MINUTES
of the
SECOND MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE

August 3, 2012
Room 322, State Capitol
Santa Fe

The second meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2012 interim was called to order by Senator George K. Munoz, chair, on Friday, August 3, 2012, at 9:20 a.m. in Room 322 of the State Capitol in Santa Fe, New Mexico.

Present
Sen. George K. Munoz, Chair
Rep. Henry Kiki Saavedra, Vice Chair
Rep. David L. Doyle
Rep. William "Bill" J. Gray
Rep. Larry A. Larrañaga
Sen. Carroll H. Leavell
Sen. Mary Kay Papen
Sen. John M. Sapien
Rep Jim R. Trujillo
Rep. Luciano "Lucky" Varela

Absent
Sen. Timothy M. Keller
Sen. Steven P. Neville

Advisory Members
Rep Donald E. Bratton
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Rep. Patricia A. Lundstrom
Rep. Jane E. Powdrell-Culbert
Rep. William "Bill" R. Rehm
Rep. Sheryl Williams Stapleton
Rep. Mimi Stewart
Rep. Richard D. Vigil

Sen. Carlos R. Cisneros
Sen. Tim Eichenberg
Sen. Stuart Ingle
Rep. Rhonda S. King
Sen. William H. Payne
Sen. John C. Ryan
Sen. Michael S. Sanchez
Rep. Shirley A. Tyler

Staff
Tom Pollard, Legislative Council Service (LCS)
Doris Faust, LCS
Claudia Armijo, LCS

Guests
The guest list is located in the meeting file.

Handouts

Handouts and written testimony are in the meeting file and posted on the New Mexico legislature web site.

Friday, August 3

Senator Munoz welcomed the committee members and guests. He reminded members that the meeting was being webcast and then asked them to introduce themselves, which they did.

Update on Recent Investment Performance and Strategy to Meet Long-Term Earnings Benchmark of the Educational Retirement Board (ERB)

Bob Jacksha, chief investment officer for the ERB, and Alan Martin, partner at New England Pension Consultants (NEPC), greeted the committee members. Mr. Jacksha began by introducing members of the ERB present for the IPOC meeting, including Mary Lou Cameron, board chair, and State Treasurer James B. Lewis.

Mr. Jacksha told the committee that the ERB's quarterly investment reports are voluminous, and that for purposes of presenting to the committee, he and his staff had narrowed the focus, but would certainly speak about any items the members wanted to discuss. He then turned the presentation over to Mr. Martin, who began by saying that his consulting company, NEPC, advises more than $400 billion in public funds, including the State of Arizona and Orange County, California.

Mr. Martin next explained that the ERB's investment returns are calculated every period using the methodology of the Bank Administration Institute (BAI) defined performance standards set in 1971. The BAI file format is a colloquial term used to describe a file format for performing electronic cash management balance reporting.

Referring to page two of the ERB handout, *Investment Performance, Evaluation and Projections*, dated Friday, August 3, 2012, Mr. Martin explained that the ERB's returns are calculated on a total return basis, including not only income and dividends but also realized and unrealized gains and losses. He stressed that looking at multiple-year period returns is critical because of the long-term nature of the ERB funds and noted that the average time in the system for an ERB retiree is about 40 years. Returns for a single year, or return numbers by themselves, can tell only part of "the story".

When evaluating the ERB's returns, Mr. Martin said the big question is, "Did we achieve our actuarial target in the long run?". He noted that, unfortunately, the information most desired and useful, yet unavailable, would be what could be expected for future returns. He analogized the job of advising the ERB on investments to being on a sailboat, saying, "We cannot direct the wind, but we can adjust the sails.". With regard to investments, all that can be earned is what the market *potentially* allows.

When evaluating how the ERB funds performed, the consultant looks at multiple benchmarks, time periods and peer groups. The ERB's funds peer groups are all public funds located in the United States with greater than $1 billion in assets, a group composed of 63 funds. Another aspect of evaluating portfolio performance requires one to refrain from comparing portfolio performance to a single market, like the Standard & Poor's 500. Comparing the ERB's portfolio performance to that of its peer group provides the optimum comparison.

According to Mr. Martin, the ERB's rank in its peer group of funds for the year ending June 30, 2012 placed it in the top 25%. The ERB's return of 2% was well above the median fund return of 1.1%.

Mr. Jacksha addressed the members regarding the peer comparison graph depicted on page six of the ERB handout. He pointed out that, over a 10-year period, the ERB has performed consistently well against its peer group funds, noting that as of June 30, 2012, the ERB funds' assets were $93 billion.

Mr. Jacksha next talked about a 2005 statutory change, which allowed the ERB broader investment authority under the *Prudent Investor Rule*. As of October 2007, the ERB made a major shift in investment philosophy, diversifying beyond stocks and bonds, and a new asset allocation plan was implemented beginning in 2008. Along with the new plan came the need to hire additional staff, consultants and managers. The fund did not experience a significant impact on returns as a result of the change in asset allocation until 2009. Over the past three years, the ERB has ranked in the top 10% of the fund universe, and, during that time period, the median public fund returned 11.9% versus the ERB's return of 13.0%. The 1.1% difference per year is worth more than $300 million in investment earnings over that three-year period.

Mr. Jacksha directed the members' attention to pages nine and 10 of the ERB handout, which depict, graphically and by percentages, the ERB's funds asset allocation of: United States equities, non-U.S. equities, fixed income, alternatives, real estate and cash. The ERB's private equity program, which for the last year made a return of 12.1%, is the number one rated program in the country.

Next, Mr. Martin provided a discussion about risk-adjusted returns. He advised that return calculations are industry standard, involving a time-weighted total return on investments, and risk measures are more varied. He continued explaining that the most common measure observed is the standard deviation of historical return streams, and the constant question is, "What is the best way to compare funds with different variability of results?". The most common answer is the *Sharp Ratio*, calculated by taking the fund's return, minus the risk-free rate, divided by the standard deviation. Using the graphs depicted on pages 13 and 14, Mr. Martin showed the members the ERB's risk-adjusted rate of return over the past three years and past five years, emphasizing that the ERB funds did well for the risk that was taken on investments.

Using the graph on page 15 of the ERB handout, Mr. Jacksha led a discussion about the ERB's attribution analysis. The graph illustrates the impact on the fund's performance that is attributable to the board's policy impact, the asset allocation impact and the fund managers' impact over a 10-year period. When questioned about the impact of low-performing managers, Mr. Jacksha noted that the ERB places low-performing managers on a "watch status". He cautioned that when reviewing manager impact and performance, it is best to look at it over time, rather than as a snapshot.

Mr. Martin then spoke to the members about how the ERB's asset allocation is developed, explaining that a forward-looking process of projected asset class returns and uncertainty is employed. The consultants and the ERB integrate assets and liabilities to understand the interplay among investment results, contributions and benefits. An effort is made to identify the risk of each contribution to the overall portfolio, and a scenario analysis and a liquidity analysis are performed in an effort to ensure that the fund can pay its liabilities as they become due.

Mr. Martin next explained that the process used to determine a projected return begins with a projection of expected future returns for each separate asset class. This process involves taking into account current, expected and historical market factors. The process begins with a projection of the expected future returns for each asset class, plus the volatility. The future correlation of asset classes is projected and then mathematically combined with the three factors to arrive at projected returns for the next five to seven years.

Mr. Martin noted that the projected returns are outlined on page 18 of the ERB handout, and although the projections have been reviewed by the board's Investment Committee, the projections have not yet been adopted by the board.

Mr. Jacksha continued the discussion by talking about the probability distribution and using the graph on page 19 of the ERB handout to illustrate the standard deviation, or where the ERB expects the fund's performance to be within the range, which is also where one would expect 66% of the returns to be.

He explained the Internal Rate of Return (IRR), which reconciles the beginning dollar amount of an investment, plus cash flows with the ending value. It represents the rate of return on the average dollar involved. Another way to look at it is to say that it is the discount rate that equates the present value of the future cash flows to the amount invested. The Time Weighted Return (TWR) is the return produced by linking the returns for each sub-period, giving equal weight to each time period. This focuses on the return on the first dollar invested and is used primarily to compare manager performance results without including distortion from differences in cash flow. Mr. Jacksha pointed out that the benefit of evaluating returns as time-weighted instead of dollar-weighted is that it provides information that is independent of the dollar amount invested, since the managers do not typically control cash inflows and outflows. Additionally, it is most accurate for managers investing in public stocks and bonds, as well as total fund calculations. Time-weighted measurement is least accurate for measuring private equity or partnership investments, particularly over shorter periods of time. Mr. Jacksha emphasized that one cannot compare IRR to TWRs.

After the presentation, there was a discussion regarding the fact that, with the exception of the two- and three-year periods, the ERB had not attained the 7.75% projected earnings rate in many of the time periods shorter than 20 years. The discussion culminated in a request from the committee chair for an actuarial projection for the fund run based on a 6.75% earnings and discount rate. Members pointed out that on the previous day, the Indiana state retirement fund had lowered its assumption to a rate that is the lowest in the country for large public plans at 6.75%.

There was a question about whether the board had discussed lowering the discount rate. Mr. Martin explained that the investment numbers and fund balance information, as well as contribution and benefits information, are given to the ERB's actuary, and the actuary recommends the target investment rate of return based on that information. Mr. Jacksha noted that the board had discussed adjusting the target investment rate at its July meeting but had not taken action at that time and would review the issue again in the future. Ms. Cameron explained that the board has examined the target investment rate and has been advised by its actuary that the 7.75% is appropriate. She noted that the board has been discussing changes to the plan and that it takes the task before it very seriously, adding that the board has devoted most of its time to solvency issues over the past two years.

Members inquired about how the new Governmental Accounting Standards Board (GASB) rules impact the reporting of the ERB. Mr. Jacksha stated that his understanding of the new rules is that under the ERB's current plan design, its funded liabilities would continue to be discounted at its assumed actuarial rate, 7.75%, but the unfunded portion of the fund's liabilities would be discounted based on a municipal bond rate, currently somewhere around 4% to 5%. This would mean that, given the ERB's 2012 projected funding ratio, about 60% of its liabilities would be discounted at 7.75% and 40% at the lower rate. The net impact of the change would be to lower the ERB's effective discount rate by at least a full 1%. The committee asked the ERB to prepare an actuarial projection based on the expected impact of the new GASB reporting rules. Mr. Jacksha pointed out that the new GASB standards are a reporting change. He noted that the unfunded liability of the ERB fund has been reported in the past, but just as a footnote. The new GASB requirements change the manner in which the unfunded liability is reported, not the fact that it is reported.

Mr. Jacksha reminded committee members that the board had recommended changes for the pension plan during the last two legislative sessions, but that neither of the recommendations had been passed. As is statutorily mandated, the ERB can only recommend changes to the legislature.

Mr Jacksha was asked, in reference to the relative performance and longer term returns, why, if the ERB fund performance is good, and it appears to be, is there an unfunded liability problem? He advised that there is an imbalance between benefits and contributions that cannot reasonably be expected to be offset by investment returns. The imbalance was masked by outstanding capital markets performance in the early years of the 29 years that the ERB has records. For example, in two years in the early 1980s, the ERB recorded one year's returns in excess of 20% and another in excess of 30%. In the 1990s, the ERB experienced double-digit returns year after year. He added that the ERB cannot, and does not, count on returns like this going forward, and it understands that it cannot invest its way out of the situation.

There was a request from a legislator for a breakdown of ERB contributions between the state general fund and federal funds.

Mr. Jacksha closed by assuring the committee that the ERB recognizes the necessity of plan design changes to improve the solvency of the ERB plan.

Update on Recent Investment Performance and Strategy to Meet the Long-Term Earnings Benchmark of the Public Employees Retirement Association (PERA)

Joelle Mevi, chief investment officer for the PERA, addressed the committee, beginning with a discussion of how to measure "relative" fund performance. Referring to page three of the PERA handout, *New Mexico Public Employees Retirement Association, Investment and Pensions Oversight Committee, August 3, 2012*, she said that the PERA fund's performance is compared relative to its benchmark, or its stated target, and relative to its peers, or other funds of similar type and size. The PERA's peer group, also known as peer universe, includes all public funds with assets greater than $1 billion.

Ms. Mevi reported that as of June 30, 2012, the PERA's 12-month return was negative 38 basis points. The fund's return over a three-year period is 11.96%, and over the life of the fund, it is 9.6%. According to Ms. Mevi, market volatility was the primary factor in the fund's poor performance, but its performance was also hampered by a slowing global economy. She noted that the PERA's hedge funds have been struggling, with less success than had been experienced in previous years, and that equities continue to be a predominant risk. She clarified that all of the PERA's funds are externally managed and that manager impact is a factor on the fund's performance.

Next, Ms. Mevi directed the members' attention to page five of the PERA handout, which depicts the PERA's asset allocation compared to its peers. Notably, the PERA's asset allocation differs widely from peer funds in its allocation of U.S. equities and non-U.S. equities. Additionally, the PERA's cash reflects a much lower percentage than that of its peer universe. She continued on page six of the PERA handout, explaining that the volatility in the capital markets greatly influences the PERA's fund performance. The domestic stock market's rate of return for fiscal year (FY) 2012 was 3.84%. For the same period, the international stock market's rate of return was -13.38%, while the bond market's return was 7.48%.

Referring to page seven of the PERA handout, Ms. Mevi indicated that the graph illustrates the PERA's earnings by asset class, as of June 30, 2012. Since the fund's inception, the earnings on domestic equities are 10.83%, non-U.S. equities have earned 7.34% and fixed income investments have earned 8.01%. Still, recent earnings have been low and have included negative earnings, with the one-year earnings of non-U.S. equities at -12.92%.

Ms. Mevi advised the members that the PERA board reviews the fund's asset allocation about every three years, saying it was last reviewed in May 2010. On page eight of the PERA handout, the graph depicts the changes in the market value of the fund by asset class. The graph clearly depicts a continuing decline in market assets since 2008. The PERA board is considering looking at opportunistic securities, as well as other asset classes not currently in the PERA portfolio.

With regard to the target rate of return used by the PERA, members were advised that until two years ago, the rate of return used by most public funds was 8%. However, in December 2011, a majority of those funds reduced their respective target rates to 7.75%. The PERA board expects the investment rate to trend downward; in fact, as mentioned before, Indiana reduced its fund's target investment rate to 6.75% on August 2, 2012.

There was a discussion about the fund's investment in international equities, and Ms. Mevi stated that historically, the fund has invested heavily in non-U.S. equities. It is expected that there will continue to be growth in emerging markets. She noted that the exposure to emerging markets does carry volatility, particularly with the global economic slowdown of recent years.

When asked whether the ERB investment staff and the PERA staff work together on asset allocation and investment strategies, Ms. Mevi responded that she and Mr. Jacksha work together and that she has also worked closely with other investment staff at the ERB. Members voiced the opinion that the meetings between the ERB staff and the PERA staff should occur more regularly. In response, Ms. Mevi indicated that would be a good idea.

The chair requested that the PERA provide the same information that had been requested for the ERB, as well as actuarial projection of the assets, liabilities and fund solvency information using a target investment rate of 6.75% instead of the fund's 7.75% rate. Ms. Mevi said the PERA would provide the information.

Letter of Appreciation from Attorney Victor Marshall Regarding Pending Litigation *State ex rel. Foy v. Austin Capital Management*.

Mr. Marshall, attorney, thanked the committee for its letter in support of the interlocutory appeal in the *State ex rel. Foy v. Austin Capital Management* case, a case alleging "pay-to-play" wrongdoing by former New Mexico State Investment Council employees. Mr. Marshall reported that the Court of Appeals heard oral arguments in the case on June 19, 2012 and could issue its decision at any time. He opined that if the state wins the interlocutory appeal, it could result in an estimated $1 billion in additional money recoveries due to the treble damages provision in New Mexico's Fraud Against Taxpayers Act. Members thanked Mr. Marshall for his letter and comments.

Status Report on Actuarial Soundness of the PERA Pension Funds and Pension Reform Proposal

Wayne Propst, executive director, PERA, addressed the committee regarding the solvency of the PERA funds and the board-approved changes to the PERA pension plan. He began by introducing some of the PERA board members in attendance, including Gerald Chavez, PERA board chair. Mr. Propst provided a handout, *Investments And Pensions Oversight Committee, Senator George K. Munoz, Chair, August 3, 2012*, for the members' review.

Pages one, two and three of the handout provide pie charts illustrating the breakdown of the PERA's membership, including retired and active members. There are a total of 64,195 PERA members, with a total of 29,496 retiree and beneficiary distributions. The pie charts on pages one and two show the breakdown among the PERA's membership of state, municipal, judicial, magistrate, legislative and volunteer firefighter members. The chart on page three reflects the breakdown of all participating employers.

Mr. Propst advised the members that, based upon Representative Trujillo's House Joint Memorial 19 from the 2012 legislative session, the PERA has worked on developing proposed changes to bring the fund's funding status to 100% by the year 2041. The memorial also requested that the PERA present benefit structure changes impacting future, active and retired members to the IPOC by October 1, 2012. As a consequence, the PERA board conducted 32 outreach meetings in 16 cities throughout the state in April and May of 2012. More than 2,000 PERA members and retirees participated in meetings at which the PERA board discussed potential changes to the plan and explained the funding challenges faced by the PERA.

Mr. Propst told the committee that the PERA board met in Alamogordo in May and adopted recommended plan changes that include shared responsibility among retirees, active members, some non-vested members and new hires. He said the changes are not a tepid response nor so minimal that the board would need to readdress the solvency issue again in three to five years.

Mr. Propst explained that the proposed changes impact members by creating two tiers for both non-hazardous duty and hazardous duty members.

The proposed plan changes would result in a two-tier system for non-hazardous duty members as follows:

- tier I includes members initially hired on or before June 30, 2010; and

- tier II includes members initially hired on or after July 1, 2010.

Tier II non-hazardous duty members would see the following benefit changes:

1. a 0.5% reduction in their annual pension factor, making their pension factor 2.5%;

2. retirement eligibility would be based on an age and service Rule of 85, or age 65 with 10 years of service;

3. a member's final average salary (FAS) would be calculated based upon a five-year FAS;

4. an eight-year vesting period;

5. a 90% pension maximum benefit; and

6. when eligible, these retirees would receive a 2% compounding cost-of-living adjustment (COLA).

The proposed plan changes would result in a two-tier system for hazardous duty members as follows:

- tier I includes members initially hired on or before June 30, 2010; and

- tier II includes members initially hired on or after July 1, 2010.

Tier II hazardous duty members would see the following benefit changes:

1. a 0.5% reduction in their annual pension factor, making their pension factor 2.5%;

2. retirement eligibility would be based on an age and service Rule of 75, or age 60 with 10 years of service;

3. a member's FAS would be calculated based upon a five-year FAS;

4. a six-year vesting period;

5. a 90% pension maximum benefit; and

6. when eligible, these retirees would receive a 2% compounding COLA.

Additional plan changes adopted by the board would impact current retirees who would receive a reduction in their annual compounding COLA, from 3% to 2%. Mr. Propst noted that this specific change will have the single biggest and most immediate positive impact on the PERA plan's funding level and the unfunded liability.

Another plan change adopted would mean that current active members initially hired on or before June 30, 2010 would receive a reduction in their annual compounding COLA from 3% to 2%. Additionally, for these members, COLA eligibility would begin seven calendar years after the member's retirement as opposed to the current two years. No COLA eligibility change is proposed for tier I members who retire at age 65 or older, or who retire due to disability.

Mr. Propst continued explaining that the PERA board proposes the following contribution changes:

1. Effective July 1, 2013, there will be an increase in employee contributions of 1.5%. He noted that the increase would be accomplished with the removal of the sunset clause enacted when the contribution shift was put in place.

2. Effective July 1, 2014, and continuing for the following two fiscal years, there will be an increase of 0.50% per fiscal year in all statutory employer contribution rates, resulting in a total employer contribution increase of 1.50% in FY 2016. Mr. Propst noted that the proposed employer contribution increases would be the first such increases since 1997 and that the increases would provide a hedge against lower-than-expected return on investments that could be experienced.

Referring to page 12 of the handout, Mr. Propst explained the projected results from the implementation of the board's proposed plan changes. He said that reducing the COLA will result in an immediate $1.5 billion, or about a 30% reduction in the PERA's unfunded liability. He stressed that all actions, taken together, are expected to result in the PERA being 100% funded by 2031 and 127% funded by 2041. Lastly, he opined that even with all of the proposed changes, the PERA defined benefit plan will provide members with a sound and secure retirement future.

Next, Mr. Propst directed the members' attention to the graph on page 14 of the handout, which depicts the projected funding status of the plan if contribution increases are not implemented, as well as the funding status projected under the board's plan change proposal. If there are no changes made to the plan and there are no contribution increases, the fund is projected to be insolvent in the year 2059. Whereas, if the board's proposed changes are implemented, and even if no contribution increases are put in place, the fund is projected to be 104.7% funded in the year 2039. When asked, Mr. Propst acknowledged that the projections are based upon the PERA fund achieving its target investment rate of 7.75%. However, he referred to page 15 of the handout, which illustrates an investment return scenario whereby the fund would earn a rate of return of only 6.75% from 2011 through 2021 (10 years), and then a projected rate of return of 7.75% thereafter. The chart shows that with the PERA board's recommended plan changes implemented during that time frame, the fund is projected to be funded at 105.2% in the year 2039.

Mr. Propst shared with the committee some of the recent rule changes implemented by the board, noting that there are changes related to the purchase of "air time", a statutory provision allowing PERA members to purchase additional service credit under certain circumstances. Previously, the PERA calculated the cost of purchasing the service credit using the member's last reported hourly wage under the last plan in which the member was employed. Now, the calculation is changed, and it uses the member's highest 36 consecutive monthly average salary as the FAS at the time of the purchase. Using the FAS more accurately reflects the full and actuarial present value of the increase in the member's pension when air time is purchased.

Additionally, the board will exercise discretion regarding the interest rate that will be paid to members who refund their PERA contributions. Previously, the PERA had paid a refund interest rate of 5.25%. However, the board lowered the rate to 2% in June 2012, reflecting the overall dramatic drop in interest rates in the market today. The board estimates the savings in the first year from lowering the interest rate for refunded contributions to be $70 million.

Mr. Propst concluded his presentation by telling the members that the PERA board recognizes that meaningful pension reform is needed to ensure retirement benefits for current and future retirees. He said that the board's reform proposal sets one of the most aggressive public pension funding goals in the country and establishes a path to eliminate the plan's unfunded liability and reach 100% funding status in approximately 20 years. He added that the board's proposal builds in significant room to allow for uncertainty in the market and changes according to accounting rules, while still reaching 100% funding status by the year 2041. Mr. Propst opined that with the PERA board's proposed changes, the PERA benefit will remain a reliable source of retirement security for generations of retirees.

Committee members thanked Mr. Propst for his presentation and expressed thanks for the PERA board's commitment to look at plan changes and adoption of the proposed changes. That was followed by a general discussion regarding the need to reach consensus among legislators and stakeholders.

Some members voiced concerns that older retirees who are facing retirement in the near future must be protected from impending changes, since they are planning and relying on their benefits as currently provided. Mr. Propst responded by saying that although the board had discussed a grandfather period, such a provision is not included in the plan changes adopted.

Diego Arencon, president, Albuquerque Area Firefighters Local 244, addressed the members, saying that the PERA board's proposed changes may be close to what the firefighters would accept but that his members want to have more input into proposed plan changes. He added that the firefighter retirees he represents are willing to reduce the COLA by 1% as long as there is a review of it. He closed by requesting a half-day time slot at the IPOC's October meeting to present on the issue.

Members noted a need to clean up the definitions used in the PERA statutes relating to "hazardous duty", "non-hazardous duty", "motor transportation" and "state police" members, noting that perhaps all public safety members that carry a side-arm should not be treated equally.

Some members asked which of the various PERA plans were the most funded and which were the least funded. Mr. Propst replied that the volunteer fire plan is 173% funded and the state police plan is 101% funded, while the least-funded plans are the judicial and magistrate plans. When asked, he further explained that all member benefits are paid out of the plan as a whole and not specifically out of funds allocated to each PERA plan.

Lastly, members asked Mr. Propst and the PERA staff to be prepared to report back to the IPOC as to exactly what the board's proposed changes will do. The members expressed the need for actual data, including information related to what the changes would do with no employer contribution increases implemented.

Members discussed the 2012 memorial requesting the formation of a task force to evaluate the issues facing public safety PERA members. Although no task force will be formed, a subcommittee of the IPOC has been tasked with meeting and discussing the various issues.

Impact of New GASB Pension Reporting Requirements on New Mexico State Finances and Bond Ratings

Mr. Pollard, Ph.D., LCS economist, and David Bucholtz, Bond Disclosure Council, State Board of Finance, presented to the committee regarding the newly instituted GASB reporting standards that apply to public pension plans and go into effect July 1, 2012.

Mr. Pollard referred to the handout, *Background for New Mexico Public Pension Discussion*, and related why discussions and concerns regarding public pensions are happening throughout the country. The U.S. government's financial difficulties have brought more scrutiny of state and local government's finance by investors and rating agencies, which expect cuts in state and local aid to be part of the solution. He noted that:

1. employee pensions are the largest long-term obligation of general fund dollars in most states and, like state general obligation debt, are provided for most state constitutions and, therefore, have payment priority over operating budgets;

2. unfunded pension liabilities grew very rapidly during first decade of the twenty-first century. The stock market boom during the 1990s allowed future retirement benefit increases to be paid from current and projected investment income rather than increased contributions from employers and employees. Stock market crashes in 2001 and 2007 reduced current and projected investment income and left the benefit increases unfunded; and

3. unfunded liabilities negatively affect not only bond ratings and borrowing costs, but also investment by businesses that are looking across states at relatively high unfunded pension liabilities as a predictor of a state's need to cut services and/or raise taxes.

Mr. Pollard stressed, however, that his presentation was not meant to imply that public employee pension benefits must be cut, nor that employee rather than employer contributions should be increased to restore long-term fund solvency. He noted that state budget cuts and a scarcity of comparable defined benefit pension plans in the private sector have contributed to a move by many states in this direction.

Mr. Pollard continued by providing background information related to the Constitution of New Mexico. He noted that several constitutional provisions provide a framework for any proposed changes to the state's pension plans. The pertinent constitutional provisions are as follows:

*__Article IX, Section 7.__ Prohibits borrowing more than $200,000 to balance the budget. This section authorizes the state to borrow money not exceeding the sum of $200,000 in the aggregate to meet casual deficits or failure in revenue, or for necessary expenses.

***Article IX, Section 8.** Authorizes general obligation bonds. Subsection A states that no such law [Authorizing General Obligation Bonds] shall take effect until it shall have been approved by a majority of qualified electors of the state. No debt shall be so created if the total indebtedness of the state would thereby be made to exceed 1% of the assessed valuation of all the property subject to taxation in the state.

***Article VIII, Section 10, Subsection A.** Authorizes severance tax bonds. This subsection states that there shall be deposited in a permanent trust fund known as the "severance tax permanent fund" that part of state revenue derived from excise taxes that have been or shall be designated severance taxes imposed upon the severance of natural resources within this state, in excess of that amount that has been or shall be reserved by statute for the payment of principal and interest on outstanding bonds to which severance tax revenue has been or shall be pledged.

*__Article XX, Section 22 (In Part).__ This section authorizes a trust fund to be set aside for the "sole and exclusive benefit" of public or educational plan member retirees. It also confers on members of retirement plans meeting minimum service requirements a vested property right in the retirement plan with due process protections under the applicable provisions of the New Mexico and United States constitutions.

This section further states that: "Nothing in this section shall be construed to prohibit modifications to retirement plans that enhance or preserve the actuarial soundness of an affected trust fund or individual retirement plan.".

Mr. Pollard noted the chart on page six of the handout that illustrates the funding status of the PERA, ERB and Retiree Health Care Authority (RHCA) funds as of June 30, 2012. The chart reflects that the PERA's funding ratio is 71%, the ERB's is 63% and the RHCA's is 6%.

According to Mr. Pollard, the rating agencies combine bonds and unfunded pension liabilities into new enhanced debt measures. Elaborating, he told the members that Moody's, Standard & Poor's and Fitch have all produced recent analyses and state comparisons on debt measures that combine bonded indebtedness and unfunded pension liabilities into a more meaningful measure.

Pensions are not quite as airtight as bonds, but have state constitutional protection in most states. Like most states, New Mexico's unfunded pension liability is huge compared to its bond debt outstanding as follows:

- New Mexico general obligation bonds outstanding: $356 million;
- New Mexico severance tax bonds: $741 million;
- state highway and transportation bonds: $1.7 billion; and
- unfunded liabilities of the ERB and PERA: $10.6 billion.

Mr. Pollard next explained that Moody's Investors Service has ranked states according to their combined pension and long-term liabilities, as a percentage of gross domestic product. Accordingly, New Mexico ranks number 15 among the top 20 states.

With regard to the GASB reporting requirements, Mr. Pollard advised that the proposed changes in pension accounting and financial reporting, to be implemented by large pension funds for the year beginning July 2012, mean that:

- unfunded pension liabilities will now appear on the employer's balance sheet, rather than in the notes, and will be reported like long-term debt;
- lower actuarial discount rates will apply for most plans, which will increase actuarial liabilities and pension expenses. Currently, the assumed investment earnings rate (e.g., 7.75%) is used as a discount rate. Under the new rules, if an unfunded liability exists, the AA-bond index rate (around 4% today) will have to be used to discount benefits during that period; and
- shorter amortization periods will be allowed for unfunded liabilities, which will also increase pension expenses. Currently, a 30-year amortization is used. Under the new rules, the average remaining service lives of incumbent employees, which is usually 12 to 15 years, will be used.

According to Mr. Pollard, Moody's proposed on July 2, 2012 its own new public pension reporting standards as follows:

1. accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011);
2. asset smoothing will be replaced with reported market or fair value as of the actuarial reporting date;
3. annual actuarially required pension contributions will be adjusted to reflect the foregoing changes as well as a common amortization period; and

4. multiple-employer cost-sharing plan liabilities will be allocated to specific government employers based on proportionate shares of total plan contributions.

Moody's states the following: "While we [Moody's] do not expect any state ratings to change based on these adjustments alone, we will take rating actions for those local governments whose adjusted liability is outsized relative to their rating category.".

Mr. Pollard noted that, although pension shortfalls are large, substantial fund assets provide a limited cushion and time to act, i.e., modest actions now, more drastic actions later. States with relatively large unfunded liabilities that have not taken action (increased contributions and/or reduced benefits) have been downgraded by rating agencies.

Mr. Bucholtz provided the members with a guide created by Brownstein Hyatt Farber Schreck, LLP, entitled *Considerations in Preparing Disclosure in Official Statements Regarding an Issuer's Pension Funding Obligations (Public Defined Benefit Pension Plans).* Mr. Bucholtz provided the members with a brief overview of the pertinent sections of the guide, emphasizing that New Mexico is in a relatively strong position, since its bonds are paid from specific revenues, severance tax and property tax, and not from the state's general fund. Therefore, pension liabilities do not bear directly on the bond rating for the state's severance tax bonds and general obligation bonds.

The committee approved the minutes from the June 2012 IPOC meeting, and with no further business, it adjourned at 3:40 p.m.