# State of New Jersey

Department of the Treasury

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**Treasurer and Pension Director present testimony to Senate Budget Committee**

TRENTON – State Treasurer Bradley Abelow today presented the following testimony to the Senate Budget Committee on the unfunded liability in the state pension system and the accounting and reporting mechanisms used by the Division of Pensions and Benefits.

Division of Pensions and Benefits Director Frederick Beaver accompanied the Treasurer and made the attached presentation regarding the state pension system.

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**Testimony of Treasurer Bradley Abelow**
**Senate Budget and Appropriations Committee**
**Pension System Funding and Accounting Practices**
**April 11, 2007**

Good morning.

I would like to make a brief introductory statement and then ask my colleague, Fred Beaver, Director of the Division of Pensions to provide a more thorough overview of the pension system and the issues confronting the system. As many of you will recall, Treasury and the Division of Pensions and Benefits have, over many years, chronicled the good, the bad and the ugly of the State pension system. The State's objective is to maintain a pension system whose assets are roughly sufficient to meet the present value of the estimated obligations to provide agreed upon retirement benefits to our public employees and retirees.

The pension funds allow us to meet our retirement obligations to teachers, judges, prosecutors, the state police, local police and firefighters as well as other State employees. It is also important to note that, once vested, the pension benefits granted to current employees are guaranteed to them by law and may not be reduced.

To the degree that the actuarially determined obligations of the pension systems exceed the value of the assets, we have a gap that we refer to as an unfunded liability.

Around this time last year, we learned that the unfunded liability for the combined systems rose from $12 billion, as of June 30, 2004, to $18 billion, as of June 2005. This year, that gap has widened even further to $24.8 billion. In addition to the unfunded pension liability, our actuary's preliminary estimate of the State's future liability for post-retirement medical benefits for current and future retirees is a staggering $78 billion. This expense remains a pay-as-you go item and the actual expense incurred in each year must be appropriated by the Legislature.

The reasons for the under-funded position of the pension system are well-known. Stated simply, New Jersey has not appropriated sufficient cash contributions necessary through the State budget to meet the long-term actuarial growth assumptions of the system. Over a period of years, stretching back to the 1990's, the State has relied on various methods to avoid making adequate cash contributions into the pension funds, while systematically increasing pension benefits. Investment earnings have simply not been able to keep pace with the combination of insufficient funding, increased benefits, longer retiree life spans and a growing population of covered employees.

The accrued liability has more than doubled over the last ten years, from $49 billion in 1996 to $110 billion in 2006 – a $60 billion increase. While over the last decade, the market value of assets has risen by only $27 billion.

Since taking office, Governor Corzine has made shoring up the pension system a top policy and budget priority. The fiscal year 2007 budget included an appropriation of cash for the pension funds that exceeded cash contributed to the systems over the previous 10 years – combined.

The Governor has proposed a larger contribution for FY 2008. The contributions enacted in 07 and proposed in 08 total about $2.2 billion. That represents 36 percent of the $6.1 billion in cash contributions that have been made since FY 1990 and is equal to the amount contributed since FY 1993.

Let me state that again. The $2.2 billion in cash contributions for FY 07 and FY 08 equal the entire amount of cash contributed by the State from FY 1993 to FY 2006.

Just as the Legislature joined him in appropriating more than $1 billion in cash contributions last year, the Governor asks for your support in continuing to address this issue by appropriating funds as proposed for the next budget.

Contributions alone -- and this year's proposed contribution is only 50 percent of the amount that is actuarially defined as full funding -- won't solve the problem of pension under-funding. Along with consistent cash contributions the state must do more to enhance the performance of the pension's investments and seek changes that control the long-term costs of the system.

We are making progress in those two areas. Our pension portfolio is now more diversified, with an asset base that can better meet the long term obligations of the pension system. The Governor has also proposed changes in the pension system for new employees that help control long-term liabilities by raising the retirement age and capping benefits for high earners in a way that will eliminate some of the worst abuses of padding, tacking and boosting.

Whatever changes evolve, there is one constant – the reporting of the complex accounting for our pension system.

The financial position of the systems funds is transparent and stated in various publications in accordance with required accounting standards.

System values are constantly measured and reported to the board of trustees of each of the retirement systems. Actuaries provide monthly reports to the boards. The information is reviewed and certified by independent auditors.

The State Auditor, appointed by the Legislature, attests to the accuracy of the information. This information is provided to employees, retirees and the public through actuarial reports, accounting reports, the State budget, the State's financial reports, and in various other disclosures, such as bond offering statements.

In addition, the governor has gone out of his way to highlight the funding status of the pension funds in his budget addresses and many town hall meetings across the state devoted to discussion of budget issues.

In short, Governor Corzine and this administration are committed to preserving and protecting the state's retirement systems. Our current funding problems have been created by a combination of under-funding and expanding benefits over a 20-year period – spanning Republican and Democratic administrations. The way forward requires a commitment to steady cash funding of the system, improved investment performance and mutually agreed steps to control growth in liabilities in the future. There is no quick fix and the time is well past to revert to sweeping the problem under the rug.

# New Jersey State Pension Systems

Disclosure
Funding
Accounting

April, 2007

# Agenda

- Introduction/Overview
  - Disclosure
  - Actuarial Methodology
  - Budget Implications
  - Funding
- Lessons of the past
  - The “Gimmicks”
- System Status
- Governor Corzine’s Funding Policy

# Disclosure Vehicles

- Monthly
  - Pension Boards receive financial statements describing plan assets, changes in assets, investments and balance sheets; these are public documents; Investment Council receives similar reports
- Annual
  - Each Board receives a detailed valuation report containing full disclosure of plan assets, liabilities and changes based on June 30th of each year

# Who Delivers Disclosure

- Monthly statements are prepared internally by the Division of Pensions with data provided by Division of Investments
- Annual Valuation reports are prepared by independent actuaries selected through a competitive bid process with Board participation
- External auditor also retained to ensure accuracy in actuarial reporting
- All are subject to examination by the State Auditor

# Actuarial Assumptions

- Key assumptions driving liability estimates include:
  - Life Expectancy
  - Size of Workforce
  - Career Service
  - Salary Growth
  - Inflation

# “Managing” Key Assumptions

- Each Board receives a triennial report examining plan experience versus assumptions
- Only one variable, the assumed rate of return, is established by the Treasurer
- Changes in these assumptions are not frequent but reflect actual experience trends

# Budget Implications

- The actuarial report delivered as of June 30, 2006 will affect normal contribution requirements for FY ’08 in most cases; PFRS actually will impact a year later
- The actual budget appropriation may or may not reflect the actuarially developed required contribution
- Any budgeted amounts are fully disclosed through the budget process

# “Transparency” +

- In addition to all the previously mentioned documentation, financial disclosure includes:
  - State’s Comprehensive Annual Financial Report (CAFR)
  - Division of Pensions & Benefits CAFR
  - Annual Reports for Each Plan

# Funding Requirements are Dynamic and Change Over Time

- Normal Cost: present value of service earned for a particular year
- Accrued Liability: present value of all past service
- Unfunded Accrued Liability: The difference between assets and liabilities and amortized over a period of time

# Key Funding Drivers

- Gains and losses are recognized, or smoothed, over “five years” to limit volatility
- Actuarial value of assets versus actuarial liabilities determines:
  - Funding status
  - Need for Employer Contributions

# Funding Requirements

- Based on Generally Accepted Principles by the Government Accounting Standards Board
  - Same basis as all public sector plans
- Suggestions that alternatives be used are totally inappropriate

# Where Are We Today?

- Late ’90s and Early ’00s
  - Internet Bubble Burst
  - Resultant Negative Investment Returns
  - Overall Downturn in the Economy
- System Surpluses Depleted
- Return of Employer Contributions
- Budget Shortfalls Aggravate Contribution Issue

# Contributing Factors

- Legislative initiatives detracted from long-standing, sound pension funding policies
- Generous benefit enhancements
- An “unexpected” downturn in market conditions

# Pension Revaluation Act

L. 1992, C. 41

- Changed the methodology by which plan assets were measured from book value to market-related value.
- Increased the plans' interest rate assumption rate from 7 percent to 8.75 percent.
- Resulted in a $733.4 million and $785.7 million reduction in State and local employer pension contributions for fiscal years 1992 and 1993, respectively.

# Pension Reform Act

L. 1994, C. 62

- Revised the actuarial funding methodology for the State plans from the entry age normal method to the projected unit credit method.
- Reduced State and local employer pension contributions to the plan by $547.4 million and $946.8 million for fiscal years 1994 and 1995, respectively.

# Pension Security Plan

L. 1997, C. 115

- Provided for the issuance of $2.75 billion in pension obligation bonds to finance the plans' outstanding unfunded pension liabilities.
- Increased the assets of the plans to market value.
- Allowed the use of surplus pension assets to offset employers' annual normal contributions to the pension system.
- Resulted in either complete or partial reductions in the State's and local employers' otherwise required normal contributions to the plan for fiscal years 1997 through 2004.

# Contribution Phase-Ins

L. 2003, C. 108

- Allowed for the phase-in of local employer pension contributions.
- In conjunction with this law, the appropriations act provided the State with authorization to use the BEF to cover a portion of its contribution requirements for PERS and TPAF.
- From FY 2004 through FY 2006, contributions were reduced by $3.9 billion, $3 billion for the state and $.9 billion for locals as compared to actual contributions made totaling $.92 billion, $.31 billion for the state and $.61 billion for locals.

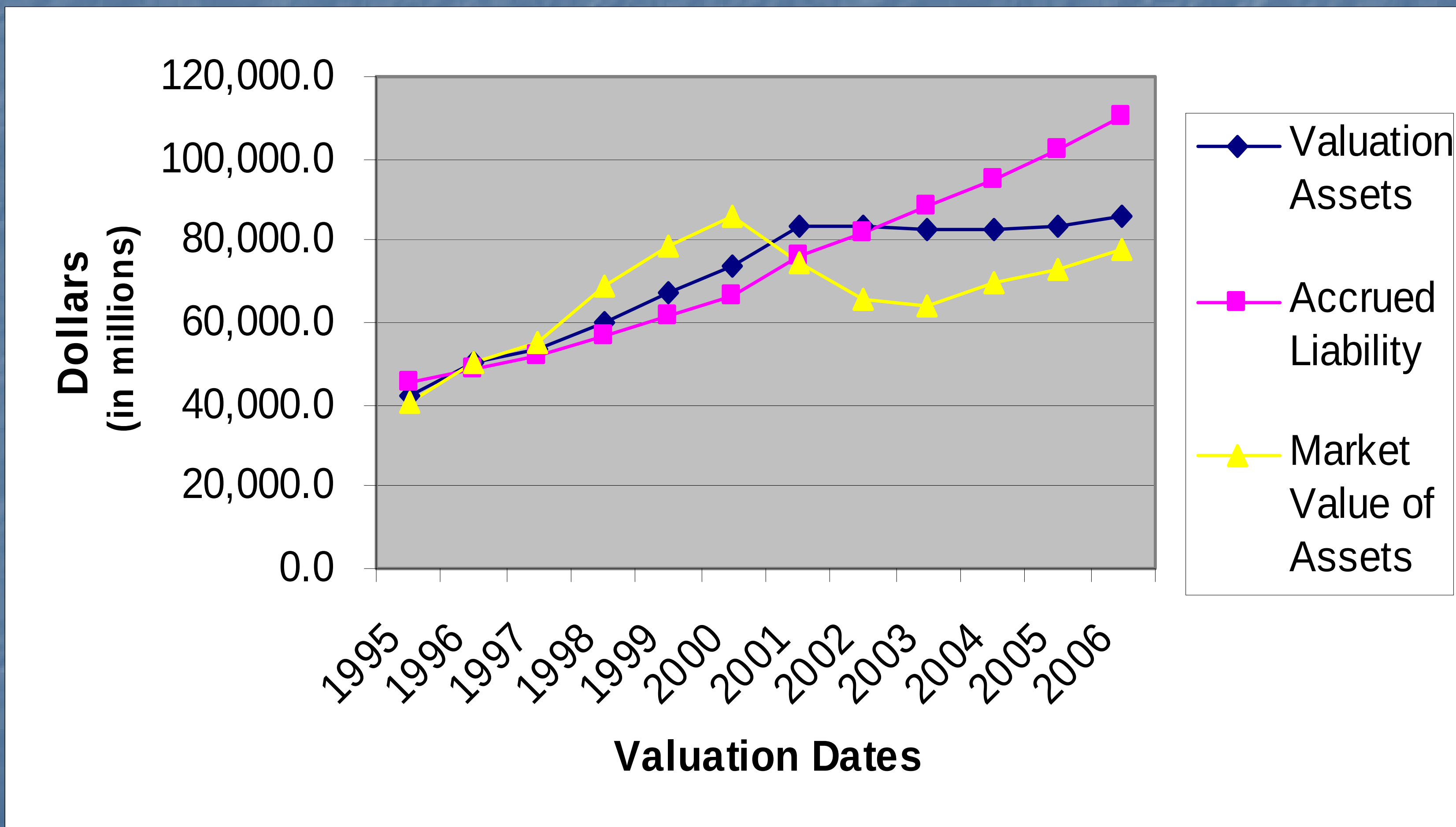
# Benefit Enhancements

- L. 2001, c. 133: Increased PERS and TPAF pensions by 9.09 percent, while increasing pension liabilities by over $4.2 billion.
- L. 1999, c. 428: Provided enhanced pensions benefits to members of the PFRS, increased pension liabilities by over $.5 billion.
- Numerous other pieces of legislation were enacted that provided extraordinary pension enhancements to prosecutors, workers compensation judges and others. Cumulatively, since 1999, these enhancements increased State and local pension liabilities by over $6.8 billion.

# Benefit Enhancement Fund

- Benefit Enhancement Funds (BEF) were created in both the PERS and TPAF with the enactment of the law providing retirees with a 9.09 percent pension increase (L. 2001, c.133).
- They were created by of increasing pension system assets to market value.
- The intent behind the BEF was to be the source of funding for the additional annual pension costs arising from the 9.09 percent pension increase, thereby keeping the benefit increase cost-neutral.
- The BEF was first used to offset regular State pension contributions in FY'04, and has since been exhausted.

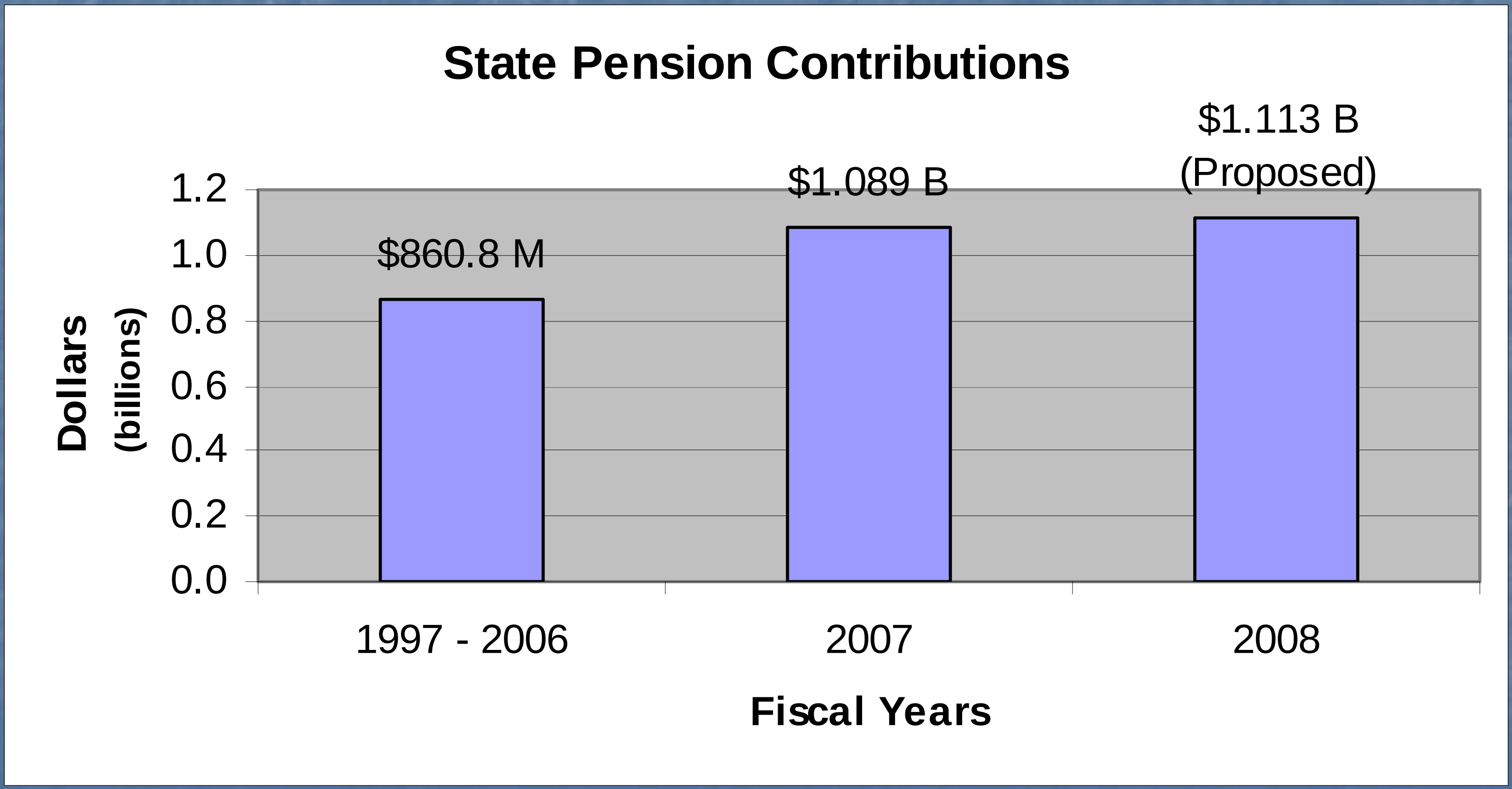
# System Status



# Governor’s Funding Policy

- State has a moral obligation to fund delivery
- The FY ’07 Contribution of $1.1B
- Recommendation for FY ’08 is $1.2B
- Previous nine years totaled only $860.8M

# Governor's Recommendations



Q & A