FISCAL NOTE TO

[First Reprint]
ASSEMBLY, No. 2794

STATE OF NEW JERSEY

DATED: April 14, 1997

Assembly Bill No. 2794 (1R) of 1997 and its companion bill, A2793 (1R), change the manner by which the State finances its pension obligations. A2794 (1R) changes the value of the assets of the retirement systems to "full-market" value of assets, for the State and participating local governments, as of the valuation reports applicable to FY1998. This one-time accounting change from the current "market-related" value of assets (20 percent of full-market) to "full-market" immediately recognizes recent capital gains instead of recognizing those gains over five years, resulting in an increased value of the accumulated assets. For valuation reports applicable to FY 1999 and thereafter, the actuarial value of assets will revert to "market-related" value of assets. A2794 (1R) authorizes the State and local employers to reduce their "normal contributions" to the systems, to the extent possible, from 100 percent of excess assets through FY2001, and on a declining percentage of excess thereafter. In addition, A2794 (1R) permits the State to pay its unfunded accrued liabilities under the various pension systems from any source of funds, including the proceeds of pension obligation bonds (POBs) to be issued by the New Jersey Economic Development Authority (EDA).

A2793 (1R), entitled the "Pension Bond Financing Act of 1997", authorizes the EDA to issue State-backed bonds to fund, in full or in part, the unfunded accrued pension liability of the State in each State pension fund, as such liabilities were certified by the valuation reports applicable for FY1998.

Administration Comments

The Department of Treasury has distributed a number of documents and graphic displays which explain the financial, actuarial and budgetary impacts of this legislation. These may be briefly summarized as follows:

A. The unfunded accrued liability of the State pension systems is $3.2 billion. In addition, there is a $1.0 projected future billion liability for cost-of-living adjustment (COLA) benefits payable to active employees.

B. Under the provisions of A2793 (1R), the EDA would issue at least $2.9 billion in POBs to "refinance" most of the $3.2 billion unfunded accrued liability of the State retirement systems. The $2.9 billion in bond proceeds would be deposited in the various pension funds. The principal and interest (debt service) on the proposed $2.9 billion POB issuance are estimated to total $14.7 billion, if the bonds are repaid with interest over 36 years. Refinancing the liability is estimated to result in savings of $42 billion to taxpayers in the years 2034 through 2056.

C. The debt service interest rate on the $2.9 billion in POBs is estimated to average 7.7 percent over the 36-year amortization period. Under current law, the opportunity cost of not having the $3.2 billion (amount of the unfunded accrued liability) invested in the capital markets is assumed to be 8.75 percent per year.

D. The repayment schedule for the $2.9 billion in POBs is to be structured in a manner wherein the annual debt service on the POBs would "mirror" the annual State contributions that are to be provided to fund the retirement systems under current law.

E. An estimated $300 million of the $2.4 billion in "surplus assets" created by the change to "full-market" value of assets under A-2794 (1R) will be used to pay the portion of the $3.2 billion unfunded accrued liability not funded with the proceeds of the POBs ($3.2 billion - $2.9 billion = $300 million).

F. $1.0 billion of the $2.4 billion in "surplus assets" will be used to pay the $1.0 billion projected future liability for cost-of-living adjustment (COLA) benefits payable to active employees.

G. An estimated $647 million of the "surplus assets" would be applied to reduce the normal State contributions to fund the retirement systems in FY 1997 and FY 1998.

H. The one-time accounting change to "full-market" value of assets will reduce the annual pension contributions of local government employers that participate in the Public Employees' Retirement System and the Police and Firemen's Retirement System in FY1998 and may serve to reduce them in future years. However, local employers are not participants in the issuance of POBs authorized by this legislation.

OLS Comments

A. A2793 (1R) does not set a specific limit on the amount or amortization period of POBs that may be issued by the EDA.

Issuing bonds in excess of the $2.9 billion now anticipated would increase the total debt service cost.

Debt authorized by the EDA is currently limited by law to a maximum 40-year amortization period. The provisions of A-2793 (1R) would override the current 40-year limit if it is necessary. The Administration could establish a longer or shorter amortization schedule. If the amortization period exceeds the Administration's 36-year proposal, the debt service on bonds will increase and the savings to future taxpayers will decrease. If the POBs are retired under an amortization schedule less than 36 years, the debt service on the bonds will decrease and the savings to future taxpayers would increase.

The present value, in 1997 dollars, of the $42 billion savings to taxpayers in 2034 through 2056 is $701.3 million when the assumed rate of return (8.75 percent) on pension investments is used.

B. The Administration's estimates were based on an average interest rate of 7.7 percent. The actual rate will be determined based on market conditions at the time the bonds are issued. Interest rates have increased somewhat since the Administration's estimates. The rate on 30-Year U.S. Treasury Bonds, as published in the Wall Street Journal on March 14, 1997, was 6.96 percent. A continuation of this recent trend could affect the average rate payable on the POBs and ultimately the value of the anticipated future savings.

The POBs would be limited obligations of the EDA. Although the principal and interest on the bonds will be paid through annual State appropriations from the General Fund, the bonds will not be "full faith and credit" obligations (debt) of the State, which would require approval in a public referendum. The POBs must contain a statement to that effect. Because the bonds are not issued directly by the State, and are not backed by its full faith and credit, but rather a promise to appropriate the annual debt service, the POBs are considered a somewhat greater credit risk than General Obligation (G.O.) bonds. According to Standard & Poor's Corp., a credit rating agency, the credit premium on POBs could be as much as 33 basis points (.33 percent) higher than G.O. bonds. The cost differential of financing $2.9 billion for G.O. bonds versus appropriation bonds may total approximately $300 million dollars.

The State Treasurer has indicated that a portion of the bond issuance may be insured. Such insurance would reduce the credit risk of appropriation bonds, resulting in a lower interest rate

payable on the bonds. Any savings would be dependent on the cost of purchasing insurance.

If the State were to wait until after a November referendum to issue the debt, the State risks more uncertainty (interest rate fluctuations) in the bond market.

C. The Administration proposal of refinancing the $3.2 billion unfunded accrued liability by issuing $2.9 billion in POBs and using $300 million in "surplus assets" is structured to replicate the annual State contributions that are now scheduled to be made between 1998 and the year 2034 to fund the retirement systems under current law. This payment schedule starts out with very low annual payments that rise steeply over time.

   Other amortization schedules that would require higher annual payments in early years result in significant total debt service savings over the life of the POBs. In this example, a level amortization of $239 million per year would require the State to contribute an additional $1.3 billion toward debt service over the first ten years (the first-year difference in FY 1998 would be $147.3 million); however, after the "crossover point" in FY 2011, level debt payments would be $7.3 billion lower through the remaining years of repayment.

D. If A2793 (1R) and A2794 (1R) are enacted, the Administration estimates the pension funds will have $2.4 billion in "surplus assets" representing the difference between market value and actuarial value of assets. To the extent there are "surplus assets" (assets in excess of liabilities) the State is, in effect, borrowing more than the amount necessary to fully fund the retirement systems. Although it is hoped that the proceeds of the bond sale will be invested and will earn more than the cost of their replacement, there is always a risk or uncertainty in borrowing money.

E. The State and local employers can only use "surplus assets" to offset their normal pension contributions if the retirement systems are fully funded and there are no unfunded accrued liabilities.

This fiscal note has been prepared pursuant to P.L.1980, c.67.