

UNTAPPED RESOURCES MAY HELP FUND PENSION AND INFRASTRUCTURE SHORTFALLS

Public Finance

Research

In the course of providing public services, state and local governments have accumulated substantial assets over time in the form of land, facilities, and enterprises. These resources are generally recognized at values substantially less than full value on the government's financial statements. There have been several recent examples of states using the value inherent in the assets or entities they control in novel ways to finance critical needs such as reducing unfunded pension liabilities or funding infrastructure. However, the valuation of such assets presents challenges. Many tend to be illiquid and have non-standard investment characteristics. If the ultimate valuation is not well understood, the nature and benefits of a program will not be clear cut. Furthermore, difficult choices will be required. Although such assets may be substantial, they are not unlimited. Those untapped resources used to fund pension shortfalls will not be available to finance infrastructure improvements, and vice versa. With these issues in mind, Kroll Bond Rating Agency (KBRA) believes untapped assets could potentially bring many billions of dollars of funding towards state and local governments infrastructure and pension needs.

The ability to unlock these resources to finance public needs can be credit positives depending upon how they are used. There are three broad issues that KBRA sees that could have credit implications as such ideas are explored:

1. An asset transfer program should be part of a well-considered, efficient, long-term plan. Contributing assets that are illiquid or that do not generate cashflow to pension funds may improve some arbitrary ratios, but in our opinion, these kinds of transfers are not likely to improve fundamental credit characteristics. Management could do better by contributing assets that generate cash flow, and/or are expected to appreciate and then can be liquidated in the future.
2. Since the use of such an asset is a one-time, non-recurring event, we believe it is important that it be used to finance long-term needs such as infrastructure or unfunded pension liabilities. Liquidating fixed assets to finance short term or operating expenses would be problematic from a credit perspective.
3. KBRA believes that it is critical that public entities better manage the underlying imbalances that led to the underfunded problem in the first instance. For example, contributing assets to pension funds without pension reform that puts annual funding on a firmer footing will only lead to a recurrence of the deficits in the future.

KBRA examines two examples below of New Jersey and Connecticut. In the New Jersey case, the state contributed its lottery enterprise to its pension funds for a period of 30 years. Connecticut is considering a plan to use public assets such as state-owned real estate or its statewide lottery system to fund pension liabilities. In light of the substantial shortfalls in infrastructure and pension funding needs, KBRA expects to see additional initiatives of this type in the future. As more such transactions are accomplished, the analysis and understanding of the costs and benefits should deepen.

New Jersey Funds Pensions with Lottery Receipts

In 2017, New Jersey contributed its lottery enterprise to three of its pension funds for a period of 30 years. The New Jersey state lottery was established by statute and administers and sells a variety of lottery games within the state in a monopolistic system controlled by the state. After the distribution of winnings and operating expenses, the lottery enterprise realizes annual net revenues of about \$1 billion. All lottery enterprise net revenues will be retained in the pension funds over the 30-year period. The net revenues are forecast by the state to grow over this period in the range of the low single digits per annum. The valuation of the lottery enterprise for the full 30-year period at the time of the contribution was \$13.5 billion. This amount represented 7.3X the pension contribution the state funded in the prior year. In addition, it significantly increased the funded ratio of the state's pension funds from 45% to 59%.

Among the challenges faced by the state was determining an appropriate fair value for the contribution of the lottery enterprise. Prior to the transfer, the lottery enterprise was not carried at fair value in the state's financial statement. The valuation method used for the transfer was a discounted cash flow analysis. Other methods, such as the valuation of comparable private enterprises and an assessment of the price for a potential sale of the lottery enterprise, were found to be not suitable because of the lottery's government ownership, monopoly position, and the legal prohibitions against selling the entity.

Under Governmental Accounting Standards Board (GASB) principles, an increase in value cannot be recognized when the asset is being transferred from one state controlled entity to another. However, the lottery contribution is recognized at the full value of \$13.5 billion in the actuarial statements of the pension funds. In light of this discrepancy, some observers discounted the benefit of the contribution.

Connecticut Considers Depositing State Assets in Pension Funds

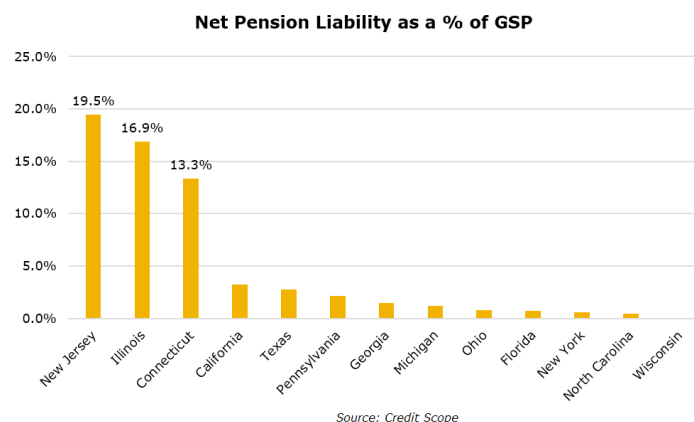
The state of Connecticut established the 13-member Pension Sustainability Commission to examine ways to increase funding to the state's pension system. The pension fund for state employees is only 32% funded and the teacher's system is 52% funded. The Commission will consider contributing state-owned real estate or perhaps the CT State Lottery to its pension system. The Commission is scheduled to submit its finding to the state legislature by January 1, 2019. Whatever means the state may choose, among the challenges will be the valuation of the assets that could be contributed to the pension funds.

Largest State and City Unfunded Pension Liabilities

As a backdrop that illustrates the scope of one of the critical needs discussed, unfunded pensions, the figure to the right presents net pension liability as a percent of gross state product for a select group of states.

Conclusion

KBRA expects to see an increased interest of states and their instrumentalities in using state and local assets to finance capital and other critical needs. As these plans are implemented, it will be important that they are thoughtfully used for long term purposes and the underlying causes of the current shortfalls are better managed going forward.



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