State Pension Funding and Models for Success

New Mexico Investments & Pensions Oversight Committee
October 1, 2024

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The Pew Charitable Trusts
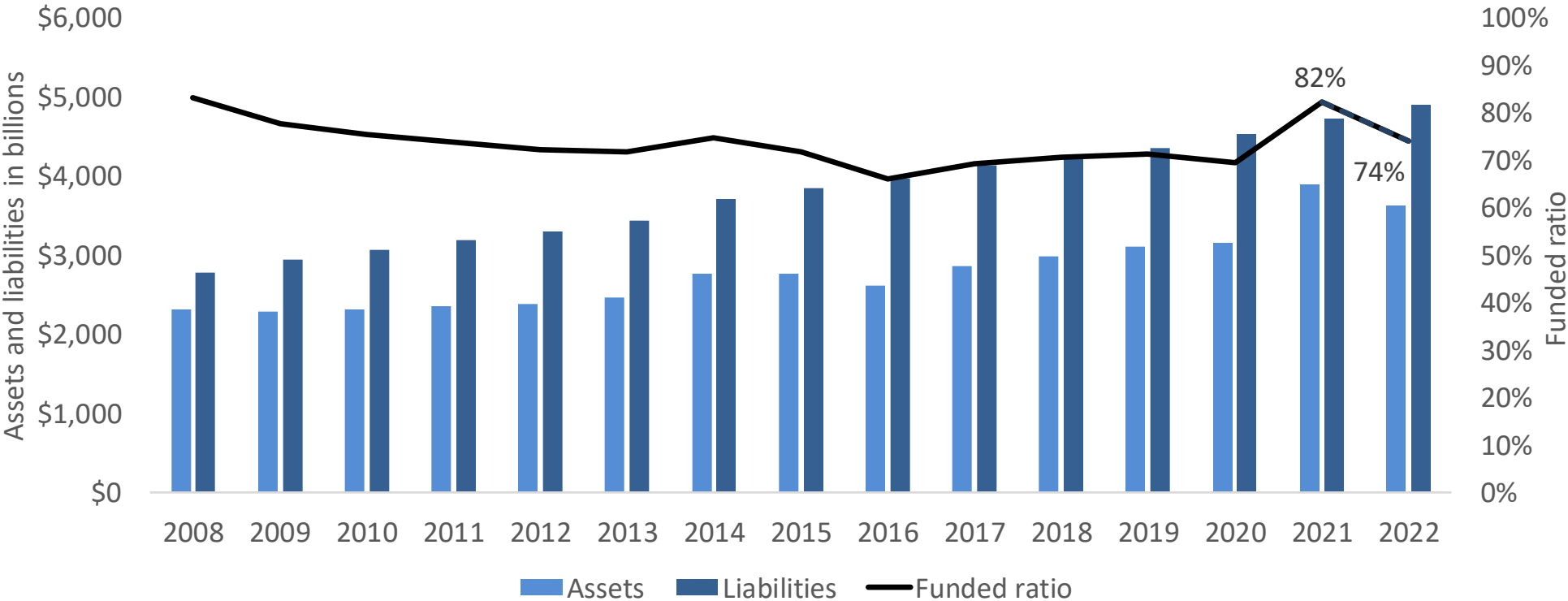State Fiscal Policy Project

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Overview

- **Best practices and model approaches to pension policy**

- **Considerations for pension sustainability**

- **Using stress testing to assess pension policy**

- **Use of variable COLAs**

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Best Practices and Model Approaches to Pension Policy

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Pension Plan Assets And Liabilities Over Time
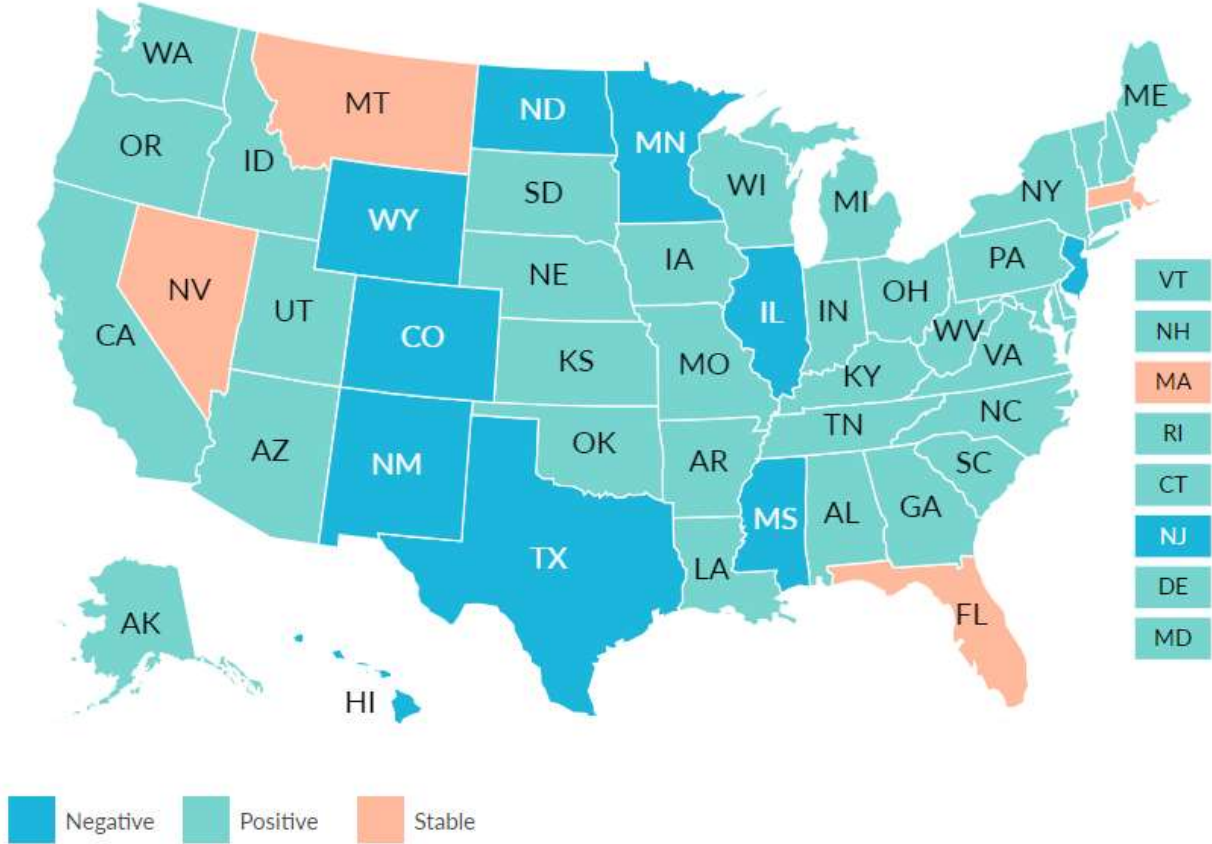
Windfall investment returns pushed the funded ratio above 80% in 2021, but subsequent losses have erased those gains.
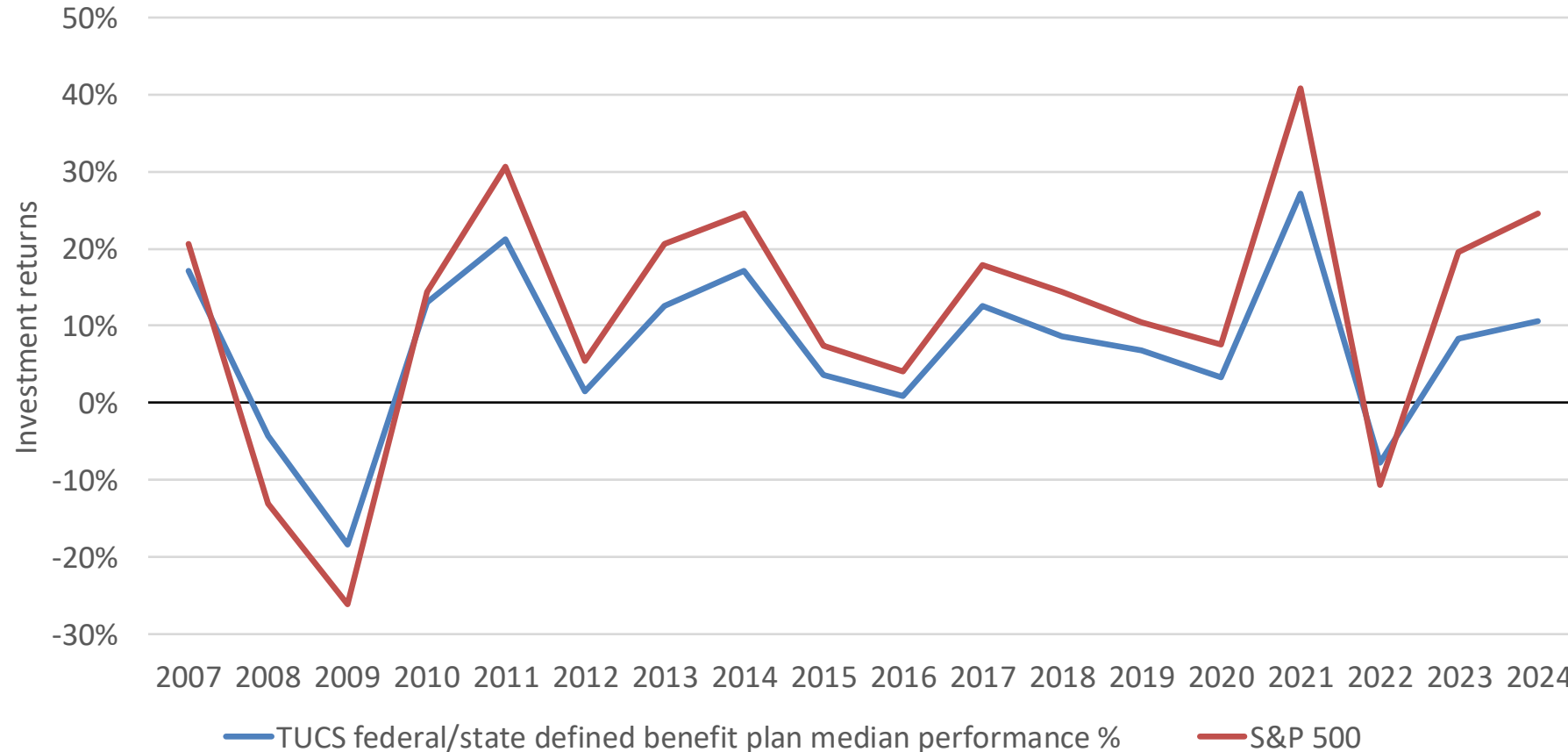
Most States Meeting Contribution Benchmarks

Forty states had positive or stable amortization from 2018-2022.

Source: Pew calculations based on state annual financial reports, pension plan financial reports, and plan actuarial valuations

# Pension Plan Investments Track Stock Performance

The typical pension plan's investments follow the ups and downs of equity markets.

Legend: TUCS federal/state defined benefit plan median performance % — S&P 500

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Good Policy Can Make A Difference

Well-funded states with tools to manage risk can keep costs stable over time.
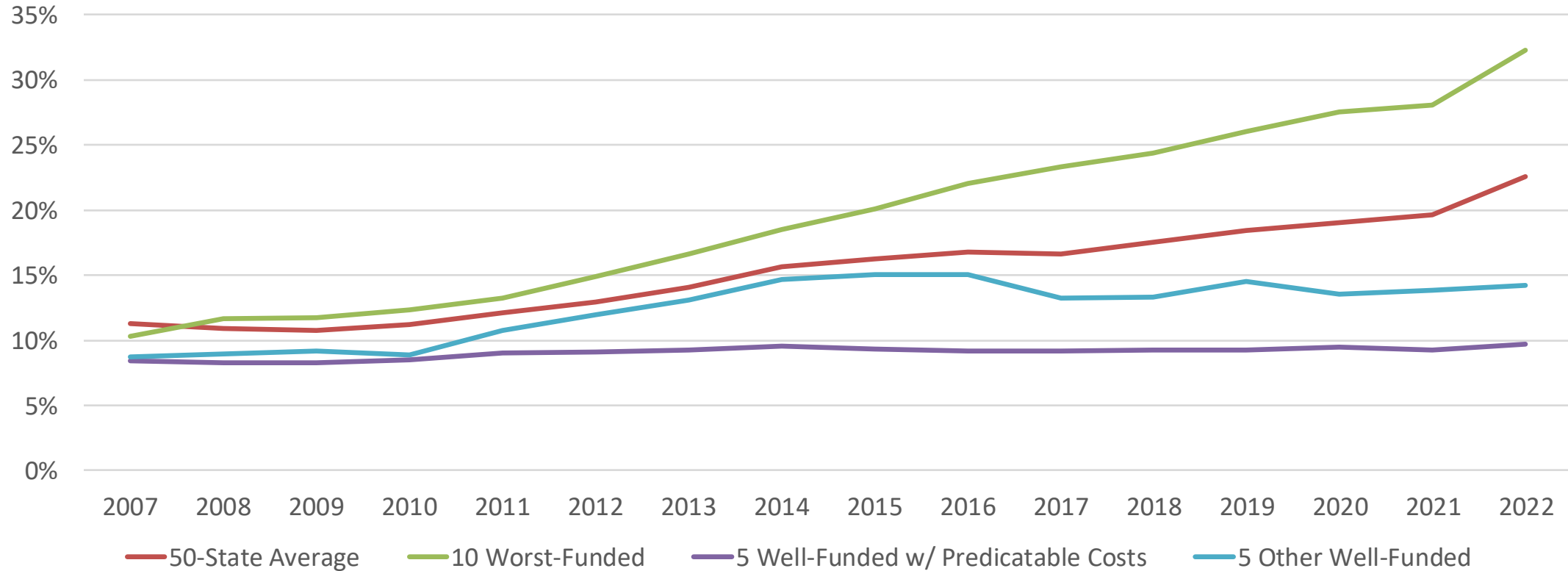

Well-funded states with stable costs include Idaho, Nebraska, South Dakota, Tennessee, and Wisconsin. Other well-funded states includes Delaware, Iowa, New York, Utah, and Washington. The 10 worst funded states as of 2022 were Alabama, Connecticut, Illinois, Kentucky, Mississippi, New Jersey, North Dakota, Pennsylvania, Rhode Island, and South Carolina.

Spotlight on Retirement Systems in Three States

Different policies, but all three are well-funded with stable costs and strong outcomes for retirement security
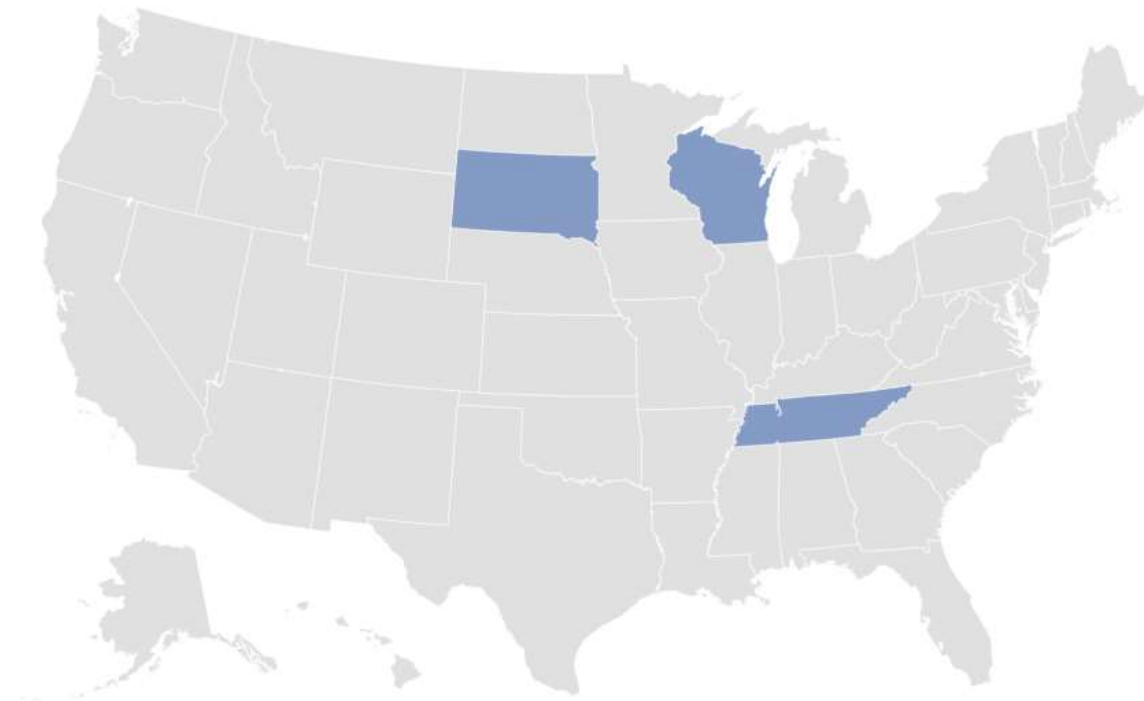
- **Wisconsin Retirement System—** Shared risk design

- **South Dakota Retirement System—**Adjustable benefits

- **Tennessee Consolidated Retirement System—** Risk-managed hybrid

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Practices of Model Retirement Systems

Provide a Path to Retirement Security
They offer benefits that provide a path to retirement security across the workforce.

Maintain Fiscal Sustainability
They fund their pension obligations sustainably in a way that's predictable and affordable for government budgets.

Plan for Uncertainty
They employ risk assessment and management policies that provide a plan for economic and demographic uncertainty.
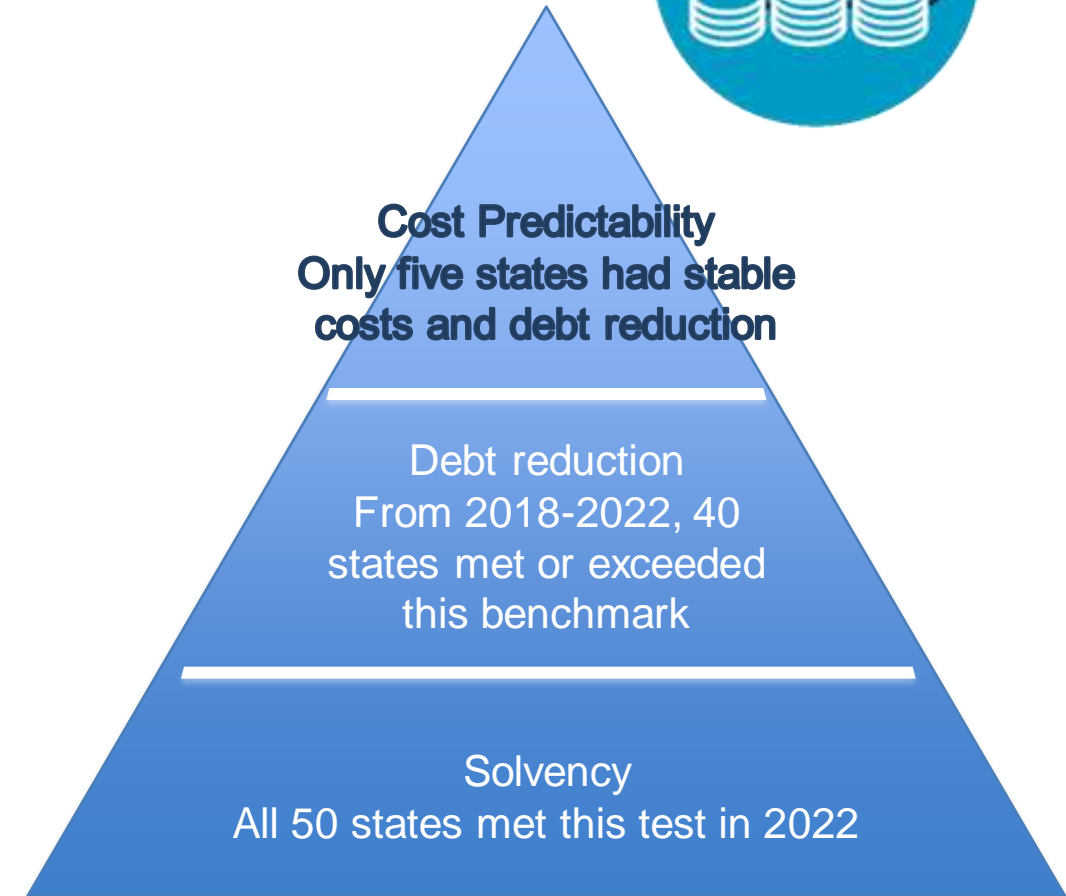
Ensure Investment Transparency
They ensure that benefit, funding, and investment policies, their implementation, and their performance are fully transparent to all stakeholders.

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Considerations for Pension Sustainability
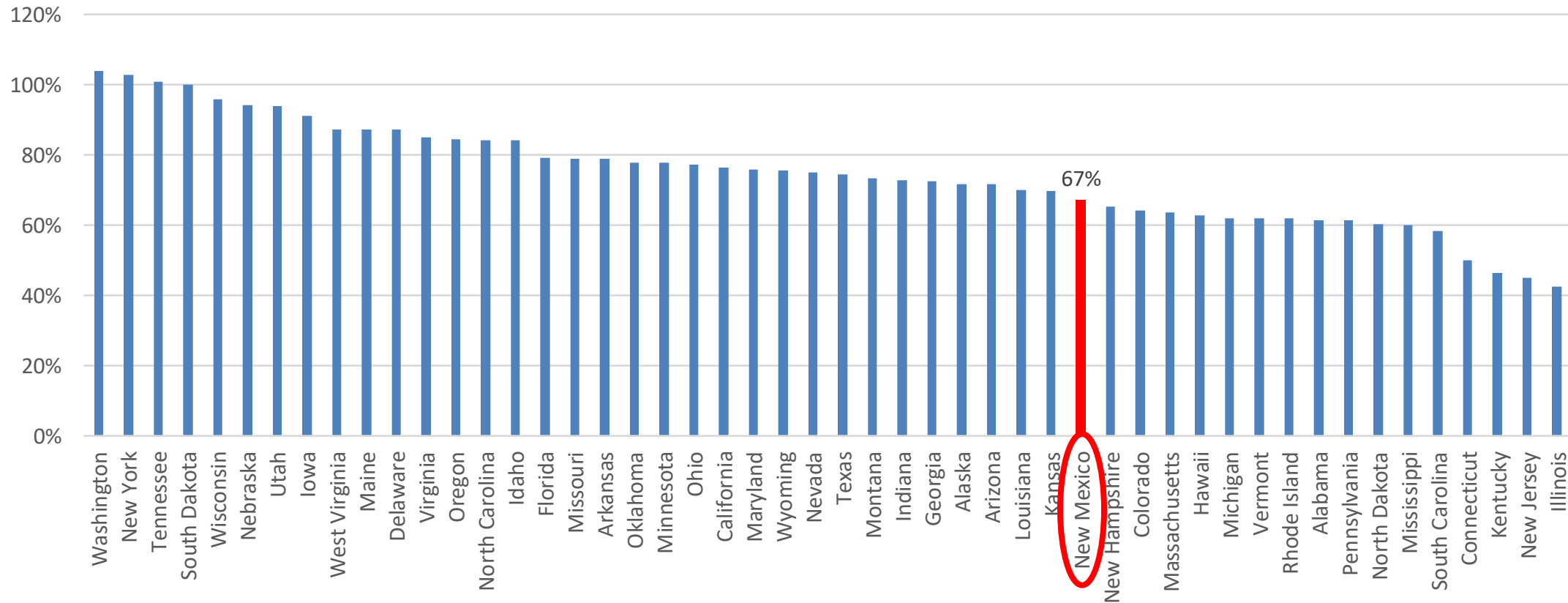
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How Do We Measure Fiscal Sustainability?

Pew assesses whether pension systems meet fund sustainability by evaluating plans' risk of **insolvency**, sufficiency of current contribution levels to **reduce pension debt**, and **predictability of costs** given various fiscal conditions, including whether investment returns fall short of expectations or whether other demographic or economic problems arise.

Cost Predictability
Only five states had stable costs and debt reduction

Debt reduction
From 2018-2022, 40 states met or exceeded this benchmark

Solvency
All 50 states met this test in 2022

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New Mexico's Funding Remains Below Average

Funded ratios for states' pension plans in 2022

New Mexico's Funding Over Time

Change in Funded Ratio for Select States from 2003 to 2022
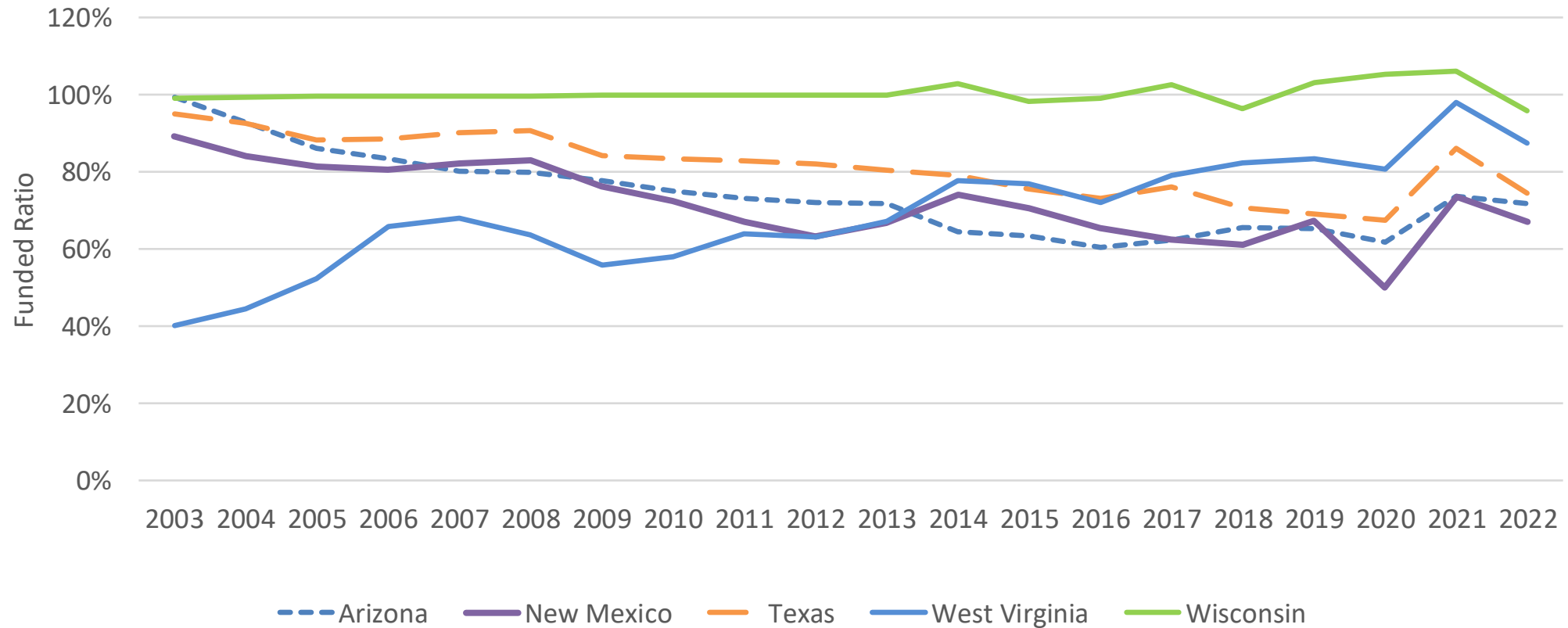
New Mexico Change in Unfunded Liability

Unfunded liabilities increased by $5 billion from 2014 through 2022, driven by $4 billion in negative amortization
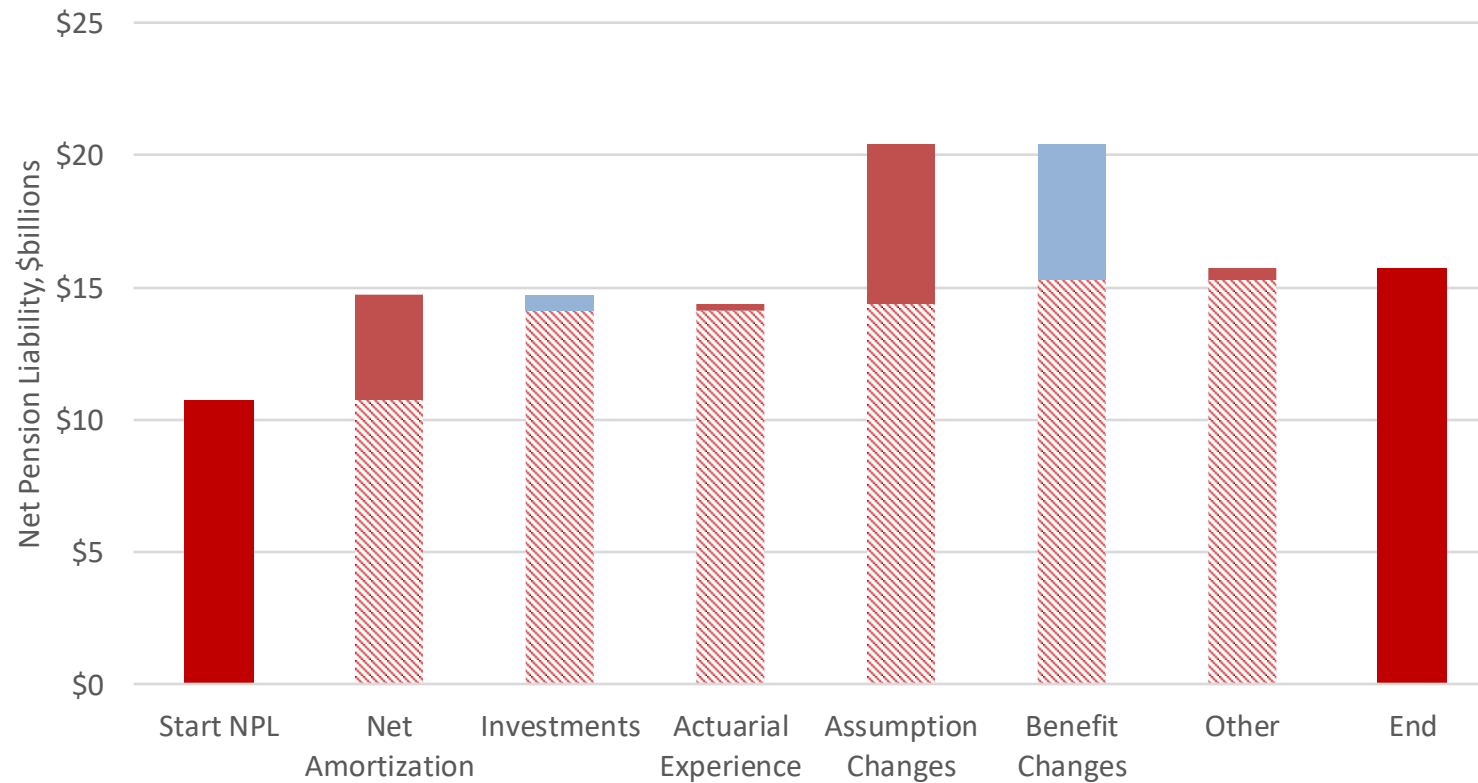
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Using Stress Testing to Assess Pension Policy

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State Risk Reporting Practices Vary

25 states conduct forward-looking assessments of investment plan risk on pension funding and contributions.

Legend: ■ Statutory requirement ■ Formal policy ■ Included in actuarial valuation
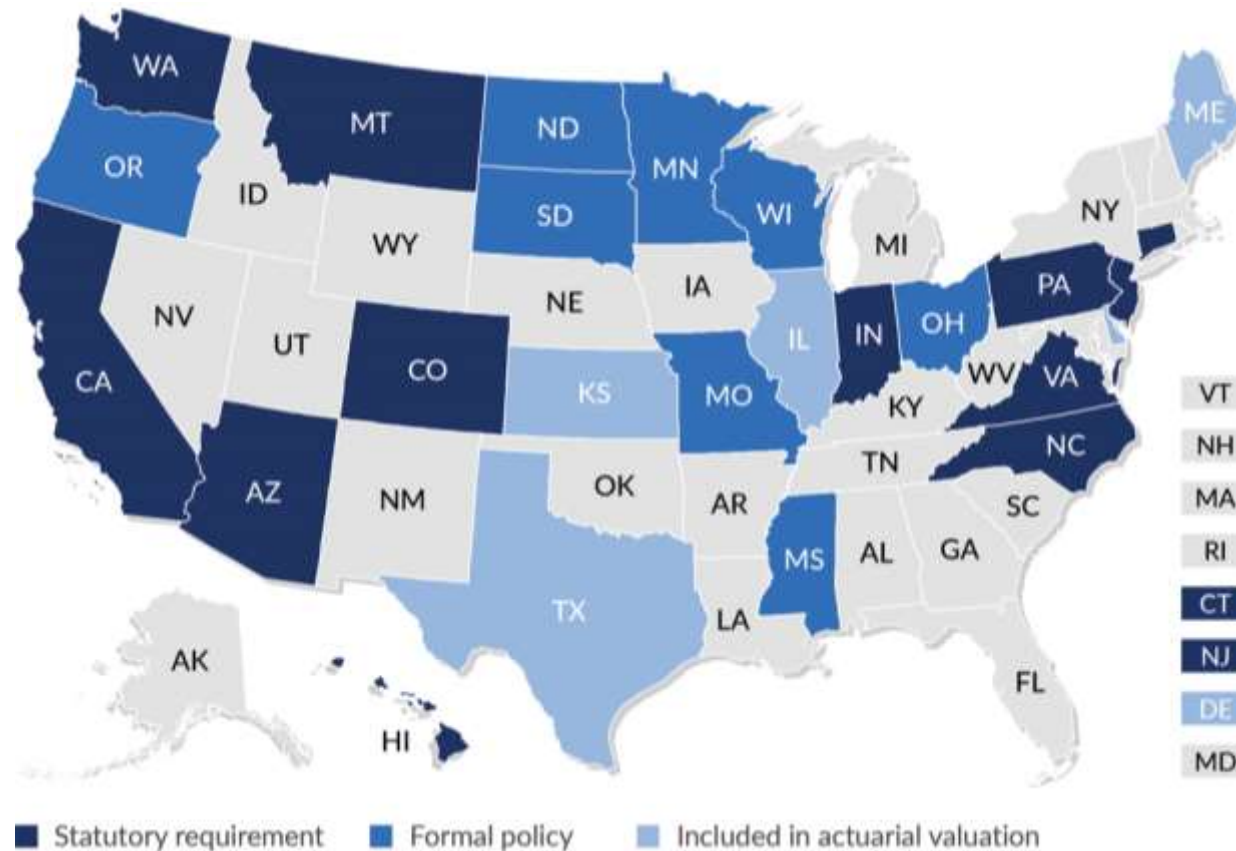
DB Plan Design Still Most Common for State Workers
States have a variety of options to manage risk.

DB
DC
DB w Risk Share
Hybrid
Cash Balance

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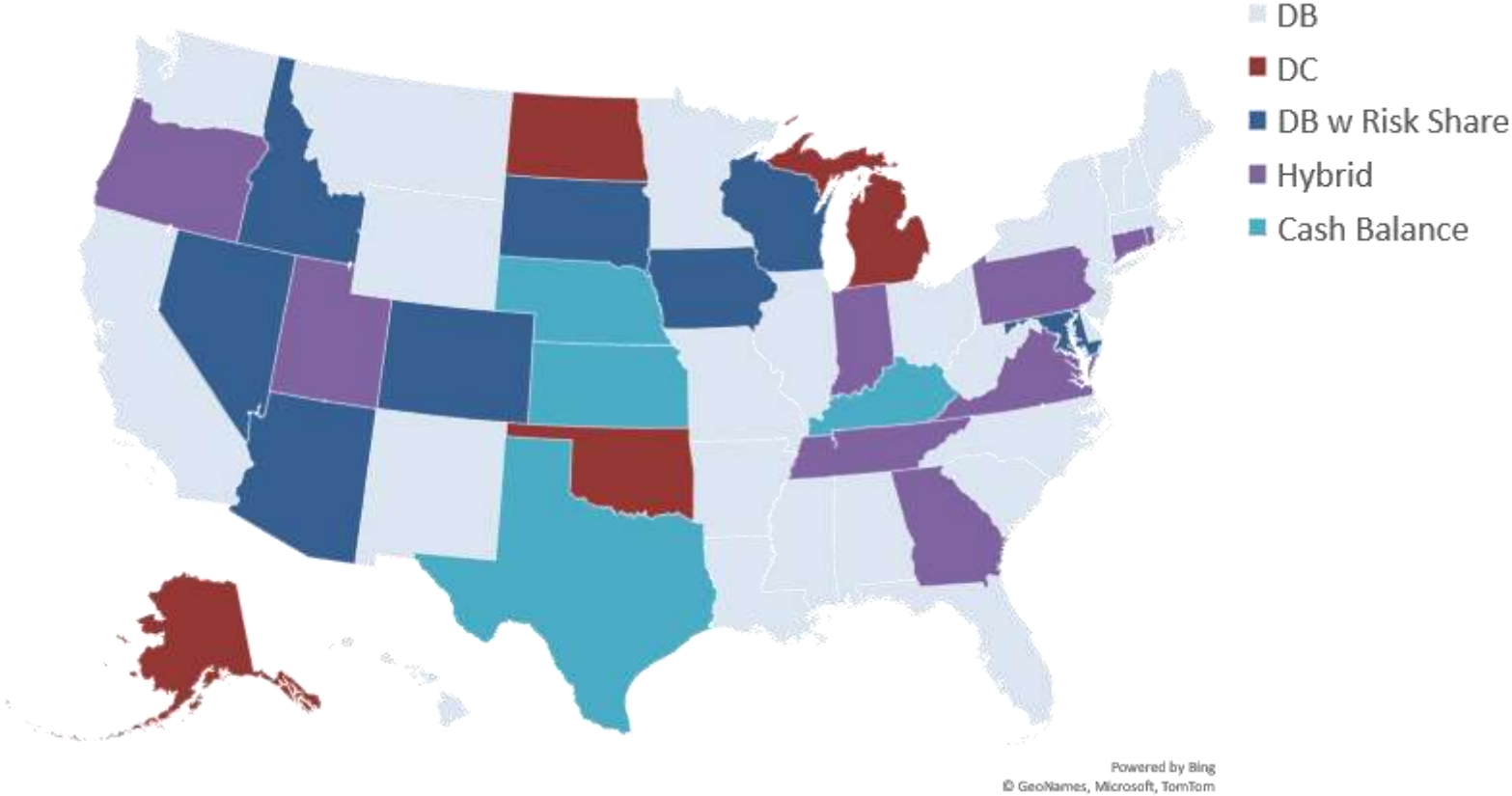
NM PERA Funded Projections and Risk Assessment

PERA's 2023 Sustainability and Solvency Analysis showed an example stress test analysis. Based on these results, there is a 1 in 4 chance that the funded ratio would be less than 35% by 2052 and a 7% chance of insolvency.

Because PERA receives a statutory fixed contribution, there isn't a need for an analysis of contribution volatility under current policy.


Projected Funded Ratio
Stochastic Projection by Percentile Rank

39% chance that PERA is fully funded after 30 years

7% chance that PERA fund is depleted after 30 years

25% ⸺ 50% ⸺ 75%
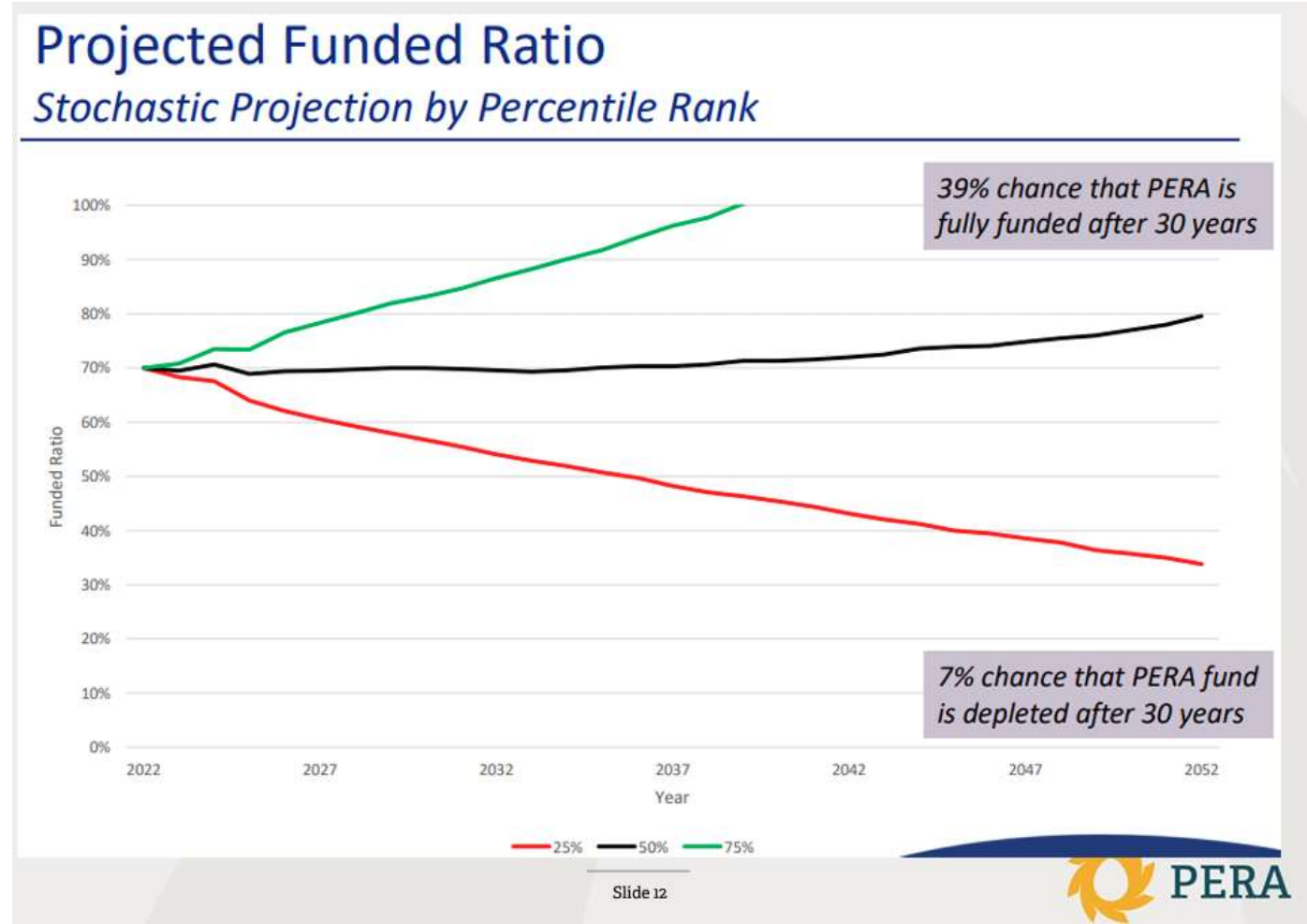
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Examples of COLA Policies

Wisconsin—Shared Risk Policy

- Wisconsin follows a shared-risk defined benefit funding model.

- Liabilities are actuarially funded, with contributions split between employer and employee.

- Retiree COLAs are adjusted to ensure that the assets set aside to pay for retiree benefits will match the cost of those liabilities.

- COLAs can be suspended or reduced per that risk-sharing policy, but Wisconsin retirees also received benefit adjustments of 5.1% and 7.4% in 2020 and 2021.

— Contribution Rate — Contribution Benchmark


■ Assets ■ Liabilities

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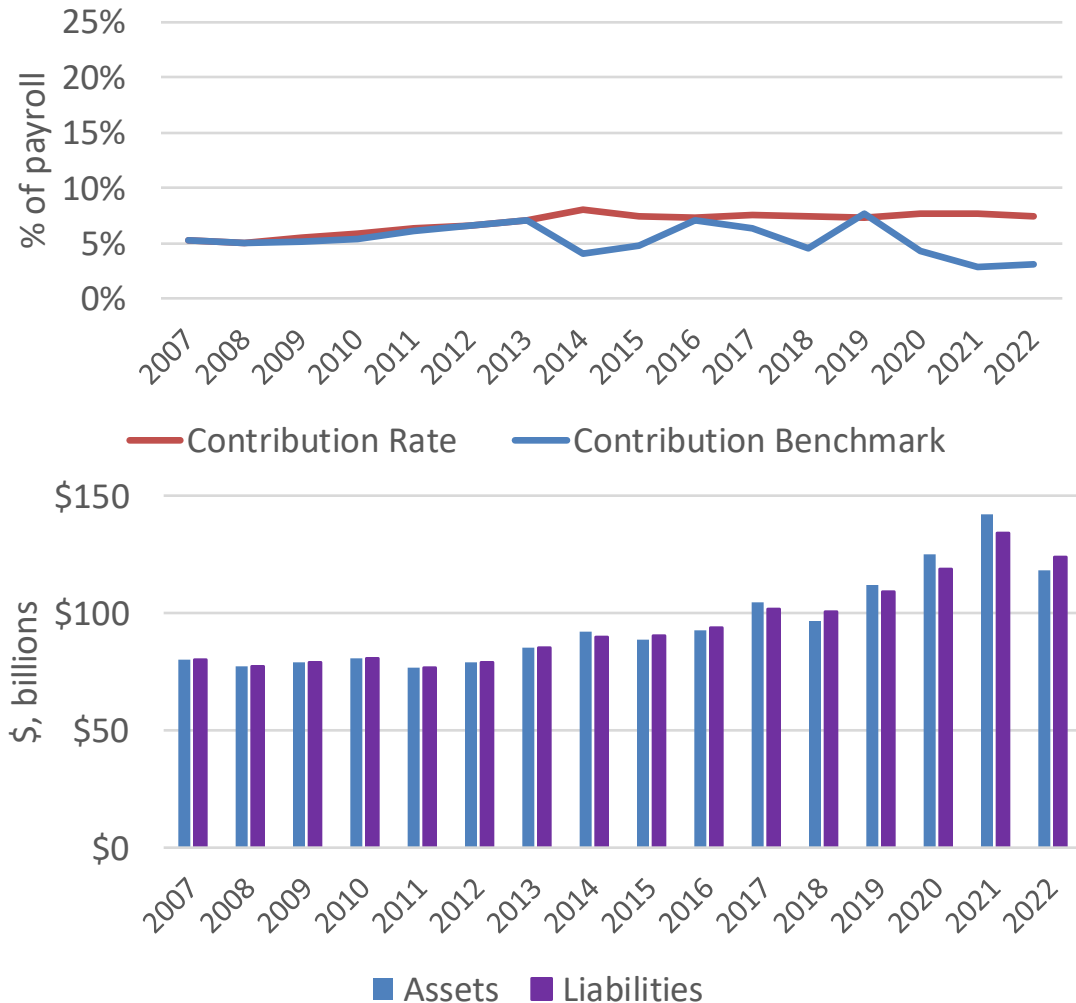
South Dakota—Adjustable COLA

- Final average salary defined benefit with 1.8% multiplier.

- Fixed contribution policy with adjustable benefits.

- The maximum allowable COLA is adjusted annually to ensure the statutory contribution rate is actuarially sufficient.

  - Maximum COLA can be no higher than 3.5% and no lower than 0%
  - As of 2023 valuation, maximum allowable COLA is 1.9%.
  - COLAs accrue at separation, not at retirement, helping protect non-career workers from inflation.

% of payroll

— Contribution Rate   — Contribution Benchmark


$, billions

■ Assets ■ Liabilities
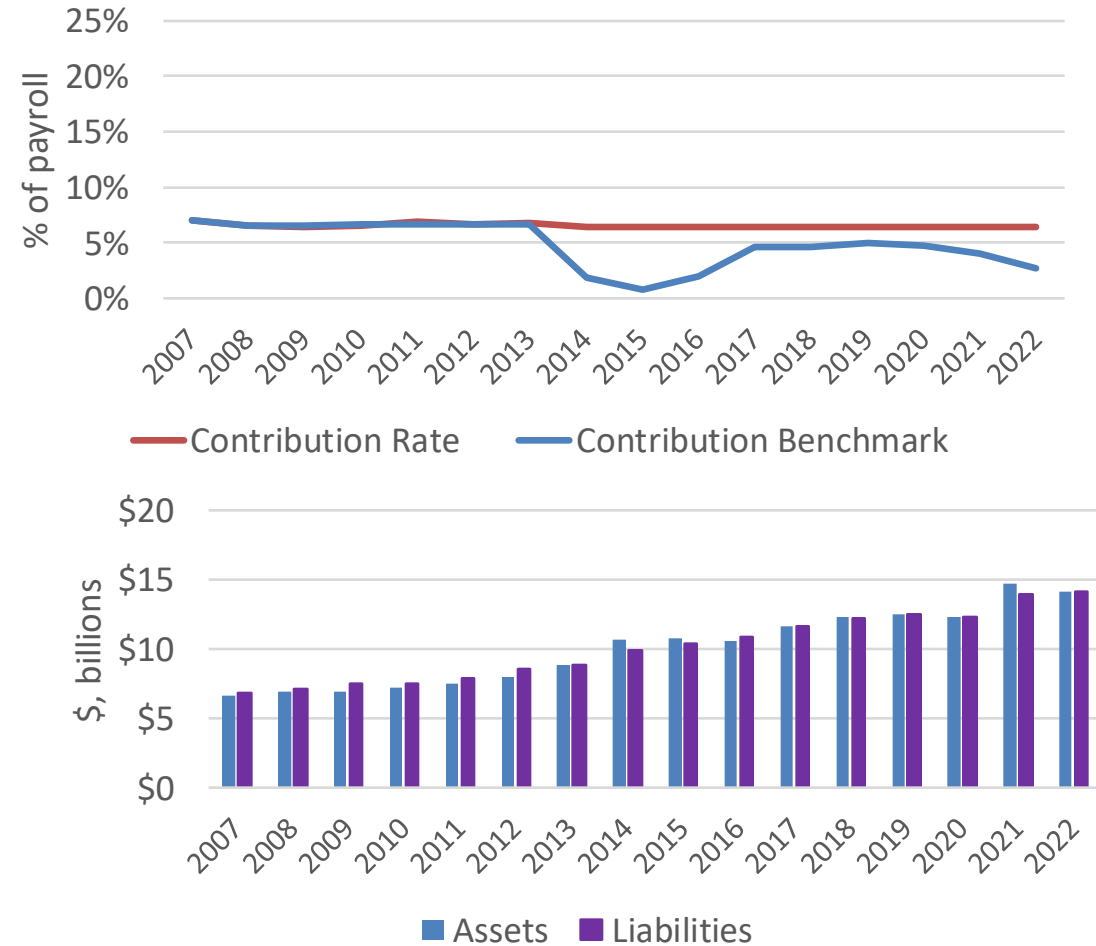
Colorado—Reacting to Stress Test Findings

- Colorado faced declining funded ratios and a stress test that showed a 1 in 4 chance of insolvency due to an insufficient fixed contribution policy.

- Lead to changes with shared sacrifice through higher employer and employee contributions and a lower COLA.

- If those changes prove insufficient, the policy will automatically adjust through additional increases in contribution rates and a further COLA reduction.

- The state mandated regular stress testing due to its value as an early warning signal of pension unsustainability.
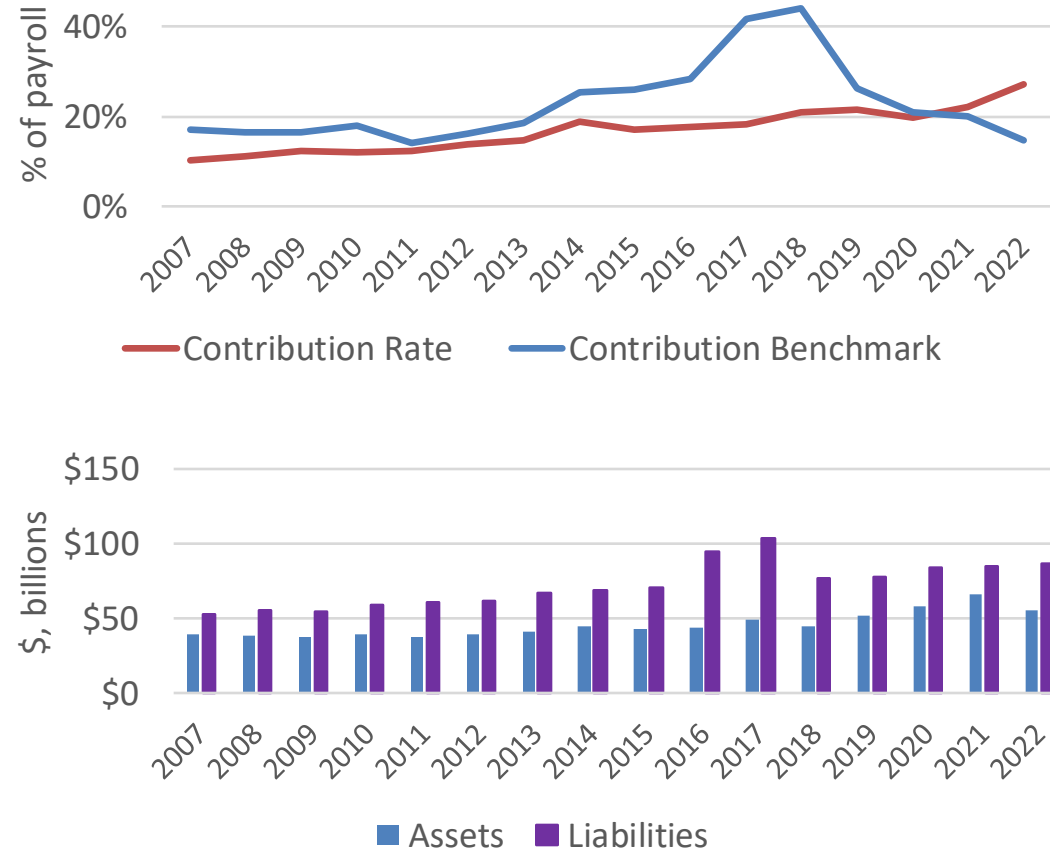
Rhode Island—Addressing Past Underfunding

- In 2011, the state made significant changes to current and future employee benefits as well as to retiree COLAs.

- The COLAs were both reduced by three-quarters until funding hit 80% and the COLA formula was changed to respond to investment returns.

- Other changes included a hybrid pension design and a later retirement age.

- Given high inflation and an improved funding situation, Rhode Island undid the COLA reduction for pre-2012 retirees but retained the risk-sharing COLA formula.
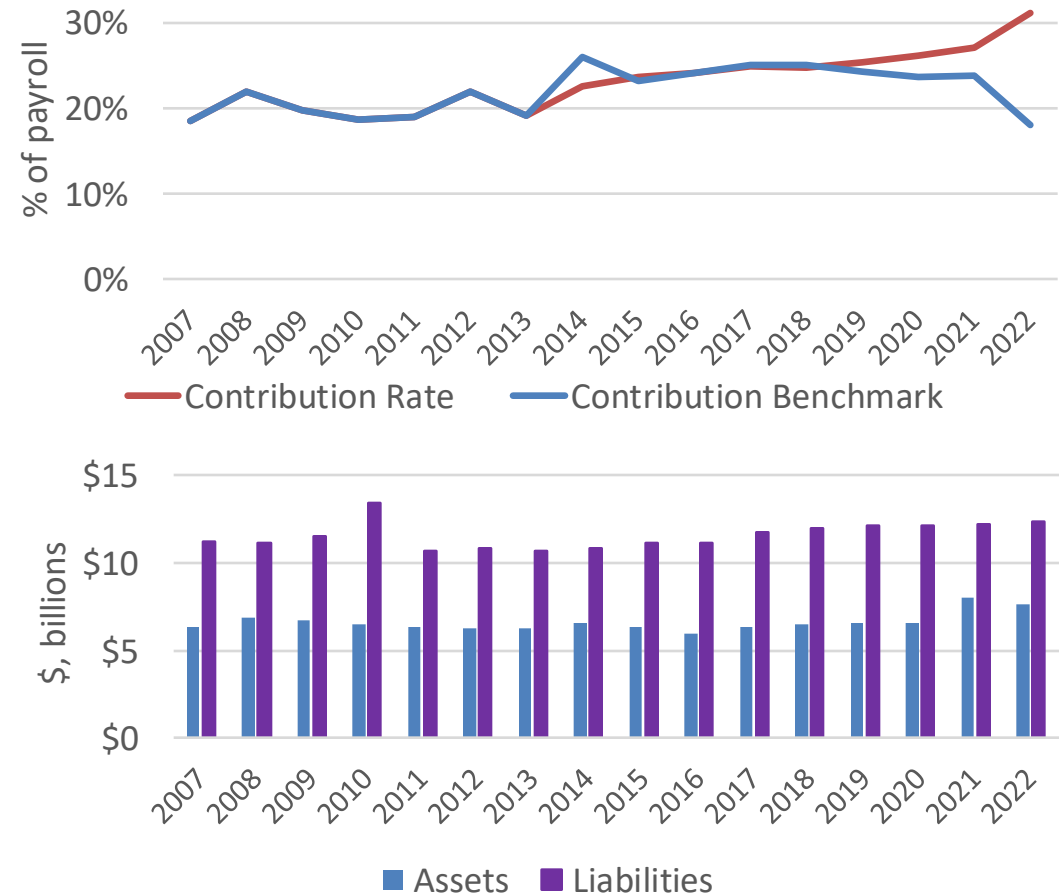
Key Takeaways

- Most states have stabilized their pension funding by 2022 though investment volatility remains a challenges and maintaining fiscal discipline will be required.

- Successful states like South Dakota, Tennessee, and Wisconsin offer examples of how good policy can maintain high funding levels, keep contributions stable, and offer a substantial benefit.

- No-one-size-fits-all as there are multiple effective approaches to learn from.

- Shortfalls between actual contributions and the contribution benchmarks needed to stabilize the funding gap has been a challenge for New Mexico.

- Stress testing is a useful tool to assess current policies and alternative approaches and has been applied in New Mexico.

- Variable COLAs are part of the toolkit of a number of states, including New Mexico, for the purpose of managing uncertainty and sharing gains.

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For more information:

https://www.pewtrusts.org/en/projects/public-sector-retirement-systems

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