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

October 19-20, 2017
State Capitol, Room 322
Santa Fe

The fourth meeting of the Investments and Pensions Oversight Committee (IPOC) was called to order by Representative Tomás E. Salazar, chair, on October 19, 2017 at 9:05 a.m. in Room 322 of the State Capitol.

Present	**Absent**
Rep. Tomás E. Salazar, Chair	Sen. George K. Munoz, Vice Chair
Rep. Miguel P. Garcia	Sen. Jacob R. Candelaria
Rep. Larry A. Larrañaga	Sen. Gay G. Kernan
Sen. Carroll H. Leavell	Rep. Patricia Roybal Caballero
Sen. Steven P. Neville	Sen. John M. Sapien
Rep. Jane E. Powdrell-Culbert	Rep. Jim R. Trujillo
Rep. William "Bill" R. Rehm (10/19)	
Rep. Larry R. Scott	
Sen. Elizabeth "Liz" Stefanics	

Advisory Members

Sen. Carlos R. Cisneros	Sen. William F. Burt
Rep. Roberto "Bobby" J. Gonzales	Sen. Stuart Ingle
Rep. Bill McCamley	Sen. Mary Kay Papen
Rep. Sheryl Williams Stapleton	Sen. William H. Payne
Sen. James P. White	

(Attendance dates are noted for members not present for the entire meeting.)

Staff
Tessa Ryan, Staff Attorney, Legislative Council Service (LCS)
Kathleen Dexter, Researcher, LCS
Nancy Martinez, Staff, LCS

Guests
The guest list is in the meeting file.

Handouts
Handouts and other written testimony are in the meeting file.

<u>Thursday, October 19</u>

Revenue Generated from State Trust Lands

Aubrey Dunn, commissioner of public lands, gave an overview of State Land Office (SLO) management of public lands and the revenue generated by those lands.

Eleven percent of the land in New Mexico is owned by the state, with earnings from those lands falling into two categories.

- Rental income, which totaled $102.3 million in fiscal year (FY) 2017, comes from mining, rights of way, grazing, renewable energy, business leases, oil and gas, fees and interest.
- Royalty income, which totaled $663.9 million in FY 2017, comes from mining, oil and gas and water.

Currently, the oil and gas industry accounts for 94 percent of the revenue generated from state trust lands. Renewable energy projects, which account for .07 percent of state trust land revenue, are also installed or under development, primarily in the state's central and eastern areas.

Depending on the source of the revenue, earnings from state trust lands are deposited into either the State Lands Maintenance Fund or the Land Grant Permanent Fund. Five percent of the five-year average market value of the Land Grant Permanent Fund is distributed annually to 21 state institutions designated by name or function in the Constitution of New Mexico, with public schools receiving the largest share at approximately 84 percent. As of this year, state trust land revenue will also go to the newly created State Trust Lands Restoration and Remediation Fund for rangeland, forest and watershed remediation; wildlife habitat improvement; illegal dump site cleanup; and cultural resource stabilization.

Commissioner Dunn noted that while the SLO does not regulate or issue permits for water wells, these wells may be drilled on state trust lands. As it does for oil and gas wells, the SLO issues easements for access to water wells. Given the fragile state of the Ogallala Aquifer in the eastern part of the state, the SLO has restricted water easements that involve the use of fresh water in certain oil and gas operations.

On questioning, Commissioner Dunn and committee members addressed the following topics.

Land Grant Permanent Fund. Members expressed both support for and concerns about increasing distributions from the fund, as well as possible limitations on distributions if they are increased. The current five percent distribution level is standard for endowment funds. If federal lands and their mineral rights are transferred to the state, fund revenue would increase.

State Investment Council (SIC). Some members of the council, including Commissioner Dunn, have refused to sign an ethics code because they feel it is a "gag order". By not signing the code, these members will be excluded from future council executive sessions, during which personnel issues and legal matters are addressed. None of the members who refused to sign the ethics code is a gubernatorial appointee.

Ogallala Aquifer. Commissioner Dunn and members made various statements concerning water wells on state trust lands over the Ogallala Aquifer, including that: 1) Texas companies with water wells across the state line sell water from the aquifer to New Mexico-based oil and gas operations; 2) Ray Westall, whose water-drilling company owes the SLO approximately $1.3 million in overdue rental payments, has filed a lawsuit against the SLO over its restrictions on water well easements; 3) the top 10 oil and gas producers in the state have not objected to the SLO's water well easement policy; 4) up to 80 percent of the water now used in hydraulic fracturing is recycled or produced water, not fresh water; and 5) Colorado has imposed restrictions on drilling into the aquifer.

Rights of way. A study conducted by the former commissioner of public lands, Ray Powell, recommended that right-of-way rates be increased by 100 percent to match market rates, which are the rates that the SLO is constitutionally required to charge. The SLO increased the rates by 25 percent last year. While oil and gas companies are not pleased about a rate increase, they are willing to pay for expedited rights of way at three times the cost of a regular right of way.

Wind towers. Wind energy installations on state trust lands near White Sands Missile Range and Cannon Air Force Base have been delayed due to pressure from the military, which uses the areas for training flights.

Oil and gas drilling leases. Drilling leases issued by the SLO are good for five years and allow both vertical and horizontal drilling.

- Commissioner Dunn agreed to provide information on:
  (1) materials used in constructing wind towers; and
  (2) revenue generated from state land leases for wind turbines.

Return-to-Work Laws and Educational Retirement

Jan Goodwin, director, Educational Retirement Board (ERB), and Roderick Ventura, general counsel, ERB, reported on issues related to ERB members who work after retirement.

An ERB member may return to work beginning 12 months after the member's retirement date without suspending ERB retirement benefits. The member is limited under the return-to-work program to earning $15,000 per fiscal year or working a .25 full-time-equivalent schedule. Unless the member qualifies for one of three program exceptions, the member must pay ERB contributions while employed under the program.

The return-to-work program, created in 2001, was originally intended to address teacher shortages in rural school districts. Of the top five entities employing return-to-work members as of FY 2017, however, three are school districts, two are universities and none is rural. As reported by employers, more than one-half of those participating in the return-to-work program are in non-teaching positions, including administrative positions.

Cooperative Educational Services (CES), a procurement agency that places retired education professionals in public school district jobs, recently filed a lawsuit against the ERB over a letter sent by the ERB to its members. The letter explained the contribution requirements under the return-to-work statute and cautioned members about taking work through third-party entities that may or may not be in compliance with those requirements.

On questioning, the presenters and committee members addressed the following topics.

Retirement contributions, benefits and eligibility. There is no difference in the state's ERB contribution cost between regular teachers and return-to-work teachers. The cost difference is seen in salaries: return-to-work teachers, who tend to be at a higher salary level, displace new teachers, who are hired at a beginning salary level.

There is no cap on ERB retirement benefits at 25 years; a teacher who works longer than that will accrue increased benefits. Actuarially, a teacher is better off working beyond 25 years than taking an early retirement and returning to work.

The 12-month gap between retirement and return-to-work employment is required by the Internal Revenue Service.

The ERB structure is consistent with best practices for retirement systems in other states.

An ERB member is eligible for cost-of-living adjustments (COLAs) beginning either at age 65 or one year following retirement, whichever is later. COLAs are based on the change in inflation and are, on average, 1.5 percent.

CES complaint. Mr. Ventura noted that it is the ERB's understanding that CES seeks a writ of mandamus to stop the ERB from sending out return-to-work information to its members because CES believes it is not in violation of the return-to-work statute.

Compensation. Ms. Goodwin noted that, though not intended for such, the return-to-work program is being used to address what is actually a compensation issue.

- Ms. Goodwin agreed to provide information on ERB contributions made by return-to-work employees.

Land Grant Permanent Fund Distributions: Who, What, How and Why

Dawn Iglesias, economist, Legislative Finance Committee, expanded on Commissioner Dunn's presentation to further explain the flow of money into and out of the Land Grant Permanent Fund.

While the net asset value for the fund — currently $16.2 billion — rose nearly every year since FY 2012, SLO deposits varied significantly during that time, with a high of nearly $800 million in FY 2014 and a low of less than $400 million in FY 2017.

Distributions from the fund for FY 2017 totaled just over $638 million in FY 2017. The fund's 21 beneficiaries receive distributions based on the earnings from specific parcels of state land, with earnings varying from year to year based on each parcel's productivity. While Land Grant Permanent Fund distributions are included in each year's general appropriation act, they are rolled into the "other state funds" category for each beneficiary and are not tracked separately at either the point of receipt or point of expenditure.

Because the Land Grant Permanent Fund beneficiaries were enumerated in the Constitution of New Mexico to comply with requirements in the Enabling Act for New Mexico and the federal Ferguson Act of 1898, a change to the list of beneficiaries would require a change to the state's constitution and would require changes to federal statutes.

On questioning, Ms. Iglesias and committee members addressed the following topics.

Discrepancy between presentations. Ms. Iglesias' materials showed distribution amounts solely from the Land Grant Permanent Fund, while distribution amounts in Commissioner Dunn's materials included amounts from the State Lands Maintenance Fund.

Rainy day fund. The consensus revenue estimate that Ms. Iglesias presented for FY 2017 through FY 2019 does not include revenue to the state's "rainy day fund" from the oil and gas school tax because the tax is not estimated to generate revenue for that fund until FY 2021.

Beneficiaries and distributions. Land parcels assigned to specific beneficiaries may be swapped for other land; in that case, the beneficiary distributions are based on earnings from the new parcels.

While constitutional amendments have been used over the years to change the names of beneficiaries, a court decision found that a change in a beneficiary's location does not require a constitutional amendment or affect its designation as a beneficiary. If a beneficiary closes, as was the case with the New Mexico Boys' School, its distribution goes to the administering state agency — in this case, the Children, Youth and Families Department. The overall annual distribution from the Land Grant Permanent Fund can be adjusted by constitutional amendment.

There are no restrictions on how a beneficiary may use distribution funds.

- Ms. Iglesias agreed to provide information on:
  (1) how the Office of the State Engineer uses the Land Grant Permanent Fund distribution allocated to "improvement of the Rio Grande";
  (2) how specific acreage is assigned to Land Grant Permanent Fund beneficiaries;
  (3) how a Land Grant Permanent Fund distribution is handled if the beneficiary no longer exists; and
  (4) the "land grant institution" designation as it applies to Land Grant Permanent Fund distributions.

Minutes

On a motion duly made, seconded and unanimously adopted, the minutes from the September 7, 2017 meeting were approved.

Public Employees Retirement Association (PERA): Sustainability and Solvency

Wayne Propst, executive director, PERA; Dominic Garcia, chief investment officer, PERA; and Jonathan Craven, consulting actuary, Cavanaugh McDonald Consulting, gave an update on the PERA funds, their returns over time and projections for their solvency.

The PERA funds closed FY 2017 with a balance of $15 billion, with one-year returns of 11 percent. Three-year and five-year returns for the fund were 4.4 percent and 8.53 percent, respectively, with the three-year return falling short of the policy benchmark and the five-year return exceeding the benchmark. Ten-year returns, at 3.97 percent, fell short of their benchmark due to the precipitous drop in asset values during the 2008 recession, which falls within the 10-year calculation time period.

The presenters gave funded ratio projections based on investment return scenarios and COLA revisions proposed by committee members in a previous meeting, as well as projections based on actual returns seen in the past five years. In 2043, the PERA will be:

- 133.1 percent funded if returns continue at the level seen in 2014;
- 87.6 percent funded if returns continue at the level seen in 2016 and 2017; and
- 29 percent funded if returns continue at the level seen in 2012.

Excluding the state police plan, which is already fully funded, plans within the PERA vary in their funded ratio projections for 2043 from 107.5 percent (municipal general plan) to 46 percent (state general plan).

PERA benefits paid in FY 2017 came to more than $1 billion and will increase as more active members retire. Since it was last fully funded in 2002, the PERA has accrued an unfunded liability of $4.82 billion, primarily due to lower-than-expected investment returns. The presenters noted that an overall PERA contribution increase of 2.91 percent would help address the shortfall.

On questioning, the presenters and committee members addressed the following topics.

Solvency measures. Fixing the PERA funded ratio situation could involve a variety of measures, including changes to contributions, benefits, COLAs and investments. The PERA needs to expand its efforts to educate members on the PERA funds' solvency status and measures that would keep the funds solvent.

PERA benefits and COLAs. The PERA benefits package is one of the most generous in the country. Changes to benefits can only be made for new employees entering the PERA system.

A COLA increases the base benefits pay while a bonus, or dividend, does not. The Wisconsin system does not have a COLA; it pays a base retirement benefit plus a dividend based on investment returns.

Other state pension systems. Wisconsin, South Dakota and North Carolina have pension systems that are, or are close to, 100 percent funded. Other states are looking at possible adjustments to their plans to address demographic changes, such as longer life spans for retirees. A member noted that it would be appropriate for the PERA to study and provide information on best practices followed by other state pension systems.

- Mr. Propst agreed to provide:
  - (1) PERA solvency projections based on:
    - (a) a one percent contribution increase from both the employer and the employee;
    - (b) a .5 percent contribution increase from both the employer and the employee; and
    - (c) COLAs in alternating years, with a thirteenth check issued to retirees in the intervening years;
  - (2) information on whether a thirteenth check issued to retirees would be taxable and require contributions to retiree health care;
  - (3) information from the National Organization of State Retirement Administrators on pension systems in other states that are doing well; and
  - (4) the total amount that has been contributed to the PERA funds since their inception and the total amount that has been earned by the funds since their inception.

New Mexico Private Equity and Other Economically Targeted Investments (ETIs) in the Severance Tax Permanent Fund

Steven K. Moise, state investment officer, SIC; Robert "Vince" Smith, deputy state investment officer, SIC; and Sally Corning, Sun Mountain Capital, gave a presentation on ETIs, which include a variety of investment types ranging from mortgage pass-through securities to film loans.

Provisions in the Severance Tax Bonding Act authorize the state to invest up to nine percent of the market value of the Severance Tax Permanent Fund in "private equities or New Mexico businesses". While the intent of New Mexico-based investments is to stimulate the state's economy, ETIs in general tend to perform below market and can have a negative effect on the Severance Tax Permanent Fund's overall performance. Currently, ETIs account for seven percent of the Severance Tax Permanent Fund; the SIC has set a target of five percent of the fund to be invested in New Mexico businesses through the New Mexico Private Equity Investment Program, with annual commitments of $30 million to $35 million. Sun Mountain Capital assesses New Mexico businesses for potential investment through the program's three initiatives: 1) a fund of funds program; 2) co-investment funds; and 3) the Catalyst Fund.

On questioning, the presenters and committee members addressed the following topics.

Catalyst Fund. The Catalyst Fund provides funds for other funds, which must raise capital first in order to qualify for the money.

Qualifying businesses. It is a challenge for Sun Mountain to find companies outside the Rio Grande corridor that qualify for investment and will yield a good investment return.

SIC. Members and presenters made various comments regarding SIC activities, duties and composition, including: 1) concerns that SIC members had been required to sign a code of ethics, or "loyalty pledge to a pot of money", and that those who had chosen not to sign will be excluded from SIC executive sessions on employment matters; 2) that the SIC is required by statute to be fiduciaries — by definition, to make decisions in the best interest of the funds in its control — except in the case of ETIs; 3) that ETIs on the one hand promote economic development in the state and on the other hand can be politically motivated; 4) that the state seems to do less well as the money per capita in its permanent funds grows; 5) that the SIC was restructured in statute to reduce executive branch or political influence; and 6) that the SIC is still in litigation to recover funds.

Local bond issuances. The SIC does not invest in local bonds, such as those issued by the Jal Public School District.

EnnisKnupp report. The SIC has implemented 78 of the 82 recommendations made in a report issued by EnnisKnupp.

- Mr. Smith agreed to provide a dollar amount for the 3.9 percent figure cited as the return on ETIs.

Investing in New Mexico: Needs, Opportunities and Benefits

Jason Espinoza, president and chief executive officer, New Mexico Association of Commerce and Industry, and Thomas J. Stephenson, managing general partner, Verge Fund, spoke of the benefits of using public money, including pension funds, to invest in New Mexico-based ventures. Mr. Stephenson acknowledged that the SIC, using its Catalyst Fund, invested in the Verge Fund in 2005 and serves as a limited partner in that fund.

Just as New Mexico statute allows for investment in ETIs, several other states have included "alternate asset classes" in their investment portfolios to direct funds to local economic development. The presenters gave as examples the New York State Common Retirement Fund, which invests in technology-based start-ups and businesses seeking expansion capital; the Badger Fund of Funds in Wisconsin, which provides capital to start-up businesses; and the Robert Trent Jones Golf Trail in Alabama, which received funding from the Retirement Systems of Alabama.

Start-up businesses seeking capital have access to the SIC Catalyst Fund only through the initial stages of development. Once a company becomes fully operational and SIC funding is no longer available, it is likely to move out of state if the next phase of funding is not found locally. Possible steps the state can take to keep these businesses from leaving include expanding SIC investments in local businesses, expanding the state's angel tax credit and exempting the sale of New Mexico businesses from the capital gains tax.

On questioning, the presenters and committee members addressed the following topics.

Investment requirements. Collateral requirements for public pension private equity investments would match private equity collateral requirements under other state investment programs.

The Verge Fund does not require that companies stay in New Mexico to receive funding.

Taos Ski Valley. Taos Ski Valley is an example of successful local investment; the village was entirely New Mexico-built and -financed.

Brain drain. New Mexico is losing its "millenial generation" population both because millenials cannot find jobs here and because they feel they cannot create jobs here.

Capital gains tax. Some companies have left the state just prior to being bought by another company in order to avoid paying the capital gains tax.

Fees, Returns and Cost-Effective Management of Large Public Fund Investment Programs

Allan C. Martin, partner, NEPC, LLC, and general investment consultant, ERB; Ms. Goodwin; and Bob Jacksha, chief investment officer, ERB, explained the types of fees imposed on the state's permanent fund investment portfolios.

Fees differ based on an investment's asset class (such as large cap equity or private equity), the market in which the investments are traded (public or private) and the type of management involved (active or passive). Ideally, fees are paid for value that is added to investments, taking into consideration the amount of risk involved. Asset classes at the high end of the fee scale have higher expected returns and carry increased risk, while expected returns and risk are lower for asset classes at the other end of the fee scale.

Fees charged in the public market are either:

- flat fees, which are usually used for passive or indexed assets;
- tier or asset-based fees, which are based on the size of the investment; or
- performance-based fees, which include a base fee plus additional compensation based on excess returns.

Private market fee structures tend to be higher than those in the public market. Private equities, which have done very well in the past five years but are also volatile, tend to have the highest fees in both markets.

Indexed funds — those that are passively managed — usually outperform actively managed funds; however, active management is more likely to add value to investments when the market is inefficient or volatile.

Mr. Martin noted that an agency's decision to manage funds in-house rather than to contract for management services should take into consideration more than just the fees that might be incurred or avoided. An agency must also consider whether it has competent personnel who can manage a portfolio and, if not, whether investment managers can be recruited and retained at the salaries the agency can offer. The ERB has investment management personnel on staff and will soon expand the number of its assets that are managed in-house.

On questioning, the presenters and committee members addressed the following topics.

Fees. Fees charged to the ERB by Mr. Martin's firm do not vary from year to year based on the market; the company charges a fixed annual fee of $375,000.

Indexed versus actively managed funds. Even though indexed funds tend to outperform actively managed funds, their success depends on what is doing well in the market at a given time. Rather than place an entire portfolio under either passive or active management, each asset class's management should be considered separately based on the current market.

The ERB changed its core bonds fund from an indexed fund to an in-house actively managed fund and has saved $1 million in fees per year since the move. Co-investing has also saved the ERB money on fees.

ERB staff compensation. The state's classified employee salary ranges hinder the ERB's efforts to attract and retain investment management personnel. A bill introduced in the last session would have made all ERB employees exempt, thus allowing the agency to bring salaries into the range paid by other pension funds.

The committee recessed at 5:55 p.m.

Friday, October 20

The committee reconvened at 9:05 a.m., with Representative Salazar chairing the meeting.

Private Sector Retirement Insecurity

John C. Scott, director, Retirement Savings Project, The Pew Charitable Trusts (Pew); John W. Mangan, regional vice president, American Council of Life Insurers (ACLI); and Sarah Mysiewicz Gill, senior legislative representative, AARP, reported on the reasons for and ramifications of the $4.1 trillion shortfall in retirement savings for private sector workers.

According to a Pew study, only 22 percent of Americans feel "very confident" that they will have enough money in their retirement. Overall, 28 percent of full-time workers and 60 percent of part-time workers have no access to an employer-sponsored retirement plan, with those percentages increasing significantly for non-white workers. In New Mexico, more than 60 percent of all workers lack access to a retirement plan — more than 336,000 workers in 2014, according to the U.S. Census Bureau.

Large employers are twice as likely to offer plans than small employers, and while workers are 2.5 times more likely to participate in retirement plans that include contributions from their employers, many plans do not include employer contributions. In addition, workers face barriers to retirement savings that go beyond access to employer-sponsored plans, including the recent recession, job insecurity, the fragility of small businesses, slow wage growth, student and consumer loan debt, health care costs, housing costs and lack of information on available savings plans.

The presenters described both positive and negative aspects of policy initiatives launched by other states to increase access to retirement plans for private sector employees. The initiatives include: 1) plans with optional automatic payroll deductions deposited to individual retirement accounts (IRAs), known as "auto-IRA plans"; 2) online marketplace exchanges where employers can get information on retirement savings plans; and 3) multiple-employer plans that allow businesses in disparate industries to create joint retirement plans. Representative Salazar presented a letter from Kim Chamberlain, general counsel, Securities Industry and Financial Markets Association, who was unable to participate in the presentation, stating the association's objections to the public initiatives for retirement savings.

On questioning, the presenters and committee members addressed the following topics.

Multiple-employer plans. Per federal law, only employers in the same industry may participate in multiple-employer plans. States that allow multiple-employer plans avoid this restriction by structuring the plans so that the state is the plan agent rather than a single business.

Auto-IRA plans. By aggregating accounts, auto-IRA plans bypass the minimum-deposit requirement for opening an IRA and have no minimum monthly deposit requirement.

The auto-IRA OregonSaves plan is a public-private partnership structured in the same manner as a 529 education savings plan, in which the individual retains investment control over the funds. As a post-tax payroll deduction, there is no tax revenue loss to the state. Employers are required to offer a plan, though employees are not required to participate. The ACLI has concerns that the OregonSaves plan does not meet requirements under the federal Employee Retirement Income Security Act of 1974.

Incentives and information. States can waive licensing fees for new businesses that choose to set up employee retirement savings plans, match the federal plan start-up tax credit, provide information on federal tax credits for retirement savings and add financial literacy to high school curricula.

Retirement Income Security Task Force

Senator Bill Tallman and DeAnza M. Valencia, associate state director for advocacy, AARP, gave an update on the work under way by the Retirement Income Security Task Force convened pursuant to Senate Joint Memorial 12 of the 2017 regular legislative session.

The joint memorial requested that the state treasurer convene a task force to identify options and a process for implementing a retirement savings vehicle for private sector employees. In its two meetings to date, the task force discussed the state's over-reliance on social security; public initiatives under way in other states, including lessons learned from those efforts; and a possible New Mexico-specific retirement savings plan for private sector workers. The Bureau of Business and Economic Research at the University of New Mexico will present a report on the issue at the task force's next meeting, scheduled for December 2017. The task force will continue to meet on a bimonthly basis and will present its findings to the IPOC in July 2018.

On questioning, the presenters and committee members discussed differences in retirement security and income stability between urban and rural populations in the state, as well as difficulties posed by possible reductions to Medicare and other federal programs.

- Senator Tallman and Ms. Valencia agreed to:
  (1) contact the Workforce Solutions Department regarding the department's unfilled seat on the Retirement Income Security Task Force; and
  (2) include on the task force's agenda those topics that were discussed by the IPOC in the 2016 interim.

Public Comment

Dr. Benjamin Shuster, legislative advocacy volunteer, AARP, brought to the committee's attention the recently named 2017 Nobel Prize laureate in economics, Professor Richard Thaler of the University of Chicago, whose most-cited research shows that people are more likely to participate in financial programs that require them to opt out rather than opt in.

Adjournment

There being no further business, the committee adjourned at 11:50 a.m.