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ISSUE UPDATE

GOVERNOR MURPHY CONTINUES TO FIDDLE WHILE THE TEACHERS' PENSION FUND BURNS

FY2022: EVEN AFTER MURPHY'S BILLIONS IN ADDITIONAL FUNDING, TPAF IS 33.9% FUNDED

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INTRODUCTION

Several months ago, Sunlight's Issue Update estimated the condition of the Teachers' Pension and Annuity Fund (TPAF) using projections that incorporated 2022's negative investment returns. We estimated that TPAF was likely funded at 34.7%, meaning there were fewer than 35 cents set aside for each dollar owed to retirees. This is a crisis level -- caused by one year of poor investment returns.

Then in March, Sunlight reported on an Urban Institute study that placed TPAF in its "Deep Red" category, ranking TPAF as one of the nine worst public pension funds in the nation. As such, with a funded ratio of 39%, TPAF was projected to become insolvent in 20 years or less.

It turns out that TPAF is in even worse condition than those prior indications. The state has just published the official TPAF FY2022 actuarial report, which indicates that TPAF's funded ratio was 33.9% at the 2022 fiscal year-end (June 30, 2022). But that measure only included half of 2022. The market declined a further -2.4% in the second half of 2022, so the funded ratio was likely *below 33%* by calendar year-end (December 31, 2022).

That TPAF's could so easily revert back to a crisis level -- even after Governor Murphy pumped record billions in contributions into TPAF -- underscores what Pew Charitable Trusts has warned:

> "This volatility is a reminder that … *states cannot count on outsize investment returns to bail out underfunded pension plans* …" [emphasis added]

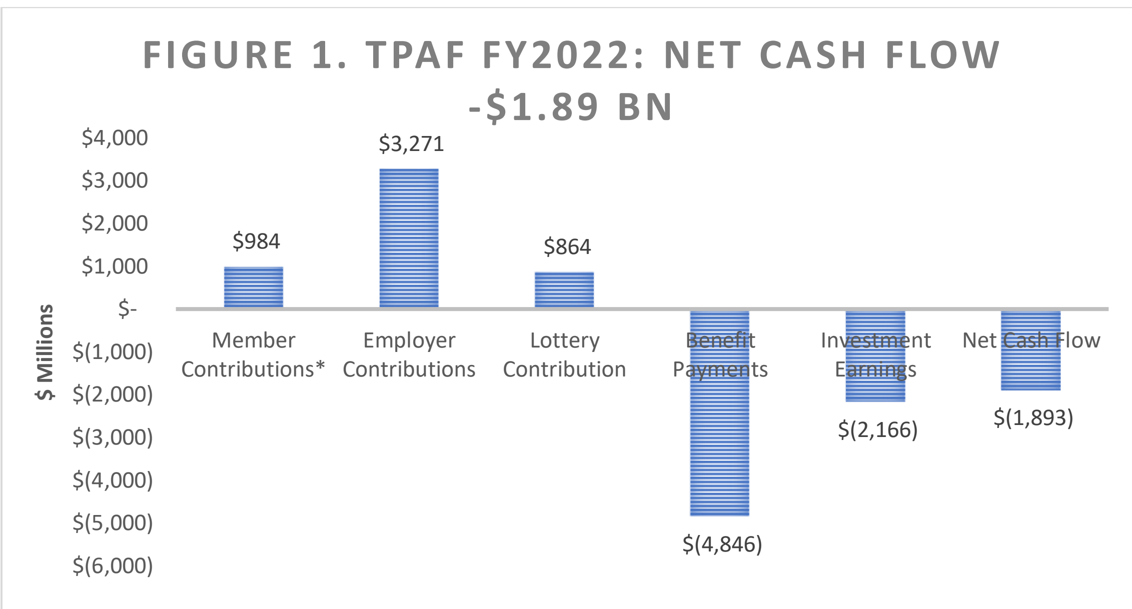
And remember that TPAF is already being aided by 78% of the state's annual lottery proceeds, which amounted to a $864 million infusion into TPAF in FY2022. On a stand-alone basis, TPAF is in even worse shape.

Murphy is throwing billions of good (taxpayer) money after bad. TPAF is structurally unsound and needs to be reformed. But Murphy steadfastly refuses to consider reforming TPAF and putting it on a sustainable path – just as his biggest political supporter, the NJEA, wants. After willingly participating in political deals that severely underfunded TPAF and blocked all reform efforts, the NJEA wants to hide the truth from teachers and pretend that making the full required contributions means everything is OK. But as the numbers show, everything is not OK. New Jersey teachers and taxpayers are being misled. With his eyes on a run for national office, Murphy is happy to play along.

THE FY2022 NUMBERS

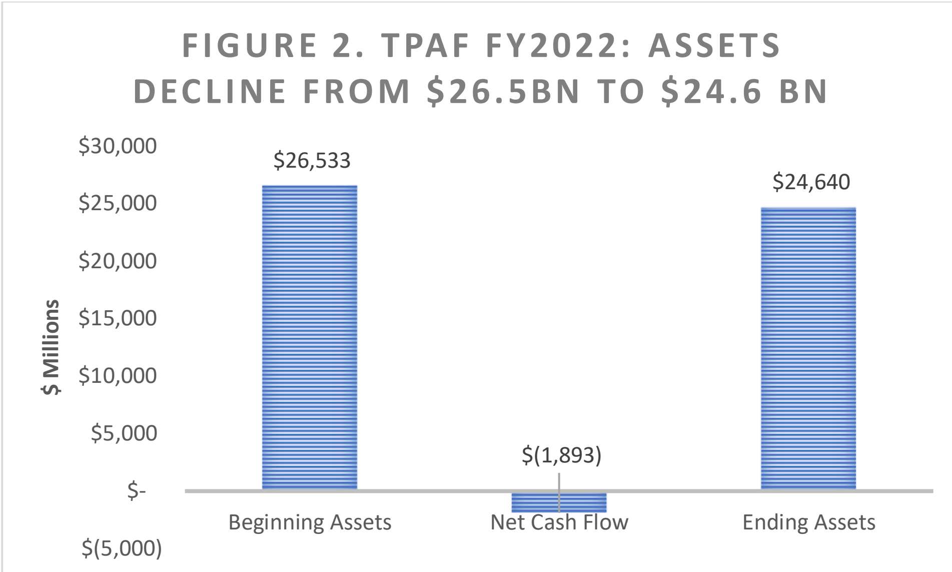
FY2022 Negative Cash Flow of $1.89 billion. Figure 1 shows why the above Pew quote is so relevant for TPAF. Even with the full required actuarial payment of $3.27 billion and $864 million from the state lottery, TPAF was only break-even in operational cash flow (which excludes investment returns) and vulnerable to market volatility – as it is every year because it is structurally unsound. As it happened, the state's investment portfolio declined -7.66% in FY2022, or -$2.17 billion. TPAF's total net cash flow was -$1.89 billion.

So TPAF was forced to sell $1.89 billion of assets to meet its annual payments to retirees. These assets are forever removed from TPAF and will not be there to appreciate when the markets rebound. This is why states cannot rely on investment returns to bail out underfunded pension plans like TPAF. This is why pumping over $4 billion of taxpayer dollars into the structurally unsound TPAF is throwing good money after bad.



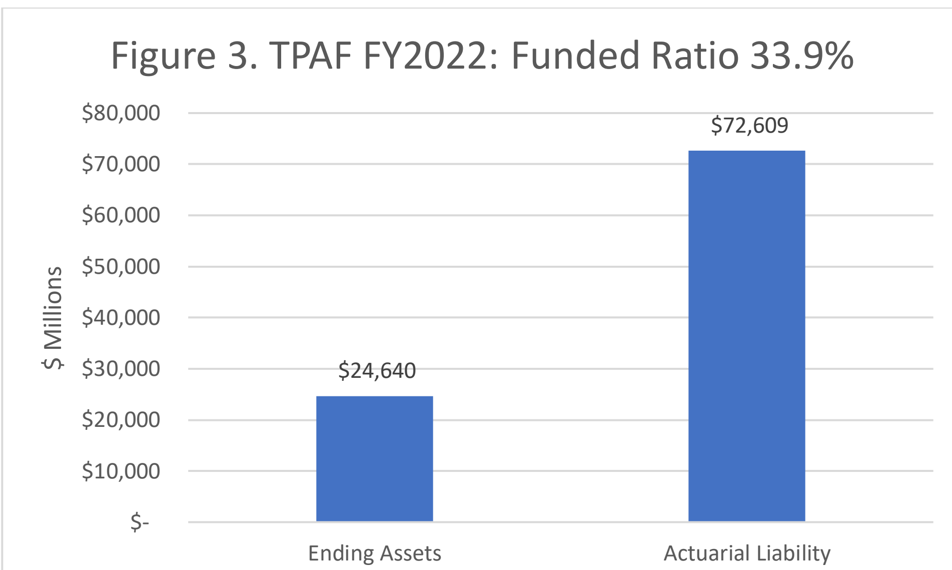
* Includes other income/contributions. Source: TPAF FY2022 Actuarial Valuation Report (p.34).

Forces the $1.89 billion Sale of Assets. As Figure 2 shows, because TPAF had to sell $1.89 billion in assets, TPAF's total assets declined from $26.5 billion at the beginning of FY2022 to $24.6 billion at the end.



Source: TPAF FY2022 [Actuarial Valuation Report](#) (p.34).

Funded ratio declines to 33.9%. In Figure 3, the ending assets of $24.6 billion must be measured against TPAF's liabilities of $72.6 billion, which results in a funded ratio of 33.9%. This is far below the 39% ratio that landed TPAF in the Urban Institute's "Deep Red" category.



Source: TPAF FY2022 Actuarial Valuation Report (p.34, 40).

But the situation was worse than that at the end of 2022 because the investment market volatility persisted in the second half of the year. As of December 31, 2022, the state's portfolio was down another -2.4%,[1] which likely lowered the funded ratio to below 33% (given that TPAF's liabilities inexorably rise and were likely higher than $72.6 billion).

[1] According to the State Investment Council, total assets were $87.5 billion at June 30, 2022 and $85.4 billion at December 31, 2022, a decline of -2.4%.

33.9% funded ratio based on very charitable assumptions. But even the very low 33.9% funded ratio benefits from some very charitable assumptions:

- **Discount rate based on high return assumption**. New Jersey uses a very high 7% discount rate for its liabilities,[2] which is derived from the plan's 7% investment return assumption. But Pew Charitable Trust states that a reasonable assumption for the typical pension plan would be 6%. With a 6% return assumption and discount rate, the funded ratio would be substantially lower.

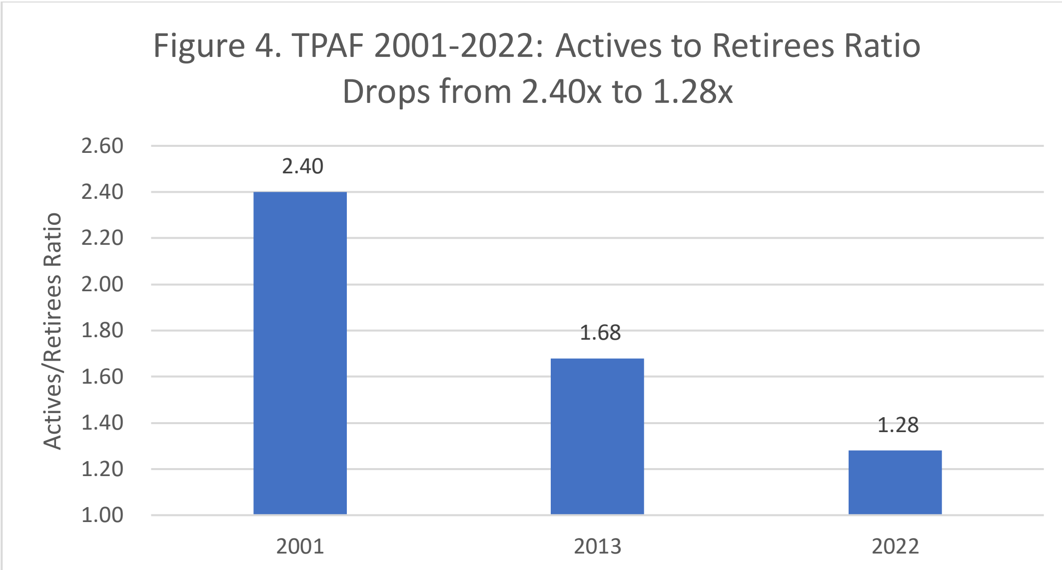
- **Full pension payments assumed -- forever**. Most importantly, government accounting rules allow New Jersey to use the 7% discount rate because it assumes that New Jersey will continue to make the full, required pension contributions *for every year in the future*. That would be $6.5 - $7.3 billion per year until 2047.[3] If New Jersey ceases to contribute this full amount, then it would use a lower discount rate and TPAF's funded ratio would drop.

Ratio of active workers to retirees declining. Even more worrisome is the long-term decline in the ratio of active workers who pay into the pension system versus the number of retirees who take money out of it. For example, over the last decade (since 2013), the number of retirees has increased by 24.8%, while the number of actives has declined by -4.7%.

As shown in Figure 4, the ratio of actives to retirees has declined from 2.4x in 2000, to 1.68x in 2013, to 1.28x in 2022.

[2] Reputable economists argue that pension liabilities should carry a risk-free discount rate because they are "a form of government debt with strong statutory and contractual rights." Oliver Giesecke and Joshua Rauh, "Trends in State and Local Pension Funds," Annual Review of Financial Economics, Volume 15, October 2022. With a risk-free discount rate, TPAF's funded ratio would drop into the low-to-mid-20% area per Stanford's Public Pension database.

[3] Preliminary Official Statement for New Jersey Transportation Trust Fund Authority Bonds, 2022, Series CC, dated November 21, 2022, Appendix 1, p. I-51. The state's overall pension contribution includes all the state lottery proceeds -- 78% of which go to TPAF – so this revenue stream will be consumed by the pensions until 2047 as well.



Sources: 2022 data from TPAF FY2022 Actuarial Valuation Report (p. 51, 53). 2013 data from NJ Division of Pensions and Benefits Annual Comprehensive Financial Report (p. 186-7). 2001 data from Andrew Biggs, "The Looming Tipping Point of New Jersey's Pension System," Garden State Initiative, January, 2022, p. 4.

As can be seen in the graph above, TPAF is rapidly approaching a "tipping point" where retirees will outnumber actives. At that point, something will have to give: active workers will have to pay more, or the state will pay more, or retirement benefits will be cut, or some combination of the three. None of this bodes well for TPAF, current teachers, retirees, or the state.

CONCLUSION

All of the above points to the fact that TPAF is not a healthy pension plan. For the sake of the retirees who depend on it, for the teachers who work long and hard with the expectation that they will receive the pensions they have been promised, and for the state and its hard-pressed taxpayers who pay the bills, TPAF cries out for a restructuring that would make it sound and sustainable.

But that is not what Governor Murphy has in mind. Rather than undertake the hard work of reforming TPAF, Murphy has chosen the politically expedient route. Taking advantage of record state budgets inflated by federal COVID relief and record tax revenues, Murphy has poured $18 billion into the state's pension system from FY2021-23, and plans another $7 billion for FY2024. Yet TPAF, the state's largest pension fund, remains in "Deep Red," crisis condition.

Why would Murphy be so irresponsible? Because his biggest political supporter, the NJEA, has steadfastly fought reform for decades and continues to do so. It demands full required payments to help deflect attention from the fact that it played a leading role in the severe underfunding of TPAF in the first place. The NJEA wants to hide the ugly truth from teachers because if they knew the truth, they would be outraged. With his eyes on the White House, Murphy is happy to play along.