LFC HEARING BRIEF

AGENCY: Education Retirement Board, Public Employee Retirement Association, Retiree Health Care Authority

DATE: August 18, 2011

PURPOSE OF HEARING: Update on post employment pension and benefits solvency

WITNESS: Jan Goodwin, ERB, Terry Slattery, PERA, Wayne Propst, RHCA

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EXPECTED OUTCOME: Improving reporting and oversight.

The average PERA member retires at age 58 and receives a monthly benefit payment of $2,335.00.

The average ERB member retires at age 59 and receives a monthly benefit payment of $1,693.00

BACKGROUND INFORMATION

State shortfalls in funding pensions for future retirees have emerged to a great extent because of the 2007 to 2009 recession, which reduced the value of assets in those funds and made it difficult for states to find sufficient revenues to make the required deposits into the trust funds. In addition, over the last decade the state expanded benefits without adequate actuarial analysis. The two issues of how states should value their pension liabilities and how much they should contribute to meet their pension obligations are not the same. The required contributions to state pension funds reflect not just on an assessment of liabilities, but also on the expected rates of return on the funds' investments, as well as other considerations. For FY12, New Mexico devoted 5.66 percent of its operating budget to pension administration, which also included operating costs for retiree health care.

Funding Pensions and Retiree Health Care for Public Employees.
PERA and ERB provide a monthly annuity payment for the retiree based on years of service, final averaged salary, and a pension-calculation factor established by the Legislature. With the current eligibility requirements, the state's pension plans allow employees to retire at a relatively young age, receive up to 80 percent of their salary with annual cost-of-living-adjustments, and join the retiree health care system long before they are eligible for Medicare. Today's members are older and healthier than previous generations and this trend is expected to continue. The resulting liabilities can be expected to continue to pressure fund solvency for pension plans. Pension reforms that reduce future costs are critical for ensuring an efficient allocation of limited resources across all state needs.

In 2010, the PERA had 27,972 retirees, a gain of 1,382 new retirees over 2009. From December 2008 to December 2010, the number of full-time employees in all state agencies declined a little more than 10.5 percent. This is a result of the aging of the public sector workforce and slow rising rates of unemployment growth among state and local governments. This dynamic continues to widen the gap between contributions and pension payrolls. For the state's underfunded plans, a declining ratio can complicate the ability of the plans to move towards full funding.

Table 1. ERB and PERA demographics

	# actives	Ave actives' salary	# retirees	Average yearly benefits	Yearly actives' contribution	Yearly employer contribution
ERB	63,297	$40,695	33,747	$20,320	$254m	$309m
PERA	59,620	$40,604	27,972	$28,020	$232m	$297m

Source: PERA, ERB, RHCA

Background on Other Post Employment Benefits (OPEB). A retiree who was an employee of either the New Mexico PERA group or participating ERB employer, eligible to receive a pension, is eligible for retiree health

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.*

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 towards health care benefits based on years of service. In addition, there is a $6 thousand 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.

Table 2. RHCA Demographics

Avg < 65 yrs	Avg ≥ 65 yrs	# < 65 yrs	# ≥ 65 yrs	# of spouses	Active Participants	# that die each year	# of surviving spouses
73	59	13,951	25,232	9,857	95,513	700	1980

Source: PERA, ERB, RHCA

Pension Plan Design. The defined benefit (DB) retirement plans under the ERB and PERA are maturing, which means the ratio of active employees to retirees is increasing. DB plans are designed to provide state employees with a predictable monthly benefit into retirement. 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 "final average salary x service credit x (multiplied by) 0.0235 = annual benefit." The benefit factor for PERA general employees is 2 percent. Final compensation is determined using the top three years of earnings. Only the Legislature can make changes to benefit levels.

Effect of COLAs on benefits for a 50 year old retiree with a $27,025 benefit per year:

ERB: COLAs begin at age 65. After fifteen years, benefit will still be $27,025.

PERA: COLAs begin the third year into retirement. By age 65, the benefit will be $51,327.

Table 3. FY11 Employee/Employer Contribution Rates

	ERB	PERA	RHCA
Average employee contributions (%)	9.4%	11.11%	1.03%
Total employee contributions ($)	$253m	$236 m	$43m
Average employer contributions (%)	13.39%	13.95%	2.06%
Total employer contributions ($)	$309m	$296m	$85m
COLAs	2%	3%	

Source: PERA, ERB, RHCA

Courts in Minnesota and Colorado recently ruled that states have the right to reduce annual cost-of-living adjustments in pensions for public employees in order to save money.

In 2011, 26 states enacted changes in public pension plans to address solvency issues. Costs were shifted to members through higher contributions, longer service requirements, higher ages before normal retirement, and lower post-retirement benefit adjustments.

As shown on the previous page in Table 3, the ERB provides a cost-of-living-adjustment (COLA) annually that starts at age 65. Average COLA increases for ERB retirees over the last 20 years have been 2 percent. The PERA provides a 3 percent COLA each year beginning the third year into retirement. The PERA COLA accounts for 20 percent of the cost of the plan.

Retirement boards across the nation are reconsidering the COLA for retirees' pensions each year. New Mexico retirees have come to expect at least an annual 2 percent COLA which is tied to the Consumer Price Index (CPI). In 2009, for the first time in 54 years, the CPI declined. The COLA statute at that time required a negative adjustment that would have resulted in an annual decrease in the pension benefit for ERB. In 2010, House Bill 239 amended the COLA statute to prohibit a decrease in the retirement benefits of retirees over age 65 if the CPI declines. COLA adjustments are not tied to a fund solvency threshold.

Pension legislation. While struggling to fulfill its pension obligations, the state is also finding it difficult to meet OPEB obligations that have been increasing for the same reason that pension benefits have increased. The state has long provided deferred compensation packages, in part, to help compensate for salaries perceived to lag behind the market. Before 2000, states regularly improved the benefit packages – reducing the time it took to earn a pension, increasing the amount of salary a pension would replace, protecting benefits against inflation, and easing the restrictions against retiring and coming back to work, often called "double-dipping." Liabilities are likely to increase rapidly in future years in the absence of reversing trends through changes to post retirement pension benefits.

In the 2010 Legislative session, direct employee compensation remained flat from FY09 levels. Benefits decreased slightly because employers now contribute 1.75 percent less to the ERB and PERA for FY12. 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 FY10 and FY11, through FY13. These contribution shifts require employees to pick up a cumulative 3.25 percent employer contribution for FY12. The 1.75 percent shift might extend into FY13, if FY12 revenues fall short of certain thresholds. For FY12, 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 FY10 from 1.95 to 3 percent in FY13.

OPEB Plan Design. As a result of the recent health plan design changes and increased premiums, pre-Medicare retirees are migrating toward the less expensive premier plan with a higher deductible and annual out-of-pocket maximum, as seen on the next page in Table 4. This has applied downward pressure on plan costs that grew only 1.9 percent from FY09-FY10, compared with projected medical inflation of 8 percent. However, this has also reduced contributions to the plan from these retirees.

Less than one half of the private-sector workforce is participating in an employer-sponsored retirement plan.

Any plan changes should support the goal of achieving an 80 percent funded ratio with a 30-year amortization period of unfunded liabilities.

Table 4. RHCA Benefit Plan

Pre-Medicare	2011 Premium	2012 Premium (8% increase)	Plan Design	Cost Share
Premier Plus Plan				
Retiree Spouse	215.94 334.32	233.22 361.07	Deductible $300 Claims paid @ 80/20 OOP $3000	35% 60%
Premier Plan				
Retiree Spouse	115.55 214.54	124.79 231.70	Deductible $800 Claims paid @ 80/20 OOP $4000	35% 60%
Medicare Supplement	2011 Premium	2012 Premium (6% increase)	Plan Design	Cost Share
Retiree Spouse	131.76 197.64	139.67 209.50	Medicare is primary	75% 50%

Source: RHCA

<u>Pension Solvency.</u> The Governmental Accounting Standards Board Statement No. 25 (GASB 25) is the relevant accounting standard for governmental retirement systems. GASB 25 requires public employers that provide pension benefits and OPEB to report on the cost of providing those benefits on a prefunded basis. Actuaries determine the future liability of the plan, known as actuarial liability. These reviews determine whether a plan is able to meet its future retirement benefit obligations. The GASB does not permit the consideration of future contribution rates not yet in effect.

Table 5. Annual Required Contribution

	ERB		PERA		RHCA	
	6/30/10	6/30/09	6/30/10	6/30/09	6/30/10	6/30/08
Normal Cost at beginning of year	$84m	$149m	$174m	$192m	$184m	$160m
Amortization of the UAAL (30 years)	$259.7m	$212m	$103m	$83m	$128m	$112m
Adjustment for timing	$13.5m	$14m	$51m	$27m	$16m	$14m
Total ARC	$357.2m	$375m	$328m	$302m	$327m	$287m

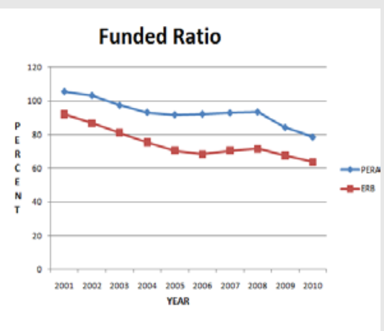
Source: PERA, ERB, RHCA

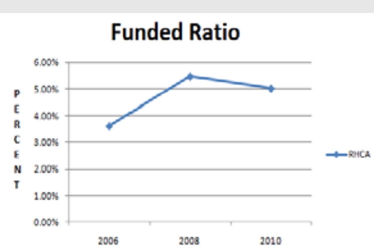
The schedule of the *annual required contribution (ARC)* in Table 5 measures annual plan costs on an accrual basis as if the costs were paid at the end of the year. The *normal cost* is the portion of benefit plan costs incurred for employee services performed during that year. The ARC consists of the employer *normal cost* and the amortization payment.

The *schedule of employer contributions* in Table 6 on the following page compares actual employer contributions with the ARC. According to GASB 25, annual pension cost should be equal to the employer's ARC to the plan, unless the employer has an obligation for past under-funded contributions.

Retirement Systems that have recently reduced their investment return assumptions:

Colorado - 8.5% to 8.0%
Penn PSRS - 8.5% to 8.0%
Virginia RS -7.5% to 7.0%
NY Common -8.0% to 7.5%
Indiana PERF -7.25% to 7.0%
Illinois -8.5% to 7.75%
ERB- 8.0% to 8.0%
PERA -(no change)
RHCA -8.0% to 7.75%





RHCA only began reporting using GASB standards in 2006.

Table 6. Schedule of Employer Contributions

	ERB		PERA		RHCA	
	2010	2009	2010	2009	2010	2009
Annual Required Contributions (ARC)	$357m	$375m	$328m	$303m	$327m	$287m
Actual Contributions	$309m	$319m	$296m	$316m	$112m	$97m
Percentage Contributed towards ARC	87.7%	86.2%	88.7%	102%	38%	34%

Source: PERA, ERB, RHCA

Overview of Pension Solvency. Despite investment gains for FY11 beyond the 8 percent assumption, plans show weaker funded ratios which may be indicators of financial instability. The financial position of the fund for the PERA is projected to weaken even further when 22 percent of the PERA's FY08 market losses, or $2.5 billion, are recognized in the next two years as part of the four-year method used by actuaries to smooth out market gains and losses. For the ERB, investment losses during 2001 to 2003 and 2008 to 2009 coupled with the deficit in pension funding have also negatively impacted the funding gap in its pension plan.

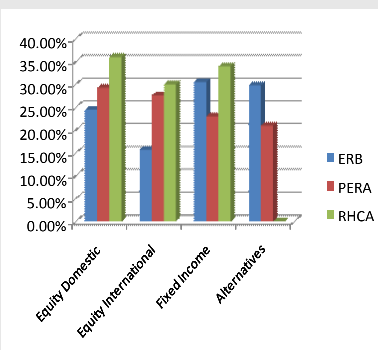
Table 7. Unfunded Accrued Actuarial Liability

	Actuarial Valuation	Value of Assets	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio
	Date	(a)	(b)	(b-a)	(a/b)
ERB	6/30/10	$9.4b	$14.35b	$4.5b	65.7%
	6/30/08	$9.3b	$13.b	$3.7b	71.5%
	6/30/06	$7.8b	$11.4b	$3.6b	68.3%
PERA	6/30/10	$12.2b	$15.6b	$3.36b	78.5%
	6/30/08	$12.8b	$13.7b	$924m	93.3%
	6/30/06	$10.8b	$11.8b	$932m	92.1%
RHCA	6/30/10	$176.9m	$3.5b	$3.35b	5.02%
	6/30/08	$170.6m	$3.12b	$2.95b	5.47%
	6/30/06	$154.5m	$4.26b	$4.11b	3.62%

Source: PERA, ERB, RHCA

*Unfunded Accrued Actuarial Liability. T*able 7 represents multi-year trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the AAL for benefits. In general, realizing returns less than the assumed long term rate of 8 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 percent. As a result, it's UAAL increased by $473 million, bringing the total UAAL for 2010 to 4.5 billion. The PERA's UAAL sits at $3.36 billion with an investment return assumption of 8 percent.

Funded Ratio and Funding Period. The funded ratio compares the value of plan assets with the plan's liabilities (pension obligations). Having 80 percent of pension obligations covered by assets has traditionally been viewed as a minimum industry indicator of fund health. The most recent actuarial valuation determined the total funded ratio dropped to 63 percent for the ERB plan, 72 percent for the PERA plan, and 5.02 percent for the RHCA plan. 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 GASB 25 recommends an amortization period no longer than 30 years. None of the state's plans meet that basic metric.

OPEB Legislation. The RHCA board policy is to maintain a 15 year solvency period. In 2007 actuaries project the fund was projected to become insolvent in seven years. The valuation placed the UAAL of the program at $4 billion. In 2007, the Legislature increased employee and employer contributions from 1.95 percent to 3 percent for active employees and to 3.75 percent for public safety employees, over a four-year period. In 2009, the Legislature removed the sunset date for the monthly distribution of tax revenues to the fund and required additional contributions from ERB and PERA members who purchase service credit. In 2010, the RHCA increased premiums to retirees based on a medical trend rate of 8 percent. In 2011, the RHCA again increased health premiums 8 percent to pre-Medicare retirees and 6 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.

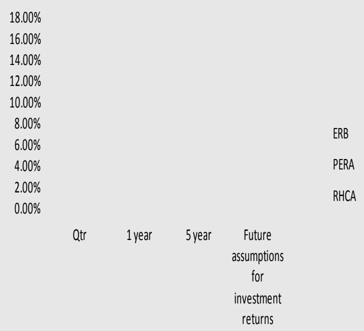
Pension Fund Profile. Mature pension plans lose money because more is paid out in benefits than is collected in contributions. This is a normal development in the evolution of a pension plan. However, losses have an impact on the asset allocation because greater liquid assets are needed to pay the benefits. In FY08, the financial markets experienced major losses and most pension funds still remain below their highs from three years ago. Table 8 shows the total market value of assets is valued at approximately $9.47 billion for ERB, $12.12 billion for the PERA, and $216 million for the RHCA. The investment markets are still changing, and the fund managers appear to recognize the need for portfolios to change with them to achieve the targeted rate of return within a reasonable amount of investment risk.

Table 8. Fund profile as of June 30, 2011

	Approximate Market Value	Equity Domestic	Equity International	Fixed Income	Alternatives
ERB	$9.47b	30.2%	16.5%	31%	22%
Long-term target		25%	15%	27%	33%
PERA	$12.12b	29.3%	27.6%	23%	21%
Long-term target		27%	27%	26%	20%
RHCA	$216m	36%	30%	34%	
Long-term target		35%	30%	35%	

Source: PERA, ERB, RHCA

Investment income. Each year, investment income is expected to make up the difference between the amount of employee/employer contributions and retiree pension payroll or in the case of the RHCA, employee/employer contributions and retiree health premiums. As seen in Table 9, the five-year



The ERB has a 2.35 percent and the PERA has a 3 percent pension benefit factor while public safety employees enjoy a 3.5 percent benefit factor.

The statewide vacancy rate is 19.1 percent in the 4th quarter of FY11. The highest rate is within the Public Education Department at 29.7 percent.

results are below the target return of 7.75 percent per year, as capital markets had been very turbulent over this period. The S&P 500 index returned 2.6 percent over the same period.

Table 9. Investment Income

Fund	Expenditure	Revenue	Balance	Qtr	1 year	5 year	Future return assumptions
ERB	$696m	$1,815m	$1,119m	3.8%	13.8%	4.8%	7.75%
PERA	$716m	$1,933m	$1,217m	6.24%	16.7%	2.93%	8.00%
RHCA	$232m	$260m	$27m	3.9%	13.2%	4.6%	7.75%

Source: PERA, ERB, RHCA

Update on the Markets. The markets have begun to slide downwards in what appears to be a repeat of the 2008 credit crisis. The downward trend may look similar, but the cause of these recent events is due to the debt crisis in the United States as well as around the world. In recent weeks, the market has dropped more than 10 percent of the market value while the volatility index has soared to new heights. The markets have experience swings in excess of 4 percent to 5 percent on several occasions in the past two weeks.

Other Issues. Typical public safety pension plans are designed around years of service, usually ranging from 20 to 25 years, and not a set, arbitrary age, due to the physical and mental strain of the profession. In New Mexico, state and municipal public safety officers, firefighters and correctional officers have retained 20 year or enhanced 25 year retirement eligibility. Public safety special interest groups have opposed any changes to 20 year retirement plans, even though these plans are seriously underfunded. Other commissioned officers within the Department of Public Safety (DPS) who do not work for the state police are eligible to retire in 30 years. The DPS has reported this disparity impacts recruitment and retention of commissioned officers.

The Future Impact of Medical Cost Trends for RHCA. Medical trend rates are not predicted to drop significantly anytime soon — in fact, they are expected to continue to rise over the next few years. Although insurers are still using more traditional techniques to manage health costs (e.g., coinsurance, deductibles, contracted networks and preapproval), they are also taking a more holistic view of health, including employee wellness, to help curb the prevalence of certain conditions such as cardiovascular disease and cancer. Wellness features are expected to play a greater role in managing medical costs going forward. These approaches may be more effective as cost-management tools than traditional cost-sharing methods.

Public Employee Compensation. In the current economic environment policy-makers must develop innovative approaches to adopt an integrated and coherent approach to total employee compensation. Of particular important is the identification of a fiscally sustainable mix of state employee salary and benefits that reflects both best practices and market rates in the private sector and other state governments.

Questions?

1. How does New Mexico compare with other states in terms of pay and benefits?

2. What is the financial position of the funds today?

3. What lessons were learned from the market downturn of FY08?

4. What can be done to stop investment losses from occurring in market downturns?

5. What is the difference between asset allocations now compared with FY08?

6. What can be done to preserve investment returns?

7. Can funds withdraw money and sit on cash if it is the safest investment vehicle at the time?

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