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F I S C A L   I M P A C T   R E P O R T

SPONSOR Stewart
ORIGINAL DATE 01/23/13
LAST UPDATED 02/06/13
HB 64

SHORT TITLE Educational Retirement Changes
SB

ANALYST Hanika-Ortiz

REVENUE (dollars in thousands)

Revenue			Recurring or Nonrecurring	Fund Affected
FY13	**FY14**	**FY15**		
	$55,000.0 (flat payroll growth)	$70,000.0 (flat payroll growth)	Recurring	ERB Fund
	$56,650.0 (3% payroll growth)	$74,263.0 (3% payroll growth)		

SOURCES OF INFORMATION
LFC Files

Responses Received From
Educational Retirement Board (ERB)
Attorney General's Office (AGO)
Retiree Health Care Authority (RHCA)
Higher Education Department (HED)
Department of Finance and Administration (DFA)
Public Education Department (PED)

SUMMARY

Synopsis of Bill

House Bill 64 (HB 64) proposes to amend the Educational Retirement Act to reduce the plan's unfunded actuarial accrued liability (UAAL) and improve long-term actuarial soundness. The bill increases employee contribution rates 2.8 percent over a two-year period for certain employees and creates a Tier 3 with additional eligibility requirements for benefits and cost-of-living adjustments (COLA) for new members hired after July 1, 2013.

More specifically, HB 64 provides for:

A. Contribution Increases. Contributions would increase for employees with full-time-equivalent (FTE) wages over $20,000, regardless of membership tier. Employees with FTE wages below $20,000 would remain at 7.9 percent.
   1. Employees with FTE wages greater than $20,000:

   (a) FY 2014 – 10.1 percent.
   (b) FY 2015 and thereafter – 10.7 percent.
2. Employees with FTE wages less than $20,000: 7.9 percent (current statute).

B. New Tier 3 Membership. Includes persons who become members on or after July 1, 2013.
1. Retirement Eligibility Criteria.
   (a) 30 Years of Earned Service Credit with Minimum Age 55 requirement. The retirement benefit of a member who begins receiving the benefit before age 55 will be reduced to an amount equal to the benefit that the member would have received if the member had begun receiving the benefit at age 55.

   (b) Rule of 80 - Member's age and years of earned service credit equals 80 with age-based reductions if below age 65. The benefits of a member who retires before age 65 will be reduced by 2.4 percent/year that the member retires before age 65 and 7.2 percent/year that the member retires before age 60.

   (c) Age 67 plus five years earned service credit.

2. COLA Eligibility. Tier 3 members would not receive a COLA until age 67, an increase of two years from the age of 65 required for Tier 1 and Tier 2 members.

FISCAL IMPLICATIONS

The fund will receive additional revenues as a result of the increased employee contributions. However, the amount of the increase is uncertain and will vary with the growth in annual employer payrolls. The table above shows the effect of the proposed contribution increases on the ERB fund for a flat payroll and payroll increase of 3 percent.

In determining costs and liabilities, actuaries use assumptions about the future, such as rates of salary increase, probabilities of retirement, termination, death and disability, and an investment return assumption. The actuarial valuation report as of June 30, 2012 used what might be considered overstated economic assumptions that included a future investment return of 7.75 percent, annual payroll growth of 3.75 percent and salary increase rate of 3 percent for inflation.

The funded status of the plan has declined from 2011 to 2012. According to the ERB actuary, the decline was due to the loss on the actuarial value of assets of $524 million and a net gain on the liabilities of $200 million. The funded ratio at June 30, 2011 was 63.0 percent, while it is now 60.7 percent. Five years ago the ratio stood at 70.5 percent, and ten years ago the ratio was 86.8 percent. During the last fiscal year, the UAAL increased from $5.7 billion to $6.2 billion.

Under the bill, the ERB actuary estimates that the fund will reach a funded ratio of 71 percent by 2030 and 93 percent by 2043, assuming a 7.75 percent long-term investment return. However, the rate of 7.75 percent may be overly optimistic given returns in recent years. If true, the changes proposed in the bill would not go far enough to ensure long-term solvency.

The bill would not increase employer contributions beyond the rates that are currently provided for in Section 22-11-21(B).

SIGNIFICANT ISSUES

A group of ERB member stakeholders met over the interim and developed a proposal to achieve solvency that excluded changes to the final average salary calculation (highest 5 years), vesting period (five years) and benefit multiplier (2.35 percent). The group consisted mostly of representatives of active and retired member groups and a few employers. On September 19 the ERB board passed the "stakeholder" proposal 4 to 3. According to DFA, the member on the board who voted against the proposal expressed concern the proposal may not represent a long-term fix for the solvency of the fund. Specifically, there was concern about the appropriateness of the 7.75 percent future earnings assumption and the fact that benefit reductions were geared toward new hires, which could have an impact on the ability to attract and retain new teachers.

On October 23, the proposed changes were presented to the Investment and Oversight Pension Committee. With the exception of a few concerns, the committee expressed support of the proposal; however the vote for support was tabled until a further review could be done. On November 28, the ERB presented the proposal to the Investment and Oversight Pension Committee again for endorsement. The committee voted to endorse the proposal with a stipulation of keeping employees with FTE wages below $20,000 at the same contribution level. HB 64 is the culmination of those efforts. The Legislative Education Study Committee has also endorsed HB 64.

The PED noted that the bill shifts the burden of solvency on new employees, while holding all others relatively harmless. The PED also noted concerns regarding how this shift to new employees might discourage teachers from seeking employment in New Mexico, opting instead to work in neighboring states.

PERFORMANCE IMPLICATIONS

New Mexico has a constitutional provision that allows modifications to retirement plans that preserve the actuarial soundness of an affected trust fund or individual retirement plan.

ADMINISTRATIVE IMPLICATIONS

Increasing employee contributions may have a negative effect on recruiting and retaining highly qualified teachers. In 2003 in response to recruitment and retention issues, the Legislature passed the three-tiered licensure system which established salary increases for licensees as they moved up in licensure level. The average budgeted returning teacher salary in New Mexico for the 2012-2013 school-years is $46.5 thousand. Research conducted by the National Education Association in 2010-2011 ranked New Mexico as 40th nationally in terms of average salaries of instructional staff, a decrease from 37th in 2008-2009.

The Legislature has not funded statewide salary increases for educators over the past several years. While some districts have reclassified individual positions and funded individual salary increases, many school employees have not received pay raises over the past 4 years, and in fact have seen take-home pay decrease as a result of retirement contribution swaps. For FY14, the Legislature is considering funding the second to last 0.75 percent employer contribution increase. Further increasing the employee's contribution rate and decreasing take-home pay may result in prospective teachers looking for education employment outside of the state where salaries are on average higher than in New Mexico, and decreases to take home pay from retirement contributions and other benefits are not as high.

DUPLICATION

SB 115 duplicates HB 64.

OTHER SUBSTANTIVE ISSUES

The average contribution to a pension plan nationally is now about 15 percent, 9 percent by the employer and 6 percent by the employee. The total contribution for the ERB plan in 2014 will be 21.05 percent, 13.15 percent by the employer and 7.9 percent by the employee. The ERB plan pays benefits equal to 2.35 percent of final earnings per year, compared with the national average of about 2 percent. A state-by-state comparison of public pension plans is provided in the January 2013 Report of the Legislative Finance Committee to the Fifty First Legislature.

The Center for Retirement Research at Boston College reports that many public pension plans have recently cut pension benefits for new hires, reducing compensation. The Center's new brief "Compensation Matters: The Case of Teachers" looks at how such cutbacks could affect teacher quality. One proxy for teacher quality is the average SAT score at a teacher's undergraduate institution. The analysis found that school districts with higher wages and or/higher pensions were able to hire teachers from institutions with higher SAT scores. These results suggest that cutting compensation for new teacher is not costless, and could reduce applicant quality.

TECHNICAL ISSUES

In the interest of fairness to all employees, the legislature may also want to consider removing the exception that holds employees earning less than $20,000 harmless from the increase in employee contributions.

ADDITIONAL OPTIONS

A COLA is the biggest driver of costs for many public pension plans. Unlike the PERA COLA which is given year three of retirement no matter the age, the ERB COLA begins at age 65 and is based on the change in CPI. If the CPI change is less than 2 percent, the COLA is equal to the CPI change. If the CPI change is greater than 2 percent, the COLA is one-half that amount with a maximum of 4 percent and a minimum of 2 percent. Over time, the ERB COLA has averaged 2 percent. The legislature may want to consider revisiting the ERB COLA for all members. For instance, the COLA could be equal to 75 percent of the change in CPI, with a ceiling of 1.5 percent and a floor of 0.5 percent. That way, neither the retiree nor the taxpayer suffers from extremes. Some states are providing a COLA only on the first $35,000 or $40,000 of benefit.

Another option to reduce spending is to decrease the multiplier to 2 percent for new hires. That would allow an employee working 30 or 35 years to retiree at 60 or 70 percent of their final average salary. That amount in concert with social security providing a replacement income of 30 to 40 percent would provide a stable income at retirement approximating the income earned those final working years. There may be little support from the taxpayer for a public retirement system that eventually provides a public employee income greater than what was earned those final working years, when combined with social security and an automatic compounded COLA.

Another option to reduce spending could include an increase in the vesting period and final average salary calculation from five years to eight years for new hires. That may encourage public employees to work longer for the state when confronted with opportunities in the private market. Closing loopholes for pension spiking is also important. This can occur when an employee works 20 years part-time, works the employee's final 5 years full-time, and ends up with a full-time pension. A sounder approach might include prorating the pension according to benefits earned under the plan. Finally, a minimum retirement age closer to Social Security eligibility for current employees might go a long way in helping preserve retiree health benefits.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Contributions and investment earnings may continue to fall short of supporting the benefit payouts and cost of administering the plan.

AHO/svb:bm