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October 28, 2003

TO: Members
Joint Committee on Finance

FROM: Bob Lang, Director

SUBJECT: Assembly Bill 611: Increase in Pension Obligation Bonding Authority

Assembly Bill 611 was introduced on October 27, 2003 and referred to the Joint Committee on Finance.

BACKGROUND

Provisions of 2003 Wisconsin Act 33, the 2003-05 biennial budget, authorized the issuance of up to $1.35 billion in either revenue obligation bonds or appropriation obligation bonds to pay off all or part of the state's share of unfunded actuarial accrued liabilities (UAAL) under the Wisconsin Retirement System (WRS) and comparable liabilities under the accumulated sick leave conversion credit (ASLCC) program for state employees. While it appears likely the state would issue appropriation obligation bonds, either type of obligation could be issued. Both types of obligations would be backed by the state's moral obligation pledge to appropriate any funds that may be necessary to repay the obligations and maintain the required reserves.

If revenue bonds were to be issued, the bonds would be backed by the state's excise taxes on alcoholic beverages, and cigarette and tobacco products. Debt service on these bonds would be first draw on the revenues associated with these excises taxes. Alternatively, the appropriation obligation bonds would be payable from a GPR appropriation in the amounts appropriated by Legislature each year. Because repayments each year would be subject to appropriation, the bonds would not be considered public debt of the state. Unlike other long-term debt obligations, which are issued by the Building Commission, the DOA Secretary was provided the authority to issue these appropriation obligation bonds.

DOA Capital Finance officials indicate that the financing rate on any bonds issued will likely be lower than the current statutory 8% interest rate imposed on the state's unfunded WRS and ASLCC pension liability balances. As a result, the state will accrue financial benefits or savings from the transaction.

The bond repayment schedules are to be structured so that state would make no debt service payments on the bonds in the 2003-05 biennium. Because bond proceeds under the transaction will be used to pay off the unfunded WRS and ASLCC program liabilities, payments on those liabilities would no longer have to be made in the biennium. Therefore, the state will realize savings associated with the transaction in the biennium in the form of lower fringe benefit costs that are currently associated with these liabilities. Act 33 also provided DOA the authority to lapse or transfer to the general fund, an estimated $120,615,300 in funds that would otherwise have been expended to make these WRS unfunded liability payments in the 2003-05 biennium. The DOA Secretary would continue to have the authority to lapse or transfer each agency's unfunded prior service and ASLCC liability payments to the general fund until the bonds issued to liquidate these pension liabilities are retired. In addition, DOA is provided authority to lapse an estimated $20,000,000 from state appropriations associated with the amounts that will be credited to state appropriations as a result of the state liquidating these pension liabilities.

Act 33 also directed the DOA Secretary to assess each PR and SEG account, and FED account, if federal funds are involved in the transaction, for the percentage of debt service costs that are associated with each fund's share of the unfunded pension liability that would have otherwise been paid by those funding sources. In making this determination, the DOA Secretary is required to include in their biennial budget fringe benefit calculations the percentage each fund source's contribution to debt service on the pension bonds in that biennium, which would be based on the percentage that each fund source makes up of the state's unfunded liabilities at the time these liabilities are liquidated.

Increase in ASLCC Liability

The UAAL of an employee benefit program, such as the ASLCC program, is calculated by comparing the expected total future benefit amounts to be paid on behalf of present state employees and retirants with the value of current plan assets recognized for valuation purposes. The difference between the expected funding requirement for the promised benefits and the program's assets constitutes the UAAL.

An actuarial valuation restating the liabilities and assets of the ASLCC (including the associated supplemental program), as of October 1, 2003, was requested by the Department of Employee Trust Funds (ETF) in response to the provisions in Act 33 to use bond proceeds to liquidate the program's UAAL. The Department believes that it is important to establish the most accurate measure of the UAAL possible in order to determine the amount of bonding that must be issued to liquidate this liability. The October 1, 2003, valuation reported a total UAAL for the ASLCC of $782.4 million, an increase of $245.8 million over the December 31, 2002 valuation.

According to ETF officials, there are three reasons for this increase. First, the December, 31, 2002, UAAL valuation was understated due to the deferred losses held in the Market Recognition Account (MRA) within the Fixed Fund of the WRS. All ASLCC assets are currently held in the WRS fixed fund. The MRA holds all realized and unrealized gains and losses in market value of the invested assets of the Fixed Fund and, by extending the time period over which investment experience is recognized as current income (or loss), tends to smooth the impact of investment gains or losses on the accounts and reserves of the Fixed Fund. The October 1, 2003, valuation measured ASLCC assets valued at fair market value rather than the smoothed actuarial value in order to determine the total amount of program liabilities that would have to be liquidated. That is, a proportionate share of the deferred market losses from the last three years that have accumulated in the MRA were fully recognized in the program's asset value. These asset losses increased the program's UAAL by approximately $180 million.

Second, a premium holiday, authorized under 2001 Wisconsin Act 109 (the 2001-03 budget adjustment act), suspended state employer payroll contributions for the ASLCC program and the supplemental program for the period May 1, 2002, through June 30, 2003. (Agencies budgeted contribution amounts were instead lapsed or transferred to the general fund.) This provision had the effect of reducing ASLCC program assets and increasing the program's UAAL by approximately $30 million to recognize the impact of that portion of the contribution holiday period from January 1, 2003, to June 30, 2003.

Third, the changes in assets and liabilities for the program for the period December 31, 2002, to October 1, 2003, were estimated. ETF indicates that the actuary did not perform an entirely new valuation for this period, but utilized asset reports provided by ETF and assumed that liabilities would increase at an annual rate of 12%. This asset and liability reestimate had the effect of increasing the UAAL by approximately $35 million.

As a result of the reevaluation of the ALSCC liability, DOA or the Building Commission do not have sufficient bonding authority to pay off the entire liability balance for that program. After applying the residual bonding authority related to the unfunded WRS liability, DOA estimates that $150 million in additional bonding authority is needed to completely liquidate the ASLCC unfunded liability.

SUMMARY OF BILL

Assembly Bill 611 would increase the current law revenue obligation or appropriation obligation bonding authority to liquidate the state's unfunded WRS and ASLCC program liabilities by $150 million. As a result, a total of $1.5 billion in bonding authority would be provided to liquidate both the state's portion of the unfunded pension system liability and the ASLCC unfunded liability.

Under current law, an appropriation obligation is an undertaking by the state to repay a certain amount of borrowed money that is payable from moneys annually appropriated by law for

debt service due with respect to such undertaking in that year. The bill would modify the definition to also include: (a) money payable from the proceeds of sale of pension liability and ASLCC appropriation obligations; (b) payments received under agreements and ancillary arrangements related the obligators; and (c) investment earnings on the obligation proceeds, and agreements and arrangements related to those obligations.

The bill would delete the Act 33 requirement that any payments made or received pursuant to any agreement or ancillary arrangement to the appropriation obligations issued are required to be made from or deposited into a program revenue appropriation account within the general fund. Rather these payments or deposits would be made as provided in any agreements or ancillary arrangements related to the appropriation obligations. The bill would also create a continuing program revenue appropriation for all moneys received as payments to the state under these agreements and arrangements to pay debt service on appropriation obligations and for the other purposes for which such agreements and arrangements were entered into, as determined by DOA.

The bill would modify the allowable use of the GPR appropriation created under Act 33 for the payment of debt service on the appropriation obligation bonds to also include any payments associated with any agreements or ancillary arrangements, deposits to reserve funds, and administrative and issuance expenses associated with the obligations.

The bill would specify that the program revenue appropriation created under Act 33 for the receipt of appropriation obligation bonds would be a continuing appropriation that would also receive any earnings on the proceeds or other moneys deposited to the appropriation. In addition, the bill would modify the allowable use of moneys deposited to the appropriation to include any payment of interest on the appropriation obligations and the redemption price of refunded obligations.

In addition, the bill would extend the state's moral obligation pledge to make timely appropriation of moneys sufficient to pay the principal and interest costs on appropriation obligation bonds to also include any payments associated with any agreements or ancillary arrangements, deposits to reserve funds, and administrative and issuance expenses associated with the obligations.

FISCAL EFFECT

The current state employer contribution requirement for the ASLCC (including the supplemental program) is 3.0% of payroll. If the entire UAAL amount relating to the ASLCC is paid off through the issuance of bonds for $782.4 million, the employer contribution rate could be decreased to the current year normal cost of the program, about 1.9% of payroll. Alternatively, if the state does not have sufficient bonding authority to pay off the entire ASLCC liability, any remaining balance would have to continue to be paid by state agencies in the current and future biennia. Under the current amortization period for liquidating the UAAL (23 years), the employer contribution level for the ASLCC would total approximately 2.1% (covering the normal program

cost and the estimated remaining UAAL balance), if the bill is not enacted. The additional contribution amount (0.2% of payroll) would impact the general fund balance in the biennium by reducing the amounts that otherwise would lapse to the general fund from state general operations appropriations in each year. DOA's fiscal estimate to the bill indicates that the additional $150 million in bonding authority, by allowing the state to entirely pay off its ASLCC liability, will allow the state to avoid the estimated $12.2 million in ASLCC contributions that would have to be made from non-federal state appropriations in the biennium. As a result, the entire amount estimated to lapse to the general fund in Act 33 related to the payoff of these liabilities would continue to lapse to the general fund because of the additional bonding authorized under the bill.

Similar to the $1.35 billion of bonding authorized in Act 33, the debt service on the additional $150 million in obligations bonds would be paid from certain state excise tax revenues if revenue obligation bonds are issued or from state GPR appropriations if appropriation obligation bonds are issued. According to DOA Capital Finance officials, no debt service payments would be made on the bonds in the 2003-05 biennium. While the debt service on the obligation bonds will be repaid with either general fund revenues or the appropriation of general fund moneys, each program revenue and segregated fund revenue would be required to lapse funds to the general fund so as to reimburse the general fund for debt service payments on the bonds issued to pay off the program revenue and segregated fund portions of the pension and ASLCC liabilities. In addition, while each fund type will effectively be making debt service payments on the bonds needed to fully liquidate the liabilities, it is currently estimated that the debt service costs will be entirely offset by the interest savings generated by paying off the liabilities and by the state no longer having to make unfunded liability payments to the WRS from state operations appropriations.

DOA Capital Finance officials indicate that the proposed statutory changes under the bill would allow the state to enter into certain variable rate financing agreements and arrangements related to the pension obligations that could result in additional interest savings to the state over the life of the transaction.

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