STATE OF NEW MEXICO

LEGISLATIVE EDUCATION STUDY COMMITTEE

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December 14, 2011

MEMORANDUM

TO: Legislative Education Study Committee

FR: Craig J. Johnson

RE: **STAFF BRIEF: RETIREMENT BENEFIT PLAN DESIGN CHANGES**

At least since the 2004 interim, the Legislative Education Study Committee (LESC) has requested and received updates from the Educational Retirement Board (ERB) and the Retiree Health Care Authority (RHCA) regarding the solvency of their respective funds.

This staff brief outlines continued efforts by ERB and RHCA to improve solvency in the 2011 interim.

Educational Retirement Board (ERB)

2011 Timeline

- On August 31, the Investment and Pension Oversight Committee (IPOC) requested that the ERB develop a recommendation by its December meeting that meets the ERB's guidelines for solvency improvement.

- On September 15, the ERB directed staff to develop a series of plan design changes that will achieve funding goals of 80 percent by 2030 and 95 percent by 2040.

- On October 18, the ERB reviewed these plan design changes and selected scenarios that were then presented to ERB members.

- From October 24 through November 17, members of the ERB and staff conducted meetings across the state so that ERB members and the general public can comment on the scenarios and vote for their preference. According to ERB staff, during the statewide meetings, the following comments were frequently heard:

  - a Final Average Salary (FAS) period of five years was much more popular than a seven year FAS, with a lower benefit;
  - it is critical to have a cost of living adjustment (COLA), even if it is lower than the current COLA;
  - a minimum retirement age is acceptable; and
  - a longer the grandfather period is better.

- On December 2, the IPOC endorsed the ERB adopted proposal to:

  - reduce the COLA by 12.5 percent for all current and future retirees. The ERB COLA is based on the change in the Consumer Price Index (CPI) and typically begins the year a retiree turns age 65;
  - establish a minimum retirement age of 55 for members who would not be eligible to retire within 10 years of the proposal's adoption; and
  - include a grandfather provision that protects all members who meet any of the current retirement eligibility requirements either before or during the 10-year period.

Attachment 1, *ERB Plan Design Change Proposal for 2012 NM Legislative Session*, compares the ERB proposal to the current plan baseline.

Cost of Living Adjustments (COLA)

Currently, ERB provides a COLA annually that starts at age 65 that is based on the change in the Consumer Price Index (CPI). Currently, if the change in CPI is less than 2.0 percent, ERB's COLA is the change in CPI. Presently, if the change in CPI is more than 2.0 percent, the COLA is 1/2 the change in CPI, but not less than 2.0 percent and not more than 4.0 percent. The ERB proposal essentially reduces the current COLA by 12.5 percent.

Here are some examples:

- The CPI is -1.0 percent. The current COLA is 0 percent. The proposed COLA is 0 percent.
- The CPI is 0 percent. The current COLA is 0 percent. The proposed COLA is 0 percent.
- The CPI is 1.0 percent. The current COLA is 1.0 percent. The proposed COLA is 0.875 percent.
- The CPI is 2.0 percent. The current COLA is 2.0 percent. The proposed COLA is 1.75 percent.
- The CPI is 3.0 percent. The current COLA is 2.0 percent. The proposed COLA is 1.75 percent.
- The CPI is 5.0 percent. The current COLA is 2.5 percent. The proposed COLA is 2.19 percent.
- The CPI is 10 percent. The current COLA is 4.0 percent. The proposed COLA is 3.5 percent.

BACKGROUND

Educational Retirement Board (ERB)

The New Mexico ERB administers retirement benefits to active and retired members from school districts, higher education and educational agencies. According to the ERB website, ERB has 31,192 retirees and 63,698 active members.

Plan design

The defined benefit (DB) retirement plans[1] under the ERB is maturing. Mature pension plans often lose money because more is paid out in benefits than is collected in employer and employee contributions. DB plans are designed to provide retirees with a predictable monthly benefit. DB plans pool the longevity risks of large numbers of individuals and need to accumulate enough funds to provide benefits for the average life expectancy of the group. The pensions are considered vested after five years of employment. The benefit formula for ERB employees is FAS x service credit x 0.0235 = annual benefit. Only the Legislature can make changes to benefit levels.

Pension reform

Now that the impact of prior-year investment losses is being more fully recognized, actions to improve the funding status of ERB's pension plan are being considered. Given the severity of the economic downturn, the plan appears unsustainable in the long run without additional pension reform to reduce the unfunded obligations. Employer and employee contributions into the ERB plan are less than the pensions and expenses paid out of the plans. Thus, the fund depends on investment returns to keep the plan solvent.

The ERB has worked to improve the solvency of the fund. In 2005, the ERB worked with the Legislature to develop higher contribution rates for members and employers to address long-term funding. Buck Consultants estimated that ERB will run out of money by 2039.

Contribution Swaps

In the 2010 legislative session, direct employee compensation remained flat from FY 09 levels. Benefits decreased slightly because employers now contribute 1.75 percent less to the ERB and PERA for FY 12. Chapter 178 (House Bill 628) shifted this 1.75 percent contribution to employees as well as extended a 1.5 percent contribution shift enacted for FY 10 and FY 11, through FY 13. These contribution shifts require employees to pick up a cumulative 3.25 percent employer contribution for FY 12. The contribution swap will continue in FY 13 if the December 2011 forecast projects a FY 12 reserve ratio less than 5.0 percent and estimates revenues to be less than $100 million more than the revenue estimate used to determine the FY 12 appropriation. Based on current revenue and reserve projections, the retirement swap will not continue in FY 13.

Despite investment gains for FY 11 above the 8.0 percent assumption, plans show weaker funded ratios which may be indicators of financial instability. ERB's investment losses during 2001 to

[1] DB plans are designed to provide state employees with a predictable monthly benefit into retirement.

2003 and 2008 to 2009 coupled with the deficit in pension funding have negatively impacted the funding gap in the plan.

Unfunded Accrued Actuarial Liability (UAAL)

The UAAL can be thought of as the amounts that will be owed in benefits for all current retirees and participating active employees minus the amount in the fund. In general, realizing returns less than the assumed long term rate of 8.0 percent adds to the plan's unfunded liabilities (pension obligations). In April of 2011, the ERB decreased the investment return assumption to 7.75 percent, down from 8.0 percent. According to the actuarial valuation conducted by Gabriel Roeder Smith and Company, the UAAL increased from $4.5 billion on June 30, 2009 to $4.92 billion as of June 30, 2010. This is primarily caused by the investment losses incurred in FY 08 and FY 09. To smooth the effects of short term investment results, they are figured into the UAAL calculation on a rolling five-year basis, so the investment losses recorded during FY 08 and FY 09 continue to have a negative impact on the change from year to year.

Funded Ratio and Funding Period

The funded ratio compares the value of plan assets with the plan's liabilities. Having 80 percent of these obligations covered by assets (funded ratio) has traditionally been viewed as a minimum industry indicator of fund health. Considerable investment losses in FY 08 through FY 09 eroded the plans' funded ratio below the industry minimum standard of 80 percent. According to the actuarial valuation, the funded ratio for ERB was 65.7 percent as of June 30, 2010.

Funded ratios must be considered in combination with funding periods (amortization periods). This is the number of years it would take to fully fund the plan based on current contribution levels. The Governmental Accounting Standards Board (GASB) 25 recommends an amortization period no longer than 30 years. None of the state's plans meet that basic metric. In addition, both plans go far beyond the recommended period of time to pay off the UAAL of 30 years established by the GASB. According to the actuarial valuation, ERB's funding period has stretched to 62.5 years.

Additional actuarial information for ERB is shown on Attachment 2.

Pension Legislation from 2011 Session

Only one of numerous bills to improve funding for both ERB and PERA pension plans through increasing contributions or changing retirement eligibility requirements garnered sufficient support to pass both houses, but it was vetoed by the governor. Both PERA and ERB boards have supported legislation to increase contributions.

Retiree Health Care Authority (RHCA)

Actuarial Condition

In 2007, a report evaluating the long-term trend and actuarial condition of the RHCA fund was presented to the Legislature. This report projected RHCA would become insolvent by 2014. In response, several solutions were identified and implemented. For example, the RHCA board increased premiums and reduced the subsidy provided to retirees. In addition, in 2009, the Legislature adopted several changes to the program including:

- increasing employee and employer contributions to the program from 1.95 percent to 3.0 percent over a four-year period;
- removing the sunset clause for a $3.0 million tax suspense fund distribution;
- increasing employee and employer contributions for employees in “enhanced retirement plans” from 1.95 percent to 3.75 percent over a four-year period;
- requiring that retirees purchase service credit from RHCA equal to the actuarial present value when purchasing service credit from PERA and ERB; and
- requiring that return-to-work employees and their employers contribute to the fund.

The RHCA board approved several changes to the program beginning January 1, 2010, including:

- consolidating the three-plan design model (gold, silver, and bronze) into a two-plan design model (premium and premium plus);
- increasing premiums charged to retirees an average of 8.0 percent for calendar year 2010;
- increasing premiums charged to retirees an average of 8.0 percent for calendar year 2011; and
- increasing the annual out-of-pocket maximum on the premier plan from $3,000 to $4,000 effective January 1, 2011.

According to RHCA staff:

- the RHCA board policy is to maintain a 15-year solvency period;
- in 2011, the RHCA again increased health premiums 8.0 percent to pre-Medicare retirees and 6.0 percent to Medicare retirees, and discontinued the subsidy for basic life for all new retirees in 2012;
- the lower percentage increase for Medicare retirees is expected to be offset by additional revenue opportunities within the Medicare Part D prescription drug program;
- taken together, these actions have helped to extend program solvency from 2014 to 2027;
- despite the changes initiated by the Legislature and actions taken by the board, current and future retirees can still expect to receive a subsidy in excess of the employee and employer contributions paid to the program over a 25-year period;
- with a UAAL of $2.9 billion, the RHCA program is expected to become insolvent by 2027 according to an updated long-term solvency analysis;
- expenditures are expected to exceed all available revenue sources by $141 million per year;
- the analysis assumes the board will continue to increase premiums annually at an amount equal to medical trends, currently projected at 8.0 percent annually; and
- in addition, the analysis assumes that payroll will remain flat through FY 12 and grow 4.0 percent thereafter.

For FY 12, employee and employer contributions to the RHCA increased for a second year in a row, from 2.5 percent to 2.75 percent. This increase was part of a four-year phased increase beginning in FY 10 from 1.95 to 3.0 percent in FY 13.

Sustainability plan

The RHCA board is currently evaluating additional plan changes to ensure solvency. According to RHCA staff, solvency could be extended to 2035 and the unfunded liability reduced if the following changes were to be adopted:

- increase pre-Medicare plan deductibles and/or combine plans into one option instead of two;
- increase prescription copayments;
- increase active employer/employee contributions by 1.0 percent over three years beginning in FY 16; and
- reduce subsidies for younger retirees.

While legislative action would be needed to increase the active employer/employee contributions, the RHCA board could make other sustainability plan changes without legislation.

BACKGROUND

Retiree Health Care Authority (RHCA)

The New Mexico RHCA provides optional medical, dental, vision, and life insurance benefits to eligible retirees and their dependents. The RHCA was created and began collecting contributions in July of 1990 and began paying benefits six months later. The State of New Mexico and public schools were required to participate while other public entities, such as municipalities, counties, and institutions of higher learning were given the option of opting out. RHCA has 466 participating employers, including all state agencies, public school districts, 56 charter schools, 22 counties, 23 cities, and 10 institutions of higher education. Total enrollment as of September 30, 2010, is 42,740. The RHCA has an 11-member board.

In FY 11, RHCA received a total of $228 million in revenue from the following sources:

- retiree contributions: $97 million or 42.0 percent;
- employer/Employee contributions: $98.0 million or 43.0 percent;
- proceeds from the Taxation and Revenue Suspense Fund: $17.9 million or 8.0 percent; and
- drug rebates and subsidies: $15.1 million or 7.0 percent.

Other Post Employment Benefits (OPEB)

While contemplating changes to make sure the state can fulfill its pension obligations, the state is also finding it difficult to meet increasing OPEB obligations.

A retiree who was an employee of either the PERA group or participating ERB employer, eligible to receive a pension, is eligible for retiree health benefits. Retirees and spouses are eligible for medical and prescription drug benefits. Dependent coverage and dental and vision benefits are 100 percent retiree-paid. Active and retired employees are not in the same health care cost pool, and plans negotiate separately. Retired employees receive a monthly subsidy toward health care benefits based on years of service. In addition, there is a $6,000 life insurance benefit for retirees who retired prior to 2012.

The magnitude of the OPEB liabilities for participating entities went largely unrealized because the state did not calculate its long-term accrued costs for the benefits promised to its employees. The RHCA had previously adopted a policy of using long-term investment income and fund balance to offset these benefit costs. In addition, premium increases lagged behind the rate of increase in the cost of providing medical care to retirees. Today, the RHCA accounts for and reports the commitments and outstanding obligations related to the OPEB in much the same manner as the state does for pensions. Pension and the OPEB plans are expected to follow an actuarial approach, which includes paying to a fund an amount expected to be sufficient, if invested now, to finance the benefits of tomorrow's retirees.

RETIREMENT FAST FACTS

- While the New Mexico Constitution protects vested pensions as a property right, Section 22 (E) also specifies the following caveat: 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.

- For FY 12, New Mexico devoted about 5.7 percent of its operating budget to pension administration, which also included operating costs for retiree health care.

- According to a Legislative Finance Committee hearing brief, the average ERB member retires at age 59 and receives a monthly benefit payment of $1,693.

- The average age of the RHCA population as a whole is 66.

NM LEGISLATIVE EDUCATION STUDY COMMITTEE
ERB SOLVENCY PROPOSAL
DECEMBER 15, 2011

Jan Goodwin, Executive Director

ERB Actuarials at a Glance

	8%		7.75%		
	06/30/09	06/30/10	06/30/09	06/30/10	06/30/11
UAAL	$4.5B	$4.9B	$4.90	$5.3B	$5.7B
Funded Ratio	67.5%	65.7%	66.4%	63.8%	63.0%
Funding Period	45 yrs	62.5 yrs	Infinite	Infinite	Infinite

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ERB Board Process

September 2011 Board Retreat:

- Received feedback from stakeholders and legislators
- Developed funding goals of 80% by 2030 and 95% by 2040

2011 Listening Tour, October 24th – November 17th :

- Traveled across the state to present plan design change scenarios to stakeholders, hear their concerns and respond to their questions.
- Listening Tour Stops: Clovis, Las Cruces, Silver City, Albuquerque (twice), Deming, Roswell (twice), Belen, Santa Fe, Gallup, Farmington and Raton.
- Developed survey for members to provide input on plan design proposals, either physically or online. Survey period was from October 25th through noon on November 18th .

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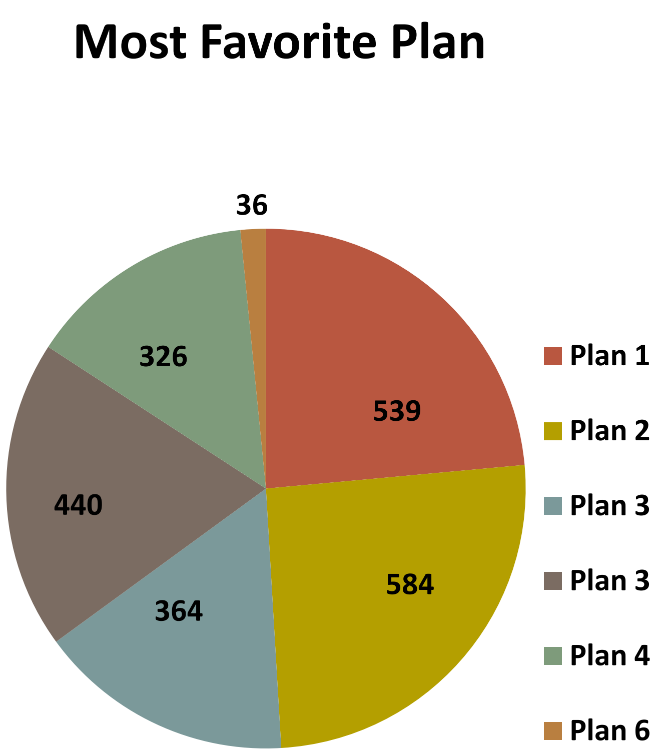
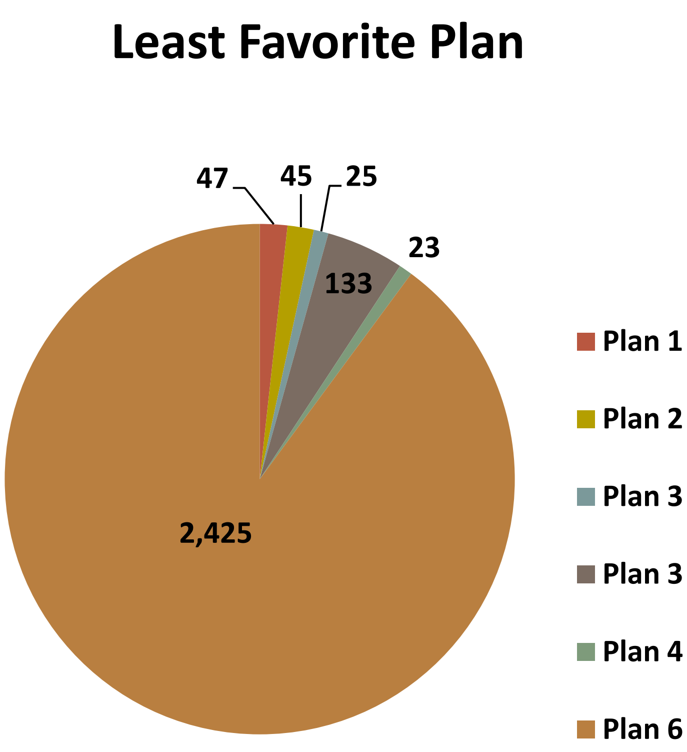
Plan Design Change Scenarios Results Summary





- ***552 online submissions were submitted that did not select a Most Favorite or a Least Favorite Plan***
- ***712 surveys were submitted via mail, email, fax or at Listening Tour presentation that were incomplete***
- ***Total responses received was 3,482, total quantifiable responses was 2,770***

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Establishing a Framework

- Shared Responsibility among Members, Retirees and Employers
- Intergenerational Equity
- Long-term Sustainability
- Preservation of Defined Benefit Plan
- Maintain Similar Benefit Structure Over Time

ERB Board Solvency Proposal

- At a special board meeting on November 21, 2011 the Board adopted a plan design proposal consistent with the previously adopted funding goals.

#	COLA	FAS	Vesting	Minimum Retirement Age	Multiplier	Contribution Rate: Employer*	Contribution Rate: Employee*	Grandfather Period	Funded Ratio: 2030	Funded Ratio: 2040	Comments
Baseline	2%	5	5	none	2.35%	13.9%**	9.9%**	n/a	65.1%	71.2%	COLA starts at age 65.
Proposal	1.75%	5	5	55	2.35%	13.9%	9.9%	10 years	78%	96.3%	

- Highlights include:
  - Maintain 87.5% of current Cost of Living Adjustment (COLA) benefit for all current and future retirees.
  - A Minimum Retirement Age of 55 for members who would not be eligible to retire within 10 years of the proposal's adoption.
  - ERB projects approximately 10,000 members will benefit from the 10- year grandfather period.

At its December 2, 2012 meeting the Investments and Pensions Oversight Committee (IPOC) endorsed the ERB Board's Solvency Proposal. A bill is being drafted for submission in the 2012 Legislative Session.

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Retiree Health Care Authority

Wayne Propst
Executive Director

Mark Tyndall
Deputy Director

NEW MEXICO
RETIREE
HEALTH CARE
AUTHORITY

General Overview

Number of Participating Retirees and Entities

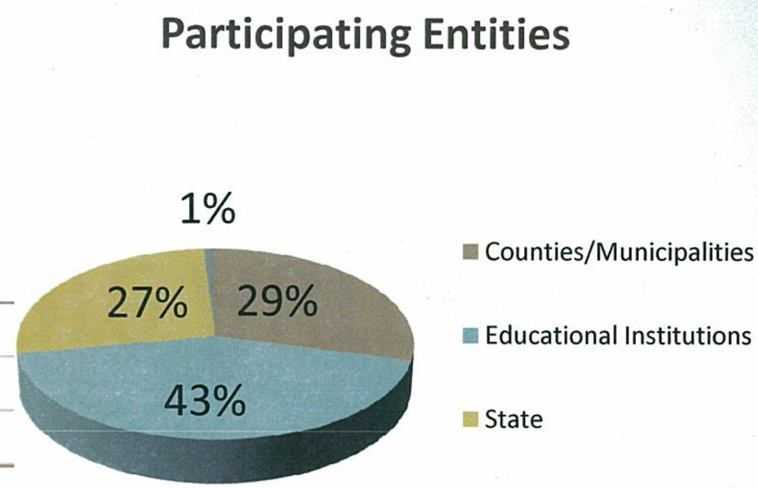
50,000 Retirees, Spouses and Dependents

300 Participating Entities

Offered Coverage

Medicare 27,000	Blue Cross (Sup)	21,000
	Presbyterian (MA)	2,000
	Lovelace (MA)	4,000
Non-Medicare 17,000	Blue Cross	11,000
	Presbyterian	6,000
Vision	Davis Vision	19,000
Dental	Delta Dental	6,000
	United Concordia	18,000
Life Insurance	Standard Insurance	Over $500 million in force (avg of $10K per member)

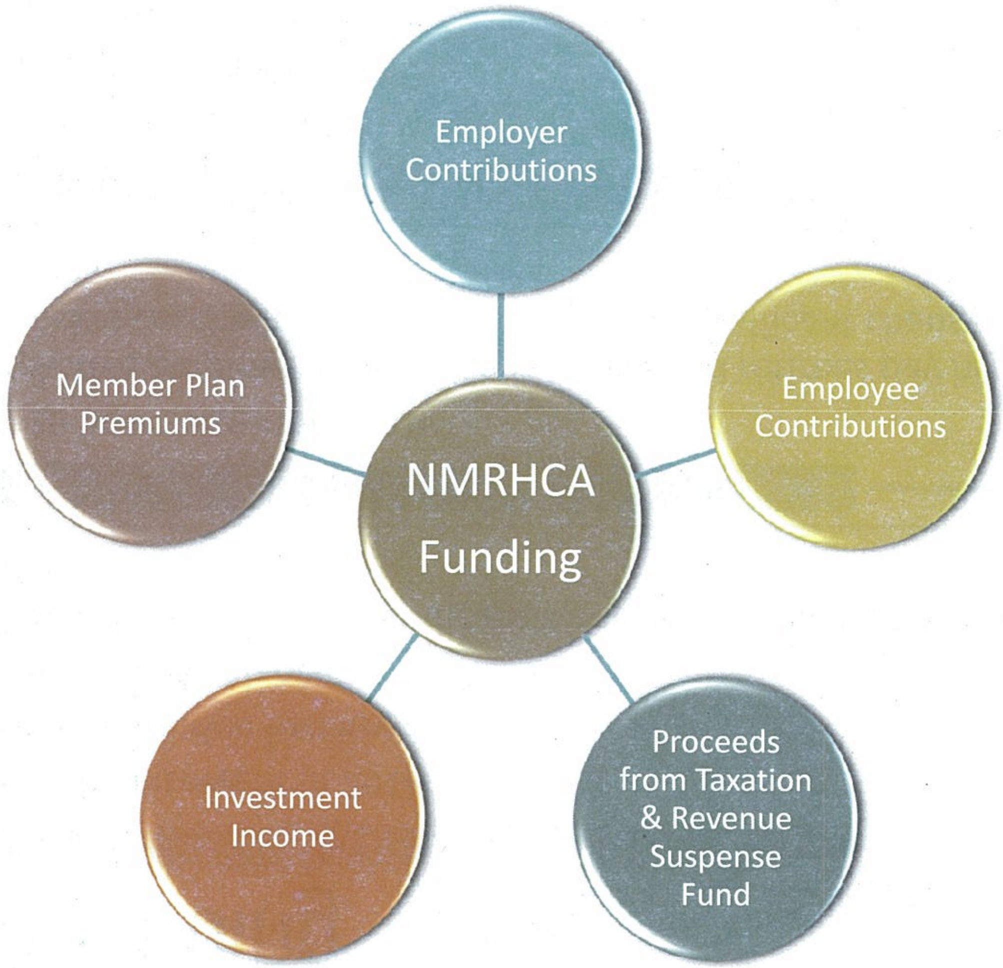
Make-up of Participating Entities



Agency Overview

- 30,000 customer phone calls and 4,000 office visits handled by Albuquerque office in 2010
- Investment Fund as of October 31, 2011- **$205,364,550**
- Current Solvency Period – **15 Years (through 2027)**

Sources of Funding



How We Are Doing

2007

- Plan set to be insolvent in 2014
- $4.1 billion unfunded liability
- $176 million fund balance
- **Action**: Subsidies reduced significantly and retirees pay higher premiums

2009

- Plan set to be insolvent in 2019
- **Action**: Active employer/employee increase and retirees pay higher out-of-pocket costs when accessing care with significant changes to plan designs

2011

- Plan solvent through 2027
- $205 million fund balance
- $3.3 billion unfunded liability
- **Action**: Adopt 5-year sustainability plan balancing cost increases between the three stakeholders

Result: Specific actions assure solvency through 2027

Ensure that the program remains solvent through shared responsibility.

- **Active employees** currently pay 1% of salary toward retiree benefits. This will have to be increased over time.
- **Public employers** currently pay 2% of salary toward retiree benefits. This will either have to be increased or the percentage paid by active employees will have to be increased further.
- **Current retirees** pay about 50% of their total premiums (retirees are subsidized more, spouses less, and dependents not at all). This will need to be adjusted or plan designs will have to bring down expenses (or a combination of the two).

Sustainability Plan Under Discussion

- Increase pre-Medicare plan deductibles and/or combine plans into one option instead of the current two
- Increase prescription copayments
- Increase active employer/employee contributions by 1% over three years beginning in FY16
- Reduce subsidies for younger retirees

RESULT: Solvency could be extended to 2035 and result in modest reduction to unfunded liability

Impact of Minimum Age for PERA and ERB

Implementation Strategy	Savings (1st Year of Impact)	Solvency Impact
Impact of Minimum Age of 55		
5 Year Safe Harbor	$6 million	+ 2 years
10 Year Safe harbor	$8 million	+ 1 year
New Hires*	N/A	N/A
Impact of Minimum Age of 60		
5 Year Safe Harbor	$14 million	+ 4 years
10 Year Safe Harbor	$18 million	+ 2 years
New Hires*	N/A	N/A

* Any minimum age requirement impacting only newly hired employees would not provide material savings prior to current solvency period