Will New Accounting Rules Force NJ to Put Billions More Into Pension Payments?

State underestimating pension liability under new accounting standards

By **Mark J. Magyar**, **June 14, 2012** in **Budget**

The national Government Accounting Standards Board is poised to approve new rules requiring pension systems to calculate their return on investment more conservatively. The change will require New Jersey to more than double its current $40 billion-plus net pension liability on official balance sheets and could force the state to increase pension contributions in future budgets.

"If New Jersey's pension contributions have to comply with the new GASB standards, the state would have to put $5 billion into the system in Fiscal Year 2016, not $3 billion," said Frank J. Abella Jr., chief executive officer of Investment Partners Asset Management Inc., indicated to state Treasury officials after last month's State Investment Council meeting.

State Treasury spokesman Andrew Pratt discounted the impact of the new accounting system scheduled to be adopted by GASB on June 25, asserting that the agency's decision to require states and cities to assume a 3.5 percent Treasury discount rate as its official return on investment conflicts with New Jersey's 14-year record of earning a 6.3 percent return since 1998.

Pratt said the state would comply with GASB reporting requirements, but that the amount of money the state will put into the pension system in future years will be determined, as always, by the state treasurer.

"This is a dispute over actuarial accounting methods, and reasonable people can disagree," he said. "What nobody can dispute is that the problem would be $20 billion worse if we had not enacted historic pension changes last year."

The GASB vote on the new accounting system that will double New Jersey's official pension liabilities will come just five days before the constitutional deadline for New Jersey to adopt its budget for the upcoming fiscal year. It will come as the Democratic-controlled Legislature wrestles over whether to approve the income tax cut that Christie wants, even though state revenues are coming in $700 million to $1.4 billion below projections after a year in which the state's economy actually shrank.

While the new GASB system will not go into effect until next June, pension expert Eileen Norcross, senior research fellow at the Mercatus Center at George Mason University, predicted that "most states will begin complying with the new GASB standards because the new accounting standards will inspire confidence with the bond-rating agencies, and that will put pressure on the others to do the same."

She said Abella's estimate of the amount of money New Jersey should be putting into its pension system in future years is "well in the ballpark." Even after enactment of New Jersey's pension law requiring public employees to contribute more toward their pensions, "New Jersey and Illinois are the states with the most massive liabilities relative to their budgets," she said yesterday.

"The state reports that its pension systems are underfunded by $44.7 billion, when liabilities are discounted at the 8.25 percent annual return that New Jersey predicts it can achieve on funds' investment portfolios," Norcross and Andrew Biggs wrote in **The Crisis in Public Sector Pension Plans: A Blueprint for Reform In New Jersey**, a working paper published by the Mercatus Center in 2010.

"When plan liabilities are calculated in a manner consistent with private sector accounting requirements," Norcross and Biggs wrote, "methods that economists almost universally agree are more appropriate, New Jersey's unfunded benefit obligation rises to $173.9 billion. This amount is equivalent to 44 percent of the state's current GDP and 328 percent of its current explicit government debt."

Even after the pension changes adopted last year, New Jersey's pension deficit was pegged at $41.8 billion as of Dec. 31. Furthermore, the "asset smoothing" method used by actuaries that spreads gains and losses across multiple years persistently overstates pension plan assets and underestimates liabilities, Norcross wrote in an analysis published last week. The study, entitled **"Actuarial Camouflage"** showed how the use of asset smoothing enabled the New Jersey Public Employees Retirement System to show assets of $30 billion in 2009 when the actual market value of the assets was $21 billion.

Norcross, who is the daughter-in-law of David A. Norcross, the former GOP U.S. Senate candidate from New Jersey who rose to serve as General Counsel for the Republican National Committee, has been working on a series of studies on New Jersey municipal pension and health benefit obligations in partnership with Abella and the Stevens Institute of Technology.

The dispute over actuarial assumptions is more than an academic dispute. On one side, the official General Accounting Standards Board, bond-rating agencies like Moody's, and pension hawks like Norcross and Abella believe state governments have exacerbated the nation's trillion-dollar pension crisis by consistently overestimating return on investment.

New Jersey's 8.25 percent expected return on investment exceeds the 6.3 percent return earned over the past 14 years by Treasury's own calculation, and that percentage was inflated by record 22 percent earnings in 1998 and 1999 at the height of the dot-com boom, Abella noted.

On the other side, most state officials are reluctant to lower their expected returns on investment or raise projected pension liabilities because it would require them to pump hundreds of millions of additional dollars into pension systems that would have to come out of other state programs. Meanwhile, union officials worry that increasing the state's pension obligations will lead governors and legislatures to cut pension benefits, as New Jersey did last year.

That reluctance may be changing, however.

Earlier this year, the California Public Employees Retirement System (CALPERS), the largest state pension system, lowered its expected return on investment from 7.75 percent to 7.5 percent, even though the CALPERS actuary calculated that the state had no better than a 50-50 chance of averaging 7.5 percent over the next 20 years.

Rhode Island lowered its expected return on investment from 8.25 percent to 7.5 percent. New York City's actuary recommended cutting its rate of return from 8 percent to 7 percent -- a level that Mayor Michael Bloomberg derided as "totally indefensible." As Bloomberg, the founder of Bloomberg News Service, the respected financial newswire, told *The New York Times,* "If somebody offers you a guaranteed 7 percent on your money for the rest of your life, you take it and just make sure the guy's last name is not Madoff."

Pratt said the Treasury Department "is always evaluating its actuarial assumptions" for the state's pension system. But changing those assumptions can cost billions of dollars: Simply cutting New York City's assumed return on investment from 8 percent to 7 percent would add $1.9 billion to the $7.3 billion a year that New York puts into its pension system.

That $7.3 billion contribution to pensions for a city with 8 million people dwarfs the $1.06 billion New Jersey will be contributing next year to cover the state's share of pension costs for state employees, teachers, and other government workers. The $1.06 billion represents the second step of a seven-year buildup to full state funding of the state's pension obligation -- after 15 years in which Republican and Democratic governors used inflated return on investment projections to justify skipping billions of dollars in pension payments.

Those state pension payments are scheduled to rise to $1.76 billion in Fiscal Year 2014, $2.54 billion in Fiscal Year 2015, $3.36 billion in Fiscal Year 2016, $4.02 billion in Fiscal Year 2017, and $5.04 billion in Fiscal Year 2018 – the year that full funding is supposed to kick in.

Those figures, however, assume that New Jersey will hit its 8.5 percent annual return on investment for its pension plans. Pratt noted that return on investment for the state's pension systems for Fiscal Year 2011 -- which runs from July 1, 2010, to June 30, 2011 -- topped 18 percent, the best fiscal year since the late 1990s. However, Abella pointed out that the nosedive in the stock market in the second half of 2011 dropped the return on investment for the 2011 calendar year to just 3.4 percent -- and that state pension officials were bragging that their 3.4 percent return was the best in the nation.

If New Jersey used the new GASB accounting principles to guide its contribution to the pension system -- by lowering its projected return on investment to the 3.5 percent Treasury discount rate -- the state's $3.36 billion pension contribution in FY2016 would jump to well over $5 billion, Abella projected.

Less drastically, even a 1 percent drop in the state's return on investment from 8.5 percent to 7.5 percent would add hundreds of millions of dollars to future state pension payments even if Treasury sticks with current actuarial assumptions.

"The good thing is that we have a self-correcting system," Pratt explained. "We have a 'true-up' every year in which we reassess the funds, and if we have to put more money into the pension funds, we will."

Douglas Forrester, the former New Jersey Division of Pensions director who ran as the GOP candidate for governor in 2005, praised the Governmental Accounting Standards Board for setting out the new standards for adoption later this month.

"To the extent that there are public standards of accountability, that's good for everybody because it forces us to face the truth," said Forrester, who now serves as president of Integrity Health. "Part of the problem of the 1990s and the last decade is that there weren't standards that forced everybody to face the truth. It's an ugly truth, no doubt about it. The state did not put in the amount of money that it was obligated to pay, and they hid behind accounting and actuarial details that bore no relationship to reality."

Forrester noted that New Jersey had a pension funding system in place where the state paid the same percentage of payroll into the pension system every year. "We went off the rails in 1994 and never got back on," he said, referring to a series of actuarial pension changes made by the Republican Whitman administration.

"I'm not sure that the state will ever gain stability until it faces the difficulty of actuarial liability," Forrester said. "Everybody is always focused on the asset side, but the problem is in the definition of liability. The systemic underfunding of the pension system occurred not just because the state hasn't put in much money, but because it defined what liabilities were in such a fantasy world way. It is an enormous problem, and it's a sad situation because planning for the future has become almost unmanageable because a system that was adequate was abandoned 20 years ago."

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