One Eagle Square
Suite 510
Concord, NH 03301-4903

(603) 226-2500
Fax: (603) 226-3676

www.nhpolicy.org

New Hampshire Center for PUBLIC POLICY Studies

"...to raise new ideas and improve policy debates through quality information and analysis on issues shaping New Hampshire's future."

Public Pension Predicament

New Hampshire's Retirement System

September 2007

Executive Director
Stephen A. Norton
snorton@nhpolicy.org

Deputy Director
Dennis C. Delay
ddelay@nhpolicy.org

Research Associate
Ryan J. Tappin
rjtappin@nhpolicy.org

Office Manager
Cathleen K. Arredondo
carredondo@nhpolicy.org

Executive Director *Emeritus*
Douglas E. Hall
doughall@nhpolicy.org

Author

Dennis Delay
Deputy Director

About this paper

One of the Center's projects since its inception in 1996 has been to address issues regarding the state government's budget. This paper is the latest in our series of reports that illuminate the budget process, state programs and the state budget. All of these papers are available at no cost on the Center's website: www.nhpolicy.org

Contact the Center at info@nhpolicy.org or call 603-226-2500.
Write to: NHCPPS, One Eagle Square, Suite 510, Concord, NH 03301

New Hampshire’s Retirement System Public Pension Predicament

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Executive Summary

In a previous report, the Center identified the state's obligation to the New Hampshire Retirement System (NHRS) as the second biggest driver of the New Hampshire State Budget (Fiscal Feast and Famine, 12/06). In that report we showed that general fund appropriations to the retirement system grew from $20.8 million in 1997 to $71.4 million in 2007, significantly outpacing the growth of New Hampshire's population and overall inflation.[1]

The role of this report is to provide more detail on the NHRS, and to explain why the NHRS is now, and will likely be, an increasing obligation for the New Hampshire State Budget. We estimate that Legislative promises made to state and local government employees and retirees will be increasingly difficult to honor without increasing state and local taxes.

We conclude this report by reviewing recent developments concerning the NHRS, and public policy implications for New Hampshire taxpayers, and government retirees. Serious consideration may have to be given to reforming the NHRS by evaluating alternate pension plans for new employees, expanding financial reporting, fully funding any proposed benefit increase, and revising the assumed investment return.

State Funding Obligations to NHRS Increase

New Hampshire's retirement law (RSA 100-A:16) sets up a requirement to recalculate the employers' contribution rate to the NHRS every two years. The state contribution to the pension fund will increase again, from $71.4 million to an expected $94 million per year, in the next biennium (2008-2009).

State obligations to the NHRS are certain to grow. Despite increased state contributions, the trust fund unfunded pension obligation is $2.5 billion and climbing. Analysis of supplemental publications from the NHRS suggest state and local employer contributions to NHRS will have to increase again in order to 'fully fund' current pension obligations. NHRS' own analysis suggests that employer contributions may have to increase another 70% (or more) in the FY2010 to FY2011 biennium.

At the local government level, the public pension fund funding responsibility for municipal governments would increase from $108 million in FY2007 to $262 million in FY2011.

State contributions to the fund would increase to $160 million per year after FY2009. Stated another way, the State's contributions to the New Hampshire Retirement System would more than double in four years from $70 million in FY2007 to $160 million in FY2011. In comparison, Medicaid provider payments, the largest single portion of the 2007 Budget, were $185 million in FY2007.

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[1] Data for the retirement system can be found in the 1996-1997 Operating Budget, NH Laws of 1995, (HB 1), Page 64, '01-10-01-02' for 1997 and in the 2006-2007 Operating Budget, NH Laws of 2005 (HB 1) Page 82, '01-10-02' in 2007.

New Hampshire state contributions to the New Hampshire Retirement System have risen from 3% of General Fund Revenues in the year 2000 to about 6% of revenues in 2007. We estimate that state contributions to the pension fund will consume an increasing share of state resources in the future, rising to 10% of General Fund Revenues by 2011, at the previously estimated $160 million per year employer contribution level.

What is the New Hampshire pension plan?

NHRS is a contributory public employee "defined benefit" pension plan qualified under section 401(a) of the Internal Revenue Code (Code) and funded through a trust which is exempt from tax under Code section 501(a). NHRS provides benefits to its eligible members and their beneficiaries upon retirement, disability, death or other termination of employment. Retirement benefits are determined by a formula which considers two variables: a member's average final compensation (averaged over the most recent three years) and length of creditable service. Although members and their employers must make regular contributions to NHRS, those contributions are not variables in determining the actual defined benefit.[2]

NHRS currently pays approximately $360 million annually in lifetime pension benefits to nearly 20,000 individuals who have retired from Granite State public sector careers. More than 53,000 state and local government employees, teachers, firefighters and police officers are active members of the System.

The NHRS plan is funded from three sources: employer contributions, employee contributions and return on investment from the net assets of the NH retirement fund.

As of 2006, more funds flowed into the NHRS pension fund (from investment income, employer contributions and employee contributions) than were paid out by the fund (in benefits, refunds of contributions and administrative expenses). [3]

How does New Hampshire's pension plan compare with the other public pension plans?

Pension funds are evaluated according to whether the current pension fund balance could pay all of the retirement benefits for existing retirees, and current employees if they retired today, over the estimated remaining portion of their lives. This measure is commonly called the actuarial funding ratio. By this measure, the NHRS is currently underfunded. The NHRS actuarial funding ratio (the ratios of the net assets available for benefits to the pension benefit obligation) has been declining and the unfunded pension benefit obligation has increased.

The financial condition of the NHRS public pension plan is not one of the best, but is not one of the worst. Independent assessments of public pension plans rank New Hampshire's in the middle of state groupings.

[2] From the New Hampshire Retirement System website, www.nh.gov/retirement/, accessed February 2007.
[3] A very easy to understand, and detailed, explanation of the New Hampshire Retirement System is available on the New Hampshire Retired State Troopers Association website at: http://www.nhrsta.org/retirementsystem.pdf

- Standard & Poor's in a February 2007 report[4] gave New Hampshire's public pension fund a General Obligation Credit Rating of "AA", based on data for the year 2005. According to the report, New Hampshire's funded ratio was 66.4%, compared to a national average of 81.8%.

- According to a February 2006 Standard & Poor's Report:[5]
  - The five best funded public plans were in Florida, North Carolina, Georgia, New York, and South Dakota.
  - Five worst funded public plans were West Virginia, Oklahoma, Rhode Island, Connecticut and Illinois.

- According to a 2006 Wilshire report[6] the actuarial funding ratio for all state public pension plans declined from 2000 to 2005 (For New Hampshire the actuarial funding ratio also declined in the same time period). All state pensions that were invested in the US stock markets suffered losses associated with declines in those markets in the early years of this decade.

The most current data for comparing public pensions comes from the online Public Fund Survey, which is updated as new information, particularly system annual financial reports, becomes available. The survey is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement and is maintained by Keith Brainard, NASRA Research Director.

Table 1 shows summary actuarial funding information for the 126 plans in the survey, compared to the New Hampshire Retirement System, accessed in July 2007.

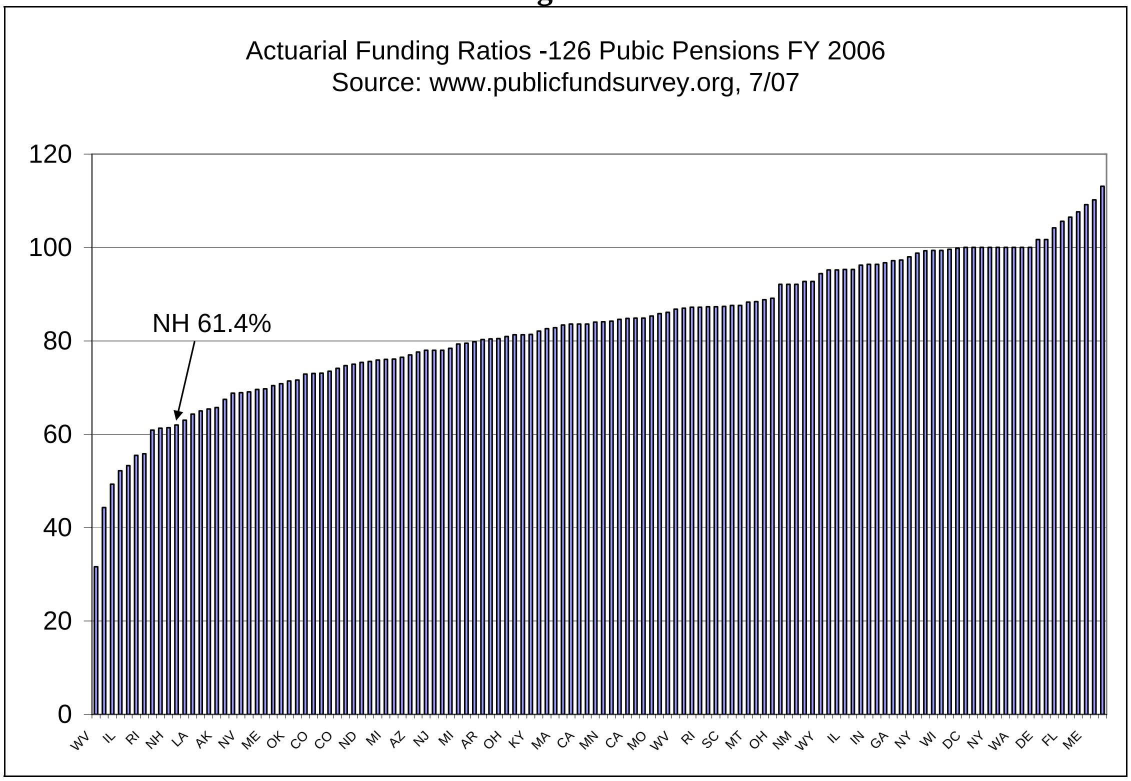
Table 1

Actuarial Funding	Actuarial Funding Ratio	Actuarial Assets (000)s	Actuarial Liabilities (000)s	Unfunded Liability (Surplus) (000)s
Aggregate for the 126 Plans	85.8%	$2,294,373,134	$2,675,265,166	$380,892,032
New Hampshire Retirement System	61.4%	$3,928,270	$6,402,875	$2,474,605
Source: www.publicfundsurvey.org				

Figure 1 compares the actuarial funding ratios for the 126 plans in the survey, including the New Hampshire Retirement System.

[4] *Improved U.S. State Pension Funding Levels Could Be On The Horizon*, Standard & Poor's Ratings Direct, 27-Feb 2007
[5] *State Retirement Systems: Recent Trends*, Sujit M. CagnagaRetna, Southern Legislative Conference, November 12, 2006
[6] Ibid.

Figure 1



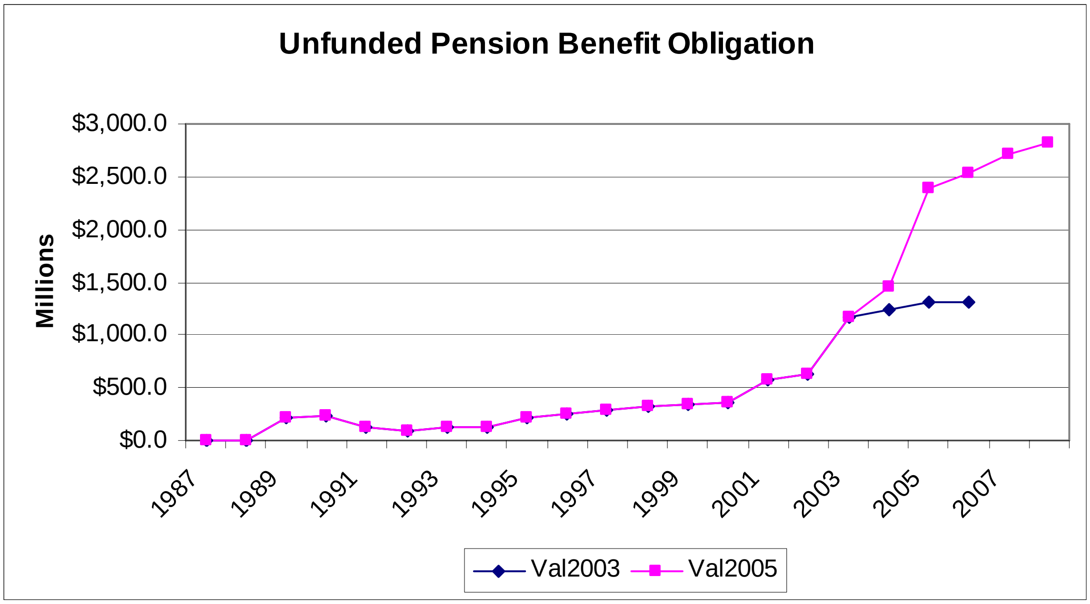
On September 7, 2007 actuaries Gabriel Roeder Smith & Company (GRS) presented an analysis of the NHRS to the Legislative retirement commission, using data from the NASRA/NCTR Public Funds Survey. GRS noted that less than 7% of the 126 plans in the survey were reported with a Funded Status under 60%, which would place NHRS in the 93rd percentile.

NHRS pension obligations

We looked at two past New Hampshire Retirement System valuation reports, one from 2003, and the latest, from 2005.[7] Within two years time the projected actuarial funding ratio of the NHRS fell from about 80% to 60%. For the New Hampshire public pension system, the expected unfunded pension obligation in two years increased from about $1.3 billion to more than $2.5 billion. This is shown on the chart in Figure 2.

[7] Twenty third and twenty fourth regular actuarial valuations of the system, NHRS website.

Figure 2



The following table shows the change in New Hampshire retirement fund assets as compared to the projected obligations of the pension fund. From the year 2000 to 2006 the accrued liabilities of the pension fund increased by almost $3 billion, while the net assets held for benefits increased by only about $800 million.[8]

Table 2
Comparison of NH Retirement Fund Liabilities and Net Assets Held for Benefits

Thousands of Dollars	Accrued Liabilities	Net Assets Held for Benefits
1997	$2,677,032	$2,941,505
1998	$2,924,658	$3,167,053
1999	$3,229,191	$2,886,526
2000	$3,460,259	$3,109,734
2001	$3,842,602	$3,264,901
2002	$4,196,314	$3,443,395
2003	$4,669,192	$3,500,037
2004	$5,029,877	$3,575,641
2005	$5,991,026	$3,610,800
2006	$6,402,875	$3,928,270
Level Change		
2000 to 2006	$2,942,616	$818,536

[8] Net assets held in trust for benefits are equal to the fair market value of net assets available for benefits minus liabilities to pay benefits, refunds and administrative expenses.

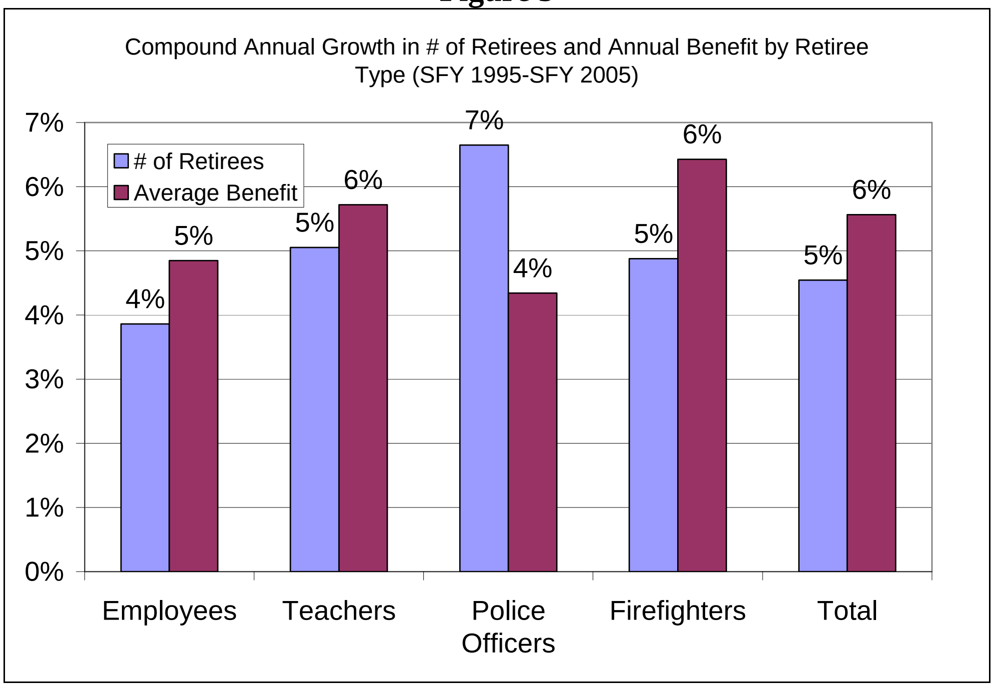
Why is the New Hampshire Retirement System "driving" the State's Budget?

The recent increases in State and local government contributions to NHRS have been caused by a complex interplay of factors: an increased number of retirees per supporting employee; higher wage levels, the basis for calculating individual pension contributions; higher premiums for health insurance; and policy changes in regard to who is eligible for what benefits.

More retirees per supporting employee

Changes in the average benefit per individual and the number of individuals receiving benefits for 1995-2005 are provided in Figure 3. The number of retirees has grown at an annual compound growth rate of 5 percent per year and the average benefit per retiree has increased at 6 percent per year, though this varies by the type of retiree.

Figure 3



The compound annual growth in the number of retirees exceeds the annual growth in the number of active members. That is, the number of retirees eligible to receive public pension benefits has been growing faster than the number of employees who pay into the retirement fund. In addition, the average benefit paid to retirees has been increasing faster than the average compensation to the existing members of the retirement system.

Figure 4 shows the trends in retirees as a percent of the active membership by employee type from 1993 to 2005. Retired firefighters have increased from less than 50% of active firefighters in 1993 to more than 65% of active firefighters in 2005. Retired teachers have increased from 23% of active teachers in 1993 to 32% in 2005.

Figure 4

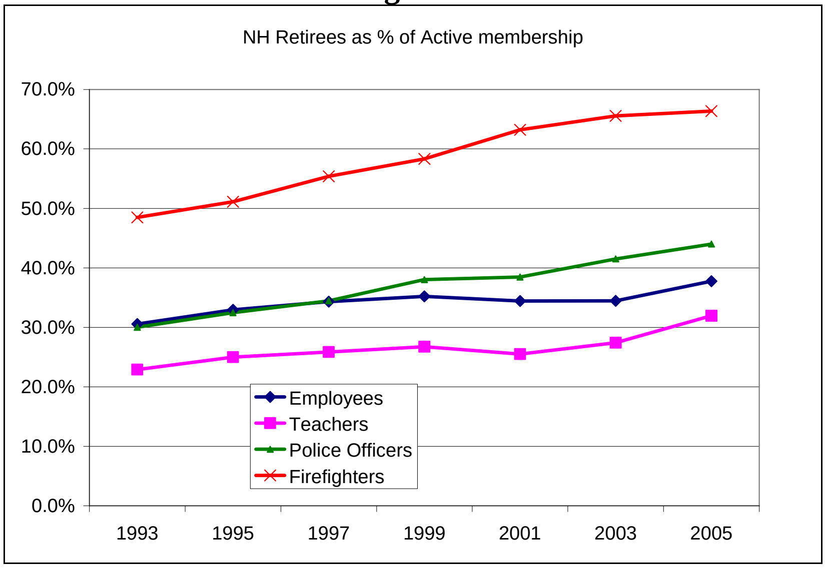


Figure 5 shows the differences in average annual retirement benefits as a percent of annual compensation by employee type from 1993 to 2005. Benefits paid to retired police officers have increased from 44% of average police member compensation in 1993 to more than 57% in 2005. Average benefits paid to regular employees have increased from 23% of average regular employee compensation in 1993 to over 30% in 2005.[9]

Figure 5

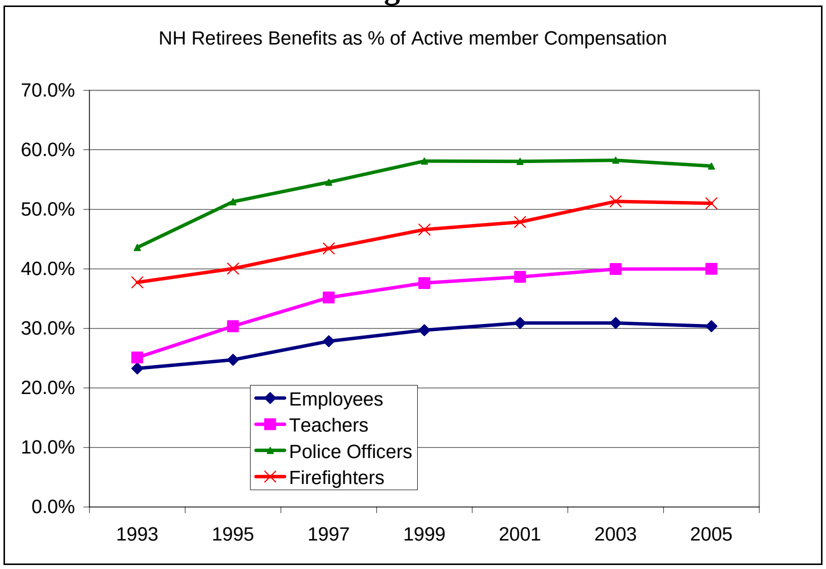
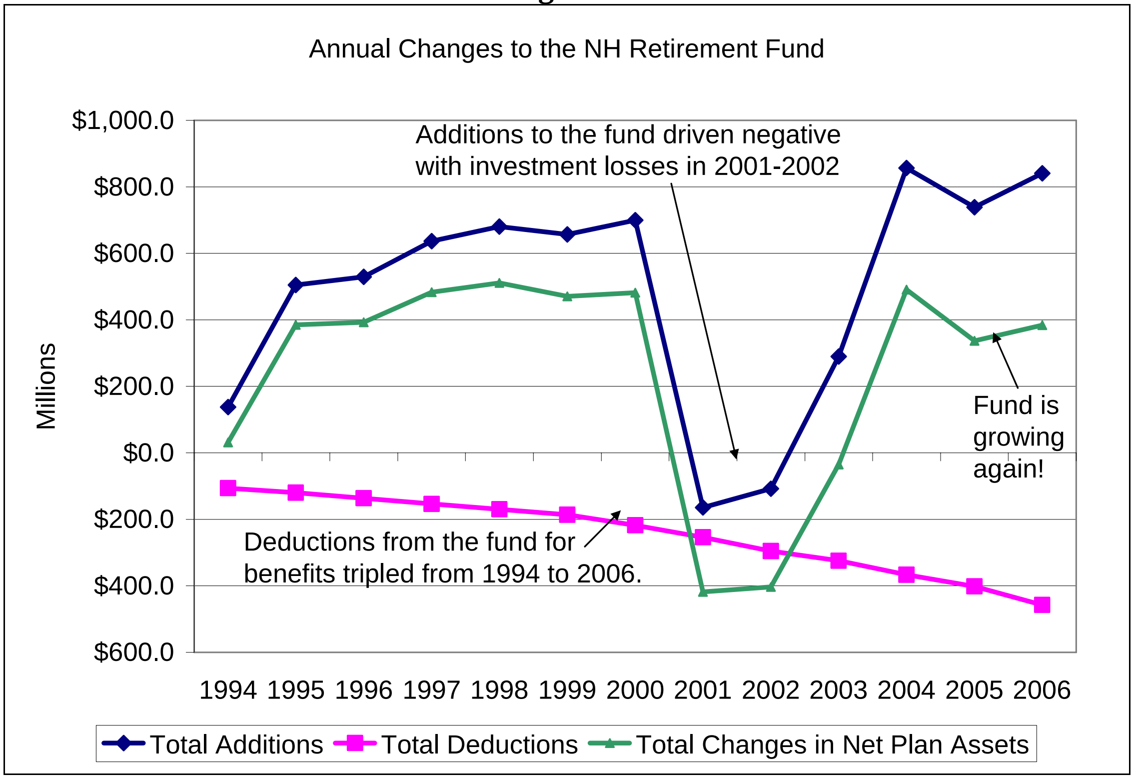


Figure 6 shows deductions from the fund to pay benefits, along with additions to the fund from employer and employee contributions and investment returns over the same time period.

[9] These ratios are higher for police and fire personnel because their wages do not include payments to the Social Security system.

Deductions from the trust fund for benefit payouts have increased significantly, but investment losses in the early part of this decade further depleted the trust fund.

Figure 6



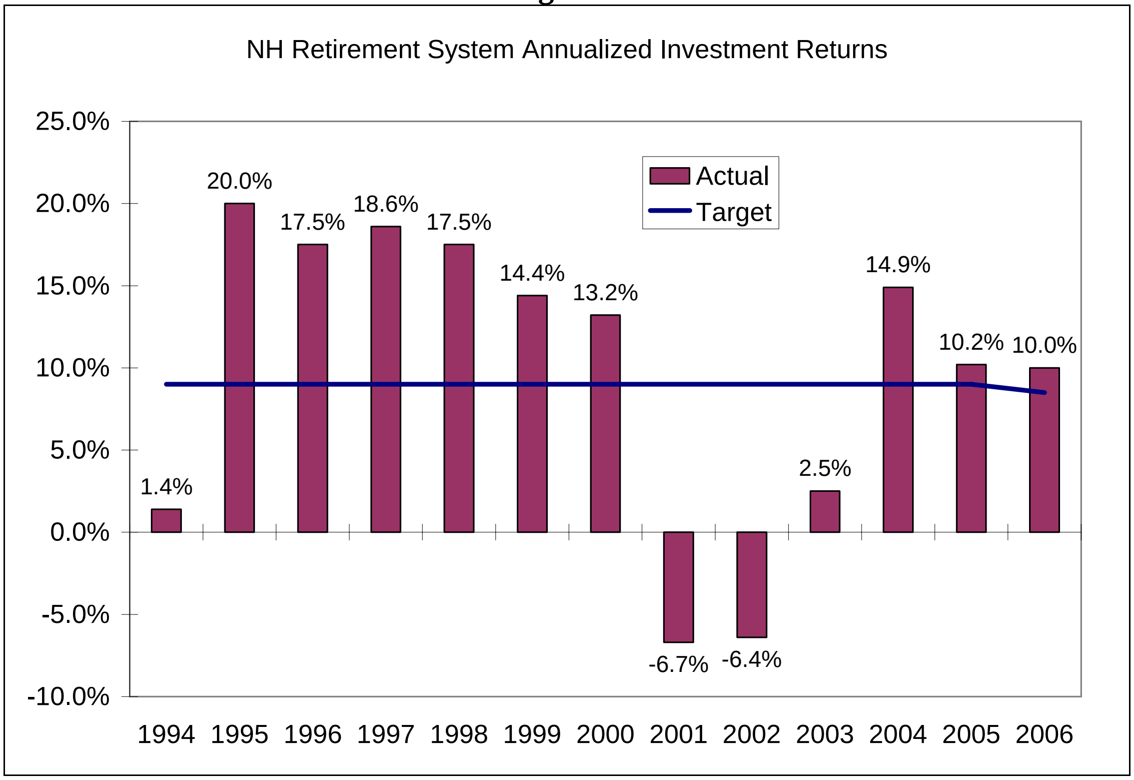
Trust fund investment performance is key

The most important reasons for recent increases in employer contributions to the NHRS can be traced to trust fund losses incurred as a result of unforeseen financial contractions at the beginning of this decade, and reduction of the assumed investment return to the fund from 9 % to 8.5 %. [10]

Net assets held for benefits (the NHRS trust fund) did not increase as expected from 2001 to 2003 because the actual rate of return to the investment fund was below the assumed investment return (the Assumption Rate). The fund had losses in 2001 and 2002, and low earnings in 2003. The actual and target rate of return is shown in Figure 7 below.

[10] The estimated long term rate of return on current and future investments in the New Hampshire Retirement System fund was reduced during fiscal year 2005 from 9.0% to 8.5%, (NHRS 2006 CAFR, page 40). Lowering the assumed return on investment means that contributions from other sources must increase in order to maintain the same actuarial funding level. This in turn implies increased contributions from employers (state and local government).

Figure 7

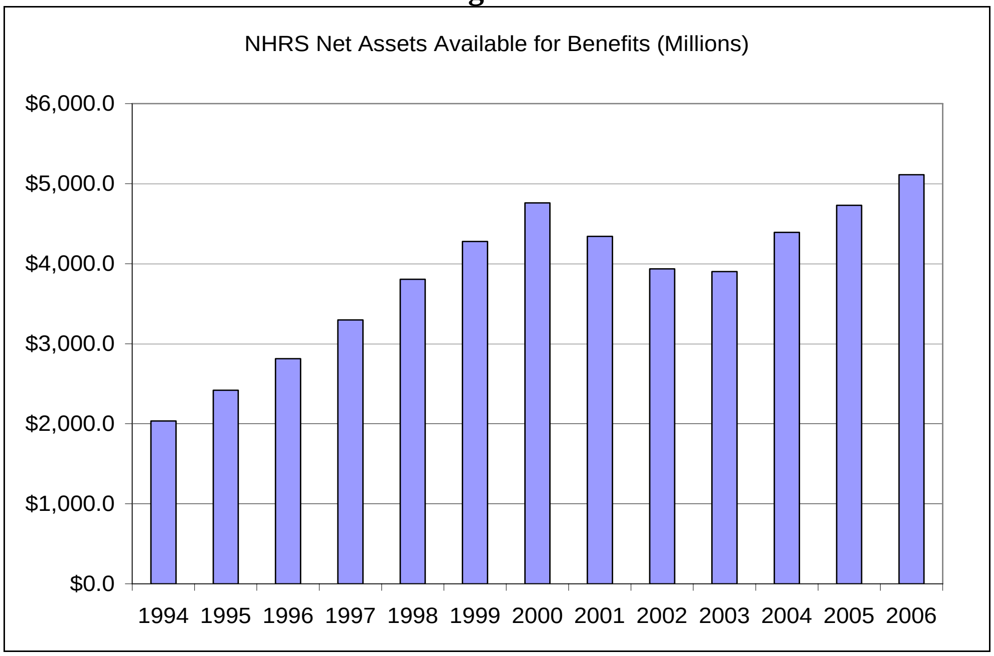


In a May 2007 letter from auditor Ennis Knupp to the NHRS, the auditor simulated the NHRS market value for a five year period ending December 31, 2006 based on assumptions in two alternative scenarios: NHRS achieving the five-year return of the NHRS policy benchmark, and NHRS achieving the median return of the Mellon Analytical Solution (MAS) Fund Universe. In that five year period the NHRS actual net return was 7.8%, compared with the NHRS Policy Benchmark of 8.7% and the MAS return of 9.2%.[11] As of December 31, 2006 the NHRS estimated market value (adjusted for cash flows) was $5.5 billion. If the NHRS had achieved the NHRS policy benchmark return, the fund value would have been $5.7 billion, an increase of $200 million over actual. If NHRS had achieved the higher MAS return the fund value would have been $5.9 billion, an increase of $400 million over the actual trust fund value at the end of 2006.

Underfunding can arise when pension contributions do not fully cover the cost of pension benefits that workers earn in a given year. But underfunding can also arise for other reasons, such as pension plan investments earning a less-than-expected return. Actuaries require that contributions to a pension fund include a payment on the amount needed to amortize the underfunded amount. Thus, undercontributing arises when not enough funds go into the pension fund to either cover the pension liability incurred in a given year, or to amortize that year's share of the unfunded liability, or both. As shown in Figure 8 NHRS Net Assets Available for Benefits declined in the years 2001 to 2003.

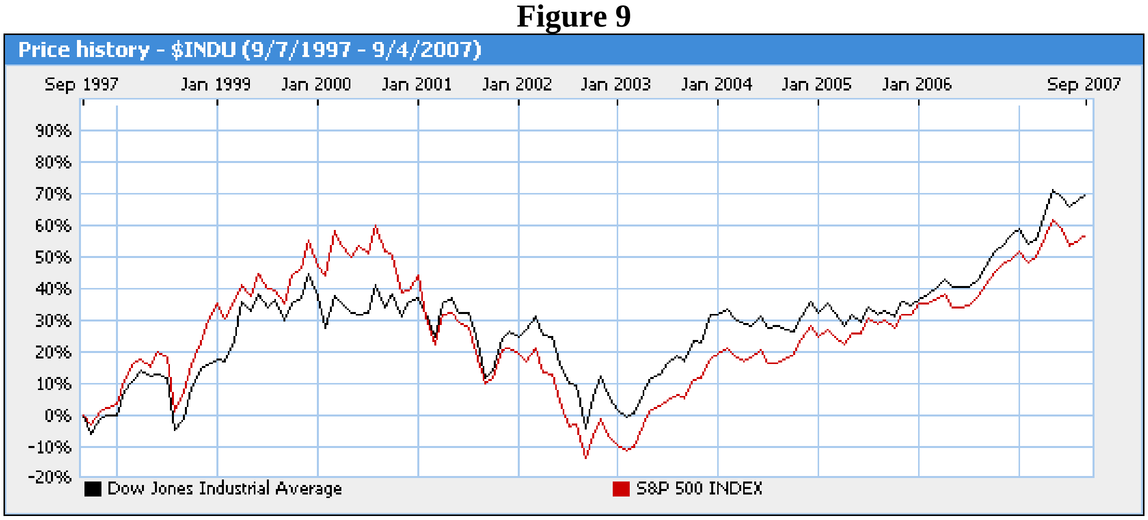
[11] The Ennis Knupp analysis noted that the NHRS Total Fund return in that five year period ranked 93rd in the MAS Public Fund Universe, and that the NHRS Policy Benchmark ranked 69th.

Figure 8



With about 50% of NHRS trust fund investments in domestic equities, it is easy to understand why a stock market decline would also cause a decline in the NHRS trust fund. During the market downturn of 2001 to 2003 the Dow Jones Industrial Average (DJIA) lost about 40% of its value. The S&P 500 Index lost 15-18% per year, while the NHRS funds declined by about 7% per year. The last ten years history of the DJIA and S&P 500 are show on Figure 9.

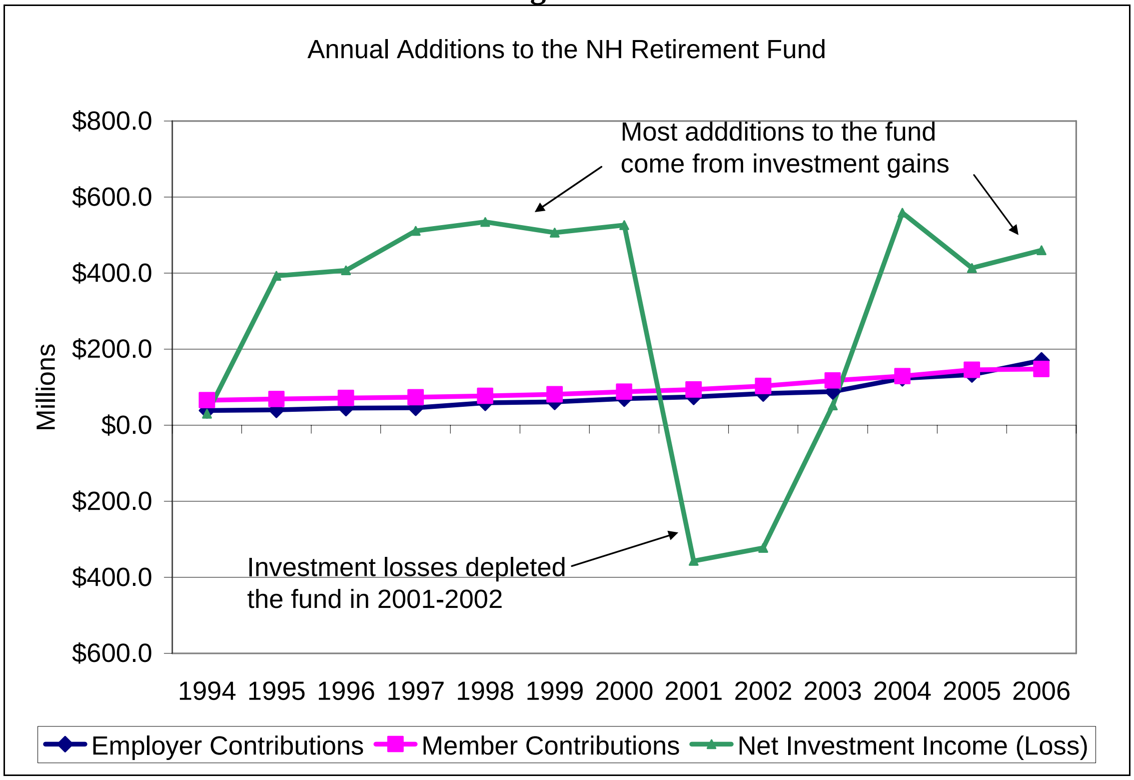
Figure 9



Source: http://moneycentral.msn.com/investor/charts/chartdl.aspx?Symbol=%24indu

In the case of NHRS, the largest factor in the underfunding of the pension benefit obligation in recent years has been poor investment performance. Employers and members both contribute to the fund, but return on fund investment is the largest overall contributor to the fund. Prior to the beginning of this decade, investments from the fund returned about $500 million to the fund each year, dwarfing the combined contributions from employers and employees. But, as shown in Figure 10, from 2001 to 2002 investment losses were substantial, and 2003 performance was poor.

Figure 10



NHRS appears to have changed its investment risk profile in the last five years, apparently increasing its target for foreign holdings in equity and fixed income investments, and decreasing holdings in alternative investments and commercial real estate. It is not clear whether this risk adjustment will increase investment performance, or avoid the kind of losses seen at the beginning of this decade. NHRS investment targets for 2001 and 2006 are shown in Table 3.[12]

Table 3

NHRS Investment Targets	2001	2006
Domestic common stock	50%	44%
Non Domestic common stock	9%	16%
Domestic fixed income	18%	26%
Non Domestic fixed income	3%	4%
Alternative investments	10%	5%
Commercial real estate	10%	5%

[12] NHRS CAFRs (annual reports) for 2001 and 2006.

Based on the most current information from the Public Fund Survey, NHRS asset allocation is not significantly different from the average of the public pension systems covered in the survey. On average, public pensions have about sixty percent of their assets in equities, as does the New Hampshire system. The comparison of New Hampshire and the Public Fund Survey average is shown on Table 4.

Table 4

Asset Allocations, NH vs. Average of 97 Public Pension Systems

	NH	**US**
Equities	62.0%	59.8%
Domestic Fixed Income	20.0%	27.5%
International Fixed Income	3.6%	0.9%
Real Estate	7.8%	4.9%
Alternatives	6.6%	4.5%
Cash	0.0%	1.8%
Other	0.0%	0.5%

http://www.publicfundsurvey.org/publicfundsurvey/assetallocations.asp

The median investment return assumption of the 126 pension plans in the Public Fund Survey is 8.0%, compared to the 8.5% currently assumed by the New Hampshire Retirement System.

The "Special Account" captured excess investment earnings and funded extra pension benefits

In most pension funds the employer contribution rate is increased to make up the difference when the pension fund's investments do not generate expected returns. When earnings exceed expectations, the employer rate may be reduced.[13] In New Hampshire's case, excess earnings in the last two decades have gone into the so called "Special Account" which has been used to fund additional pension benefits.

Before 1983, investment earnings in excess of the Assumption Rate were applied toward the Employer Contributions required to be paid into NHRS by the State and local governments. The result of this application of excess earnings was to reduce or hold down the rate of increase of the contributions required of the State and local governments. However, in 1983, the Legislature enacted RSA 100-A:16, II (h) that established the "Special Account" mechanism.

Under this mechanism, any earnings in *excess* of the Assumption Rate + ½% were deposited in the "Special Accounts" and do not accrue to the fund used to pay annuities. For example, in 2005 the system earned about 10% and the year before about 14%. The Assumption Rate was 9.0% in 2005 and earnings in excess of 9.5% went into the Special Accounts. None of those excess earnings went to shore up the pension side of NHRS holdings.

[13] "Employee (contribution) rates tend to remain at a fixed level", *Improved U.S. State Pension Funding Levels Could Be On The Horizon*, Standard & Poor's Ratings Direct, 27-Feb 2007

The funds accumulated in the Special Account have been used for two purposes – to grant cost of living increases (COLAs) to the retiree benefits, and to subsidize retiree health benefits by paying retiree health insurance premiums after retirement.

During the years of greater than expected return on investment, the Special Account swelled, even as the benefits funded by the Special Account were expanded. COLA rates were increased, medical subsidies were enlarged to include more retiree groups and a statute was passed to compound the medical subsidy by 8% per year. But because the Special Account funds were diverted from the pension side of NHRS holdings, the main trust fund lacked funds that would have strengthened the pension actuarial funding ratio.

However, the "Perfect Storm" of flattening, then declining, investment returns, more retirees and the 8% per year statutory compounding of the subsidy has led to a situation in which the payment made from the Special Account to lump-sum fund the present and future medical subsidy obligation and COLAs will not be sufficient to deliver on that promise. The last time new money from asset gains went into the Special Account was FY 2000, and the Special Account fund has gone from a high of $731.6 million in FY2000 to a balance of $213.93 million in FY2007. Without appropriate action, the Special Account for some retiree groups will likely be depleted in five years or less.

Employer contribution rate history

NHRS has the statutory authority to increase employer contribution rates as needed and reviews rates every two years. Employer contribution rates to NHRS have increased over the last three biennium periods, increasing state and local obligations for funding the system. Higher funding obligations from retiree system employers really means higher taxes for New Hampshire citizens, since the 'employers' are state and local government entities.

Table 5 shows the employer contribution rates for state employees. State (and local) contribution rates for teachers, fire and police have increased by similar amounts in the last six years.

Table 5

Employer Contribution Rates	Group I Employees
Effective July 1, 2003 - June 30, 2005	5.90%
Effective July 1, 2005 - June 30, 2007	6.81%
Effective July 1, 2007 - June 30, 2009	8.74%

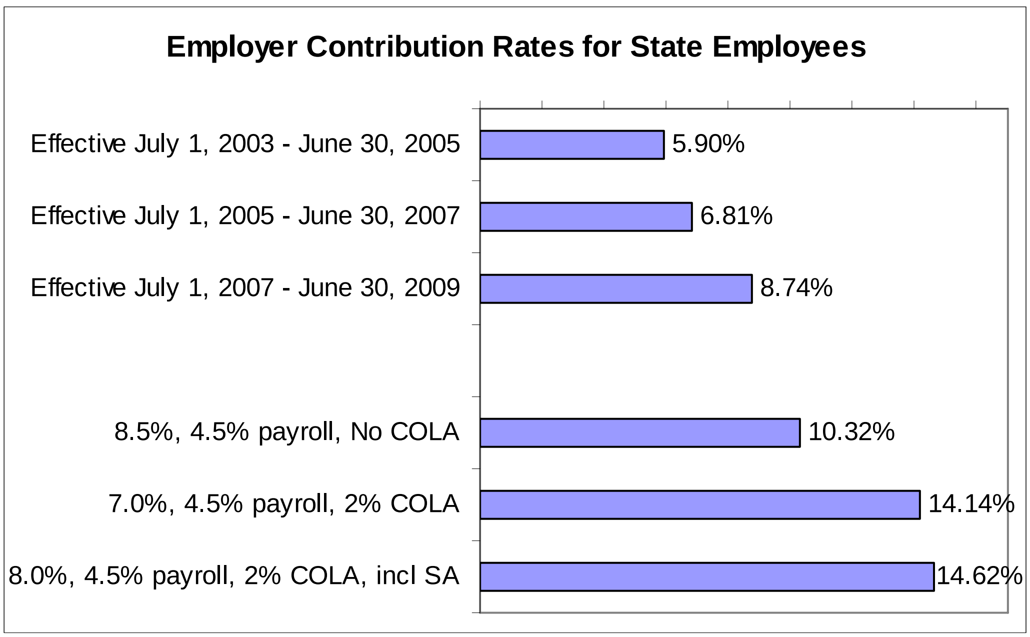
Employer contribution rates, even at their current levels, are insufficient to fund the system. During the February 2007 monthly NHRS board meeting, the new actuary for NHRS presented information about valuation data, methods and assumptions, and alternative calculations used to estimate how much money must be contributed to the pension plan in order to support the benefits that will become payable in the future.

The new valuation actuary issued those findings in a Replication and Review report, dated February 12, 2007. The purpose of the report was "to gain an overall understanding of the valuation model used by prior actuary, the benefits provided by NHRS and the methods and assumptions employed by the prior actuary." The new report notes that calculations done by the prior actuary mis-stated the costs in the retirement system. The new actuary offered recalculated contribution levels, based on alternative methods and assumptions.

In Figure 11 we compare the employer contribution rates for state employees calculated in the February 2007 Replication and Review report, with the history of actual employer contribution rates over the last six years. The report estimated three alternative employer contribution rates that should have been set for July 1, 2007 to June 20, 2009, given the following assumptions:

- 8.5% Investment Return; 4.5% Payroll Growth; No COLA; Entry Age Normal Cost
- 7.0% Investment Return; 4.5% Payroll Growth; 2.0% COLA; Entry Age Normal Cost
- 8.0% Investment Return; 4.5% Payroll Growth; 2.0% COLA; Entry Age Normal Cost Inclusion of Special Account Assets in Pension Assets (This is the method that, in the actuary opinion, gives the most accurate representation of system costs.)

Figure 11



The method endorsed by the actuary, which yields the highest employer contribution rate shown in Figure 11, contains a number of assumptions:

- The updated estimate relies on the recently adopted Entry Age Normal funding method, versus the Open Group Aggregate funding method. The Entry Age Normal method ensures compliance with certain GASB[14] funding methodology rules, while the Open

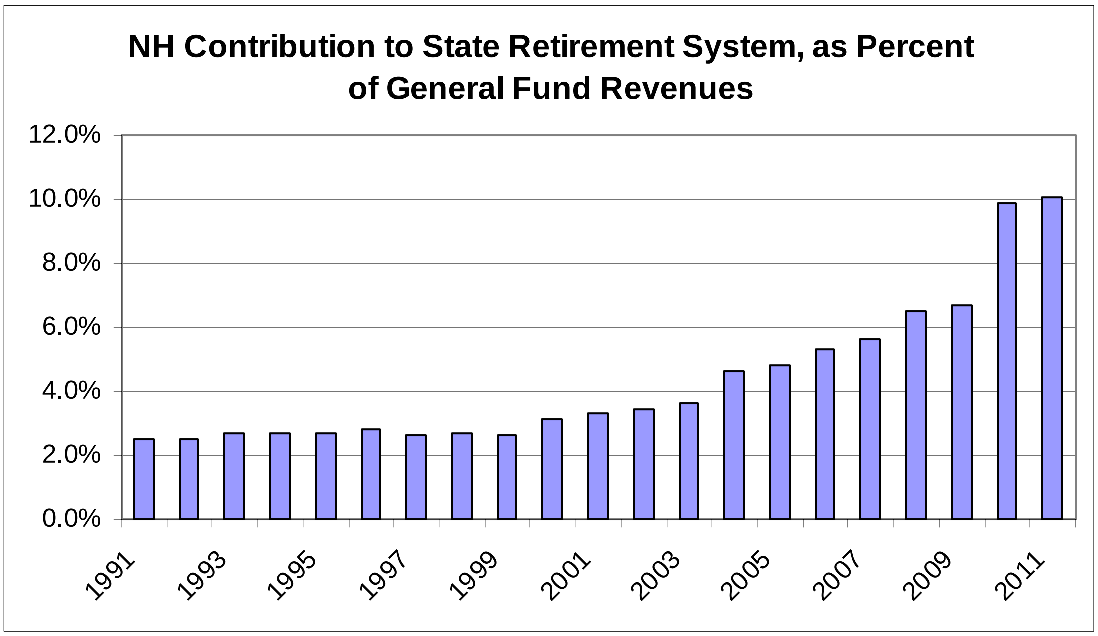
[14] Governmental Accounting Standards Board

Group Aggregate method may not have complied with those rules. New Hampshire had been the only state pension in the country to use the Open Group Aggregate method.

- The updated estimate uses a more reasonable 8.0% assumed return on investment, rather than the current assumed 8.5%.
- The so-called Special Account, used now to fund pension cost of living adjustments (COLAs), is included in the pension assets.

Figure 12 shows the results of a calculation, expressing the past and future state contributions to NHRS as a percentage of State General Fund Revenues, and assuming the highest employer contribution rates as shown in the previous charts. Under that assumption, the State contribution to the public pension fund would increase from about 3% of General Fund Revenues at the beginning of the decade to 10% of General Fund Revenues by the 2010-2011 biennium.

Figure 12



Comparison of Employer and Employee Contribution Rates

The following charts show the history of employer contribution rates and employee contribution rates, including the increases discussed. Group I members are state employees and teachers, while Group II members include firefighters and police. The State of New Hampshire is responsible for 35% of the employer contribution for teachers, firefighters and police.

Figure 13

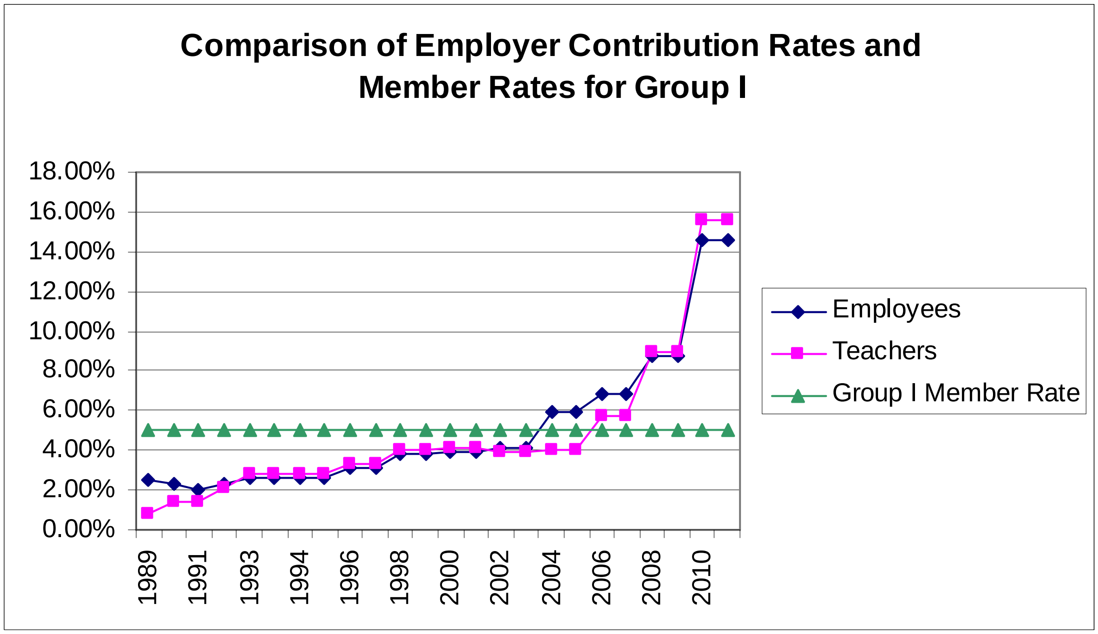
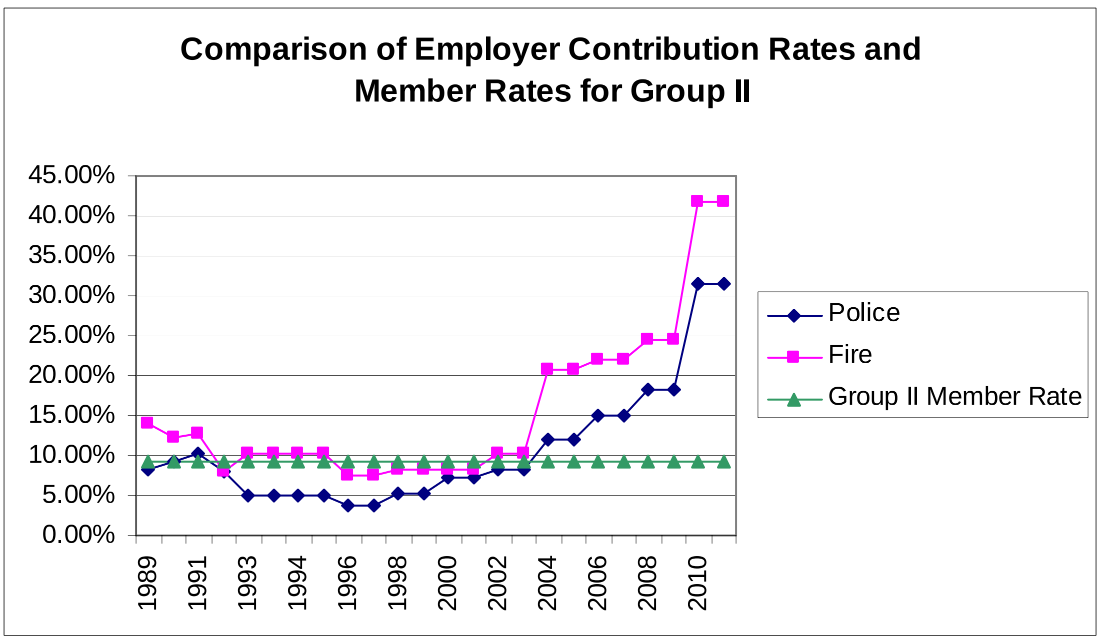


Figure 14



Local Government Implications

Municipal governments in New Hampshire also pay into the NHRS. Total municipal government payments into the public pension will increase by almost fifty percent, from $108 million in FY2007 to $157 million in FY2009. Assuming the same increase as shown above, payments by

New Hampshire municipalities into the public pension system will have to grow to $262 million by FY2011, a two thirds increase over FY2009 levels.

Recent Developments

The New Hampshire General Court passed two pieces of legislation in the 2007 session related to the pension fund. HB 653 changed the procedure for calculating and financing benefits, while HB 876 established a commission to make recommendations to ensure the long-term viability of the New Hampshire retirement system.

- HB 653 changed the pension funding methodology from open group aggregate to entry age normal[15], changed the length for discharging of the unfunded accrued liability from twenty to thirty years (or the maximum period allowed by the Government Accounting Standards Board), and mandated that annual employer contribution requirements not be less than employee contribution rates. HB 653 also changed the funding of the 'special account' for additional benefits; assuming that the public pension trust fund is at an actuarial funding level of at least 85%, only investment returns in excess of a 10.5 percent will be put into the special account. While this last change will help shore up the trust fund, it removes funding for retiree cost of living adjustments (COLAs) for perhaps a decade.

- HB 876 established a commission to make recommendations to ensure the long-term viability of the New Hampshire Retirement System – the commission's report is due by December 1, 2007.

Public Policy Considerations

Our analysis shows that investment returns (from the investments made with the net plan assets) have been the largest source of additions to the trust fund, eclipsing contributions made by employers or employees. However, recent investment losses have slowed growth in the net assets available for benefits. There is no guarantee that unforeseen financial market downturns, and associated investment losses, will not deplete the trust fund balance again in the future, requiring ever greater contributions to the fund by state (and local) government.

Decades ago public pension funds used to be more reliant on fixed income securities. But as employee representatives have pressed for ever larger entitlements, public pension funds have pursued riskier investments with higher returns, which explains public pension fund reliance on stocks. In years of good investment returns, this allows pension funds to offer more benefits, which become more difficult to fund in the bad years.

[15] New Hampshire was the only public pension plan in the US to use the 'open group aggregate' actuarial method http://www.publicfundsurvey.org/publicfundsurvey/actuarialassumptions.asp

E.J. McMahon, director of the Empire Center for New York State Policy and a senior fellow at the Manhattan Institute, has suggested a number of changes to public pension funds which should be seriously considered in public pension reform:[16]

- Shift to defined contribution plans for all future workers – because traditional defined benefit plans rely on contributions for younger employees to finance the benefits of long-term workers such a shift would not be a quick fix. But the alternative of maintaining a defined benefit plan with lower benefits for the newly hired is worse, according to Mr. McMahon.
- Immediately recognize and fund the full cost of any benefit increase – because the ability to amortize benefits over decades makes extra pension benefits appear to be a 'free lunch'.
- Expand financial reports to include alternative funding assumptions – for example, follow the lead of the New York City's actuary and show how funds would balance if assets were marked to market and if liabilities were discounted at market rates.
- Gradually lower the required rate of return – and invest accordingly – because over the long term this is an essential step for reducing the taxpayers' collective risk, and revealing the true economic costs of current benefits.

One important issue that should be addressed by the NHRS Study Commission is the accounting rule requiring state governments to disclose health-care and other non-pension retiree costs (referred to as other post employment benefits or OPEB). GASB 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* will likely require NHRS to reflect on its balance sheets the projected future cost of the health insurance subsidy for retirees. To the extent this cost reflects any actuarial weakness in NHRS assets to meet all its obligations in their entirety to present and future retirees (both pension annuity and medical subsidy), it appears according to GASB standards that the employer rates must be raised (again) to meet those obligations.

In addition, the Special Account method of funding pension benefits may not be in compliance with federal tax rules. A May 24, 2007 letter from KPMG to NHRS noted that the San Diego Retirement System which "uses a mechanism similar to the New Hampshire Retirement System (NHRS or the System) to fund post-employment benefits may be in violation of certain Internal Revenue Code (IRC) sections including IRC Section 401(a)(2), or the 'exclusive benefit rule' and IRC Section 401(h) as well as other statutory requirements. These potential violations by this other entity may result in its entire plan being subject to disqualification as a defined benefit pension plan." KPMG recommended that the NHRS "seek an opinion from an outside expert on tax and compliance matters related to the operation of its Pension and Post-Retirement activities to determine whether its current and past operations were in full compliance with all applicable laws and regulations." The Special Account may now become a liability, since extra pension benefits may no longer be legally funded from "excess" earnings.

[16] *Public Pension Price Tag,* Wall Street Journal, August 21, 2006

A further concern for policy makers is this: not everyone who is now working will be entitled to receive the retiree medical subsidy-- the Legislature has set up "haves" and "have nots". Here is how the situation stands at the moment:

Teachers & Employees (Group I):

All teachers and employees who are retired or who do retire before July 1, 2008 with at least 20 years service and who are age 60 when they retire will receive the medical subsidy

Police & Fire (Group II):

Police and firefighters who were on the job or retired before July 1, 2000 with at least 20 years service and who are age 45 when they retire will receive the medical subsidy. However, police and firefighters who began work on July 1, 2000 or thereafter will not receive the medical subsidy when they retire unless the Legislature passes future legislation to include them. When this distinction was first made, it applied to police and firefighters on the job or retired before July 1, 1987. Over the years, the Legislature has gradually advanced the cutoff date, making more and more Group II members eligible.

For each of the above groups there are some exceptions, for example if one is disabled on the job.

The money to fund this subsidy in perpetuity for eligible retirees and employees was set aside by the NHRS in a special sub-account. It was projected to be sufficient to lump-sum fund the subsidy. Due to changes in initial assumptions, poor investment returns and other factors, the funds that were set aside are projected to run out in 2011 for Teachers & Employees; in 2017 for Police; and in 2024 for Fire…unless, of course, the Legislature raises the money to continue the subsidies or drastically modifies them in some respect.

The foregoing makes clear that substantial and difficult policy changes will be necessary if NHRS is to regain financial soundness and if State and local taxpayers are to avoid major increases in tax burdens associated with employer contributions to the system.