STATE OF NEW MEXICO

INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

Funding and Rating Considerations Regarding State Pension Obligations

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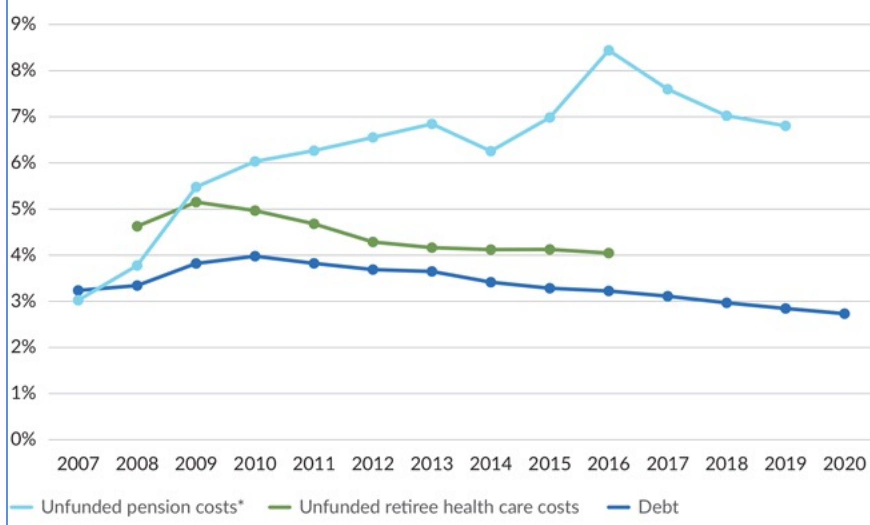
Historical Context

- Twenty-five years ago, in the wake of the stock market boom of the late 1980s and 1990s, public pension plans were in good shape, and most state plans – like New Mexico's – were fully funded. As of June 30, 2000, the funded ratios (System Assets/System Liabilities) of PERA and ERB were 106% and 92%, respectively.[1]

- By 2010, according to a study by Barclay's, state pension funds on average were just over 60%, as unfunded liabilities became the norm rather than the exception for public pension funds.

- As unfunded liabilities became the norm, they have increasingly come to be considered as long-term liabilities of the sponsoring governments, in the same manner as a community's general obligation bonds.

- While pension obligations have always been considered as state debts, they have emerged as significant challenges since the 2008 financial crisis, as state unfunded pension liabilities now collectively exceed $1 trillion.[2]



*Standards for reporting unfunded pension liabilities by states changed in fiscal year 2014.

Source: Pew's analysis based on data from the U.S. Bureau of Economic Analysis and pension and retiree health care data collected from state comprehensive annual financial reports and retirement plan actuarial valuations. Debt data is from Moody's Investor Services (© Copyright 2022 Moody's Analytics Inc. and/or its licensors and affiliates. All rights reserved.)

1) State of New Mexico General Obligation Bonds, Series 2001 official statement
2) https://www.pewtrusts.org/en/research-and-analysis/articles/2022/07/07/states-unfunded-pension-liabilities-persist-as-major-long-term-challenge

Unfunded Pension Obligations Now Integrated Into Credit Analysis

State	Issuer Rating	NTSD + ANPL + ANOL + other long-term liabilities as % of own-source revenue
Illinois	Baa1	676.7%
Connecticut	Aa3	602.1%
New Jersey	A2	583.2%
Hawaii	Aa2	500.3%
Kentucky	Aa3	401.9%
Massachusetts	Aa1	377.6%
Maryland	Aaa	323.1%
Delaware	Aaa	274.0%
Maine	Aa2	271.2%
Pennsylvania	Aa3	270.0%
Texas	Aaa	265.6%
South Carolina	Aaa	264.5%
Vermont	Aa1	251.0%
Montana	Aa1	235.4%
California*	Aa2	234.4%
West Virginia	Aa2	232.0%
Louisiana	Aa2	216.0%
Rhode Island	Aa2	214.3%
Nevada	Aa1	211.0%
Alaska	Aa3	201.2%
Kansas	Aa2	199.8%
Michigan	Aa1	185.0%
Washington	Aaa	181.6%
Missouri	Aaa	160.5%
Mississippi	Aa2	156.5%
New York	Aa1	153.6%
New Hampshire	Aa1	146.1%
Oregon	Aa1	137.8%
Colorado	Aa1	129.0%
Arkansas	Aa1	117.7%
Ohio	Aa1	110.7%
Alabama	Aa1	104.0%
Florida	Aaa	103.1%
Georgia	Aaa	93.7%
Wisconsin	Aa1	93.6%
Indiana	Aaa	91.9%
New Mexico	*Aa2*	*90.7%*
Arizona*	Aa1	90.6%
Virginia	Aaa	90.1%
North Carolina	Aaa	79.3%
South Dakota	Aaa	75.1%
Minnesota	Aaa	74.1%
Utah	Aaa	66.0%
Oklahoma	Aa2	63.2%
Iowa	Aaa	57.9%
Nebraska	Aa1	57.7%
Idaho	Aaa	56.8%
Tennessee	Aaa	55.3%
Wyoming	NR	54.6%
North Dakota	Aa1	32.2%
Median		**155.0%**

NTSD stands for net tax-supported debt. ANPL stands for adjusted net pension liability. ANOL stands for adjusted net OPEB liability. NR stands for no rating.
*NTSD, ANPL, ANOL and other long-term liabilities reflect fiscal 2020 figures because fiscal 2021 audited financial statements were not available as of the publication of this report. *Sources: State and pension plan audited financial statements and Moody's Investors Service*

- The funding of public pension liabilities is among the most difficult challenges facing governments today.
- As defined benefit pension plans embodied in labor agreements evolved over time, governments took on greater investment risk as they increased benefit payouts.
- When pension fund investment returns fell short of the actuarial earnings target, new liabilities were created, bypassing what in many states are long-standing rules constraining the creation of new debt.
- As unfunded pension liabilities come to far exceed publicly sold bonds on state balance sheets, the rating agencies have expanded their credit assessments to consider unfunded defined benefit pensions as well as Other Post-Employment Benefits are an integral part of municipal credit analysis.
- GASB 67 balance sheet treatment of market value of unfunded liabilities vs. actuarial practice of five-year smoothing of asset values can provide starkly different view of pension funding status.

Moody's and S&P Pension Analysis and Metrics Have Evolved

- Moody's focus has changed its primary focus from funded status to pension system discount rates:
  - *Conceptual approach:* What is value of system assets today, and what would it cost to buy an annuity at real market rate to fund future obligations.
  - *Adjustment of measurement of accrued liabilities:* To reflect the uncertainty of investment returns, accrued liabilities are recalculated using a discount rate that reflects the yield on high-grade corporate bonds.
  - *Elimination of asset-smoothing:* As with GASB 67, the reported fair value of assets as of the reporting date is used, rather than an actuarial, multi-year smoothed value.
  - *Focus on "tread water" assessment:* The ultimate assessment is whether based on its own terms, a pension system is making progress or losing ground toward paying down its unfunded liabilities.
- S&P focus remains on funded status, and community commitment to meet its obligations:
  - *"We review state pension liabilities and trends related to funding progress. This analysis focuses on the principal state pension plans and includes changes in assets and liabilities, funded ratios, funding discipline, and unfunded pension liability."*[1]
  - A state's commitment to funding annual contributions that address the long-term pension liability is a key credit consideration.
  - Assessment focuses on (i) three-year average of pension funded ratio, and (ii) pension funding discipline.
  - Pension liabilities not yet included in tax-supported debt ratios due to variation in how the liabilities are calculated, but are assessed relative to population and personal income to facilitate comparisons across states.

1) S&P Global Ratings. U.S. State Ratings Methodology

Cost and Risk Profile of State Pension Obligations Over Time

- Retirement obligations have outstripped debt as long-term source of cost, unpredictability and credit risk.

	Pensions	OPEB	Debt service
Degree of predictability	LOW Demographic shifts, assumption changes, pension asset and investment return volatility cause unpredictability	LOW Aging population, healthcare cost inflation and the typical pay-go nature of OPEBs cause unpredictability	HIGH Future debt payments established at the time of issuance give high predictability; risky debt structures are an uncommon exception
Likelihood to increase over time	HIGH Pension amortization schedules are back-loaded in nature and costs often projected to grow over time even if all assumptions are achieved	HIGH Healthcare cost inflation is generally anticipated to grow at 4%-5% annually over the forseeable future, directly impacting OPEB contributions	LOW In general, total debt service costs are expected to remain level, the case over the last decade; though costs could increase via rising intrest rates
Legal ability to modify	MIXED Legal flexibility to reform pension benefits varies greatly across states; nonetheless, material pension reductions may be politically difficult	MIXED Legal flexibility to reform OPEBs varies greatly across states; nonetheless, material OPEBs reductions may be politically difficult	MIXED Some ability to stretch out debt service schedules through refundings; unable to reduce outstanding debt burdens absent bankruptcy or out-of-court restructuring
Credit impact	HIGH Reliance on actuarial assumptions coupled with already high unfunded liabilities can lead to higher contributions and therefore stress budgets	MIXED Although OPEB burdens and costs are nominal for most governments, volatility of costs and growing liabilities can stress budgets	LOW Absent a material ramp-up in debt issuance and/or risky debt structures, government debt profiles remain stable and predictable

OPEB stands for other post-employment benefits, primarily retiree healthcare.
Source: Moody's Investors Service

Credit Analysts Recognize Positive State Steps in Pension Funding

- Four years ago, Moody's summed up its pension-related concerns as follows:[1]

  "The credit quality of the State of New Mexico (Aa2 stable) is challenged by its extremely large pension liabilities, including both its direct obligation to the Public Employees' Retirement System (PERA) and its indirect obligation to the Educational Employees' Retirement System (EERS). The state provides K-12 school districts with essentially 100% of their operating funding. The need to assist districts in addressing their EERS pension liabilities represents a significant financial pressure for the state."

- In contrast, in its September 12, 2022 New Mexico General Obligation Bond credit report Moody's recognized the State's progress in pension funding, and the importance of Senate Bill 72 in 2020 and Senate Bill 36 in 2022:

  "The State of New Mexico (Aa2 stable) benefits from strong fiscal governance, proactive pension management and the rebuilding of reserves with growth in oil- and gas-related revenues… New Mexico's leverage (total debt, pension, OPEB and other long-term liabilities) will continue to be manageable, supported by the state's proactive approach to addressing pension liabilities, which represent the largest share of the state's long-term liabilities."

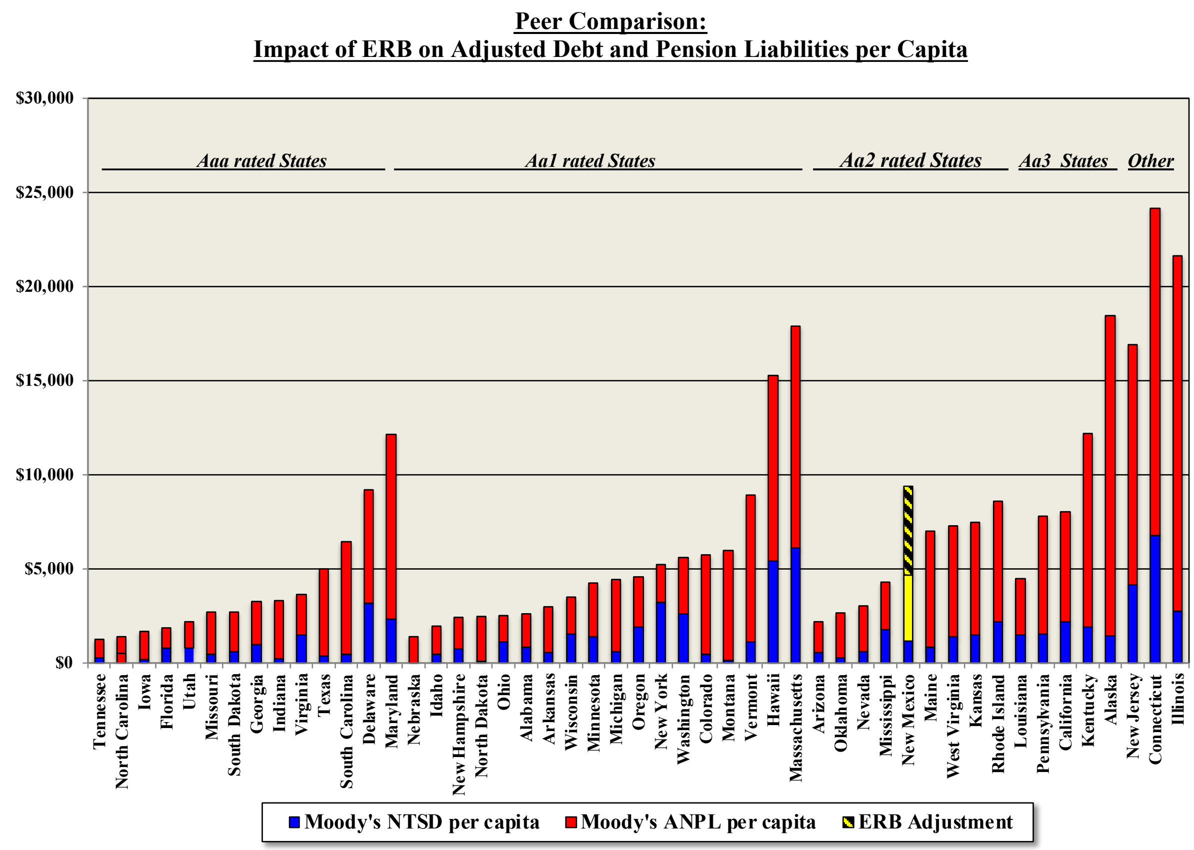
- Still, Moody's continues to note the particular challenge ERB presents to the State:

  "The state is also indirectly responsible for funding the large liability in its teachers' retirement plan, the Educational Employees Retirement System, because it takes financial responsibility for the vast majority of school districts' operations. If school districts' liabilities were allocated to the state, its total liabilities would more than double to 202.5% of own-source revenue or closer to 300% of own-source revenues when removing the fiscal 2021 permanent fund investment income in the denominator"

1) Moody's June 20, 2018 New Mexico General Obligation Bond credit report.

Role of Unfunded Pension Obligations in New Mexico Liabilities

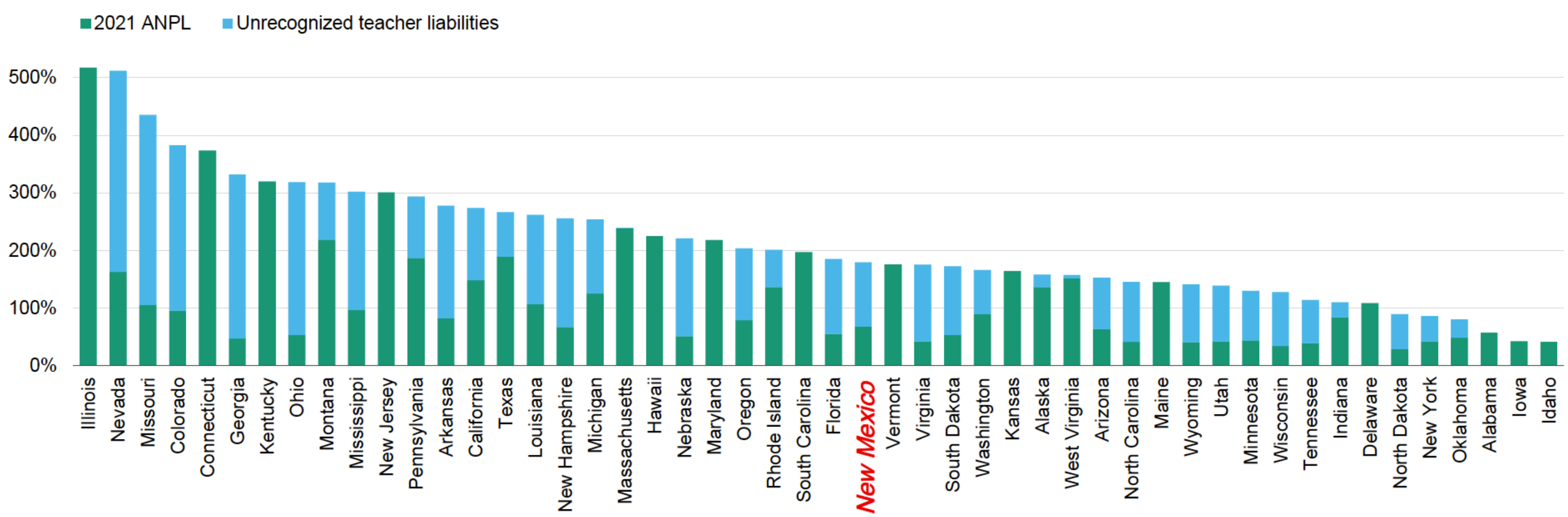
- Issues of discount rate, asset smoothing and other funding assumptions in measuring size of assets and obligations makes peer comparisons difficult.
- Pension and OPEB liabilities are only New Mexico state liabilities without dedicated funding source.
- Moody's recalculation of pension obligations based on corporate bond yields significantly impacts perception of pension underfunding.
- New Mexico liabilities as percent of personal income place it solidly among rating peers, but are magnified with inclusion of ERB underfunding.



Recognizing ERB Liabilities Is Key Step For State of New Mexico

- As a general matter, New Mexico overall net pension liabilities as percent of personal income place it solidly among its state peers.
- Like New Mexico, many states have sought to sidestep state responsibility for unfunded liabilities of teacher pension funds.
- In its February 22, 2022 Sector Comment, Moody's highlighted New Mexico as a case in point on this issue, as ERB liabilities have historically been viewed as local school district obligations, despite funding coming through State appropriations.
- As stated earlier, Moody's observed that recognizing ERB liabilities as State liabilities has the effect of doubling the overall liability burden of the State, with no dedicated source.

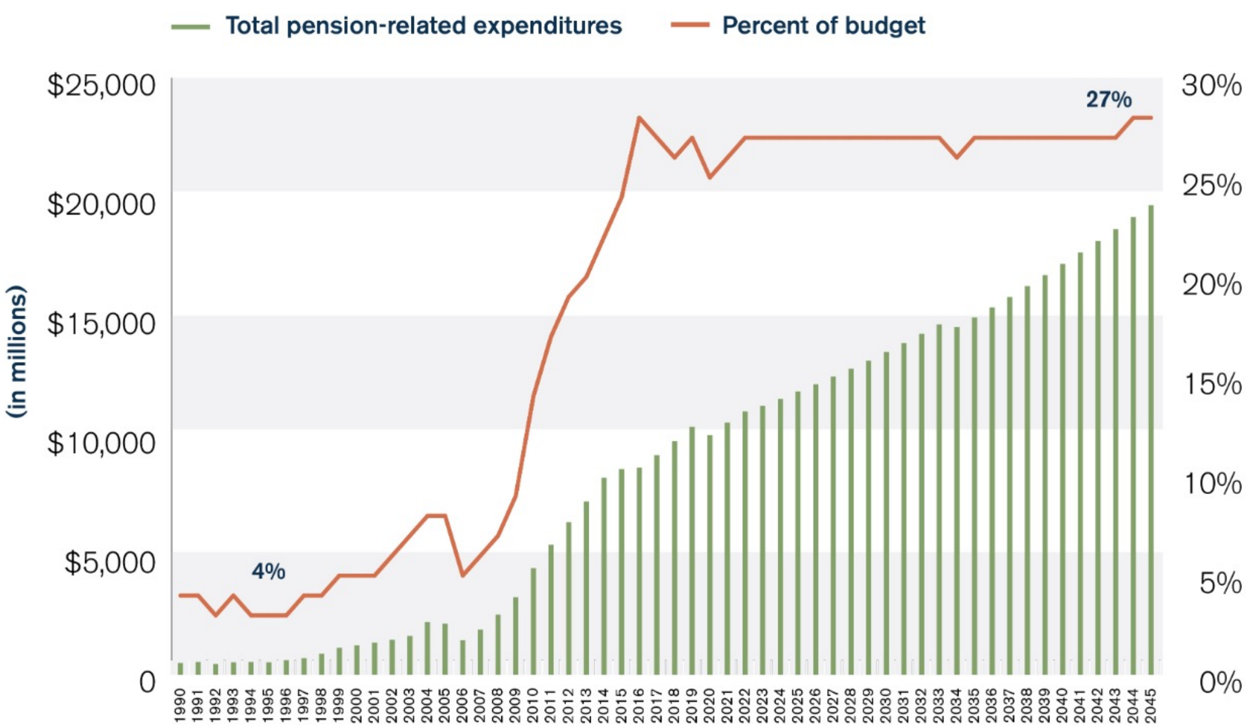
Pension burdens increase significantly for some states when adding all teacher liabilities
Fiscal 2021 adjusted net pension liability (ANPL) including currently unrecognized teacher liabilities as a % of state own-source revenue



Sources: State and pension plan financial statements and Moody's Investors Service

Illinois Pension Crisis Illustrates Looming Risks of Pension Issues

- In the decade+ since the 2008 financial collapse, zero interest rate policies and quantitative easing have particularly challenged pension investments.
- Rating agencies recognize that June 30, 2022 pension system financial results likely to show two lost years, as stock market values now approximate levels of two years ago. Going forward, equity risks remain, while reasonable fixed income returns seem likely for the first time in a decade.
- Illinois pension funding crisis is the canary in the coal mine for states that decline to grapple with funding issues, and open pensioners up to competition with bondholders, public employees and public services for scarce resources in periods of stress or insolvency.



Source: Commission on Government Forecasting and Accountability, Chicago Teachers' Pension Fund, Comptroller's Traditional Budgetary Financial Reports