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

September 7, 2017
Room 322, State Capitol
Santa Fe

The third meeting of the Investments and Pensions Oversight Committee was called to order by Representative Tomás E. Salazar, chair, on September 7, 2017 at 9:05 a.m. in Room 322 of the State Capitol.

Present
Rep. Tomás E. Salazar, Chair
Sen. George K. Munoz, Vice Chair
Sen. Jacob R. Candelaria
Rep. Miguel P. Garcia
Sen. Gay G. Kernan
Rep. Larry A. Larrañaga
Sen. Steven P. Neville
Rep. Jane E. Powdrell-Culbert
Rep. Patricia Roybal Caballero
Sen. John M. Sapien
Rep. Larry R. Scott
Sen. Elizabeth "Liz" Stefanics
Rep. Jim R. Trujillo

Absent
Sen. Carroll H. Leavell
Rep. William "Bill" R. Rehm

Advisory Members
Rep. Roberto "Bobby" J. Gonzales
Sen. Stuart Ingle
Rep. Bill McCamley
Rep. Sheryl Williams Stapleton
Sen. James P. White

Sen. William F. Burt
Sen. Carlos R. Cisneros
Sen. Mary Kay Papen
Sen. William H. Payne

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

Guests
The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

<u>Thursday, September 7</u>

Legislative Finance Committee (LFC) Quarterly Investment Report

Dawn Iglesias, economist, LFC, reported on the performance of investment portfolios managed by the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA) and the State Investment Council (SIC).

Over the past year, the aggregate value of the portfolios grew by nearly nine percent to a total of $48.6 billion, with the SIC portfolio showing the strongest return, at 10.7 percent. Returns in fiscal year (FY) 2017 ranged from 11 percent to 13 percent, a performance level that exceeded one- and five-year targets set by all agencies and that was due in part to a strong equities market.

While the investment strategies for all of the portfolios share a common focus — growing and preserving their funds for the long term — differing mandates for distributions from the funds have affected their growth. Distributions from the SIC-managed Land Grant Permanent Fund and Severance Tax Permanent Fund are calculated based on the funds' balances, revenue and contributions; if one of these funds shrinks, its distributions shrink as well. In contrast, distributions from the pension funds managed by the ERB and the PERA are based on benefits contractually owed to retirees, regardless of fund balances. This difference in liabilities across the funds is reflected in their growth in the last five years: the permanent funds grew by as much as 52 percent, while the pension funds grew at approximately 30 percent.

Portfolios at all three agencies consist of a blend of actively managed investments and passively managed, or indexed, investments. Nearly three-fourths of the SIC portfolio is actively managed by external investment firms working under contract. The ERB's actively managed investments constitute a similar share of its portfolio and are primarily handled by external firms as well; however, eight percent of the ERB portfolio is actively managed in-house. The PERA's portfolio is more heavily weighted to passive management than the other portfolios: just over one-half of its investments are passively managed while the balance is actively managed.

Two types of fees are paid for external investment management in all portfolios: 1) *management fees*, which cover the cost of managing a fund and are paid out of the fund itself, calculated on basis points; and 2) *performance fees*, which are a share of the profits generated by a fund and are paid out of the agency's state budget allocation. For FY 2016, combined management and performance fees came to $119.4 million for the ERB portfolio, $79.3 million for the PERA portfolio and $189.1 million for the SIC portfolio.

Ms. Iglesias noted that while all three portfolios performed well in the past few years, the agencies are considering changes to investment strategies to further improve performance, including shifting certain actively managed assets to passive management and building longer-term relationships with certain "core" investment managers.

Evaluating the portfolios for risk over the past five years, Ms. Iglesias found that each of the portfolios fell into the "good" range, a category that suggests that the level of return was fair for the level of risk taken. The PERA's portfolio was found to be the most volatile.

On questioning, Ms. Iglesias and committee members, as well as Dominic Garcia, chief investment officer, PERA, and Bob Jacksha, chief investment officer, ERB, who were in the audience, addressed the following topics.

Interagency cooperation. While Ms. Iglesias noted anecdotally that the ERB and the PERA work well with each other, she suggested that any questions about how much cooperation there is among the ERB, the PERA and the SIC be directed to the respective agencies.

Investment management fees and companies. Relative to the size of each fund, the ERB paid proportionally more in investment management fees (84 basis points) in FY 2016 than the SIC paid (59 basis points). Both actively and passively managed assets incur management fees, though fees for passive management are significantly lower.

Most of the investment management companies under contract with the ERB, the PERA and the SIC are large, out-of-state companies. The ERB's website includes information on investment management companies working under contract for the agency.

PERA. The PERA portfolio ranks the highest among state investment funds for risk. Investment strategies for this fund are currently being revised to reduce both risk and volatility.

Asset allocations. If a portfolio's performance does not match an upward trend in the market, asset allocations are changed. Active versus passive management classifications are based on market performance as well as management costs.

- Ms. Iglesias agreed to provide:
  (1) information on which investment companies are handling investments for the PERA, the ERB and the SIC;
  (2) whether any of the investment companies are handling investments for more than one of the agencies; and
  (3) a clarification on how investment management fees are paid by the SIC.

ERB: Sustainability and Solvency

Jan Goodwin, executive director, ERB, gave a presentation on the ERB's status in regard to sustainability and solvency. She opened with a definition of "solvency" — the ability of an organization to pay its obligations into the future — and stated that "the ERB is solvent".

In monitoring its solvency status, the ERB conducts a biennial "experience study" to assess the assumptions and methods used by its actuary. Economic assumptions include factors such as the long-term return rate on ERB investments, which affects fund balance projections, and the inflation rate, which affects calculations for wages and retiree benefit cost-of-living adjustments (COLAs). Based on the most recent experience study, the ERB adopted the following changes to its actuarial assumptions at its April 2017 meeting:

- the projected return rate for the investment portfolio was reduced from 7.75 percent to 7.25 percent;
- the inflation rate assumption was reduced from three percent to 2.5 percent;
- the wage inflation assumption was reduced from 3.75 percent to 3.25 percent;
- the payroll growth assumption was reduced from 3.5 percent to three percent; and
- the COLA assumption was reduced from two percent to 1.9 percent.

The ERB's projected date for reaching a 100 percent funded ratio is 84 years out, in the year 2100. Changes to plan elements, such as contribution rates and retirement eligibility age, can affect the time it would take for the plan to reach full fundedness. Plan enrollment also has an effect; current active membership is the same as it was in 2000 and may fall further, which could reduce revenue to the fund and delay full fundedness beyond current projections. "Return to work" retirees are another detriment to the fund, as many of them are not required by statute to make ERB contributions. Ms. Goodwin estimated that more than $6.27 million in ERB contributions were forgone in FY 2017 due to retirees returning to work and filling positions that otherwise would have gone to contributing active ERB members.

Various statutory changes can be made that would affect active members and future members, such as adjusting the vesting period or increasing contribution levels. However, the only change that can be made that affects retirees is a change to the COLA. COLA calculations have changed over time, ranging from nearly 2.75 percent in 1991 to zero in 2010. In 1984, COLAs were capped at four percent and negative adjustments were allowed; in 2010, the negative COLA provision was eliminated.

Changes to contribution levels can increase revenue to the fund but can also increase costs, as happened with the contribution "swaps" made in House Bill 628 from the 2011 regular session. With the intent of reducing state General Fund expenditures, the bill reduced employer contributions and increased employee contributions; with this change, however, the ERB's liability for benefits payable upon death or withdrawal increased because these benefits are paid calculated solely on employee contributions. Ms. Goodwin noted that the cost to the fund of this contribution swap was $37.4 million as of June 2014, and she estimated that the cost has doubled since that time. Similarly, the cost of legislation from 2005 that delayed employer contributions to the ERB cost the fund $143.6 million as of June 2014 and twice that amount to date.

On questioning, Ms. Goodwin and committee members, as well as Roderick Ventura, general counsel, ERB, who was in the audience, addressed the following topics.

Funded ratio. The dip in the ERB funded ratio projected during the years 2018 through 2064 on page 13 of Ms. Goodwin's handout is a result of Tier 1 members retiring.

The ERB plans to propose legislation in the 2019 session to adjust ERB plan elements so as to shorten to 30 years the time it would take to reach 100 percent fundedness.

COLAs. The COLA has averaged 1.5 percent over the years and is currently set at 1.3 percent. Last year, the COLA represented nine percent of the total ERB pension costs, or $90 million; however, this amount also includes the compounding factor from COLAs in prior years. Eligibility for a COLA is dependent on a retiree's tier classification, age and date of retirement. Approximately 10 percent of ERB retirees are not eligible for a COLA.

Membership. ERB membership would increase if the economy improves and the state's population increases, thus resulting in more teachers being hired. Vacancies in both public education and higher education aggravate the decline in ERB membership.

The ERB has approximately 50,000 inactive members, 40 percent of whom have vested. Some of those members are enrolled in the PERA system, and some of them have moved out of state.

A person can be an active member of only one state pension plan at a time. If an active PERA member takes a teaching job as an adjunct professor, that person would continue to pay into the PERA system rather than the ERB system and would not earn ERB service credit for that teaching position.

Substitute teachers. Long-term substitute teachers make ERB contributions, but short-term substitutes — those who work less than a quarter-time schedule — do not. Some substitutes who have paid into the ERB system have not received pension benefits or withdrawn their money from the system because the ERB cannot locate or contact them.

Pension system failure. In some places in the country, such as Detroit, pension systems have failed when a local government's finances collapse. One contributing factor in Detroit's pension problems was its policy of issuing a thirteenth pension check to retirees each year; the ERB does not issue such additional checks. The ERB's proposals to adjust pension plan elements are aimed at avoiding a pension system failure.

Spiking. The spiking phenomenon, in which a part-time employee switches to full-time work during the final years before retirement, is more a perceived problem than an actual one and has been a minor cost to the ERB. A bill that had been sponsored by former Senator Sue Wilson Beffort would have adjusted final average salary calculations to prevent spiking, but the bill failed.

Budget adjustment request. The Department of Finance and Administration did not approve the ERB's budget adjustment request.

- Ms. Goodwin agreed to provide:
  (1) information on which states pay social security for teachers; and
  (2) an actuarial report on the effect on the ERB fund of return rates that are higher or lower than the projected 7.25%.

Retiree Health Care Authority (RHCA): Sustainability and Solvency

David Archuleta, executive director, RHCA, reported on the RHCA's solvency status, which is gauged by means of an annual solvency study.

The RHCA solvency study's analysis of future revenue and expenditures assists the RHCA board in developing strategies to sustain its health care system for retirees. Based on the latest analysis, the RHCA is projected to be solvent for 18 years out, to the year 2035.

In 2016, the RHCA had nearly 160,000 participants enrolled. In the same year, its assets totaled nearly $472 million, with a plan funded ratio of just over 11 percent and an unfunded accrued liability of $3.8 billion. New reporting requirements issued by the Governmental Accounting Standards Board will take effect for data reported for FY 2017 and following years.

The RHCA board has included several measures in its strategic plan aimed at sustaining the system. Most of its proposed steps can be taken without legislative involvement, such as reducing subsidies, adjusting programs and increasing copays. Mr. Archuleta noted that all of these measures would increase costs for retirees. The board's one proposal that would increase costs for members — increasing contribution levels — would require legislation.

On questioning, Mr. Archuleta noted that:

(1) last year, approximately 300 retirees participated in RHCA wellness programs, which are administered through the insurance companies;
(2) the RHCA offers nine Medicare plan options and has expanded those plans into new areas of the state; and
(3) one solvency measure under consideration is to tie subsidy levels to a retiree's age at retirement.

Minutes

On a motion duly made, seconded and unanimously adopted, the minutes from the August 3, 2017 meeting were approved.

Adjournment

There being no further business, the committee adjourned at 12:10 p.m.