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

July 27, 2011
State Capitol
Santa Fe

The second meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2011 interim was called to order by Senator George K. Munoz, chair, on Wednesday, July 27, 2011, at 9:14 a.m. at the State Capitol in Santa Fe, New Mexico.

Present
Sen. George K. Munoz, Chair
Rep. Henry Kiki Saavedra, Vice Chair
Rep. David L. Doyle
Sen. Timothy M. Keller
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. John M. Sapien
Rep. Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Rep. William "Bill" J. Gray
Sen. Steven P. Neville
Sen. Mary Kay Papen

Advisory Members
Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Rep. Rhonda S. King
Rep. Patricia A. Lundstrom
Sen. William H. Payne
Rep. Jane E. Powdrell-Culbert
Rep. William "Bill" R. Rehm
Sen. John C. Ryan
Rep. Sheryl Williams Stapleton
Rep. Mimi Stewart
Rep. Richard D. Vigil

Sen. Tim Eichenberg
Sen. Stuart Ingle
Sen. Michael S. Sanchez
Rep. Shirley A. Tyler

Staff
Tom Pollard, Legislative Council Service (LCS)
Doris Faust, LCS
Claudia Armijo, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and written testimony are in the meeting file and posted on the New Mexico Legislature web site.

<u>Wednesday, July 27</u>

Senator Munoz welcomed committee members and guests. He asked the members to introduce themselves, which they did. He also reminded them to turn their microphones on and off before and after speaking.

Proposals to Maintain the Long-Term Solvency of the Public Employees Retirement Association (PERA) and Educational Retirement Board (ERB) Pension Funds

Terry Slattery, executive director, PERA, addressed the committee. He began by introducing the PERA board members that were in attendance at the meeting. Mr. Slattery referred to the *Benefit Adequacy Study-Phase I Through IV, Spring 2010* handout produced by Gabriel Roeder Smith & Company (GRS), consultants and actuaries for the PERA. At the request of the committee chair, Mr. Slattery began by discussing the long-term solvency forecast. According to the study, the most recent forecasting simulations indicate that, without changes, the PERA will need contribution increases in all divisions to meet the PERA board's 30-year financial target, unless recent market losses are offset by future gains. Mr. Slattery reminded the committee members that the board continues to endorse and recommend the implementation of the PERA "Ideal Plan", which is viewed by the board as "actuarially sound".

Mr. Slattery referred to page 5 of the study, which provides a comparison of the PERA benefits to benefits of other state pension plans. He concluded that PERA plan benefits are as good or better than similar pension plans, including those in Hawaii, Iowa, New Hampshire, Utah and Wyoming. He noted that with regard to the cost-of-living adjustment (COLA) benefit, although the PERA plan is not identical to that of any other state, it is most similar to Wyoming's. New Mexico's COLA provides that pensions are increased 3% per year, provided a retiree's retirement has been in effect for at least two calendar years, or if the retiree is on disability, for one calendar year. He reminded members that the board's goal as it relates to the COLA is not to increase retirees' purchasing power; rather, it is to maintain benefit levels in relation to the rising cost of living.

Mr. Slattery directed members' attention to page 22 of the study, which depicts the PERA's total normal cost to that of comparable pension plans. As of the June 30, 2009 valuation, the PERA's total normal cost, including all membership plans, is 21.22%. However, the normal cost pursuant to the plan's new eligibility conditions is 20.39%. When compared to the normal cost of the other plans in the study, PERA's normal cost is higher, followed by Hawaii's normal cost of 16.2%.

Mr. Slattery informed members that at its January 2010 meeting, the PERA board established goals and objectives for benefits payable to the PERA members, specifically in association with the Ideal Plan. The goals and benefits for the PERA's nonuniformed members include:

1) a full career should consist of 30 years of service (currently it is 25 years);

2) normal retirement age should be no younger than age 55;

3) benefits eligibility should be based on a sliding scale like the Rule of 85;

4) there should be no early retirement benefits provided;

5) replacement ratios should be approximately 75% from the PERA and 25% from social security;

6) the vesting period should be five years;

7) the COLA should be based upon the Consumer Price Index (CPI) with a 0% floor and a 3% cap;

8) the plan should not contain a hybrid feature like some other state pension plans;

9) the cost sharing of the plan should be one-third employee and two-thirds employer; and

10) some lower cost plans should be made available for use by small municipalities.

The goals and objectives established for the PERA uniformed members include:

1) a full career should consist of 25 years of service;

2) normal retirement age should be no younger than age 50;

3) benefits eligibility should be based on a sliding scale like the Rule of 80;

4) there should be no early retirement benefits provided;

5) replacement ratios should be approximately 100% from the PERA and 0% from social security;

6) the vesting period should be five years;

7) the COLA should be based upon the CPI with a 0% floor and a 3% cap;

8) the plan should not contain a hybrid feature like some other state pension plans;

9) the cost sharing of the plan should be one-third employee and two-thirds employer; and

10) some lower cost plans should be made available for use by small municipalities.

Mr. Slattery reminded committee members of the characteristics of the PERA Ideal Plan for nonuniformed members. The Ideal Plan provides that a member's retirement benefit amount is based on a multiplier of 2.5% of the member's final average salary (FAS) instead of the current 3% multiplier. The Ideal Plan provides for a maximum retirement benefit of 90% of the member's FAS, which is calculated from the member's salary during the last 36 consecutive months of the member's employment. Mr. Slattery noted that providing a high-percentage FAS benefit can persuade some would-be retirees to work longer. When members work longer, they continue to contribute into the plan, and once they retire, they cost less in the form of benefit payouts because they are collecting for shorter periods of time. In sum, Mr. Slattery noted that members working longer periods means actuarial gains for the plan, and actuarial gains lead to plan solvency.

With regard to the uniformed members pursuant to the provisions of the Ideal Plan, a member's retirement benefit amount would be a product of 3.5% of the member's FAS as calculated from the last 36 months of consecutive employment, with a maximum benefit of 90% of the FAS calculation.

Mr. Slattery told the committee that, without exception, the normal costs associated with the Ideal Plan for all plan divisions — state general, state police, municipal general, municipal police and municipal fire — are projected to be at least 2% less than the normal costs of the current PERA plans.

Mr. Slattery closed his remarks regarding the study by noting that it contains an appendix with a Summary of Assumptions used for the study. He then provided the committee members with an additional handout, *PERA Responses to Requests for Information from the June 6, 2011 IPOC Meeting*. At the June 6, 2011 meeting, committee members had inquired as to how the PERA's funding status would be affected if the PERA assumed a 7% rate of return instead of the 8% target assumed currently. The PERA actuaries concluded that for the June 30, 2010 valuation, assuming a 7% rate of return, the PERA's funded status would have decreased from 78% to 70% funded.

The handout also includes PERA's investment performance for the past six years and how the PERA's investment losses are smoothed into the actuarial value of assets from June 30, 2008 to June 30, 2012.

The handout also contains information regarding the average age of the PERA retirees. Average retirement ages for members in all plans range from a low of 46.06 years for municipal police to 61.94 years for magistrate members, with the state general members average retirement age at 57.91 years.

Committee members had also requested information regarding pending lawsuits that have arisen from legislation affecting the PERA that has already passed. According to the information provided in the PERA handout, two cases have been dismissed and were not appealed by the plaintiffs. Those cases are *David Archunde v. PERA and the City of Albuquerque*, filed in federal court in September 2008, and *Jack Clough v. PERA* filed in federal court in January 2001. In the *Archunde* lawsuit, the plaintiff alleged that requiring double dippers to make nonrefundable contributions during the period of July 1, 2003 through December 31, 2006 violated the takings clause of the U.S. Constitution. In the *Clough* case, the plaintiff, a "grandfathered" double dipper, was required to make nonrefundable contributions on July 1, 2010. He alleged that the contributions violated numerous laws and constitutional provisions involving age discrimination, takings, equal protection, contract, due process and bill of attainder.

The last case noted in the handout is *Rod Coffman, et. al v. PERA and Governor Richardson*. Like *Clough*, the plaintiff in the *Coffman* lawsuit is a grandfathered double dipper required to make nonrefundable contributions as of July 1, 2010. The plaintiff is raising constitutional claims pursuant to the contract, equal protection and the takings clause of the U.S. Constitution. The difference between the *Clough* and the *Coffman* cases is that the plaintiffs in the *Coffman* case are law enforcement officers, and they are asking for certification of the case as a class action. The PERA filed a motion to dismiss the case in June 2011. No ruling has been issued in the case.

Rick Scroggins, deputy director, ERB, spoke to members regarding the ERB's defined benefit plan. He provided a handout titled *Long Term Solvency of the Educational Retirement Board* dated July 27, 2011. Referring to the handout, Mr. Scroggins reminded the members that the ERB provides members' benefits through a defined benefit plan, noting that this differs from a defined contribution plan, which does not offer its members a guaranteed retirement income. He reminded committee members that the ERB calculates a retiree's benefit amount by the member's FAS multiplied by the member's service credit, multiplied by .0235. The member's FAS is calculated by using the greater of the member's average annual earnings in the last 20 calendar quarters immediately preceding retirement or the member's average annual earnings in any 20 consecutive calendar quarters in which the member has earnings. The ERB calculates retirees' COLA benefits with the first COLA made on July 1 of the year in which the retiree reaches the age of 65 or on July 1 of the year following the member's retirement date, whichever is later. The COLA is tied to the CPI. If the change to the CPI is less than 2%, the COLA will be the same percentage as the change in the CPI. If the change in the CPI is greater than 2%, the COLA will be one-half of the change in the CPI, but not less than 2%, nor greater than 4%. Mr. Scroggins noted that in 2009, for the first time in 54 years, the CPI declined. As a result, the statutory provisions regarding the ERB's COLA required a negative adjustment, which would have resulted in an annual average decrease of $69.00 in a retiree's pension benefit. House Bill 239 was passed during the 2010 legislative session (Laws 2010, Chapter 81) and amended the

COLA provisions to prohibit a decrease in the retirement benefits of retired members over the age of 65 in the event of a decrease in the CPI.

Mr. Scroggins noted that the current ERB members' contributions do not meet the current benefit payments going to retirees, with a $98.4 million shortfall in FY10. He noted that in 2000, there were three active members contributing to the fund for each retired member. Additionally, employee payroll has increased 61.65% from 2000 to 2010, while retiree payroll has increased 111.2% during the same time frame. The number of active members has increased 5.34% between 2000 and 2010, while retiree numbers have increased 59.3%.

Mr. Scroggins explained that the ERB plan is considered a "mature plan", and he anticipates a continued increase in the number of retirees, with one-third of the plan's members being retired by the year 2015.

Referring again to the handout, Mr. Scroggins noted that as a result of the ERB's actuarial experience study, as of June 30, 2010, the ERB board was presented with, and voted at its April 2011 meeting to accept, the following recommendations:

1) decrease the investment return assumption to 7.75%. In so doing, the unfunded actuarial asset liability increases by $473 million and the funded ratio decreases from 65.7% to 63.6%;

2) make revisions to post-retirement mortality;

3) make changes to retirement rates at ages 65 to 69 and with 25 or more years of service;

4) decrease the salary scale for members with at least 10 years of service from 5% to 4.75%;

5) change to an individual entry age normal cost funding method, increasing the normal costs rate from 12.48% to 14.09%; and

6) change the population growth assumption to 0.75% per year, resulting in no impact on valuation results.

Mr. Scroggins told members that the ERB's funded ratio (the ratio of the actuarial value of assets to the actuarial accrued liability) is estimated to be 61.6% in 2011. In 2006, the funded ratio was 70.5%, and the funded ratio reached an all-time high of 91.9% in 2001. It began to decrease as the negative investment experience in the years 2001 through 2003 were phased into the actuarial value of assets. Without any changes to the plan, the funded ratio is not expected to reach the desired 80%. The funding period, also known as the amortization period, should not exceed 30 years. The ERB's current funding period is estimated to be infinite.

Mr. Scroggins explained that the ERB is considering a number of options to reduce the funding period. Included in those options is providing for a minimum retirement age. According to Mr. Scroggins, the ERB does not currently impose a minimum retirement age for members. In New York, for example, the minimum retirement age for pension plan members has increased from 55 to 62 for new employees.

Another option is to cap pension benefits. In Illinois, the maximum pension amount for retirees in the state's pension plan has been capped to $106,800 (FICA wage limit) and the payout is based on the member's highest salary during eight consecutive years of the last 10 years prior to retirement. The ERB plan does not currently provide a cap for benefit payouts.

A third option under consideration by the board is to increase contributions to the fund. The ERB is in the process of phasing in employee and employer contribution increases that will result in increasing employee contributions from 7.6% in FY05 to 7.9% in FY09 and increasing employer contributions from 8.65% to 13.9% by FY13. It is noted that for FY12, employees earning more than $20,000 are contributing 11.15% and the employer is contributing 9.15%.

Another option under consideration is the reduction of the actuarial assumed rate of return. As noted before, the ERB board has already reduced the rate to 7.75% from the previous target rate of 8%.

The ERB board wants to continue on a path to actuarial soundness, including an 80% funding ratio and amortization of the unfunded actuarially accrued liability within the desired 30 years. Primary to the board's goals are sustainable retirement benefits without a reduction for current retirees. The board also believes the burden should be shared by both current and future members.

Mr. Scroggins reminded the members of the committee that the ERB hired the consulting firm Research & Polling, Inc., to conduct a survey of active ERB members. The purpose of the survey was to find out what, if any, support the polled members might have for certain changes to the ERB plan.

According to the ERB, members responding to the survey are willing to:

1) increase current member contributions by 0.5%;

2) change the FAS from five years to seven years;

3) implement a minimum retirement age of 60 years for unreduced benefits;

4) implement increased multipliers with continuing additional years of service; and

5) implement a minimum retirement age of 60 years for members to receive any retirement benefits.

Lastly, Mr. Scroggins told members that, at the direction of the board, the ERB staff is currently working with GRS to examine the potential impact of various combinations of plan changes and assumption factors. The elements being examined include:

1) the multiplier;

2) member and employer contributions. GRS has been asked to look at increasing employee contributions to 9.9% and employer contributions to 13.9%, both consistent with the board's recommendations last year;

3) changing the FAS to seven years or an average of entire employment time;

4) implementing a minimum retirement age;

5) changing the COLA; and

6) changing the vesting period to 10 years.

Mr. Scroggins said the ERB staff hopes to report its findings to the board on August 12, 2011. The ERB will then report the board's decisions and other information to the IPOC.

The chair asked IPOC members for questions for Mr. Slattery or Mr. Scroggins. A discussion ensued regarding the PERA board's endorsement of the Ideal Plan, with Mr. Slattery stating that the PERA board still recommends the Ideal Plan. He said the board prefers the Ideal Plan to the current two-tier plan in place. He further noted that the board would apply the provisions of the Ideal Plan to all members not yet vested as of July 1, 2012, which represents 40% of the PERA members.

Discussion continued with members noting that the PERA board also recommends increasing contribution rates. Members expressed concern over increasing the employers' contributions to a rate of 20%. Some members asked if the legislature's Retirement Systems Solvency Task Force had endorsed the Ideal Plan. The chair of that task force, Representative Stewart, noted that the task force did not endorse the Ideal Plan. Rather, the task force sent the Ideal Plan to the IPOC for review and possible endorsement. When asked if the PERA board involved the PERA members in the development of the Ideal Plan, Mr. Slattery responded that the members were not involved.

Committee members inquired as to the status of the PERA and ERB members' pension benefits rights, asking if those rights are considered statutory rights or constitutional rights. Committee members recognized that the issue is unresolved and only speculative until determined by a court.

Committee members discussed whether the governor would place the issue of changes to the PERA plans on the call for the special session in September 2011. Mr. Slattery stated that the PERA board is waiting to see what items the governor places on the call.

Returning to the topic of increasing contributions to the plan, committee members asked Mr. Slattery if the PERA board would consider an increase in contribution rates less than its recommended 8%. Mr. Slattery responded by saying yes, and perhaps increments of 0.5% could be considered. He added that the PERA board is not comfortable changing benefits structures for current PERA members.

Carter Bundy, legislative director for the American Federation of State, County and Municipal Employees (AFSCME) in New Mexico, presented the members with a handout dated July 19, 2011. The handout is a memorandum on the topic of pension solvency and reform ideas. The ideas represent suggestions from the AFSCME, although Mr. Bundy clarified that the AFSCME cannot speak for any other union.

Mr. Bundy explained that the memo before the committee is divided into three major sections: major changes, which should generate significant savings to the PERA funds; smaller changes, which may primarily be helpful for policy reasons but which also may have a beneficial impact on the PERA funds; and defensive positions, which are essentially preservation of the status quo. He clarified that none of the ideas worsen the financial situation for the PERA, and almost all of them help it at least marginally.

Mr. Bundy said that it is the hope of the AFSCME that a core group of legislators from both parties, in both chambers, will take these ideas and ask for an actuarial study of them. Pension reform is complex and has many interested parties, so lining up broad support for a specific plan well ahead of the next session will prevent the kind of meltdown that invariably happens when legislation as complex as this is amended "on the fly" during the session.

Mr. Bundy proceeded to outline the major savings recommendations, noting that most of the experts who have testified over the last few years at the interim committee hearings have consistently said that there are three major ways to reduce liabilities: require and/or motivate people to work longer; reduce and/or delay COLAs; and lower the multiplier (the number that, multiplied by final average salary and years of service, equals the final pension benefit). Mr. Bundy suggested that a fourth concept be included in this "major savings" category: expanding the number of years used to calculate FAS from three years to eight years.

Next, Mr. Bundy suggested a change in the retirement age. He explained that many states use a "Rule of ##" policy, where a member can retire with a certain combination of age and years of service. One of the real problems, especially from a public perception point of view, is that people can graduate from high school, work 25 years at a safe desk job and retire at age 43 with 75% of their FAS. Even if the vast majority of pension funding comes from employees and investment returns, rather than directly from the taxpayer, there is just a sense that it is wrong. He proposed a "Rule of 85" for non-public safety workers, whereby the combination of age and years of service would have to equal 85. That means that someone starting public employment right out of high school would have to work 33.5 years to retire, or 8.5 more years than the employee currently has to work, so only a few people would ever be able to retire before age of 55. He further explained that someone starting at age 35, which is the average starting age for state employees, would have to work until the person is 60 years of age to meet the Rule of 85.

Mr. Bundy said that the savings realized by these changes will require actuarial analysis, but for non-public safety workers, the minimum number of years required before retirement will be 8.5 years longer than under the 25-and-out system for people who start right out of high school and 3.5 years longer for those same people pursuant to the plan introduced by Representative John A. Heaton, which went into effect last year.

The next recommendation presented by Mr. Bundy was the one to reconfigure the COLA. He clarified that, as with the other ideas and recommendations, the AFSCME asserts that this should only be applied prospectively, opining that both legally and as a matter of basic fairness, there is no way that employers should "bait-and-switch" people they have already hired and certainly no way those who are already vested should have their pension deals broken.

According to Mr. Bundy, a first idea is to tie the COLA to the CPI, with a cap and floor so that neither the retiree nor the state gets hurt too badly by extremes. Social security does this, and even though there are some good arguments that seniors, with heavier health costs, may deserve an even higher COLA than the CPI, those arguments are countered by the fact that Medicare is still such a strong program, at least for those over 65.

Mr. Bundy proceeded with offering the recommendation of lowering the multiplier, explaining that the current formula to figure out the retiree's pension in most plans is to take the FAS, multiply it by years of credited service (expressed in hundredths, so 25 years equals 0.25) and then multiply by a "multiplier", which for many plans, including the state general plan, is 3.0. If a member retires after 25 years of service, the member gets 75% of the FAS. By lowering the multiplier, someone retiring after 25 years would get 60% of the FAS while someone working for 30 years would get 75% of the FAS, and the cap could be raised to 90% of the FAS for someone with 35 years of service. Mr. Bundy opined that such changes would provide incentive for people to work longer through their most productive years.

Mr. Bundy next suggested changing the FAS calculations by using the employee's highest eight years' salary (matching the proposed vesting period) instead of 3.0 for the PERA. He acknowledged that such a change is a controversial idea because it significantly lowers the pension amounts received by future employees.

Next, Mr. Bundy shared some ideas for additional policy changes and smaller savings. He noted that the vesting period could be expanded from five years to eight years. Another idea recommended by Mr. Bundy is to lower or eliminate the guaranteed rate of return on non-vesting employees' contributions even though it may be only a few million dollars a year. It can be argued that if the PERA does not legally have to pay out the interest on the employee share, it is obligated to the fund not to pay out bonus interest voluntarily.

Another recommendation would be to toughen requirements on members moving to more generous plans. One of the problems in Municipal Fire Plan 5, to which most firefighters belong, is that people can come into the plan from a different plan, log in three years of service and suddenly take advantage of the most generous of all the PERA plans (it pays a multiplier of 3.5 of FAS for each year; most major PERA plans pay a multiplier of 3.0).

The next suggestion presented by Mr. Bundy is to increase contribution rates for the funds that are in the most trouble. Firefighters in particular have been willing to increase their contributions to ensure that future firefighters are able to have a 20-year retirement. He clarified that the AFSCME does not speak for the firefighters.

Mr. Bundy recommended that the plans do not give full-time service credit to part-time workers. Right now, someone can work 22 years on a part-time basis, work three years on a full-time basis and end up with a full-time pension. Mr. Bundy strongly recommends that part-time work be valued as such. Not only does the current system make no policy sense, but, if widely used, it is detrimental to the fund.

Mr. Bundy recommended establishing a consistent "public safety" definition. He opined that not all jobs currently covered by "public safety" are truly the types of jobs that should have a 20-year retirement. There seems to be a fair number of desk jobs that somehow get swept up in the 20-year retirement, and there is simply no policy reason for that.

Mr. Bundy also recommended preservation of some current policies. He recommended keeping the policy banning double dipping. Double dipping is a problem, first and foremost, because the fund takes a big hit when people "retire" earlier than they otherwise would. A nearly unanimous bipartisan coalition resisted the temptation to carve out a number of exceptions last year, but that coalition is being tested by claims that cities, counties, courts and some state agencies can only recruit and retain qualified workers if they allow double dipping.

Next, Mr. Bundy recommended that the contribution rate should not be lowered. If the first priority of pension reform is to ensure long-term solvency, and if future employees' benefits are lowered to do so, it does not make sense to also lower contributions. He opined that it is easier to maintain the current status quo on contribution levels and then lower them if the plan becomes "super-solvent" than it is to find out that a few assumptions were wrong and then try to raise contribution levels.

Mr. Bundy also recommended preserving the employer-employee splits, where employers have agreed to pick up a portion of the employees' contributions. Under current law, local employers are allowed to make an irrevocable decision to pick up part of the employees' contribution. There are questions as to whether these irrevocable decisions would still apply if a new tier of benefits are created. Mr. Bundy opined that this issue does not affect the PERA's solvency but could result in about a 10% pay cut for tens of thousands of employees around the state. Pension reform is not meant to be a windfall to local government or a huge pay cut for workers; the AFSCME respectfully asks that the legislature take whatever measures are necessary to ensure that current splits stay in place when pensions reforms are considered.

Mr. Bundy stressed that the AFSCME believes that the promises to current employees should be upheld. It is nothing less than a bait-and-switch or a broken promise to change the plans of current retirees and members. People have taken jobs in the public sector in New Mexico and kept them even when they have had opportunities to go to the private sector, federal government or other states, often relying on the promise of the existing retirement plans. That does not even address the strong constitutional and contract claims that will be made by, at the very least, every current retiree and previously vested member.

According to Mr. Bundy, the recent events in Colorado and Minnesota involving changes to those states' pension plans do not directly affect New Mexico law, and some parts of those decisions indicate that where the employer has consistently made a promise, courts will be less likely to uphold a breach of that promise (for example, in Colorado, the lower court ruled that one reason it was legal to change the COLA was because the COLA had changed so many times in the past). Regardless of the legal issues, however, it is fundamentally unfair to change the rules mid-stream on people who guard the jails, nurse the sick and teach the kids.

In summary, Mr. Bundy told the members that the memo provided by the AFSCME presents a strong array of significant, permanent reform ideas and that this is an opportunity to simultaneously address solvency, perception and policy issues in one fell swoop. Starting the first year people are hired under the new proposals, solvency numbers will improve because the solvency number is simply assets divided by current and future liabilities. Liabilities will start going down with the very first set of new employees under these plan recommendations, even in the plans for public safety employees.

In furtherance of the topic discussion, a panel consisting of Christine Trujillo, president of the American Federation of Teachers (AFT), David Heshley, executive director of the Fraternal Order of Police, and Eduardo Holguin, government relations coordinator for the National Education Association (NEA), addressed the committee. Mr. Heshley began by noting that New Mexico's police officers are for the most part members of the PERA, but some are members of the ERB. He noted that the police officers have not received pay raises for quite some time. Consequently, their pay has not kept up with inflation.

Ms. Trujillo presented the members with a handout addressed to the IPOC, the legislature and Senator Munoz, the IPOC chair. The memorandum proposes the repeal of House Bill 854 (Laws 2009, Chapter 127), which, according to Ms. Trujillo and the New Mexico chapter of the AFT, violates the Constitution of New Mexico, unfairly targets a particular group of workers for a pay cut and takes money directly out of the pockets of New Mexico families. House Bill 854 increases the amount of money that employees who terminate employment before retirement can withdraw from the fund. According to Ms. Trujillo, this violates Article 20, Section 22 of the

Constitution of New Mexico, which states that the legislature "shall not enact any law that increases the benefits paid by the system in any manner or changes the funding formula for a retirement plan unless adequate funding is provided". Additionally, Ms. Trujillo noted that House Bill 854 is the subject of pending litigation.

According to Ms. Trujillo, House Bill 854 was part of a budget package that cut school and state employees' pay 1.5% for two years. The legislation increased the workers' payments into their pension funds by 1.5% and reduced by 1.5% the amount that state employers pay into those same pension funds. Ms. Trujillo noted that the affected employees have not received salary increases in a long time. Although employees are not asking for back pay at this time, the current 11.5% contribution rate for employees is too high for members.

Next, Mr. Holguin spoke to the committee members. He provided them with a handout prepared on behalf of the executive director, Charles Bowyer, entitled *NEA-New Mexico Proposals to the Pension Oversight Committee*. According to Mr. Holguin, and indicated within the handout, evidence presented to last year's Retirement Systems Solvency Task Force does not indicate that the Educational Retirement Fund is in crisis or insolvent. To the contrary, the report of Buck Consultants indicated that because of its lower normal costs, the ERB is in a better solvency position than the PERA over the long haul. Yet the proposals for changes in the PERA created by its board are changes for new hires only. The NEA urges the legislature to be equally cognizant of current members' needs. Any changes that increase the gap between the PERA benefits and the ERB benefits are politically unacceptable to education employees. Buck Consultants also concluded that delaying any drastic change has very little influence on the ultimate financial solvency on the funds of either the PERA or the ERB.

Mr. Holguin relayed that the NEA firmly believes that Article 4, Section 19 and Article 20, Section 22 of the Constitution of New Mexico make any diminution of benefits to currently vested members of the ERB under current economic conditions unconstitutional. The NEA supports a consensus agreement of the New Mexico Education Partners, stating, "The New Mexico Education Partners will not support any changes to the benefits of currently vested members of the Educational Retirement Board; this includes our opposition to any changes in retirement eligibility for vested members. We will explore support for recommendations that move the Educational Retirement Fund toward agreed upon and verifiable solvency targets.".

Mr. Holguin expressed support for incentives, rather than mandatory changes to retirement eligibility, to encourage members to retire later. Such incentives might include: (1) adding an extra year of service credit for each five years that a member delays retirement past full unreduced eligibility; or (2) providing that any member retiring at age 62 or older receive a COLA one year after retirement.

At the conclusion of Mr. Holguin's prepared remarks, there was a discussion about the items on which employees/members are willing to agree. Some committee members asked if the LCS staff could draft legislation reflecting all items agreed upon by employee/members in the hopes of the committee proposing and endorsing legislation. The chair added that it would be beneficial to set aside one meeting of the IPOC to meet with the various board members to gain consensus on the solvency issues.

Update on Recent Legal and Financial Developments Affecting State Pensions

Mr. Pollard and Ms. Faust spoke to members about legal and financial developments affecting state pensions. Mr. Pollard began by advising members that on July 8, 2011, the Governmental Accounting Standards Board (GASB) proposed changes in pension accounting and financial reporting standards for state and local governments.

According to Mr. Pollard, and detailed in the handout he provided, the GASB's stated goals are to improve the visibility and quality of pension information in governmental financial statements and to encourage intergenerational equity. The new rules require the following:

1) unfunded pension liabilities will now appear on the employer's balance sheet, rather than in the notes as is now the case;

a. an employer's unfunded retirement obligations will be reported on its balance sheet, and pension expense will hereafter be reported in the operating statement;

b. long-term pension liability will be reported like long-term bond debt liability; and

c. annual pension expenses using new GASB calculations will become far more volatile and may be impractical to budget. Many employers will face "sticker shock" if they attempt to fully fund the actuarially calculated cost under these new standards;

2) lower actuarial discount rates will apply for most plans, which will increase liabilities and pension expenses;

a. where investment fund assets exist to fund all future obligations, the expected investment rate of return used now can continue to be used;

b. where assets are insufficient, i.e., where investment assets and their earnings will be depleted by the benefits, the effective discount rate for that unfunded portion will be an AA tax-exempt bond index rate (which is around five today);

c. those two rates will be blended by the actuaries. Seriously underfunded plans, and especially unfunded other post-employment benefits plans, will have the lowest discount rates and thus the (relatively) higher reported liabilities and costs; and

3) shorter amortization periods will be allowed for unfunded liabilities, which will also increase pension expenses;

a. amortization of unfunded liabilities, which now can be stretched out over 30 years, will be tightened up significantly;

b. in general, unfunded liabilities may be amortized over the average remaining service lives of incumbent employees, which are usually 12 years to 15 years (one-half of 25-year and 30-year careers and one-half of current amortization periods), and certain changes for retirees will be expensed immediately; and

c. the net impact overall on current pension solvency analysis is similar to refinancing a 30-year mortgage with a l0-year or 15-year amortizing note; annual payments required to amortize unfunded pension liabilities will go up; and

4) large pension funds are scheduled to implement the new rules beginning in July 2012.

Ms. Faust told the members that states are making changes to their respective pension plans, but the unanswered question remains, "Is it constitutional?".

In Minnesota, the legislature enacted omnibus changes to multiple plans. In an ensuing legal challenge, the court found that the changes did not violate the state or federal constitutions. In its findings, the court specified that pension plan benefits are not a contractual right unless they are so specified in a specific statement. Unlike in the Constitution of New Mexico, the Minnesota constitution does not confer a property right in pension benefits to state employees.

In Colorado, a court reviewed similar claims to those alleged in the Minnesota case, with similar results. The plaintiffs in Colorado asked the court to invalidate the legislative change to the COLA. However, the court found no contractual right in the COLA benefit because the COLA had been changed on so many occasions prior to the disputed change. Notably, the court in the Colorado case also noted the dire situation faced by the Colorado pension plan.

Establishing Realistic Investment Earnings Benchmarks

Joelle Mevi, chief investment officer, PERA, spoke to the members regarding realistic investment earnings benchmarks. She provided a handout dated July 27, 2011. She began by noting that the starting point in constructing a realistic earnings benchmark is the actuarially assumed target rate of return, which for the PERA is 8.0%. The next steps are to allocate investments into assets that will achieve the 8.0% return while assuming the inherent risks of those assets; construct a diversified asset allocation by using capital market assumptions and economic forecasts; and seek to reduce portfolio volatility by diversifying return streams, e.g., investing in non- or low-correlated assets. The goal is an optimal risk-versus-rewards balance, given certain risk tolerance levels.

Ms. Mevi directed the members' attention to a chart on page 2 of her handout, which depicts a pension risk framework, noting that the biggest and primary risk is that assets do not support the liabilities. She noted that further information provided in the handout explains the asset class correlation matrix, which depicts how different asset classes correlate to each other.

According to Ms. Mevi, capital market (CM) assumptions are the most widely used tools in the management of institutional portfolios. The asset class behaviors that CM assumptions estimate, like risk, return and correlation, are widely accepted as the most powerful drivers of the total fund return over the long run. Consequently, the mix of asset classes, as well as the risk, return and correlation associated with them, is the most powerful driver of total fund returns over the long run.

Ms. Mevi explained that risk, return, correlations, diversification and asset allocation all combine to construct an "efficient frontier". She then noted that the handout includes detailed information regarding the PERA's 2011 efficient frontier, including a comparison of the PERA's optimal portfolio for years 2005, 2009 and 2011.

Ms. Mevi concluded her presentation by telling members that the PERA retirement funds are diversified across non-correlated asset classes that are both passively and actively managed. The combination of assets and a management mix is designed to achieve risk-adjusted returns sufficient to meet the actuarial target rate of return over the long term. She added that CM assumptions (10-year annualized) and the fund's efficient frontier are updated annually. An asset/liability study will be conducted by R.V. Kuhns and Associates in late 2011 following the completion of the FY11 actuarial study. Lastly, on July 28, 2011, the PERA board will take action on an actuary recommendation to reduce the target rate of return assumption to 7.75% from the current 8.0%.

Bob Jacksha, chief investment officer, ERB, next addressed the committee. He provided the members with the handout, *Establishing Realistic Investment Earnings Benchmarks*. He began by noting that the ERB's returns have recently been very similar to those of other pension plans.

Mr. Jacksha explained the development of asset class assumptions and provided information regarding the current asset class weights and indexes used to calculate the current ERB policy index. He explained that inflation is an important component of the ERB's asset allocation assumptions, and it is a building block for projecting returns in stocks, bonds and commodities. Measures for inflation include the CPI, the Producer Price Index and the treasury inflation protected securities break-even inflation. Mr. Jacksha said that the ERB is projecting 3% inflation over the next five to seven years.

Mr. Jacksha directed the members' attention to page 17 of the handout, which contains a chart illustrating the updated expected return for 2011 CM assumptions, pointing out that the ERB expects a compounded return for 2011 of 8.1% for the next five to seven years, down from the 8.9% in 2010.

Robert "Vince" Smith, deputy state investment officer, State Investment Council (SIC), joined the discussion by explaining the SIC's returns expectations for the land grant permanent funds. His presentation was accompanied by a handout dated July 27, 2011. Mr. Smith explained that the SIC is undertaking an asset study in the normal course of its management of the permanent funds. The target rate of return in its investment portfolio is an integral part of that study. He added that the SIC staff has produced an analysis of portfolio objectives. The purpose of the analysis is to help guide the SIC investment portfolios that are expected to meet the objectives of the permanent funds with reasonable investment risk. Mr. Smith next explained the permanent funds' explicit and implicit objectives:

1) providing for the statutory distributions to beneficiaries;

2) protecting the corpus from inflation; and

3) providing for some real growth of the corpus.

Mr. Smith explained the contents of the handout, telling committee members that his intention is to answer three questions:

1) What level of return was necessary to achieve the funds' objectives in the past?

2) Using history as a guide, and making assumptions regarding the future, what level of return might be necessary for the funds to achieve their objectives in the future?

3) Once the necessary rate of return is understood, what level of investment risk is necessary to achieve that rate of return?

Mr. Smith directed IPOC members' attention to page 6 of the handout, which depicts the historical required rate of return model, noting that the results indicate the need to make a rate of return between 6.0% and 8.0% in order to meet the funds' goals.

Next, he directed members' attention to page 11 of the handout, depicting the "Forward-Looking Model", pointing out the statutory distributions assumptions of 5.5% and inflation of 2.5%. He noted that this model backs up the assumptions and information in the historical model. He concluded that using the noted assumptions, the forward-looking model produces similar results to the historical model. He further concluded that income for the State Land Office is a critical component and bears great analysis. He added that returns from the investment portfolio become increasingly important in maintaining the fund's corpus.

Mr. Smith concluded by telling members that the current low rate of "risk-free" return structurally lowers total return available at every risk point. In consideration of the condition of the investment markets, the SIC reduced the target rate of return for the permanent funds from 8.50% to 7.50%. This still makes for a vigorous return target. Achieving the risk premium will be critical; interest rates (and therefore the "risk-free rate") are expected to rise going forward; but statistically, it will be difficult for rates to rise enough in the next 10-year period to offset a major disappointment in risk premiums achieved.

The SIC recognizes that the investment markets are changing and that the portfolio must change with them to achieve the targeted rate of return with a reasonable amount of investment risk.

After a 30-year period of steadily declining U.S. and global interest rates, rates are expected to begin to climb back toward longer-term averages. Fixed income investments that are purchased (or owned) today will produce low rates of return in that type of environment.

Economic growth in the U.S. and other developed nations, where the bulk of SIC portfolios are invested, will likely underperform relative to the last three decades. To a degree, this will constrain growth in the equity markets.

Higher rates of inflation are expected to occur in the U.S. The U.S. dollar may show persistent weakness against a global basket of currencies. This affords an opportunity in foreign-currency-priced investments for those investing with U.S. dollars.

Update on the Progress of Current or Pending Litigation Involving the State's Investment or Pension Funds and Allegations of "Pay-to-Play" Investment Fraud or Related Matters

Frank Foy, plaintiff in pending litigation, along with Victor Marshall, Mr. Foy's attorney in the litigation, addressed the committee. Mr. Foy opened his remarks by saying that he believes New Mexico needs to "clean house" because pay-to-play has been a big problem in the state for a very long time. He recommended replacing all management at the SIC and the ERB, leaving no one in place that was hired or appointed during Governor Bill Richardson's administration. Mr. Foy opined that people like Steven Moise of the SIC and Jan Goodwin of the ERB should resign because they have conflicts, although he did not elaborate on the nature of the alleged conflicts. Notably, following Mr. Foy and Mr. Marshall's remarks, many legislators took great issue with Mr. Foy's call for the resignation of anyone hired or appointed during the Richardson administration. Many legislators expressed total support for Mr. Moise, who was in attendance at the meeting. Some legislators thanked Mr. Foy for his courage to come forward with the allegations of pay-to-play but, nonetheless, disagreed with his call for the resignations.

Mr. Marshall identified himself as counsel for Mr. Foy and the State of New Mexico since July 14, 2008, when Mr. Foy filed his first lawsuit pursuant to New Mexico's Fraud Against Taxpayers Act (FATA). The act provides for the filing of a civil suit for actions that occurred on or after July 1, 1987. The act further provides that a person may bring a civil action for a violation of Section 3 of the FATA on behalf of the person and the state. The action shall be brought in the name of the state, and the person bringing the action shall be referred to as the qui tam plaintiff. Once filed, the action may be dismissed only with the written consent of the court, taking into account the best interests of the parties involved and the public purposes behind the FATA.

Mr. Marshall told the committee members that when Mr. Foy initially filed his lawsuit, Mr. Marshall and Attorney General Gary King discussed the limited resources within the

Attorney General's Office (AGO) to pursue the litigation. Mr. Foy said that, at that time, he and the attorney general were in agreement, and Mr. Marshall proceeded with the litigation, while the attorney general filed an amicus brief in support of a couple of the pending issues, including the issue of retroactivity put forth in the case.

Mr. Marshall continued the discussion by explaining that in his opinion, many courts do not fully understand the provisions of the FATA, particularly the lower courts, and notably on the question of retroactivity as it applies in the Foy case. Mr. Marshall then suggested that the IPOC consider passing a resolution asking the New Mexico Court of Appeals to grant the appeal of the case as soon as possible and to rule that the statute as written is both constitutional and representative of the legislature's intent. Committee members discussed the suggestion of writing a letter to the court. Members expressed concern over intruding or appearing to try to influence the work of the court. After a lengthy discussion of the matter, members voted without objection on a motion to direct the LCS staff to draft a letter on behalf of the committee to the court of appeals apprising the court of the legislature's specific intent to provide for the retroactive application of the provisions of the FATA and advising the court that the committee members are in full support of the actions being taken in the pending litigation.

Mr. Marshall opined that the attorney general should delegate the authority to proceed in the litigation to the SIC and that the SIC should start a new request for proposals (RFP) process in the search for a law firm to represent the state in the litigation. Mr. Marshall alleged that when the SIC hired the Day Pitney firm, the hiring process was flawed. In discussions that followed, the SIC denied employing a flawed process in the hiring of the Day Pitney law firm.

Additional discussions focused on the role of Mr. Foy as the "whistleblower" and plaintiff in the suit. Some members expressed concern over the potential for Mr. Foy to receive a large sum of money in the case, as well as the large attorney fees that may be collected by Mr. Marshall, even if he does not spearhead the litigation going forward. Mr. Foy could receive between 25% and 30% of the recovery in the case. Committee members voiced appreciation for the efforts and courageous nature of Mr. Foy's actions on behalf of the state, as well as the work already performed and expenses incurred by Mr. Marshall, but they still questioned the validity and extent of the potential reward for the efforts. Most members seemed to stand behind the objectives of the FATA, in spite of questions regarding the realities of litigation brought pursuant to the statute.

Chris Schatzman, general counsel, ERB, provided an update on the lawsuits for recovery of lost investment money. He provided a handout with an overview of the cases in which the ERB is involved.

Mr. Schatzman advised that the update includes those matters in which the ERB has filed a lawsuit as a plaintiff or has joined an action as a representative plaintiff. It does not include actions filed by others, such as actions filed pursuant to the FATA. Cases brought by the ERB include:

- *Aldus Equity Partners, L.P.* The ERB filed a lawsuit against Aldus and related entities, including Renaissance Private Equity Partners, Erasmus Capital, Saul Meyer and other former partners in Aldus in state district court in Santa Fe County on October 18, 2010. Based on additional information it has obtained, the ERB's outside counsel is preparing an amended complaint that will be filed soon. After the amended complaint is filed, the defendants can file motions to dismiss and other dispositive motions; and

- *Austin Capital Management, LTD.* The ERB is a representative plaintiff for public pension funds in a class action lawsuit against Austin Capital Management (ACM); KeyCorp, ACM's corporate parent; Victory Capital Management; another subsidiary of KeyCorp; and certain officers of KeyCorp and ACM Austin Capital in U.S. district court for the southern district of New York. Prior to becoming a representative plaintiff in this action, the ERB reviewed class actions that had been filed or that were being developed for filing. This case was the only one that included non-Employee Retirement Income Security Act of 1974 plaintiffs. The defendants have filed a motion to dismiss, briefing has been completed on that motion and counsel expects the judge to schedule oral arguments after he returns from vacation. Discovery is stayed until the motion is decided.

When asked about the discovery process related to the litigation, Mr. Schatzman told committee members that the ERB has produced everything in its possession. He added that a lot of the information produced is nonresponsive because it is a result of a computer-based word search culminating in voluminous search results. He added that the ERB is using a targeted approach in the litigation and is not going after defendants when evidence against the defendant is not available. Evidence is critical to survive a motion to dismiss, and the ERB will not pursue cases unless it anticipates recovery.

Mr. Moise and Evan Land, SIC general counsel, next addressed the members. Mr. Moise began by thanking committee members for their supportive remarks on his behalf made earlier in the course of the meeting. He reminded members that he serves at the pleasure of the SIC board and can be removed at any time. He added that the highest standards of care and loyalty are his objectives and goals and the objectives and goals of the entire SIC staff.

Mr. Land told members that there could be questions regarding the constitutionality of the retroactivity provisions in the FATA. He noted that two judges have looked at the statute and said that it could not apply to acts prior to the first half of 2007 because of the punitive nature of the treble damages provided for in the act. According to Mr. Land, the SIC wants to pursue the litigation in order to get at the earlier conduct, which may be precluded from litigation brought pursuant to the FATA. Mr. Land explained that the SIC is not bound by the retroactivity constraints because it is not bringing the litigation pursuant to the FATA and its claims are civil in nature.

Mr. Land said that the SIC is pursuing legal action against 19 defendants and intends to use the discovery process to leverage information against those and other defendants and to push defendants to settle in order to avoid massive attorney fees.

Mr. Land assured members of the committee that the process employed by the SIC in its hiring of the Day Pitney law firm was in accordance with the proper processes of issuing an RFP. Additionally, he noted that the Day Pitney law firm has already had proven success in litigation against the very same defendants being pursued by the SIC.

Noting that Mr. Foy is currently suing the SIC, discussion about the SIC and Mr. Foy and his counsel working together became a topic of discussion among the members. Mr. Land expressed encouragement for Mr. Foy's rights pursuant to the FATA. But he noted that Mr. Foy and Mr. Marshall could both be compensated for their time and efforts even if the litigation were led by the attorney general, asserting that the court could rightfully compensate Mr. Foy and Mr. Marshall for their work up to this point.

Attorney General King spoke to the IPOC and presented it with copies of the lawsuit filed by the AGO on behalf of the SIC on June 30, 2011 in state district court. He additionally provided copies of the affidavit Mr. Foy filed in Mr. Foy's FATA case on October 22, 2009. Attorney General King highlighted several sections of the affidavit he considered important to the discussions involving the litigation, particularly with regard to Mr. Foy's knowledge about wrongful acts involving the SIC.

Attorney General King began by telling the members that Mr. Land had provided much of the information for the committee that he had planned on discussing. He reminded the members that the FATA legislation was proposed by the AGO, and he considers it an excellent tool to fight corruption in New Mexico. He noted that the FATA is a broad statute, and unlike other statutes, the relator under the FATA does not have to have first-hand personal knowledge of the crime. Another key aspect and good tool of the FATA is the treble damages provision. That provision can provide for a good settlement result in claims brought pursuant to the FATA. The AGO filed an amicus brief in support of the retroactivity provision of the legislation as passed by the legislature.

Attorney General King noted that Mr. Foy does not have any specific knowledge related to the SIC case. Additionally, Mr. Foy has named many defendants, and Attorney General King opined that it is unclear whether Mr. Foy has the resources to litigate such a large case, and remarked that in cases such as the Foy case, it is pretty clear that the lead litigator should be the attorney general.

Attorney General King addressed the committee members' and others' frustration with the slow pace of the litigation and the perceived inaction by the AGO. He said that part of the delay was due to an ongoing criminal investigation, adding that the AGO is still interested in getting criminal convictions against wrongdoers. He said that three years ago, when Mr. Foy initially filed the case, the AGO did not know that the State of New Mexico would need to weigh in on the litigation, but that situation has changed.

Attorney General King next discussed the issue of the AGO's conflict of interest as asserted by Mr. Foy. The attorney general expressed certainty that the AGO has no conflict of interest. He advised that in conflict of interest questions, the court looks at rules of ethics for lawyers, specifically whether the representation of a client presents a conflict for the attorney.

There was a discussion regarding the risks and costs of litigation. Attorney General King emphasized that the discovery associated with litigation is expensive for the state because the state agencies must provide the sought-after documents. He reminded the members that the state will not get any of the money lost if there is no recovery. Members discussed the potential for recovery and inquired as to the chances of all parties — the attorney general, Mr. Foy, the SIC and the ERB — presenting a "united front" in the litigation. Mr. Schatzman noted that after lengthy discussion with all parties, it is generally agreed that there are several separate causes of action. He added that he agrees with Mr. Land that Mr. Foy and Mr. Marshall can be compensated for their time and expenses regardless of who leads the litigation going forward.

With no further business, the committee adjourned at 5:15 p.m.