



**NH Retirement System**  
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**NHRS Bill Brief: SB 229-FN (as introduced)**  
*Prepared for the NH Senate ED&A Committee*

**Summary:** AN ACT establishing a defined contribution retirement plan for public employees.

**Analysis:** This bill establishes a defined contribution retirement plan for public employees and requires the issuance of a request for proposals for plan administration. Beginning November 1, 2012, all new hires by employers participating in the retirement system shall be enrolled in the public employee defined contribution plan.

**Sponsors:** Sen. Groen, Dist 6; Sen. Boutin, Dist 16; Sen. Bradley, Dist 3; Sen. Bragdon, Dist 11; Sen. De Blois, Dist 18; Sen. Forsythe, Dist 4; Sen. Gallus, Dist 1; Sen. Lambert, Dist 13; Sen. Stiles, Dist 24; Sen. White, Dist 9; Rep. Hawkins, Hills 18; Rep. Winter, Merr 3; Rep. Hill, Merr 6; Rep. O'Brien, Hills 4; Rep. Bettencourt, Rock 4

### **Financial Considerations**

**Employer Contributions:** SB 229 seeks to keep the employer rates for the new Defined Contribution (DC) plan the same as those for the existing Defined Benefit (DB) plan, with participating employers paying a portion of the DC employer contribution rate toward the retirement system's Unfunded Actuarial Accrued Liability (UAAL). According to the Defined Contribution Retirement Plan Study prepared by the retirement system's consulting actuary, Gabriel Roeder Smith and Co. (GRS), establishing the proposed Defined Contribution plan would increase the funding obligations of the employers over the life of both the DC and DB plans. The executive summary of that report is attached to this brief.

**Member Contributions:** No impact; participants in both the DB plan and the DC plan would continue to pay the current contribution rates, which are 7% for Group I (Employee and Teacher) members, 11.55% for Group II Police members, and 11.8% for Group II Fire members.

**Impact on Unfunded Actuarial Liability (UAAL):** The UAAL is the difference between the actuarial value of a retirement system's assets and the actuarial value of its accrued liabilities (i.e. the future cost of benefits already accrued). NHRS has a UAAL of \$4.25 billion, which is being amortized over the next 26 years through employer contributions. The average UAAL rate for FY 2014 is 9.92% and thereafter is approximately 10 percent of covered payroll, although the rates differ among member classifications.

GRS has determined that under SB 229, the estimated DC employer contribution toward the UAAL is at the outset, lower for Group I members and higher for Group II members, but eventually becomes lower for Group II members, as well. This produces a shortfall over time that is, on a present value basis, either \$237 million or \$361 million, depending on how death/disability premium costs for the DC plan are funded. The shortfall will be made up by increasing employer contribution rates to both the DC and DB plans over time.

Further, the estimated shortfall noted above is based on an assumed rate of investment return of 7.75% for the life of the plan. However, closing the DB plan to new members will, over time, change the demographic make-up of the covered NHRS population from a mixture of active and retired members to retirees only. The investment allocation for a retiree-only plan will need to be different from the current NHRS allocation – a retiree-only plan's benefit payments tend to be more conservative, similar to income payments from bonds. Changing the asset allocation to a higher allocation of bonds will require a lower rate of return assumption with correspondingly higher actuarial accrued liabilities and

employer contribution rates. GRS has modeled how a potential change in investment allocation would impact the UAAL by lowering the long-term rate of return on assets from 7.75% to 6.65% per year. (The 6.65% assumption was based on input from the NHRS Independent Investment Committee and NEPC, the retirement system's investment consultant.) Under this scenario, the NHRS UAAL would increase by \$1.2 billion, from \$4.3 billion to \$5.5 billion, the funded ratio would decline from 57.4% to 51.1% and the total employer contribution rate would increase by 3.97% of payroll (2.26% of payroll for employer normal cost and 1.71% for the UAAL amortization), as of June 30, 2011.

**NHRS Administrative Costs:** The bill outlines three options for plan management and administration; NHRS administrative costs would be dependent on which of these options are chosen.

**State of NH Expenditures:** The Department of Administrative Services (DAS) states this bill will increase state general fund expenditures by \$188,616 in FY 2013. DAS states that continued contract management and administration will be required in FY 2013 and each year thereafter, however those costs are indeterminable at this time.

### Legal Considerations

In a preliminary review of SB229 (*memo attached*), Groom Law Group, the retirement system's outside fiduciary counsel, identified several potential issues with the bill, including:

- The proposed legislation grants the Department of Administrative Services – an agency under the executive branch – the authority to select the outside service provider that could conceivably handle duties that the NHRS Board of Trustees currently performs. However, the New Hampshire Supreme Court has recognized NHRS' independence from the executive branch based, in part, on the System's status as a trust.
- IRS regulations provide that the normal retirement age under a tax-qualified plan must be "reasonably representative of the typical retirement age for the industry in which the covered workforce is employed." A normal retirement age of age 62 or later is presumed to satisfy the reasonably representative requirement. The normal retirement age in SB 229 for Group I members (age 60) is outside the IRS language of the safe harbor.
- SB 229 does not appear to contemplate the necessity for any process for fiduciary monitoring of a potential service provider's performance of administrative and management duties of either the DB plan or the DC plan.

### Accounting Considerations

KMPG, the retirement system's external independent auditor, has prepared a memo (*attached*) regarding the transition to a DC plan that raises potential financial reporting issues that could adversely impact the state and municipal bond ratings. Applying the employer UAAL contribution rate to both DB and DC covered payroll is a creative funding mechanism. However, based on the closed and declining active DB member payroll, accounting rules would require financial reporting using the so-called level dollar amortization, rather than the current level percent of payroll amortization method. According to GRS, funding the annual required contribution (ARC) on a level-percent basis but reporting it on a level-dollar basis would result in reported employer contributions of 76% of the ARC. ARC is one of the criteria we understand rating agencies look at when determining credit-worthiness.

### Index of attachments:

*Executive Summary, GRS DC Plan Analysis for the NHRS, Jan. 11, 2012*  
*GRS Supplemental Valuation of LSR 12-2876.1, Nov. 29, 2011*  
*Legal Memo, Groom Law Group, Jan. 6, 2012*  
*Accounting Memo, KPMG, Feb. 1, 2012*

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## EXECUTIVE SUMMARY

This report was prepared at the request of the New Hampshire Retirement System (NHRS) for analysis of proposed defined contribution (DC) plan described in legislation LSR 12-2876. The purpose of this analysis is to provide information related to the effect of the proposed legislation on benefit design and plan funding, specifically with regard to:

- How the proposed legislation will affect funding for the NHRS defined benefit (DB) plan;
- The relative cost of the proposed DC plan compared to the NHRS DB plan; and
- The likely income replacement ratio of the DC plan compared to the NHRS DB plan.

In all areas, over time, transitioning to the proposed Defined Contribution plan will be more expensive for the employees and employers than maintaining the current Defined Benefit plan based on the recent changes made by the legislature to the Defined Benefit plan.

Incorporating the proposed Defined Contribution plan into the NHRS would increase the funding obligations of the employers over the life of the plans.

The findings in this report depend on the actuarial assumptions use in the June 30, 2011 draft valuation of the NHRS except as indicated. In particular:

- The rate of return on assets is 7.75% per year, unless otherwise specified,
- The rate of payroll growth is 3.75% per year,
- The statutory amortization period of the Unfunded Actuarial Accrued Liability is a 30-year closed period beginning in the fiscal year ending June 30, 2008 (with 26 years remaining beginning in the fiscal year ending June 30, 2014),
- The active headcount is assumed to remain constant in all future years

It is important to note that different assumptions would produce different results. The actual DB employer contribution rates and DC employee benefits will depend on actual experience over time. Actual experience will likely differ from the assumed experience. The assumptions are intended to represent the reasonable expectation of the average outcome over time.

The primary findings in this report are listed below.

1. There is a shortfall in NHRS DB funding under the proposal (under both a literal and alternative interpretation). The shortfall is projected to grow over time and will require additional DB plan employer contributions to fully fund the Unfunded Actuarial Accrued Liability (UAAL) in the statutory period. For NHRS as a whole, the present value of the contribution shortfall is estimated to be \$237 million which absent future employer contribution increases would increase the UAAL and lower the funded ratio. This shortfall is expected to be made up with increasing employer DB UAAL contribution rates.
2. The proposed employer DC contribution rates are higher than the comparable employer contribution rates for members hired on or after July 1, 2011 (the DB normal cost). Under the proposed legislation, the annual contributions to the DC plan would be 10.00% of pay for Group I participants (Employees and Teachers) and 16.00% of pay for Group II participants (Police and Fire). However, the normal cost for newly hired DB plan members would be 8.38% for Employees, 7.14% for Teachers, 12.34% for Police and 13.13% for Fire. Consequently, the proposed DC rates would be higher than the normal costs for new members in the DB plan.

3. The proposed DC plan would likely provide retirement benefits that are near to or lower than those provided under the current DB plan for career members. For Group I members, the DB plan is estimated to replace 47% of pre-retirement income and the DC plan is estimated to replace 34% to 46%. For Group II members, the DB plan is estimated to replace 56% of pre-retirement income and the DC plan is estimated to replace 43% to 58%. Note that ranges of outcomes described for the DC plan depend on a range of investment return scenarios from 5.75% per year to 7.75% per year to illustrate the variability of outcomes. Since participants in a DC plan will manage their individual investment accounts, replacement ratios will vary among participants and may even end up outside this range.
4. Closing the DB plan to new members will change the demographic make-up of the covered NHRS population from a mixture of active and retired members to retirees only in the long-run. The investment allocation for a retiree-only plan will need to be different from the current NHRS allocation – a retiree-only plan’s benefit payments tend to be more similar to income payments from bonds. Changing the asset allocation to a higher allocation of bonds will require a lower rate of return assumption with correspondingly higher actuarial accrued liabilities and employer contribution rates. This potential change in investment allocation is modeled by lowering the long-term rate of return on assets from 7.75% to 6.65% per year.

As a result, less investment income would result and additional funding would be required to secure NHRS benefits. Reflecting this asset allocation, total unfunded actuarial accrued liability of NHRS would increase by \$1.2 billion from \$4.3 billion to \$5.5 billion, the funded ratio would decline from 57.4% funded to 51.1% funded and the total employer contribution rate would increase by 3.97% of payroll (2.26% of payroll for employer normal cost and 1.71% for the UAAL amortization), as of June 30, 2011. The actual change in portfolio allocation may be made gradually over time and the actual plan experience will vary. The results under the single assumption of 6.65% rate of return are intended to illustrate one reasonable scenario only.

5. Changing the investment allocation as described in item 4 would also increase the normal cost for newly hired DB plan members. Under an assumed rate of return of 6.65% per year, the total normal cost for newly hired DB members is 9.42% for Employees, 8.34% for Teachers, 14.78% for Police and 16.02% for Fire. While these results are higher than under the current valuation assumptions as described in item 2, they are lower than the proposed DC total contribution rates of 10% for Employees and Teachers and 16% for Police and slightly higher than the 16% for Fire.

The report also provides additional information describing the advantages and disadvantages of DB and DC plans and Risk/Benefit Analysis. This information is intended to provide additional education background on retirement plan design. A key difference between DB and DC is that the investment risk is borne by the employer in a DB plan and by the participants in a DC plan.

Strategic decisions regarding retirement benefit design and plan funding involve clear objectives from the policy-makers. We hope the information presented in this report will assist decision-makers in the design process. The results in this report may be refined in future reports to further align with the objectives of the policy-makers, employers, members, and other stakeholders

**NHRS**  
**SUPPLEMENTAL ACTUARIAL VALUATION**  
**LSR 12-2876.1**

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**REQUESTED BY:** New Hampshire Retirement System

**DATE:** November 29, 2011

**SUBMITTED BY:** David T. Kausch, FSA, EA, MAAA  
Randall J. Dziubek, ASA, EA, MAAA  
Heidi G. Barry, ASA, MAAA  
Gabriel, Roeder, Smith & Company

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This report contains the results of a supplemental actuarial valuation of proposed system changes as described in LSR 12-2876.1. The proposed changes include:

- This bill establishes a defined contribution retirement plan for public employees and requires the issuance of a request for proposals for plan administration. Beginning November 1, 2012, all new hires by employers participating in the retirement system shall be enrolled in the public employee defined contribution plan.

Supplemental valuations do not predict the results of future actuarial valuations. (Future activities can affect future valuation results in an unpredictable manner). Rather, supplemental valuations give an indication of the probable effect of the **change only** on future valuations without comment on the complete end result of the future valuations.

The signing actuaries are independent of the plan sponsor, are Members of the American Academy of Actuaries (MAAA), and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

The valuation was based upon data furnished by NHRS for the June 30, 2011 actuarial valuation as disclosed in our draft report issued November 1, 2011.

This includes economic assumptions adopted by the Board of:

- The assumed rate of interest of 7.75% and
- The assumed rate of wage inflation of 3.75%

The amortization period is a closed 26-year period beginning in FY 2014.

A brief summary of the data used in this valuation is presented on the next page.

**NHRS**  
**SUPPLEMENTAL ACTUARIAL VALUATION**  
**LSR 12-2876.1**

**AS OF JUNE 30, 2011**

Valuation Group	Active Members	Valuation Payroll	Average		
			Age	Service	Pay
Employees:					
Male	9,821	\$ 487,016,910	48.6	11.1	\$49,589
Female	15,718	626,849,823	48.6	10.1	39,881
Total	25,539	1,113,866,733	48.6	10.5	43,614
Teachers:					
Male	4,119	244,851,420	45.7	13.3	59,444
Female	14,347	791,524,917	46.0	12.6	55,170
Total	18,466	1,036,376,337	45.9	12.7	56,123
Police:					
Male	3,606	230,141,091	39.1	11.0	63,822
Female	524	29,367,714	39.0	9.0	56,045
Total	4,130	259,508,805	39.1	10.8	62,835
Fire:					
Male	1,555	105,204,154	40.7	12.7	67,655
Female	48	2,823,441	39.2	9.4	58,822
Total	1,603	108,027,595	40.7	12.6	67,391
Total:					
Male	19,101	1,067,213,575	45.6	11.7	55,872
Female	30,637	1,450,565,895	47.2	11.2	47,347
Grand					
Total	49,738	\$2,517,779,470	46.6	11.4	\$50,621

**NHRS**  
**SUPPLEMENTAL ACTUARIAL VALUATION**  
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**New Provisions Under Consideration:**

Employees, Teachers, permanent Policemen and permanent Firemen beginning service on or after November 1, 2012, shall as a condition of employment, participate in the public employee defined contribution plan.

**Specific provisions of LSR 12-2876.1 are as follows:**

**Defined Contribution Members:**

- Mandatory member contributions of 7.00% of compensation for Group I members, 11.80% for Group II Fire members, and 11.55% for Group II Police members
- Employer contributions (into members' individual accounts) of :
  - Group I – 10.00% of compensation minus the 7.00% member contribution and minus the cost of the premium for long term disability and life insurance
  - Group II – 16.00% of compensation minus the 11.80% or 11.55% member contribution and minus the cost of the premium for long term disability and life insurance
- Additional required employer contributions will be applied to the UAAL of the NHRS equal to the amount determined under RSA 100-A:16,II minus the employer contribution determined in the previous bullet
- Member DC balances attributable to employer contributions become 20% vested after 4 years, 40% vested after 5 years, 60% vested after 6 years, 80% vested after 7 years, and 100% vested after 8 years

**Defined Benefit (NHRS) Members:**

- No changes to statutory contributions

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**ACTUARIAL STATEMENT**  
**PENSION RESULTS**

**Effect of Proposal as Currently Written**

Member Classification	Employees	Teachers	Police	Fire	Total*
<b>Derivation of Estimated Employer DC Contribution</b>					
(1) Rates Defined in RSA 100-E:5, I and E:5, II	10.00 %	10.00 %	16.00 %	16.00 %	10.89 %
(2) RSA 100-E:5, I(a) and E:5, II(a) (Member Contributions)	(7.00)%	(7.00)%	(11.55)%	(11.80)%	(7.69)%
(3) RSA 100-E:5, I(b) and E:5, II(b) (LTD and Life Insurance)	(0.39)%	(0.11)%	(1.03)%	(1.03)%	(0.38)%
(4) Employer DC Contribution Rate	2.61 %	2.89 %	3.42 %	3.17 %	2.82 %

Derivation of Employer Contribution Towards UAAL	2014-15	2014-15	2014-15	2014-15	2014-15
(5) RSA 100-A:16, II (Employer Pension Rate)	10.44 %	11.96 %	21.35 %	23.79 %	12.78 %
(6) RSA 100-E:5 (Employer DC Contribution Rate)	(2.61)%	(2.89)%	(3.42)%	(3.17)%	(2.82)%
(7) RSA 100-E:6 (Net Employer Contribution Rate to DB Plan)	7.83 %	9.07 %	17.93 %	20.62 %	9.96 %
(8) UAAL Rates For FY 2014 and Later	7.96 %	9.95 %	15.45 %	16.41 %	9.92 %
(9) Excess (Shortfall) in Contribution Rates	(0.13)%	(0.88)%	2.48 %	4.21 %	0.04 %

\* Total rates will vary depending on actual DB and DC members.

Projected Impact on Employer Contributions (Total DB and DC)					
Member Classification	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
State Employees Pension	\$ -	\$ (47,091)	\$ (111,207)	\$ (268,242)	\$ (394,417)
State Police Pension	-	111,891	275,567	280,626	264,150
State Fire Pension	-	5,833	15,016	19,887	23,367
<b>State Subtotal</b>	-	<b>70,633</b>	<b>179,376</b>	<b>32,271</b>	<b>(106,900)</b>
Political Subd. Employees Pension	-	(51,083)	(120,634)	(290,981)	(427,851)
Political Subd. Teachers Pension	-	(529,502)	(1,306,652)	(2,532,268)	(3,538,554)
Political Subd. Police Pension	-	290,197	714,703	727,823	685,093
Political Subd. Fire Pension	-	162,719	418,928	554,804	651,900
<b>Political Subd. Subtotal</b>	-	<b>(127,669)</b>	<b>(293,656)</b>	<b>(1,540,621)</b>	<b>(2,629,412)</b>
<b>Grand Total</b>	-	<b>(57,036)</b>	<b>(114,280)</b>	<b>(1,508,350)</b>	<b>(2,736,312)</b>

Impact of Pension Funded Status		
As of June 30, 2011		
Member Classification	Present Value of Shortfall	Percent of Actuarial Liability
Employees	\$ (49,111,005)	(1.5)%
Teachers	(172,134,009)	(4.4)%
Police	(21,259,770)	(1.1)%
Fire	5,120,900	0.6%
<b>Total</b>	<b>\$ (237,383,884)</b>	<b>(2.4)%</b>

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**ACTUARIAL STATEMENT  
PENSION RESULTS**

**Alternate Interpretation Without LTD and Life Insurance Adjustment  
(See Comment 8)**

Member Classification	Employees	Teachers	Police	Fire	Total
<b>Derivation of Estimated Employer DC Contribution</b>					
(1) Rates Defined in RSA 100-E:5, I and E:5, II	10.00 %	10.00 %	16.00 %	16.00 %	10.89 %
(2) RSA 100-E:5, I(a) and E:5, II(a) (Member Contributions)	(7.00)%	(7.00)%	(11.55)%	(11.80)%	(7.69)%
(3) RSA 100-E:5, I(b) and E:5, II(b) (LTD and Life Insurance)	(0.39)%	(0.11)%	(1.03)%	(1.03)%	(0.38)%
(4) Employer DC Contribution Rate	2.61 %	2.89 %	3.42 %	3.17 %	2.82 %

Derivation of Employer Contribution Towards UAAL	2014-15	2014-15	2014-15	2014-15	2014-15
(5) RSA 100-A:16, II (Employer Pension Rate)	10.44 %	11.96 %	21.35 %	23.79 %	12.78 %
(6) RSA 100-E:5 (Employer DC Contribution Rate) (3) + (4)	(3.00)%	(3.00)%	(4.45)%	(4.20)%	(3.20)%
(7) RSA 100-E:6 (Net Employer Contribution Rate to DB Plan)	7.44 %	8.96 %	16.90 %	19.59 %	9.58 %
(8) UAAL Rates For FY 2014 and Later	7.96 %	9.95 %	15.45 %	16.41 %	9.92 %
(9) Shortfall in Contribution Rates	(0.52)%	(0.99)%	1.45 %	3.18 %	(0.34)%

Projected Impact on Employer Contributions (Total DB and DC)					
Member Classification	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
State Employees Pension	\$ -	\$ (188,363)	\$ (444,830)	\$ (846,091)	\$ (1,160,344)
State Police Pension	-	65,420	161,118	103,177	36,540
State Fire Pension	-	4,406	11,343	13,957	15,495
<b>State Subtotal</b>	-	<b>(118,537)</b>	<b>(272,369)</b>	<b>(728,957)</b>	<b>(1,108,309)</b>
Political Subd. Employees Pension	-	(204,331)	(482,537)	(917,814)	(1,258,707)
Political Subd. Teachers Pension	-	(595,690)	(1,469,984)	(2,790,477)	(3,870,267)
Political Subd. Police Pension	-	169,672	417,870	267,597	94,768
Political Subd. Fire Pension	-	122,909	316,435	389,379	432,273
<b>Political Subd. Subtotal</b>	-	<b>(507,440)</b>	<b>(1,218,216)</b>	<b>(3,051,315)</b>	<b>(4,601,933)</b>
<b>Grand Total</b>	-	<b>(625,977)</b>	<b>(1,490,585)</b>	<b>(3,780,272)</b>	<b>(5,710,242)</b>

Impact of Pension Funded Status		
As of June 30, 2011		
Member Classification	Present Value of Shortfall	Percent of Actuarial Liability
Employees	\$ (120,948,221)	(3.6)%
Teachers	(184,182,008)	(4.7)%
Police	(49,783,560)	(2.7)%
Fire	(5,845,443)	(0.7)%
<b>Total</b>	<b>\$ (360,759,232)</b>	<b>(3.6)%</b>

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**Comment 1:** The proposal includes a provision for participating employers to continue funding the NHRS on the payroll for members of both the defined benefit plan and the defined contribution plan (i.e., an open group). Despite the fact that the annual contribution toward the unfunded actuarial accrued liability will be made on an open group, we believe the current rules under GASB 25/27 do not allow for continued use of a level percent of payroll amortization approach in the determination of the Annual Required Contribution (ARC). For purposes of determining the ARC we believe the System will be required to use a level dollar method or a method that reflects the declining payroll of the closed active population of the System. To the extent future actual contributions (based on a level percent of pay amortization) are lower than the calculated ARC (based on a level dollar approach), the System will report contribution less than 100% of the ARC. As an example, for NHRS in total, the ARC would increase from 12.78% of payroll to 16.90% resulting in employer contributions of 76% of the ARC. However, if the proposed changes in the Exposure Draft for GASB 25/27 are formally adopted by GASB (currently expected by FY 2014), the calculation of the ARC will be eliminated but the issue remains.

**Comment 2:** As shown on page 4, under the proposed changes, the estimated employer contribution toward the UAAL is lower for Group I members than the result calculated in the most recent actuarial valuation as the amount necessary to amortize the UAAL over a 26-year period (the reverse is true for Group II). This implies that the UAAL for Group I would not be expected to be fully paid off over the desired 26-year period (whereas Group II would be expected to be paid off earlier). In addition, future valuation results of the System could change over time as the demographics of the population changes. This would result in changes to the calculated employer payment toward the UAAL which could further exacerbate the situation. The estimated present value of the shortfall of contributions as of June 30, 2011 is \$237 million for NHRS in total as shown in the table at the bottom of page 4. This shortfall will be made up with increasing employer DB contribution rates over time. Given that the employer contribution rates for NHRS are set through biennial valuations, it would be more consistent with NHRS' funding objectives to define the employers' contribution to NHRS on the payroll of defined contribution members as the amount established to amortize the UAAL under RSA 100-A:16.

**Comment 3:** The proposed DC plan contains a vesting schedule as described on page 3. At this time we believe the treatment of forfeitures has yet to be addressed. The estimated costs of the proposed DC plan shown on page 4 (Item #4) were determined as if forfeitures are allocated to the accounts of remaining members. To the extent forfeitures will be used to reduce future employer contributions into members' DC accounts, the cost of the DC plan may be lower than the estimates shown. We have assumed that the employer contributions to NHRS would not be reduced by any DC forfeitures.

**Comment 4:** Adding a Defined Contribution Plan for new hires after a certain date effectively would close NHRS to new hires. GRS is neither for nor against the proposed change.

**Comment 5:** The proposal does not address the funding of the medical subsidy benefits. We have assumed that employer contributions for the medical subsidy benefits would be assessed to both DB and DC member payroll. If the intent is to only assess DB payroll, the current method of contributing the minimum amount necessary to fund medical subsidy benefits will be insufficient since the last dollar of DB payroll will be paid before the last medical subsidy benefit.

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**Comment 6:** Under the proposed changes, employers may be required to make continued payments toward unfunded DB benefits long after they have any DB members left. A reasonable rule of thumb for the total population is that 10 years after the change half of the workforce will be in the defined contribution plan. Different employers will reach a point of having no DB members at different times, however it is possible that many of them will reach that point before the scheduled amortization of the UAAL is complete.

**Comment 7:** The proposed LTD and life insurance benefits and their corresponding premiums under RSA 100-E:5, I(b) and II(b) are unknown at this time. For purposes of our actuarial analysis, we estimated the cost of providing these benefits as the normal cost of disability and death-in-service benefits provided to current NHRS members. The actual cost of these benefits will depend on the final provisions and premiums which are not part of the scope of our analysis and may vary considerably from the amounts shown.

**Comment 8:** The proposed base DC percentages of 10% for Group I and 16% for Group II were selected without the benefit of knowing the expected cost of the DB plan provisions for new hires. Based on the information shown below, it is estimated that the employer costs for the proposed DC plan will be higher over the long run than the costs of the current DB benefits for new hires. A reasonable comparison of the long-term cost of the DB to the DC plan is a comparison of the DB employer normal cost to the employer DC cost.

<b>Member Classification</b>	<b>Employees</b>	<b>Teachers</b>	<b>Police</b>	<b>Fire</b>	<b>Total</b>
Ultimate Normal Cost For Newly Hired Members of DB Plan					
Total	8.38%	7.14%	12.34%	13.13%	8.41%
Member Contributions	(7.00)%	(7.00)%	(11.55)%	(11.80)%	(7.69)%
Ultimate Employer DB Normal Cost	1.38%	0.14%	0.79%	1.33%	0.72%
Estimated Employer DC Cost (from page 3)	<u>2.61%</u>	<u>2.89%</u>	<u>3.42%</u>	<u>3.17%</u>	<u>2.82%</u>
DC Cost in Excess of DB	1.23%	2.75%	2.63%	1.84%	2.10%

Estimated Employer DC Cost shown here does not include the cost of providing long-term disability or life insurance whereas the ultimate Employer DB Normal Cost does reflect the cost of disability and death benefits provided through NHRS.

**Comment 9:** We have based certain results shown on page 4 on a literal reading of LSR 12-2876.1 with regard to the estimate of required employer contributions needed to fund the unfunded actuarial accrued liability (UAAL). Under our interpretation it appears the UAAL contribution will contain a component equal to the cost of premium contributions for long term disability and life insurance. We believe this may not be the intention. Results determined under the alternate interpretation that the premium cost for disability and life insurance should not be included in the UAAL payment are shown on page 5. Note, this interpretation increases the present value of the shortfall in the employer UAAL contribution discussed in Comment 2 to \$361 million as of June 30, 2011.

**NHRS**  
**SUPPLEMENTAL ACTUARIAL VALUATION**  
**LSR 12-2876.1**

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**Comment 10:** Future actuarial measurements may differ significantly from the current measurements presented in this report due to such factors as the following: plan experience differing from that anticipated by the economic or demographic assumptions; changes in economic or demographic assumptions; increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as the end of an amortization period or additional cost or contribution requirements based on the plan's funded status); and changes in plan provisions or applicable law. Due to the limited scope of our assignment, we did not perform an analysis of the potential range of such future measurements.

**Comment 11:** This calculation is based upon present and proposed plan provisions that are outlined in the report. If you have reason to believe that the assumptions that were used are unreasonable, that the plan provisions are incorrectly described, that important plan provisions relevant to this proposal are not described, or that conditions have changed since the calculations were made, you should contact the authors of this report prior to relying on information in the report. Also, in the event that more than one plan change is being considered, it is very important to remember that the results of separate actuarial valuations cannot generally be added together to produce a correct estimate of the combined effect of all of the changes. The total can be considerably greater than the sum of the parts due to the interaction of various plan provisions with each other, and with the assumptions that must be used.

**MEMORANDUM<sup>1</sup>**

January 6, 2012

TO: New Hampshire Retirement System Board of Trustees  
FROM: Groom Law Group, Chartered  
RE: LSR 12-2876.1 and SB 249

**Introduction**

You have asked us to identify legal and fiduciary concerns regarding the language in LSR 12-2876.1, which addresses the establishment, functioning, administration, and management of a public defined contribution ("DC") plan, and SB 249, which provides for the private administration and management of the New Hampshire Retirement System ("NHRS" or the "System"). We have identified concerns relating to the impact of the proposed DC plan on NHRS's funding status and investment objectives, the administration and management of NHRS by an outside service provider, and compliance with the Internal Revenue Code ("Code"). We discuss our concerns below.

With your consent, we have relied solely on the facts and representations as you provided them, and we have assumed these facts and representations are true, correct, and complete, and have made no independent investigation thereof. Variations from the facts and representations you provided could cause the legal conclusions in this memorandum to change. This memorandum is based on the Constitution of New Hampshire and laws

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<sup>1</sup> On January 10, 2012, the NHRS Board of Trustees waived the attorney-client privilege with regard to this memorandum.

of New Hampshire at the date hereof and is subject to change with subsequent amendment or interpretation of such laws.

### **Proposed Legislation**

LSR 12-2876.1 limits membership in NHRS to employees who start their employment before November 1, 2012, and establishes a DC plan for public employees who begin employment on or after November 1, 2012. LSR 12-2876.1 sets out employee and employer contribution rates for the DC plan, provides for employer payments to NHRS on behalf of DC plan members in order to fund NHRS's unfunded accrued liability, provides that employers pay the costs for long term disability insurance benefits and life insurance benefits, establishes rules for vesting and the disbursement of funds, and sets out options for the management and administration of the DC plan, as well as the NHRS corpus fund.

SB 249 articulates the legislature's finding that the administrative and management services currently handled by NHRS can be provided more efficiently and less expensively by a private-sector service provider. The legislation instructs New Hampshire's department of administrative services, which is part of the State's executive branch, to contract with a "suitable professional services organization" for the administration and management of the operations of NHRS. SB 249 § 2, I. Under SB 249, the NHRS Board of Trustees ("Board") and the department of administrative services must prepare a description of the duties and procedures governing the administration and management of NHRS. SB 249 § 2, I. Then, the department of administrative services must publish a request for proposals ("RFP") for service providers, review and consider qualifications after receiving proposals, and negotiate a

contract with the "highest qualified firm" for the "administration and management of the operations of the retirement system at compensation which the department of administrative services determines is fair and reasonable to the state." SB 249 § 2, II.

### Analysis

We discuss in detail below the legal and fiduciary concerns we have identified in connection with the proposed legislation.

#### **a. Impact of the Proposed DC Plan on NHRS's Funding Status and Investment Objectives.**

GRS provided NHRS with a Defined Contribution Retirement Plan Study ("Report"), dated December 27, 2011, in which it describes the potential cost to NHRS of enactment of LSR 12-2876.1, as proposed. The Report provides that, for NHRS as a whole, the present value of the contribution shortfall under the proposed legislation is estimated to be \$237 million.<sup>2</sup> See Report, at A-1, B-3, C-2.

Additionally, in its presentation at NHRS's November Board meeting, GRS opined that the System might have "different investment objectives requiring a lower rate of return assumption" once active employees retire and the System is populated exclusively by retirees. See GRS's New Hampshire Retirement System June 30, 2011 Valuation, November 8, 2011, at 45. On this point, we recommend that the Board consider 1) whether an increasingly retiree-lopsided System might require a change in investment objectives and a lower rate of return assumption *before* the System becomes retiree-only, and 2) when, in terms of the ratio of active employees to retirees, such

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<sup>2</sup> This raises the question whether the proposed level of funding is "determined by sound actuarial valuation and practice, independent of the executive office," as required under the New Hampshire Constitution Article 36-a ("Article 36-a"). Further, under the proposed legislation, it is unclear whether the service provider selected by the department of administrative services might be responsible for hiring an actuary, a duty currently performed by the Board pursuant to RSA 100-A:14 and 15. The service provider's choice of actuary under LSR 12-2876.1 also could implicate the requirements of Article 36-a.

changes might be necessary. GRS's experience with this dynamic in other public systems might provide some insight here.

**b. Administration and Management of NHRS by an Outside Service Provider.**

RSA 100-A:14 and 15 provide that the Board administers NHRS, and the Board and the Independent Investment Committee manage NHRS's assets. Proposed RSA 100-E:13, II (b) and (c) of LSR 12-2876.1, however, would permit the department of administrative services to allow "qualified entities engaged in retirement and pension plan management" to compete for these duties by submitting RFPs to the department of administrative services. SB 249 requires the department of administrative services to contract with a "suitable professional services organization" for the administration and management of NHRS's operations.<sup>3</sup> SB 249 § 2, I.

Outsourcing administrative and management duties is unusual for a public employee plan and raises some concerns. First, the proposed legislation grants the department of administrative services – an agency under the executive branch – the authority to select the outside service provider that will handle duties that the Board currently performs. Allowing an executive branch agency to decide who administers and manages the trust corpus and under what conditions they are administered and managed could be viewed as shifting control over the System's assets to the executive branch. Executive branch authority over the NHRS's assets could, in turn, create a greater potential than under the current system for the diversion of assets from NHRS for use by the State, which the New Hampshire Supreme Court in *Board of Trustees of the New Hampshire Judicial Retirement Plan v. Secretary of State*, 161 N.H. 49, 55-56 (2010)

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<sup>3</sup> It is unclear whether the "administration and management of the operations of the retirement system" to be performed by a service provider pursuant to SB 249 includes investment management duties.

("Sudan") found violates Article 36-a. A determination that the State could save money on the administration and management of the DC plan by using the same service provider to administer and manage the System, for example, could constitute a diversion of assets from the System for use by the State in violation of Article 36-a. *Id.*

Additionally, the New Hampshire Supreme Court in *New Hampshire Retirement System v. Sununu*, 126 N.H. 104, 109 (1985) recognized NHRS's independence from the executive branch based, in part, on the System's status as a trust. *See* New Hampshire Constitution Article 36-a (NHRS's assets are to be "invested or disbursed as in trust"). Under the common law of trusts, the Court reasoned, the Board "owes the System's members and beneficiaries a fiduciary obligation to manage the System for the benefit of its members and beneficiaries." The executive branch, "[i]n contrast to the duty owed by the [B]oard narrowly to the trust beneficiaries," has "a responsibility to a far broader constituency." *Id.* The Court concluded that involvement by the executive branch in approving the System's personal service contracts would therefore "carry with it the potential for affecting the [B]oard's duty to the trust beneficiaries in a way the legislature did not intend." We believe the same concerns apply to the executive branch's involvement in selecting a service provider to administer and manage NHRS. Notably, the *Sununu* court also recognized the "long-standing administrative interpretation of the System's independence and of the powers and obligations of the board of trustees under RSA chapter 100-A." *Id.* at 110.

Furthermore, pursuant to the New Hampshire Supreme Court's decisions in *Sununu* and *Sudan*, *supra*, the department of administrative services would become a

fiduciary in soliciting and collecting RFP responses concerning the administration and management of the System, and in selecting the service provider.

In addition, neither LSR 12-2876.1 nor SB 249 appears to contemplate the necessity of or any process for fiduciary monitoring of the service provider's performance of NHRS-related administrative and management duties. Moreover, to the extent authority is delegated by the department of administrative services to a service provider, much or all of the delegated authority may require the service provider to accept fiduciary obligations if plan participants are to be adequately protected. Legislative amendments are needed to establish these points regarding the monitoring and performance of the service provider.

Many of our concerns with the private administration and management of the System in fact extend to the DC plan in general. The lack of any provision in LSR 12-2876.1 for monitoring the administration and management of the DC plan is one example. Unless further statutory language governing the DC plan is proffered, the adoption of a formal plan document would likely be necessary to account for omissions in the statutory language such as LSR 12-2876.1's failure to contemplate the need for monitoring of the service provider's performance.

**c. Compliance with the Internal Revenue Code.**

Optional Membership

Except for certain grandfathered plans, a governmental plan is not generally permitted to adopt a 401(k) feature (i.e., a cash or deferred election with respect to contributions, accruals or other benefits). Treas. Reg. section 1.401(k)-1(e)(4)(i). However, a one-time irrevocable election by an employee to participate or not

to participate in the plan is not a cash or deferred election, so long as such election is made when the employee first becomes eligible to participate in a plan of the employer. Treas. Reg. section 1.401(k)-1(a)(3)(v). Accordingly, the portion of LSR 12-2876.1, proposed RSA 100-E:3, that makes membership in the DC Plan "optional in the case of elected officials, unclassified state employees appointed for fixed terms, or full-time employees of the general court" raises concerns. A "one-time irrevocable election" must be made upon an employee's becoming eligible under any plan of the employer. Therefore, an employee who is currently, or was previously, a member of the retirement system would not be eligible to make a one-time irrevocable election to be covered under the proposed defined contribution plan.

Additionally, due to the technicalities of Treas. Reg. § 1.401(k)-1, a subtle distinction in the language of a statute could affect whether the requirements of the regulation are satisfied. For example, if legislation were drafted to allow an employee to refuse state employee benefits *no later than the time an employee first becomes eligible under a plan or arrangement of the employer*, then the election would likely be permissible under the regulation. However, where, as here, the legislation is drafted to allow an employee to refuse state employee benefits without identifying the time frame for such election, the language would not satisfy the regulatory exception under Treas. Reg. § 1.401(k)-1(a)(3)(v). If the System, as a governmental plan, were to implement the legislation as proposed, the plan may risk the loss of its qualified status.

#### Normal Retirement Age

IRS regulations provide that the normal retirement age under a tax-qualified plan must be "reasonably representative of the typical retirement age for the industry in which

the covered workforce is employed." A normal retirement age of age 62 or later is presumed to satisfy the reasonably representative requirement; a normal retirement age between age 55 and age 62 must satisfy the reasonably representative requirement on a facts and circumstances basis; and a normal retirement age of 50 or later for public safety employees is presumed to satisfy the reasonably representative requirement. Treas. Reg. section 1.401(a)-1(b)(2). These rules are scheduled to be effective for governmental plans for plan years beginning on or after January 1, 2013.<sup>4</sup>

The retirement ages (age 60 for Group I and age 50 for Group II) provided in the language of LSR 12-2876.1 creating RSA 100-E:12 might be problematic. For Group I, the proposed language is outside the language of the safe harbor, which covers members age 62 years and older. The proposed language for Group II would meet the safe harbor of age 50 for public safety employees. Although there is some concern as to whether the proposed normal retirement age for Group I will meet IRS requirements, this issue could be resolved by upcoming IRS guidance on permissible normal retirement ages for governmental plans. This potential issue may need to be addressed at a later date.

#### Voluntary Contributions

The scope of the language in LSR 12-2876.1 creating RSA 100-E:4 regarding additional voluntary member contributions is unclear. We suggest seeking clarification on whether the language is intended to cover members of the defined benefit plan, or only members of the proposed defined contribution plan.

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<sup>4</sup> The effective date for governmental plans was delayed by the IRS. See IRS Notice 2007-69 (Aug. 10, 2007) (providing initial transition relief); IRS Notice 2008-98 (Oct. 10, 2008) (providing transition relief until plan years beginning on or after January 1, 2011); IRS Notice 2009-46 (Oct. 28, 2009) (providing transition relief until plan years beginning on or after January 1, 2013).

### Pick-Up Contributions

A contribution to a qualified plan established by a State government will not be treated as picked up by the employer under Code section 414(h)(2) unless formal action is taken to specify that the contributions, although designated as employee contributions, are being paid by the employer. A person duly authorized to take such action with respect to the employer must take such action (e.g., in meeting minutes, a resolution, or an ordinance). IRS Rev. Rul. 2006-43 (Aug. 28, 2006).

The language of proposed RSA 100-E:1 of LSR 12-2876.1 provides for contributions to be picked up under Code section 414(h). However, to comply with IRS requirements, employers must take formal action to authorize the pick-up of the member contributions. If the State does not have the authority to make such an election on behalf of participating employers, further action must be taken by the employers to satisfy the IRS requirements.

#### **d. General.**

Under RSA 100-E:9, IV, as provided in LSR 12-2876.1, the conversion to a "life annuity contract" is ambiguous and unclear. As drafted, we believe this term could be interpreted either as a stream of payments (1) from NHRS or (2) from an insurance company annuity. Given that the former scenario involves administration on the part of NHRS, we recommend that the System seek legislative clarification of this provision.

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We look forward to discussing these concerns with you at next week's Board meeting.



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February 1, 2012

George Lagos, Executive Director  
New Hampshire Retirement System  
54 Regional Drive  
Concord, New Hampshire 03301-8507

Dear George,

You have requested that we comment on the conclusions reached by the New Hampshire Retirement System and its actuaries regarding the financial reporting implications (under U.S. GAAP in effect currently) of the proposed changes described in SB 229 as introduced (the Proposal). We understand that under the Proposal, beginning on November 1, 2012, all new hires by employers participating in the System would be enrolled in a new public employee defined contribution plan (rather than System's current defined benefit plan). Members of the System up to that date would remain in the defined benefit plan, and participating employers would continue to fund their benefits using payroll of members of *both* the defined benefit plan and the defined contribution plan. At issue is whether, upon adoption of the Proposal, a level amortization of payroll approach can be applied to this collective "open group" – consisting of the covered payroll of both plans – to determine the "annual required contribution" (ARC, a term defined under GAAP) of the System's defined benefit plan.

The System's existing defined benefit plan and the proposed defined contribution plan would be separate plans with different employees and, accordingly, separate covered payrolls. Therefore, although under the Proposal annual contributions toward the unfunded actuarial accrued liability would be made on the aforementioned open-group basis, the System's actuaries have concluded, and we concur, that existing GAAP precludes amortizing the liability through a level percentage of payroll approach to determine the ARC. To calculate the ARC, the actuaries have further determined, and we agree, that the System will need to use a level-dollar method of amortization (or another method that reflects the declining payroll of the closed active population of the System's defined benefit plan).

We also agree with the actuaries, as identified in their November 29, 2011 supplemental valuation letter, that if future *actual* contributions (based on level percentage of payroll amortization) are less than the calculated ARC, under GAAP the System would need to report the shortfall in contributions.

I would be happy to discuss the Proposal and the information discussed above further. Please do not hesitate to contact me if you have further questions.

Sincerely,

David R. Gagnon  
*Partner*

cc: David T. Kausch, Gabriel Roeder Smith & Company  
Gregory Driscoll, KPMG LLP