LEGISLATIVE EDUCATION STUDY COMMITTEE
BILL ANALYSIS

Bill Number: SB 115a **51st Legislature, 1st Session, 2013**

Tracking Number: .190404.5SA

Short Title: Educational Retirement Changes

Sponsor(s): Senator Stuart Ingle and Others

Analyst: Ian Kleats **Date: March 12, 2013**

ENDORSED BY THE INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

AS AMENDED

The Senate Finance Committee amendments provide for a reduction of the cost-of-living adjustment (COLA) until the retirement plan's funded ratio is 100 percent. Among its provisions, the amendment:

- **defines relevant terms such as "funded ratio" and "median adjusted annuity";**
- **exempts members receiving disability retirement from the reduction; and**
- **allows the Educational Retirement Board (ERB) to impose a negative COLA under certain circumstances.**

The amendment creates a two-tiered structure for retired members:

(a) members with 25 or more years of service credit at retirement and whose annuities are equal to or less than the median adjusted annuity; and
(b) all other members, including those members whose annuities are equal to or less than the median adjusted annuity if the member has fewer than 25 years of service credit.

Tier (a) would experience a 10 percent reduction of its COLA, while tier (b) would have its COLA reduced by 20 percent.

Substantive Issues, Amendments

The two-tiered structure could result in unintended distributional implications. Consider two members:

- one member has an annual pension benefit at the median; and
- the other has an annual pension benefit just above median.

The differential COLA reduction could result in the member at median having a larger pension benefit than the member that was previously above the median. Beyond that this could be perceived as creating winners and losers between nearly identical members, the policy could result in other notable effects.

Suppose that there is a group of retired members that continually alternate between one side of the median and the other. The long-run COLA reduction for this group might average 15 percent. This implies that, if the group consistently below the median has an average COLA reduction of 10 percent, over time these two groups will converge; consequently, the group above the median, with an average COLA reduction of 20 percent, will converge downward toward the median. The policy proposed by this amendment could significantly homogenize the size of pensions, making the underlying characteristics of the members' service less important.

Finally, the imposition of a two-tiered structure could raise concerns of inequity. ERB members retiring with fewer than 25 years of service already have smaller pensions than similar members with more than 25 years due to the current uncapped pension factor. As a result, members with fewer than 25 years of service are more likely to have annual pension below the median before any COLA differential. Because those members are subject to the 20 percent COLA reduction regardless of the amount of their annual pension, their pension benefit could continue to languish behind members with similar final average salaries.

It is unclear why 25 years was chosen as the cutoff for imposing the more severe of the COLA reductions. Under current law and provisions of SB 115, the clearest reference to a cutoff of that magnitude is the "30 years and out" option for normal retirement, and members have a wide array of options for normal retirement through the "Rule of 75/80." Moreover, the plan currently has a mechanism in place to diminish the pension benefit of members retiring before 30 years, including the calculation of pension factor and a reduction of benefits for those members retiring prior to 60 years of age.

Technical Issues, Amendments

The Senate Finance Committee amendment, as written, could require the ERB to impose a negative COLA when the growth in the consumer price index is negative. ERB staff have indicated that, even if it were allowed in the amendment, ERB would not apply a negative COLA.

Senate Finance Committee Amendment #5 creates a new Subsection D, which contains the notwithstanding language that suspends the current COLA calculation in Subsection C until the retirement plan reaches a 100 percent funded ratio. Subsection D applies an 80 or 90 percent factor to the COLA as calculated in paragraphs (1) and (2) of Subsection C. However, the provision prohibiting a negative COLA is contained in paragraph (3), which is not referenced and would not apply because of the notwithstanding language.

If deemed appropriate, this technical issue could be addressed by amending the phrase to read either "under Paragraphs (1) and (3) of Subsection C of this section" or "under Paragraphs (2) and (3) of Subsection C of this section."

Original Bill Summary:

SB 115 amends multiple sections of the *Educational Retirement Act* effective July 1, 2013 to:

- increase employee contribution rates for certain members;
- define age and service requirements for retirement of new members;

- set the retirement benefit amount for new members while providing for benefit reduction of new members retiring prior to a minimum age; and
- delay the cost-of-living adjustment (COLA) qualification age for new members.

Contribution Rates

As proposed in SB 115, the employee contribution rate will:

- increase to 10.7 percent (up from 7.9 percent) for members whose annual salary is greater than $20,000, phased in over the course of two fiscal years (FY 14 and FY 15); and
- continue at 7.9 percent for members whose annual salary is $20,000 or less.

Age and Service Requirements

SB 115 defines age and service requirements for the retirement of new members, being those who become members on or after July 1, 2013, that are different from current members; the ERB analysis refers to these members as "Tier 3 members." New members would be eligible to retire at:

- any age with 30 or more years of earned service credit;

  - if the member retires prior to age 55, however, the retirement benefit will be reduced to an amount actuarially equivalent to the benefit received if the member had been age 55 at retirement;

- age 67 with five or more years of earned service credit; or
- any combination of age and years earned service credit totaling at least 80;

  - if the member retires prior to age 65, the retirement benefit will be reduced in accordance with other provisions of SB 115.

Calculation of Benefits

SB 115 defines the calculation of the retirement benefit for new members including a mechanism to reduce that benefit when retiring prior to a certain age. The features of this calculation, which is the same as for those who became members on or after July 1, 2010, but are not new members, include:

- the annual retirement benefit equaling:

  - 2.35 percent x Total Service Credit x Average Annual Salary; and

- if the member retired through the option requiring any combination of age and years earned service credit totaling at least 80, the benefit will be reduced by:

  - 0.6 percent for each quarter year prior to age 65, but after age 60; and
  - 1.8 percent for each quarter year prior to age 60.

COLA Eligibility

Regarding COLA eligibility, SB 115:

- increases the minimum age to 67 for new members to be eligible for the COLA; and
- maintains the minimum age of 65 for current members to be eligible for the COLA.

The provisions of SB 115 have an effective date of July 1, 2013.

Fiscal Impact:

SB 115 does not contain an appropriation, but enactment of SB 115 would fulfill contingency language proposed by the Legislative Finance Committee (LFC) FY 14 budget recommendation and currently in HB 3, *Education Appropriation Act*, to fund scheduled increases to the ERB employer contribution rate. The FY 14 executive budget recommendation does not propose any contingency language for that funding.

Fiscal Issues:

The ERB projects that, if the bill is enacted, the Educational Retirement Fund's funded ratio will:

- begin at 60.6 percent at the end of 2012;
- exceed 71 percent by 2030; and
- reach 93 percent by 2043.

During the interim, testimony to the Legislative Education Study Committee (LESC) by Legislative Council Service staff for the interim Investments and Pension Oversight Committee (IPOC), indicated:

- the industry standard for actuarial soundness of a pension fund suggests that any funded level below 80 percent carries increased risks; and
- based on accounting and financial statement requirements from the Governmental Accounting Standards Board, ratings agencies could begin downgrading the bond rating of governments unless steps are taken to improve actuarial standing of public pensions.

As ERB notes in its analysis, SB 115 would result in significant improvement to the actuarial soundness of the Fund.

Substantive Issues:

Economic Implications

The 2.8 percent increase to the employee contribution rate, when fully phased in, translates to about $1,260 less in annual take-home pay for the average New Mexico teacher based on a 2011 average salary of $44,984 as reported in the Public Education Department's Stat Books.

At the aggregate level, ERB's bill analysis suggests that:

- its annual covered payroll for FY 13 and beyond could reach or exceed $2.675 billion; and
- based on that figure, LESC staff estimate the increased contribution rate could result in reduced disposable income of at least $70.0 million per year relative to current law, which could have substantial implications for economic growth and government revenues.

The possible contractionary impact of the increased contribution rate could be partially offset if ERB were to make investments of those contributions in companies that operate wholly within the state, but the current composition of ERB investments suggests a significant portion of investments are made out of the state or even internationally.

Dr. Dean Baker[1], in written testimony provided to a joint session of the Senate Judiciary and the House Labor and Human Relations Committees during the 2013 legislative session, stated that "[i]f we overfund our pensions by having [higher] tax rates than would otherwise be necessary in the present, then we will be causing unnecessary losses of economic output."

Differences between Funded Ratio and Solvency

To put Dr. Baker's statement in context, it is important to make the distinction between funded ratio and plan solvency which, although related, should not be confused for the same concept.

Funded ratio is:

- the actuarial value of assets ("what we have today") divided by the actuarially accrued liability ("what we might owe in the future for today's workers");
- dependent on accrual basis accounting ("putting future expenses or income on today's books"); and
- dependent on actuarial methods ("statistically weighting by possibilities").

Solvency is:

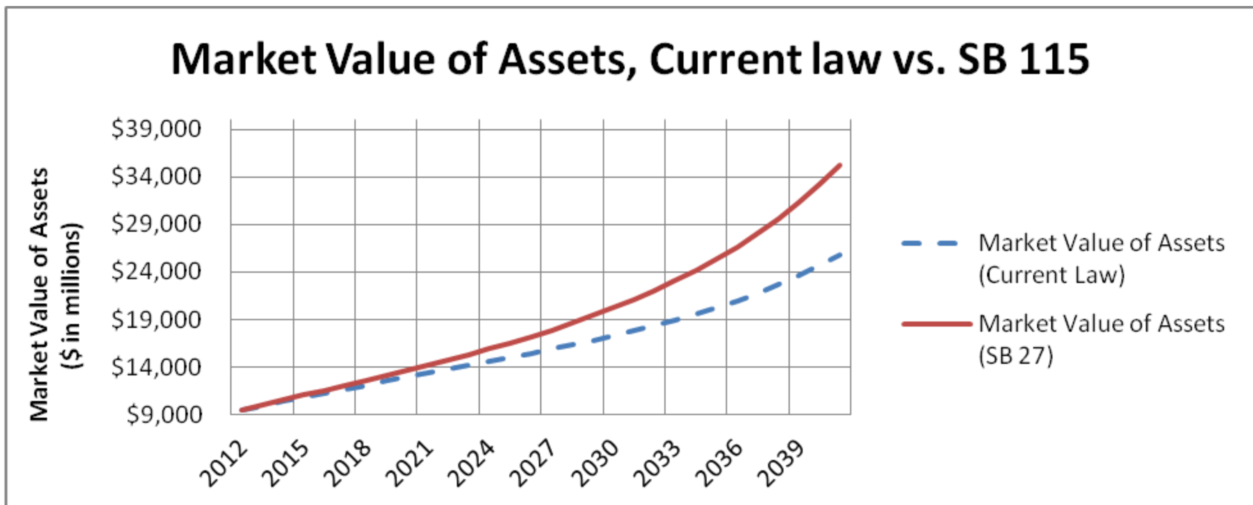
- the ability to meet maturing obligations as they come due; or
- "being able to pay our bills today for what we promised yesterday."

Consequently, it is entirely possible for the state to meet its pension obligations through ERB, that is to say the fund could remain solvent, indefinitely into the future even with a funded ratio persistently less than 100 percent. Programs with this feature could be characterized as partially or fully pay-as-you-go.

A graph helpful in showing when the fund is going to be insolvent, or in other words, when ERB is no longer going to be able to pay its bills, is the projection of market value of assets. The graph below illustrates the amount ERB has available to pay out benefits and other costs in future periods. As such, when net assets drop below $0, the fund would be insolvent, and when

[1] Dr. Dean Baker is co-director of the Center for Economic and Policy Research in Washington, DC. He previously worked as a senior economist at the Economic Policy Institute and an assistant professor at Bucknell University. He has also worked as a consultant for the World Bank, the Joint Economic Committee of the US Congress, and the OECD's Trade Union Advisory Council.

they display a long-term downward trend, it would indicate that potential corrective action might be necessary to prevent insolvency.



Source: ERB

Under current law, the ERB fund's market value of assets would trend upward, never having a trajectory that might suggest, even under current provisions, that the fund is at risk of becoming insolvent; in other words, the ERB fund in its current form could remain solvent indefinitely into the future. As noted in the ERB bill analysis, the changes proposed by SB 115 would improve the plan's actuarial funded status, but based on the projections above, the bill would not improve true solvency because there is nothing to improve upon from the baseline.

In addition, the provisions of SB 115, although improving the fund status, are not structured in such a way to target a funded ratio of exactly 100 percent; instead, these provisions target a funded ratio much higher. A funded ratio of more than 100 percent provides little more protection against insolvency than a ratio of 100 percent. A funded ratio exceeding 100 percent could be considered overfunding, which according to Dr. Baker's testimony, could cause unnecessary loss of economic output.

Background:

ERB states that a proposal with the same provisions of SB 115 was first developed by a group of its member stakeholders. The group:

- comprised representatives of active and retired members, covering the full spectrum of preK-12 and higher education employees and also included employers;
- consisted of 17 stakeholder organizations in total; and
- reached unanimous consent for the proposal on July 17, 2012.

ERB endorsed the proposal after a split vote of 4-3 on September 19, 2013. ERB then took its stakeholder-approved, board-endorsed proposal to interim legislative committees for discussion, and:

- IPOC unanimously endorsed the proposal on November 28, 2012 after amending it to keep contributions at 7.9 percent for employees whose annual salaries are $20,000 are less; and
- LESC unanimously endorsed the proposal as amended by IPOC on January 14, 2013.

The Attachment, "Schedule of Contribution Rates," details historic employee and employer contribution rates for ERB along with rates for FY 14 and FY 15 as proposed by SB 115; the increased employer contribution rates in those two years are not a result of provisions in SB 115, but are the result of current law.

FY 13 is the final year of a 1.5 percent employee-employer contribution swap enacted by Laws 2009, Ch. 127, which increased the employee rate while decreasing the employer rate by the same amount in an effort to improve the fiscal position of the State.

Further solvency action through Laws 2011, Ch. 178 resulted in an additional employee-employer contribution swap of 1.75 percent. The duration of that swap was contingent on revenue forecasts not exceeding budgeted amounts by a certain amount, and year-end reserve levels under 5.0 percent of appropriations. At the end of FY 12, the contingency conditions were not fulfilled, resulting in a termination of the additional 1.75 percent swap beginning FY 13.

Committee Referrals:

SEC/SFC/HLC/HAFC

Related Bills:

HB 64 *Educational Retirement Changes* (Identical)
HB 96 *Educational Retirement Sick Leave*

Public Employee Retirement Legislation

CS/CS/SB 25a *Judicial Retirement Changes*
SB 26 *Supplemental Retirement Contributions*
CS/SB 71 *Retiree Health Care Contributions*
CS/SB 86 *Public Employee Average Salary Calculations*
SB 114a *Legislative Retirement Qualification*
SB 121 *Law Enforcement Returning to Work*
SB 168 *Public Safety Officers Returning to Work*
CS/HB 95 *Judicial Retirement Changes*
CS/HB 147 *Public Employees Returning to Work Retirement*
HB 169 *Judicial Retirement Contributions*

Schedule of Contributions Rates

Fiscal Year	Wage Category	Date Range	Member Rate	Employer Rate	Total	% Employee Pays
58-59		7/1/1957 -6/30/1959	3.00%	4.00%	7.00%	42.86%
60-74		7/1/1959 -6/30/1974	4.00%	6.50%	10.50%	38.10%
75-79		7/1/1974 -6/30/1979	5.50%	6.50%	12.00%	45.83%
80-81		7/1/1979 -6/30/1981	6.50%	6.50%	13.00%	50.00%
82-84		7/1/1981 -6/30/1984	6.80%	6.80%	13.60%	50.00%
85-93		7/1/1984 -6/30/1993	7.60%	7.60%	15.20%	50.00%
94-2005		7/1/1993 -6/30/2005	7.60%	8.65%	16.25%	46.77%
2006		7/1/2005 -6/30/2006	7.675%	9.40%	17.075%	44.95%
2007		7/1/2006 -6/30/2007	7.75%	10.15%	17.90%	43.30%
2008		7/1/2007 -6/30/2008	7.825%	10.90%	18.725%	41.79%
2009		7/1/2008 -6/30/2009	7.90%	11.65%	19.55%	40.41%
2010 & 2011	$20k or less	7/1/2009 -6/30/2011	7.90%	12.40%	20.30%	38.92%
2010 & 2011	Over $20K	7/1/2009 -6/30/2011	9.40%	10.90%	20.30%	46.31%
2012	$20k or less	7/1/2011 - 6/30/2012	7.90%	12.40%	20.30%	38.92%
2012	Over $20K	7/1/2011 - 6/30/2012	11.15%	9.15%	20.30%	54.93%
2013	$20k or less	7/1/2012 - 6/30/2013	7.90%	12.40%	20.30%	38.92%
2013	Over $20K	7/1/2012 - 6/30/2013	9.40%	10.90%	20.30%	46.31%
Proposed 2014	Over $20k	7/1/2013 - 6/30/2014	10.1%	13.15%	23.25%	43.44%
Proposed 2015	Over $20k	7/1/2014- future	10.70%	13.90%	24.60%	43.50%