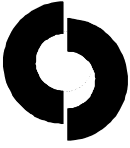

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

Interpretive Letter #791
August 1997
12 U.S.C. 24(7), Part 1

July 10, 1997

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Dear [ ]:

This is in response to your letter seeking a legal opinion regarding the risk-based capital requirements for State of New Jersey State Pension Funding Bonds ("Bonds"). We conclude that the Bonds would qualify as Type I securities under the OCC's investment securities regulation. The Bonds therefore would qualify for a 20 percent risk-weight under the OCC's risk-based capital regulation.

Background

The New Jersey Economic Development Authority ("Authority") is issuing the Bonds pursuant to the recently enacted New Jersey Pension Bond Financing Act ("Act") to fund a portion of New Jersey's current unfunded accrued liability for certain state pension funds and retirement systems. Prior to enactment of the Act, New Jersey was required to make annual payments to the retirement systems, with the specific amounts actuarially determined and governed by state statutes. Under those state statutes, New Jersey made three types of annual contributions to fund the state's obligations under its pension and retirement systems: an annual contribution, a contribution to cover the medical costs of retirees, and the "unfunded accrued liability contribution" representing pension benefits earned in prior years that, based on standard actuarial practices, are not yet fully funded.[1]

The Act would replace the actuarially determined liability schedule for the unfunded accrued liability with a series of required payments made by the State Treasurer ("Treasurer"). The Act states that "[i]t is in the public interest to fund this unfunded accrued liability, in full or in part, through the issuance of bonds, notes or other obligations by the New Jersey Economic

[1]In its fiscal 1997 appropriations act, New Jersey has determined to contribute $628.5 million per year to its pension and retirement systems.

Development Authority *which shall be retired through annual payments to be made by the State*, subject to appropriation by the State Legislature." (emphasis added). New Jersey will continue to make the "annual contribution" and the contribution to cover the medical costs of retirees based on existing statutory requirements.

The Bonds are limited obligations of the Authority, payable from revenues appropriated by the Treasurer under a contract between the Authority and the Treasurer ("Contract"). Although the Authority has no taxing power, the Contract would provide that the Treasurer shall pay from New Jersey's general fund directly to the Bonds' trustee prior to or on each payment date an amount sufficient to meet the principal and interest servicing costs on the Bonds for that period. Under the Contract, the Treasurer would be required to request that the governor in each fiscal year include in the state budget message an appropriation of all amounts sufficient to service the Bonds and payable from New Jersey's general fund. The Treasurer would inform the Bonds' trustee and the Authority of any failure to request the full amount contemplated by the Contract. If the appropriate appropriation is not made, the Treasurer would be required to ask the governor for a supplemental appropriation until New Jersey appropriated all funds due under the Contract. The state legislature would have no legal obligation to make such appropriations. You note that New Jersey has $4 billion in outstanding bonds payable through similar contractual arrangements with the Treasurer, including notes issued by the Transportation Trust Fund, the Economic Recovery Fund, and the Sports and Expositions Authority. The state has used such arrangements for 20 years and the State Legislature always has appropriated funds sufficient to service those notes.

You state that, because debt service on the Bonds essentially replaces the payments New Jersey currently is required to make with respect to the unfunded accrued liability pursuant to the relevant statutes, the Bonds constitute a general obligation of New Jersey and therefore entitled to a 20 percent risk-weight under the federal banking agencies' risk-based capital guidelines.

Law

National banks may purchase investment securities for their own account "under such limitations and restrictions as the Comptroller of the Currency may by regulation provide." 12 U.S.C. § 24(Seventh). Section 24(Seventh) states that the limitations on bank purchases of securities do not apply to "general obligations of any State or political subdivision thereof." *Id.* OCC regulations implementing section 24(Seventh) define "Type I" securities as "[g]eneral obligations of a State of the United States or any political subdivision." 12 C.F.R. § 1.2(I). The OCC further defines "general obligation of a State or political subdivision" to include:

> An obligation payable from a special fund or by an obligor not possessing general powers of taxation, when an obligor possessing general powers of taxation, including property taxation, has unconditionally promised to make payments into the fund or otherwise provide funds to cover all required payments on the obligation.

Id. at § 1.2(b)(2).

A national bank may demonstrate the indirect commitment of full faith and credit by a state through the existence of a statutory provision or agreement that unconditionally commits the State or the political subdivision to provide funds that, together with other available funds, are sufficient for the timely payment of interest on, and principal of, the obligation. Such funds may be in the form of annual grants or advanced whenever the other available revenues are not sufficient for the payment of principal and interest. *Id.* at § 1.100(b)(4). In addition, the OCC considers an obligation to be supported by the full faith and credit of a state or political subdivision when the promise or other commitment of the state or political subdivision will produce funds which, together with other funds available for that purpose, will be sufficient to provide for all required payments on the obligation. *Id.* at § 1.110(a). A national bank may consider an obligation expressly or implicitly dependent on voter or legislative authorization of appropriations as supported by a state's or political subdivision's full faith and credit if it determines, on the basis of past actions by the voters or legislative body in similar situations involving similar projects, that it is reasonably probable that the obligor will obtain all necessary appropriations. *Id.*

The OCC has concluded that "appropriations clauses" -- clauses stating that certain payments that are either statutory or contractual obligations require appropriation by a legislature -- do not prevent the conclusion that an obligation is supported by the full faith and credit of a state or political subdivision thereof. The bank must determine, on the basis of past actions by the voters or legislative body in similar situations involving similar projects, that "it is reasonably probable that the obligor will obtain all necessary appropriations." *See* Interpretive Letter No. 675 (March 15, 1995), *reprinted in* [1994 - 1995 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 83,623.

The OCC also has concluded that, where a state treasurer is obligated to commit on behalf of a state to deposit sufficient money from the state's general revenue fund into a note service fund to pay principal and interest on a bond, the bond should be considered a general obligation since an unconditional promise by the state to make such payments exists. *See* Letter from William B. Glidden, Assistant Director (August 16, 1988) (unpublished) ("Glidden Letter").

OCC risk-based capital regulations contain four risk weights for national bank assets and off-balance sheet items, ranging from zero to 100 percent. *See* 12 C.F.R. Part 3, Appendix A, Section 3. The 20 percent risk-weight category includes "claims representing general obligations of any public-sector entity in an OECD country, and that portion of any claims guaranteed by any such public sector entity. In the U.S., these obligations must meet the requirements of 12 CFR [1.2(b)]." *Id.* at section 3(a)(2)(ix). In contrast, revenue obligations of a public-sector entity in an OECD country that are repayable "solely from the revenues generated by the project financed through the issuance of the obligations" receive a 50 percent risk-weight. *Id.* at section 3(a)(3)(i).

Discussion

The Bonds qualify as Type I securities, and, therefore, should be subject to a 20 percent risk-weight. In this instance, an obligor with general powers of taxation has committed to provide funds that cover all required payments on an obligation, as Part 1 requires. *See* 12 C.F.R. § 1.2(b)(2). The proposed Contract between the Treasurer and the Authority contemplates that New Jersey will appropriate sufficient revenues to cover service on the Bonds. The Contract commits the Treasurer to obtaining funds through the appropriations process from the state's general fund to support the Bonds and New Jersey's obligations to its pension and retirement systems. The Authority, an entity without taxing powers, will service the Bonds with funds appropriated by the State, pursuant to the Contract. The OCC previously has stated that a state treasurer's commitment to deposit funds from a state's general fund to support the servicing of bonds should render such notes general obligations under Part 1. *See* Glidden Letter, *supra*. The facts in the instant situation are similar to those outlined in the Glidden Letter. In both situations, the state treasurer has committed to transfer funds from a state's general fund to service the bonds, subject to legislative appropriation.

The existence of an "appropriations clause", whereby the funds to service the Bonds are dependent on the State's appropriation process, does not bar the conclusion that the Bonds are Type I securities, even though there is no guarantee that the legislature in fact will appropriate the necessary funds in a timely manner. *See* Interpretive Letter No. 675, *supra*. Part 1 states that a statutory provision or agreement that unconditionally commits the state to provide funds that, together with other available funds, are sufficient to ensure timely payments on the obligation, constitutes a full faith and credit obligation of that state. Such funds can be in the form of annual grants. 12 C.F.R. § 1.100(b)(4). The recent passage of the Act strongly suggests that New Jersey has made a commitment to channel the necessary funds to the Authority to service the Bonds. The Treasurer's commitment to pursue the necessary appropriation of funds constitutes the type of "statutory provision or agreement" envisioned by section 1.100(b)(4). The Contract obligates the Treasurer to seek the necessary funding and the historical record demonstrates that New Jersey has always made available the necessary appropriations.

Part 1 also states that national banks may consider past actions by voters or a legislative body to support the determination that the Bonds are supported by the full faith and credit of New Jersey and thus qualify as Type I securities. *See* 12 C.F.R. § 1.110(a) and Interpretive Letter No. 675, *supra*. In this instance, national banks may look to the recent passage of the Act as evidence that New Jersey will make available the necessary funds to service the Bonds and therefore provide the necessary state support for New Jersey's pension and retirement systems. The Act represents a mechanism for ensuring continued state support of New Jersey's pension and retirement systems. The state has never defaulted on its obligations to its pension and retirement plans and the executive and legislative branches of the state worked to ensure passage of the Act and are aware of its provisions and requirements. Finally, New Jersey has issued similar notes over the past 20 years involving contractual arrangements between the

Treasurer and the issuer of such notes that establish a commitment by the Treasurer to seek appropriations from the State Legislature. New Jersey has always honored its commitment on such instruments. Thus, national banks would have a reasonable basis for concluding that New Jersey will meet its obligations on the Bonds in the instant case.

Because the Bonds would meet the requirements under 12 C.F.R. § 1.2(b)(2) for a general obligation of a state or political subdivision, they would qualify for a 20 percent risk-weight under the OCC's risk-based capital regulations. The Bonds are "obligations of any public sector entity in an OECD country", since the Authority constitutes an entity established by New Jersey and the Bonds ultimately are supported by payments from the state's general revenues.

Conclusion

National banks may purchase the Bonds as Type I securities and should treat them as having a 20 percent risk-weight under Part 3. The OCC does not endorse specific investments and this letter should not be used in a manner that suggests otherwise. If you have any questions, please do not hesitate to contact me at (202) 874-5210.

Sincerely,

/s/

Lee Walzer
Senior Attorney
Securities and Corporate Practices Division