P U B L I C   H E A R I N G

before

SENATE STATE GOVERNMENT COMMITTEE

"Pension Fund Revaluation Proposal"

February 13, 1992
2:25 p.m.
Committee Room 12
Legislative Office Building
Trenton, New Jersey

MEMBERS OF COMMITTEE PRESENT:

Senator Joseph L. Bubba, Chairman
Senator Peter Inverso, Vice-Chairman
Senator Gerald Cardinale
Senator William E. Schluter

ALSO PRESENT:

Joseph P. Capalbo
Office of Legislative Services
Aide, Senate State Government Committee

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Hearing Recorded and Transcribed by
Office of Legislative Services
Public Information Office
Hearing Unit
162 West State Street
CN 068
Trenton, New Jersey 08625

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PUBLIC HEARING

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NOTICE OF PUBLIC HEARING

The Senate State Government Committee will hold a public hearing on the Pension Fund Revaluation Proposal.

The hearing will be held on **Thursday, February 13, 1992 at 2:00 P.M. in Committee Room 12 of the Legislative Office Building, Trenton, New Jersey.**

The public may address comments and questions to Joseph P. Capalbo, Committee Aide, or make bill status or scheduling inquiries to Deborah Del Vecchio, Secretary, at (609) 292-9106.

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TABLE OF CONTENTS

TABLE OF CONTENTS (continued)

* * * * * * * * * *

mjz: 1-38
hmw: 39-67

SENATOR PETER INVERSO (Vice-Chairman): The purpose of this meeting is to hold a public hearing on the Pension Fund Revaluation Proposal.

Our first speaker will be Margaret McMahon, Director of the Division of Pensions, New Jersey Department of the Treasury.

M A R G A R E T   M c M A H O N: Good afternoon. Does this sound like it is on? (referring to microphone)

UNIDENTIFIED MEMBER OF COMMITTEE: It is being recorded, so there is no amplification.

MS. McMAHON: Oh, okay. Before I begin, I would like to make sure that everyone has a copy of the Proposal and the questions and answers. Okay.

The Pension Fund Revaluation Proposal: The purpose of the Proposal is to set forth a system which will allow the State of New Jersey to reflect more realistically the financial conditions of the pension systems, while continuing to assure an adequate accumulation of reserves in the retirement systems at the least cost to current and future taxpayers.

The Proposal is technically defensible, reflects present common practice, and will continue to maintain and improve the benefits security of current and future retirees. The recommended policy, as with all such policies, is flexible and subject to fine-tuning based on the developing experience of each new New Jersey retirement system. This flexibility is key to the continued successful funding of the New Jersey systems.

Let me say a few words about the New Jersey systems: The New Jersey retirement systems are leaders among the 50 states in the establishment, maintenance, and financing of the systems. They have been that way in the past, and will continue in the future. The New Jersey pension systems fund the cost of living for retirees, something that only a few states do, and we are virtually alone in funding postretirement medical benefits. So, we are definitely leaders in the field.

The idea we are proposing is not a new idea. A number of commissions, study groups, and independent auditors have recommended most of the changes that are part of this Proposal.

I am going to go over briefly the major components of the Proposal, and then throw it open to questions and answers:

There are three parts to this Proposal. The first part is, we will be changing-- We are suggesting a change in the valuation of assets from a book value to a market-related value. The second change, we are changing the economic assumptions consistent with the first change. It makes sense to change economic assumptions when you are going from book to a market-related valuation.

The three economic assumptions that we are changing: We are adjusting the assumed rate of return on investments from 7 percent, which is based on book value, to 8 3/4 percent, based on market-related value. I keep using the term "market-related value." When you talk about book and market, most pension systems which use market value use a value that is an average. What we are suggesting is a five-year average, which dampens the volatility. The use of market-related value is mandated in the private sector by ERISA, and I would say that about 75 percent of the states overall use market-related value.

Now, on the conservative side, we are also adjusting the salary scale assumption from 5 percent to 6 1/4 percent, and we are adjusting COLA assumption from 2 1/2 percent to 3 percent.

To put this in the proper context, the first two changes account for about 75 percent of the overall reduction in contributions that we are talking about. So, these are the two critical and related changes.

The third change is the change in the actuarial funding method. Right now, we are using an actuarial funding method that funds part of the cost, not the normal cost, but the cost that is attributable to changes between what the actuary thinks is going to occur and what actually occurs. There are both what we call actuarial "losses" and "gains." They are usually factored into what we call the normal cost. So employers, from year to year, see a slight change in their normal cost. When we try to fund these changes, we'll say a "benefit enhancement" or something like that, over a relatively short period of time, usually 12 years. We are changing this part of the funding method to fund these particular liabilities over a 30-year period.

The funding period will be a 30-year period to begin with, and then, as changes up or down occur, that funding period becomes elastic. It can go to 29 1/2; it can go to 30, 31 years. It can go all the way up to 40 years. At that point, the rate would be recalculated. I might add that there are some pension systems where there is no 40 stopgap; where it just runs out far into the future.

Getting back to the market-related value of assets as opposed to book value, if you look at the return on investments over the last 10 years, it has been 15.5; over the last five years, it has been 10.2. In doing this analysis in preparing this evaluation, the actuary not only looked at the past 10 years and the past five years, but looked back to one of the classic technical studies, which is called the Ibbotson Study, which really goes back to 1926. And, overall, the rate of return over a 65-year period has been better than 10 percent. So, certainly setting the interest assumption at 8 3/4 is well within the parameters of what has been the historical return.

One of the things many people ask about when they are concerned about pension systems is, "Well, how are you funded?" A number of people have already asked that question, so let me answer it: There are different kinds of standards that are used when you look at the funding of pension plans. There is a Federal standard, and they are called "FASB" rules, which stands for the Federal Accounting Standards Board, and then there is another similar board, the "GASB," the Government Accounting Standards Board rules. According to the Federal rules, we are funded at a percentage of -- well, around 120 percent for the pension plans. Under the GASB rules, we are at about 85 percent or 90 percent. Some of them might say, "Well, we still have a large unfunded liability," which is very appropriate, because when we look at our unfunded liability, some of these liabilities are contingent liabilities; that is, they are based upon the fact that New Jersey is not going to go out of business; that employees will continue to work and will continue to accrue benefits.

Clearly, the funding levels for the private sector, where there is concern, especially lately, that companies will go out of business -- to have a funding level that can pay pension benefits to participants if a company goes out of business. That is where the FASB 100 percent standard is looked at. So, we are funded-- If New Jersey ever went out of business, we are funded to take care of all of our benefits today; some of our benefits in the future; and are continuing to fund at an appropriate level.

I think the Proposal is prudent. We studied a number of different options, ones that would have had funding levels without a 40-year point at which we would reexamine, but we felt this was a very prudent way to go given all of the historical data we looked at, and given the actuaries' best bet of how the future might shape up.

I would also say, nothing is cast in stone. What we are trying to do is set in place a Proposal and some assumptions that will take us through a period of time well into the future. However, a valuation of these pension plans is done every single year. Adjustments -- minor adjustments -- are made. Every three years, there is a comprehensive experience study done, and certainly if changes are needed to be made because the future turned out quite differently than anticipated, those changes are made prudently and at the appropriate time. So, this is something that is followed up very carefully from year to year.

If you have any questions on the Proposal, I would be happy to answer them.

SENATOR INVERSO: Well, first of all, thank you. I guess for some of us it is deja vu, since we just went through this this past Monday at the Appropriations and Budget Committee level, but for some of the Senators here today this is perhaps the first time they have had the opportunity for you to give the overview.

At this point, I will ask the Senators if they have any questions. Bill?

SENATOR SCHLUTER: Yes. Ms. McMahon, thank you, and I am saying this for anyone else who will be testifying. I am a very simpleminded individual, and I have to have it drawn for me in a very simple way, as far as where the money is going to reduce the premiums, to reduce the State contributions, to provide the saving that is anticipated from the program. I can understand the market value; I can understand the book value, and there is about a $5 billion difference. I can understand the anticipated interest rate of 8 3/4 percent. I can understand these other increase factors.

But what I would like to know in very simple terms is, where does the State of New Jersey pick up the extra money? If you can do it just with one pension system, say PERS, and State participation of PERS, maybe I could understand. The others, and you can elaborate-- Do you see what I am getting at?

MS. McMAHON: If I understand your question, we are, as you characterized it, picking up extra money by reducing contributions to the pension plans. We are doing that in four pension plans -- the four largest: PERS, the Teachers, Police and Fire, and State Police. There are some differences between the pension plans, and some slight differences in the way they are approached, but basically the changes, as I explained, come from the fact -- and you mentioned the $5 billion-- That $5 billion-- The actuary couldn't recognize that that $5 billion was there when he was setting up the costs of the system. So, what we are suggesting now, when you go to the market-related value, not that we are recognizing the full $5 billion, but a portion of that will be recognized. By recognizing a larger portion of assets, that means our liabilities are reduced. By the fact that we know -- we know what the return on investment has been-- It is very easy to look back 10, 15, even 65 years. If we know what a reasonable rate of return is on investments -- and there should be a relationship between the rate of return on investments and the interest assumption that the actuary uses when money is put away each year-- If you put a dollar away this year, if it is going to earn 8 3/4 percent, you are going to have more at the end than if it is going to earn 7 percent. You may be able to put less away. So, those two factors together makes the most significant difference in reducing the amount that the actuary tells us must be put away to fund these future benefits.

Did I answer your question?

SENATOR SCHLUTER: No, I didn't understand it. You may have answered it, but I didn't understand it.

MS. McMAHON: Well, let's take another try at it.

SENATOR SCHLUTER: I am trying to understand the cash flow, if you will: where the money comes from, how much it is going to be, what the State is going to get in increased funds for the hole in its budget, or whatever, and whether it is drawing down on that $5 billion, to put it that way, or whether it is just reduced employer contributions, or exactly what.

MS. McMAHON: All right.

SENATOR SCHLUTER: Is this a one-shot deal? Is it a continuing thing? Do we take so much out of the $5 billion each year until we run out? These are questions that I, with my simple mind, just do not understand.

MS. McMAHON: Okay. Maybe I can clear some of it up. If you have the proposal--

SENATOR SCHLUTER: Yes, I have it right here.

MS. McMAHON: --turn to the exhibits following page 17.

SENATOR SCHLUTER: Yes.

MS. McMAHON: All right?

SENATOR SCHLUTER: I have studied it.

MS. McMAHON: All right. If you look at Exhibit 2--

SENATOR SCHLUTER: Yes?

MS. McMAHON: I am looking at the 1991 bars. As you can see, the disbursements are far greater than the revenues.

SENATOR SCHLUTER: Yes, I can understand that. They are far greater than the earnings, too.

MS. McMAHON: Right. So, right now our disbursements are covered by the interest earnings, and the employer and employee contributions really get added to the asset base, if they are not used. All right?

SENATOR SCHLUTER: Yes.

MS. McMAHON: If this chart went out into the future, what we are going to be-- That top part of the bar -- the gray part--

SENATOR SCHLUTER: Yes?

MS. McMAHON: A part of it is going to come off, and that represents employer contributions. So that is less money that the employer has to put in.

SENATOR SCHLUTER: Okay, all right.

MS. McMAHON: Okay. So, that is one part of it. The reason that is being reduced comes from two different things: It comes from the fact that we have a larger amount of money available now that can be recognized. Part of that $5 billion is going to be-- It is like finding out that you have a bigger bank account. So you have more money in the bank because you are recognizing some of that $5 billion. Also, the money that you are putting away each year, instead of using a 7 percent increase assumption, we are going to use an 8 3/4 percent, so you have to put in less. So, those are the two pieces, really, that reduce the employer contributions.

SENATOR SCHLUTER: Then, from what you are saying, you are not drawing down on any--

R O L A N D M. M A C H O L D: You are reducing the amount that goes in.

SENATOR SCHLUTER: Just reducing the amount that goes in.

MR. MACHOLD: Though I should say that for 1992, this fiscal year, there are two parts to the savings here.

I am Roland Machold.

SENATOR SCHLUTER: I know who you are.

MR. MACHOLD: There are two parts to the savings: one of the prospective ones, which is for next year-- That is $680 million going forward over time. That is not taking money out; that is simply reducing from a much higher level -- $900 million -- the amount that is going to be paid in by the employers, see, for all of these reasons.

There is also a portion of $572 million, I think -- or $576 million--

MS. McMAHON: It's $572 million.

MR. MACHOLD: --$572 million, which is for Fiscal Year 1992, that is proposed in the budget. In other words, it is as if this program was started. Now I only mention that because you were saying, does money come out of the system? The Fiscal Year 1992 appropriation has already been made. This budget is the '93 budget. If, in fact, that recognition takes place, it will require the withdrawal of $572 million from the pension plans, from the amounts that -- the higher amounts that were contributed last year.

SENATOR SCHLUTER: But that $572 million is the only--

MR. MACHOLD: That's right. All the rest is a reduction of--

SENATOR SCHLUTER: Everything else is prospective?

MR. MACHOLD: Prospective, right.

MS. McMAHON: Right. I also would add that the question has come up, is this a one-time savings? Clearly, it is not. Pension contributions will go up in the future, but what we have done is drop down the level. They will go up, but they are now starting--

SENATOR INVERSO: But, Director, the $572 million is a one-time saving.

MS. McMAHON: The $572 million is a one-time saving, right.

SENATOR INVERSO: Yeah, but the rest is an acturial--

MS. McMAHON: Right.

SENATOR INVERSO: --prospective based upon the variable changes that the Director alluded to.

Just a question here: There are other states that have adopted this, as we indicated earlier, and I know the private sector is required, under ERISA and under -- actually it is FASB '87-- But, when the other states adopted it-- Do you have any information you can share with us with regard to how much of the differential and market value they reflected in terms of recomputing the contribution level for that period they were doing it in?

MS. McMAHON: Our actuaries-- We did ask that question. I do not have the hard data with me, but I am sure I could get it. The five-year averaging was the most popular approach.

SENATOR INVERSO: Yes, but I am not asking that, because--

MR. MACHOLD: What the nominal savings were for--

MS. McMAHON: Oh, okay.

SENATOR INVERSO: Yes. In our Proposal -- the State's Proposal -- we are reflecting one-third in the first year of the differential, the $5 billion. For the purposes of the numbers we are using differential. What I am asking is, how much of that have other states-- What is the corresponding percentage that other states in adopting this have recognized in the first year?

MS. McMAHON: I'll have to ask that question. I am not sure.

SENATOR INVERSO: Could you find out for me?

MS. McMAHON: Yes.

SENATOR INVERSO: I would appreciate that. Yes, I'm sorry. Senator Cardinale has a question.

SENATOR CARDINALE: This 8 3/4 percent assumption-- We have been in a period of relatively high interest rates in the past several years, and we seem to be in a period of much -- dramatically lower interest rates. What kind of an impact is that likely to have over the next several years with respect to the security of the plan that you are proposing?

MS. McMAHON: Well, I'll start the answer, and then Roland, I am sure, can chime in and wrap it up beautifully. As I said before, if you look back in history -- and some of the technical studies we looked at, you know, go back 60 years -- even though there were drops in the market, over the long term, the rate of return was 10 percent, even taking into consideration some big drops along the way.

When you are looking at pension plan funding, you are looking at very long term. As I mentioned earlier, these pension plans are looked at every year, and certainly if something dramatic starts to happen -- remembering that anything dramatic that happens we are only factoring in 20 percent of what's happening, because it is a five-year average, and that does dampen volatility-- So, I guess if it is any assurance, if anything starts to change dramatically, changes will be made. But if you look back over history, even though there are a lot of ups and downs for the long term -- and that is what we are looking at-- We are looking at a horizon of 30 or 40 years.

Roland, do you want to add to that?

MR. MACHOLD: I want to clear up-- Maybe there is a semantic thing. The words "interest rate" do not refer to current interest rates. What we are really talking about is total return in the marketplace. So, when interest rates go down, it is a blessing for our bond portfolio, which goes up in value, as you might expect under those circumstances. So, in point of fact, one of the reasons we have had good returns throughout the '80s is that we had 15 percent interest rates back in 1982, and when interest rates came down, our whole portfolio continued to-- The market value, obviously, turned upwards very sharply. That's the return.

SENATOR CARDINALE: I understand that, but that gives me a concern, and I will tell you why that gives me a concern: If you are selling those bonds, I understand you are generating income, but that income has to be converted into some other investment.

MR. MACHOLD: That's true.

SENATOR CARDINALE: The current rate of return on those investments at the point you make them is what you are going to have to deal with. This is essentially a system whereby you do produce income, but you also take in contributions.

Now, if at any point in time-- You are not like a private person who says, "I am going to sell out and retire." You can't retire, because you have a continuing operation. So, while I can appreciate that your value -- your nominal value -- may go up, in terms of the income that that nominal value is producing in your case-- I wonder how significant that difference really is. Are we, because we now have a nominally higher value, partially because of the increase in the salability of your bonds-- What does that really mean in real terms to your obligations?

MR. MACHOLD: Right. We don't pay-- Obviously, there is a cash income. You're right. There is what we call a "reinvestment risk." If a bond runs off at 10 percent, you have to reinvest it at 6 percent, and you have obviously reduced your income.

We are not looking at that kind of a differential, because that is only income. There is also the so-called "market gain." Half of our portfolio is stocks; a little bit more than half. What we are looking for is, over a long period of time, average market returns, including both income and market appreciation. So, it is a blend of all of those factors. The studies Ms. McMahon is referring to, do look at each class of assets and show what the standard deviation of returns is, as well as the nominal returns over that period of time.

The point isn't to try to match payouts with actual cash income. What it is trying to do is match book liabilities and a balance sheet item against book assets, and book assets will grow in value according to this, with a combination of cash and market returns both. So, once those go up, it could be we would have nothing but zero coupon -- not coupon bonds, but say we had nothing but Digital Equipment -- a bad example, because the stock has not done well -- but it's got no dividend, you see, and if, by chance, that went up 10 percent a year over that period of time, we would not have funded a single benefit out of income, but we would have the money available at the end because we would have met our actuarial assumption.

SENATOR CARDINALE: So, do you sell stocks to meet your obligations?

MR. MACHOLD: We have not had to, because we have a strong, positive cash flow. The positive cash flow has far exceeded the outflow.

SENATOR CARDINALE: All right. Now, in terms of that cash flow, what aspect of that cash flow is due to the increasing number of people for whom contributions are being made? It has occurred to me that we have been in an increasing employment cycle in government in New Jersey, so you are obviously covering more people each year. Now, it also occurs to me that someday that's got to end. As these people become older -- this increasing number of people become older -- and more are retired, as opposed -- in relationship to the number who are working-- Have you factored in that component? I think among the things I heard you say was something that seemed to stir a little warning in me; that because we are not going out of business, we are always going to have more people contributing to this system. Well, that contributions factor is growing, but someday those people are going to have to be paid. Now, is this safe with respect to that factor?

MS. McMAHON: All right, let me answer that this way: A number of people have questioned me, "What about the baby boom?" You know, we have a lot of people in the work force now who will be retiring all at once, practically, and will be a drain on Social Security, which-- Any comparison is not an appropriate one, since Social Security isn't funded. But the baby boom will say that is in State government right now, increasing the amount of contributions.

The amount of contributions that the employer is putting in, and the employee is putting in, is funding their future retirement benefit. So clearly, these individuals are putting in money, and we are putting in money for them, which will grow to the point that it can pay their retirement benefit in the future. That is really not a concern.

SENATOR CARDINALE: As I look at your exhibits, they seem to be exhibits not related to the individual who is putting money in and having money put in for him and then retiring. They seem to be related to the overall pension system. I realize that is made up of all of these individuals, but there are other factors. This overall pension system has always been very, very, very strong. It also occurs to me -- and you had it in your original remarks -- that, in fact, one of the factors in this strength is that it is an increasing system; a system that has been increasing in size. If it began to decrease in size, or it just stopped growing, what impact would that have on what you propose to do now?

MS. McMAHON: In other words, are you saying that the point will be reached where there will be a greater number of retirees and a smaller work force? Is that your concern?

SENATOR CARDINALE: Well, suppose you just stopped increasing the number of people who are covered by the pension plan, and it just became solid?

MS. McMAHON: It wouldn't matter.

SENATOR CARDINALE: It wouldn't matter?

MS. McMAHON: No. As a matter of fact, I will be able to provide additional charts and information. As questions come up, if there are additional charts you need that would make this point more clear, I know I will be able to get them because some of the questions that are being raised here, you know, were raised in the dialogue and the discussion which went on for months and months and months. If I gave you, or shared with you, all of the material and charts that I could possibly have given to you, you know, it would have been a 10-pound book. What we tried to do was pull out the highlights, but any very specific concerns, I think either-- I think that a chart would perhaps help.

SENATOR CARDINALE: Let me go back to the Exhibit 2 you were using a moment ago, using 1991. If you compare 1991 employer and employee contributions, and you add them together, and you look back 10 years -- which is about as far back as we can go -- and you look at those two items, there is a marked disparity between the total-- Now, if I can get that somewhere-- It is about -- something over $2 billion in '91, and I would guess less than $1 billion in-- So, we have a doubling of the contribution over a period of 10 years--

MS. McMAHON: And it has been mostly--

SENATOR CARDINALE: Whoever contributed it-- It becomes immaterial. A factor in that is the increase in salaries, I am sure, over the 10-year period. Another factor is the increase in the number of employees, which we all know has occurred over that 10-year period. But, isn't that a kind of disparity that comes to an end, or are you projecting, in essence, through this kind of a reevaluation of our pension plan-- Are you projecting that the rate of increase in number of employees is going to continue? I would suggest to you that if that is so -- and it appears to be so from your exhibit -- we are going to run out of people who live in New Jersey to be employed, at some point in time.

I can understand that there is a market value factor, but to what degree is this factor responsible for your feelings that it is safe to do this? If you can't answer that now -- maybe, you know, you did not anticipate that question -- maybe you can get back to us with that answer. I think it is an important factor in our consideration as to whether we are going to be involved with this. It should be a factor for all of the employee groups, which have to understand that the population of New Jersey is growing at a much slower rate than the population of these pension plans.

MR. MACHOLD: Let me just interject -- and this is a conceptual thing-- I am not sure I can answer the question, but remember that each new employee is not necessarily a plus to the system. I think, under the assumption that you put forward, each new employee, in effect, helps to pay for the others.

SENATOR CARDINALE: I am worried that that may be what is happening here.

MR. MACHOLD: Well, this is the problem with Social Security. I mean, people are truly concerned, because Washington does not have enough people paying Social Security in the 21st century. This is a very legitimate concern, but I don't think-- Remember, that is not funded, and that is a tremendous difference. Every new employee here, if there is a proper balance struck, brings in his own liability, which is projected out in the future, together with his own personal contribution, plus the portion that is added from the employer. There is intended -- not only across-the-board but if everybody was divided into single employees, each of whom was an absolutely normal employee, which is not the case -- to have a balance in here, so that-- I think what Marge is saying is, it really doesn't matter. Right now, if the pension fund system were to stop immediately, a whole lot of liabilities -- old projected liabilities would end-- If the whole State closed down, we would have plenty of money to pay off everybody in the systems right now, so that bringing on new people, in effect, brings on a complex of new assets and liabilities which are intended to match.

SENATOR CARDINALE: I didn't hear that in your direct testimony. What I heard in the direct testimony was that we would have enough to pay the current, but out to the future we would not have enough to pay. That is what prompted the question in the first place. Maybe I misunderstood your remarks.

MS. McMAHON: Okay. The way we are funding the pension plans -- and when I talked about the different levels of funding, you may look at us-- On one hand, we are fully funded at this point. That means that if New Jersey went out of business and everybody had to collect their benefits, we could pay it. We are also funding for the future benefits that will be accrued by the employees who are currently employed. It would not be appropriate to pay that future liability now.

SENATOR CARDINALE: What do you mean, "now"?

MR. MACHOLD: To fund it.

MS. McMAHON: To fund it. In other words, to put--

MR. MACHOLD: Money in place for a liability that hasn't even--

MS. McMAHON: The employee has not earned the benefit. I mean, the assumption is that the employee is going to stay on until retirement and perhaps collect medical benefits and have a working life of 15 years in the future. So, the payment for that liability -- the employee may not stay -- is going to be prospective.

To get back to a point you made about future employees, this particular actuarial funding method looks at-- It is a closed group. It looks at the people who are employed and funds accordingly. If you want to be less conservative with your funding -- and there are methods -- they look at future employees who may come on board and spread the funding over a longer period of time. So this is, in fact, a more conservative method, because as Roland pointed out, the employee comes in, and between his employer and himself, he starts to fund his own benefit.

SENATOR CARDINALE: If we look at this as a closed system today--

MS. McMAHON: Yes?

SENATOR CARDINALE: --we have people who are going to retire this year. If, in fact-- What I hear you saying is -- and I don't think this is what you mean -- if New Jersey closed down, the person who is a year away from eligibility to collect from the plan-- What impact would shutting down the entire system under this scenario have on that person? You tell me that the people who are eligible for retirement, and those who are already retired, would be fully funded, essentially.

This contingent liability, these people who if they work one more year, or two more years, or five more years, will then have a right to call on-- To what extent does our present plan fund that contingent liability?

MS. McMAHON: Okay. I believe the Senator probably knows more about private sector plans, but I did work in the private sector for a while, so I think I can respond to that.

Basically, when a company goes out of business, the folks who are not vested yet, who normally would not get a benefit because they have only worked five years and vesting is, in fact, 10 years, would be entitled to a benefit. That is part of the termination rules. So when I say to you that we are fully funded, I mean we are funded to the point that we could pay a benefit to a person who otherwise isn't really eligible for that benefit. But, we are not fully funded to the point to pay them the benefit that they would be eligible for in the future.

SENATOR INVERSO: And it is not meant to be that way.

MS. McMAHON: And it would be irresponsible and burdensome on current taxpayers or private sector current shareholders, really. The IRS probably wouldn't allow you, because of tax write-offs and so on, to do it any other way.

SENATOR INVERSO: Following up on Senator Cardinale's questions, one of my questions is: When you look at your chart here, you show that the earnings have more than outpaced disbursements out of the plan. I am just wondering, do the actuaries do a projection to determine at what point our disbursements out of the plan, which would be retirement benefits, start to really eat into that differential that the earnings are providing? Then it is a question of basically being on a current funding arrangement.

MS. McMAHON: I think one of the highlights in the report talks about that. Right now, our revenues are two-and-a-half to three times disbursement.

SENATOR INVERSO: Higher than the disbursements, right.

MS. McMAHON: Under the new policy, the revenues will be two to two-and-a-quarter times.

SENATOR INVERSO: Over what period of time has that been projected?

MS. McMAHON: It will never be a point-- In other words-- Let me look. Over the next 20 years, the disbursements will -- if I may draw upon the white part of the chart -- go into, we'll say, the employee contributions, but they would never get to a point where they would approach outstripping revenues.

SENATOR INVERSO: By revenues you mean employer contributions--

MS. McMAHON: Total revenues.

SENATOR INVERSO: Total revenues, yes. Right now we have had the luxury of earnings more than accommodating the disbursements out of the plan. At some point I would expect that that would narrow, right?

MS. McMAHON: It will narrow, but there will still be-- Maybe a graph showing that out 20 years would have--

SENATOR INVERSO: Yes, because that is going to be met with employer contributions, presumably.

MS. McMAHON: Right. More will be met from employer contributions.

SENATOR INVERSO: Yes. I just wanted to-- I know this is not an exact science, even though actuaries think everything is mathematically precise. But, there are so many subjective judgments that go into this thing, and so many variables. I think Senator Cardinale's concern is down the road.

SENATOR CARDINALE: It would seem to me from this graph, for instance, that we don't ever need to have either the employees or the employer ever make another contribution, because the current earnings on the system would carry -- if we can look at this graph over the last 10 years. Like Senator Inverso, I feel uncomfortable with that, and I wonder how much we can rely on the fact that the earnings will always exceed the disbursements.

I understand that revenues are way up there, but that is partially earnings and partially the contributions.

SENATOR INVERSO: I would like to give Senator Bubba an opportunity once you respond to Senator Cardinale. If you do not have that information, you need to provide us with some of the actuarial charts and other types of--

MS. McMAHON: Right. I think I can get you a couple of charts that would give you a clearer picture 20 years out, and would probably answer your question.

SENATOR CARDINALE: Thank you.

SENATOR INVERSO: Senator Bubba?

SENATOR JOSEPH L. BUBBA (Chairman): We are trying to explain what we are doing by developing relationships more than, you know, talking the actuarial issues here.

On that basis, I caught you saying, "The rate of return of 10 percent." Were you talking about the stock market?

MS. McMAHON: The whole fund.

MR. MACHOLD: Stocks, bonds.

MS. McMAHON: The stocks and bonds.

SENATOR BUBBA: You are talking about this fund--

MS. McMAHON: I am talking about the returns. The Division of Investment is right here and can verify--

SENATOR BUBBA: Oh, okay. I thought you were talking about the stock market in general.

MS. McMAHON: No.

MR. MACHOLD: It's market appreciation plus income, so it is a combination of both.

SENATOR BUBBA: Okay. As I look at this chart, I would like to see the relationship-- You know, we have enough investments in our portfolio that, generally speaking, there will be a relationship between the portfolio and the market. So I would like to see a relationship drawn between where the stock market was in these years and where the fund was, because as I look at it, you know -- and I can't say that I recall exactly where the Dow Jones was at every moment-- But, it would seem to me that the years that we did well here were the years that we did well with respect to the market. You know, I want to see the relationship between the two, and we want to be able to extrapolate, or rather, lay it on to this chart here.

Secondly, if you take a look at Exhibit 2, there seems to be -- and, of course, it is only a part chart, so, you know, we know that it is not absolute certainty-- But, it would seem to me that there is a direct relationship between employer contribution and earnings. That would mean, to me, that obviously if there were less of an employer contribution -- and that is what we are talking about -- there would be less earnings of some sort, because of the relationship.

Now, in addition to that, you've got -- the point that Senator Cardinale was making -- more people putting money in. You've got the employer making a greater contribution today than he will tomorrow. That money is making earnings. Those earnings are greater today than they will be tomorrow, because the contribution from the employer is greater today than it will be tomorrow, and, you know, everything else follows.

If, in fact, the relationship between the fund and the stock market is reasonable, I would really have personal problems because of the point I brought up the last time we met; that is, the success of the market has been unprecedented in the past 10 years. If you go from '60 to '70, or God only knows what is going to happen in the next 10 years, you will see that there was no-- The market certainly did not react the way it is reacting now. Maybe it would place me in my comfort zone -- as I mentioned the last time -- if I saw relationships that could be drawn in the '60s, or in the '70s. You are drawing the relationship in the last 10 years. The market has been wonderful. If you took the same information and laid it over the '70s, and the same information and laid it over the '60s, I think then I could develop, maybe, a better relationship in my mind. So I think that would be helpful.

SENATOR INVERSO: You want a longer base period for measuring what the real earning has averaged for a period of time. Maybe it should be 30 years -- what's reasonable?

SENATOR BUBBA: Yes, because they are going to take-- They are going to try to flatten the curve by a 30-year or 40-year process. So, I would like to see the flat curve, as it has been.

MS. McMAHON: Okay. I will be able to get you that. Let me add, when I talked about some of these technical studies that were done -- and I referred to the Ibbotson Study by our actuary, which, in fact, goes back to 1926-- It was a very different marketplace, certainly, in the prewar period. I know that when the technical analysis was done for this proposal-- What you have in front of you is a summary; you know, what we felt were the questions most people would ask. But clearly what the actuary did, in coming up with the interest assumption of 8 3/4 percent, was to look at a period of time post war. So the period looked at was really from the mid-'40s up until the present, in making the analysis, and I think I could share some more information.

SENATOR BUBBA: I think I misstated something, and I want to be clear. I don't want you to utilize the 5 percent, or five-year method of flattening. I don't want you to flatten the-- I want to see the actual relationship.

SENATOR INVERSO: You want to see the numbers.

MS. McMAHON: Right, okay. We can show you that.

SENATOR INVERSO: The other thing, too, is, I think you have to cull out of the fund the equity component.

MS. McMAHON: Yes.

SENATOR INVERSO: Because you know, we may be in there with double digit bonds that we were fortunate enough to get into when there were those kinds of rates out there, and you saw those bonds locked in, and then measure the equity component against the longer period that Senator Bubba alluded to-- But certainly if you take a look, the Dow went from 500 to 3300. You know, I don't know if we can expect that kind of substantial appreciation down the road. I realize we are talking 15 1/2 over 10 years versus eight. But that 15 1/2, as you indicated earlier, is a melding of the bond rates, or bond returns, plus equity returns. So you have had the best, really the best of both worlds over that period of time.

Is it reasonable to expect that that would continue to an extent that would permit an 8 3/4 percent rate to be reasonable? I think that is where we are going.

MS. McMAHON: Okay. The one point I know I keep coming back to-- Even if all of your comfort levels were achieved from the charts and the material I will share with you -- and I think you will have a comfort level from that -- no one has a real clear crystal ball, but we know that these evaluations are done yearly. The studies are done every three years. Adjustments have been made in the past when reality did not mirror what the actuary predicted. So, adjustments will be made.

SENATOR BUBBA: I understand the point about the crystal ball. We all want to be immortal in life -- I mean in death. We really do. We want to be immortal. I don't want to be immortal over this. I don't want to do something today that will not fund the pension 20 years from now, and have a lot of people remember me. I don't want to be remembered that way. That is why--

MS. McMAHON: Senator, neither do I.

MR. MACHOLD: That's where we are going to be 20 years from now, I hope.

R I C H A R D F. K E E V E Y: Mr. Chairman, I am Rich Keevey, Director of OMB. I came up because I thought there was some clarification necessary on the budget impact. I just want to add another point. In addition, we didn't speak to the savings on the TPAF in the teachers' pension system. As you know, what is occurring there is, there is no impact on the bottom line appropriation for school aid. But instead of putting $341 million more into the TPAF system, $341 million can go into the foundation aid, which is the basis for increasing the school aid appropriation. That money, together with the $145 million which has been reduced from the appropriations necessary to fund the employees who work for the State government, are continual savings. The one-time savings -- the $573 (sic) -- is a combination of getting refunds back to the State, not only from the employees who work for the State, but also the contributions that the State made this year on behalf of the teachers' pension system, and also the local contributions that were made by local governments into the pension system. The proposal in the budget is that that money also come back to the State government, so that the aggregate of the one-time number -- the $573 (sic) million -- is a function of those three: the State employees' contribution, the teachers' pension, and the local contribution.

SENATOR SCHLUTER: If I may--

SENATOR INVERSO: Sure.

SENATOR SCHLUTER: --since he addressed me-- Mr. Keevey, as a refund for Fiscal Year 1992--

MR. KEEVEY: This current year, right.

SENATOR SCHLUTER: Ninety-two?

MR. KEEVEY: Yes.

SENATOR SCHLUTER: Okay. Along the same line, if that $572 comes back to the State Treasury--

MR. KEEVEY: Correct.

SENATOR SCHLUTER: --that will be additional funds -- unrestricted funds -- will it not, to the State Treasury?

MR. KEEVEY: That money has already been factored into the budget. It is a resource in the '93 budget.

SENATOR SCHLUTER: Yes, I realize that.

MR. KEEVEY: Right.

SENATOR SCHLUTER: And, of course, the budget is subject to legislative approval.

MR. KEEVEY: Correct; that is correct.

SENATOR SCHLUTER: Now, that is for Fiscal Year 1992.

MR. KEEVEY: Right. We show it as a resource in the '93 budget.

SENATOR SCHLUTER: In the '93 budget?

MR. KEEVEY: That is correct.

SENATOR SCHLUTER: How much are we going to save in the '93 budget?

MR. KEEVEY: Related to that?

SENATOR SCHLUTER: Related to the lower employer-- The State is going to save related to lower employer contributions.

MR. KEEVEY: That is $145 million. That money has been reduced out of the '93 appropriation in the various pension accounts.

SENATOR SCHLUTER: One-hundred-and-forty-five million?

MR. KEEVEY: Yes, 145 -- $144.4 million, and that will be a permanent reduction. We have pulled down the appropriation base necessary to fund that.

SENATOR INVERSO: Well, that's because the presumption is that the $341 million -- or the $342 million -- would continue as a source of funding for foundation aid in the future, right?

MR. KEEVEY: Right, the $144 million is different than the 341.

SENATOR INVERSO: I understand that.

MR. KEEVEY: Okay.

SENATOR INVERSO: But what I am saying is, the reduced appropriation for pensions in Fiscal Year '93's budget is $679,000 -- $679 million -- were it thousands.

MR. KEEVEY: Right.

SENATOR INVERSO: The $145 million -- that is a State savings--

MR. KEEVEY: Correct.

SENATOR INVERSO: --is predicated on $341 million going to the schools in foundation aid funding, and $192 million going back to the local municipalities, counties, and school--

MR. KEEVEY: They are all occurring at the same time.

SENATOR INVERSO: Okay.

MR. KEEVEY: And in the future they will occur.

SENATOR INVERSO: Okay, but as you said earlier, nothing is cast in stone. What we are saying here is, the $341 million is next year's breakout of the total savings of $680 million. So, if the additional school aid number were to fluctuate subsequent to '93, or for that matter even in '93, then the State part, obviously, has to fluctuate correspondingly.

MR. KEEVEY: Yeah.

SENATOR INVERSO: Right.

MR. KEEVEY: We do know that the 1994 appropriation that we have to make for school aid is somewhat already determined. It is based upon 80 percent of the growth in the per capita personal income. So whatever that will be, that is our maximum appropriation.

SENATOR INVERSO: That you would have to make?

MR. KEEVEY: That we would have to make.

SENATOR INVERSO: Right.

MR. KEEVEY: Then we divide it up between how much goes into the pensions and the residual--

SENATOR INVERSO: Right, right.

MR. KEEVEY: Right, okay.

SENATOR INVERSO: Again, the point I am making is -- and I want this clear in my mind -- the $342 million that represents a State additional foundation aid funding out of the pension savings, is Fiscal Year '93's number--

MR. KEEVEY: Yes.

SENATOR INVERSO: --and may not be the number thereafter.

MR. KEEVEY: That is correct, but it will be in that order of magnitude.

SENATOR INVERSO: Yes, I understand. I just wanted to make sure. I understood that.

MR. KEEVEY: Right, okay.

SENATOR INVERSO: I appreciate that. Thank you.

Senator Bubba?

SENATOR BUBBA: Where did the premise -- and I am not trying to be critical-- Did you suggest that the "excess" could be spent from the pension? In other words--

SENATOR INVERSO: Do you mean the appropriation of $572 million?

SENATOR BUBBA: Yeah. I would imagine that maybe Sam Crane in the Treasurer's Office indicated that there was $572 million that could help in reducing the deficit, or help the State budget in some way. You know, if this proposal were to come to us -- to me -- and someone were to describe it that in the future these contributions could be reduced because of XYZ, or what we would be going through in this process, but we were going to keep the $572 million, you know, to fall back on, as a crutch, I think I would have been a lot more comfortable. But, you know, to, in effect, take money away-- I'm saying to myself, you know, I mean, yesterday it was a road, and today it is a pension fund. That's tomorrow?

If we truly want to do something to reduce the contributions but protect the fund, then why don't we just leave the $572 million in?

MS. McMAHON: Well, I think I can make one comment, and then Rich can probably make another.

When work on this proposal was started a number of months ago, probably shortly after the start of this particular fiscal year, when we had the actuaries start to do the work, we asked them to do the '92 year, as well as the future year. So certainly, this proposal is coming forward in Fiscal Year '92, and it seemed appropriate that we could begin this year.

MR. KEEVEY: I think it is as simple as that. You have to begin at one point in time. We chose to recommend that it begin in Fiscal Year 1992. Absent that money, of course, that would have made a different set of budgetary decisions in the '93 budget. It is simple as stated: It would have to be $572 million less appropriations in the '93 budget, if we didn't have that resource.

SENATOR INVERSO: I think your question, Senator Bubba, ought to be raised, too, when we go back to the Budget Appropriations Committee level, because I am not sure they can truly answer that.

SENATOR BUBBA: Yes.

SENATOR INVERSO: I think maybe the Treasurer can answer that, or someone else--

SENATOR BUBBA: Right.

SENATOR INVERSO: --but I am not sure that they can. They are dealing with this from the perspective of the

Department, what was done in terms of explaining to us the approach and their methodology. In terms of the budget considerations-- I think that goes, perhaps, beyond your realm right now. I don't know.

MR. MACHOLD: The actual work on this did begin, not only at the beginning of '92, but about three years ago actually.

SENATOR INVERSO: In '89, right -- or so?

MS. McMAHON: Right.

MR. MACHOLD: That is when those two reports came out.

SENATOR INVERSO: The ABA and the Buck Report.

MS. McMAHON: Right.

SENATOR INVERSO: Senator Cardinale?

SENATOR CARDINALE: May I ask another question?

SENATOR INVERSO: Yes.

SENATOR CARDINALE: You raised another question with me, I guess, in some of these things, but it never really struck me before. Part of this $500-and-some-odd million is actual-- You want to say that we have been collecting too much into the pension system. Part of that was that too much was collected from the municipalities, for instance. But, we are not going to give it back to the municipalities, we are going to keep it. Is that essentially what you are saying?

MR. KEEVEY: Yes, to the part that we are not giving it back to the municipalities.

SENATOR CARDINALE: What is the magic about going back one year? Is there anything wrong with the logic that might say we could go back two years, or three years, or five years, and recapture those overcontributions for each of those years?

MR. KEEVEY: I think that might need to be discussed a little more deeply with the actuary as to the viability of what could be done. I don't know whether we are prepared to have the data to respond directly to you as to how that might impact on the viability of the system, if it went beyond the proposal that we are talking about, and what that would do to your projections that we have provided you to date, etc.

SENATOR CARDINALE: So that by going back just one year, you can really take more in the subsequent years. If you went back several years, then you wouldn't be able to take as much in the future years.

SENATOR INVERSO: Theoretically--

MR. KEEVEY: Yeah, that would change the whole list of assumptions in there, and the calculations would be changed accordingly. Theoretically, the contributions that we have to make in the out years now are "X." If we took a couple of years back, the appropriation needs would be "X" plus something.

SENATOR INVERSO: Okay. Any other questions or comments? (no response) Sorry we have given you a double hit on this at both Committee levels, but there was no other way to approach it, since both Committees have jurisdiction over it.

SENATOR SCHLUTER: May I just ask a couple of quick questions?

SENATOR INVERSO: Yes.

SENATOR SCHLUTER: October 1987 -- Black Friday, Black Monday, whatever it was--

MR. MACHOLD: What happened? (laughter)

SENATOR SCHLUTER: What was the then 24, 25, whatever it was, market value of the billion of our pension system-- How much did that hit--

MR. MACHOLD: I remember it well. (laughter)

SENATOR SCHLUTER: --in the market value, for example? Give us a couple of figures, from what to what?

MR. MACHOLD: Well, I believe, roughly speaking, that the market value would have been about $20 billion then. I was called up, and I was very innocent. I should have realized that when a reporter calls you up, you don't always have to tell him something.

SENATOR INVERSO: I'll write that down. (laughter)

MR. MACHOLD: I hope the reporters behind me will delete that, but I very innocently said, well, the market was down. It was down 20 percent -- the stock market. I said, "Well, 20 percent--" We, at that point, had a $10 billion portfolio. I said, "It is probably down about $2 billion." I had no idea. I mean, it was just as good a guess as any, because we have to have a market basket very similar to (indiscernible). That was in The London Times. "Machold losses $2 billion," was the headline. It was in The London Times, The New York Times, The Los Angeles Times, and The Singapore Times. (laughter) I was the only major investor in the country who hadn't said that his computers were down that day. (laughter)

SENATOR SCHLUTER: So, in other words--

MR. MACHOLD: But, let me say what actually happened, because it is actually a very useful illustration. That week there was a tremendous disturbance in the marketplace, for a whole lot of reasons. What happened was that disintermediation took place. People got out of stocks and they ran to bonds. Bond prices went up 10 percent. But, because of our diversification, by the end of that week, our whole portfolio was down 3 percent, which in nominal numbers sounds pretty substantial -- obviously, $600 million -- but it was not critical. Three percent is a number which is within what you would call a "standard deviation." For that calendar year-- We don't keep score on a calendar year, but for that calendar year our whole portfolio was up 5 percent. So, these market shocks do come, but they tend to be self-correcting if you are diversified, and self-correcting over time, as long as the markets remain viable.

So, these things do come. Obviously this wasn't a major depression. That was really a market correction, and a number of other factors. I can't predict that for a major depression there would be an automatic snapback.

SENATOR SCHLUTER: You answered the question very well as far as the magnitude of the drop because of the equity portion of the portfolio.

MR. MACHOLD: Yes.

SENATOR SCHLUTER: And the fact that the fixed income helped to turn it around 3 percent gives me more assurance, and should give other people more assurance of the way it is managed.

SENATOR INVERSO: Just for my purpose, to be sure I am correct, is the fiscal year of the pension fund the same fiscal year as the State's fiscal year?

MR. MACHOLD: Yes.

SENATOR INVERSO: Because sometimes they are different.

MR. MACHOLD: Yes.

SENATOR INVERSO: They're all the same? They are all a June 30 year?

MS. McMAHON: Right.

SENATOR INVERSO: So when we are looking at market value and book value, we've got to peg it to that point in time. They are not--

MR. MACHOLD: Yeah, and that is important because there have been some different numbers in this differential.

SENATOR INVERSO: Yes, that is why I-- Right.

MR. MACHOLD: At June 30, 1991, the differential was $5.2 billion between book and market. In the course of conversation, people ask me, "Well, what is it now?" because they know the market has changed again. The answer actually is $8 billion.

SENATOR INVERSO: That 33 1/3 looks reasonable, doesn't it? (laughter)

MR. MACHOLD: Well, it could go down.

SENATOR INVERSO: I hear what you're saying. It has registered with me, believe me it has. Do you hear what we're saying? We're talking about a significant increase in that differential.

MR. MACHOLD: Well, that has actually adjusted a little bit in January, because both markets are--

SENATOR INVERSO: A little bit, yes.

SENATOR SCHLUTER: If I may continue, Mr. Chairman, you have indicated where the average return of the pension fund was 15 percent for so many years.

MR. MACHOLD: Ten years.

SENATOR SCHLUTER: For 10 years, and now it is down to a continuing rate of maybe 10 percent, or whatever.

MR. MACHOLD: It's been about that. Nobody can guess what is going to happen for the future. If you looked at the 10-year period previous to this, from '71 to '81-- I don't have the numbers in my mind, but I am quite sure that the numbers would have been single digit -- medium single digit, 5 percent, 6 percent -- over that period, because that is when oil prices took off; that is when interest rates rose very sharply; and bond prices eroded. The stock market had a major recession in 1974, '75, which it did come back from. I mean, I don't have a specific number, but you can't really look at one decade against the next. In the long term, this Ibbotson Study which was referred to, would show you that the stock market, over long periods of time, would turn on the order of 6 percent over the rate of inflation, which has been consistently 3 percent to 4 percent. It has been about 4 percent for the last five years.

Now, obviously, a lot of things can happen. We could be into a hyperinflationary period; we could have a depression, a zero inflation. I might only be earning 8 percent, but it might be great if we had zero inflation.

SENATOR SCHLUTER: Okay. Along that line, we have an assumed interest rate of 8 3/4 percent.

MR. MACHOLD: That's an assumed--

SENATOR SCHLUTER: An assumed interest rate.

MR. MACHOLD: --actuarial interest rate.

SENATOR SCHLUTER: Now, Senator Bubba said before that he doesn't want, 20 years from now, for the generations who are about to be paid out to have defaults or anything to blame on him. Is there some kind of early warning system that you might recommend? I think in the Appropriations Committee this might be good to have, a built-in figure each year, built-in by the law that they have to provide it. What is the pension earning over the five-year average, or whatever--

SENATOR INVERSO: Well, the actuarial determination is made every year.

MR. MACHOLD: The actuaries will do that automatically.

SENATOR SCHLUTER: I'm sure they will, but it is not part of your, like, for example, assumed-- The anticipated revenue is certified by the Governor.

SENATOR INVERSO: Right.

SENATOR SCHLUTER: It seems to me that if you kicked this anticipated increase rate up to the same level of attention as anticipated revenue, people could look at it and say, "Oh my goodness, it is down to 9 percent," or, "It is down to 8 percent," or whatever. "We ought to do something."

MR. MACHOLD: I think to build it into a year-by-year thing-- Of those 10 years I referred to, there have been years that were 14, 15 1/2-- Two were negative years.

SENATOR SCHLUTER: I meant over--

MR. MACHOLD: Some kind of period.

SENATOR SCHLUTER: --a running average, or whatever, so that there would be something which is an early warning system. I don't know it as well as you do, but the Social Security system in our nation has gone--

MR. MACHOLD: Bankrupt.

SENATOR SCHLUTER: --sour pretty fast when nobody was watching it. Now, maybe some people did know that that was going to come about. I would like all of the signals to be present for this system so that it doesn't go sour, or something happen that we cannot anticipate.

SENATOR INVERSO: Senator Schluter, maybe that is something that is soon to be impaneled, I would trust. The Pension Review Commission should have that as one of its obligations and responsibilities. I mean, apart from that, I presume the actuarial rate of interest would change only with the accord of the Division of Pensions. I don't know how it works at this point in time.

MR. MACHOLD: The actuarial rate is set by the Treasurer under existing law.

SENATOR INVERSO: It is set by the Treasurer?

MR. MACHOLD: Yes.

SENATOR INVERSO: The 8 3/4 rate will be set by the Treasurer?

MR. MACHOLD: Well, if it follows the pattern of the previous law, which was that the actuarial interest rate, called "regular interest rate," for years had been set by the Treasurer, upon the advice of both the Director of the Division of--

SENATOR INVERSO: Okay, but it is set by his fiat, and is not subject to, say, our review, or anyone else's review. You know, we don't want to get into micromanaging -- I think I said that at an earlier Committee meeting -- but maybe the Pension Review Commission ought to properly have something like this under its purview.

SENATOR SCHLUTER: Two things, Mr. Chairman: Do you mean the 8 3/4 percent -- going from 7 percent to 8 3/4 percent -- does not require legislative approval?

MS. McMAHON: Oh, yes, it does.

MR. MACHOLD: Yes, it does.

SENATOR SCHLUTER: It does?

MS. McMAHON: Yes.

MR. MACHOLD: Well, because we are changing the system. The previous system was on a--

SENATOR SCHLUTER: Okay, but once it gets to 8 3/4, if that changes, who has the authority to change it, the Treasurer? (brief indiscernible discussion between Ms. McMahon and Mr. Machold)

MS. McMAHON: The 105 percent rule is what I--

MR. MACHOLD: Well, that is the reason, but it also says the Treasurer shall set the regular rate of interest.

MS. McMAHON: Right, right.

MR. MACHOLD: I don't know how you drafted the new law. The 8 3/4 is clearly either in the legislation, or presumed in the legislation. I'm not sure.

MR. KEEVEY: Yes, it is in the legislation that is being drafted.

SENATOR SCHLUTER: Then, prospectively, this could be changed by the Treasurer?

MR. KEEVEY: I don't know the answer to that.

SENATOR SCHLUTER: Could you let us know?

MS. McMAHON: Yes.

SENATOR SCHLUTER: To me, that is important.

SENATOR INVERSO: Right.

SENATOR SCHLUTER: Secondly--

SENATOR INVERSO: Yes, Bill?

SENATOR SCHLUTER: This is not a quarrel with you, Senator.

SENATOR INVERSO: I hope you wouldn't quarrel with me, Bill. It's too early in the game. (laughter) We're in the same party.

SENATOR SCHLUTER: The Pension Review Commission was specifically constituted not to get into the integrity, or the investment policy of the pension. It was only to study parity. I could be corrected on this, but I don't think the Pension Review Commission has anything to do with earnings or earning rates or investment policy or anything like that. It was specifically-- Is the NJEA in the room? Is that your understanding of the Pension Review Commission -- of the legislation?

D O L O R E S T. C O R O N A: (speaking from audience) Yes, that is our understanding.

SENATOR SCHLUTER: And, Vince?

V I N C E N T M. T R I V E L L I: (speaking from audience) The way it was drafted, it just talks about increases in benefits. It doesn't talk about any of this.

SENATOR INVERSO: But, is there anything that would exclude it from doing that? That is probably a topic for another session. (several persons speaking at once here)

SENATOR SCHLUTER: I think you would have to have legislation to charge it to do it, but I would question whether that would be good policy.

SENATOR INVERSO: All right, okay. Well, if I spoke out of context with the legislation, no problem. But I think maybe somebody ought to-- I think they ought to consider it, but, you know, we will discuss that at another time, certainly. This Commission ought to be a fairly important Commission and have a good influence on not only the future of pension benefits, and what have you, but the whole composition of the fund.

SENATOR SCHLUTER: I think perhaps that some of the groups that maybe didn't support that Commission, but at least went along with it, went along on the basis that--

SENATOR INVERSO: On that basis, yes.

SENATOR SCHLUTER: --it did not, in any way, strike at the investment policies of the--

SENATOR INVERSO: I understand. Well, the investment policies and the rate of interest are two different things. I mean, one flows from the other, but they are not necessarily the same animal.

SENATOR SCHLUTER: Thank you. I have been taking too many--

SENATOR INVERSO: I appreciate that. Okay, is there anything else then? (no response) One question I have: We have not seen any legislation yet? Do you plan to have something put before us as soon as possible?

MS. McMAHON: The legislation is being drafted in my office. I have yet to get a copy to the Treasurer, who I am sure will want to share a copy with the Governor's Office. At that point, I would imagine--

SENATOR INVERSO: We would hope that it would not be too late down the road -- you know, too far down the road--

MS. McMAHON: No. We should have a draft ready next week.

SENATOR INVERSO: Oh, great; super. I appreciate that.

MR. MACHOLD: It's either that or June 29. (laughter)

SENATOR INVERSO: It will probably be somewhere in between. Okay, anything else? Any other questions of the three individuals? (no response)

Thank you for coming. You might want to stay, because we have other individuals who have some comments and input, and there may be some questions they raise which you would like to respond to -- if you would care to.

Again, I would like to mention for anyone out there who is here for some of the legislation that was on the agenda, that legislation is not being discussed today.

We will now have Dee Corona and Len Koch, from NJEA.

MS. CORONA: Good afternoon, Mr. Chairman, and members of the Committee.

SENATOR INVERSO: Good afternoon.

MS. CORONA: Thank you for the opportunity to come before you on certainly what is a very complex issue. We've already had much discussion on the issue, but we definitely know that we will get much more in the future.

Let me start out by saying that the NJEA supports the concept behind the change in this proposal; that is, going from book value to market value. That is not a new concept to us, but we are not prepared, Mr. Chairman, to support the State's plan at this stage of the game. We're in the throes of studying that State plan, and we are interested in how all that is going to be implemented.

Our primary interest, so that you understand, is to protect more than 138,000 members who are part of those pension plans. They look to us for protection of that retirement benefit, and they recognize, just as we do, that too often in hard economic times pension funds are looked to for universal remedies for a budget. So we want to be careful that we're just not doing that, and risking the retirement of our members.

The representatives of NJEA have been to several meetings with the Treasurer and the Division of Pensions, and I would say at this stage of the game that they have been most cooperative in meeting with us and giving us the time to ask a lot of questions. In fact, at our most recent meeting on Tuesday, the NJEA has engaged some independent actuaries and our actuaries met with the State actuaries and had a very esoteric discussion.

As I said, we're not prepared to testify that we support the State's proposal because we still have a lot of unanswered questions. And the reason why we have those unanswered questions is primarily for two reasons: one, we have not seen the piece of legislation that will implement this plan, and we want to see the details of that; and two, we have not seen an actuarial complete analysis of the plan, and I don't know if one exists. So those are two things that we are raising which pretty much inhibit our actuaries from being able to give a complete analysis at this stage of the game of that proposal.

We do, however, want to raise a couple of issues with you today, despite the fact that we have not seen the legislation, nor have we seen an analysis of the proposal. With me today is Leonard Koch of our Research Division, who will raise some issues with you and perhaps give you some more food for thought -- if I may say that. Thank you, Mr. Chairman. I would like to turn it over to Mr. Leonard Koch.

SENATOR INVERSO: I could have used some food. No lunch today, so I appreciate that.

MS. CORONA: You should have told us. We would have brought some for you.

SENATOR INVERSO: Mr. Koch, please.

LEONARD KOCH: Thank you, Dee. Let me start out by saying that we are all on a learning curve here, as we address the State proposal for modifying the funding of the pension system. For years the NJEA has been most concerned about the security of the pension system for its members, and clearly, that is our number one concern as we approach the evaluation of this proposal.

Our actuaries were somewhat-- Well, I think the legislative leaders this morning and our actuaries were somewhat frustrated by the fact that most of the questions really couldn't be answered this morning.

There's basically two major concerns of security that we are looking at. One is that there is too much money being taken out of the fund right now. We don't know the answer to that question. In order to be able to answer that question, we believe that the State actuaries should be able to take the actuarial valuations of March 1990 and March 1991 and virtually redo them based on the proposal. As we understand the proposal, and as it was explained here this afternoon, the proposal will adjust the funding of the system for Fiscal Year '92. Well, the Fiscal Year '92 funding is determined and reported out in the annual valuation of the pension system, which took place March 31, 1990. So, for our actuaries to be able to certify to us, as we have asked them to do, that the amount of money that will taken out is safe and sound, they would like to see the revised actuarial report for March 31, 1990 that is essential and will be based on the proposals being made.

SENATOR INVERSO: All right, let me ask this question: That actuarial study as of March 30, '90; that's done then for the pension payment to be made prospectively, starting with June of that year?

MR. KOCH: Right.

SENATOR INVERSO: To June 30 of '91, in essence?

MR. KOCH: That's correct, for the '91-'92 Fiscal Year.

SENATOR INVERSO: No, no. The study was made March '90, correct? The employee census on which that study was based had to be a June '89 year, right?

MR. KOCH: Oh, that's correct. That's correct.

SENATOR INVERSO: Okay. So that's the period that we are talking about. It's the Fiscal Year of the plan ended June '89? Because that's the base on which the contribution would be made prospectively, right?

MR. KOCH: That's correct. The factors in the March 31, 1990 study are based on events that occurred up till June of 1989, as I understand it.

SENATOR INVERSO: Right. Okay, so that's what I understood.

MR. KOCH: In that their proposal goes back to that period, it seems appropriate that we adjust the report to reflect what's happening there.

SENATOR INVERSO: Sure.

MR. KOCH: Please don't interpret that to mean that at this point we are saying that there is too much being looked at here. We just simply don't know.

The second part of our evaluation is, does the proposed method adequately provide for benefit security over the long run? I believe you were hinting at that issue in the dialogue that just took place. We are concerned with the trade-off between keeping contributions stable and addressing problems as they may arise, and problems that are related to actuarial gains and losses that get beyond the basic issue of book value versus market value. We will need several pieces of information to evaluate what provision has been made for future benefit security. First we need to see a copy of the bill, which has been expressed, which lays out the provisions for adjusting assumptions when experience does not meet those assumptions and details the extent of any limits which are to be placed on the discretion of the executive branch, similar to the statutory limit currently in effect; that is, under current law. You referred to it earlier today in your discussion, the Treasurer set the assumed interest rate at 7 percent. And in the current statute, the investment people have to match that 7 percent within a 105 percent leeway. If they don't, more contributions are required in order to keep the fund solvent under the current terms of our statute. We don't know yet until we see the bill, and I think, again, you are focusing on that as well, and I think Bill Schluter -- Senator Schluter -- certainly focused on that; that is, how will that 8 3/4 percent be adjusted into the future, and what warning signals are going to be placed into the statute so that we don't end up in a tailspin that later on could cause us all a great deal of grief?

We are concerned that the proposed method may not reflect deviations from assumptions in the base phasing of. That by keeping contributions stable, actions on the problems which arise could be unduly delayed. In the proposal as I understand it, as there are actuarial loses, the effect of that actuarial loss will not be on a change in the contribution to the system, but it will be on a change in the actuarial liability with respect to the years in which that liability will be paid off. It will originally be set as I understand it, at 30 years, but in order to deal with actuarial losses, it could expand to as much as 40 years. We're not clear what happens if we ever hit that 40-year period. We believe it is essential that the proposal be prepared with test runs of probabilities of deviations being considered, so that by reviewing the run we could see the impact of what the contributions will be out into the future in the event we hit that 40-year cap. When we review the statute we will be looking at that carefully to see if it reveals any information along how we deal with that.

I would hope that if we end up in a decline situation that when we hit the 40-year period that we are obligated to go to 39 years the next year, and we're not looking at a scenario where we stay at 40 years until something miraculously happens to start picking us up again.

These are issues that our actuary will be looking at, and we have charged the actuary to, essentially, advise us that the proposal is sound for the security of our members. And hopefully they will be able to do that work quickly, and I assume that they will as long as they get the information that they need in order to feel secure in their recommendations to us.

MS. CORONA: Mr. Chairman, if I may: This morning, as Len said, our actuaries appeared before the Senate Education Committee. We're not able to get into a whole lot of substance because we did not have the information. They were invited to be there by Senator Ewing. They presented an outline to the Senate Education Committee which I would share with this Committee, also, even though our actuary is not here to embellish these comments. I think some attention to the second page in particular, which says, what is needed to evaluate benefit security impact for TPAF. It would give the Committee an idea of some of the things that would be needed to really look into what the impact of this proposal would be on the pension fund. I'd be willing to share that with you.

SENATOR INVERSO: Can I ask the Director of Pensions a question? Does an actuarial analysis of this proposal exist? I ask the question, what you would call an analysis, but was an actuarial study actually done?

MS. McMAHON: (speaking from audience) There was a study-- As a matter of fact, Actuarial Sciences, the firm that Dee is referring to, are the actuaries for NJEA. They were the actuaries involved in the very definitive study which took place in 1989, in which there was quite a bit of agreement on the steps to be taken. The proposal was based upon that study with further analysis that was done. If you are asking me if there is a thick report that outlines all of this, at this point? No. Would our actuaries be able to get one together within a couple of weeks? Yes, I'm sure.

A number of questions have come up from all of you that have come up, as I say, over the months when we were discussing all of this, where I think some additional charts might be helpful. If need be we can get together a report.

SENATOR INVERSO: Okay. Thank you.

MR. KOCH: May I comment, also, and say that at our meeting with the Director and the State's actuary, these points were raised and we did have a great deal of cooperation with the exchange in the discussion. The reason these issues are mentioned here are simply because these are the reasons why today we cannot make a definitive statement in terms of our position on this proposal.

SENATOR INVERSO: Mr. Koch, may I ask you, are you with ASA, or NJEA?

MR. KOCH: I'm sorry.

MS. CORONA: NJEA -- our Research Division of NJEA.

MR. KOCH: That's her fault. She is supposed to introduce me.

SENATOR INVERSO: No, no, no. She did, but I-- You're not with ASA, Actuarial Sciences. This was supplied by them?

MS. CORONA: That's right. That was our independent actuarial--

SENATOR INVERSO: But they also did the '89 study which apparently serves as the foundation.

MS. CORONA: That's right, they did.

SENATOR INVERSO: I think Buck did an '89 study, too, if I recall correctly?

MR. KOCH: Yes, they both did it. The one major change as ASA explained it to us, which I think is a very positive change, by the way-- I just don't know how it's going to play out yet, and we would not know that until we see some test runs: That is the significance of that 40-year cap on paying off the accrued liability. As it was explained to me when the studies were done in '89 by both Buck and ASA, neither one at that time put that in there, and I think that's what Marge just referred to. That there were some modifications. And I have to say, that that appears to be a very positive modification with respect to protecting the members' interest in terms of their security. But not having been part of that, we don't know how that plays out.

SENATOR INVERSO: Okay, thank you. Are there any questions from the Committee? (no response)

MS. CORONA: Thank you very much, Mr. Chairman.

SENATOR INVERSO: Okay, thank you.

I'd like to ask Bill Dressel and Lou Neely-- Is this a tandem presentation?

L. MASON NEELY: A return to the chair here.

SENATOR INVERSO: You probably got a snack though.

WILLIAM G. DRESSEL, JR.: Mr. Chairman, I have a report we will pass out, and our testimony will be-- (witness distributes report)

Thank you, Mr. Chairman. For the record, my name is Bill Dressel. I'm the Assistant Executive Director of the State League of Municipalities. Lou Neely, the Finance Director from East Brunswick, who is also the Chairman of the League's Pension Study Committee joins me.

Mr. Chairman you have before you a letter and a report that Mr. Neely and our committee prepared. I have a couple of comments:

First of all, the League of Municipalities enthusiastically supports the concept of shifting from a book value to a market value. This idea is not new. As I recall, it was embodied in the 1987 Blue Ribbon Pension Study Report, that former Governor Kean commissioned. The League supported that report at that time, and we support this proposal at this time. This is a fiscally responsive management concept that is commendable. We also support the fact that the savings will result in lower stabilized employer contributions.

We do have some concerns, however, with some of the technical implementation aspects of the bill. We have reviewed them. We have also expressed our concerns with Marge McMahon, and, like the NJEA, I echo our satisfaction with the degree of assistance that we have received from Marge McMahon and her staff. We look forward to continuing that good working relationship on this, and also the bill when we see it.

At this time, Mr. Chairman, I would like to introduce Mr. Neely, who will speak with regard to our technical concerns.

MR. NEELY: Thank you. Let me first parley, if I can, that the conversations that you had with the administrative staff: Senator Schluter asked the question, "What happened in 1987?" It's interesting. If you look at the ratio of assets to liabilities, 1987 was the highest year of assets to liabilities. It turned out to be, if you were to look at the last 11 years, it turned out to be the best year on paper, and the comment that Roland Machold made, when fixed assets are down, equities come up, and vice versa. So, in 1987, the relationship of equities, or assets to liabilities, for the local portion of the -- was 159 percent, if you use the market value approach, and if you use the traditional book value approach, it was 97 percent. If you look at the State's portion of that, it was 151 percent, versus an 82 percent. So that you can see that looking at it over time, you do have significant fluctuations in the market, and by looking at the value and the mix of investments -- and that's really what we are concerned about -- GASB, Statement 3, requires that the Division of Investment disclose the level of investment by risk. And they do that each year in the reports. We look at those levels of risk and we are very pleased with that. For that reason we can support the shifting from book value to market value, following FASB's 35.

I want to comment that there are some problems as indicated. If you would turn to the table that is in the report, it shows you some of the concerns we have.

This information was developed based upon information provided by the Division of Pensions. If you will notice, it lists the five systems dealt with. The first table says that the State contributed, as the employer's portion, last year, $199,219,714 for the State's portion of PERS -- the Public Employee Retirement System. The relationship of that coming back in the forthcoming year when that is shifted, Rich Keevey indicated that it's going to be about $144.4 million of overall savings, or a relationship of 72 percent. If you would drop down and look at the number that shows for Teachers Pension and Annuity, you would see that the relationship there is the $578 million contribution, and they are anticipating a $314 million shift next year, or 58 percent.

You say, why such a difference in relationship? And the difference in relationship is because increased benefits were given when the teachers received all of the additional health benefits, they were rolled in as part of the funding, and therefore they became system liabilities. Those same form of benefits were rolled into the Police and Fire Retirement System at the objections of local governments.

The proposal that you have before you would be to shift the incremental cost of those back onto local governments. We take that as a personal affront, because when Chapter 109, Laws of 1979 were passed, we were told the State is increasing this benefit, the State is going to pay for this benefit, and therefore local governments, you shouldn't have a voice. That's the same message we received when the State increased the benefits for the TPAF. "League stay out of it. It's a State issue. We're going to pay for it." But last year we saw the Governor turn that back on us and say, "Look at all the money we are having to pay," which represented those benefits.

When Chapter 204 was adopted in 1989, the same incremental promise was made, and now we see that the proposed legislation would turn that back onto local government. We want to see the technical aspects of the bill. We don't want someone reneging on the promises that were made.

Secondly, if you go on and look at the table I have shown, it demonstrates that $200 million of the $572 million, as Budget Director Keevey said, is the result of local payment by local governments. We don't want the State to keep our overpayments. We support the concept. We support the accounting. The market shows that. We've done a lot of analysis and that is positive, but we don't want to give $200 million to the State and then have them give it back to us the next budget year. Because quite frankly, we don't get a dollar for dollar back. We get sometimes 60 cent dollars back, sometimes 40 cent dollars back, and we're looking for every dollar we put in, to get a dollar back. If it's a refund-- If I overpay my electric bill, I don't want the electric company sending it off to my neighbor. In this case, if we've overpaid because we are going to change the valuation, we don't want the Pension Division sending it off to our Governor. We would like to have it come back to local governments in proportion to what they paid.

That doesn't mean that the lion's share of it -- over $300-and-some million -- doesn't go back as a fund revenue to be used as part of the legislative and budget appropriation cycle in this forthcoming year. But we don't want to have those round-trip dollars, raised by local property taxes, to go from the Pension to the State, back to us, because it's just poor accounting.

Therefore, one of the key elements in this system is that: number one, the cost for the incremental benefits for the special retirement for the police and fire not be cast back onto local governments. We are looking at the legislation for that. We think that the proportionate return based upon overpayments should be given back to the local governments in proportion to what they paid, and in what the State paid the State should keep that. Clearly the State paid all of the Teacher Pension and Annuity funds, they should keep all of that. Clearly they paid the State's portion, and they should keep that.

Now it was interesting that the Pension Director commented that we are one of the few states that are dealing with postretirement medical benefits. And only the State is dealing with that, because there is no legislation allowing local governments to do that. If you look at the local government, we can't accrue for postretirements, and yet we have people retiring. We are giving, because we are part of the State Health Benefit System in many communities, retirement benefits to people who retire, yet we have no legislative power to do that, and that's not rolled into our actuarial base. That's why the portion that would be shifted to us somewhat skews when they begin to show the macro numbers. It shows that the cost to local government without the postretirement costs in there; that police piece being picked up, is somewhat lost. It's only $22 million or $23 million. Those are real dollars, lots of dollars, and I can't tell you a town in the State that wants to pay an extra $22 million or $23 million, when there was a promise made.

I would like to then draw your attention to Exhibit 1 of the State's handout, because you asked questions on that.

SENATOR INVERSO: Lou, before-- Do you have-- You allude to $200 million shown here as the allocation of the 572?

MR. NEELY: Right.

SENATOR INVERSO: That is the number that the municipalities and counties would expect?

MR. NEELY: Municipalities, counties, special authorities-- Of the 1682, I think, contributing agencies, those were the local governments' contributions that were made.

SENATOR INVERSO: Okay.

MR. NEELY: Now if you look at Table 1, the question was raised, what happens with regard to revenues and disbursements? I think if you look at 1982, and look at the relationship with the shaded to the solid white, the relationship there is disbursements are one to two-and-a-half of the revenues received. That same relationship is maintained all the way through 1992, which tells us that the assumptions used for valuing the system have been relatively constant, that they have been able to increase the overall assets, that they have been able to increase the earnings on it. And so the relationship is exactly parallel as you look at it over time. We don't have a concern with regard to disbursements versus revenues because this is a defined benefit system. When employee "X" is hired on day one, that employee is listed, a set of defined benefits they may receive at a certain period of time, and the valuation that is used to support that begins to fund those from day one. So that everybody who is full-time employee who is enrolled in the system is considered part of the liabilities of the system, and is funded based upon the future years. If they leave before their vesting, their contribution stays with the system. If they leave after 10 years and vest, then that defined piece is fixed at that time, it's fully funded into the future, and there is no need for additional dollars.

I think the questions that have been raised are good questions, but based upon this being a defined benefit system and the actuarial methods that have been used, I see no problem shifting from book value to market value. It simply is an accounting methodology that is used. The overall assumptions are still very valid. The technical aspect of who keeps what dollars and who gets shifted on paying the additional liabilities are the concerns we have.

If you turn to Exhibit 2 of the State, you begin to see what's happened in the marketplace. 1982 has a relationship between earnings, employee contributions, and employer contributions. This point cannot be highlighted enough. The employee contributions have increased, by the time you reach 1991, by only one-quarter, while employer contributions have increased by one-and-a-quarter times, which simply says that the cost of funding this defined benefit system has fallen on the employers.

That's a key factor. The majority of the cost of funding this system beyond the fixed assets -- the earnings from the fixed assets -- have shifted to the employer. Therefore, I see no problem with the potential refunds being returned to those employers who have paid that money, and who have consistently over the last 10 or 11 years paid more than when the system was designed. Initially the system was designed that employees would contribute approximately 5 percent, and employers would contribute 5 percent. Enhanced benefits have been given and all of those enhanced benefits have resulted in accrued liabilities. Those accrued liabilities have fallen on the employer, not the employee, a la the police and fire system, two years ago when we raised cane saying that system should not be enhanced. We do not want it back on us again, and that's what this legislation does.

So that the relationship-- Those dollars should come back to local governments where they paid them, they should go back to the counties where they paid them, and they should stay with the State where they paid them, but we certainly don't want indirect State aid of local dollars going to the State to turn around and send them back to us -- poor accounting, poor utilization, poor utility, and poor practice.

If you then turn to Exhibit 3, which the State has provided, which shows the relationship of book value to market value over that course of time, 1982 to 1981 (sic) you will see that book value has increased by approximately two times. Market value has increased over time by 3 3/4 percent. Clearly-- Rep times-- Clearly it shows that the market is healthy, which is a reflection of inflation, the value that has been added to our overall economy, and the assets which have been accumulated and invested. The relationship of assets to liabilities in the pension system for local governments, Public Employee Retirement System -- which resulted last year in $261 million of payment by local governments, was 112.1 percent at market value in 1980. In 1989, it's 112.4 percent. It's been relatively constant over that time. Because of that consistency, without increased enhanced benefits, we see no problem with this shift.

Now the State, which rolled in medical benefits as part of their pension system, their value changed from 1980, from 101 percent to 81 percent. They simply spent some of that accrued value to fund those postretirement liabilities. The same relationship happens with the Teachers' Pension and

Annuity. When a $3.5 billion benefit was given to the teachers' system of the State, they funded that simply by rolling that in as a liability of the teachers pension system. That has not happened with the locals for public employees, and therefore the benefits into the future are marginally affected by that in proportion to what the assets to liabilities are.

Given all of that, we think that it is sound accounting. It's a good business practice in this time of downturn economy, and the question is, let's not discolor it by someone reaching into local governments' pockets, or by shifting costs that don't belong to local governments back onto local governments. With that I'll conclude, or answer questions, if you have any.

SENATOR INVERSO: Bill, since you and I are the Committee, do you have any questions?

SENATOR SCHLUTER: A lot to absorb.

SENATOR INVERSO: Yes. Okay.

MR. NEELY: Thank you.

MS. McMAHON: (speaking from audience) I have one comment.

SENATOR INVERSO: You can stay there, Lou (addressing witness) Can he stay there?

MS. McMAHON: Yes. My comment is just on one piece of it. What Mr. Neely talked about is putting costs that the State said that they would bare back on local government, and it's just a point of information, not a-- (indiscernible)

When Chapter 109 was passed, and this was the law that enhanced the police and fire benefits, I'd like to read--

SENATOR SCHLUTER: Excuse me, was that '89?

MR. NEELY: Seventy-nine.

MR. DRESSEL: That was 60 percent after 25 years of service, if I recall. The promise that the State made was that they would pay the incremental cost.

MR. NEELY: The incremental piece. The normal contribution would continue to be paid by the employer, and the incremental cost of that special retirement, based upon an actuarial analysis, would be paid by the State. That incremental piece then increased when the 1989 was amended, and they gave the increased 5 percent enhanced benefit. That's the piece we would like to see continue with the State.

MS. McMAHON: And my point of information is just to give some understanding of why the shift is occurring. I refer back to the language in the law which says something like this: Any savings realized by the retirement system as a result of any future increase in regular interest as determined annually by the State Treasurer, shall be applied by the actuary towards meeting the cost of this additional liability. It is from that language, there is now an increase in the regular interest, and so that is why this proposal was designed this way.

SENATOR INVERSO: Did you get snookered, Lou?

MR. NEELY: No. That's completely a misinterpretation of the statute. Let me tell you why that is.

MS. McMAHON: Just a point of information.

MR. NEELY: As a point of information-- When you use salary assumptions and you use income return assumptions, and you base that upon a book value, the salary assumptions were ridiculously low for the police and fire. While the salary assumptions were at 5 percent or less, the savings because of binding arbitration were forced at 8 percent, 9 percent, 10 percent throughout the years, and therefore the system was out of balance. If there were enhanced earnings because of something that did occur, those savings beyond what were normal savings and normal contributions, they were not possible to identify.

We dealt with this when we dealt with the last issue of police and fire because they said by refinancing the system, Office of Fiscal Affairs came out and supported then Director Forrester saying, "This is going to save money." Well, in fact, it has not saved money, and we have done a study of the towns that were part of that. We've published that study in the "League Magazine," and there have been no savings. For someone to come back and suggest that this interest earnings, when you are going to revamp the whole system -- change the method of accounting, change the salary assumptions, the retirement assumptions, the earning assumptions, and the cost of living assumptions -- and then draw out a little piece of interest earnings over here and say that that gives us some grounds-- We would say impossible. Therefore, we rest our case.

MR. DRESSEL: Enough said, thank you, Mr. Chairman.

SENATOR INVERSO: Thank you.

We have Vince Trivelli and Jimmy Hedden, of CWA and AFSCME.

MR. TRIVELLI: Thank you very much. I'll try to be brief, because we have--

SENATOR INVERSO: Yes, we have one more presenter after you two, so we're getting close to the end.

MR. TRIVELLI: It's getting late in the day. Just for your information, CWA represents public employees -- between 55,000 and 60,000 public employees, State workers about 38,000, and the rest are local government workers. So this is both a State worker issue and a local government issue. It is not merely a State worker issue.

I want to thank you for holding this hearing, but we urge you to hold another one down the road a little bit. We have just begun to do the analysis of this proposal. We were provided information by the Director of Pensions last Friday. We have hired our own actuary who now has that information, and we will be sitting down with them, and then sitting down with the State. So we have done none of those things yet that will enable us to get to the first question, which is, is this fair, is the system going to be fully funded down the road? Until we answer that question, we can't go on to any of the other questions.

There are two things that I wanted to point out to start out, however, though. About two years ago -- and some of the Senators will remember this -- the State did prefund -- took over the responsibility for COLAs and health benefits for retirees. Unlike the other funds, the PERS fund got no enhanced benefits. But at that time, those two liabilities which were substantial, became liabilities not of the State, but of the fund. At that time the assumed interest rate was -- grew, from 6 1/2, to 7 percent. At that time it was said that the 7 percent number was the prudent number, and now we are, two years down the road, saying that 8 3/4 is the prudent number. We want to talk about that and ask why that 7 percent was prudent so recently, but now 8 3/4 is prudent.

We also want to point out that the way the system -- those benefits -- were prefunded, we objected to at the time. We objected to it because the idea of prefunding was, you put more money in now, you put more money in 30 years to cover that liability so that you could put less in 30 years from now after you have covered the liability for the COLAs and the health benefits. It was not done that way. It was done in order to help the State budget. For the first five years, on both the State and local level, the State and localities put in less than they normally would have to, and beginning, I believe -- and I will get the Committee the charts from that time -- I believe in 1995 they have, both on the State and local level, multimillions of dollars of responsibility facing them for 30 years because of the COLA and health benefits they took over. And we want to know how that interplays with this?

We have a lot of questions. We are just beginning to try to answer them. The basic concept that the State and localities put in 45 percent less, which is a rough number, is a lot less money. We have the responsibility to protect this fund for future employees, current employees, and current retirees, and we are going to take that responsibility seriously and we are going to take our time in looking at this. The State has been talking about it for a year. They talked to us about it the day before the budget went in.

If we answer the question of whether this is fair and equitable, then we would talk about where the money would go.

SENATOR INVERSO: Well, we're not going to rush this thing through.

MR. TRIVELLI: I understand that, Mr. Chairman.

SENATOR INVERSO: This is a very significant change in approach, and it warrants as much input, deliberation, study, and questions and answers as anyone cares to give to it. I know I can speak for the Chairman on that. This thing will be reviewed and examined to, hopefully, everyone's satisfaction. I think there is no question that there seems to be a general consensus of conceptual support for what is being done. Then it's a question of-- Maybe not speaking for you, but from what I've heard to this point in time, but it's a question of some of the fine-tuning.

MR. TRIVELLI: As people have said, we also want to see the bill. There are many things in that bill--

SENATOR INVERSO: We do, too.

MR. TRIVELLI: --which would be crucial to all of this.

SENATOR INVERSO: We do, too. That's why I asked, earlier.

MR. TRIVELLI: Concepts are one thing. As we all know, legislative language is quite another thing.

SENATOR INVERSO: Absolutely, right. Jim?

JAMES HEDDEN: Vince and I are singing the same song, and no need to repeat what Vincent and others have said. One of the things we will be looking to do would be, obviously, to increase the disposable income of our members. If there are savings on one end, we'd like to see those savings spread to as many people as possible.

SENATOR INVERSO: Okay. Bill, any questions? (no response)

When do you think your actuary will have had an opportunity to complete the review.

MR. TRIVELLI: I can't say yet. We will share it as soon as we get it.

SENATOR INVERSO: Let us know as it goes along.

MR. HEDDEN: Ten days to two weeks.

SENATOR INVERSO: That's a reasonable period of time.

Thank you.

MR. HEDDEN: Thank you.

MR. TRIVELLI: Thank you.

SENATOR INVERSO: All right. We have Norma Sawyer, who is the Chairperson of the PERS Board of Trustees.

NORMA SAWYER: Good afternoon.

SENATOR INVERSO: Good afternoon.

MS. SAWYER: I think it's important that I explain what I am representing, because -- and who I am not representing. I don't have a bargaining unit affiliation, however, my constituency is primarily bargaining unit people. I am Chair of the PERS Board of Trustees, however since this was released I have not had a meeting, so I don't want to be perceived as speaking for my Board. I think the Board does a very good job of coming to conclusions, and would prefer to be able to speak at another time.

I was happy to accept the invitation to be here and I was motivated to come simply because I was afraid I'd wake up tomorrow morning and find out our pension system was changed. Things seem to moving very quickly.

I do want to say that I work for an instrumentality of the State. I am, therefore, a public worker. I am not a State employee. I work for Rutgers University, and it's my understanding that all of the benefit plans are also cross-referenced in just about every bargaining unit contract there is in the State. If you make substantial retroactive changes in a system, you are likely to set that off balance, I suppose. You might want to look into that.

I want to comment that Director McMahon and her staff have been very helpful to me. However, I am amazed that this is all that we have to deal with. I have a briefcase that I brought with me, over there, and I have piles of paper here, and that's my accumulation from two years as Chair of the Board -- reports from Buck Consultants. This is all we have to deal with and react to, and it's somewhat different.

I also view things a little differently than perhaps Director McMahon. I happen to see what is proposed as a proposal that is somewhat like what Senator Moynihan talks about when he is talking about Social Security. I see it as deficit spending in a way, because it's postponing the payment of the liabilities and putting them into the next generation. I don't know where these workers are right now. They are certainly not being born in New Jersey. Someone has to pay eventually, and I think that we should really be doing work force study investigations, and we should look at future income potential of State employees, because we do have a shrinking pool of workers.

I am particularly concerned about whether or not anyone has looked into the constitutionality of what you contemplate doing because from my perspective as Chair of the Board, and as a trustee, these are trusted funds. So when you look at the assets of a system which has been designed to be protected from political interference and from pressure -- and we have a Board of Trustees that is designed to make certain that only the interests of the beneficiaries are served -- how can we turn around and then say that system's assets are State assets and they can be reallocated? I have real problems with that. I think people should move slowly, because if you don't make the time to do it right the first time, you certainly won't have enough time to fix it.

I do have some questions about how you plan on knowing what your trustees have to say. You have Boards of Trustees who serve you on a monthly basis. You cannot issue checks without our blessing, and yet we are cut off from the communication loop to the people creating the legislation. I would like to invite any of you here to our Board meeting, which is next Wednesday, at 10:00 in the morning. It might be--

SENATOR INVERSO: Could I equally extend an offer to you and your Board? We are going to be meeting at the State Government Committee level, and also at the Budget and Appropriations Committee level on this issue down the road. Certainly the invitation is open to you. Just as a sidebar, someone says this is the first time anyone from the Board of Trustees has ever made an appearance before a Committee like this, and it's refreshing and it's good. Perhaps you can go back to your meeting and indicate that this is an issue that the Board, rightly so, would have some interest in and any comments, questions or input the Board would care to provide to us as a Committee, we would be most willing to entertain.

MS. SAWYER: That I appreciate.

SENATOR INVERSO: It's got to be open. We learned a lesson from the past. It's got to be open.

MS. SAWYER: I do want to mention some of the figures. First of all, I'm not an actuary; I'm not a bookkeeper; I'm not even running for reelection. I am curious about whether or not the totals include contributions to Social

Security, contributions to health care benefits, and the liability? I am also interested in seeing someone look into why it is that our fiscal reorganization two years past, which was supposed to straighten things out, did not? Last year, when you did studies to ensure that we would have sufficient funds at the State level to allow for early retirement, you said the State would absorb the funds -- and when I say, "You," I mean government.

SENATOR INVERSO: Sure.

MS. SAWYER: Now it's proposed that PERS pay for that out of its assets. This is simply by recognizing the market surplus.

So I'll back up to my point of entry. I believe the assets of the fund are the property of the members and not the State, and I think you should look at that first. If you could overcome that problem, I really believe that you should take very slow steps -- short steps -- and involve the Boards. Thank you.

SENATOR INVERSO: I think you are absolutely right. Again, when you go back to your meeting, will you express our open invitation to the Board, through you or whomever, to come to subsequent meetings, and provide us the input that you feel is warranted.

MS. SAWYER: Well, if you would provide me with when you meet and what you are meeting on. This is a new experience for me. It's the first time I have been in this building, so--

SENATOR INVERSO: Our next meeting I am told, is the 27th at 2:00.

MS. SAWYER: The 27th at 2:00?

SENATOR INVERSO: Yes. I guess the question is whether we have-- I guess this is going to be an ongoing item on our Committee agenda, so that you would have an opportunity then to provide input on this question.

MS. SAWYER: Thank you.

SENATOR INVERSO: As you heard from earlier presentations, this is not going to be resolved overnight. I'm sure you are relieved to hear that.

MS. SAWYER: Well, I get the impression we are pushing toward June 30.

SENATOR INVERSO: Well, we need to have a budget in place, obviously, by July 1, and since this proposal has the impact of over $1 billion in next year's budget, we need to get a handle on it before the eleventh hour, and time has a way of slipping by. But we started the process very early on this issue because of the paramount importance that it has to you, to others who are represented here, and to the State as a whole.

MS. SAWYER: Might I suggest that it would be, perhaps, easier to have all Boards meet together with your Committee in one large room with the pension folks, so you could gather substantial information once we have had a chance to look at what it is that is being legislated?

SENATOR INVERSO: Well, okay, thank you.

Bill, you have a comment?

SENATOR SCHLUTER: Yes, you asked a question that maybe Ms. McMahon can answer: What in these figures that we have is the portion that is attributable to Social Security, if any attributable to health benefits, and whether any other-- Were there any other questions you had on the proposal?

MS. SAWYER: Well, whether or not the accrued liability -- the deferred one that was amortized over 40 years, two years ago -- was also included in the projected liability?

MS. McMAHON: (speaking from audience) Okay. Let me respond to first, Social Security: Social Security is separate and apart from this.

SENATOR SCHLUTER: Okay.

MS. McMAHON: And I know Norma has addressed a concern of, I guess, all of us who some day hope to collect from Social Security; and that is, will there be enough workers to support it -- to support the system? Social Security is enough different from this system that it's an apple, and we're an orange. Our system is actuarially funded. The Social Security is a pay-as-you-go system. When they talk about-- When Moynihan talks about concerns, he's right on, because money isn't being put away on a regular basis. So Social Security issue, or comparison, I don't think is a valid one. As I say, Social Security will still continue to be paid. It's separate and apart from this.

MS. SAWYER: Except that they take money out of your check every payday.

MS. McMAHON: Right, but it has really, nothing to do with the proposal.

SENATOR SCHLUTER: The health benefits?

MS. McMAHON: The health benefits: When I talked about stabilizing the rate -- you know, having this 30- to 40-year funding period so the normal cost doesn't fluctuate at all-- What we decided not to touch at all is the phase in of the medical and COLA. I pointed out that very few states do this. We just started, really, a couple of years ago. So, we had to, when we looked at that liability, we are providing these benefits to people who are almost ready to retire, and that benefit hasn't been funded. Certainly if we were to fund it, bring it up-to-date, we would have broken the bank. So there was a very methodical system put in place two years ago, where it was going to be phased in over a 25-year period. We are not touching that at all. The contributions for medical will continue just the way they were planned for.

Now, I might mention as an aside to this, because it is something else we are exploring. There was a game plan, so to speak, of how much money to put in to fund medical. There are some Federal regulations that will prevent us from funding at the level that we intended. We are going to start bumping into those limits. What we are exploring with the actuary --

and it will probably take a year for us to get it together -- is setting up a trust outside of the pension fund, so that the medical benefits can be funded in the way that we have planned. We're looking at a problem that is not here yet that is going to occur.

I guess what I am trying to say is that the medical benefits are being funded appropriately and the way that they were planned for, and that's not being changed.

SENATOR SCHLUTER: Excuse me. If I may, Mr. Chairman? Are the medical benefits in the, for example, in Exhibits 1 and 2?

MS. McMAHON: Yes.

SENATOR SCHLUTER: Does it include the-- The disbursement bar includes medical?

MS. McMAHON: Okay, the disbursement bar includes the monthly pension benefits, so the medical benefit isn't in the disbursement. What comes out of the fund is a premium payment to the health benefits fund, to fund the health benefits for those retirees who are entitled to free benefits. Not all retirees--

SENATOR INVERSO: But that's not part of the disbursement bar?

MS. McMAHON: No, it's not.

SENATOR INVERSO: The moneys that come out-- In essence, the health benefits are through an insured arrangement, and the fund is providing the dollars to pay the premiums for that insured arrangement?

MS. McMAHON: Right.

SENATOR INVERSO: I think that's what Senator Schluter is getting to. This disbursements there are only retirement disbursements, not disbursements for premiums to ensure the health benefits -- to provide the health benefits insurance.

MS. McMAHON: That's right. I'll have to double check that, but I believe that's what the--

SENATOR SCHLUTER: Are the contributions to the health benefits in the contribution bar -- the revenue bar?

MS. McMAHON: The revenues coming in for the health benefits?

SENATOR SCHLUTER: Yes.

SENATOR INVERSO: On the employer's side.

MS. McMAHON: On the employer's side. You know, I'll have to check that.

SENATOR SCHLUTER: Okay. I don't think they could be one and not the other.

MS. McMAHON: Right.

SENATOR INVERSO: Exactly.

MS. McMAHON: They're either both in or both out.

SENATOR INVERSO: Right.

MS. SAWYER: I have a question about the income to the fund. You have it at an all time high, which is quite believable. What I am curious about is the Division of Investments, which is separate from the Division of Pensions. Their expenses are funded from the income of the fund. Is that correct?

MS. McMAHON: Right. Both the--

MS. SAWYER: Now, is it before or after expenses that you have this high percentage rate?

MS. McMAHON: Okay. I believe it is after expenses. The expenses to the fund for administrative costs -- and maybe there will be another time when I can go on about that, how our expenses are so tiny compared to every other pension system -- and if Roland was here he would back me up. Basically the pension system and the Division of Pensions is run at administrative costs that are very, very modest.

SENATOR INVERSO: Okay. Yes, Senator?

SENATOR SCHLUTER: Before the School Board people depart, could I--

SENATOR INVERSO: You caught them. They are trying to get out very inconspicuously, Bill, and you got them.

SENATOR SCHLUTER: They only work half a day. But I just wanted to make it clear to anybody here that there is an assumption out there with the school districts, and the school boards, and the general public, that the $341 million is going to go back into the school foundation aid as in the Governor's budget. But we have got to, as Senator DiFrancesco and Assemblyman Haytaian have said in their letter this morning-- We have got to go through our process here, and we have got to authorize it legislatively, and authorize it through the Appropriations Act. So that is not an automatic, even though it very well might happen. I know that a lot of the public is very, very upset about that, delay in school board elections, and all of these things, but I think it is a lot better that we are doing, as Senator Inverso has said-- It's a lot better that we are conducting business this way, where we are bringing in people, and everything is on top of the table, than what has been done in the past, where we haven't known what is going on.

MS. McMAHON: I agree with you 100 percent, and I hope that I can continue to be helpful in bringing forth whatever information it is that is necessary for each one of you to have a comfort level so this can go forward.

SENATOR INVERSO: Well, this is not an easy subject. I mean, the concept, perhaps, is easy, maybe even not that. But when you get into the forest on this thing, and you get into looking up the trees, you are not sure where you are, because any one of these can be a subject unto itself for great debate -- any one of these variables. But the key thing is that everyone wants to make sure that it is actuarially sound, fiscally sound, and that the integrity of the fund is maintained in order to ensure retirement benefits are there when they need to be. We all have the same stake in this to do it, no matter which side you are on.

MS. McMAHON: Well, Norma and I will be collecting benefits from the system someday, so we certainly have an equal stake in it.

SENATOR INVERSO: I would like to thank you all for coming. It's about 4:30, or so. We appreciate the input. Thank you. The meeting is adjourned.

(HEARING CONCLUDED)

APPENDIX

STATE OF NEW JERSEY

Pension Fund Revaluation Proposal

Prepared by: Division of Pensions
Date: January 1992

IX

PENSION FUND REVALUATION PROPOSAL

Table of Contents

BUCK
CONSULTANTS
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Secaucus, New Jersey 07096-1533

JAN 24 1992

January 23, 1992

Mr. Samuel Crane
Treasurer
State of New Jersey
125 West State Street
CN 002
Trenton, New Jersey 08625-0295

Dear Treasurer Crane:

We are writing to comment briefly on the proposed changes in the pension funding policy under various New Jersey State Retirement Systems.

Our comments reflect Buck Consultants' considerable experience in the public sector, having begun in 1916 as actuaries and consultants to public sector clients. We presently count over 25 state systems from 22 states among our clients. Buck has served the State of New Jersey since the Systems were originally established in the 1920's. My personal experience includes 20 years of dealing with public sector clients (primarily state systems). I presently work with the States of Connecticut, New Hampshire and New Jersey. With regard to New Jersey, I have served as the actuary for the Public Employees' Retirement System and the Teachers' Pension and Annuity Fund since 1985.

The proposed changes in pension funding policy reflect the recommendations of our firm, supported in general or specifically by at least two other nationally recognized actuarial firms who have worked with the State. These recommendations also reflect in part the recommendations of various panels and commissions who have studied the New Jersey Systems.

Detailed technical analyses undertaken by Buck and other actuarial firms indicate that the proposals are prudent, actuarially sound and can be expected to generate reasonable costs to sponsoring employers <u>and</u> taxpayers in the near and long term. The proposals are technically defensible, reflect present common practice and will continue to maintain and improve the benefit security of current and future retirees.

Within the guidelines and constraints of the profession, we strive to help our clients deal with the regulatory and financial complexities associated with the sponsorship of retirement programs. We believe that the proposed changes in funding policy are responsible and appropriately responsive to the present and anticipated economic environment. The recommended policy, as with <u>all</u> such policies, is flexible and subject to fine tuning based on the developing experience of each New Jersey retirement system. This flexibility is key to the continued successful funding of the New Jersey Systems.

Buck Consultants, Inc.
201 902-2300   Fax 201 902-2450

We firmly support the recommended policy for the reasons discussed above.

Respectfully submitted,

Robert D. Baus

Robert D. Baus
Consulting Actuary

RDB:KT
DOC:L08809VT.WP5

BUCK CONSULTANTS

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January 24, 1992

Mr. Samuel Crane
Treasurer
State of New Jersey
125 West State Street
CN 002
Trenton, NJ 08625-0295

Dear Treasurer Crane:

Approximately a year ago the State of New Jersey engaged our firm to perform actuarial services for the State Police and Police & Fire Systems. We have been asked to comment upon the refinancing program which is being proposed commencing with fiscal year 1992.

By way of introduction, Milliman & Robertson has extensive experience in providing actuarial services to public sector clients. We have performed actuarial studies or valuations for over half the State Systems. We have served as public plan consultants since the 1940's. Prior to our work with the State of New Jersey, we have consulted with thirteen separate State-wide Systems, having an average of 170,000 plan participants.

With respect to my experience, in addition to the State of New Jersey Systems, I currently serve as a Consultant to the Pennsylvania and Ohio Retirement Study Commissions, and the Illinois Municipal Retirement Fund. Prior to joining M&R, I served the Pennsylvania State Employees' Retirement System, Alabama Teachers Retirement System, Kentucky Teachers Retirement System, Ohio School Employees Retirement System, and the Ohio Teachers Retirement System. I am a frequent speaker on public system employee benefit issues, having addressed meetings sponsored by the National Council on Teacher Retirement, the National Conference of Public Employee Retirement Systems, International Foundation of Employee Benefit Plans, American Management Association, and the Financial Executives Institute.

During 1989 two separate actuarial studies were performed for the State, in order to analyze the reasonableness of the assumptions and methodologies used to develop contributions to the pension systems. These studies recommended changes in the economic assumptions, asset valuation method, and actuarial funding method. It is our opinion that the recommended assumptions are reasonable estimates of long-term experience and that these assumptions, along with the revised asset and funding methodologies, are appropriate in view of current actuarial practice in both the public and private sectors. In addition to providing stability, the revised methodology will result in improved intergenerational equity among taxpayers, since the system's costs would be based upon assumptions that are more realistic than before, as viewed in light of both the current economic climate and reasonable expectations regarding future experience.

We would be happy to answer any questions you may have or to explain in greater detail the basis for our conclusions.

Respectfully submitted,

William A. Reimert

WAR:wat

PENSION FUND REVALUATION PROPOSAL

Summary

PURPOSE

The adoption of the Pension Fund Revaluation Proposal will allow the State of New Jersey to reflect more realistically the financial conditions of the systems while continuing to assure an adequate accumulation of reserves in the retirement systems at the least cost to current and future taxpayers.

MAJOR COMPONENTS OF PROPOSAL

1. Use of **market-related value** of assets as opposed to book value.

2. Change **economic assumptions** consistent with change to market-related value:
   - — adjust assumed rate of return on investments from **7%** (based on book value) **to 8 3/4%** (based on market-related value)
   - — adjust salary increase scale assumption from **5% to 6 1/4 %**
   - — adjust COLA assumption from **2 1/2% to 3%**

3. Change the **actuarial funding method** from the present one, which creates a fluctuating contribution pattern from year to year, to the proposed method, which will generate an employer contribution rate that will remain stable each year.

PENSION PLANS AFFECTED

Public Employees' Retirement System	(PERS)
Teachers' Pension and Annuity Fund	(TPAF)
Police and Firemen's Retirement System	(PFRS)
State Police Retirement System	(SPRS)

PENSION FUND REVALUATION PROPOSAL

Summary

EFFECT OF PROPOSED CHANGES IN FUNDING POLICY ON EMPLOYER PENSION CONTRIBUTIONS FOR FISCAL YEAR '93

(All Amounts in Millions)

PERS (STATE)	
Contribution Under Current Method	$ 261.4
Proposed Method	$ 169.3
Savings Over Current Method	**$ 92.1**
PERS (LOCAL)	
Contribution Under Current Method	$ 296.6
Proposed Method	$ 133.4
Savings Over Current Method	**$ 163.2**
TPAF (STATE)	
Contribution Under Current Method	$ 726.3
Proposed Method	$ 377.4
Savings Over Current Method	**$ 348.9***
PFRS (STATE)	
Contribution Under Current Method	$ 57.3
Proposed Method	$ 29.0
Savings Over Current Method	**$ 28.3**
PFRS (LOCAL)	
Contribution Under Current Method	$ 217.6
Proposed Method	$ 188.6
Savings Over Current Method	**$ 29.0**
SPRS (STATE)	
Contribution Under Current Method	$ 18.0
Proposed Method	$ 0.0
Savings Over Current Method	**$ 18.0**
State Savings	$ 145.7
Additional School Aid	$ 341.6
Local Savings	$ 192.2
TOTAL	**$ 679.5**

**includes additional school aid of $341.6*

PENSION FUND REVALUATION PROPOSAL

Summary

HIGHLIGHTS

BACKGROUND

- Changes to funding policy have been recommended by various study groups, commissions and auditors over the last eight years:

  —1984 New Jersey State Pension Study Commission
  —1987 Ernst and Young Annual Audit Reports 1987-1990
  —1989 State of New Jersey, Pension Funding Policy Study
  —1991 Governor's Management Review Commission
  —1991 Quality Education Commission

- The proposed changes are actuarially sound and were endorsed by the actuaries for the State pension systems — Buck Consultants and Milliman and Robertson, Inc.

- Market value or market-related value is used by most of the states to value pension plan assets. Private plans **are required** to use market-related value under federal law.

- Benefits currently provided by the systems are not affected. Current and future retirement benefits will remain safe and secure under the new funding method.

- Under the current method, annual fund revenues (employee contributions, employer contributions and investment earnings) are **2 1/2 to 3 times greater** than fund disbursements. Under the proposed method, annual fund revenues will be **2 to 2 1/4 times greater** than fund disbursements.

MARKET-RELATED VALUE

- Use of market-related value (5-year average) rather than current market value is recommended to smooth out market volatility.

- Use of market-related value will **significantly increase** the asset value of the pension systems recognized for funding.

HIGHLIGHTS *(continued)*

ECONOMIC ASSUMPTIONS

- The 8.75% assumption for rate of return on investments is supported by the use of market-related value of assets. The increase in this assumption reduces the actuarial value of the pension liabilities which must be funded through future employer contributions.
- The average annual market rate of return for all pension systems was 15.5% over the last 10-year period.
- Consistent with the increase in the rate of return, more conservative economic assumptions are being adopted relative to salary increase scale and COLA adjustments.

ACTUARIAL METHOD

- New method recognizes the long-term nature of public pension plans and funds all benefits over full working life of members.
- The new method is technically sound and in common use among state-sponsored systems.

OUTCOMES

- Annual employer contributions to the pension systems will be **significantly reduced**. Total fiscal year '93 reduction in State and local employer contributions amounts to $680 million.
- Adoption of the new funding policy for fiscal year '92 will result in an additional savings to the State of $572 million.
- Recurring savings each year to State and local employers as employer contributions will be reduced in each subsequent year relative to what they would have been under the current method.
- Significantly more direct aid to school districts will be available because of the reduced employer contributions to TPAF.
- Employees will be assured of stable funding for their future benefits.
- Each generation of taxpayers will pay their fair share of pension costs. Current taxpayers will not be overburdened.

PENSION FUND REVALUATION PROPOSAL

Background

HISTORY

Before considering the Pension Fund Revaluation Proposal, it is important to reflect upon the history of the State public retirement systems. It is precisely this history which makes the Pension Fund Revaluation Proposal possible and appropriate at this time. New Jersey has been a leader among the 50 states in the establishment, maintenance and financing of retirement systems for public employees. The two major State retirement systems, the Public Employees' Retirement System (PERS) and the Teachers' Pension and Annuity Fund (TPAF) were initially established in the 1920s. The systems have been actuarially funded since their inception. The third major system, the Police and Firemen's Retirement System (PFRS), was established in 1944 after local systems authorized by law in 1920 generally failed to provide adequate and secure retirement benefits for local police and firemen. Like its two larger predecessors, PFRS was also actuarially funded from the beginning. The State Police Retirement System (SPRS) was established in 1965 on an actuarially funded basis.

The State retirement systems have grown dramatically over time. In the aggregate, they are currently the ninth largest retirement systems in the country among all public and private systems in terms of assets. In 1991, the total number of active members was 413,775, and the number of retirees 112,892. The total benefit payroll was $1.4 billion. The employer and employee contributions for the year were $1.3 billion and $614 million, respectively.

FINANCIAL CONDITION

Throughout most of their history, the State retirement systems were funded upon very conservative actuarial assumptions. The assets of the systems were valued at book value, generally what it cost to buy a security. The assumed rate of return on investments was relatively low, 3 % to 4 %. These assumptions were appropriate for that time period. The systems were all relatively young and the amount of assets relatively small compared to current assets. The authorized investments were limited and the assets were primarily fixed income securities, like bonds. This situation prevailed until the recent past.

In the last 10 to 15 years, the financial conditions of the State retirement systems began to change dramatically. The investment opportunities for State pension funds were expanded greatly. The percentage of the funds which could be invested in stocks was gradually increased to the current authorized level of 60%. Approximately half of the assets are currently invested in stocks. The rate of return on the assets of the pension funds rose. The assets of the State retirement systems experienced spectacular growth from 1982 through 1991 as graphically illustrated in Exhibit 3. The assets grew from $6 billion to $29 billion at market value for an average annual rate of growth of 19%. This growth includes employer and employee contributions as well as return on investments. The average annual market rate of return on investments alone over the same time period was 15.5%.

This growth in assets and return on investments far outpaced the growth in benefit payments from the retirement systems. Exhibits 1 and 2 illustrate the total revenues and disbursements of the retirement systems over the last 10 years. The return on investments exceeded the disbursements in every year. The benefit payroll was more than covered by the return on investments, with a significant amount left over to add to the asset pool. The employer and employee contributions added substantially more to the pension funds. Because a larger percentage of the assets was being invested in stocks, a substantial amount of unrealized gain (growth in value of securities) developed. This gain in value of the pension assets could not be used for pension funding purposes because they had to be valued at book. This "book value" requirement also limited the future rate of return on assets that could be assumed for pension funding purposes.

In determining the annual employer contributions in recent years, the actuary had to ignore the substantial growth in market value of the assets of the retirement systems over their book value and the potential for even greater growth in market value in the future. The result was that the employer contributions were substantially higher than they would have been if the current and potential for future growth in the market value of pension assets were recognized. Thus, money has poured into the State retirement systems in recent years. The revenue of the systems has been from 2 1/2 to 3 times the amount of benefits paid in recent years.

REVIEW OF PENSION FUNDING POLICY

This situation clearly called for a review of the pension funding policy. The past administration recognized that a review of the State pension systems was necessary and established the New Jersey State Pension Study Commission at the beginning of the administration. Among its numerous recommendations, the Commission recommended that the unfunded accrued liability of the State retirement systems be funded as a percentage of payroll rather than on a flat dollar basis. In support of this recommendation, the Commission's report stated that:

> *Percentage of payroll funding of prior service liabilities in the government sector, especially with respect to larger government systems, can be justified, in part, on the basis that these government entities are more permanent in nature than many private industry companies and, therefore, the need may not be as great for these government retirement systems to fund prior service liabilities at the higher flat dollar amortization level.*

The independent accounting firm which has audited the financial statements of the State retirement systems since 1986, Ernst and Young, has recommended a review of the actuarial assumptions for the state retirement systems in each of its annual audit reports from 1987 through 1990. Its recommendation was as follows:

> *Actuarial Assumptions - State law has put considerable restraint on the actuaries' exercise of professional judgment in some key areas of valuation. For example, the actuaries are restricted as to assumption revision and interest choice. The actuaries attempted to offset these restrictions by providing detailed explanations of what they were doing and why. They provided supplemental information from time to time in looking at the funding process from other perspectives. The State may want to review its restrictive requirements or at least encourage actuaries to provide additional supplemental information which, in their judgment, would be useful.*

Governor Florio's Management Review Commission conducted an extensive operational review of the State fringe benefit programs. In its report of the review, the Commission recommended that pension assets be valued at market rather than book. In support of the recommendation, the report stated:

> *Investments are valued at book" for purposes of determining the limitations on common stock holdings and other purposes. This is not in keeping with modern investment techniques. A share of AT&T held today is worth the same whether it was purchased in 1969 or 1989. Use of book value distorts the purposes of the limitations since selective sales of holdings with embedded gains or losses allows vastly differing holdings to appear to be at the same level of stock exposure. Also, if the plans are at the limits, book value accounting may force managers to base sales decisions on capital gain status rather than investment merits.*
>
> *Use of book value in reporting returns is also flawed. This approach only considers dividend and oupon yields. When purchasing stocks, more overall return is expected from appreciation than dividends. Book returns are not particularly meaningful.*

PENSION FUND REVALUATION PROPOSAL

One of the major areas considered by the Quality Education Commission, which was established by the Governor to review the new State school aid policy, was funding of retirement benefits for teachers. While the Commission's final report has not yet been issued, it has been reported that it is recommending that the valuation method for State pension fund assets be changed from book to a market-related value.

The Division of Pensions was well aware of the need for a review of the funding policy for the State retirement systems. In the fall of 1989, it commissioned a major study of the funding of PERS by two actuarial firms. One of the firms was Buck Consultants, the consulting actuary to PERS and TPAF for decades. The other firm, Actuarial Sciences Associates, Inc. (ASA), was formerly the in-house actuarial staff for AT&T before it was established as a separate entity. The methodology for the study was rather unique. Each actuarial firm was asked to do a comprehensive study of the funding of PERS independently and to prepare a report on their findings and recommendations. After the reports were submitted, the firms were brought together to debate and defend their respective studies and recommendations.

Each actuarial firm recommended the following:

1. That the asset valuation method for PERS be changed to a market-related method using some averaging technique to smooth out market fluctuations;

2. That the interest rate assumption be significantly increased based upon the historic, average long-term market rates of return for the asset mix of the system; and

3. That the actuarial funding method be changed to a method which funds the benefits over a significantly longer period of time than the current method.

In support of its recommendations, ASA stated:

> *ASA recommends the adoption of its proposed methodology since such methodology satisfies the criteria for benefit security and intergenerational taxpayer equity and, therefore, protects the interest of the major constituencies. These goals are achieved using a rational and systematic actuarial method which will produce a reasonable level of contributions and result in responsible funding.*

In support of its recommendations, Buck offered the following:

> *In general we believe and have recommended that the State of New Jersey move towards realistic, explicit funding assumptions and methods which better portray the funding requirement and funded status of the systems. ...*
>
> *We have reviewed the current investment criteria and its evolution and conclude that it is generally more restrictive than the investment guidelines required by the majority of private plans. ... We believe the State could minimize future contributions and reduce the volatility of the funding ratio by modifying these restrictions.*

The new pension funding policy being proposed is essentially one of the methods recommended by Buck Consultants in the 1989 study.

MAJOR COMPONENTS

The three major components of the Pension Fund Revaluation Proposal are as follows:

1. Change the method for valuing the assets of the retirement systems from book value to a market-related value;
2. Adjust the assumed rate of return on future investments and other economic assumptions, i.e., rate of salary increase and rate of cost-of-living increase, consistent with the change in the asset valuation method; and
3. Change the actuarial funding method to recognize the long-term nature of the retirement systems and fund benefits over the full working life of the members.

The first two components are related to the asset valuation method for the retirement systems. The assets of the systems are currently valued at book value. It is proposed that the valuation method for the assets be changed from book value to a market-related value. This change makes possible the second proposed change that the assumed rate of return on investments of pension assets be increased from 7 %to 8 3/4%. As part of this change, it is also recommended that the other economic assumptions used in pension funding, i.e., rates of salary increase and the rate for cost-of-living increases, be increased accordingly to correspond to the increase in the assumed rate of return on investments. The third change is independent of the first two and concerns the actuarial funding method used to determine employer contributions to the retirement systems. It is sufficient to indicate at this point that the third component of the proposal is a recommendation that the actuarial funding method be changed to a new method which provides a stable, unfluctuating rate for employer contributions. All of the components will be discussed in greater detail below.

The impact of each change is as follows:

1. **Change in Asset Valuation Method: From Book Value to Market-Related Value**

The Current Policy — The assets of a fund are accumulated to pay pension benefits as they fall due. The difference between the amount of total assets existing in a pension fund and the present value of the funds liabilities represents the value of future benefits that **must be funded by future employer and employee contributions**. Currently, the pension system assets are valued at cost, or book value, when the actuaries calculate the annual employer contributions due the funds. Gains (or losses) due to market appreciation (or depreciation) of assets are not recognized until an asset is sold. As illustrated in Table 1, the FY'91 book value of pension system assets amounted to $23.9 billion, almost $5.2 billion **less** than market value.

Table 1
FY'91 ASSET VALUES

	BOOK	MARKET	DIFFERENCE
PERS	$ 8,518,984,196	$ 10,399,564,224	$ 1,880,580,028
TPAF	10,127,721,712	12,297,267,313	2,169,545,601
PFRS	4,723,325,845	5,734,523,207	1,011,197,362
SPRS	546,127,828	657,166,914	111,039,086
TOTAL	$23,916,159,581	$ 29,088,521,658	$ 5,172,362,077

The Proposed Policy — By changing the asset valuation method from book value to a market-related value, the entire actuarial valuation process will recognize that a larger asset base exists to cover the liabilities of the pension system. Future employer contributions will be reduced because the pension systems' uncovered liabilities will be reduced significantly with the recognition of the market value of assets.

Recommended for adoption is a market-related asset valuation method known as the "5-year write-up method". Such a method would serve to dampen the affect of market "swings" in the value of assets by averaging any unexpected appreciation (or depreciation) in over a five year period.

Items Supporting Policy Change

- Future employer contributions will be reduced.
- The market value of assets realistically portrays the true long term value of the system's assets.
- By using a market based asset valuation as opposed to book value, a retirement system can take advantage of asset appreciation without requiring that the assets be sold.
- Market value of pension system assets has been historically higher than book value as illustrated in Exhibit 3.
- As a result of the Employee Retirement Income Security Act (ERISA), private plan sponsors since 1976 have been **required** to use a market-related asset valuation method.
- The number of states using market-related value is over 60%.

2. Increasing the Economic Assumptions

The Current Policy — As part of the process of putting together the annual pension system valuation, the actuary must make a number of actuarial assumptions. Some of the economic related assumptions the actuary must make are: 1) The rate of return on system assets, 2) the progression of compensation levels and 3) the impact of inflation on retirement benefits. Table 2 lists the current and proposed assumptions for PERS and TPAF.

Table 2
CURRENT AND PROPOSED ECONOMIC ASSUMPTIONS

Economic Assumption	Current	Proposed
Valuation Interest Rate		
PERS	7%	8.75%
TPAF	7%	8.75%
Salary Increase Scale		
PERS	5.0 %	6.25%
TPAF	4.75%	6.25%
COLA		
PERS	2.50%	3%
TPAF	2.25%	3%

The most significant of these assumptions is the rate of return on system assets, which is currently set at 7%. This rate determines the level of future benefits that will be funded by earnings on pension system assets as opposed to employer contributions. Because book value does not recognize unrealized market appreciation on system assets as earnings, a low rate of return must be assumed under the current funding procedures.

The use of a low valuation interest rate forces the actuary to assume artificially constrained salary scale and cost of living adjustment rates. These rates are necessary for the actuary to project the liabilities of the fund, since pensions are based on final salaries and retirement benefits are periodically augmented due to inflation.

The Proposed Policy — The new funding policy will increase the economic assumptions to the realistic levels indicated in Table 2. By converting the asset valuation method from book value to a market-related value, unrealized appreciation in the pension assets will now be recognized as earnings on the assets. Under the current method, only interest, dividends, and gains on assets actually sold are recognized earnings, which supports the lower valuation interest rate assumption. The recognition of higher earnings on assets will serve to reduce future employer costs because more of the liabilities to pay benefits will be funded through the increased value of assets and anticipated earnings.

The use of a higher valuation interest rate assumption will have a significant impact on the calculation of the pension systems' Present Value of Projected Benefits (the liabilities of the fund). To arrive at this figure, the actuary discounts to present value the total sum of all the retirement benefits to be paid in the future from the system using the valuation interest rate. By using the higher rate, the present value of projected benefits would be a significantly lower amount, which would ultimately serve to reduce the employer's normal cost.

Item Supporting Policy Change

- Historical total market rates of return on pension system assets as provided by the Division of Investment supports a higher interest rate assumption. Average annual market rate of return over the last 10 years equals 15.5%.

3. Adoption of a New Actuarial Funding Method

The Current Policy — Annually, the actuaries of each pension fund prepare a valuation report which contains the total employer contribution required to adequately fund the system. The technique used to arrive at this amount is called an actuarial funding method (of which there are several types). The method currently used is known as the **entry age normal cost method with aggregate level normal cost and frozen initial liability.** In both the current and proposed funding methods, the annual employer contribution is made up of two parts:

a) the normal cost contribution, and
b) the unfunded accrued liability payment.

Under the current method, the actuary develops a normal cost rate that, when applied to the salaries of the funds' active members, determines the normal cost contribution. When the fund experiences actuarial gains and losses, the effect is to impact the normal cost rate calculation for the year. Actuarial gains and losses occur when the set of actuarial assumptions adopted for a pension system do not mirror exactly the real experience during a valuation year. The result is a fluctuating normal cost contribution pattern from year to year. Normal costs are unpredictable, inhibiting the budgeting process.

The Proposed Policy — The new funding policy calls for the adoption of a new actuarial funding method called the **entry age method with open end supplemental liability**.

Under the proposed method, the actuaries will set a normal cost contribution rate that will remain constant from year to year. Any actuarial gains or losses experienced by the funds will be reflected in the unfunded accrued liability. This method will require the actuaries of the pension system to calculate a statistically average new entrant normal cost contribution rate for the system. This is accomplished by analyzing each participant in the pension system, and, based on the age each member entered the system and his/her starting salary, and relying on a set of adopted actuarial assumptions, calculating the total benefit that will ultimately be paid to each participant. By doing so, the actuary can develop a normal cost rate that will provide for a systematic and consistent manner to fund each participant's pension over his/her working career. An overall system normal rate is developed by statistically averaging each such individual rate.

Payment of the unfunded accrued liability will generally be a constant percentage from year to year. This will be accomplished by keeping the period over which the unfunded accrued liability will be paid flexible. In the year the new funding policy is initially adopted, this period will be set at 30 years. Each year thereafter, to the extent the funds' experience differs from expected, any actuarial gain or loss will be absorbed in the unfunded accrued liability. By adjusting the period over which this liability will be paid to one greater or smaller than the original 30 years, the accrued liability portion of the annual employer contribution to the fund can be kept at a constant rate from year to year. To be conservative, the new policy has a **maximum** funding period of 40 years. Should actuarial losses increase the funding period beyond 40 years, the unfunded accrued liability contribution rate will be increased to retain the 40 year maximum.

Items Supporting Policy Change

- Annual employer contributions will be reduced as compared to the current method. A major consideration between the current and proposed actuarial funding methods is the treatment of actuarial gains and losses. In operation, the actual experience of a pension system will always differ from that expected by the actuarial assumptions. Under the current method, the additional costs associated with this difference are added to future service contributions (the normal cost). These costs are funded over the expected future careers of system members, which are usually as short as 10 to 12 years. The funding of gains and losses are accelerated over a much shorter period than necessary in the public sector, resulting in a fluctuating contribution pattern, inhibiting the budgeting process. While the current method is appropriate for a private plan because of the shorter corporate planning period, in the public sector, it can tend to overburden current generations of taxpayers. Under the proposed method, costs arising due to actuarial losses will be funded over a period extending up to 40 years. This will allow gains and losses to be absorbed gradually and to offset one another to a greater degree, thus stabilizing the contribution rate.

- The new funding method adopts the philosophy that State retirement systems should take a longer view of funding pension liabilities because it is reasonable to assume that a state will exist indefinitely. Taking such a view allows a state to more equitably share the cost of pensions between different generations of taxpayers.

- Current funding method has generated fund revenues that are 2-1/2 to 3 times greater than disbursements, as illustrated in Exhibits 1 and 2. Present contribution levels plus investment income significantly exceed disbursements. This generally means current taxpayers are overburdened relative to the systems' costs.

- The entry age-open end supplemental liability method is technically sound and is in common use among state-sponsored systems.

CONCLUSION

With the adoption of the recommended changes, the State, and all the local employers participating in the State's retirement systems will take a major step toward a more realistic approach to funding pensions.

By recognizing the long-term nature of the State's plans, the costs associated with pension funding can be spread over longer periods, thus creating "intergenerational" equity. The current generation of taxpayers will not be overburdened.

Moving from the old policy to the new policy will also represent a major change in the budgeting process. The adoption of the entry age open end supplemental liability funding method will introduce an annual employer contribution rate that will remain a constant level of pay from year to year, which will stabilize the budgeting process.

The use of a market-related value of assets will allow the pension funds to recognize the unrealized appreciation on pension assets, over 45% of which are invested in stocks — investments that are made primarily for their market appreciation potential. The recognition of unrealized appreciation or depreciation rationalizes the use of higher economic assumptions, specifically the 8.75% expected rate of return on system assets, which will serve to reduce current and future employer pension contributions.

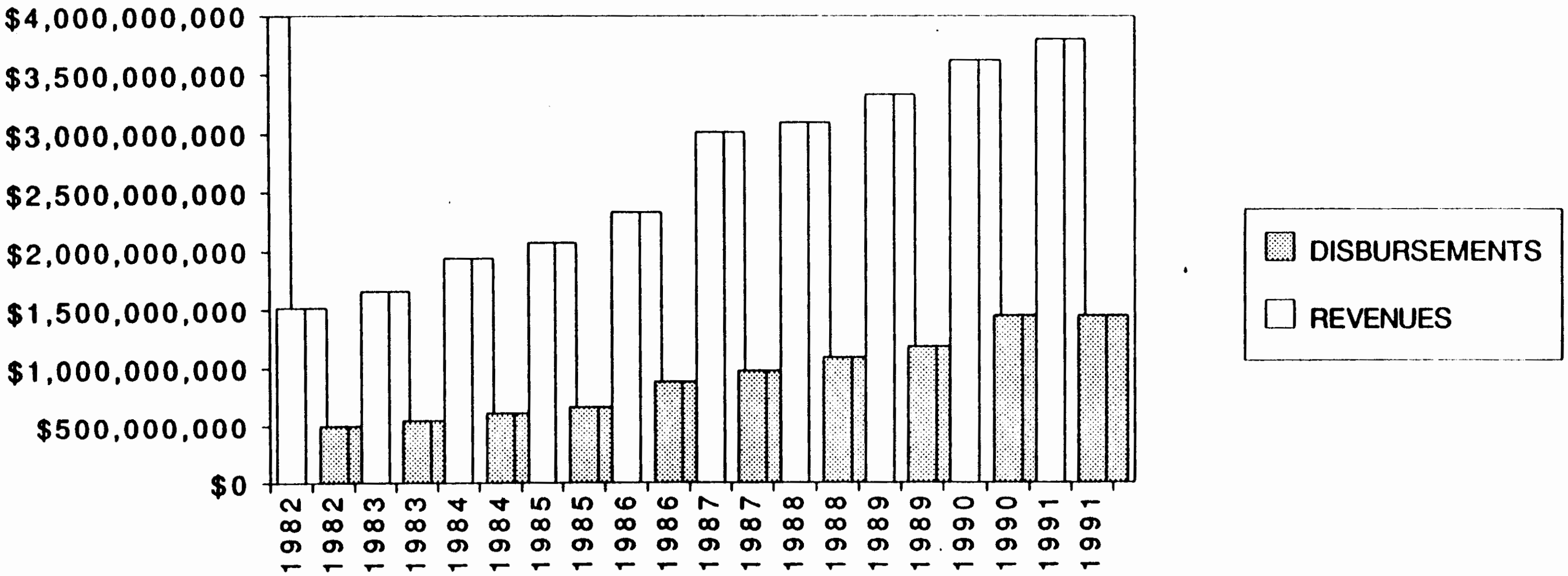
PENSION FUND REVALUATION PROPOSAL

The primary objective of any actuarially funded pension system is to make sure that sufficient funds are on hand to pay retirement benefits as they fall due. The proposed recommendations are made with this objective in mind. With the adoption of this proposal, a positive step will be made toward a more realistic and equitable method of funding for the present and future pensions of all the members of New Jersey's State retirement systems.

Exhibits

Exhibit #	Description
1	**Comparison of Total Revenues v. Total Disbursements: All Pension Systems - 10-Year Period** Illustration depicting the cash flows of the pension systems under the current funding method which has generated annual fund revenues that are 2 1/2 to 3 times greater than annual fund disbursements.
2	**Comparison of Total Revenues v. Total Disbursements: All Pension Systems - 10-Year Period (Breakdown by Employer and Employee Contributions and Investment Earnings)** Illustration depicting the cash flows of the pension systems under the current funding method with annual revenues broken down into employer contributions, employee contributions and investment earnings. The graph demonstrates not only that the present funding method has generated annual fund revenues that are 2 1/2 to 3 times greater than annual fund disbursements but that annual investment earnings on pension assets alone were more than annual fund disbursements for the last 10 years.
3	**Comparison of Market Value of Assets v. Book Value of Assets: All Systems** Illustration depicting the significantly higher value of assets valued at market rather than book as of 6/30/91.
4	**Fact Sheet** Fiscal Year '91 data relating to each of the affected pension systems including active and retired membership, system cash flows and asset values at market and book values.

EXHIBIT 1
NEW JERSEY PENSION SYSTEMS
COMPARISON OF TOTAL REVENUES
VS TOTAL DISBURSEMENTS
10 YEAR PERIOD



24x

EXHIBIT 2
NEW JERSEY PENSION SYSTEMS
COMPARISON OF REVENUES VS DISBURSEMENTS
10 YEAR PERIOD

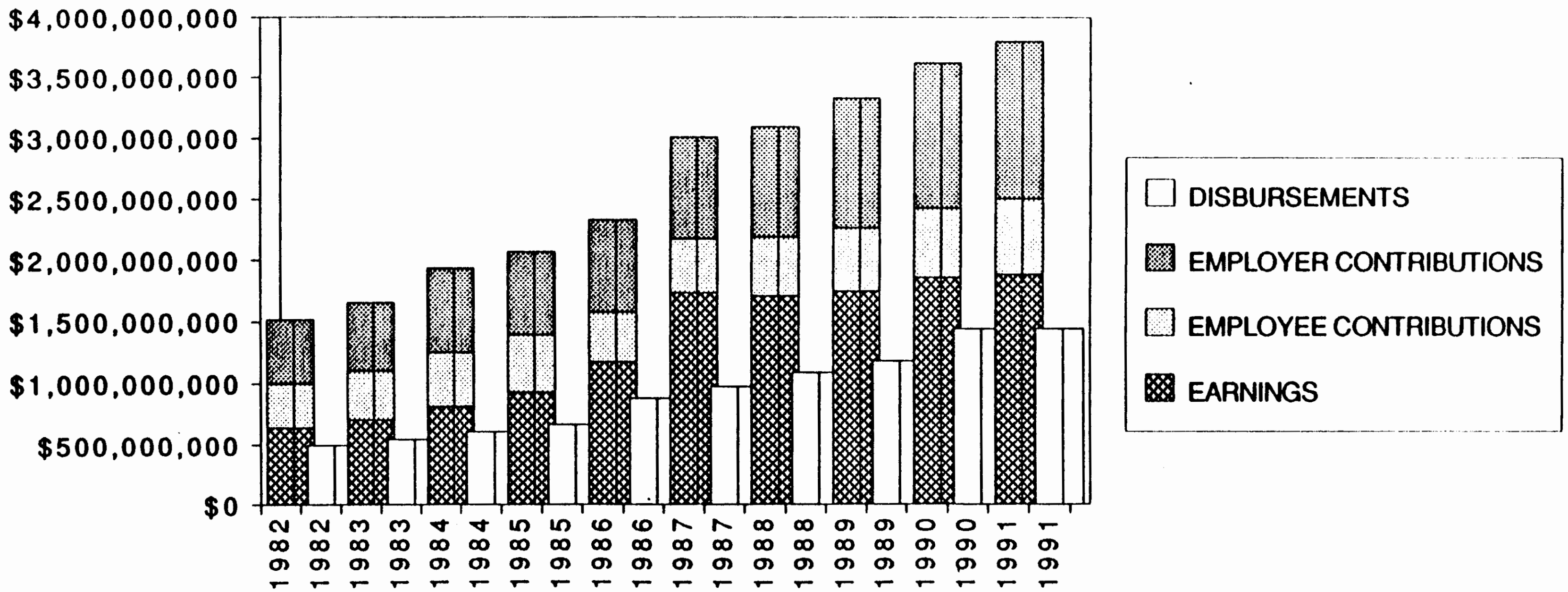
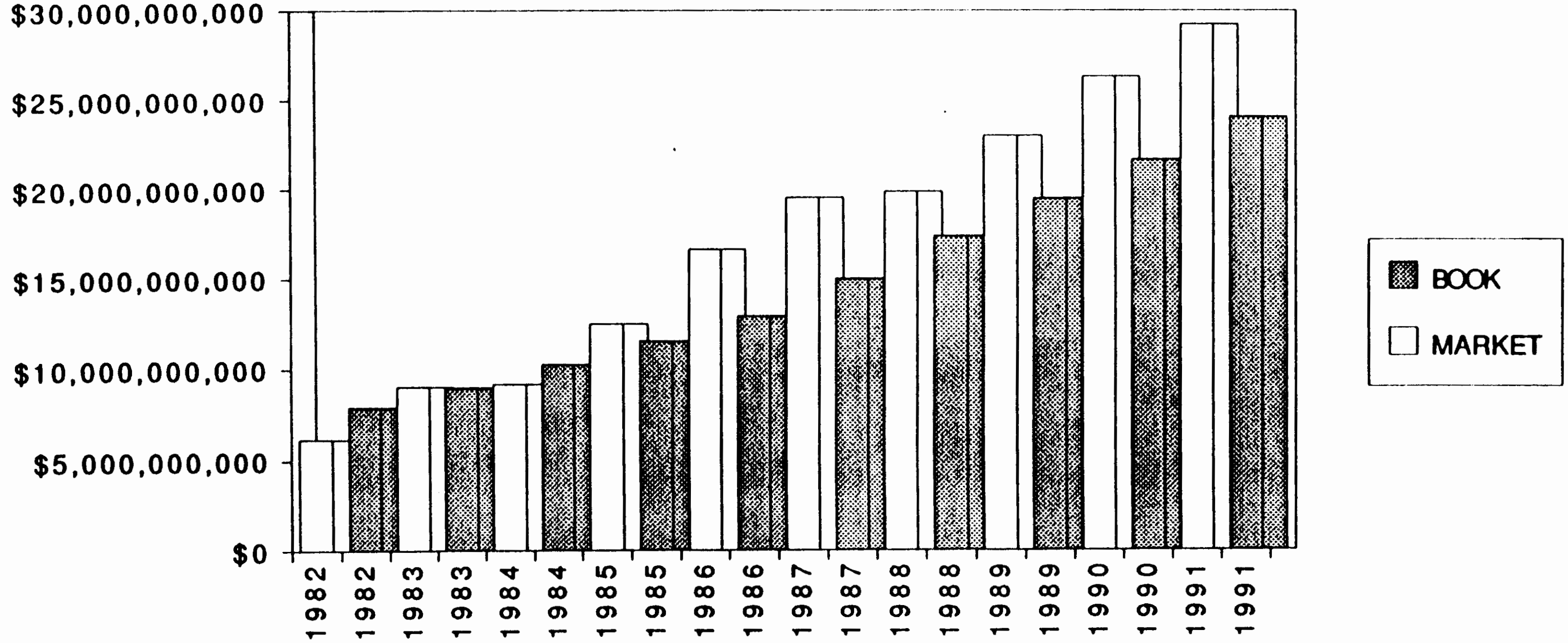


EXHIBIT 3
NEW JERSEY PENSION SYSTEMS
COMPARISON OF MARKET VS BOOK
10 YEAR PERIOD



PENSION FUND REVALUATION PROPOSAL

Exhibit 4

Fact Sheet — Fiscal Year '91

MEMBERSHIP			
	ACTIVE	RETIRED	COMBINED
PERS - State	76,491	21,550	98,041
PERS - Local	185,878	43,752	229,630
TPAF	113,964	34,181	148,145
PFRS	34,844	12,237	47,081
SPRS	2,598	1,172	3,770
TOTALS	**413,775**	**112,892**	**526,667**

BENEFITS PAID	
PERS	$547,025,144
TPAF	$561,718,248
PFRS	$251,446,112
SPRS	$27,012,123
TOTALS	**$1,387,201,627**

CONTRIBUTIONS			
	EMPLOYER	EMPLOYEE	COMBINED
PERS - State	$199,219,714	$124,907,703	$324,127,417
PERS - Local	$261,061,224	$170,742,381	$431,803,605
TPAF	$578,285,349	$188,855,368	$767,140,717
PFRS	$223,062,967	$122,308,022	$345,370,989
SPRS	$28,594,448	$7,524,233	$36,118,681
TOTALS	**$1,290,223,702**	**$614,337,707**	**$1,904,561,409**

ASSETS			
	BOOK	MARKET	DIFFERENCE
PERS	$8,518,984,196	$10,399,564,224	$1,880,580,028
TPAF	$10,127,721,712	$12,297,267,313	$2,169,545,601
PFRS	$4,723,325,845	$5,734,523,207	$1,011,197,362
SPRS	$546,127,828	$657,166,914	$111,039,086
TOTALS	**$23,916,159,581**	**$29,088,521,658**	**$5,172,362,077**

Glossary

Actuarial Assumptions: Actuarial assumptions are those used in actuarial calculations to forecast future events.

Actuarial Funding Method: When funding a pension plan, it is necessary to assign or allocate—in a systematic and consistent manner—the expected cost of a plan for a group of participants to the years of service that give rise to that cost. The technique used to accomplish this purpose is called an actuarial cost, or funding, method.

Actuarial Gains and Losses: Actuarial experience gains and losses are the effects on actuarial costs of deviations between past events predicted by actuarial assumptions and events that actually occurred.

Actuarial Present Value of Future Benefits: The actuarial present value of future benefits is the discounted lump sum amount which represents the amount needed today to pay future benefits. The term actuarial present value is intended to connote that the derivation of such a value or amount involves changes in the membership population, salary scales, and other functions, in addition to an interest discount for the time value of money.

Book Value of Assets: An asset valuation method where assets are recorded at cost. Book value of assets reflect interest and dividends earned on investments and any gains realized when assets are sold.

Entry Age Method with Open-End Supplemental Liability: This is the proposed actuarial funding method to be used to develop annual employer contributions to the pension funds. Like the current method, it funds the systems' benefits over each member's career. Under this method, a fixed normal contribution rate is developed that remains constant from year to year. The unfunded accrued liability absorbs additional plan costs arising from actuarial gains and losses, which are paid off over a flexible period of time ranging from 0 to 40 years (initially set at 30 years). A flexible payoff period allows for the development of an unfunded accrued liability rate that should remain constant from year to year.

Entry Age Normal Cost Method with Aggregate Level Normal Cost and Frozen Initial Liability: This is the actuarial funding method currently used to determine the annual employer contribution to the pension fund. In the first year this method is implemented, it attempts to fund the system's benefits over each member's career. The portion of the liability that arises on account of future service is funded as a level percentage of pay. The liability that arises from past service and not covered by existing assets is paid off over a fixed period of time much like a mortgage. Additional plan costs due to actuarial gains and losses are absorbed by the normal cost.

Market Value of Assets: An asset valuation method whereby the assets of the pension fund include realized and unrealized gains due to market appreciation, along with investment income and dividends.

Normal Cost: Normal cost is the cost assigned under an actuarial funding method to any year after the inception of a retirement system. Normal cost does not include any portion of the unfunded accrued liability, but may include adjustments for actuarial experience gains or losses.

Unfunded Accrued Liability Cost: The unfunded accrued liability cost is the result of paying off the systems' unfunded accrued liability over a fixed period of years. An unfunded accrued liability typically exists at the plans inception because of the assumption benefits or actuarial costs accrued before the establishment of the system. This cost, along with the normal cost, make up the employer's annual contribution. An unfunded accrued liability may arise after the inception of the system because of benefit changes, changes in actuarial assumptions, and actuarial losses.

QUESTIONS & ANSWERS

PENSION FUND REVALUATION PROPOSAL

Prepared by: Division of Pensions
Date: January 1992

30X

QUESTIONS & ANSWERS

I Change to Market Value

II Interest (Rate of Return) Assumption Increase

III New Actuarial Funding Method

IV General

I CHANGE TO MARKET VALUE

1. WHAT IS THE NEW METHOD AND WHY ARE YOU CHANGING?

   The new method essentially recognizes the true or market value of assets by reflecting 20% of the unexpected appreciation or depreciation in value each year. The change is designed to better reflect the true long-term value of the systems' assets. The present method (book value), by way of example, ignores about $5.2 billion of asset value in the calculation the annual contribution. That means the contribution levels ignore 15% or more of the actual existing assets. This is inequitable to current taxpayers.

2. WHO ELSE USES THIS METHOD OF VALUING ASSETS?

   In the private sector the federal laws require the use of a method which reflects market value. The proposed method is one of several methods used for this purpose. The latest survey of public sector plans indicates that over 60% use a method of this type.

3. DOES THIS NEW METHOD PUT CURRENT AND FUTURE RETIREES AT RISK?

   No, in fact, this new method is superior to the present method since it portrays the true value of the systems' assets instead of the artificially low value associated with the present method.

II INTEREST ASSUMPTION INCREASE

4. ISN'T THE 8 3/4% INTEREST RATE UNREASONABLY HIGH IN THE CURRENT ECONOMY?

This is a complicated area. You must remember that the interest rate and other assumptions are selected as a package to represent the expected long-term experience of the systems. As such, we are looking down the road 40, 50, 60 years or more. As a result, you must consider present conditions, but these are only one aspect of a larger picture.

It's of interest to note that the total systems' returns of the past five years have averaged 10.2% and over 10 years have averaged 15.5%.

It is also helpful to note that we are not only changing the interest rate — we are anticipating more realistic future rates of pay increase and inflation.

5. DO THE ACTUARIES SUPPORT THESE CHANGES?

Each of our present actuarial consultants fully supports these changes. Two other leading firms who have been involved with the systems over the past several years have also supported these or similar changes.

6. I DO NOT UNDERSTAND HOW YOU CAN JUSTIFY AN 8 3/4% INTEREST RATE GIVEN THE BANKS' CREDITING ONLY 4% OR 5%. CAN YOU EXPLAIN?

It is true that the Bank rates are in the 4-5% range. These are short-term rates used by banks in their 6-month CDs. Long-term rates such as Treasury bills are at a level of 8%. Furthermore, you must recognize that there are significant restrictions on Banks' freedom to invest. Our pension funds — totalling some $29 billion — allow professional managers to do many things from an investment viewpoint. We invest in all types of stocks; we invest in may types of fixed income securities (bonds, etc.). As a result, we have earned 15.5% on average over the past 10 years. Our consultants and investment experts have studied our portfolios and have agreed that 8 3/4% is a reasonable expectation for our investment philosophy and size.

III NEW ACTUARIAL FUNDING METHOD

7. WHY ARE YOU CHANGING?

The present method, along with the other assumptions, concentrates too much of the cost of our systems on the present — thus, overburdening the current taxpayers. Our goal is to spread the systems' costs over present and future taxpayers on an equitable basis. The new method — and other changes — are designed to meet this goal in a rational and sound way.

8. WILL THIS METHOD IMPACT THE FUNDED LEVEL OF THE SYSTEM? OR WILL THIS METHOD IMPACT THE SECURITY OF THE RETIREES' BENEFITS?

No. The systems - at $29 billion - obviously have sufficient funds to pay benefits for many, many years. The old policy would have continued to produce cash flows into the systems of two to three times payouts, or more. The new policy will still generate significant positive cash flows. Our actuaries estimate that the systems will move towards 100% funding of the projected system obligations over the next 20 years or so. This is an admirable and appropriate goal.

IV GENERAL

9. WHY DO THESE CHANGES REDUCE ANNUAL COSTS?

For two primary reasons: First, because we are now recognizing the true current value of present assets. Since the result is a higher asset value, this translates into a lower future contribution requirement. Second, using a market-based value approach allows our actuaries to anticipate future appreciation of the fund's investment. This allows our actuaries to anticipate the full future investment earnings we will realize.This is the basis for higher interest assumption. As a result, the higher future investment return again translates to lower required contributions.

10. WHY MAKE THE CHANGE AT THIS TIME?

The new method has been discussed with our actuarial consultants over the past five to six years. In addition, the various pension study commissions and reviews over the past decade have each noted the need to address this area. Extensive studies and projections in 1989 focused on several possible methods and our further analyses since that time culminated in the decision to move ahead at this point.

11. SUPPOSE IT DOESN'T WORK?

Nothing is set in stone. The present policy — the methods and assumptions — have evolved over the past five or six decades. They are constantly monitored and reviewed and are frequently changed. This process will continue. If the returns do not measure up or if inflation remains low or if any of the components appear to be out of line, our actuaries will raise these issues and corrective steps will be taken as they have in the past.

12. CAN YOU GUARANTEE THE SYSTEMS WILL NOT RUN OUT OF MONEY?

Keeping in mind that the funding policy — the assumptions and methods — are constantly monitored by our actuaries and other professionals and are formally reviewed every three years, it is difficult to imagine any events which would bankrupt any one of the systems. We are working towards a 100% funded ratio for our systems and will monitor this progress closely. Our New Jersey systems are already better than the national average of 82% in this area and we will continue to work to improve the present condition.

I. Introduction

- Benefit Security Focus
- 1989 Study
- Evaluation Should be Based on Complete Proposal

II. Theoretical Concepts in Proposal

- Concept of Move to Market Based Asset Measurement
- Change in Funding Method and Assumptions
- Asset Measurement Method, Funding Method, and Assumptions must be Considered in Tandem

III. Importance of Methods and Assumptions

- Description of Funding Process
- What Methods are Needed?/How are They Changed?
  - Asset value
  - Handling Future Gains and Losses
  - Pattern of Cost
- What Assumptions are Needed?
  - Future Pay - Benefit on Retirement
  - Future Inflation - Benefits after Retirement
  - Return on Assets
  - Spreads - Pay, Inflation, Medical

IV. What is Needed to Evaluate Benefit Security Impact for TPAF?

- Detailed Description of Method for Setting Assumptions
  - Dealing with Changes
    - Prior Assumptions too Pessimistic
    - Prior Assumptions too Optimistic
    - What is Emerging Experience?
  - Must Reflect Plan Demographics/Characteristics
  - Assets Reflect Current Environment/Assumptions Must Also
  - Assumptions Have Significant Effect on Benefit Security

- Evidence that Long-term Security of Members is Protected
  - Capital Markets have Changed since 1989 Study
  - Projections of Long Term Costs
    - By Component
    - Contributions
    - Funded Status
    - Probability of Targeted Funded Status Being Met
  - Public Understanding of Extended Policy Effect
    - Members and Policy Makers

- Complete Actuarial Report Reflecting New Proposal

Legislative
Viewpoint

NEW JERSEY STATE LEAGUE OF MUNICIPALITIES
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HELEN YELDELL, Legislative Analyst

February 13, 1992

Hon. Joseph L. Bubba
Chairman, Senate State Government Committee
279 Browertown, Rd., Suite 100
West Paterson, NJ 07424

Dear Joe:

The attached report represents the findings of our review of the Administration's pension funding revaluation proposal.

Although we support the actuarial assumptions and accounting methodology used in shifting from a book value to market value we have some serious concerns with the policy implications of the plan that are set forth in our report.

Lou Neely, Finance Director, East Brunswick and Chairman of our Pension Review Committee will amplify further on our technical concerns.

We stand ready to assist your committee in crafting a proposal which meets our mutual needs and we look forward to working with you on this.

Very truly yours,

William G. Dressel, Jr.
Assistant Executive Director

WGD:jg
cc: Members of Senate State Government Committee
Enclosure

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LEAGUE OF MUNICIPALITIES

COMMITTEE REPORT

PENSION FUNDING REVALUATION PROPOSAL

February 6, 1992

39X

NEW JERSEY STATE LEAGUE OF MUNICIPALITIES

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This short report is a summary of the League's Pension Advisory Committee's recommendation. You specifically asked that we review the Governor's proposed modification to New Jersey State Pension Systems inclusive of:

Public Employee Retirement System (PERS)
Teachers Pension and Annuity Fund (TPAF)
Police and Fire Retirement System (PFRS)
State Police Retirement System (SPRS)

Two documents dated January, 1992 were provided for the review. They were a delineation of the proposal to revalue pension assets from book value to market value accounting approach. Both documents have proven to be helpful in evaluating the concept.

It has been the League's position, of the past number of years, that system assets have been unvalued using the current accounting valuation. The Governor is now proposing to change the book value method of valuation to market value following the procedure as outlined in the Financial Accounting Standards Board Statement No. 35 (FASB 35). This method of valuation is sound and one which the League can endorse.

Beyond supporting the accounting method delineated in FASB 35, the League also believes the assumptions used in developing future employer contributions are reasonable and sound. The assumptions for return on investments, inflation and COLA (cost of living adjustments) are supported. These funding targets are established with a high degree of confidence.

Our endorsement for shifting from book value to market value does not mean there are no problems. Whenever there is a change in accounting methods there has to be concern with ripple effects which may be encountered. Specifically, I am referring to the fact that members of the uniform services are covered by binding arbitration. A shift in accounting method will result in lower employer contribution. It is highly possible "unions" will consider any savings part of the collective bargaining process. The Legislation should clearly state a change in methodology should not be considered an instrument for collective bargaining. The League in the past was told by the State; pensions are not subject to the collective bargaining process.

In 1979, Chapter 109 was passed with the understanding the State would fund those mandatory costs. When Chapter 204, P.L. of 1989 were passed over League's objection, we were again told this was a State issue. Now the Governor plan is trying to pass those costs back onto local governments. This ever increasing contribution should not be shifted nor should the promise of the past decade be broken.

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The accounting proposal is to be retroactive to July of the State's current fiscal year. Adoption of a change in accounting methods will result in refunds of employer contributions. The amount of refund should be distributed to the agency in proportion to the amount they paid. The State is obviously the largest employer and therefore, they would receive the largest refund along with the TPAF refund. Local governments would receive a proportionate employer refund resulting when assets are based on market value.

The following table is estimated distribution of the proposed $572 million dollar refund:

EMPLOYERS
PENSION CONTRIBUTIONS

System	Employer Amount Paid	% of Total
PERS - State	$199,219,714	15.4407%
PERS - Local	$261,061,224	20.2338%
TPAF - State	$578,285,349	44.8205%
PFRS - Local	$223,062,967	17.2887%
SPRS - State	$28,594,448	2.2162%
Total	$1,290,223,702	100.0000%

Distribution of $572 Million Employer Refund

System	% of Total	Distribution
PERS - State	15.4407%	$88,320,867
PERS - Local	20.2338%	$115,737,310
TPAF - State	44.8205%	$256,373,541
PFRS - Local	17.2887%	$98,891,391
SPRS - State	2.2162%	$12,676,890
Total	100.0000%	$572,000,000

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Summary

The concept of shifting from book value to market value in accordance with FASB 35 is sound and acceptable. The League has endorsed this concept in the past and continues to endorse the concept. The salary, earnings, and COLA assumptions are reasonable and could be endorsed. The investment relationship of equities, fixed income and money markets must be monitored to ensure the integrity of the system. The current relationship is prudent.

The League did not support the $2.7 billion PFRS enhancement nor the $3.5 billion TPAF enhancement. A change in accounting method should not result in a shift of liabilities or a loss of integrity.

Respectfully submitted,

L. Mason Neely

L. Mason Neely
Chairman, League Pension Study Committee