Date: October 24, 2019
Prepared By: Joseph W. Simon, Senior Fiscal Analyst
Purpose: To review the current position of the educational retirement fund and ERB's priorities during the 2020 legislative session.
Witness: Jan Goodwin, Executive Director, Educational Retirement Board
Expected Outcome: Better understanding of pension-related legislation in the 2020 legislative session.

Educational Retirement Board FY21 Priorities

The New Mexico Educational Retirement Board (ERB) oversees retirement benefits for public employees of school districts, charter schools, higher education institutions, and certain state agencies. ERB's board of trustees oversee a staff to administer that ensure covered employers comply with the provisions of the Educational Retirement Act (ERA), assist eligible employees with applying for retirement, and invest the plan's $13 billion trust fund. More than 60 thousand active employees, 49 thousand retired employees, and 48 thousand former employees that have yet to retire are covered by the system. In FY18, the plan collected $676 million in contributions, with more than 75 percent of these contributions originating from state general fund appropriations, mostly from the state equalization guarantee distribution for employee salaries and benefits. In FY18 ERB paid out more than $1.1 billion to retirees, with more than $900 million paid to retirees who continue to live in New Mexico.

Educational Retirement Issues

Traditional "defined benefit" pension plans, like the plan offered by ERB, provide members a secure retirement benefit by pre-funding pensions with a combination of employer- and employee-paid contributions. Contributions are invested over the course of the employee's career and when the employee reaches retirement criteria set in statute, the employee is eligible to retire and receive a cash benefit for life. In New Mexico this benefit is considered a property right protected by the constitution.

According to NASRA, nearly two thirds of public pension plans had assumed investment returns of 8 percent a decade ago. Today, only 5 percent of public plans assume a rate of 8 percent or more. A recent editorial in the trade publication *Pensions & Investments* suggested the current median rate of 7.25 percent — the return assumed by ERB — may be too high given some investment firms excected future investment returns.

In recent years, many public pension plans in the United States have faced challenges related to their financial sustainability. Nationwide, retirement plans granted additional benefits to employees in the late 1990s, when a booming stock market was boosting investment returns higher than anticipated. Most plans also experienced substantial losses on assets during the Great Recession. According to the National Association of State Retirement Administrators (NASRA), public pension plans ended FY17 with only 71.9 percent of the funds required to pay accrued liabilities, down from 100.8 percent at the end of FY01.

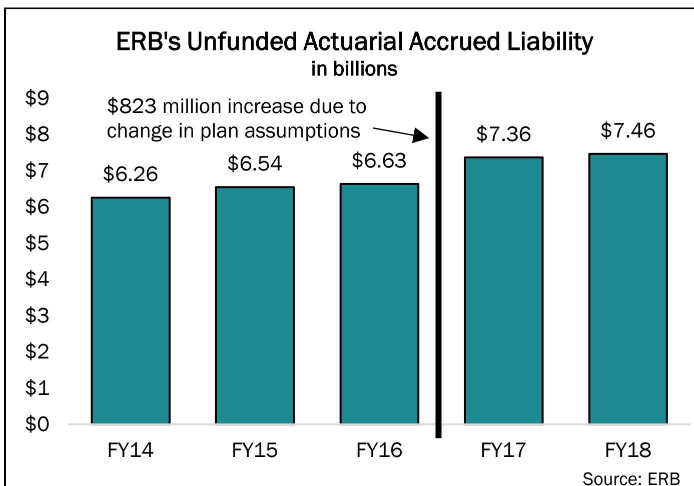
In New Mexico, the educational retirement fund remains solvent, meaning the plan is projected to be able to pay all promised benefits now and into the future, but the plan continues to face a significant unfunded liability. According to ERB staff, much of this unfunded liability is related to benefit increases granted to members in the 1990s.

When a pension plan does not hold enough assets to pay for all of the benefits it has already promised, the plan has an unfunded liability. Most plans with an unfunded liability are projected to pay down the unfunded liability over time. A plan only becomes insolvent when a plan cannot pay the promised benefit.

Ideally, a pension plan would either hold 100 percent of the assets needed to pay promised benefits or have a plan to pay off the unfunded liability over a few years. In FY18 ERB projected it would take 70 years to pay off the unfunded liability, but ERB estimates changes made during the 2019 legislative session will reduce this repayment period to 46 years. ERB's actuaries are in the process of updating these projections, based on the fund's financial position as of June 30, 2019; annual actuarial valuation reports are typically available in December.

Financial Sustainability

According to ERB's actuaries, the educational retirement fund has promised $20.5 billion in benefit payments but currently only has $13 billion in assets, or 63.5 percent of the amount needed to pay for these benefits. ERB-covered employers are liable for the remaining $7.5 billion in accrued liabilities. Generally, pension plans want to pay off the unfunded liability in 30 years or less. ERB's actuaries projected employer contribution rates would need to be 18.7 percent of payroll, up from 13.9 percent at the time, to pay off the unfunded liability in 30 years, based on the plan's design and actuarial assumptions in FY18.



Actuarial estimates of the fund's liabilities are based on assumptions set by ERB's trustees following periodic studies of the fund's experience by ERB's actuaries. Because investment returns are an important part in funding ERB's benefit, the plan's assumed rate of investment return is a key assumption in calculating the unfunded liability. Following ERB's most recent experience study, the board reduced the assumed rate of return on investments from 7.75 percent to 7.25 percent; combined with other assumption changes, the unfunded liability increase by $823 million in FY17 due to these changes. According to the NASRA, the median assumed rate of return nationally is 7.25 percent. Prior to FY11, the plan assumed an 8 percent return on investment.

ERB develops its legislative proposals in consultation with their stakeholder groups, which includes representatives of public schools, higher education institutions, labor unions, and retiree groups.

2020 Legislative Proposals. At the October meeting, ERB's board of trustees approved legislative priorities for the 2020 legislative session. The proposal would create a general fund transfer equivalent to 3 percent of ERB-covered employer's salary expenses by FY23, phased-in at 1 percent per year in FY21 through FY23. The transfers would continue until ERB's unfunded liability is eliminated. The proposal would not increase employer contributions directly. ERB staff indicate higher education institutions did not support an employer contribution increase because the Legislature has typically only funded the general fund portion of the increase – contributions made from salaries paid by federal or other funds had to be made of from those sources. ERB's proposal would shift the

costs of those contributions to the state. In addition, ERB is seeking $100 million in one-time payments from the general fund, including $50 million in FY21 and $50 million in FY23.

The initial proposal from ERB appears to commit the state to fund transfers to the educational retirement fund outside the normal appropriation process by placing a requirement to transfer general fund dollars in statute. Further the proposal does not specify the exact dollar amount of the transfer, only a percentage that would need to be calculated on an annual basis. Adopting this proposal could limit the Legislature's ability to manage the state's finances, particularly if revenues to the general fund deteriorate.

2019 Amendments to the Educational Retirement Act

During the 2019 legislative session, changes to the ERA were enacted to reduce the length of time it would take to pay down ERB's unfunded liability. Laws 2019, Chapter 258 (House Bill 360) made the following changes to ERB's plan:

- Increased employer contribution rates from 13.9 percent of salary to 14.15 percent of salary for FY20 and subsequent years;
- Required retirees from the Public Employees Retirement Association that work for ERB-covered employers, other than police officers hired prior to July 1, 2019, to make nonrefundable contributions to the educational retirement fund;
- Extended coverage of the Educational Retirement Act to short-term substitute teachers working more than 0.25 FTE, who are currently excluded from coverage by administrative rule, beginning in FY21;
- Introduced measures to prevent sudden, large salary increases from increasing an employee's benefit if they retire shortly after receiving the raise, sometimes called "anti-spiking" provisions;
- Increased the salary threshold for higher employee contribution rates from $20 thousand to $24 thousand, with employees who make less than $24 thousand contributing 7.9 percent of salary to the fund and employees making more than $24 thousand contributing 10.7 percent to the fund;
- Created a tiered benefits multiplier, where employees with shorter service periods receive a smaller benefit than those with longer service periods, for those hired after July 1, 2019;
- Set the "soft" retirement age of 58, where a member who qualifies for retirement may retire but will have a reduced benefit, for those hired after July 1, 2019; and,
- Required that a retiree working for an ERB-covered employer for more than 0.25 FTE, regardless of salary level, to join the return-to-work program, preempting an ERB administrative rule that allowed a retired employee earning less than $15 thousand per year to work more than 0.25 FTE without joining the return-to-work program and making contributions to the fund.

According to ERB, 797 PERA retirees worked for ERB-covered employers in FY17, with 485 people employed by school districts and charter schools. While previous law reqired the employer to make contributions on these salaries, the employee was not required to contribute. ERB estimated collecting contributions from PERA retirees would bring in $2.2 million in employee contributions, although this figure assumes that PERA retirees continue their employment despite the new requirement.

Although the changes included in HB360 reduced the repayment period from 70 years to 46 years, the initial proposal included higher employer contribution rates — an increase of 3 percentage points rather than 0.25 percentage points — and a one-time transfer of $248.3 million from the general fund to the educational retirement fund. Had these additional contributions been approved, it would have changed the estimated date ERB's unfunded liability would be eliminated to 2048, or within the 30 year time frame that most pension plans target for amortizing unfunded liabilities.

Under current law, if ERB is less than 90 percent funded, retirees have their COLA reduced by 10 percent if they have at least 25 years as ERB members and earn below the median. Other employees have their COLA reduced by 20 percent. When ERB reaches 90 percent funding, these reductions will move to 5 percent and 10 percent, respectively, unit full funding is reached.

Eliminating the unfunded liability could have a positive impact on both employers and employees. Under current law, if ERB is less than 100 percent funded, annual cost-of-living adjustments paid to retirees are reduced. Additionally, most of the current employer contributions are directed to paying down the plan's unfunded liability; of the 13.9 percent of salary the employer is required to contribute, ERB's actuaries estimate 3 percentage points are directed to the cost of benefits earned in the current year, while 10.9 percentage points is directed to pay down the plan's unfunded liability. Paying off this liability will allow the Legislature to reduce contribution rates, potentially increasing employee take-home pay or freeing up funds, which could be allocated to other priorities. Additionally, rules from the Government Accounting Standards Board, which sets accounting guidelines for public entities, require ERB to produce an estimate of the unfunded liabilities attributable to each employer. These estimates must be reported in the financial statement of each employer. Recently, bond rating agencies have noted the high levels of these liabilities when issuing ratings for New Mexico public schools. Similarly, high levels of pension-related debt were a noted factor in a 2018 downgrade of New Mexico's bond rating.

Return-to-Work Issues

Amendments to the Educational Retirement Act in FY19 created new restrictions for employees that have retired and are receiving a pension benefit but continue to work for an ERB-covered employer, known as "return-to-work". Generally, the Educational Retirement Act sets out the rules for the return-to-work programs, but prior to this year ERB's administrative rules included an exception that allowed part-time or low-paid employees to continue to provide services to an ERB-covered employer without joining the return-to-work program outlined in statute. Under the return-to-work exception, any retiree who worked for less than 0.25 FTE or who earned less than $15 thousand was not required to join the return-to-work program, but could continue to receive their pension while working for an ERB-covered employer. Provisions included in HB360 required a retired employee working more than 0.25 FTE, regardless of salary, join the return-to-work program.

Under current law, the return-to-work program is set to expire January 1, 2022. According to ERB, a total of 3,225 people were participating in the return-to-work program or the return-to-work exception in FY17. About 1,000 of these people were employed as a teacher at a public school, college, or university. It is unclear what impact the expiration of the return-to-work program will have as school districts and charter schools continue to struggle with high vacancy rates for teachers; while the change will eliminate one pool of eligible employees to fill such vacancies, some teachers might defer their retirement and work for more years if return-to-work is not an option.

Because of changes in HB360, not all retired employees were allowed to continue working. An important restriction of the return-to-work program is that a retiree must not be employed by an ERB-covered employer for at least one year following their retirement. As a result of the change, a retiree working for an ERB-covered employer for more than 0.25 FTE that earned less than $15 thousand in FY19 might not have been able to continue working in FY20, unless they had a previous one-year period when they did not work for an ERB-covered employer.

Anecdotal reports indicate the elimination of the return-to-work exception is impacting a number of retired teachers who have worked as substitute teachers in retirement. Many of these individuals were working more than 0.25 FTE but earning less than $15 thousand. This change may have the effect of discouraging teachers from agreeing to substitute on a part-time basis.

Even if those workers did qualify for return-to-work, they could see a reduction in take-home pay. State law required those who do qualify for the return-to-work program to make nonrefundable contributions to the fund; however, those working under the return-to-work exception were not making contributions. In addition, employers with staff that qualified for the return-to-work exception did not make contributions on that portion of their payroll. ERB projected the change to the return-to-work program could increase contributions by $4.1 million, with $1.8 million from employee contributions and $2.3 million from employer contributions.

ERB reports that changes to the return-to-work exception were primarily related to rules from the Internal Revenue Service that require a "bona fide termination" with no agreement for reemployment before a person can draw a pension. ERB reports that failure to ensure the plan meets IRS requirements could jeopardize the tax status of ERB.

Other States' Return-to-Work Policies. In general, most states do not allow retired employees to return-to-work without restrictions. These policies attempt to strike a balance between the length of time a person must be retired before returning to work, how much the retiree can earn without suspending their pension benefit, and when to require contributions to the fund. According to a recent report from NASRA and the Center for State and Local Government Excellence, all states require at least some employees to observe a break in service prior to returning to work. Some states make exceptions for older retirees (for example, Arkansas does not require a break for employees over age 65) or for those working in a "critical shortage" area (for example, California, where the 6 month requirement is waived to fill a position of critical need, subject to restrictions). Based on the information compiled in the report, New Mexico has a more restrictive lay out period for return-to-work employees than many other states. Only six statewide teacher or public school retirement systems require at least some employees to provide a one year break in service before returning to work.

Break-in-Service Requirements for State Teacher or Public School Retirement Systems

One Day to One Month	Arkansas (employees over 65), Georgia, Illinois, Louisiana, Missouri, North Dakota (less than 700 hours of annual service), Texas (half-time employment)
More than One Month to Six Months	Arkansas (employees under 65), California, Connecticut, Kentucky (part-time basis or different employer), Massachusetts, Montana, Ohio, Oklahoma
More than Six Months to One Year	Kentucky (full-time with same employer), Minnesota, New Mexico, New York, North Dakota (full-time employment in critical shortage area); Texas (full-time employment)
Unspecified Break Required	Pennsylvania

Source: National Association of State Retirement Administrators and Center for State and Local Government Excellence

*This table includes only retirement systems that limited to cover teachers and, in some cases, other school employees. Retirement systems that cover other public employees were are included. In many states a single system covers both public school and other public employees.

However, those states with shorter lay out periods often have restrictions on the number of hours an employee can work or the salary an employee can earn in retirement, while a person in ERB's return-to-work program has no such limitation, the ERA also allows someone working less than 0.25 FTE to return-to-work without a break in service. Work limitations vary by state, but often these amounts are higher than 0.25 FTE, which is about 10 hours per week or 5 days per month, according to ERB guidance.

Return-to-Work Earnings Limitations for State Teacher or Public School Retirement Systems

Day/Hour Based Earning Limitation	Illinois (120 days or 600 hours); Kentucky (0.7 FTE in addition to daily wage threshold); Massachusetts (960 hours in a calendar year); Missouri (550 hours each school year); New Mexico (0.25 FTE); North Dakota (700 hours if not in a critical shortage area)
Percentage of Benefit-Based Earning Limiation	Connecticut (45 percent of salary for the position occupied); Georgia (50 percent of salary prior to retirement/limited to three months in a full-time position each year); Louisiana (25 percent of retirement benefit); Missouri (50 percent of salary based on salary schedule); Montana (33.3 percent of salary prior to retirement, adjusted for inflation)
Dollar-Based Earning Limitation	California ($43,785); Kentucky (daily wage theshold set by retirement system for each member, at least $170); Massachusetts (pension plus salary cannot exceed salary of position they retired from); Minnesota ($46 thousand for those under 62; no limit for those over 62); New York ($30 thousand); Oklahoma ($15 thousand if under age 62, $30 thouand if over age 62 when retired for less than 36 months)
Other Restrictions	Pennsylvania (no other appropriate certified teachers are available or position is outside regular instructional hours)
No Earning Limit Indicated	Arkansas; Kentucky (critical shortage); Massachusetts (critical shortage); North Dakota (critical shortage); Ohio; Oklahoma (retired for more than 36 months); New Mexico (more than 0.25 FTE); Texas

Source: National Association of State Retirement Administrators and Center for State and Local Government Excellence

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Contribution policies also vary by state. While retirees participating in ERB's return-to-work program must make nonrefundable contributions, most other teacher retirement plans do not require employees to make contributions, although some teacher retirement plans do require the employer to pay employee's share on behalf of the retiree.

Contribution Requirements for State Teacher or Public School Retirement Systems

No Contributions Required	California; Connecticut; Georigia; Illinois; Minnesota; Missouri; New Mexico (0.25 FTE or less); New York; Pennslyvania
Employer Contributions Only	Arkansas; Connecticut; Kentucky
Both Employer and Employee Contributions	Louisiana; New Mexico (over 0.25 FTE); North Dakota; Ohio; Oklahoma (both paid by employer); Texas (both paid by employer)

Source: National Association of State Retirement Administrators and Center for State and Local Government Excellence

*This table includes only retirement systems that limited to cover teachers and, in some cases, other school employees. Retirement systems that cover other public employees were are included. In many states a single system covers both public school and other public employees.