economic shock away from an infinite funding period.

A pension plan with an infinite funding period estimates it will not have sufficient revenue to pay off its unfunded liability.

Following the assumption modifications, ERB staff undertook a statewide tour to discuss pension sustainability with ERB members. Additionally, beginning in July 2018, ERB assembled a group of education stakeholders to review ERB's plan and make recommendations to the board regarding sustainability legislation for the 2019 legislative session. ERB's goal is to develop legislation to be approved by the board in October and presented to the Investment and Pension Oversight Committee for possible endorsement in November.

Pension Sustainability in New Mexico

Like most states, ERB's plan is a traditional **defined benefit** pension plan, where employees pay a set percentage of salary and are guaranteed a lifetime pension based on the number of years of employment and the employee's average salary. Many employees in the private sector have been switched to **defined contribution** systems, including 401(K) plans, where employees do not receive a guaranteed payment and retirement income will vary, depending on how much was contributed and an individual's investment earnings.

In New Mexico, the benefit provided through ERB represents an important component of educational employees' total compensation package. School districts and charter schools contribute more than $200 million to ERB annually. When universities, the State of New Mexico, and other entities are included, educational employers contributed nearly $400 million to ERB in FY17 to provide retirement benefits for New Mexico educators. Retirement benefits play a crucial role in helping the public education system attract and retain qualified teachers, and policymakers should carefully consider any proposed changes to ensure plan design features are serving the state's recruitment and retention needs.

At the same time, it is critical that the system be financially sound. While ERB's most recent actuarial valuations show that the system remains solvent, maintaining a large unfunded liability for many years has downsides. Currently, the bulk of employer contributions to the fund go toward paying down the unfunded liability rather than funding the cost of the benefits earned in the current year. In June, Moody's downgraded the State of New Mexico's general obligation bond rating, in large part due to the unfunded liabilities in ERB and in the Public Employee's Retirement Association (PERA). Because of the state downgrade, New Mexico school districts that are receiving an enhanced bond rating, based on the state's guarantee of school district bonds, also received a downgrade.

Nationally, public pension plans vary widely in design and in the level of benefit provided to the employee. For public school employees in the United States, most plans are at the state level and are defined based on the unique set of state laws and constitutional requirements that can determine the flexibility a Legislature has when attempting to address fund sustainability. For example, some states may be able to make changes that impact the benefits of current members, while others states have protections that make this more difficult.

New Mexico Constitutional Provisions

Like many other states, the New Mexico state constitution provides protections for public pension systems. In 1998, Section 22 of Article 20 was added to the New Mexico Constitution, which provides:

- Pension plan members acquire a "vested property right" after meeting minimum service requirements and are guaranteed due process protections;

- Pension trust funds must be invested solely for the benefit of the members;
- Pension trust funds may not be diverted or appropriated for another purpose;
- Pension boards are solely responsible for the administration and investment of the retirement systems;
- Pension boards are solely responsible for adopting actuarial assumptions, based on recommendations of independent actuaries; and
- The Legislature may not increase benefits or "change the funding formula" without providing adequate funding.

While these provisions may limit the Legislature's ability to adopt some sustainability reforms, the constitution also states:

> *"Nothing in this section shall be construed to prohibit modifications to retirement plans that enhance or preserve the actuarial soundness of an affected trust fund or individual retirement plan."*

While this provision would seem to provide some flexibility, it is unclear how this flexibility may be exercised or implemented. At the time the proposed amendment was considered by the Legislature, the Attorney General's Office noted it was not clear how this paragraph was meant to align with the fifth amendment to the U.S. Constitution, which prohibits the taking of property without "just compensation." It is unclear how a court would rule if the Legislature attempts to alter benefits for current members. In *Bartlett v. Cameron*, a 2014 New Mexico Supreme Court decision that established that a cost-of-living adjustment (COLA) is not part of the underlying retirement benefit and therefore not afforded constitutional protections, the court declined to address the issue. The court's opinion stated:

> *"At oral argument, the State appeared to argue that the Legislature could reduce not only the COLA, but also the underlying retirement benefit, even after the date of retirement, a questionable assertion that we need not address in this opinion."*

While it may be possible to alter retirement benefits for current members, doing so would likely invite litigation. Previous pension reform legislation in New Mexico has only altered the benefits calculation for members hired after a set date in the future. This is not dissimilar for practice in many other states, which also have legal protections in place for members who are already part of the pension system.

Considerations in Pension Plan Design

In general, pension plans aim to provide their members with a secure retirement while maintaining a plan that does not require greater sacrifices from employees or taxpayers in one generation over another.

Income Replacement Rates. Traditionally, defined benefit pension plans are only one component of what some refer to as the "three-legged stool" of retirement. The other legs are represented by income from Social Security and from the personal savings of the retiree. Unlike many other states, membership in Social Security is an important part of the retirement benefit in New Mexico. Because New Mexico employees pay into Social Security, their defined benefit pension plan does not

In states where teachers do not participate in the Social Security system, a retired teacher that earned Social Security through other eligible employment or through a survivor's benefit may see a drastically reduced Social Security benefit, or even no benefit at all.

The Social Security Administration notes most retirement advisors recommend retirees have at least 70 percent of pre-retirement income for a comfortable retirement.

necessarily need to match the same level of income replacement as in states where teachers do not participate in Social Security. According to the Social Security Administration (SSA), Social Security benefits are designed to replace about 75 percent of income for the lowest earners, about 40 percent of income for medium earners, and about 27 percent of income for the highest earners, assuming retirees wait to the full retirement age of 67 to collect. With ERB's plan replacing 2.35 percent of final average salary for each year of employment, employees reach a salary replacement rate of 60 percent after 25.5 years and a salary replacement rate of 70 percent after about 30 years.

Intergenerational Equity. Benefits in traditional pension plans come from three sources: member contributions (in most cases), employer contributions, and investment returns. Pension plans pre-fund their retirement benefits over a long period of time to take advantage of compounding interest. Because people are expected to pay into the system for decades, it is important for pension plans to consider the impact a combination of increased contributions and reduced benefits have on differences in the benefit between members who began their employment at different times. Analysis from ERB's actuaries indicates that ERB members hired in the 1970s and 1980s will likely receive a much better return on their investment in the pension fund than members hired in the 1990s or 2000s (see **Appendix A**, **"How do the generations compare**," from a GRS presentation to ERB).

Even though it presents intergenerational equity issues, many pension plans make plan modifications that reduce future employee benefits because not doing so could impact the solvency of the pension fund. Plans may also seek ways to even out the sacrifices of plan changes by balancing reforms between retired members, current members, and future members so that all interested stakeholders are treated fairly. While some plans have limited ability to impact plans for retirees and current members, some states have made changes to future cost-of-living adjustments, which impact current and future retirees. Some plans, including ERB in New Mexico, have increased contribution rates for current members who have not retired.

Plan Risk. Traditional defined benefit pension plans assign all of the risk from lower than expected investment returns or from changes in life expectancy and other demographic factors to the employer. While pension underfunding often comes from the failure to provide contributions that meet the total cost of the pension plan, some plans have seen significant losses attributable to changes in investment returns, a lack of growth in the number of new teachers or in teacher pay, and increased life expectancy.

Prior Changes in New Mexico

According to ERB actuarial reports, as of June 30, 2005, the funding period for the educational retirement fund was estimated to be infinite. To improve the pension plan's solvency, Laws 2005, Chapter 273 (SB 181) increased employee contributions by 0.3 percentage points and employer contributions by 5.25 percentage points. The combined contribution increased to 21.8 percent of salary, with the increases phased in over four years for employees and over seven years for employers. Revenue

downturns following the Great Recession led the Legislature to delay the phase-in, and the contribution increase was not fully implemented until FY14.

The 2005 reforms were designed to put the fund on a path to 100 percent funding, which ERB's actuaries estimated would be achieved by 2035, with unfunded liabilities peaking at nearly $4.5 billion in FY19. By the end of FY08, actuaries projected the unfunded liability would extend to 2039; however, the actuaries noted this estimate did not account for significant investment losses in the first half of FY09. In December 2008, the actuaries estimated that if financial markets did not recover by the end of FY09, the funding period would once again be infinite. As a result, the Legislature again undertook pension reform in the 2009 legislative session.

While the 2005 reforms addressed only contribution rates, Laws 2009, Chapter 288 (HB 573) changed benefit levels for new members and did not increase contribution rates beyond those increases that were still being phased in pursuant to the 2005 law. The 2009 law increased retirement eligibility for members hired after July 1, 2010 from 25 years of service to 30 years of service. Those with less than 30 years of service could retire under the "Rule of 80," if the member's age plus their years of service credit equaled at least 80. Previously, member age plus service would need to be at least 75. Members that retired under the "Rule of 80" would also see a reduced payment if they were under age 65 at the time of retirement. Any member who does not have 30 years of service or does not reach the Rule of 80 may retire at age 67, up from age 65 previously.

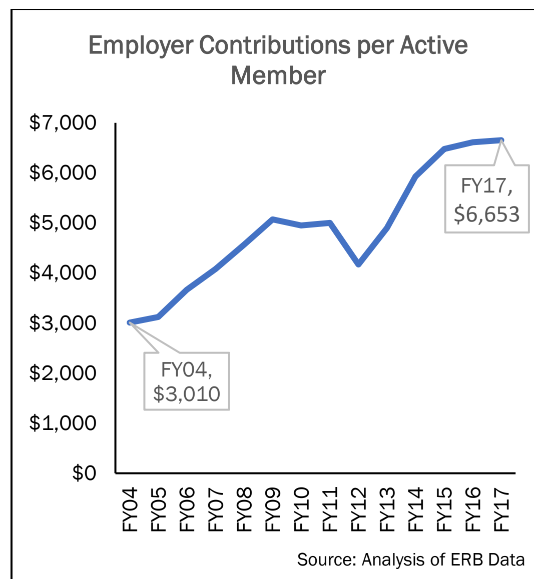
Continued difficulty reducing the unfunded liability led to further reforms in 2013. Laws 2013, Chapter 61 (SB 115) made further changes to the pension plan for members hired after July 1, 2013 and increased employee contributions for active members earning more than $20 thousand per year. Those earning $20 thousand or less did not see a contribution increase. Under the 2013 law, those eligible to retire with 30 years of service will see a reduced benefit if they retired before age 55. The law also made changes to cost-of-living adjustments. New members will not receive a COLA before age 67 and all members will receive a reduced COLA until the plan is 100 percent funded, although the COLA will be reduced by a smaller amount once the plan achieves a funded ratio of 90 percent.

ERB Contributions and Active Members

(contributions in millions)

Year	Employer	Employee	Total	Members
FY04	$189.3	$162.1	$351.4	62,901
FY05	$197.9	$169.1	$367.0	63,362
FY06	$226.5	$178.2	$404.7	61,829
FY07	$255.9	$189.4	$445.2	62,687
FY08	$290.8	$201.9	$492.8	63,698
FY09	$323.7	$212.0	$535.7	63,822
FY10	$313.3	$250.7	$563.9	63,297
FY11	$308.4	$247.4	$555.8	61,673
FY12	$253.8	$289.9	$543.7	60,855
FY13	$299.7	$248.8	$548.4	61,177
FY14	$362.5	$268.7	$631.2	61,173
FY15	$395.1	$292.8	$688.0	60,998
FY16	$397.0	$295.9	$692.9	60,057
FY17	$395.8	$296.0	$691.8	59,495

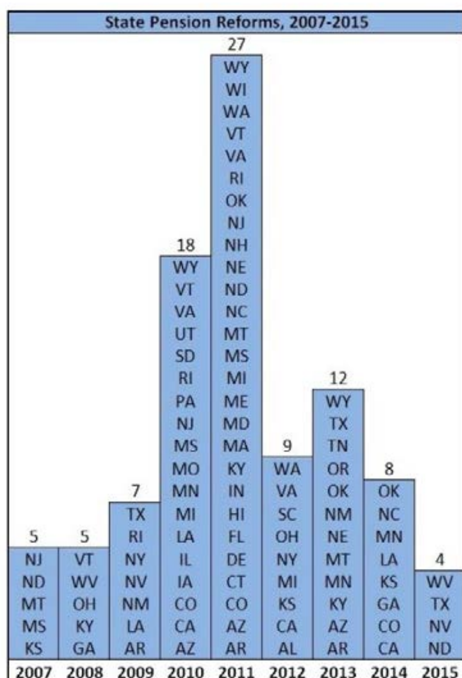
Source: ERB Annual Reports



The vast majority of the employer contribution goes to paying off the system's unfunded liability. In FY17, about 21 percent of the employer's contribution went to funding benefits earned in the current year, while the rest went to paying down the unfunded liability.

Although ERB has undergone significant changes since 2005, several strategies pursued by other states have not been implemented in New Mexico, including changes to the length of time an employee must work before vesting in the pension system, increasing the period of time for calculating a members final average salary, reducing the retirement benefits multiplier, or placing a cap on annual retirement benefits.

Pension Reform in the States



Source: National Association of State Retirement Administrators, "Significant Reforms to State Retirement Systems," June 2016.

Pension Sustainability Legislation in Other States

While, like New Mexico, other states have a history of adopting changes to public pension systems, the National Association of State Retirement Administrators (NASRA) has noted changes to public pension systems have never been as significant as the reforms adopted in the aftermath of the Great Recession. According to information compiled by NASRA, every state apart from Alaska, which closed its defined benefit plan to new employees in 2005, and Idaho, where the pension board can increase contributions without the need for legislation, had at least one legislative reform to their pension system between 2007 and 2015, although not all of these reforms impacted public school teachers. Information in the remainder of the brief has been compiled from a NASRA study of changes in statewide pension plans between 2007 and 2015; however, changes in plans that do not include public school employees were not considered. As a result no changes were reported for Alaska, Connecticut, Georgia, or Idaho.

Contribution Rates

One option to increase the sustainability of New Mexico's pension system is to increase contributions flowing into the pension trust fund. This can be done by increasing employee contributions, increasing employer contributions, or by providing the trust fund with an additional revenue source, such as a direct distribution from the state.

Employee Contribution Rates. Between 2007 and 2015, 29 states increased employee contributions to their pension plans. Many states have employee contributions of less than 8 percent, but a number of states increased employee contributions closer to or above 10 percent over this period. In some cases, such as Florida and one of Utah's plans, small member contributions were added to what had previously been non-contributory plans. Since the 1950s, ERB members have paid at least 38 percent of the total contribution and as much as 50 percent, excluding the FY12 pension swap, when members contributed almost 55 percent. Members earning more than $20 thousand currently contribute 43.5 percent of the total contribution.

Employers and employees make contributions to ERB based on annual salary. Under current law, ERB members earning more than $20 thousand per year make a contribution of 10.7 percent of annual salary. Members earning less than $20 thousand contribute 7.9 percent of annual salary. Employers contribute 13.9 percent of salary for all members.

Although many states have increased employee contributions, ERB employee contributions are on the higher side of employee

contributions compared with plans nationally. This also compares with a rate of 8.9 percent for New Mexico state employees enrolled in PERA, which raises equity issues when combined with the fact that the state is paying a higher contribution (almost 17 percent) on behalf of state employees. Another factor to consider is the estimated cost of benefits that are earned in the current year, known as the "normal cost." According to ERB's actuary, the normal cost of the pension plan in FY17 was 13.6 percent, only 2.7 percent higher than the employee contribution. This means the bulk of the employer's 13.9 percent contribution goes not to pay for future benefits, but to pay for the costs of the unfunded liability on previously earned benefits. Were the employee contribution to exceed the normal cost, newly employed ERB members would be making contributions to pay down the existing unfunded liability, rather than fund their own pension benefits. Additionally, increased employee contribution rates could impact retention of employees currently eligible for retirement and have an impact of the large number of teaching position vacancies that currently exist in New Mexico.

Employer Contribution Rates. Between 2007 and 2015, only seven states, including New Mexico, increased employer contributions through legislation. A major reason for this is that many states require employers to contribute at a rate that varies from year to year based on the actuarial position of the retirement fund. Many states require employers to pay the full annual required contribution, or the amount the pension fund estimates it will need to pay for benefits earned in the current year (the normal cost) and to make progress on paying down its unfunded liability (the amortization payment).

ERB goal of paying off the unfunded liability by 2042 was set after the 2013 pension reform legislation.

In FY17, the statutory employer contribution in New Mexico of 13.9 percent covered only 82.8 percent of the amount needed to pay the full annual required contribution, or about $82 million less than would be required to meet the goal of paying off the unfunded liability by 2042. While some states statutorily require employers pay the full contribution, New Mexico school districts have no ability to raise significant operational revenue independent of the revenue appropriated by the state. As a result, imposing an employer contribution that varied from year to year would pose significant challenges for school districts and charter schools. It may also violate the constitutional requirement that any change to the pension plan's "funding formula" be adequately funded by the Legislature, although it is not clear if the term "funding formula" applies only to the benefits calculation.

Impact of Increased Employer Contributions

Increase	Funding Period
0 Percent	61 years
1 Percent	48 years
2 Pecent	40 years
3 Percent	35 years
4 Percent	31 years
5 Percent	28 years
6 Percent	26 years
7 Percent	24 years

Source: ERB

Some states have looked at alternative methods to increase employer contributions to pension funds. Between 2007 and 2015, at least two states approved direct distributions of state revenues to pension funds. Some states, such as Oklahoma, have older laws which provide for a dedicated revenue stream for their pension funds. Sources of these funds include sales and use taxes, liquor or gambling revenue, or budget surpluses. However, New Mexico's volatile revenue structure could make regular general fund revenue distributions problematic, and the Legislature risks over-promising when a future Legislature could decide to limit such distributions. Some states have chosen to take "pension holidays" — a

ERB's actuary cautions that estimates of reforms on the funding period are not cumulative because unfunded liabilities grow exponentially. As a result, it requires more "effort" to reduce the funding period from 20 to 15 years than it does to reduce from 25 to 20 years.

decision not to make a pension contribution — when contributions are subject to legislative appropriation.

ERB's actuary has estimated the impact of increasing the employer contributions would have on the plan's funding period. According to the report, increasing the employer contribution rate by 1 percentage point would decrease the plan's funding period from 61 to 48 years. Employer contributions have a larger impact on paying down the unfunded liability because, unlike employee contributions, they cannot be refunded. An increase of seven percentage points would be needed to meet the plan's funding goals without other reforms. ERB estimates each percentage point increase in employer contributions has a general fund impact of about $27 million, based on total covered payroll of about $2.7 billion.

In New Mexico, cost-of-living adjustments are annual increases to a retiree's benefit that are meant to account for inflation. Not all states provide an annual adjustment, and many do not tie this increase to inflation.

Cost-of-Living Adjustments

Between 2007 and 2015, 26 states made changes to cost-of-living adjustments. According to NASRA, COLAs vary widely from state to state. Some states only grant COLAs on an ad hoc basis, while others provide them every year, similar to New Mexico. A number of states tie COLAs to investment performance, while New Mexico and other states tie the adjustment to the consumer price index (CPI) to account for inflation. A handful of states only apply the COLA to a portion of the retiree's total pension payment. Some states have granted their pension system's board the authority to enact COLA reform, including Arkansas, Georgia, and Idaho.

Because COLAs impact retired members, these changes are one strategy for pursuing intergenerational equity while plans are reducing retirement benefits for new members. In New Mexico, a large portion of the unfunded liability is related to future COLAs because the adjustments are compounding, which is not the case in every state. ERB's actuary indicated that there are a wide variety of strategies that could be pursued to limit the impact future COLAs have on the unfunded liability, including a move from an annual COLA to a less-frequent COLA until the system is fully funded. For example, Rhode Island will provide a COLA every four years until the plan reaches 80 percent funding. Rhode Island also changes its COLA to base half of the increase on investment returns and half of the increase based on CPI and applies the COLA to the first $26 thousand in payments. However, the largest impact on the unfunded liability would be to suspend the COLA for a set number of years. Other states have adopted this strategy with pension sustainability legislation. The Legislature could also consider providing ERB with the authority to set annual cost-of-living adjustments based on the fund's actuarial status, such as allowing the board to approve a COLA reduction if the annual actuarial valuation indicates the fund is less than 100 percent funded.

Impact of Cost-of-Living Adjustment Suspensions

Increase	Funding Period
0 years	61 years
5 year	48 years
10 year	41 years

Source: ERB

Benefits Accrual

Final Average Salary. Nineteen states made changes to the period used when calculating final average salary, which is the calculation used to determine a retiree's pension and is typically the member's average salary over a set period of time. Almost

every state that made this change increased the period from three years to five years, which reduces pensions by including additional lower salary years. However, New Mexico already calculates pensions based on the members average salary in the five highest consecutive years. Only one state, Florida, increased the period beyond five years, to eight years. In addition to increasing the period, a number of states also moved to exclude one-time payments, such as cash payments for accrued sick-leave, from the pension calculations, but these are not included in ERB's current calculation.

ERB's current benefits multiplier is 2.35 percent, so a member receives 2.35 percent of his or her final average salary for each year of employment. A member with 30 years of service would receive:

2.35 * 30 = 70.5 percent of final average salary

Benefits Multiplier. At least 16 states have recently reduced the size of the pension benefit by decreasing the benefits multiplier. The multiplier is the percentage of a member's final average salary that a member receives in retirement for each year of service. Compared with other states, New Mexico has a relatively high multiplier, which means ERB's plan replaces a larger percentage of income than in some other states. At a staff retreat this summer, ERB staff provided the board with some examples of well-funded pension systems (see **Appendix B, Comparisons of Retirement Plans**). Notably, all of these systems also participate in Social Security, like New Mexico, and all of these systems provide for a lower salary replacement rate after 30 years of service.

ERB staff have observed that a tiered benefits multiplier may help to improve equity in the retirement system and increase incentives for teachers to remain on the job even after reaching retirement eligibility. Unlike the current flat rate multiplier, a tiered multiplier starts at a low rate and increases as the member adds more years of service credit. ERB staff say that short-term employees tend to pay a smaller share of their overall benefit received. As a result, longer-term employees are subsidizing short-term employees. Further, because many short-term employees begin with an ERB employer later in life, the contributions those members put in the system do not have as long to build investment returns, a key part of ERB's plan.

ERB's actuary estimated the impact of adding a tiered multiplier to the ERB system, both at current rate of 2.35 percent as the maximum and at a lower rate maximum. The impact is relatively weak, in large part because the actuary assumes it will only apply to new employees because changing benefits for current workers might be unconstitutional.

Impact of Tiered Benefits Multiplier

Increase	Funding Period
No Change	61 years
Tiered, with Top Rate of 2.35%	48 years
Tiered, with Top Rate of 2%	41 years

Note: The current multiplier is 2.35%.

Source: ERB

Vesting Period. Fifteen states increased the period of time members have to be employed before they become eligible for the defined benefit pension. However, one of these states, North Carolina, increased the period and then reversed that decision, citing concerns the state was not competitive with other employers. ERB staff have raised the concern that by increasing the vesting period, more members will be encouraged to withdraw contributions if they leave the system before vesting (because more people will fail to vest before leaving employment), meaning ERB can no longer invest those funds and build fund assets. With a shorter vesting period, short-term employees may leave their contributions in the fund in case they decide to return to an ERB employer to fully vest in the system; however, ERB staff have also

indicated some younger members that leave ERB employers are likely to withdraw funds even after they vest. Regardless of the impact on refunds, longer vesting periods do not reduce the unfunded liability, although they may prevent some future liabilities. They could also have an impact on recruitment, particularly for "second career" teachers and teachers who move to New Mexico from out of state and work for a limited period.

Caps to Pension Benefits. A handful of states, including Alabama, Nevada, and Pennsylvania, placed caps on the annual retirement benefit of retirees. These caps were implemented in two ways. Alabama applied a percentage cap on the amount of final average salary a member could receive in retirement, similar to the 80 percent cap that applies to PERA members hired after 2010. Once members have sufficient service credit to reach that cap, the only way to increase the pension benefit is to increase final average salary. While such a system helps to prevent very large pension, it could have the effect of disincentivizing longer service. Other states have capped the total amount of the pension, but these caps tend to be rather high. For example, New Hampshire enacted a cap of $120 thousand. To comply with Internal Revenue Service requirements for defined benefit plans, New Mexico currently caps contributions at the amount allowed by the Internal Revenue Code, or about $280 thousand in 2018.

Anti-Spiking Measures. Pension spiking — the deliberate manipulation of salary in order to receive a larger pension benefit — is one area targeted by a handful of states when reforming pension systems. While ERB staff notes pension spiking does not necessarily have a large actuarial impact on the system's unfunded liability, it is important to put in place a transparent and equitable system for all members. Pension spiking amounts to "gaming" the system and likely results in some additional costs to other members and taxpayers. Pension spiking can happen in two ways. First, if an employee receives a sudden and significant salary increase late in their career. This can increase the employee's final average salary, without the employee making contributions on that larger salary for many years. Most states addressed this by capping the amount that a member's final average salary can increase from one year to the next. Some states provided exemptions for people who change jobs and received a corresponding salary increase.

Another way pension spiking can happen is if a member works part time for many years and full time for a small number of years. Because both part-time and full-time employees earn a full year of service credit for each year worked, this could allow members to make contributions for many years on a very small salary and retire based on a much larger salary earned for only a few years. Under current ERB rules, anyone employed by one or more ERB employer for more than 0.25 FTE is required to become an ERB member. No other state addressed this form of pension spiking between 2007 and 2015, possibly due to differences in how other states treat part-time employees when determining member eligibility; some states only provide benefits for full-time employees or have higher FTE requirements for part-time employees. Because New Mexico is a rural state with many small school districts, the need for part-time employees could be greater than in other states. In some cases, it may not be economically feasible for school districts to employ full-time personnel, and not providing benefits could narrow an already limited pool of job candidates. ERB might

consider investigating the possibility that part-time employees accrue service credit at a slower rate than full-time employees, but this could be administratively burdensome and might have an impact on the ability of rural schools to recruit needed staff.

Retirement Age and Service Credit

The most frequent pension reform pursued by state pension plans was increases to the retirement age. Many of these reforms addressed systems that had simply never provided a minimum retirement age or that allowed members to retire after 25 years of service, regardless of their age. In total, 35 states made changes to their minimum retirement age, the amount of service credit needed to retire, or the penalties that applied when a person retired early. Many states maintain a minimum retirement age in the 50s, although many states, like New Mexico, apply a penalty for members who retire under a set age. A number of states also increased the minimum age for an retirement without paying a penalty to age 67, which matches the full retirement age for Social Security.

One important consideration in changing the retirement age is that most cases involved only changing the retirement age for new hires. As a result, the full effect of a change in the retirement age will not be seen for a number of years. Even those states that had the option of changing the retirement age for current members typically provided a small cushion for those within five or 10 years of retirement.

A number of states provided that the Social Security retirement age would be the retirement age for the pension plan. It is not clear from the NASRA information if this change effectively indexes the retirement age for current members were the federal government to increase the normal retirement age in the future. It is also unclear if this would be allowed under the New Mexico constitution if it had the effect of increasing the retirement age for current employees.

Changes to Plan Design

While most states retained traditional, defined benefit pension plans for educational employees, a small number of states closed their traditional defined benefit pension plans for new members and required newly hired employees participate in hybrid plans that provide a lower defined benefit coupled with a defined contribution plan. In some states, including Indiana, hybrid plans were established before 2007, the earliest year in the NASRA study.

When considering a hybrid plan, it is important to remember that it will not impact the current unfunded liability. To pay down the current unfunded liability, plans must make arrangements for continued contributions for employees that have moved to other systems. As a result, adopting a hybrid pension plan can have the effect of increasing plan costs; however, some states have chosen to adopt hybrid plans to help share the risk of investment losses and demographic changes between employee and employer and possibly avoid future unfunded liabilities.

Defined Contribution Plans. Only Alaska has a mandatory defined contribution plan for public school employees that does not feature a defined benefit element, although Michigan and Oklahoma operate defined contribution plans for public employees other than teachers. Several other states allow employees to opt-in to defined contribution plans. For example, in 2012, Michigan began to allow educational employees to opt-out of the hybrid plan and into a defined contribution plan.

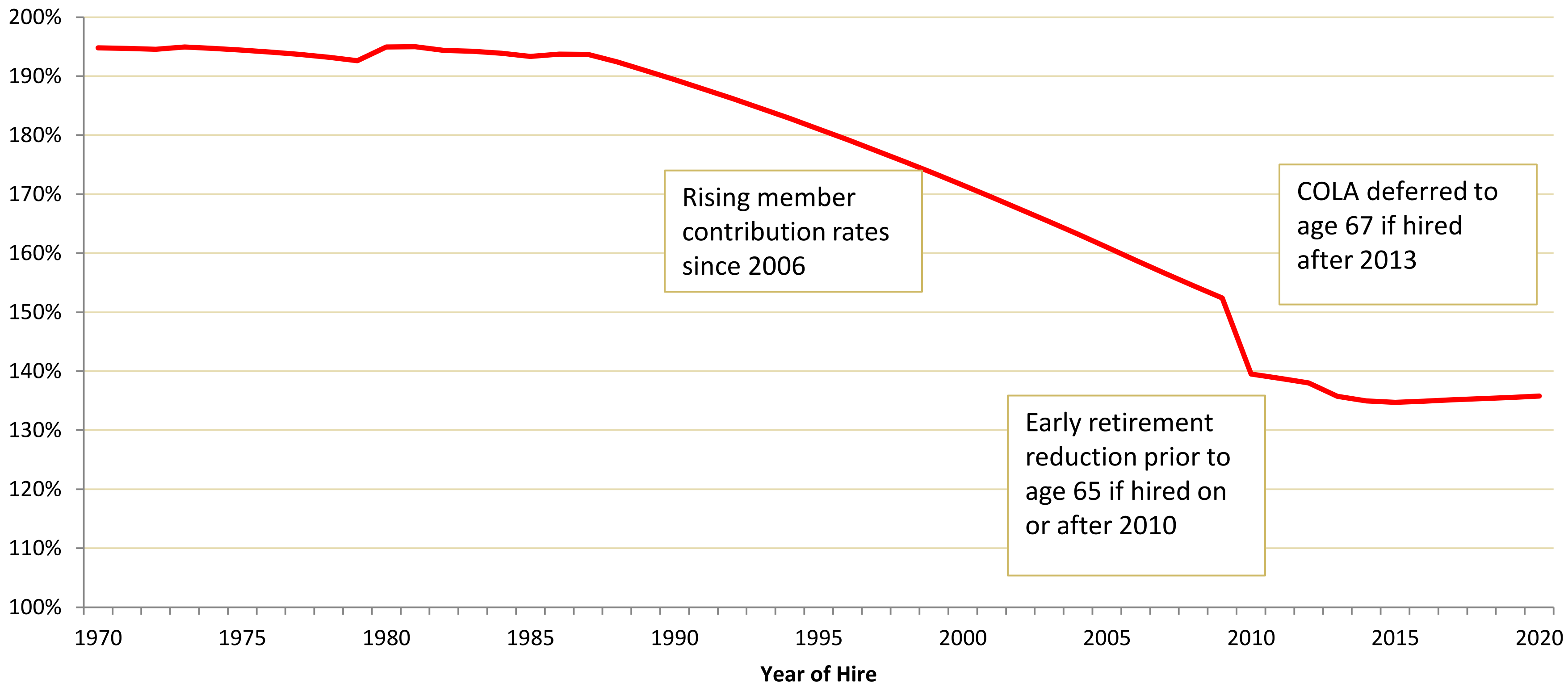
According to the Center for Retirement Research at Boston College, some states have moved to defined contribution plans to reduce the investment and demographic risk borne by the employer and to provide benefits for workers who remain employed for only a short period. Only about 2 percent of public employees are enrolled in defined contribution only plans and teachers tend to be more interested than other public employees in earning benefits over a career. Additionally, many critics of defined contribution plans are concerned they do not provide sufficient income in retirement.

Conclusion

While ERB remains able to pay its promised pension benefit now and into the future, continuing with the current system will lead the state to pay billions more in contributions before the unfunded liability is fully retired and member and employee contributions can be reduced. Nationwide, many other states have been dealing with the same issues, particularly since the 2008 financial crisis. Very few states have sought to address these problems with only one solution; pension reform in most states has required a multi-pronged approach that balances the sacrifices needed to maintain sustainable systems between past, current, and future employees and taxpayers.

ERB's board will consider potential sustainability legislation in the fall and make recommendations to the Legislature. It is also likely the New Mexico Retiree Healthcare Authority — which provides retired public employees and teachers with subsidized health insurance for pre-Medicare retirees and Medicare supplement plans for other retirees — will bring forward legislation to address long-term solvency of that plan. It is also likely that teachers and other educational employees will seek additional salary increases, similar to movements to increase teacher pay that other states saw earlier this year. The Legislature will need to carefully consider the balance between salary increases, which can be realized by employees in the short-term, and the needs of the retirement systems, which will only be realized by employees in the long term. Ultimately, it is the responsibility of the Legislature to consider how to best design these plan to ensure the state's employee benefits programs meet the recruitment and retention needs of New Mexico's educational employers.

How do the generations compare?



Source: GRS presentation to the ERB Board

GRS Retirement Consulting

Appendix B: Comparisons of Retirement Plans

	Delaware SEPP-6/30/2017	Idaho PERSI-7/1/2016	Illinois MRF-12/31/2016	New York STRS-6/30/2016	North Carolina Teachers - 12/31/2016	Colorado PERA 12/31/2016	Arizona 6/30/2017	Oklahoma 6/30/2017	Texas TRS-8/31/2017	NM ERB-6/30/17
Funded Ratio	85.3%	86.3%	88.9%	98.4%	90.4%	56.3%	77.6%	70.4%	80.5%	62.9%
Total no. of Members	36,198	144,560	410,000	428,000	672,514	313,266	586,306	175,052	1,545,057	153,514
Total Assets under Management	$8.5 Billion	$17.4 Billion	$33 Billion	$115.5 billion	$64.2 Billion	$22.5B	$36.2 Billion	$15B	$145.9 Billion	$12.5 Billion
Benefit Multiplier	1.85%	2%	1.66% first 15 years, 2% over 15 years	less than 20 years-1.66%, more than 20 years 1.75% first 20, 2% over 20	1.82%	2.5%	less than 20 years-2.1% 20-20-24.99 years-2.5% 25-29.99 years- 2.2% 30+ years- 2.3%	2%	2.3%	2.35%
Employee Contribution Rate	5% of salary over $6,000	6.79%	4.5%	3-6% based on salary	6%	8%	11.34%, will be 11.64% effective 7/1/18. Includes retiree healthcare	7%	6.7%	7.9% if salary is $20,000 or less. 10.7% if salary is greater than $20,000
Employer Contribution Rate	9.5%	11.66%	11.69	17.53%	9.15%	19.15%	11.34%, will be 11.64% effective 7/1/18. Includes retiree healthcare	9.5% for K-12 and Junior Colleges. 8.55% for Universities.	7.76%	13.9%
Social Security Coverage	yes	yes	yes	yes	yes	no	yes	most	no	yes
Replacement Rate (30 years)	55.5%	60%	54.9%	55%	54.6%	75.0%	69%	60%	69%	70.5%
COLA	Ad hoc	CPI up to 1% mandatory, lesser of CPI or 6% discretionary maximum	Annual 3% or 1/2 CPI whichever is less	50% change in CPI up to 3%, but at least 1%	Ad Hoc	If hired before 2007: 2%, If hired after 2006: Up to 2%, Board has voted to cap COLAs at 1.5% for all and suspend COLAs for two years.	Up to 4% based on excess earnings over a 10 year period. Last paid in 2005. Hired after 9/13/13 , no COLA	Ad Hoc	Ad Hoc	CPI up to 2%, 1/2 of change in CPI above 2% but no less than 2% or more than 4%, 10 or 20% reduction until fully funded.
	Retirement plans identified by National Institute on Retirement Security as having "well-funded" plans					Neighboring States				ERB

Source: ERB

Appendix C: Changes to Statewide Public School Pension Systems, 2007 to 2015

	State	Increase Employee Contributions	Increase Employer Contributions	Direct State Contribution	Increased Vesting Period	Increase Period for Calculating Average Salary	Reduced Benefits Multiplier	Limit Annual Retirement Benefits	Raised Retirement Age	Anti-Spiking Measures	Changes to COLAs	Hybrid Plans	
1	Alabama	YES				YES	YES	YES	YES				1
2	Arizona					YES			YES		YES		2
3	Arkansas	YES											3
4	California	YES	YES	YES		YES	YES		YES				4
5	Colorado	YES	YES						YES		YES		5
6	Delaware				YES				YES				6
7	Florida	YES			YES	YES			YES		YES		7
8	Hawaii	YES	YES		YES	YES	YES		YES		YES		8
9	Illinois				YES	YES		YES	YES		YES		9
10	Indiana												10
11	Iowa	YES	YES		YES	YES			YES				11
12	Kansas	YES	YES			YES	YES		YES		YES		12
13	Kentucky	YES					YES		YES				13
14	Louisiana					YES			YES	YES	YES		14
15	Maine								YES		YES		15
16	Maryland	YES			YES	YES	YES		YES		YES		16
17	Massachusetts					YES	YES		YES	YES			17
18	Michigan	YES									YES	YES	18
19	Minnesota	YES									YES		19
20	Mississippi	YES			YES		YES		YES		YES		20
21	Missouri										YES		21
22	Montana	YES				YES			YES		YES		22
23	Nebraska	YES				YES				YES	YES		23
24	Nevada						YES	YES	YES	YES	YES		24
25	New Hampshire	YES				YES		YES	YES				25
26	New Jersey	YES				YES	YES		YES		YES		26
27	New Mexico	YES	YES						YES		YES		27
28	New York	YES			YES	YES	YES		YES				28
29	North Carolina									YES			29
30	North Dakota	YES			YES				YES				30

Appendix C: Changes to Statewide Public School Pension Systems, 2007 to 2015

	State	Increase Employee Contributions	Increase Employer Contributions	Direct State Contribution	Increased Vesting Period	Increase Period for Calculating Average Salary	Reduced Benefits Multiplier	Limit Annual Retirement Benefits	Raised Retirement Age	Anti-Spiking Measures	Changes to COLAs	Hybrid Plans	
31	Ohio (Teachers)	YES				YES	YES		YES		YES		31
32	Ohio (School Employees)								YES				32
33	Oklahoma								YES		YES		33
34	Oregon										YES		34
35	Pennsylvania	YES			YES		YES	YES	YES				35
36	Rhode Island				YES		YES		YES		YES	YES	36
37	South Carolina	YES	YES		YES				YES		YES		37
38	South Dakota										YES		38
39	Tennessee											YES	39
40	Texas	YES							YES				40
41	Utah											YES	41
42	Vermont	YES							YES				42
43	Virginia	YES		YES		YES	YES		YES		YES	YES	43
44	Washington								YES				44
45	West Virginia	YES			YES				YES				45
46	Wisconsin	YES			YES								46
47	Wyoming	YES				YES	YES		YES		YES		47
48	**Count**	29	7	2	14	19	16	5	35	5	26	5	48

Source: National Association of State Retirement Administrators, "Significant Reforms to State Retirement Systems," June 2016