BILL NUMBER: H.R. 4822 (Nunes) as introduced March 21, 2016

SUMMARY

H.R. 4822 requires the state or local government employee pension plan sponsor to report to the U.S. Treasury Secretary each plan year beginning on or after January 1, 2017, specified information using the U.S. Treasury Obligation Yield Curve—so as to derive and apply a “risk free” rate of return—to calculate the information, where applicable. Failure to comply with the reporting requirements results in the forfeiture of federal tax benefits to bonds issued by the relevant state or political subdivision until noncompliance is remedied. H.R. 4822 also directs the Secretary to create and maintain a public website to post the required information 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. Creating a different means of measuring the liabilities of CalSTRS programs will cause confusion among members and the general public. It is the policy of the board to adopt an oppose position on legislation that adversely affects the actuarial balance of the funds administered by CalSTRS. Although this bill does not directly affect the actuarial balance of the funds administered by CalSTRS, it does affect the *perception* of the actuarial balance of the funds.

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.

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:

Specifically, H.R. 4822:

- Requires a state or local government employee pension plan sponsor to report to the U.S. Treasury Secretary each plan year beginning on or after January 1, 2017, and no later than 210 days after the end of the plan year:

  - 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; and
  - The current cost of the plan for the plan year;
- Requires forfeiture of federal tax benefits to bonds issued by the relevant state or political subdivision for failure to comply until noncompliance is remedied;
- Requires a supplemental report using required valuation methods and calculation assumptions if a 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; and
- Directs the Secretary to create and maintain a public website to post the required information 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.

The keystone of H.R. 4822 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, the law would apply the federal tax benefit forfeiture to bonds issued by the State of California, seriously jeopardizing its ability to issue bonds.

In addition, the valuation and calculation assumptions specified by H.R. 4822 will create confusion for stakeholders and the general public when they attempt to evaluate the financial status of CalSTRS. The confusion arises 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 Secretary, the set generated under the GASB requirements and the set generated under Moody's approach. For example, as it pertains to valuing assets, CalSTRS currently utilizes a three-year smoothing method for its actuarial funding calculations, whereas H.R. 4822 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. 4822 stipulate that the calculation of liabilities also assume a discount rate based on the U.S. Treasury Obligation Yield Curve. This requirement would 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. In addition, using interest rates to discount liabilities, and market value of assets, rather than smoothed assets, to define plan assets, would result in wildly fluctuating funding levels from year to year, based on changing interest rates and investment returns. Should H.R. 4822 pass, significant ongoing communication would be required for members, other CalSTRS stakeholders and the general public to clarify the complicated differences in financial reporting.

LEGISLATIVE HISTORY

H.R. 1628 (Nunes-CA, 2013)/S. 779 (Burr-NC, 2013), among other provisions, would have required 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, 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 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. H.R. 1628 died in the House Ways & Means Committee. S. 779 died in the Senate Finance Committee.

H.R. 567 (Nunes-CA, 2011)/S. 347 (Burr-NC, 2011), among other provisions, would have required the state or local government employee pension plan sponsor to file a report to the U.S. Secretary of the Treasury each plan year that includes specified information. 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. H.R. 567 died in the House Ways & Means Committee. S. 347 died in the Senate Finance Committee.

H.R. 6484 (Nunes-CA, 2010), among other provisions, would have required the state or local government employee pension plan sponsor to file a report to the U.S. Secretary of the Treasury each plan year that includes specified information. 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. This measure died in House Ways & Means Committee

PROGRAM BACKGROUND

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 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 actuarial, governmental accounting and legal standards already in place. H.R. 4822—which first emerged in nearly identical bills in 2011 that died in committee—is cited as *The Public Employee Pension Transparency Act*. The bill purports 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. 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 information specified by the bill are already reported through actuarial valuations and audited financial statements (prepared in accordance with Actuarial Standards of Practice and Governmental Accounting Standards Board accounting and financial reporting standards).

Currently, CalSTRS reports plan information annually to the State Controller's Office, including plan membership, contributions, actuarial economic assumptions, amortization methods and funding progress. California public employee retirement systems are required to furnish audited financial statements to the Controller on an annual basis, and an actuarial valuation for defined benefit plans must 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.

In August 2012, GASB published new accounting standards 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. 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 a second set of numbers associated with CalSTRS funding levels that members, other CalSTRS stakeholders and the general public would have to absorb.

Furthermore, in April 2013, Moody's Investor Services, a private firm that opines on the credit risk of debt obligations outlined its new approach to adjusting the pension assets and liabilities of states 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. 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 estimates 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 government pension obligations has tangential effect on CalSTRS by introducing yet another set of numbers of plan funding available for public intake and comparison.

H.R. 4822 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 2013, on a nationwide basis, contributions made by state and local governments to pension trust funds account for 4.1 percent of direct general spending.

FISCAL IMPACT

Program Cost – None.

Administrative Costs/Savings – Additional financial reporting using alternative methods and assumptions would need to be generated for the federal government. Other costs for reporting and communicating the information are expected to be minor.

SUPPORT

None known.

OPPOSITION

CalSTRS

ARGUMENTS

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

Con: 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.

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

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