BILL NUMBER: H.R. 1628 (Nunes) as introduced April 18, 2013
S. 779 (Burr) as introduced April 23, 2013

SUMMARY

H.R. 1628 and S. 779 require state and local government employee pension plan sponsors to report their respective financial data to the U.S. Secretary of the Treasury each plan year beginning on or after January 1, 2014, utilizing existing valuation methods and calculation assumptions, as well as alternative methods and assumptions prescribed by the Secretary, including use of a "risk free rate of return" to discount plan liabilities. Failure to comply with the reporting requirements will result in the forfeiture of federal tax benefits to bonds issued by the state or political subdivisions for which the plan provides benefits until noncompliance is remedied.

In addition, H.R. 1628 and S. 779 direct the U.S. Secretary of the Treasury to create and maintain a public website to post the information received from the reporting plans and specifies that the U.S. government will not be liable for obligations related to current or future shortfalls in state or local government employee pension plans.

BOARD POSITION

Oppose. The creation of financial reports that utilize alternative valuation methods and calculation assumptions will add confusion and potentially compromise decision-making for members, retirees, other CalSTRS stakeholders and the general public by providing a misleading picture of plan funding status when compared to financial reporting already being done in accordance with existing governmental accounting and legal standards. In addition, substantive and expensive changes will be needed to the technological systems that support accelerated employer reporting to CalSTRS.

REASON FOR THE BILL

The financial status of state or local government employee pension plans and the extent to which these plans are underfunded is asserted by the legislation's sponsors to be obscured by opaque and deceptive governmental accounting practices, resulting in the perceived misstatement of plan asset values and understatement of plan liabilities. Sponsors feel this legislation will require enhanced transparency for state and local pension plans while prohibiting the federal government from bailing out those systems.

ANALYSIS:

Existing Law:

Congress has the authority pursuant to clauses 1 and 3 of Section 8 of Article 1 of the Constitution of the United States to levy taxes. This authority includes the ability to establish conditions upon which special federal tax benefits are granted, including certain specified tax benefits for state and local government employee pension benefit plans. The Internal Revenue Code (IRC) is the body of law that codifies all federal tax laws, including specified federal tax benefits. Bonds issued by a state or any of its political subdivisions are generally exempt from federal income tax.

This Bill:

H.R. 1628 and S. 779 require a state or local government employee pension plan sponsor to file a report to the U.S. Secretary of the Treasury each plan year beginning on or after January 1, 2014, and no later than 210 days after the end of the plan year that includes statements on:

- The schedule of funding status, including plan assets, current liabilities and the net unfunded liability.
- The schedule of contributions.
- Alternative projections of the cash flows associated with the current liability for each of the next 60 plan years utilizing assumptions and calculation methods specified by the Secretary to achieve comparability across plans.
- Actuarial assumptions, including the assumed rate of return on investments and other assumptions specified by the Secretary.
- The number of active and retired plan participants.
- Investment returns, including each of the five preceding plan years.
- The degree to, and manner in which, any unfunded liability will be eliminated and the extent to which the plan sponsor has followed the plan's funding policy for each of the five preceding plan years.
- The amount of pension obligation bonds outstanding.
- The current cost of the plan for the plan year.

Failure to comply with the reporting requirements will result in the forfeiture of federal tax benefits to bonds issued by the state or political subdivisions for which the plan provides benefits until noncompliance is remedied. Moreover, if a state or local government employee pension plan does not value assets utilizing fair market value, or does not calculate liabilities assuming a discount rate based on the U.S. Treasury Obligation Yield Curve, a supplemental report will be required reflecting these prescribed valuation methods and calculation assumptions. Finally, H.R. 1628 and S. 779 direct the U.S. Secretary of the Treasury to create and maintain a public website to post the information received from the reporting plans. Also, the proposed legislation specifies that the U.S. government will not be liable for obligations related to current or future shortfalls in state or local government employee pension plans.

The keystone of H.R. 1628 and S. 779 is the consequence if state or local pension plan sponsors do not comply with the financial reporting deadline and requirements—specifically, the forfeiture of federal tax benefits to bonds issued by the sponsor. Although CalSTRS does not issue bonds, a broader interpretation of the law could extend the federal tax benefit forfeiture to bonds issued by the State of California, seriously jeopardizing its ability to issue bonds.

Moreover, H.R. 1628 and S. 779 specify that reports to the U.S. Secretary of the Treasury must be submitted no later than 210 days after the plan year ends (June 30 for CalSTRS). This deadline would require CalSTRS to submit the required reports by approximately early February and represents a significant acceleration in the data collection, calculation and reporting process currently administered by CalSTRS. More specifically, employers currently are required to submit payroll information to CalSTRS within 45 days of the end of the pay period. For payroll periods ending June 30, the information must be submitted by mid-August. Following a review and validation of the data, the Annual Update process begins in September. Annual Update is the process that calculates each member's contributions, interest and service credit, and transfers funds in excess of 1.000 year of service credit for the year from members' Defined Benefit accounts to their Defined Benefit Supplement accounts. Actuarial valuation data are then generated a week after Annual Update, and the extracted data are manually validated before being transmitted to the consulting actuary for the actuarial valuation. The actuarial valuation is then completed and generally presented to the Teachers' Retirement Board in April. To comply with the 210-day deadline required by H.R. 1628 and S. 779, CalSTRS would have to accelerate its data collection and calculation process by several months; an endeavor that would require a significant and expensive overhaul of the technology and systems CalSTRS and its employers use for the reporting process.

In addition, the valuation and calculation assumptions specified by H.R. 1628 and S. 779 will create confusion for stakeholders and the general public when they attempt to evaluate the financial status of CalSTRS. The confusion will arise from the four different sets of numbers produced to describe the financial status of CalSTRS—the set adopted in the actuarial valuation, the set reported to the U.S. Secretary of the Treasury, and the potential sets generated under the new GASB requirements and Moody's approach (explained in more detail under Program Background.) For example, as it pertains to valuing assets, CalSTRS currently utilizes a three-year smoothing method, whereas H.R. 1628 and S. 779 stipulate that the fair market value method also be reported to the Secretary. As it pertains to calculating liabilities, CalSTRS currently assumes a rate of 7.5 percent to discount liabilities—a rate adopted by the board—whereas H.R. 1628 and S. 779 stipulate that the calculation of liabilities also assume a discount rate based on the U.S. Treasury Obligation Yield Curve. This requirement will artificially inflate plan liabilities by discounting them at the "risk free" rate of return on U.S. Treasury obligations, rather than the 7.5 percent return from a diversified investment portfolio utilized by CalSTRS. Valuing assets and calculating liabilities with varying methods and assumptions will yield starkly different results, particularly when applied to a portfolio the size of CalSTRS. CalSTRS' report to the Secretary will require assets be valued with two methods and liabilities be calculated assuming two discount rates, creating a source of confusion to interested parties as to the true financial status of the system. Should H.R. 1628 and S. 779 pass, ongoing communication will be needed for members, retirees, other CalSTRS stakeholders and the general public to clarify the differences in financial reporting.

LEGISLATIVE HISTORY

H.R. 567 (Nunes, 2011)/S. 347 (Burr, 2011) would have required the state or local government employee pension plan sponsor to file a report with the U.S. Secretary of the Treasury each plan year that includes, but is not limited to: a schedule of funding status; a schedule of contributions; alternative projections for annual contributions, asset values, liabilities, and the funding percentage for each of the next 20 plan years utilizing specified assumptions and calculation methods; and the manner in which any unfunded liability will be eliminated. Failure to comply with the reporting requirements would have resulted in the forfeiture of federal tax benefits to bonds issued by the state or political subdivisions for which the plan provides benefits until noncompliance is remedied. Also would have directed the Secretary to create and maintain a public website to post plan information required by this act. H.R. 567 died in the House Ways & Means Committee. S. 347 died in the Senate Finance Committee.

<u>H.R. 6484 (Nunes, 2010)</u> would have required the state or local government employee pension plan sponsor to file a report with the U.S. Secretary of the Treasury each plan year that includes, but is not limited to: a schedule of funding status; a schedule of contributions; alternative projections for annual contributions, asset values, liabilities, and the funding percentage for each of the next 20 plan years utilizing specified assumptions and calculation methods; and the manner in which any unfunded liability will be eliminated. Failure to comply with the reporting requirements would have resulted in the forfeiture of federal tax benefits to bonds issued by the state or political subdivisions for which the plan provides benefits until noncompliance is remedied. Also would have directed the Secretary to create and maintain a public website to post plan information required by this act. This measure died in the House Ways & Means Committee.

PROGRAM BACKGROUND

Discussion and skepticism over the financial health of state and local government employee pension plans persists as a topic of public debate. Increasingly dated studies by a small handful of academics that challenge and attempt to discredit the traditional methods by which public pension plans measure solvency continue to be cited to fuel the rhetoric, causing some lawmakers—under the guise of greater financial transparency—to propose legislation that mandates the calculation of plan funding status and liabilities using a “risk free” rate of return as the discount factor. This approach artificially inflates plan liabilities when compared to the accepted methods prescribed by the rigorous governmental accounting and legal standards already in place. H.R. 1628 and S. 779—which first emerged nearly identically as H.R. 567 and S. 347 in 2011, but died in committees—are each cited as *The Public Employee Pension Transparency Act*. Both bills purport to create an environment where all public pension plans can be evaluated using one-size-fits-all valuation methods and calculation assumptions, but those methods and assumptions seriously understate plan funding status by artificially inflating plan liabilities.

While transparency is the asserted rationale for H.R. 1628 and S. 779, data on CalSTRS funding status—determined using a range of alternative discount rates for valuing liabilities, contribution schedules, plan participants, historical investment returns and other required information specified by the proposed legislation are already reported within the annual actuarial valuations and audited financial statements generated by CalSTRS (prepared in accordance with accounting and financial reporting standards prescribed by the Governmental Accounting Standards Board).

Furthermore, in August 2012, GASB published new accounting standards—statements 67 and 68—that marked the most significant changes to the financial reporting of public pension plans in a generation. GASB 67 altered financial reporting for pension plans, while GASB 68 modified reporting requirements for plan employers subject to GASB standards. Under the new requirements, a government plan can discount pension liabilities using the expected rate of return on investments until it reaches a crossover point—the point when projected benefit payments for current employees and inactive employees exceeds the projected funding. If the crossover point is reached, benefit payments projected to be made from that point forward are to be discounted using a lower rate equal to the high-quality municipal bond interest rate. Although the new requirements are intended to improve the transparency, consistency and comparability of pension plan financial statements, they currently represent the potential for a second set of numbers associated with CalSTRS funding levels that members, retirees, other CalSTRS stakeholders and the general public will have to absorb and weigh as decision-useful information.

Moreover, in April 2013, Moody's Investor Services, a private firm that opines on the credit risk of debt obligations—but does not set standards or requirements for pension obligation funding or reporting—outlined its new approach to adjusting the pension assets and liabilities of state and local governments for the purpose of evaluating pension risk for independent credit ratings. Moody's cited a need to bring greater transparency and consistency to the analysis of pension liabilities as the impetus for its new approach. The four principal adjustments Moody's will make to as-reported pension data include allocating cost-sharing plan liabilities to specific governments based on their proportionate share of total plan contributions; discounting accrued actuarial liabilities using a high-grade long-term taxable bond index as of the actuarial valuation date; replacing asset smoothing with market values as of the actuarial valuation date; and amortizing the adjusted net pension liability over 20 years using a level-dollar method to create a measure of the annual burden related to the pension liability.

Moody's noted that the incorporation of these pension adjustments into its credit-rating methodology will have no immediate impact on state credit ratings—because of its self-proclaimed "strong" existing qualitative understanding of the pension-related credit pressures facing states—and estimated less than 2 percent of the total population of its general obligation and related ratings will be placed under review for possible downgrade. CalSTRS does not issue debt and does not seek guidance from Moody's on pension asset and liability reporting, but Moody's new approach toward adjusting state and local government pension obligations will have tangential effect on CalSTRS by introducing yet another set of numbers for plan funding available for public intake and comparison.

Currently, CalSTRS reports plan information annually to the State Controller's Office that includes, but is not limited to: plan membership, contributions, actuarial economic assumptions, amortization methods and funding progress. Moreover, California public employee retirement systems are required to furnish audited financial statements to the Controller on an annual basis. An actuarial valuation report for defined benefit plans must also be filed with the Controller at least every three years. The required reporting allows for periodic and independent analysis of the financial transactions of each public retirement system and allows the Controller to make comparisons between plans and evaluate their financial condition. The Controller, in turn, publishes an annual report that serves as a reference source for persons concerned with the status and adequacy of funding for public retirement systems in California.

Lastly, the proposed legislation declares that pension costs and the seeming lack of meaningful disclosure "constitute a serious threat to future economic health … and places an undue burden upon state and local government taxpayers." However, according to the National Association of State Retirement Administrators in May 2013, from 1980 to 2012, pension costs as a percentage of all state and local government spending ranged from 2 percent to 4.2 percent.

FISCAL IMPACT

Program Cost – None.

Administrative Costs/Savings – The mandated federal reporting deadline of 210 days from plan year end will require CalSTRS to accelerate the reporting requirements from employers, resulting in a significant and expensive overhaul of the technology and systems that support the reporting. Other costs associated with reporting and communicating the required information are expected to be minor.

SUPPORT

American Conservative Union
Americans for Limited Government
Americans for Prosperity
Americans for Tax Reform
Council for Citizens Against Government Waste
Free Enterprise Nation
National Federation of Independent Businesses
National Taxpayers Union
U.S. Chamber of Commerce

OPPOSITION

American Federation of State, County and Municipal Employees
American Federation of Teachers
Fraternal Order of Police
Government Finance Officers Association
International Association of Fire Fighters
International City/County Management Association
International Public Management Association for Human Resources
National Association of Counties
National Association of Police Organizations
National Association of State Auditors, Comptrollers and Treasurers
National Association of State Retirement Administrators
National Conference on Public Employee Retirement Systems
National Conference of State Legislatures
National Conference of State Social Security Administrators
National Council on Teachers Retirement
National Education Association
National League of Cities
National Public Employer Labor Relations Association
National School Boards Association
Service Employees International Union
U.S. Conference of Mayors

ARGUMENTS

Pro: Assumed comparability of the financial health of sponsors amongst all plans.

Con: Potentially major cost for reporting entities to overhaul the reporting systems of employers so as to accelerate the data collection by CalSTRS at plan year end to comply with the mandated federal reporting deadline.

Financial reporting under alternative methods and assumptions presents excessive financial data that can be confusing and lead to erroneous conclusions about the true funding status of the plan when compared to financial reporting already being done in accordance with existing accounting and legal standards.

Counterproductive federal intrusion on governmental plan funding, which heretofore has not been subject to federal mandates and regulation.

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