F I S C A L   I M P A C T   R E P O R T

SPONSOR HECS **DATE TYPED** 02/13/05 **HB** 1128/HECS

SHORT TITLE State Pension Obligation Funding **SB**

ANALYST Geisler

APPROPRIATION

Appropriation Contained		Estimated Additional Impact		Recurring or Non-Rec	Fund Affected
FY05	FY06	FY05	FY06		
			Significant, see narrative	Recurring	General Fund, Educational Retirement Fund

(Parenthesis ( ) Indicate Expenditure Decreases)

REVENUE

Estimated Revenue		Subsequent Years Impact	Recurring or Non-Rec	Fund Affected
FY05	FY06			
		Significant negative impact, see narrative	Recurring	General Fund

(Parenthesis ( ) Indicate Revenue Decreases)

Relates to: HB 270, SB 181, Governor's ERB initiative

SOURCES OF INFORMATION
LFC Files

SUMMARY

Synopsis of Bill

House Bill 1128 authorizes the state board of finance to issue state pension obligation tax revenue bonds for the funding & refunding of the state unfunded accrued pension liability. The bill creates a state pension obligation bond retirement fund to repay the bonds with gross receipts tax revenues (general fund), which are continuously appropriated for this purpose. The bill creates the state pension contribution fund to facilitate transfer of bond proceeds to pension funds. The bill contains an emergency clause.

Significant Issues

Creation of Unlimited Authority to Issue Debt

House Bill 1128 provides the Board of Finance the ability to issue pension bond debt at will and provides for a continuing appropriation of general fund revenue for bond repayment. Issuing of pension bond debt will have a negative impact on general fund revenue. However, providing a cash infusion to a pension fund may provide a net gain to the state and reduce the need for additional future general fund appropriations to restore the solvency of the pension fund. See additional discussion on the pros and cons of pension bonds below as well as fiscal impact.

Relationship to Governor's ERB Proposal

Governor Richardson announced on March 9, 2005 a proposal to provide $100 million to the Educational Retirement Board to shore up the actuarial solvency of the educational pension fund. The Governor's proposal will use $100 million in non-recurring funds targeted for capital projects to fund the ERB plan, and issue $100 million in tax exempt debt to fund the capital projects.

Although, the executive's proposal technically is not a pension obligation bond, the concept is similar: borrow at a low rate, and distribute a relatively large sum to the pension fund, expecting the actuarially assumed rate of return on investments (8 percent) to exceed the cost of borrowing.

Educational Retirement Board Actuarial Position

At June 30, 2004, the educational pension fund unfunded liability was $2.4 billion. The fund's amortization period for its unfunded liability, which the Governmental Accounting Standards Board states should be less than 30 years, is infinity. The pension fund's funding ratio, the actuarial value of assets as a percentage of actuarially accrued liabilities, has declined to 75.9% at June 30, 2004, down from 91.6% at June 30, 2000 (a 80% funded ratio is a common benchmark). House Bill 1091 will provide a funding mechanism to address the declining actuarial position of the educational pension fund and will provide a mechanism to address any future problems with state pension plans.

Advantages and Disadvantages of Pension Bond Concept

Pension Bonds are a taxable debt obligation of the state issued to provide financial support to a pension fund. The state repays the bonds and the pension fund receives the bond proceeds, which it in turn invests in stocks and bonds, expecting a long term return, presumably at a higher rate than the cost of the debt issuance.

Advantages of pension bonds:

1) Issuing debt immediately and transferring the proceeds to the retirement fund improves the actuarial position of a pension fund.
2) Low interest rates may offer strong arbitrage possibilities to borrow at around 6% and reinvest the funds to earn more, say 8%, thru investments.
3) If the unfunded actuarial liability of the pension fund is viewed as a state debt, the projected

arbitrage gain from pension bonds allow the State to pay a smaller annual amount than what would have otherwise been required to pay off the unfunded actuarial liability. Similar to refinancing a mortgage, pension bond can be structured to allow the State to realize savings upfront or in level amounts over the life of the bond.

Disadvantage of pension bonds:

1) Repayment of pension bond debt would create a hard obligation to finance the annual debt service at the expense of other state priorities.
2) There is some risk that the investment return will be lower than the interest on the borrowed funds, which means the state will suffer a net loss.
3) The difficulty of achieving long term returns greater than borrowing costs and bad market timing has caused losses among a number of states/municipalities that have issued pension bonds. There are divergent viewpoints on the wisdom of issuing pension bonds in near term given market uncertainties.
4) Although pension bonds represent an alternative to contribution increases, it is still possible that a structural problem will persist because the contribution levels are too low relative to promised benefits.

FISCAL IMPLICATIONS

This bill provides the executive new authority to issue debt and provide for continuing appropriations for debt repayment from the general fund. If debt were to be issued in FY 06 no funding has been identified for debt repayment in the current version of the budget. The exact cost is unknown because the bill does not specify how large the pension bond will be, but the fiscal impact will be significant because pension bonds are typically issued in increments of hundreds of millions of dollars. For example, a $100 million bond with a 20 term at 6 percent would cost approximately $10.5 per year. Given the size of the unfunded actuarial liability, $2.4 billion, any pension bond issue would likely be well in excess of the above example. See suggested amendment below.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

Relates to SB 181 and HB 270, which also propose to address shortfalls in the educational retirement fund. HB 270 proposes increasing the employer contribution .75% for ten years. SB 181 proposes increasing the employer contribution .75% for 5 years and the employee contribution .25% for 4 years, as well as creating a new benefit plan for future educational employees.

OTHER SUBSTANTIVE ISSUES

Major Features of Bill:

<u>Authority of Board of Finance (Section 4)</u>

The board is authorized at anytime and from time to time to issue revenue bonds, notes, or other obligations in compliance with the act to fund the payment in full or in part of the unfunded accrued liability. The board also has the authority to undertake related activities such as reimbursing the state amounts previously paid with respect to the unfunded accrued liability, refunding previously issued bonds, paying issuance and related administrative costs, entering into additional obligations in connection with bonds anticipated to be issued, making deposits to reserve funds and the interest rate stabilization account of the bond retirement fund, paying accrued interest of funding capitalized interest, and entering into other contracts deemed necessary by the board such as legal, consulting, and underwriting services.

<u>State Pension Obligation Bond Retirement Fund Created (Section 5)</u>

The fund is created in the state treasury as a special fund which includes a capitalized interest account and an interest rate stabilization account. Earnings of the bond retirement fund and both sub-accounts shall be credited to the bond retirement fund. The bonds and any additional obligations are special and limited obligations of the state payable solely from the bond retirement fund or other special funds as approved by the bondholders. The bonds do not create an obligation or indebtedness of the state or any retirement system within the meaning of any constitutional provision. No breach of obligations pursuant to the act shall impose a pecuniary liability or charge upon the general credit or taxing power of the state, and neither the bonds nor additional obligations are general obligations for which the state's full faith and credit is pledged.

<u>State Pension Contribution Fund Created (Section 9)</u>

The state pension contribution fund is also created in the state treasury as a special fund to transfer the proceeds of bonds to the designated retirement system in an amount proportionate to the portion of the designated retirement system's unfunded accrued liability funded with bond proceeds.

<u>Abatement of Unfunded Accrued Liability (Section 10)</u>

Section 10 states that notwithstanding any other provisions of law, if the proceeds of bonds are used to pay all or any portion of unfunded accrued liability to be paid from the general fund, the state treasurer shall abate payment from the general fund to the extent of any payment made from bond proceeds.

ALTERNATIVES

In addition to pension bonds or other debt, other possible approaches to reducing the unfunded actuarial liability include increasing the employer and/or employee contributions to the fund and reducing future plan benefits.

AMENDMENTS

The intent of the bill could be clarified by amending the bill to specify a planned amount for bond issuance, or a range of possible amounts.

GG/lg