

FISCAL NOTE TO  
[First Reprint]  
**SENATE, No. 1905**

**STATE OF NEW JERSEY**

DATED: JUNE 26, 1997

Senate Bill No. 1905 (1R) of 1997 and its companion bill, S-2148, change the manner by which the State finances its pension obligations. S-1905 (1R), entitled the "Pension Bond Financing Act of 1997", authorizes the New Jersey Economic Development Authority (EDA) to issue State-backed appropriation 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 FY 1998.

S-2148 changes the value of the assets of the retirement systems to "full-market" value of assets for the State and participating local government employers as of the actuarial valuation reports applicable to FY 1998. This one-time accounting change from the current "market-related" value of assets (20 percent of full-market) to "full-market" value 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. S-2148 authorizes the State and local employers to reduce their annual "normal contributions" to the systems, to the extent possible, by up to 100 percent of the value of excess assets through FY 2002, and on a declining percentage of excess assets thereafter. In addition, S-2148 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 EDA.

S-1905 (1R) also provides for a reduction, during the calendar years 1998 and 1999, in the contribution rate of State and local government employees of 1/2 of 1 percent of salary and for a similar reduction in employee contributions in the future if the State Treasurer determines that excess assets shall be used to reduce the employers' (State and local governments) normal contributions beyond FY 1998.

These bills are identical to A-3049 and A-3047.

**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 billion projected future liability for cost-of-living adjustment (COLA) benefits payable to active employees.
- B. Under the provisions of S-1905 (1R), the EDA would issue at least \$2.75 billion in POBs to "refinance" most of the \$3.2 billion liability of the State retirement systems. The \$2.75 billion in bond proceeds would be deposited in the various pension funds. The principal and interest (debt service) on the proposed \$2.75 billion POB issuance are estimated to total \$12.6 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 \$2.75 billion in POBs is estimated to average 8.07 percent over the 36-year amortization period. Under current law, the opportunity cost of not having the \$3.2 billion (amount of the liability) invested in the capital markets is assumed to be 8.75 percent per year.
- D. The repayment schedule for the \$2.75 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, but with several important differences:

Specifically, for FY 1998, the debt service will equal the amount that would have been required to be applied in FY 1998 to finance the unfunded accrued liabilities of the retirement systems under current law (\$90.8 million);

For fiscal years 1999 through 2004, inclusive, the debt service shall at least equal the current unfunded accrued liability payments, plus an additional \$25 million each year;

For fiscal years 2005 through 2020, inclusive, the debt service shall at least equal the current unfunded accrued liability payments;

For fiscal years 2021 through 2035 (or whenever the last bonds are retired), the debt service shall be leveled off so that payments at least equal the unfunded accrued liability payment scheduled for FY 2020, but are not more than the unfunded accrued liability payment for FY 2021, as determined under current law.

- E. An estimated \$450 million of the \$2.4 billion in "surplus assets" created by the change to "full-market" value of assets under A3047 will be used to pay the portion of the \$3.2 billion liability not funded with the proceeds of the POBs (\$3.2 billion - \$2.75 billion = \$450 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 \$589 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. (This amount was originally calculated to be \$647 million.)

#### **OLS Comments**

- A. As noted, the unfunded accrued liability of the State retirement systems is calculated by the administration to be \$3.213 billion. At the same time, however, two of the systems, the Teachers' Pension and Annuity Fund (TPAF) and the Public Employees' Retirement System (PERS) are retaining \$543 million in "basic benefits surplus" assets that are not being considered in calculating the unfunded accrued liability and therefore sizing the proposed bond issue. The Administration deducts \$204 million in assets from the TPAF and \$339 million in assets from the PERS to arrive at the \$3.2 billion figure. There is no convincing actuarial or accounting rule which would prevent this \$543 million from being considered as an offset to the \$3.2 billion unfunded liability.

S-1905 (1R) limits the amount of bonds that may be issued by the EDA to an amount that will yield \$2.75 billion in bond proceeds to refinance the liability of the retirement systems plus an estimated \$15 million for the cost of issuing the bonds. The bill also establishes a maximum 38-year amortization period.

The Administration has indicated an intention to repay the bonds over 36 years at an estimated debt service cost of \$12.6 billion. 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 in future savings to taxpayers in 2034 through 2056 is \$701 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 8.07 percent. The actual rate will be determined based on market conditions at the time the bonds are issued. Interest rates, which have fluctuated considerably, have increased slightly since the Administration's original estimates. 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 \$2.765 billion for G.O. bonds versus appropriation bonds may total approximately \$285 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. As noted previously, the debt service on the \$2.75 billion POB issuance is structured to be similar, although not identical, to 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 before leveling off in 2021.

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. For instance, a level amortization schedule for the proposed \$2.765 billion issuance would cost approximately \$8.6 billion compared to the \$12.6 billion currently proposed. In this example, a level amortization of \$237.7 million per year would require the State to contribute an additional \$1.0 billion toward debt service over the first thirteen years (the first-year difference in FY 1998 would be \$146.9 million); however, after the "crossover point" in FY 2010, level debt payments would be \$5.0 billion lower through the remaining years of repayment.

- D. If S-1905 (1R) and S-2148 are enacted, the Administration estimates the pension funds will have \$2.4 billion in "surplus assets". Approximately \$1.9 billion represents the difference between the actuarial value of assets and the full-market value of assets. The remaining amount, approximately \$543 million, consists of assets currently recognized by the TPAF and PERS retirement systems as surplus assets (basic benefits surplus). 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 can only use "surplus assets" to offset the normal pension contributions if the retirement systems are fully funded and there are no unfunded accrued liabilities.
- G. Normal pension contributions are defined by the Administration to include the cost of funding basic pension benefits, COLAs and group life insurance benefits but not the pay-as-you-go cost of funding post-retirement medical benefits.

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