

NAPPA 2015 Legal Education Conference

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Federal Legislative Update

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The State of Public Pensions

- The “Wilshire 2015 Report on State Retirement Systems: Funding Levels and Asset Allocation” found that the funding ratio for the 131 state defined benefit retirement systems covered in its study was 80 percent in 2014, up from 74 percent in 2013.
- Despite the fact that the 2008-09 market decline reduced public pension asset values by 25 percent, they were once again above their 2007 peak by 2013 (NASRA), and as of 9/30/2014, state and local retirement trusts held \$3.7 trillion in assets. (Fed. Reserve)

The State of Public Pensions

- This remarkable comeback has been accomplished at the same time that public plans distributed more than \$1 trillion in benefits to more than eight million retirees and their survivors, and required, on a nationwide basis, only 3.9 percent of all state and local direct general spending in order to do so. (U.S. Bureau of the Census)

The State of Public Pensions

- Despite sharp declines in capital markets in 2000-02 and again in 2008-09 -- with accompanying economic recessions that caused required pension contributions to rise significantly at the same time that the ability of states and local governments to respond was severely challenged – public plans received an average of 89 percent of their annual required contributions (ARCs) during the FY 2001-2013 period. Only six states — New Jersey, Pennsylvania, Washington, North Dakota, Kansas, and Colorado — averaged less than 75 percent, while half the plans got 95 percent of their ARCs. (NASRA)

The State of Public Pensions

- More than one half of the 126 plans in the Public Fund Survey have reduced their investment return assumption since FY2008; the median is 7.75 percent. (NASRA)
- Since 2009, 36 states have increased required employee contribution rates. (NASRA)

The State of Public Pensions

- In September, 2014, Moody's claimed that the 25 largest U.S. public pensions face about \$2 trillion in unfunded liabilities. However, over the next 30 years, total US economic activity will be more than \$750 trillion, assuming 2.5 percent average annual growth in real GDP. "Split it up over 30 years and the alleged pension shortfall comes to \$67 billion a year or about 0.26 percent of GDP." (Ryan Chittum, former *Wall Street Journal* reporter and deputy editor of the *Columbia Journalism Review's* business section.)

The State of Public Pensions

- In April, 2014, the Pew Charitable Trusts reported that state pensions had incurred unfunded liabilities of \$915 billion based on 2012 data. But looked at another way, this shortfall is equal to approximately 0.2 percent of projected GDP over the next thirty years, the period over which the shortfall would have to be filled; alternatively, it is equal to about 2.0 percent of projected state and local tax revenues over this same period. (Dean Baker, co-founder of the Center for Economic and Policy Research)

So What's the Problem?

The Public Pension Debate

“Putting it in context”

- Who?
- What?
- Why?

Who?

- Ancient History: Grover Norquist
- Conservatives/anti-union; anti big government
- Big business – US Chamber of Commerce; Business Roundtable
- Politics: American Legislative Exchange Council (ALEC)
- Big money: Koch brothers; Laura and John Arnold

What?

- Convert Social Security to individual accounts
- Financial economics
- Switch corporate America to DC plans
- The “new” philanthropy: grants as investments; buying credibility
- Convert public sector DB plans to DC plans, cash balance plans

Why?

- Stop “corporate governance” interference
- Take power away from unions; “downsize” government
- Justify corporate America’s abandonment of DB pensions
- Divert attention from national retirement crisis
- “The only people making money off of DB plans are the participants”

So how does Washington fit into all of this?

- “Air cover” for the real action taking place at the state level
- Diversion: the problem is public pensions, not Social Security, national retirement crisis, income inequality
- Justification for changes in retirement savings incentives for budgetary reasons, not retirement policy
- Reason to change municipal finance mode;
- Money and politics: you scratch my back, I’ll scratch yours

Danger Ahead for Public Pension Plans

- The new Congress: GOP control.
- Offsets to “pay for” any future debt limit increase or other budget balancing efforts.
- Tax reforms affecting retirement savings.
- “Must-do” legislation always an invitation to mischief.

Pensions as Revenue Offsets?

- Mandatory Social Security: \$81 billion over 10 years.
- Consolidate and cap tax-deferred contributions to DC plans to lower of \$20,000 or 20% of income: \$45.9 billion/10 years. New CBO option: \$15,500 cap, regardless of age, and overall employer/employee limit of \$46,000/yr raises \$89 billion over 10 yrs.
- Cap at 28 percent (joint filers with \$250,000-plus in income) the rate at which deductions and exclusions related to DC retirement savings reduce a taxpayer's income tax liability (i.e., the 39.6% tax bracket would pay an 11.6% tax on DC contributions): \$7.5 billion/yr. (\$529 billion/10 yrs if applied to all itemized deductions.)
- Repeal Employer Pick-Up: \$4.8 Billion/10 years (2005 estimate).
- Limit total amount individual can save for retirement in tax-favored settings to amount necessary to provide annual benefit of \$205,000 at age 62, or about \$3 million: \$9 billion over 10 years.

Tax Reform Tax Expenditures

- ✓ Losses to the Feds from granting certain deductions, exemptions, deferrals, credits: \$1.3 trillion for 2013.
- ✓ Of this \$1.3 trillion loss, \$1.1 trillion alone is from individuals; for comparison, there will be only \$1.2 trillion raised from the overall individual income tax in 2013.

	<u>2012-16</u>	<u>2013-17</u>
Employer-provided health care	\$706.6 billion	\$760.4 billion
Retirement security incentives	\$654.3 billion	\$714 billion
Home mortgage interest deduct.	\$364 billion	\$379 billion

- ✓ 2012-16: DB plans amount to \$198.9 billion; DC plans are \$306.4 billion.

Pensions and Tax Reform

- Suspension of inflation adjustments for the maximum benefit under DB plan, maximum combined contribution by an employer and employee to DC plan until 2024.
- Coordination of contribution limitations for 403(b) plans and governmental 457(b) plans: removes special contribution limits and simply applies section 401(k) contribution limits across the board (\$17,500 plus \$5,500 “catch-up for those over age 50). Total employer and employee contributions cannot exceed \$52,000 for 2014.
- Application of 10-percent early distribution tax to governmental 457 plans.
- Reduction in minimum age for allowable in-service distributions to age 59½ from age 62.

Pensions and Tax Reform – Big Deals

- Certain tax preferences denied to those in 35 percent tax bracket, including employer contributions to DC plans to the extent excluded from gross income; described as a 10% “surtax” that will be computed by taking the taxpayer’s adjusted gross income, adding back the expenses related to the excluded preferences, and then multiplying the sum by 10%.
- Unrelated business income tax (UBIT) to apply to public pensions: income from a trade or business that is not substantially related to the performance of an organization’s tax-exempt functions would be taxed at highest corporate rate. Why is it there? Only raises \$100 million over 10 years!

Tax Reform – Is it for Real?

- Probably nothing major until after 2016 elections.
- Items on the table, scored—always a potential problem.
- Senate Finance Chair Hatch – his motivations.
- House Ways and Means Chair Ryan – his priorities.

Possible Pension Add-on's
Public Employee Pension Transparency Act
PEPTA

- ✓ HR 1628 (Nunes, Ryan, Issa); S 779 (Burr).
- ✓ Plan sponsors to report funding info annually to Treasury using market value of liabilities (MVL), no asset smoothing.
- ✓ “Voluntary,” but failure to report would lose sponsor the Federal tax-exempt treatment of muni bonds.
- ✓ Prohibits Federal bail-out of public pension debt.
- ✓ Fewer cosponsors: 10 in House, 2 in Senate; no hearings.
- ✓ In 2012, attempt to use legislation fixing interest rate subsidy for Stafford loans as a vehicle for PEPTA.

Possible Pension Add-on's

Secure Annuities for Employee (SAFE) Retirement Act

- ✓ Hatch would create new “replacement” DB pension plan called an “Annuity Accumulation Retirement Plan”; no cosponsors. But Hatch is pushing hard to find a Dem.
- ✓ Permissive: State and local governments could purchase fixed annuity contracts from insurance companies for each employee every year during their working career. Life insurance industry would pay the pensions and bear all the investment risk.
- ✓ Hatch claims bill would eliminate pension plan underfunding prospectively, while delivering lifetime retirement income.
- ✓ Protects retirement benefits from being cut in a bankruptcy.
- ✓ Vows to add to any bill with tax provisions that is moving.

Problems with Hatch Annuity Bill

- Existing DB plans would remain as closed plans, so costs would increase; doesn't address existing UAAL.
- Unsure level of income replacement; research suggests that Hatch's SAFE income replacement is significantly lower than current DB systems.
- No requirement that once begun, annual purchase of annuities must continue or be consistent; employees will have no way to plan for retirement.
- State insurance guaranty programs vary widely; are NOT pre-funded.
- Practical concerns of elderly potentially keeping up with dozens of individual annuity checks each month.
- No survivor and disability benefits.
- Once one state decides to try it, others are likely to follow.

Other Federal Legislative Issues

- Mandatory Social Security
- GPO/WEF Reform
- Investment issues

2014 Regulatory Issues

Treasury: Normal Retirement Age Regulations

- ✓ Released in final form in 2007, but application to governmental plans extended several times.
- ✓ Problems with use of service in defining the time when employee was eligible for unreduced benefit.
- ✓ Safe harbors in regs were unworkable for public plans.
- ✓ 2012 notice of intent to amend regs for public plans, with focus on in-service distributions before age 62.
- ✓ What about return-to-work? Part time work? DROPS?
- ✓ Devil will be in the detail of the new regulations.

Treasury: Definition of Governmental Plan

- ✓ **BIG DEAL!** Governmental plans exempt from reporting, participation, vesting, and fiduciary standards of ERISA.
- ✓ ANPRM issued 11/8/2011; no actual proposed regs yet, but new charter school regs -- back on the front burner?
- ✓ 5 “main” factors (Control of Governing Body; Public Election of Governing Body; Fiscal Responsibility; Treatment of Employees as Public Employees; Delegated Sovereign Powers.
- ✓ Eight “other” factors: Operational Control; Direct Funding; Specific Enabling Law; Treatment as Govt Entity for Fed Tax Purposes; Treatment Under State Law; Court Decisions; No Private Interest; Serves a Governmental Purpose.

Treasury: Individual Elections/Pick-Up Rule

- ✓ Orange County, San Jose PLR's on individual elections into new tiers.
- ✓ Rev. Rul. 2006-42: Cash-or-deferred elections?
- ✓ Problems: impact on purchase of service credits; chill on reform flexibility; “cookie cutter” PLR.
- ✓ Sanchez bill (HR 205) would permit certain employer contributions as picked up even if the employee can make irrevocable election between two alternative benefit formulas involving the same or different levels of employee contributions.
- ✓ Unions split; Treasury undecided.
- ✓ CA initiative—the “nuclear option.”

Treasury: Office of State and Local Finance

- ✓ Treasury's liaison to state and municipal officials and associations:
 - monitor developments in municipal bond markets
 - support policies to improve the management of public pensions and other liabilities
 - develop “potential Federal policy responses to issues that emerge in municipal financing markets.”
- ✓ No authority to write and enforce rules and regulations.
- ✓ Kent Hiteshew, formerly with JPMorgan, is Director.
- ✓ Potential problems?

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- **SEC**
 - ✓ NJ, IL, KS settlements: Who's next?
 - ✓ Investing acumen of plans a growing issue; new pay-to-play allegations involving alternative investments.
- **GASB**
 - ✓ Employer implementation: communication issues.
 - ✓ Definition of Compensation problems.
 - ✓ OPEB next?

ARNOLD FOUNDATION

- \$1.4 billion in assets
- “Philosophy of Philanthropy”:
 - ✓ *Seek transformational change, not incremental change.*
 - ✓ *Think big, take risks and be aggressive and highly goal-oriented.*
 - ✓ *Seek to solve problems and better lives and institutions, not just study or illuminate problems.*
- Grants are “strategic investments”
- “The way to create a sound, sustainable and fair retirement savings program is to stop promising a benefit and instead promise an accrual or savings rate.”
- The DB model is “just a bad system”; “we can provide the protections for workers that we want in a simpler, better system,” namely DC or cash balance.

ARNOLD FOUNDATION

- \$4.85 million to Pew for pension project;
- \$1 million to Center for State and Local Government Excellence for pension database at Boston College;
- \$2.25 million to Novim “to support the development of a website and mobile application that will cover the major public sector pension plans in all 50 states”;
- \$748,000 to Bellwether for teacherpensions.org; tag line is “Fixing an Unfair and Insecure System”;
- \$3.5 million grant to WNET, the NYC affiliate of PBS;
- \$693,600 to George Mason Univ. for judicial symposia on pension reform; new grant of \$1.8 million for law pros workshop
- \$1 million grant to Reason Foundation for pension reform handbook; assistance to reformers at no charge;

New George Mason Law and Economics Center Law School Professors Workshop

- “[T]o introduce law professors to the looming financial and structural crises facing state pensions systems across the nation in order to improve their research and teaching.”
- Tuition free; room and board paid; \$2,000 “honorarium”
- September 17 - September 20, 2015; Westin Palo Alto Hotel in in Palo Alto, California (adjacent to Stanford)
- Professors Joshua Rauh (Stanford), Robert Pozen (Harvard Business School)

What can be done?

Questions?