MINUTES
of the
SECOND MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

July 11, 2018
State Capitol, Room 307
Santa Fe

The second meeting of the Investments and Pensions Oversight Committee was called to order by Representative Tomás E. Salazar, chair, on July 11, 2018 at 9:07 a.m. in Room 307 of the State Capitol.

Present
Rep. Tomás E. Salazar, Chair
Rep. Miguel P. Garcia
Rep. Jane E. Powdrell-Culbert
Rep. Patricia Roybal Caballero
Rep. Larry R. Scott
Sen. Elizabeth "Liz" Stefanics
Rep. Jim R. Trujillo

Absent
Sen. George K. Munoz, Vice Chair
Sen. Jacob R. Candelaria
Sen. Gay G. Kernan
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Steven P. Neville
Rep. William "Bill" R. Rehm
Sen. John M. Sapien

Advisory Members
Sen. Carlos R. Cisneros
Rep. Roberto "Bobby" J. Gonzales
Rep. Bill McCamley
Sen. James P. White

Sen. William F. Burt
Sen. Stuart Ingle
Sen. Mary Kay Papen
Sen. William H. Payne
Rep. Sheryl Williams Stapleton

Staff
Tessa Ryan, Staff Attorney, Legislative Council Service (LCS)
Kathleen Dexter, Researcher, LCS
Nancy Martinez, Staff, LCS

Guests
The guest list is in the meeting file.

Handouts
Handouts and other written testimony are in the meeting file and posted on the legislature's website.

Wednesday, July 11

Retiree Health Care Authority (RHCA) Update

David Archuleta, executive director, RHCA, gave an overview of the RHCA's plan benefits, as well as solvency and sustainability challenges.

The RHCA provides health, dental and vision plans for both pre-Medicare and Medicare-eligible retirees, paid for through public employee and employer contributions to the Retiree Health Care Fund. Premium costs charged to retirees are offset by subsidies based on the number of years a retiree served as an active public employee. In contrast to plans available through the New Mexico Health Insurance Exchange, RHCA plans are not age-banded, have lower annual out-of-pocket maximums and include prescription drug coverage.

In its most recent Governmental Accounting Standards Board filing, the RHCA showed plan fundedness at 11.26 percent. The RHCA's most current solvency analysis projects that without increases to contribution rates and premiums or changes to the benefits package, the RHCA will begin deficit spending in 2020 and will become insolvent in 2035. Premiums and benefits can be adjusted by the RHCA board; contribution rates, however, are set in statute and can be adjusted only by legislative action. Rising medical care costs are a major issue for the RHCA; Mr. Archuleta cited studies by the U.S. Bureau of Labor Statistics and the Centers for Medicare and Medicaid Services that show these costs rising at an "unsustainable level". This trend, coupled with the recent elimination of the individual mandate in the federal Patient Protection and Affordable Care Act, aggravates the RHCA's solvency issue.

On the recommendation of a work group formed in 2007, the RHCA board has taken actions over the past several years to improve solvency. These include reducing or phasing out certain subsidies; increasing cost-sharing; establishing age and service requirements for receiving maximum plan subsidies; and establishing an open enrollment period. Actions the board plans to take in the next five years include adjusting plans to reduce costs; further reducing certain subsidies; increasing premiums; evaluating new programs and adjusting existing programs; developing value-based purchasing initiatives; and providing information to retirees on managing their health. The board will also advocate for legislation in the 2019 legislative session to increase employee and employer contribution rates.

On questioning, Mr. Archuleta and committee members addressed the following topics.

Status. The statute that created the RHCA states that the legislature did not intend to create "trust relationships", and there has been no action to change the plan to an irrevocable trust, as recommended by the 2007 work group. The statute allows for changes to the program as well as its termination. If it were terminated, the RHCA trust fund currently does not have the balance to return all of the contributions made to date.

Liabilities. Under new federal requirements, RHCA liabilities must be allocated to and reported by its participating political subdivisions. If these allocations were considered on a par with liabilities from an irrevocable trust, which the RHCA is not, they might affect the political subdivisions' credit ratings.

Solvency. Each one percent increase in RHCA contribution rates is projected to generate $40 million in revenue, approximately one-third of which would come from the General Fund as employer contributions for state employees. The RHCA has modeled out revenue impacts from increases of one percent and 1.5 percent in combination with reductions in pre-Medicare retiree subsidies; the board will consider these at its next meeting and will hold meetings with stakeholders in the next month. The cost of the increase for an individual who earns $40,000 per year would come to approximately $6.00 per paycheck.

Benefits are currently paid for by employee and employer contributions and retiree premiums. A certain portion of those contributions is also put into the RHCA trust fund. Without changes to contribution rates, the RHCA will have to start drawing on the trust fund to pay its benefits obligations in 2020.

Increasing costs for specialty prescription drugs are a major contributor to the RHCA's solvency issues. The RHCA is limited in how much it can negotiate to reduce drug prices.

Members. The RHCA's Medicare-eligible membership is increasing, and its pre-Medicare membership is decreasing. These trends have a positive fiscal effect on the RHCA.

Members can take their concerns to the RHCA board, which is a representative body with members from an array of groups covered by the RHCA.

Plans. The RHCA's pre-Medicare premier plan equates to a silver-level plan on the open market, and the value plan equates to an open-market bronze-level plan. A retiree's cost for these plans is approximately 34 percent of an open-market cost because the retiree has pre-paid for the plan with payroll contributions over the course of his or her career.

Medicare plans are less costly for the RHCA than pre-Medicare plans because the federal government covers 80 percent of the cost of Medicare plans. The RHCA's expense for Medicare plans is entirely for prescription drug coverage.

Wellness programs. The RHCA offers gym memberships, online cooking classes and online health and disease management classes and conducts outreach to increase participation.

Tax Administration Suspense Fund. In the 2016 special session, the legislature reduced the RHCA's distribution from the Tax Administration Suspense Fund by approximately $350 million over the life of the fund. Increased investment earnings in 2017 made up for some of the lost revenue.

Mr. Archuleta agreed to provide:

(1) information on and a table of RHCA contribution increases to date;
(2) a booklet outlining RHCA benefits; and
(3) information on the portion of the RHCA's total liabilities that are attributable to pre-Medicare retirees.

Educational Retirement Board (ERB) Update

Jan Goodwin, executive director, ERB, reported on the ERB pension system and its assets, solvency and sustainability.

In response to questions posed by committee members at the previous meeting, Ms. Goodwin noted that:

- though higher inflation can yield higher investment returns, overall it has a slight negative effect on the ERB plan;
- a one percent vacancy rate in state employment results in a decrease in contributions and would delay full ERB fundedness for two years; and
- approximately 14 percent of ERB members became eligible to retire a year ago, 17 percent became eligible last month and 25 percent will become eligible three years from now.

Ms. Goodwin noted that the ERB plan is solvent, with a funded ratio just shy of 63 percent, and is on the path to full fundedness. In 2014, the projected date for full fundedness was 26 years out; however, when the board later adjusted mortality projections, inflation projections and earning assumptions, full fundedness moved to 61 years out. The ERB is developing proposals for reaching full fundedness more quickly — "within a reasonable amount of time", as stated in Ms. Goodwin's proposed definition of "sustainability". Once the plan is fully funded, it will be better able to withstand market downturns, contributions can be reduced, cost-of-living adjustment (COLA) reductions can end and credit ratings for the state and the ERB's participating employers will improve.

Contribution levels, eligibility requirements and COLAs are fixed in statute and can only be changed by the legislature. Each has been adjusted at least once since 2005; the ERB will present proposals for further statutory adjustments to improve the plan's sustainability at the committee's November meeting.

Ms. Goodwin closed with an overview of the ERB's strategic goals, which center on keeping the fund financially sound; improving services; identifying and managing risk; and building effective, collaborative relationships with stakeholders.

On questioning, Ms. Goodwin and committee members addressed the following topics.

Retirement patterns. The average retirement age for ERB members is increasing. Sixty-five percent of retirees are short-term employees — those who begin their careers at a later age and retire with fewer than 25 years of service. One consideration to help with the ERB's fundedness is to enact tiered multipliers, under which a retiree's pension multiplier is tied to the number of years that the retiree serves.

Contributions and benefits. Contribution levels as set in statute fall short of the actuarially required contribution level that would more quickly lead to 100 percent fundedness. An actuarially determined employer contribution rate is considered best practice. Some states allow for fluctuations in both contributions and benefits based on investment performance.

Portfolio. The portfolio's asset allocation has been adjusted and diversified to better weather a potential market downturn.

Fundedness and liabilities. Differences in ERB fundedness ratios as reported by other sources are a result of using different earnings assumptions. The ERB has run a sensitivity analysis on its earnings assumptions.

As of June 30, 2017, the ERB's unfunded liability was approximately $7.4 billion. Some other states with significantly higher unfunded liabilities, such as Illinois, exacerbated their fundedness problems by providing "pension contribution holidays", during which employees earned service credit but were not required to make contributions. The ERB has never done this.

Spiking. The ERB proposed legislation a few years ago, and will again in 2019, to enact "anti-spiking" measures that prevent manipulation of an employee's salary to yield a higher pension calculation.

Vacancies. The current vacancy rate in public and higher education has negatively affected the ERB through decreased contributions. A member stated concerns about school districts that hire long-term substitutes rather than permanent teachers, noting that this affects not only the ERB but also the quality of teaching.

Defined contribution and hybrid plans. The ERB investigated defined contribution and hybrid plans a decade ago and found that defined benefit plans are less expensive because they allow for pooling of risk, cost less for investment management and yield higher investment performance. Defined contribution plans were originally designed as a supplement to defined benefit plans and require double the amount of contributions to yield the same benefits as a defined benefit plan.

Salary increases. The Department of Finance and Administration denied all recently proposed salary increases for ERB staff, and the ERB has accepted its denial.

Ms. Goodwin agreed to provide:

(1) on request, information on defined benefit plans and defined contribution plans; and

(2) information on the probability rating of the ERB's 61-year projection for full fundedness.

Public Employees Retirement Association (PERA) Update

Wayne Propst, executive director, PERA, and Dominic Garcia, chief investment officer, PERA, gave an update on the PERA pension system's solvency and sustainability outlook.

The PERA's defined benefit pension system was designed to work together with social security and other plans, such as defined contribution plans, to provide a secure retirement income for public employees. In a comparison of defined benefit plans and defined contribution plans, Mr. Garcia showed that defined contribution plans require significantly higher contribution rates because they cannot take advantage of pooled risk or investment economies of scale and tend to yield lower returns as retirees "de-risk" their portfolios with age.

In response to questions from the committee's previous meeting, Mr. Garcia showed that the impacts of inflation and economic growth on the PERA have been roughly equal since 1970, with periods of rising rates offsetting falling rates in nearly equal measure. He also showed how the assets in the PERA's diversified portfolio perform in these fluctuations and balance one another.

The PERA's unfunded actuarial accrued liability as of June 30, 2017 was $5.07 billion, with a plan funded ratio of nearly 75 percent and full fundedness projected in 55 years. In its recent report and downgrade of the state's bond rating, Moody's Investors Service (Moody's) labeled the state's direct pension liabilities for the PERA as "moderate" and calculated the unfunded liability at $6.6 billion, a number that PERA staff are not able to duplicate. Mr. Propst said he believes that Moody's used a significantly lower discount rate in its investment return projections than the PERA uses. The PERA board is reviewing an experience study of the mortality, investment, retirement rate, salary and payroll growth assumptions and will adjust its projections downward based on the study's findings.

The PERA system includes five plans, each with its own funded ratio and projection path. Of the plans, only the state police plan is fully funded; the others range from approximately 80 percent funded to 60 percent funded, with two of those plans — the state general plan and the municipal fire plan — on a downward projection path.

Mr. Propst noted that changes made in Senate Bill 27 (2013) have had a positive effect on the state's pension systems; however, that effect has been muted by factors both within and beyond the PERA's control. The PERA board will develop legislative proposals to make additional adjustments in statute to strengthen the pension system and will present those proposals to the committee later in the interim.

On questioning, the presenters further explained the differences in cost and returns between defined benefit plans and defined contribution plans — pooled risk, economies of scale and investment returns — and noted that a large portion of the PERA's unfunded liability was generated 20 years ago when benefits were increased.

State Investment Council (SIC) Update

Steven K. Moise, state investment officer, SIC, and Vince Smith, deputy state investment officer, SIC, reported on the state's permanent funds, which are managed by the SIC.

The Land Grant Permanent Fund, Severance Tax Permanent Fund and Tobacco Settlement Permanent Fund all increased in value in the year ending May 31, 2018, with increases ranging from $11 million (Tobacco Settlement Permanent Fund) to $1.4 billion (Land Grant Permanent Fund). The Water Trust Fund lost value during that period because statute requires an annual distribution of $4 million regardless of the fund's balance or investment performance. In contrast, distributions from the Land Grant Permanent Fund and Severance Tax Permanent Fund are based on a percentage of the five-year rolling average of the funds' balances. Mr. Moise noted that because statute requires a specific dollar-amount distribution from the Water Trust Fund, there is a "better than 50 percent chance" that the fund will be depleted within 20 years.

Mr. Moise presented a chart of distributions from the Land Grant Permanent Fund and Severance Tax Permanent Fund since 2000. Distributions from the Land Grant Permanent Fund grew in all but two years during that period; the Severance Tax Permanent Fund has been less stable, with decreased distributions in seven of those years. The funds have benefited from increased oil and gas production in the past several years, due primarily to hydraulic fracturing, or "fracking", in the Permian Basin. Mr. Moise cited experts who project a potential production capacity of 30 years in that basin; however, he added that the state must keep its permanent funds strong enough to weather production downturns that still might occur, as well as the eventual end of oil production in that area.

The Tobacco Settlement Permanent Fund, which receives annual distributions from tobacco manufacturers under the Master Settlement Agreement, also saw an increase in distributions in the past year. Its balance, however, dropped sharply in the past few years as the fund, which is designated in statute as a reserve fund, was tapped to balance the state budget.

Mr. Smith gave a history of inflation since 1930, noting that rates have remained relatively low and stable since the early 1980s, averaging approximately 2.25 percent in the past 25 years. The SIC expects this average to continue in the next decade and has adjusted the investment portfolio accordingly. The national economy, as of late 2017, began moving into "late cycle", a phase that has historically been followed by a market downturn. With this possibility on the horizon, the SIC conducted a liquidity study on the portfolio, which shows that the Land Grant Permanent Fund is in a better position to handle a downturn than the Severance Tax Permanent Fund. The SIC has since adjusted portfolio investments for "targeted liquidity".

Mr. Moise noted that he and Mr. Smith will respond at the committee's August meeting to questions posed by committee members at the June meeting. Those questions concerned economically targeted investments and legislation for job creation efforts using the "windfall" oil and gas revenue the state is currently receiving.

On questioning, the presenters, committee members and Charles Wollmann, director of communications and legislative affairs, SIC, addressed the following topics.

Tobacco Settlement Permanent Fund. A member proposed that some of the state's windfall oil and gas revenue be used to restore to the Tobacco Settlement Permanent Fund money that was used to balance the budget.

J.P. Morgan. J.P. Morgan serves as the SIC custody bank and has provided, at no cost, a risk management tool with which the SIC can assess risk in its portfolio.

Tribal and colonias infrastructure earmarks. Earmarks for funding tribal and colonias infrastructure projects do not affect the Severance Tax Permanent Fund but, rather, come from the Severance Tax Bonding Fund.

New money. The permanent funds generated $70 million in "new money" that can be used in the next year.

SIC local government clients. The SIC handles investments for 21 local government entities, including counties, cities and school districts.

Adjournment

There being no further business, the committee adjourned at 3:15 p.m.