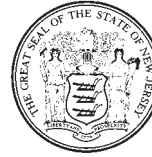


**DEPARTMENT OF
THE TREASURY**

John E. McCormac, CPA
State Treasurer

**DIVISION OF PENSIONS
AND BENEFITS**

Frederick J. Beaver
Director



State of New Jersey
DIVISION OF PENSIONS AND BENEFITS
PO Box 295 • Trenton, NJ 08625-0295

**TEACHERS' PENSION
AND ANNUITY FUND
OF NEW JERSEY**

**BOARD OF TRUSTEES
as of June 30, 2003**

HARRY BALDWIN
Chairperson

FREDERICK J. BEAVER
State Treasurer's Representative

JOHN KEELER

GRACE HAISLIP

MARIE FLYNN

DEBORAH RIVOSA

JAMES CLEMENTE

KATHLEEN COATES
Secretary

MILLIMAN USA
Actuaries and Consultants

MEDICAL BOARD
William Coleman, M.D.
David Jenkins, M.D.
William E. Ryan, M.D.

TO THE HONORABLE
JAMES E. MCGREEVEY
GOVERNOR of the STATE OF NEW JERSEY

Dear Governor McGreevey:

The Board of Trustees of the

TEACHERS' PENSION AND ANNUITY FUND

is pleased to present the Fiscal Year 2003 Annual Report in accordance with the provisions of N.J.S.A. 18A:66-59.

Respectfully submitted,

A handwritten signature in cursive script that reads "Harry W. Baldwin".

HARRY BALDWIN
Chairperson

Teachers' Pension and Annuity Fund
BOARD OF TRUSTEES



Harry Baldwin
*Chairperson
Teacher Representative*



John Keeler
Elected by Board



Grace Haislip
Teacher Representative



James Clemente
Teacher Representative



Deborah Rivos
*Gubernatorial
Appointee*



Marie Flynn
*Gubernatorial
Appointee*



Frederick J. Beaver
*State Treasurer's
Representative*



Susanne Culliton
*Deputy Attorney General
Legal Adviser*



Kathleen Coates
Board Secretary



Jackie Bussanich
Support Staff

SIGNIFICANT LEGISLATION

Chapter 42, P.L. 2002

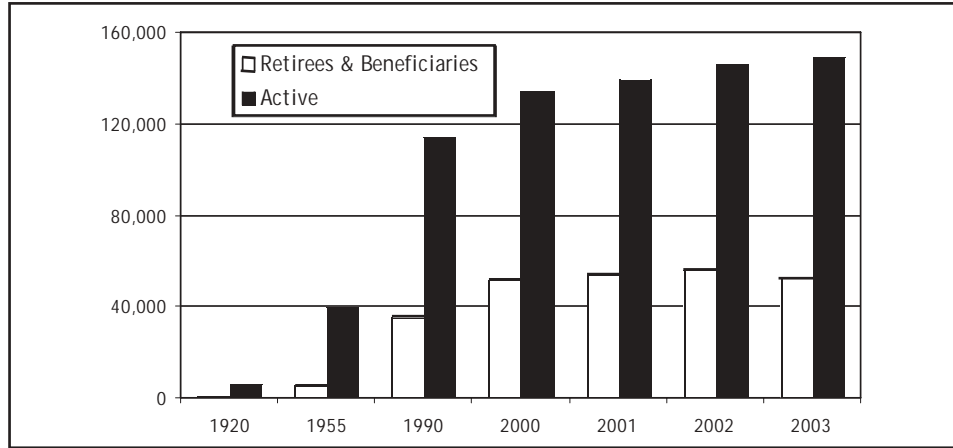
This law allows units of local governments (municipalities, counties, authorities, school boards, etc.) to issue refunding bonds to retire their unfunded accrued liability owed to the State's various pension systems created through the granting of early retirement benefits to their employees. Refunding bonds may be issued to retire the pension liabilities for a local governmental unit's participation in an early retirement incentive program established pursuant to P.L. 1991, c. 229, P.L. 1991, c. 230, P.L. 1991, c. 231, P.L. 1993, c. 138, P.L. 1993, c. 181, P.L. 1993, c. 163 and P.L. 1993, c. 99. The law would also allow units of local governments to use refunding bonds when they offer early retirement incentive programs for employees affected by consolidation agreements authorized by Chapter 59, P.L. 1999. The adoption and issuance procedures would be the same as procedures that exist under current law for the issuance of refunding bonds by the local unit.

This law also permits county improvement authorities and the Economic Development Authority to pool early retirement benefit refunding bonds from local units in order to obtain better interest rates and terms.

This law was effective July 12, 2002.

MEMBERSHIP

- As of June 30, 2003, the active membership of the Fund totaled 148,915. This includes 409 State employees and 148,506 employees from 1,671 participating local employers. There were 13,071 inactive members in the Fund as of June 30, 2003.
- There were 59,290 retirees and beneficiaries receiving annual pensions totaling \$1,676,566,493. *(This includes cost-of-living increases paid under the provisions of the Pension Adjustment Act).*
- Beneficiaries of 118 active and 1,994 retired members received lump sum death benefits in the amount of \$46,568,761.
- The Fund's assets totaled \$26,703,636,553 at the close of the fiscal year 2003.



MEMBERSHIP ACTIVITY

During fiscal year 2003, the following transactions were processed by the Division of Pensions and Benefits on behalf of the membership of the Teachers' Pension and Annuity Fund of New Jersey.

- **ENROLLMENTS** - 11,203 new members were enrolled during fiscal year 2003.
- **LOANS** - 18,883 loans were issued to members. The total loans receivable as of June 30, 2003 is \$241,542,590.
- **WITHDRAWALS** - there were 1,556 withdrawals during fiscal year 2003.
- **RETIREMENT** - 4,682 members retired under the following retirement types:

<u>TYPE OF RETIREMENT</u>	
Service	1,689
Early	563
Ordinary Disability	215
Accidental Disability	15
Veteran	196
Deferred	229
Over 55 - Early	1,771
Other	4
TOTAL	4,682

<u>OPTION SELECTION</u>	
Maximum	1,975
Option 1	316
Option 2	113
Option 3	108
Option 4	15
Option A	549
Option B	313
Option C	907
Option D	386
Other	0
TOTAL	4,682

KPMG LLP
New Jersey Headquarters
150 John F. Kennedy Parkway
Short Hills, NJ 07078

Independent Auditors' Report

The Board of Trustees
State of New Jersey
Teachers' Pension and Annuity Fund:

We have audited the accompanying statements of fiduciary net assets of the State of New Jersey Teachers' Pension and Annuity Fund (the Fund) as of June 30, 2003 and 2002, and the related statements of changes in fiduciary net assets for the years then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State of New Jersey Teachers' Pension and Annuity Fund as of June 30, 2003 and 2002, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Management's Discussion and Analysis and the supplementary information included in the schedule of funding progress and schedule of employer contributions are not a required part of the financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit this information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. The schedule of changes in fiduciary net assets by fund is presented for purposes of additional analysis and is not a required part of the financial statements of the Fund. Such information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

September 19, 2003

KPMG LLP

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Management's Discussion and Analysis
June 30, 2003 and 2002

Our discussion and analysis of the Teachers' Pension and Annuity Fund (the Fund)'s financial performance provides an overview of the Fund's financial activities for the fiscal year ended June 30, 2003 and 2002. Please read it in conjunction with the basic financial statements and financial statement footnotes which follow this discussion.

FINANCIAL HIGHLIGHTS

2003 - 2002

- Net assets held in trust for pension and post-retirement medical benefits decreased by \$708,974,345 as a result of this year's operations from \$27,258,134,841 to \$26,549,160,496.
- Additions for the year were \$1,392,105,717, which are comprised of member and employer pension contributions of \$604,914,820 and investment income of \$787,190,897.
- Deductions for the year were \$2,101,080,062, which are comprised of benefit and refund payments of \$2,091,193,357 and administrative expenses of \$9,886,705.
- The Fund utilized net assets (excess assets above the required funding level) to meet this year's normal pension contribution requirements in part.
- Net assets held in trust for post-retirement medical benefits were used this year to pay part of premiums and other periodic charges for health care benefits for qualified retirees and their dependents.

2002 - 2001

- Net assets held in trust for pension and post-retirement medical benefits decreased by \$3,998,316,766 as a result of the year's operations from \$31,256,451,607 to \$27,258,134,841.
- Additions for the year were (\$2,174,527,523), which are comprised of member and employer pension contributions of \$335,195,188 and investment losses of (\$2,509,722,711).
- Deductions for the year were \$1,823,789,243, which are comprised of benefit and refund payments of \$1,814,140,853 and administrative expenses of \$9,648,390.
- The Fund utilized net assets (excess assets above the required funding level) to meet the year's normal pension contribution requirements.
- Net assets held in trust for post-retirement medical benefits were used to pay premiums and other periodic charges for health care benefits for qualified retirees and their dependents.

THE STATEMENTS OF FIDUCIARY NET ASSETS AND THE STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS

This annual report consists of two financial statements: *The Statements of Fiduciary Net Assets* and *The Statements of Changes in Fiduciary Net Assets*. These financial statements report information about the Fund and about its activities to help you assess whether the Fund, as a whole, has improved or declined as a result of the year's activities. The financial statements were prepared using the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the period they are earned, and expenses are recorded in the year they are incurred, regardless of when cash is received or paid.

The Statements of Fiduciary Net Assets show the balances in all of the assets and liabilities of the Fund at the end of the fiscal year. The difference between assets and liabilities represents the Fund's fiduciary net assets. Over time,

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Management's Discussion and Analysis, Continued

increases or decreases in the Fund's fiduciary net assets provide one indication of whether the financial health of the Fund is improving or declining. *The Statements of Changes in Fiduciary Net Assets* show the results of financial operations for the year. The statements provide an explanation for the change in the Fund's fiduciary net assets since the prior year. These two financial statements should be reviewed along with the information contained in the financial statement footnotes, including the required supplementary schedules, to determine whether the Fund is becoming financially stronger or weaker.

FINANCIAL ANALYSIS

STATEMENTS OF FIDUCIARY NET ASSETS

2003 - 2002

The Fund's assets mainly consist of cash, investments and contributions due from members and participating employers. Between fiscal years 2002 and 2003, total assets decreased by \$706,753,798 or 2.6% from \$27,410,390,351 to \$26,703,636,553. The total assets decreased because pension benefit payments to retirees and beneficiaries exceeded the revenues received by the Fund.

Liabilities consist of pension and death benefit payments owed to members and beneficiaries, noncontributory group insurance premiums owed to the Fund's insurance provider, and other payables. Total liabilities increased by \$2,220,547 or 1.5% over last year from \$152,255,510 to \$154,476,057. This is mainly due to an increase in retirement benefit payments.

Net assets held in trust for pension and post-retirement medical benefits decreased by \$708,974,345 or 2.6%.

2002 - 2001

Between fiscal years 2001 and 2002, total assets decreased by \$3,963,930,535 or 12.6% from \$31,374,320,886 to \$27,410,390,351. The decrease in total assets is mainly due to a loss in the fair value of the Fund's investments and an increase in benefit payments. During the year, the Fund had an estimated investment loss of 9.0%.

Total liabilities increased by \$34,386,231 or 29.2% over last year from \$117,869,279 to \$152,255,510. This is mainly due to an increase in retirement and insurance benefit payments. In addition, accruals for insurance benefit payments include three months of premium charges and increased by \$6.5 million.

Net assets held in trust for pension and post-retirement medical benefits decreased by \$3,998,316,766 or 12.8% primarily due to the investment losses realized by the Fund.

STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS

ADDITIONS TO FIDUCIARY NET ASSETS

2003-2002

	2003	2002	Increase (Decrease)
Member Contributions	\$303,570,787	\$331,060,403	\$(27,489,616)
Employer Contributions	301,342,962	4,134,785	297,208,177
Investment & Other	787,191,968	(2,509,722,711)	3,296,914,679
Totals	\$1,392,105,717	\$(2,174,527,523)	\$3,566,633,240

Additions primarily consist of member and employer contributions and earnings from investment activities. Member contributions decreased by 8.3% partly due to a reduction in the employee contribution rate from 4.5% to 3%, which was effective January 1, 2002. (The new rate affected only half of the year in the prior fiscal year.)

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Management's Discussion and Analysis, Continued

The State made a contribution of \$298.3 million for fiscal year 2003 post-retirement medical (PRM). In addition, the PRM reserve of \$43.9 million was used to cover additional premiums due in fiscal year 2003.

For fiscal year 2003, the 84% of available excess valuation assets could be utilized to offset normal contributions. Thereafter, a certain percentage of available excess valuation assets may be used as specified in the legislation. The State was not required to make a normal contribution to the Fund between 1997 and 2003 based on Pension Security legislation passed in 1997.

After the prior two consecutive years of investment losses, the Fund had investment gains in fiscal year 2003. The total investment gain for all pension funds was estimated to be 3.3% compared to 9.0% loss in the prior year.

2002-2001

	2002	2001	Increase (Decrease)
Member Contributions	\$331,060,403	\$371,618,136	\$(40,557,733)
Employer Contributions	4,134,785	177,542,203	(173,407,418)
Investment & Other	(2,509,722,711)	(3,394,654,946)	884,932,235
Totals	\$(2,174,527,523)	\$(2,845,494,607)	\$670,967,084

Member contributions decreased by 10.9% due to a reduction in the employee contribution rate from 4.5% to 3%. The rate change was effective January 1, 2002. Employer contributions decreased significantly due to the fact that the State was not required to make a contribution in fiscal year 2002 toward the cost of post-retirement medical benefits. Under legislation passed during the year (Chapter 11, P.L. 2002), the State was permitted to use net assets held in trust for post-retirement medical benefits to cover the year's anticipated premiums.

Fiscal year 2002 was the third consecutive year that the State has not been required to make a normal pension contribution to the Fund. The required normal contributions have been funded using net assets (excess assets above the required funding level). Net assets have been available mainly due to Pension Security legislation passed in 1997. This legislation authorized the New Jersey Economic Development Authority to issue bonds and to use the proceeds from the bond sale to eliminate the unfunded accrued pension liabilities of the retirement systems. The Fund received bond proceeds in 1997 of \$1,547,688,633. This influx of funds, coupled with investment returns in the late 1990s, has produced excess net assets which have been utilized to cover the normal contributions from 2000 through 2002. Excess net assets also covered the full normal contribution in 1998; however, in 1999, only a partial offset was made, and the State was required to make a payment that year.

In fiscal year 2002, the total investment loss for all pension funds was estimated to be 9.0% compared to 10.4% in the prior year.

DEDUCTIONS FROM FIDUCIARY NET ASSETS

2003 - 2002

	2003	2002	Increase (Decrease)
Benefits	\$2,065,315,692	\$1,791,516,438	\$273,799,254
Refunds & Adjustments	25,877,665	22,624,415	3,253,250
Administrative Expenses	9,886,705	9,648,390	238,315
Totals	\$2,101,080,062	\$1,823,789,243	277,290,819

Deductions are mainly comprised of pension benefit payments to retirees and beneficiaries, refunds of contributions to former members, and administrative costs incurred by the Fund. Benefit payments increased partly due to the benefit enhancements which were effective with the November 1, 2001 retirement checks. (The new rate affected

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Management's Discussion and Analysis, Continued

only eight months in the prior fiscal year.) The number of retirees receiving benefits has also increased. The number of refunds processed has increased compared to last year due to more terminations. Administrative expenses have increased mainly due to contractual increases in salaries.

2002 - 2001

	2002	2001	Increase (Decrease)
Benefits	\$1,791,516,438	\$1,539,418,801	\$252,097,637
Refunds & Adjustments	22,624,415	23,730,536	(1,106,121)
Administrative Expenses	9,648,390	7,923,827	1,724,563
Totals	\$1,823,789,243	\$1,571,073,164	\$252,716,079

Benefit payments increased primarily because legislation was passed (Chapter 353, P.L. 2001 and Chapter 133, P.L. 2001) that provides a 9.09% increase in benefits to retirees and beneficiaries. The benefit enhancements were effective with the November 1, 2001 retirement checks. The number of retirees receiving benefits has also increased. The number of refunds processed has decreased compared to last year due to fewer terminations. Administrative expenses have increased mainly due to contractual increases in salaries and higher fringe benefit costs.

RETIREMENT SYSTEM AS A WHOLE

The overall funded ratios of 100.0% for fiscal year 2003 and 108.0% for 2002 indicate that the Fund has assets sufficient to meet its benefit obligations.

CONTACTING SYSTEM FINANCIAL MANAGEMENT

The financial report is designed to provide our members, beneficiaries, investors and other interested parties with a general overview of the Fund's finances and to show the Fund's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Division of Pensions and Benefits, P.O. Box 295, Trenton, NJ 08625-0295.

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Statements of Fiduciary Net Assets

June 30, 2003 and 2002

	2003			2002		
	PENSION FUND	POST-RETIREMENT MEDICAL FUND	TOTAL	PENSION FUND	POST-RETIREMENT MEDICAL FUND	TOTAL
Assets:						
Cash	\$ 3,087,365	—	3,087,365	—	—	—
Investments, at fair value:						
Cash Management Fund	1,006,897,996	12,193	1,006,910,189	939,343,406	1,546,743	940,890,149
Bonds	79,869,047	967	79,870,014	123,593,287	203,511	123,796,798
Common Pension Fund A	12,504,208,011	151,413	12,504,359,424	12,140,724,660	19,991,181	12,160,715,841
Common Pension Fund B	7,339,537,581	88,874	7,339,626,455	7,739,483,631	12,744,002	7,752,227,633
Common Pension Fund D	4,824,877,633	58,425	4,824,936,058	4,869,414,703	8,018,084	4,877,432,787
Mortgage Backed Securities	438,827,309	5,314	438,832,623	868,600,920	1,430,257	870,031,177
Total investments	26,194,217,577	317,186	26,194,534,763	26,681,160,607	43,933,778	26,725,094,385
Receivables:						
Contributions:						
Members	64,454,002	—	64,454,002	62,765,295	—	62,765,295
Employers	55,544,914	—	55,544,914	204,025,670	—	204,025,670
Accrued interest and dividends	144,458,676	—	144,458,676	162,440,427	—	162,440,427
Members' loans	241,542,590	—	241,542,590	256,038,595	—	256,038,595
Other	14,243	—	14,243	25,979	—	25,979
Total receivables	506,014,425	—	506,014,425	685,295,966	—	685,295,966
Total assets	26,703,319,367	317,186	26,703,636,553	27,366,456,573	43,933,778	27,410,390,351
Liabilities:						
Accounts payable and accrued expenses	11,460,340	—	11,460,340	15,380,735	—	15,380,735
Retirement benefits payable	141,037,830	—	141,037,830	129,205,708	—	129,205,708
NCGI premiums payable	1,977,887	—	1,977,887	6,548,168	—	6,548,168
Cash Overdraft	—	—	—	1,120,899	—	1,120,899
Total liabilities	154,476,057	—	154,476,057	152,255,510	—	152,255,510
Net Assets:						
Held in trust for pension benefits	\$ 26,548,843,310	317,186	26,549,160,496	27,214,201,063	43,933,778	27,258,134,841

See schedule of funding progress on page 19.
See accompanying notes to financial statements.

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Statements of Changes in Fiduciary Net Assets

Years ended June 30, 2003 and 2002

	2003			2002		
	PENSION FUND	POST-RETIREMENT MEDICAL FUND	TOTAL	PENSION FUND	POST-RETIREMENT MEDICAL FUND	TOTAL
Additions:						
Contributions:						
Members	\$ 303,570,787	—	303,570,787	331,060,403	—	331,060,403
Employers	3,020,752	298,322,210	301,342,962	4,134,785	—	4,134,785
Other	1,071	—	1,071	1,172	—	1,172
Total contributions	306,592,610	298,322,210	604,914,820	335,196,360	—	335,196,360
Investment income:						
Net (depreciation) appreciation in fair value of investments	7,116,650	241,636	7,358,286	(3,363,897,919)	(29,360,080)	(3,393,257,999)
Interest	574,949,013	—	574,949,013	701,328,488	—	701,328,488
Dividends	207,943,503	—	207,943,503	185,553,692	—	185,553,692
	790,009,166	241,636	790,250,802	(2,477,015,739)	(29,360,080)	(2,506,375,819)
Less: investment expense	3,059,905	—	3,059,905	3,348,064	—	3,348,064
Net investment income	786,949,261	241,636	787,190,897	(2,480,363,803)	(29,360,080)	(2,509,723,883)
Total additions	1,093,541,871	298,563,846	1,392,105,717	(2,145,167,443)	(29,360,080)	(2,174,527,523)
Deductions:						
Benefits	1,723,135,254	342,180,438	2,065,315,692	1,538,587,185	252,929,253	1,791,516,438
Refunds of contributions	25,877,665	—	25,877,665	22,624,415	—	22,624,415
Administrative expenses	9,886,705	—	9,886,705	9,648,390	—	9,648,390
Total deductions	1,758,899,624	342,180,438	2,101,080,062	1,570,859,990	252,929,253	1,823,789,243
Change in net assets	(665,357,753)	(43,616,592)	(708,974,345)	(3,716,027,433)	(282,289,333)	(3,998,316,766)
Net assets - Beginning of year	27,214,201,063	43,933,778	27,258,134,841	30,930,228,496	326,223,111	31,256,451,607
Net assets - End of year	\$ 26,548,843,310	317,186	26,549,160,496	27,214,201,063	43,933,778	27,258,134,841

See accompanying notes to financial statements.

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Notes to Financial Statements

June 30, 2003 and 2002

(1) DESCRIPTION OF THE FUND

The State of New Jersey Teachers' Pension and Annuity Fund (the Fund; TPAF) is a cost-sharing contributory defined benefit plan with a special funding situation which was established as of January 1, 1955, under the provisions of N.J.S.A. 18A:66. The Fund is included along with other state-administered pension trust and agency funds in the basic financial statements of the State of New Jersey.

The Fund's designated purpose is to provide retirement benefits, death, disability and medical benefits to certain qualified members. Membership in the Fund is mandatory for substantially all teachers or members of the professional staff certified by the State Board of Examiners, and employees of the Department of Education who have titles that are unclassified, professional and certified. The Fund's Board of Trustees is primarily responsible for the administration of the Fund.

According to the State of New Jersey Administrative Code, all obligations of the Fund will be assumed by the State of New Jersey should the Fund terminate.

Vesting and Benefit Provisions:

The vesting and benefit provisions are set by N.J.S.A. 18A:66. The Fund provides retirement, death and disability benefits, as well as medical benefits for certain qualified members. All benefits vest after eight to ten years of service, except for medical benefits, which vest after 25 years of service or under the disability provisions of the Fund. Retirement benefits for age and service are available at age 60 and, under recently enacted legislation referred to below, are generally determined to be 1/55 of final average salary for each year of service credit (as defined). Final average salary equals the average salary for the final three years of service prior to retirement (or highest three years' compensation if other than the final three years). Members may seek early retirement after achieving 25 years service credit, as defined, or they may elect deferred retirement after achieving eight to ten years of service credit, in which case benefits would begin the first day of the month after the member attains normal retirement age.

Members are always fully vested for their own contributions and, after three years of service credit, become vested for 2% of related interest earned on the contributions. In the case of death before retirement, members' beneficiaries are entitled to full interest credited to the members' accounts.

Eligible retirees receiving monthly benefits are entitled to cost-of-living increases equal to 60% of the change in the average consumer price index for the calendar year in which the pensioner retired as compared to the average consumer price index for a 12-month period ending with each August 31st immediately preceding the year in which the adjustment becomes payable. The regular retirement allowance is multiplied by the 60% factor as developed and results in a dollar amount of the adjustment payable. Retired members become eligible for pension adjustment benefits (COLA) after 24 months of retirement.

Significant Legislation:

Chapter 42, P.L. 2002 permitted local government units to issue refunding bonds to retire an unfunded accrued liability resulting from early retirement benefits, effective July 12, 2002.

Chapter 23, P.L. 2002 provided early retirement incentive benefits to State employees who meet specified age and service requirements and who retire within a specified time period that generally extended from February 1,

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Notes to Financial Statements, Continued

2002 to July 1, 2002. The incentive benefits include an additional three years of service credit to employees who are at least 50 years of age with at least 25 years of service credit; State paid health care benefits to employees who are at least 60 years of age with at least 20, but less than 25, years of service credit; and an additional monthly benefit of \$500 per month for 24 months following the date of retirement to employees who are at least 60 years of age with at least 10, but not more than 20, years of service credit. For those eligible for veterans' retirement benefit, the incentive is an additional pension of 3/55 of the compensation upon which the retirement benefit is based to employees who are at least 55 years of age with 25 or more years of service credit.

Chapter 11, P.L. 2002 allowed the State to use net assets in post-retirement medical (PRM) fund to cover required pay-as-you-go medical premiums. This legislation also suspended in fiscal years 2002 and 2003 the additional PRM contribution to increase the fund balance by 1/2 of 1% of active member salaries for the valuation period. The additional PRM contribution will resume in fiscal year 2004 and will be computed to provide an increase in the reserve fund of 3/5 of 1% of active member salaries for the valuation period.

Membership and Contributing Employers:

Membership and contributing employers of the Fund consisted of the following at June 30:

<u>2002</u>	<u>PENSION BENEFITS</u>	<u>POST-RETIREMENT MEDICAL BENEFITS</u>
Retirees and beneficiaries currently receiving benefits and employees entitled to benefits but not yet receiving them	<u>57,398</u>	<u>39,714</u>
Active members:		
Vested	77,054	29,287
Non-vested	<u>65,106</u>	<u>112,873</u>
Total active members	<u>142,160</u>	<u>142,160</u>
Total	<u>199,558</u>	<u>181,874</u>
Contributing Employers	114	1

<u>2001</u>	<u>PENSION BENEFITS</u>	<u>POST-RETIREMENT MEDICAL BENEFITS</u>
Retirees and beneficiaries currently receiving benefits and employees entitled to benefits but not yet receiving them	<u>55,109</u>	<u>37,530</u>
Active members:		
Vested	77,293	29,127
Non-vested	<u>58,557</u>	<u>106,723</u>
Total active members	<u>135,850</u>	<u>135,850</u>
Total	<u>190,959</u>	<u>173,380</u>
Contributing Employers	120	1

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Notes to Financial Statements, Continued

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Measurement Focus and Basis of Accounting:

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. The Fund is accounted for using an economic resources measurement focus. The Fund that focuses on total economic resources employs the accrual basis of accounting, which recognizes increases and decreases in economic resources as soon as the underlying event or transaction occurs.

The accrual basis of accounting is used for measuring financial position and changes in fiduciary net assets of the Fund. Under this method, revenues are recorded in the accounting period in which they are earned, and deductions are recorded at the time the liabilities are incurred. The financial statements of the Fund conform to the provisions of Governmental Accounting Standards Board (GASB) Statement No. 25, "Financial Reporting for Defined Benefit Plans and Note Disclosures for Defined Contributions Plans" and No. 26, "Financial Reporting for Post-employment Healthcare Plans Administered by Defined Benefit Pension Plans." Plan assets are recorded at fair value. Employer contributions are recognized when payable to the Fund. Benefits and refunds are recognized when payable in accordance with the terms of the Fund.

Financial Reporting Model:

Effective July 1, 2000, the Division adopted two new statements of financial accounting standards issued by the Governmental Accounting Standards Board (GASB):

Statement No. 34 *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*

Statement No. 37 *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus*

Statement No. 34 (as amended by Statement No. 37) requires as required supplementary information Management's Discussion and Analysis which includes an analytical overview of the Fund's financial activities.

Investment Valuation:

Investments, including short-term investments (State of New Jersey Cash Management Funds), are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Mortgage backed securities are valued on the basis of future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Investments that do not have an established market are reported at estimated fair value.

The State of New Jersey Division of Investment, under the jurisdiction of the State Investment Council, has the investment responsibility for all funds administered by the State of New Jersey Division of Pensions and Benefits. All investments must conform to standards set by state law.

The State of New Jersey Division of Investment administers three common pension funds which are utilized by the Fund. A brief description of each common pension fund is as follows:

Common Pension Fund A - The operations of Common Pension Fund A are governed by the provisions of Article 62 of the State of New Jersey Investment Council regulations for the purpose of investing in corporate common stocks, securities convertible into corporate common stocks or covered call options.

Common Pension Fund B - The operations of Common Pension Fund B are governed by the provisions of Article 63 of the State of New Jersey Investment Council regulations for the purpose of investing in fixed income and debt securities.

Common Pension Fund D - The operations of Common Pension Fund D are governed by the provisions of Article 67 of the State of New Jersey Investment Council regulations for the purpose of investing in international debt and equity securities, currencies, currency futures, and options.

TEACHERS' PENSION AND ANNUITY FUND

Notes to Financial Statements, Continued

The State of New Jersey, Department of the Treasury, Division of Investment, issues publicly available financial reports that include the financial statements of the State of New Jersey Cash Management Funds, Common Pension Fund A, Common Pension Fund B and Common Pension Fund D. The financial reports may be obtained by writing to the State of New Jersey, Department of the Treasury, Division of Investment, P.O. Box 290, Trenton, New Jersey 08625-0290.

The purchase, sale, receipt of income, and other transactions affecting investments are governed by custodial agreements between the Fund, through the State Treasurer, and custodian banks as agents for the Fund. State laws and policies set forth the requirements of such agreements and other particulars as to the size of the custodial institutions, amount of the portfolio to be covered by the agreements, and other pertinent matters.

GASB Statement No. 3 requires disclosure of the level of risk assumed by the Fund. Category 1 includes investments that are insured or registered or for which the securities are held by the Fund or its agent in the Fund's name. As of June 30, 2003 and 2002, all investments held by the Fund (other than mortgage backed securities and the State of New Jersey Cash Management Funds which are not categorized) are classified as Category 1.

In 2001, the Board of Trustees approved that the Post-Retirement Medical Fund earn a rate of return consistent with the Fund and henceforth. In prior years, the Post-Retirement Medical Fund earned a statutorily determined fixed rate of return of 8.75%.

Federal securities are maintained at Federal Reserve Banks in Philadelphia and New York through the custodian banks in trust for the Fund. A significant portion of corporate equity and debt securities are maintained by the Depository Trust Company (DTC) through the custodian banks in trust for the Fund. The custodian banks, as agents for the Fund, maintain internal accounting records identifying the securities maintained by the Federal Reserve Banks and the DTC as securities owned by or pledged to the Fund.

Securities not maintained by the Federal Reserve Banks or DTC are in the name of a designated nominee representing the securities of the Fund, which establishes the Fund's unconditional right to the securities.

Members' Loans:

Members can borrow up to 50% of their accumulated member contributions. To obtain a loan, a member must have at least three years of service credit in the Fund. Repayment of loan balances is deducted from payroll checks and bears an interest rate of 4%. Members who retire with an outstanding loan have the option of paying the loan in full prior to receiving any benefits or continuing their monthly loan repayment schedule into retirement.

Administrative Expenses:

The Fund is administered by the State of New Jersey Division of Pensions and Benefits. Administrative expenses are paid by the Fund to the State of New Jersey, Department of the Treasury, and are included in the accompanying statements of changes in fiduciary net assets.

Cash and Cash Equivalents:

GASB Statement No. 3 also requires that deposits held in financial institutions be categorized to indicate the level of risk assumed by the entity. Category 1 consists of deposits that are insured or collateralized with securities held by the entity or by its agent in the entity's name. Category 2 consists of deposits collateralized with securities held by the pledging financial institution's trust department or agent in the entity's name. Category 3 consists of deposits which are uninsured and uncollateralized.

Based upon aggregate collateral levels maintained for all state bank accounts as a whole, substantially all cash balances maintained in financial institutions as of June 30, 2003, which include funding for the July 1, 2003 retirement payroll, are designated Category 3.

TEACHERS' PENSION AND ANNUITY FUND

Notes to Financial Statements, Continued

(3) CONTRIBUTIONS

The contribution policy is set by N.J.S.A. 18:66 and requires contributions by active members and contributing employers. Plan member and employer contributions may be amended by State of New Jersey legislation. Members contribute at a uniform rate. In accordance with legislation passed in 2001 (Chapter 133, P.L. 2001), the employee contribution rate was lowered to 3% effective January 1, 2003. Prior to this date, employees had been contributing at a rate of 4.5%. The rate will remain at 3% for as long as surplus assets are available in the Fund. Employers are required to contribute at an actuarially determined rate. The annual employer contribution includes funding for basic retirement allowances, cost-of-living adjustments and noncontributory death benefits. The State of New Jersey's contribution also includes funding for the cost of medical premiums after retirement for qualified retirees. In accordance with Chapter 62, P.L. 1994, post-retirement medical benefits have been funded on a pay-as-you-go basis since 1994. Prior to 1994, medical benefits were funded on an actuarial reserve basis. Beginning 1996, the State has made an additional contribution to the Post-Retirement Medical Reserve Fund to ensure an increase in the fund balance of 1/2 of 1% of the salary of active state employees.

For fiscal year 2003, the 84% of available excess valuation assets could be utilized to offset normal contributions. Thereafter, a certain percentage of available excess valuation assets may be used as specified in the legislation. The State was not required to make a normal contribution to the Fund between the years 1997 and 2003. The normal contribution for basic pension benefits, noncontributory death benefits, and cost-of-living adjustments was funded by excess valuation assets in accordance with Chapter 115, P.L. 1997. This legislation provides for actuarially determined excess valuation assets to offset required normal contributions of the State of New Jersey and the local participating employers.

The State made a contribution of \$298.3 million for fiscal year 2003 post-retirement medical (PRM). In addition, PRM reserve of \$43.9 million was used to cover additional premiums due in fiscal year 2003. The State made no PRM contribution in fiscal year 2002. Legislation passed in 2002 (Chapter 11, P.L. 2002) allowed the State to use net assets in PRM Fund to cover required pay-as-you-go medical premiums. This legislation also suspended in fiscal years 2002 and 2003 the additional PRM contribution to increase the fund balance by 1/2 of 1% of active member salaries for the valuation period. The additional PRM contribution will resume in fiscal year 2004 and will be computed to provide an increase in the reserve fund of 3/5 of 1% of active member salaries for the valuation period.

To fund the benefit increases provided by Chapter 133, the legislation provided for the use of excess assets. A special benefit enhancement fund (BEF) was established from which the required normal contributions for the increased benefits will be charged. To fund the accrued liabilities incurred by the Fund, the actuarial value of assets for the valuation period ending June 30, 1999 was adjusted to reflect the full market value of assets.

The BEF will also provide funding for the benefit increases under Chapter 353, P.L. 2001. Actuarially determined excess valuation assets will cover the additional accrued liability incurred by the retirement fund. No additional formula State contribution is required in fiscal year 2004; instead, that contribution will be covered by the BEF.

According to the Budget Appropriations Act of 2004, the State will pay pension obligations through a five-year phase-in.

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Notes to Financial Statements, Continued

(4) FUNDS

This Fund maintains the following legally required funds:

Members' Annuity Savings and Accumulative Interest Fund (2003 - \$6,038,217,700; 2002 - \$5,782,201,078)

The Members' Annuity Savings Fund is credited with all contributions made by active members of the Fund. Interest earned on member contributions is credited to the Accumulated Interest Fund. The annual rate of interest on member contributions, as required by Chapter 62, P.L. 1994, is 8.75%.

Contingent Reserve Fund (2003 - \$2,058,849,317; 2002 - \$ 5,073,217,056)

The Contingent Reserve Fund is credited with the contributions of employers other than post-retirement medical contributions. Interest earnings, after crediting the Accumulated Interest Fund, Retirement Reserve Fund, and Special Reserve Fund, are credited to this account. Additionally, payments for life insurance premiums are made from this Fund.

Retirement Reserve Fund (2003 - \$17,667,357,328; 2002 - \$15,565,429,321)

The Retirement Reserve Fund is the account from which retirement benefits other than life insurance premiums, contributory group insurance premiums, and post-retirement medical premiums, including cost-of-living benefits and medical benefits for certain retirees, are paid. Upon retirement of a member, accumulated contributions, together with accumulated regular interest, are transferred to the Retirement Reserve Fund from the Annuity Savings Fund. Any additional reserves needed for the retirement and cost-of-living benefits are transferred from the Contingent Reserve Fund. Annually, interest as determined by the State Treasurer (8.75% for 2003 and 2002) is credited to the Retirement Reserve Fund.

Special Reserve Fund (2003 - \$0; 2002 - \$0)

The Special Reserve Fund is the fund to which excess interest earnings and gains from sales and maturities of investments are transferred and against which any losses from the sales of securities are charged. The maximum limit on the accumulation of this account is 1% of the market value of the investments allocated to the Fund, excluding Cash Management Fund investments and bonds allocated to the Contributory Group Insurance Premium Fund which amounted to \$103,130,994 and \$99,427,120 as of June 30, 2003 and 2002, respectively. Amounts in excess of 1% are credited to the Contingent Reserve Fund.

Contributory Group Insurance Premium Fund (2003 - \$101,541,730; 2002 - \$93,020,974)

The Contributory Group Insurance Premium Fund represents the accumulation of member group insurance contributions in excess of premiums disbursed to the insurance carrier since the inception of the contributory death benefit program plus reserves held by the insurance carrier. Members are required by statute to participate in the contributory group insurance plan in the first year of membership and may cancel the contributory coverage thereafter. The current contribution rate for active members is 0.4 of 1% of salary, as defined.

Post-Retirement Medical Fund (2003 - \$317,185; 2002 - \$43,933,778)

The Post-Retirement Medical Fund is credited with employer contributions for post-retirement medical benefits, interest earnings on post-retirement medical reserves, and from which post-retirement medical premiums are paid.

Benefit Enhancement Reserve Fund (2003 - \$682,877,236; 2002 - \$700,332,634)

The Benefit Enhancement Reserve Fund is a special reserve fund from which required normal contributions to provide benefit increases under Chapter 353, P.L. 2001 and Chapter 133, P.L. 2001 will be charged. The fund was established in 2003 and credited with excess assets equivalent to member contributions for fiscal years 2000 and 2001 by transferring reserves in the Contingent Reserve Fund to the Benefit Enhancement Fund. Additional transfers will be made, as required, to maintain a fund balance equal to the present value of expected additional normal contributions due to the increased benefits. The State will be required to make contributions

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Notes to Financial Statements, Continued

to the Benefit Enhancement Fund on behalf of State and local employers if excess valuation assets are not available.

(5) INCOME TAX STATUS

Based on a 1986 declaration of the Attorney General of the State of New Jersey, the Fund is a qualified plan as described in Section 401(a) of the Internal Revenue Code.

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Required Supplementary Information

Schedule of Funding Progress

ACTUARIAL VALUATION DATE	ACTUARIAL VALUE OF ASSETS (a)	ACTUARIAL ACCRUED LIABILITY (b)	UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY (b - a)	FUNDED RATIO (a / b)	COVERED PAYROLL (c)	UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY AS A PERCENTAGE OF COVERED PAYROLL (b - a) / c
March 31, 1997	\$22,045,481,579	\$21,224,484,588	\$(820,996,991)	103.9%	\$5,771,763,164	(14.2%)
March 31, 1998	24,478,860,383	23,484,403,450	(994,456,933)	104.2%	5,989,748,156	(16.6%)
June 30, 1999	27,457,451,678	25,546,083,289	(1,911,368,389)	107.5%	6,254,198,406	(30.6%)
June 30, 2000	30,203,205,322	27,404,618,051	(2,798,587,271)	110.2%	6,571,641,181	(42.6%)
June 30, 2001	35,351,379,511	32,745,357,185	(2,606,022,326)	108.0%	6,948,381,383	(37.5%)
June 30, 2002	35,148,246,433	35,146,591,842	(1,654,591)	100.0%	7,348,993,141	0.0%

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Required Supplementary Information, Continued

Schedule of Funding Progress - Additional Actuarial Information

Significant actuarial methods and assumptions used in the most recent June 30, 2002 and June 30, 2001 actuarial valuations included the following:

	June 30, 2002	June 30, 2001
Actuarial cost method	Projected unit credit	Projected unit credit
Asset valuation method	5 year average of market value	5 year average of market value
Amortization method	Level percent, closed	Level percent, closed
Payroll growth rate for amortization	5.00%	5.00%
Remaining amortization period	1 year	40 years for UAAL balance 10 years for asset method change
Actuarial assumptions:		
Interest rate	8.75%	8.75%
Salary range	5.95%	5.95%
Cost-of-living adjustments	2.40%	2.40%

Annual covered payroll is an estimate based upon annualizing one quarter's actual payroll.

**STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND**

Required Supplementary Information, Continued

Schedule of Employer Contributions

YEAR ENDED JUNE 30,	ANNUAL REQUIRED CONTRIBUTION	EMPLOYER CONTRIBUTIONS⁽¹⁾	PERCENTAGE CONTRIBUTED
1997	\$372,060,546	\$1,601,688,633 ⁽²⁾	430.5%
1998	297,219,462	—	0.0%
1999	314,671,482	258,816,649	82.2%
2000	368,904,564	—	0.0%
2001	—	—	N/A
2002	—	—	N/A
2003	194,435,594	—	0.0%

Notes to Schedule

- (1) Excludes post-retirement medical contributions and contributions received from other State of New Jersey retirement systems or funds for certain members who transferred their eligible prior service credit to the Teachers' Pension and Annuity Fund.

In accordance with Chapter 115, P.L. 1997, available excess valuation assets were used to fund, in full or in part, required employer contributions.

- (2) For the year ended June 30, 1997, the employer contributions exceeded the annual required contributions as a result of legislation that was enacted (Chapter 114, P.L. 1997) authorizing the New Jersey Economic Development Authority to issue bonds, notes or other obligations for the purpose of financing, in full or in part, the State of New Jersey's portion of the unfunded accrued liability under the State of New Jersey retirement systems.

Schedule 3

STATE OF NEW JERSEY
TEACHERS' PENSION AND ANNUITY FUND

Schedule of Changes in Fiduciary Net Assets by Fund

Year ended June 30, 2003

	MEMBERS' ANNUITY SAVINGS AND ACCUMULATIVE INTEREST FUND	CONTINGENT RESERVE FUND	RETIREMENT RESERVE FUND	SPECIAL RESERVE FUND	CONTRIBUTORY GROUP INSURANCE PREMIUM FUND	POST-RETIREMENT MEDICAL FUND	BENEFIT ENHANCEMENT FUND	OTHER	TOTAL
Additions:									
Contributions:									
Members	273,611,093	—	—	—	29,959,694	—	—	—	303,570,787
Employers	—	3,020,752	—	—	—	298,322,210	—	—	301,342,962
Other	—	—	—	—	—	—	—	1,071	1,071
Total contributions	273,611,093	3,020,752	—	—	29,959,694	298,322,210	—	1,071	604,914,820
Distribution of net investment income	476,075,237	(1,165,467,928)	1,418,875,076	—	2,522,731	241,636	54,944,145	—	787,190,897
Total additions	749,686,330	(1,162,447,176)	1,418,875,076	—	32,482,425	298,563,846	54,944,145	1,071	1,392,105,717
Deductions:									
Benefits	—	22,607,092	1,676,565,422	—	23,961,669	342,180,438	—	1,071	2,065,315,692
Refunds of contributions	25,746,916	130,749	—	—	—	—	—	—	25,877,665
Administrative expenses	—	9,886,705	—	—	—	—	—	—	9,886,705
Total deductions	25,746,916	32,624,546	1,676,565,422	—	23,961,669	342,180,438	—	1,071	2,101,080,062
Net increase (decrease) before transfers among reserves	723,939,414	(1,195,071,722)	(257,690,346)	—	8,520,756	(43,616,592)	54,944,145	—	(708,974,345)
Transfers among reserves:									
Retirements	(469,378,696)	(1,245,610,976)	1,714,989,672	—	—	—	—	—	—
Other	1,455,904	(573,665,041)	644,628,561	—	—	—	(72,399,544)	—	—
Net increase (decrease)	256,016,622	(3,014,367,739)	2,101,928,007	—	8,520,756	(43,616,592)	(17,455,399)	—	(708,974,345)
Net assets held in trust for pension and post-retirement medical benefits:									
Beginning of year	5,782,201,078	5,073,217,056	15,565,429,321	—	93,020,974	43,933,778	700,322,634	—	27,258,134,841
End of year	6,038,217,700	2,058,849,317	17,667,357,328	—	101,541,730	317,186	682,877,235	—	26,549,160,496

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