

State of New Mexico

Pension Solvency Overview: PERA & ERB



This report offers the Pension Integrity Project at Reason Foundation’s preliminary analysis of the pension crisis currently facing New Mexico. After a review of historical financial and actuarial data published by New Mexico’s largest public pension plans—the Public Employees Retirement Association of New Mexico (PERA) and New Mexico Education Retirement Board (NMERB)—we identified severe problems stemming from flawed approaches to measuring and scheduling contributions, consistent underfunding, and overly optimistic investment assumptions.

The Pension Integrity Project believes that, if not addressed, these issues will lead to a steady increase in costs borne by taxpayers and a growing risk of pension insolvency.

Our initial findings are as follows:

- (1) Despite recent funding policy reforms, both PERA and ERB continue to maintain low funded ratios and are likely to experience continued growth in required employer contributions.
- (2) The amortization policies for both PERA and ERB are perpetuating debt across generations by using an “open” amortization period which resets the period used to calculate actuarially required contributions each year to a 30-year term commitment.
- (3) Investment underperformance relative to assumed rates of return have added \$3.3 billion in unfunded liabilities to ERB alone and pushed PERA and ERB to lower their expected investment gains from 8% to 7.25% to reflect future market performance.
- (4) The discount rate, a figure used to calculate the total liability, is likely undervaluing the amount of promised benefits. Thus, even if the state paid 100% of the actuarially required contributions, it may not be saving enough to cover all promised pensions.

Restoring PERA and ERB to fiscal health will require blending the rigorous actuarial analysis and risk assessment needed to deconstruct the components of the problem with a comprehensive solution-building strategy focused on engaging and considering the objectives of all stakeholders.

The Pension Integrity Project proposes to undertake these analyses for the legislature on a pro bono basis, at no charge whatsoever to New Mexico taxpayers. Given similar partnerships in other jurisdictions—including our central role in designing and negotiating Arizona’s groundbreaking public safety pension reforms the last several years—we believe that the Pension Integrity Project’s analyses can provide New Mexico policymakers with the tools necessary to solve the current pension crisis.

New Mexico Pension Solvency Overview

Table 1: New Mexico Pension Plan Solvency Overview, as of June 30, 2017

| Plan | Accrued Liability | Payroll | Assets | Unfunded Liability | Funded Ratio |
|--------------|-----------------------|----------------------|-----------------------|-----------------------|---------------|
| PERA | \$20.2 billion | \$2.2 billion | \$14.8 billion | \$5.4 billion | 73.30% |
| ERB | \$19.9 billion | \$2.7 billion | \$12.5 billion | \$7.4 billion | 63.00% |
| Total | \$40.1 billion | \$4.9 billion | \$27.3 billion | \$12.8 billion | 68.20% |

Source: Reason Foundation Analysis of New Mexico PERA and ERB 2017 Valuation Reports.

Table 1 provides a general summary of PERA and ERB's fiscal health. The unfunded liability—or the amount of promised benefits that are greater than assets of a pension plan— currently being maintained by PERA and ERB totals almost \$13 billion. Given the majority of pension liabilities for the state rest with PERA and ERB, we have limited the scope of our analysis to these two larger plans.

A. Funding Policy and the Impact on Employer Contributions

The funding policies of state pension plans are leading to a systematic misappropriation of taxpayer dollars due to the use of statutorily-based contribution rates (e.g., contribution rates established in state law) instead of actuarially driven rates. Such statutorily-based funding policies intend to promote year-to-year contribution stability and typically enjoy lower initial contribution rates. This can be quite attractive to policymakers as the lower initial rates allow for lower taxes in the early years after investment shortfalls.

However, low initial payments in the near-term come at the expense of greater contribution payments and greater tax and service trade-offs in the long-term. This rigidity has starved the plans of needed contributions. Cumulatively, the state has paid only 81% of the total required contributions to PERA and ERB over the past 15 years (see Table 2).

Table 2: Actuarially Required Contribution (ARC) Payments, as of June 30, 2017

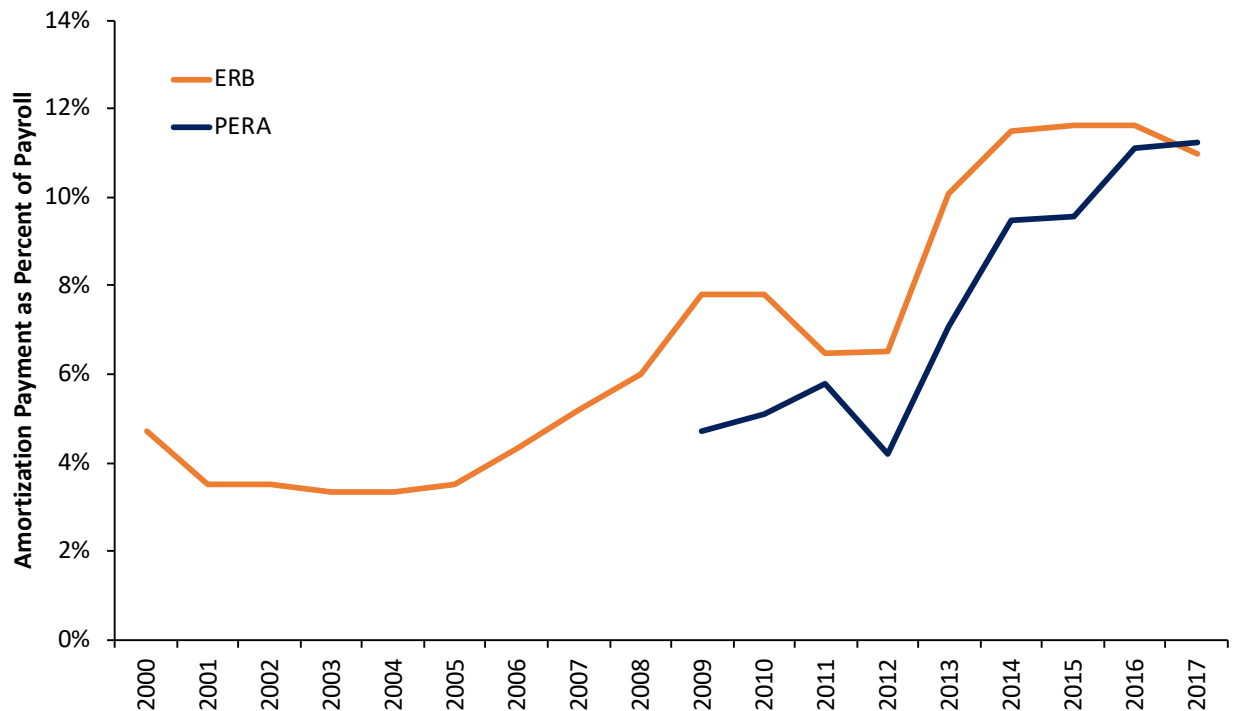
| FY | New Mexico PERA | | | New Mexico ERB | | | PERA + ERB |
|---------------------------|-----------------|-----------------|---------------------|-----------------|-----------------|---------------------|---------------------|
| | ARC (\$M) | ARC Paid (\$M) | Percent of ARC Paid | ARC (\$M) | ARC Paid (\$M) | Percent of ARC Paid | Percent of ARC Paid |
| 2002 | \$204.7 | \$204.7 | 100% | \$179.1 | \$179.1 | 100% | 100% |
| 2007 | \$257.1 | \$257.1 | 100% | \$368.2 | \$290.9 | 79% | 88% |
| 2012 | \$518.9 | \$274.9 | 53% | \$480.7 | \$299.7 | 62% | 57% |
| 2017 | \$392.2 | \$334.0 | 85% | \$477.8 | \$395.8 | 83% | 84% |
| Total (since 2002) | \$5.17 B | \$4.35 B | 84% | \$6.01 B | \$4.69 B | 78% | 81% |

Source: Reason Foundation Analysis of New Mexico PERA and ERB 2017 Valuation Reports.

B. Perpetuating Debt Through an Open Amortization Method

Chronic underfunding of PERA and ERB led to an increase in unfunded liability amortization payments. These amortization payments have ballooned as a share of payroll from 4.71% in 2000 to 10.98% in 2017 for ERB (see Figure 1).

Figure 1: Rising Amortization Payments



Source: Reason Foundation analysis of New Mexico PERA and ERB CAFR and Valuation Reports.

If the state consistently contributed the full amount of the actuarially required contributions to ERB and PERA, debts likely may have still increased for both plans due to the method used to amortize the unfunded liabilities. ERB uses an “open” 30-year amortization schedule, which every year re-calculates a 30-year payment schedule to fully fund the system. This method of calculating amortization payments is conceptually similar to refinancing a home mortgage every single year, and effectively means there is no fixed timeline for paying off unfunded liabilities.

C. Overly Optimistic Investment Rate of Return Adding to Unfunded Liabilities

The investment returns of both major New Mexico pension plans have a long-term pattern of underperforming assumptions in any given year. Both PERA and ERB had an at least an 8% assumed rate of return until 2011 when it was lowered to 7.75%, before being reduced to 7.25% in 2017 to reflect future market expectations. Over that 17-year period, the average market valued return has been just 6.16% and 6.76% for PERA and ERB respectively, and 4.97% and 5.80% over the past 10 years.

Figure 2: New Mexico PERA Investment Return History

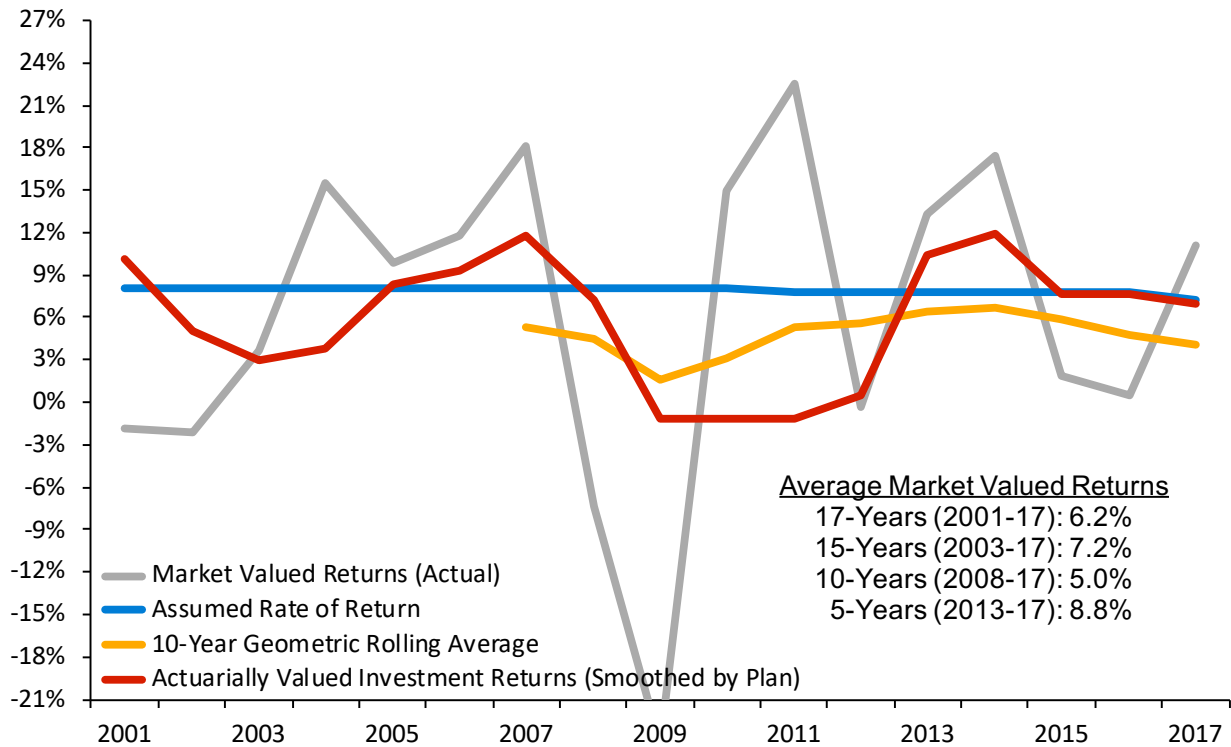
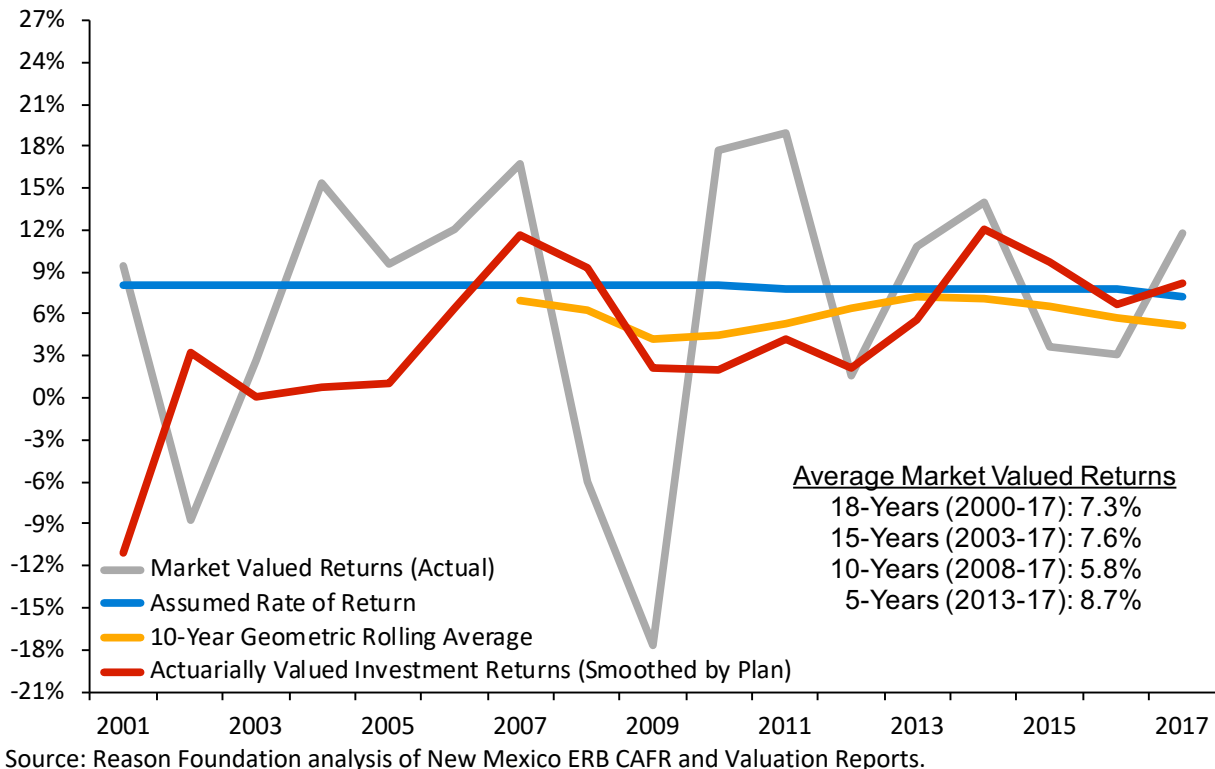


Figure 3: New Mexico ERB Investment Return History



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These trends are not unique to New Mexico as most public sector pension plans have seen actual investment returns underperform assumption targets. Economic changes in the United States and across the world suggest there is a “new normal” for markets. Most major forecasts for equities and bonds further suggest that returns over the next 20 years will be significantly lower than the past few decades.

D. Undervalued Pension Liabilities

The “discount rate” is a figure used by pension plans to determine the value of promised pension benefits. Actuaries calculate the value and timing of these benefits and then use the discount rate to determine their present value. The result, known as the actuarially accrued liability (AAL), is important for calculating the funded ratio of a pension plan, as well as the actuarially determined employer contribution (ADEC).

Preliminary analysis suggests that the PERA and ERB discount rate of 7.25% is inflated. If this is true, then it means the value of long-term pension obligations — the amount expected to be paid out to all pensioners over time — are being inaccurately calculated. The amount of accrued liabilities recognized by the plan should be higher, and thus the amount of unfunded liabilities recognized should be higher.

The effect of the inaccurate discount rate would be that New Mexico’s two largest pension systems are being implicitly and systematically underfunded. The official actuarial reports show how dramatic such an inaccuracy could be. According to the plans’ own 2017 GASB 67 reports, if the discount rate were just one percent lower the amount of unfunded liabilities would be valued \$5.8 billion higher. Continuing to use an inflated discount rate has the effect of shifting the burden of paying for pension benefits to future generations.

Conclusion

Although recent reforms implemented in 2013 and 2017 have pointed New Mexico PERA and ERB in the right direction, both plans remain in poor health and will require significant additional reform to achieve long-term solvency.

The Pension Integrity Project’s proposed analysis would start by building actuarial models of the state’s pension plans utilizing historical data published by the plans themselves. Using these models, the Pension Integrity Project will create a projection of what the PERA and ERB liabilities would be using more realistic discount rates, and how lower than expected investment returns could affect pension solvency. Finally, we would use these actuarial models to test the effects of various prospective approaches to reform.

The Pension Integrity Project leveraged a similar approach in 2016 to achieve successful reforms of Arizona’s statewide police and fire pension system, which culminated in an overwhelming bipartisan vote in the legislature and voter approval of a constitutional amendment at the ballot box. We have also been deeply involved in major recent reforms enacted in Michigan, Colorado

and South Carolina.

Anyone interested in learning more about the capabilities of the Pension Integrity Project at Reason Foundation and our offer to assist in a New Mexico pension reform effort is encouraged to reach out to PIP Staff directly using the contacts below.

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