LFC Hearing Brief

NEW MEXICO LEGISLATIVE FINANCE COMMITTEE

Despite recent efforts to reform public employee pensions, the funds remain significantly under-funded. In June 2018, Moody's Investor Service downgraded New Mexico's credit rating citing, in addition to other factors, the large amount of pension related liability currently carried by the state. It has become clear the current benefit structure is unsustainable and further refinement of the pension systems is needed.

In 2017, the Public Employee's Retirement Association (PERA) reported an average annual benefit of $28.6 thousand paid to its 38.2 thousand retirees while the Education Retirement Board (ERB) reported paying an average $22.5 thousand annual benefit to its 47.3 thousand retired members. That same year, PERA reported an unfunded actuarially accrued liability (UAAL) of $5.1 billion while ERB reported a $7.4 billion UAAL.

Overview of New Mexico Pensions

Most state and local government employees in New Mexico, from small town firefighters to college professors, are eligible for pension plans administered by ERB or PERA. These governmental agencies offer "defined benefit" plans that ensure plan members receive a set monthly retirement payment. Pension benefits are determined by three factors: final average salary, years of service (or service credit), and a pension multiplier with a formula that looks like:

Pension = Final Average Salary X *Service Credit* X *Pension Multiplier*

Because retirement payments are fixed regardless of investment returns or contribution levels, the soundness of the retirement funds are judged on their ability to meet not only current obligations but also the obligation to future retirees. In order for a pension plan to remain solvent, the employer and employee contributions and investment returns must be able to cover the cost of benefit payouts and the administrative expenses of the fund. The financial health of a defined benefit pension plan is often measured using metrics including: the funded ratio which divides the plan assets by the total plan liabilities; the UAAL or amount of assets needed to pay future obligations minus plan assets; and the amortization period, or the amount of time it would take for contributions and investment income to pay down the entire amount of the pension liability.

New Mexico's two pension systems currently have a $12.5 billion UAAL. The amortization periods for the funds are also concerning; ERB estimates that it will take 61 years for the fund to pay off, or amortize, the UAAL while PERA reports an infinite amortization period meaning that there is no way for current contribution and investment income to pay for benefits.

AGENCY: Public Employees Retirement Association and Education Retirement Board

DATE: August 23, 2018

PURPOSE OF HEARING: Pension Solvency and Investment Performance

WITNESS: Jan Goodwin, Education Retirement Board; Wayne Propst, Public Employees Retirement Association.

PREPARED BY: Connor Jorgensen, LFC Analyst

EXPECTED OUTCOME: Informational Hearing

PERA pays out $1.1 billion in benefits to retirees and survivors annually. ERB pays $1 billion annually.

New Mexico's public pension plans currently have an unfunded liability of $12.5 billion. Without significant reforms, the unfunded liability will continue increasing further imperiling state finances.

New Mexico Pension Plans Compared Nationally

New Mexico's pension plans are significantly more generous than plans across the nation; New Mexico offers employees a pension multiplier of between 2.35 percent and 3 percent in addition to social security eligibility for non-public safety occupations. A report by the Urban Institute found that the average non-public safety pensions in the U.S. offered service credit of between 1.75 percent and 1.85 percent. There are only three other pension plans that offer a base pension multiplier of 2.5 percent: Colorado, Louisiana, and Nevada. None of these states participate in social security, which pays between 30 percent and 70 percent of the average lifetime earnings based on a 35-year work history and a retirement age of 65 or higher. Attachment 1 is a list of pension multipliers by state.

Employer Contribution Rates	
State	**Rate**
Arizona	11.3%
Colorado	10.2%
Kansas	13.2%
NM ERB	**13.9%**
NM PERA	**17.0%**
Nevada	14.5%
Oklahoma	16.5%
Texas	7.0%
Wyoming	8.4%

Source: LFC Files

New Mexico's richer benefit is paid for by higher pension contributions. The State of Wisconsin produced a comparative study of state pension plans in 2016 which showed employee contributions to the pension funds averaging just over 6.7 percent of payroll. Currently, PERA and ERB employees both pay significantly more, 8.92 percent and 10.7 percent respectively, than the average. However, the employer contribution of 13.9 percent for ERB and 16.99 percent for PERA are relatively high when compared to other states in the region.

The combination of social security eligibility, a high pension multiplier, a compounding COLA, and generous employer contributions results in New Mexico providing among the richest retirement benefits in the nation.

PERA and ERB Plan Features

While the pension benefit formula is similar for both PERA and ERB, there are significant differences in both benefits and contributions. Some of the differences in the plans are shown below.

	PERA	ERB
Pension Multiplier*	3.0%	2.35%
	2.5%	
Employee Contribution	8.92%	10.70%
Employer Contribution	16.99%	13.90%
Maximum Benefit**	90%	None
COLA	2%	2% max.
Final Avg. Salary*	High 3	High 5
	High 5	

*PERA offers a pension multiplier of 3 percent and a final average salary based on 3 years applies to those hired prior to July 1, 2013. A second tier of the pension was added after July 1, 2013. Tier 2 provides a pension multiplier of 2.5 percent and a final average salary based on 5 years. ERB has several pension tiers, however the multiplier has not changed since 1991.
**PERA's maximum pension is 90% of final average salary.

In general, the PERA plan provides a richer benefit to members at a higher cost to the state and includes two membership tiers. Tier 1 includes employees who began employment prior to July 1, 2013. Tier 2 members commenced employment after this date. Tier 1 members receive a 3 percent pension multiplier so that a member will qualify for a 90 percent pension benefit after 30 years of service. Tier 2 members would have to complete 36 years to reach 90 percent and ERB members would have to work 38.3 years to receive a 90 percent pension.

PERA and ERB Benefit Comparison

	ERB	PERA
Retired Members	47,340	39,487
Active Members	59,495	56,431
Avg. Benefit	$ 23,472	$ 28,642
Avg. Age at Retirement	62.1	61.3
Avg. Service Credit	20	22

Source: PERA and ERB CAFR

In addition, the final average salary, upon which the pension benefit is based, is defined as the three highest consecutive years for PERA while ERB calculates the final average salary based on the highest five consecutive years of pay.

The plans also have different minimum retirement age criteria that change based on when the member became a plan member. PERA members hired after July 1, 2013 are eligible to retire at age 65 with eight or more years of service credit or when the sum of the member's age and years of service credit equals 85. This is often referred to as the "rule of 85". ERB members hired after July 1, 2013 are eligible to retire at any age with 30 years of service credit, at age 67 with five years, or under a rule of 80.

Since the 1960's, ERB has had penalties for early retirement that PERA does not. For members retiring under the rule of 80, ERB requires benefits of members who retire after age 60 but before age 65 be reduced 2.4 percent for each year they retire before age 65 and reduces benefits by 3.2 percent for each year the member retires prior to age 60. In addition, tier 3 members hired after July 1, 2013 have a minimum retirement age of 55. The earlier a member retires, the less time their contributions are invested which significantly reduces investment gains from compounding interest. ERB currently allows return to work after a one year layout which encourages early retirement and increases double-dipping.

2013 Pension Reform

The last significant pension reform occurred in 2013 when the Legislature passed reform bills for both PERA and ERB. Senate Bill 27 made several significant changes to the PERA plan including the creation of a new retirement tier in the state general plan 3. The new tier reduced the pension multiplier from 3 percent to 2.5 percent for new hires, adjusted the minimum retirement age, and increased the vesting period for new hires. Additionally, the COLA was reduced from 3 percent to 2 percent for current retirees.

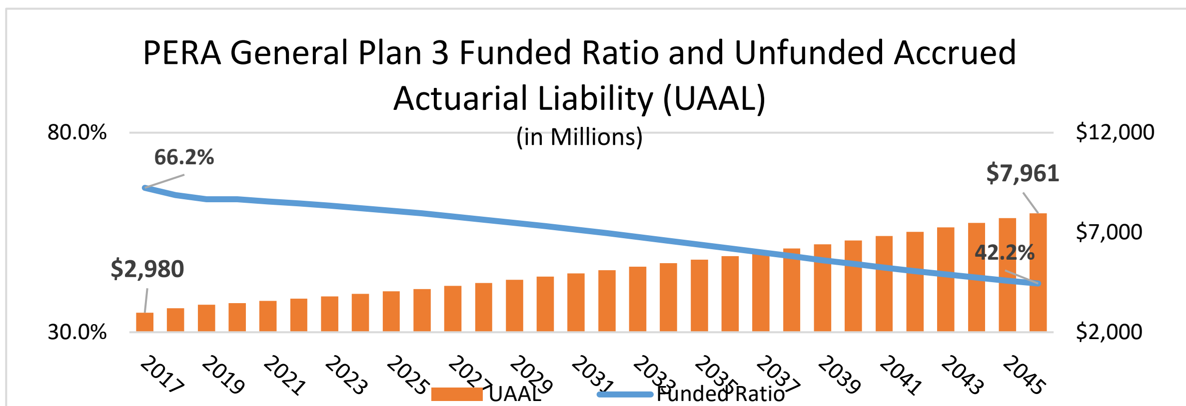
> "Credit rating agencies could downgrade New Mexico because of its failure to improve pension fund balances."
>
> -From FIR for SB27

Although the changes were significant, the legislation did not address early retirement through a penalty for early retirement such as ERB has. Also, the legislation did not require the COLA to reflect changes in the consumer price index (CPI) or a similar measure of inflation resulting in COLAs in excess of inflation being paid.

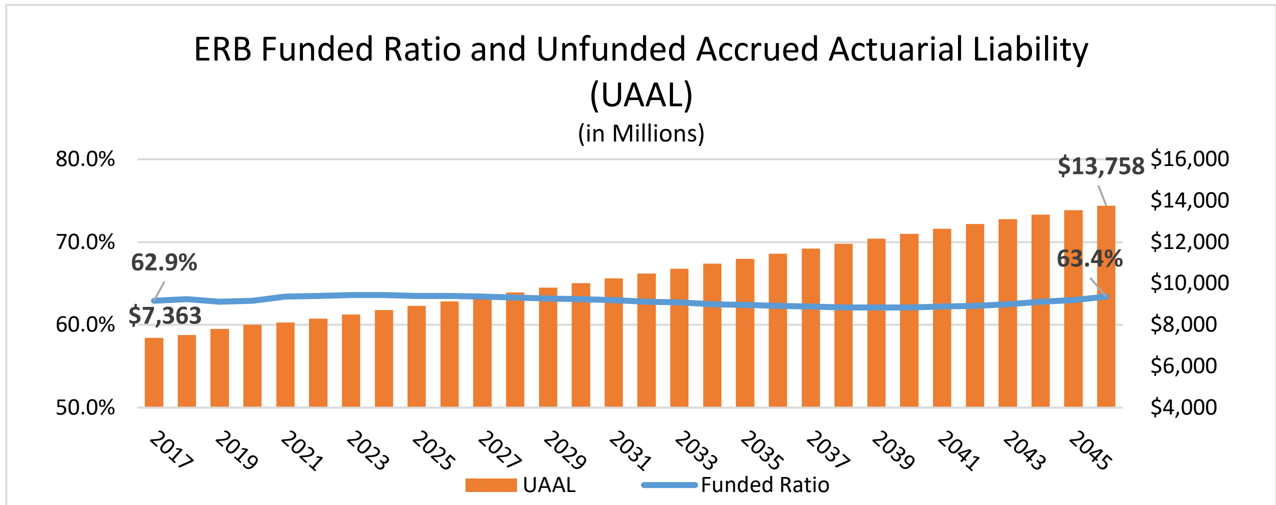
Senate Bill 115 made several changes to ERB including increasing the employee contribution from 10.1 to 10.7 percent, creating penalties for early retirement, and delaying COLA eligibility. At the time of passage, ERB estimated the funding ratio of the plan with the new changes would be 101 percent by 2043.

Pension Plan Solvency

Before comparing the PERA and ERB plans, it is important to distinguish between the obligations of the plans. PERA is made up of five independent plans: state general coverage plan 3; the state police plan; municipal general; municipal police;



and municipal fire. State employees who are not state police are covered in state general coverage plan 3, often referred to as general plan 3. Of the five plans managed under PERA, general plan 3 is the most severely under-funded.



While ERB faces significant funding issues, the financial outlook for the plan is more favorable than PERA's general plan 3 primarily as a result of a lower pension multiplier and a COLA that is reduced to account for the real rate of inflation.

Actuarial Assumptions

PERA recently reduced the investment return assumption from 7.5 percent to 7.25 percent. ERB assumes 7.25 percent investment returns.

The current national median expectation is 7.35 percent.

PIMCO, one of the world's largest money management funds, estimates stock returns of 4.5 percent over the next 10 years.

All calculations of pension liabilities are based on actuarial assumptions that are used to determine what the future value of contributions and investment income will be as well as the future cost of benefits. Assumptions affecting benefits are generally referred to as demographic assumptions and account for changes in life expectancy or mortality, the size of the state workforce, and salary increases. Assumptions affecting the financial position of the fund are referred to as economic assumptions and include the rate of return on investments and the rate of inflation. If a plan experiences investment returns or changes in life expectancy that differs from the assumptions, it may dramatically affect the funded ratio and UAAL because of the long time horizon used to calculate these metrics.

Both PERA and ERB have made recent changes to their actuarial assumptions. While life expectancy experienced a minor increase, the main driver was the investment return assumption. PERA and ERB now anticipate a 7.25 percent annual return on invested capital. Although lower than previous assumptions, PERA, ERB, and the State Investment Council have cautioned that the actual return on assets over the next 10 years may be significantly lower than the target.

Options for Reform

PERA reports 70 percent of pension liabilities are related to current retirees. 41 percent of PERA membership is made up of retirees.

ERB estimates 60 percent of pension liabilities are related to current retirees who make up 44 percent of membership.

Pension reform efforts may focus on three areas: cash flows; benefits; and COLAs. Cash flows refers to the contributions made to the fund by employees and employers as well as investment earnings. The ERB and PERA boards are responsible for investment policy development while the Legislature sets contribution rates statutorily. Similarly, benefits and COLAs are paid in accordance with statute.

Contribution Increases

With regard to increasing revenue to the fund, the Legislature has two options: increasing state appropriations for employer contributions or mandating increases in employee contributions. Increasing the ERB employer contribution rate by 1 percent would cost $26 million and would reduce the amortization period from 61 years to 48 years. Increasing the PERA employer contribution rate by 1 percent would cost $22 million and would reduce the amortization period from infinite to 56 years.

Benefit Reductions

Reducing benefits will improve the health of the pension fund by limiting the payouts to future retirees. Benefit reductions may be made to current and future employees in a number of ways. While the Legislature may pursue different legislation to address high expenditures including anti-spiking measures to prevent manipulation of a members high salary calculation and pensionable wage caps, the largest changes to funded status may be made through adjustments to the COLA, minimum retirement age, and pension multipliers.

Tiered Multiplier Example	
Years of Service	Multiplier
1-10	1.35
11-20	2.35
20-30	3.35
30+	2.35
Average	**2.35**

Minimum Age and Service Requirements

Because a large portion of pension fund income is derived from investment earnings, the more time contributions to the fund have to earn compounding interest, the better the health of the fund will be. The Legislature can affect retirement decisions by setting retirement ages that are more reflective of the longer life expectancies of today. Methods currently being employed include early retirement penalties imposed by ERB. However, these early retirement penalties are undermined to an extent by allowing members to double-dip.

In addition to making changes to minimum retirement ages, pension multipliers may be changed to induce members to work longer careers. Currently, ERB provides 2.35 percent of salary per year of service while PERA provides 3 percent to those hired prior to July 1, 2013 and 2.5 percent for those hired after. Reducing the pension multiplier would result in either a reduced benefit to members who work a shorter career or a longer career for those members who intend to receive the maximum benefit.

Many states use a "tiered multiplier" to provide an incentive for employees to work longer as well as reduce the benefits from short careers. A tiered multiplier provides a different multiplier through the course of a career. For example, employees earlier in their career would receive a lower multiplier than those at the end of their career. This provides a disincentive to "short career" retirements while providing an inducement to prolong the career in the later years of service. Again, the longer contributions are invested, the better pension solvency becomes.

Cost of Living Adjustments

PERA pays a COLA of 2 percent per year regardless of inflation resulting in pension payments growing faster than inflation. For example, state employees who retired in 1998 received COLAs that grew 10 percent faster than inflation over this time.

Current retirees receive annual cost of living adjustments (COLA). Statute requires PERA to provide an annual 2 percent COLA regardless of the real rate of inflation while the ERB statute allows the COLA to be adjusted based on inflation. Over the past 10 years, ERB's COLA has fluctuated between 0 and 2 percent and ERB anticipates an average COLA of 1.55 percent in the future. Because the COLA compounds over time, it has been a major driver of pension plan costs; PERA

estimates a 5 year suspension of the COLA would save the plan approximately $700 million while ERB estimates savings of $824 million.

The COLA is the only portion of the benefit of a retired member that a court has decided may be changed. The New Mexico Supreme Court ruled in Bartlett v. Cameron that a COLA is not part of a "core benefit," or the annuity calculated based on salary, years of service, and the pension multiplier, and is thus subject to change.

The Legislature may adjust COLA payments by amending existing statute in two primary ways: 1) setting a new maximum COLA payment and other requirements regarding calculating the amount of the COLA or 2) by delegating authority to set the COLA amount to the PERA or ERB boards. PERA's analysis suggests that changing the COLA will impact the funded ratio and the UAAL more than any other single change.

COLA Versus CPI

Year	CPI	ERB	PERA
2008	4.0%	2.0%	3.0%
2009	-0.4%	2.0%	3.0%
2010	1.6%	0.0%	3.0%
2011	3.2%	1.6%	3.0%
2012	2.1%	2.0%	3.0%
2013	1.5%	1.6%	2.0%
2014	1.6%	1.2%	2.0%
2015	0.1%	1.3%	2.0%
2016	1.3%	0.1%	2.0%
2017	2.1%	1.0%	2.0%

Closing Loopholes and Other Reforms

PERA no longer allows employees to double-dip. However, there are still over 400 workers in state service that were exempted from this restriction. ERB continues to allow double-dipping. Preventing double-dipping would allow fund contributions to remain invested for a longer period of time, taking advantage of the effects of compounding interest. Additionally, service credit could be reduced for part-time workers so that the state is not providing a full retirement benefit for part-time workers.

Defined Contribution Plans

As the economy changes, so too have the priorities of workers; people change careers more often than they did in decades past resulting in an increased demand for a more portable retirement savings option. In addition, defined contribution (DC) plans reduce the liability to the state by not including a guarantee of an income replacement level upon retirement. While these plans provide the state increased financial security by shifting risk to retirees, the plans are often more costly to administer. In addition, transitioning to a DC plan will not address the existing liabilities related to currently retired members as well as the service credit earned by current active members.

The National Institute for Retirement Security estimates DC plans cost up to 46 percent more than defined benefit (DB) plans. The cost disparity exists for three reasons: 1) there is no risk pooling; 2) DC plans provide a less balanced portfolio; and 3) lower returns and higher fees. In a DC plan, an individual must plan retirement for their maximum life expectancy to avoid running out of money in the later years of life. This results in the need for a higher overall savings rate while a DB plan can pool mortality risk to ensure a stable benefit regardless of life expectancy. Second, as individuals age, they need to "de-risk" their portfolios to protect against market volatility in the latter years of their careers. The transition away from higher-return assets comes at a large opportunity cost to individuals. Finally, DB plans can take advantage of more economies of scale and drive down investment fees while also being able to take advantage of investment options not available to the average person.

Implementation of DC or hybrid (DB and DC plan mix) may be pursued in a variety of ways. Some options include offering DB plans primarily to blue collar workers while DC plans could be offered to professionals making over a certain

income threshold. This approach would limit the amount of income a public employee would be guaranteed, but would provide a portable investment option that is often valued by professional workers.

Legal Considerations

New Mexico's constitution provides protections for public pension systems. In 1998, Article 20, Section 22 was added to the constitution. The Section provides that, among other things, pension plan members acquire a "vested property right" after meeting minimum service requirements and are guaranteed due process protections. The constitutional language may limit flexibility when pursuing reforms, but the Constitution also includes language stating: "*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…*"

It is unclear whether or how the state may change pension benefits for current members. In 2014, the New Mexico Supreme Court issued a decision in Bartlett V. Cameron which stated the COLA was not part of the core pension benefit and could therefore be changed. However, the opinion also included the following language regarding changing benefits for current members:

"*At oral argument, the State appeared to argue 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.*"
Also included in the Bartlett opinion is a discussion on future changes to benefits:

"A higher funded ratio is in the members', as well as the State's, interest as it better cushions the Fund […]. That in turn mitigates the need for other, potentially more drastic, changes in the future which could include changes to members' benefits or service requirements, as well as further changes to the COLA. If such changes had to be made […] they could be far more drastic than those made by SB115 and more deeply affect active and retired members."

While it may be possible to alter retirement benefits for current members, doing so would likely invite litigation.

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