

# **Federal Legislative Update**

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# Many Misperceptions Regarding State/Local Finance and Pensions

- Reports/discussions capitalize on fears and misunderstanding:
  - Bond Defaults
  - Bankruptcies
  - Bailouts
- Fueling interest by legislators/regulators

# Public Employee Pension Transparency Act (HR 567/S 347)

- Imposition of Federal reporting requirements on state and local governments regarding pension costs to U.S. Treasury:
  - 1) schedule of the funding status of the plan;
  - 2) schedule of contributions by the plan sponsor for the plan year;
  - 3) alternative projections for each of the next 20 plan years relating to the amount of annual contributions, the fair market value of plan assets, current liability, the funding percentage, and other matters specified by the Secretary to “achieve comparability across plans;”
  - 4) statement of the actuarial assumptions used for the plan year;
  - 5) statement of the number of plan participants who are retired or separated from service and are either receiving benefits or are entitled to future benefits and those who are active under the plan;
  - 6) statement of the plan's investment returns;
  - 7) statement of the degree to which unfunded liabilities are expected to be eliminated; and
  - 8) statement of the amount of pension obligation bonds outstanding.

# Supplemental Reporting

- A restatement of all information in the annual report must be made using:
  - fair market value for plan assets, and
  - US Treasury obligation yield curve rates to determine the value of liabilities

# Taxation of Bonds for Reporting Failures

- “with respect to any plan maintained with respect to employees of one or more States or political subdivisions of one or more States, no specified Federal tax benefit shall be allowed or made with respect to any specified bond issued by any such State or political subdivision (or by any bonding authority acting on behalf, or for the benefit, of such State or political subdivision) during the noncompliance period.”
- Somewhat unclear as to who is required to report – the plan sponsor or the plan – and whose bonds could be affected in the case of a “failure to meet reporting requirements”

# Concerns

- Creates a worrisome precedent regarding federal regulation of state and local governments and taxation of their bonds
- Falsely depicts the true condition of state and local governments and their retirement systems
  - Requires state and local governments to report as though they are invested only in U.S. Treasuries, not the diversified portfolios actually in use.
- In 2006, Congress rejected similar public reporting requirements for corporate pension plans because the private sector argued that such reporting significantly increased costs and volatility, and was irrelevant.
  - The U.S. Chamber of Commerce testified that “these calculations are among the most burdensome and costly procedures a plan can ever endure,” “would not provide relevant information in the majority of cases,” and “this information would unduly alarm plan participants.”

# Concerns, cont.

- State and local government retirement systems are already highly transparent, accountable and required to adhere to strict standards set by the Governmental Accounting Standards Board (GASB).
- PEPTA inappropriately preempts a formal, multi-year project in which GASB has been examining its current accounting and reporting standards for state and local government pensions and is expected to issue proposed new disclosure requirements in mid-2011.
- At a time when both Congress and the Administration want to remove regulatory barriers, this bill would impose complicated, costly Federal mandates that will only interfere with state and local recovery efforts.

# State Bankruptcy

- No federal legislation yet introduced
- Exploratory hearings held in two separate House subcommittees
- Both hearings implicated pension benefits as a major impetus behind exploring this need.
  - The House Judiciary Subcommittee even titled its hearing “The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter”

- State bankruptcy is vastly different than municipal bankruptcy (Chapter 9)
  - Cities and counties are corporations, but States are sovereigns and possess their own constitutional power to default—just as the U.S. does.
  - No state has requested such authority
  - The nation's governors and legislators have issued letters to Congress in opposition, arguing the mere specter of a federal law allowing states to declare bankruptcy would only serve to increase interest rates, rattle investors, raise the costs of state government, create more volatility in financial markets, and erode state sovereignty under the 10th Amendment to the U.S. Constitution.

# 3% Non-wage Withholding Requirement

- Revenue raiser added in the 11th hour of conference negotiations on the “Tax Increase Prevention and Reconciliation Act” of 2006
- One year delay included in the 2009 American Recovery and Reinvestment Act
- H.R. 674, S. 89, S. 164 would repeal this provision

# Tax Reform/Deficit Reduction Commission

- The National Commission on Fiscal Responsibility and Reform (“Deficit Commission”)
- Debt Reduction Task Force (“Domenici-Rivlin”)
- Several areas where the two reports seem to be heading in the same direction
  - eliminating all existing income tax expenditures, and using the revenue to lower rates and reduce deficits
  - A small number of “simpler, more targeted provisions that promote work, home ownership, health care, charity, and savings” would replace the current tax structures

# Largest Tax Expenditures

- In FY 2009, according to the Congressional Joint Committee on Taxation:
  - exclusion of health benefits from income taxation (\$94.4 billion)
  - home mortgage interest deduction (\$86.4 billion)
  - net exclusion of pension contributions and earnings associated with defined benefit and defined contribution retirement plans (\$73 billion)

# Tax Treatment of Retirement Savings

- As an “illustration” of what the Deficit Commission believed would be appropriate:
  - consolidate retirement accounts
  - cap tax-preferred contributions to lower of \$20,000 or 20% of income
  - expand the saver’s credit
  - tax expenditure structures related to defined benefit plans would be left untouched.
- Domenici-Rivlin Task Force proposal also retained tax expenditure related to employer defined benefit retirement plans, but suggested modification of those associated with 401(k) plans, Individual Retirement Accounts, and Keogh plans.
- What about “Pick-ups”???

# Mandatory Social Security Coverage

- Both the President's Deficit Commission and the Domenici-Rivlin Budget Task Force propose all newly-hired employees of state and local governments after 2020 be covered under Social Security.
- “Future bailout risk” of public pension funds, and simplification of benefit coordination cited. GPO/WEP repeal could fuel issues (although reintroduction of bills has not yet occurred)

# Pick-up Contributions and Revenue Ruling 2006-43

- RR 2006-43 required formal action by employing unit with regard to treating employee contributions as picked up under 414(h)(2)
- Clarified a participating employee, from and after the date of the “pick-up”, must not have a cash or deferred election right with respect to designated employee contributions. Participating employees must not be permitted to opt out of the “pick-up”, or to receive the contributed amounts directly instead of having them paid by the employing unit to the plan.

# Issues Surfacing

- Current Treasury/IRS reading of Revenue Ruling 2006-43 could render optional defined benefit plan tiers and other employee elections/options (purchases of service credits, DROP arrangements, etc.) that change the level of the “picked-up” (i.e. tax-deferred) employee contribution, to be a prohibited cash or deferred arrangement (CODA) under the plan.

# Concerns

- Appears impact of RR 2006-43 on DB plan tiers, DROPs, purchases of service credit, etc. was unintended
- Some suggested Treasury should consider timing, circumstances, financial condition, etc. under which a new tier or plan can receive picked up contributions
- Others believe this could easily send the wrong message as to a single one-size-fits-all federal solution to state and local pension issues.

- Some wish to prohibit all individual elections in governmental DB plans, or only allow them to increase benefits under the plan
  - Would likely run afoul of DROPs and tiers
- Others feel best option may be to clarify that a CODA does not include an election to prospectively modify contributions or accruals under an existing broad-based qualified governmental defined benefit plan (so long as made pursuant federal, state, or local law, or administrative rule/policy /collectively bargained provision adopted in accordance with such law).

# IRS Compliance Initiative

- Staff from the IRS/Treasury announced they would abandon the governmental plans compliance questionnaire and accompanying report
  - instead work more collaboratively with the public plan community
    - develop a governmental plan compliance guide
    - identify priorities for needed guidance
- Before this slow down, governmental plans were strongly urged by regulators to file for determination letters under Cycle C and E. Reportedly, hundreds of determination letter requests are being held up by uncertainty regarding pending guidance

# Pending Guidance Issues

- Definition of “governmental plan”
  - DOL, Treasury, IRS, EEOC
  - notice of proposed rulemaking expected soon
  - difficulties may arise regarding level to which quasi-governmental, government association/union, tribal government and privatized employees are allowed to participate in governmental plans.

# Pending guidance issues, cont.

- Normal retirement age regulations
  - employees must be vested at NRA
  - employees can receive in-service distributions at NRA
  - PPA allowed in-service distributions on or after age 62 in addition to NRA
  - 2007 regulations implementing new law:
    - NRA must “not be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.”
    - called into question NRA based in whole or part on years of service (delayed effective date on governmental plans)
  - Governmental plan effective date delayed twice more (1-1-2013), continued disagreement over application in governmental plan setting

# Growing SEC Interest

- New SEC Enforcement Division Unit on Municipal Finance and Public Pensions, Informal Inquiry into Public Plans
- Settlement against State of New Jersey, open investigations into bond offerings in Rhode Island, Illinois and California relating to pension fund disclosures
- Finalization of Pay-to-Play Rule
- Office of Municipal Securities in the Division of Trading and Markets
- Proposed rules on “municipal advisor”

# Proposed “Municipal Advisor” Rules

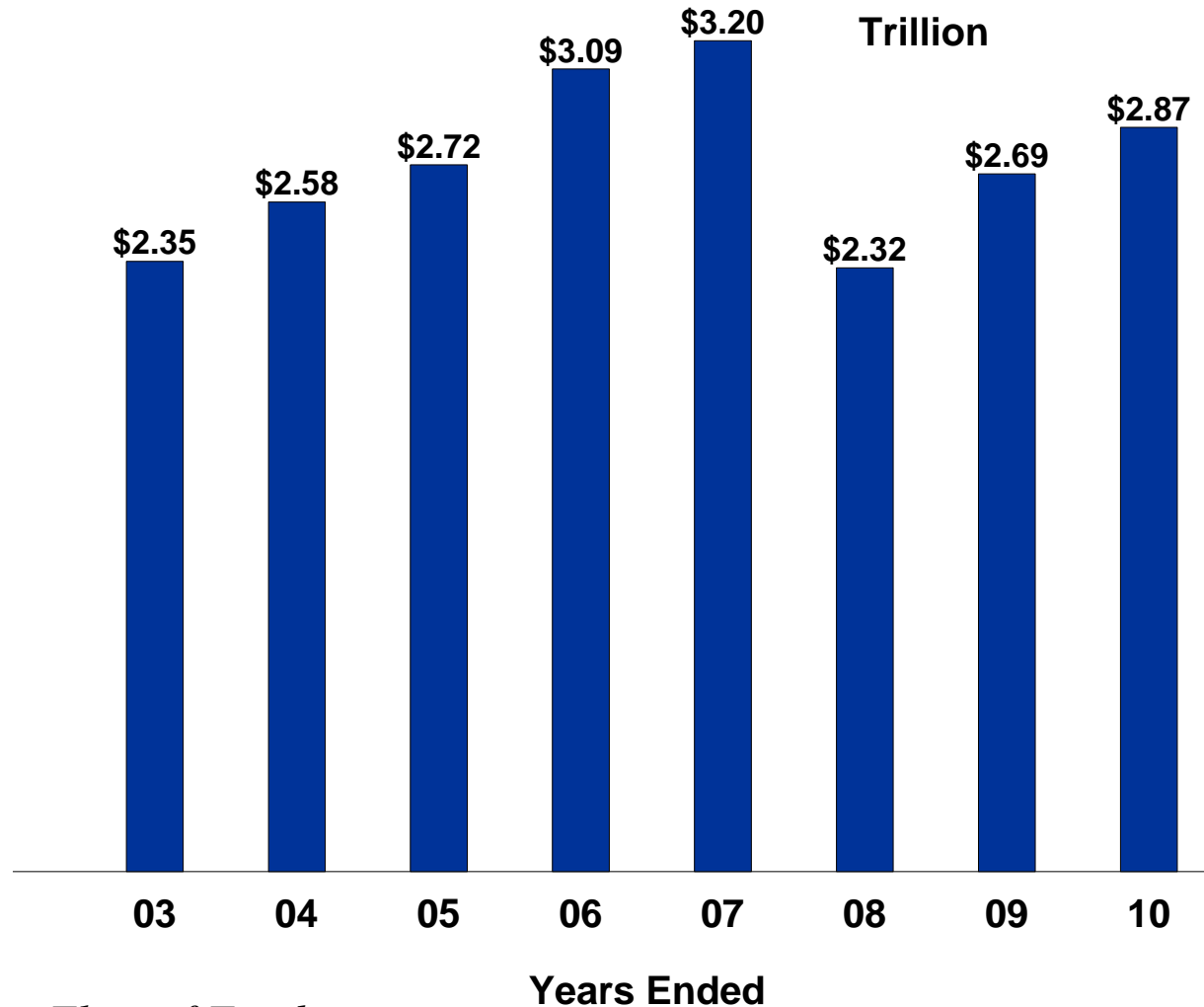
- Dodd-Frank Wall Street Reform and Consumer Protection Act makes it unlawful for municipal advisors to provide advice to, or solicit, municipal entities (including public pension funds/457 plans) without registering with the SEC and MSRB
- Dodd-Frank excluded “employees of a municipal entity” from the definition of “municipal advisor,” but did not explicitly refer to the board members of a municipal entity.
- SEC has proposed that elected and ex officio board members would be excluded from the definition of “municipal advisors,” but not appointed board members.
- Many comments filed objecting to this approach
  - all trustees of state and local government retirement systems (whether elected or appointed), as members of a governing body of a governmental pension fund, are, per se, a part of that municipal entity, and, as such, should be expressly excluded from the definition of a “municipal advisor.”

**Educating Federal Legislators  
and Regulators is Critical!**

# Getting the Facts Out on Plan Solvency

- Retirement systems remain a small portion of state and local government budgets.
- Public pension plans are not in a current crisis
- State and local governments are taking steps to secure their pensions for the long-term
- State and local government retirement systems do not require, nor are they seeking, Federal financial assistance.

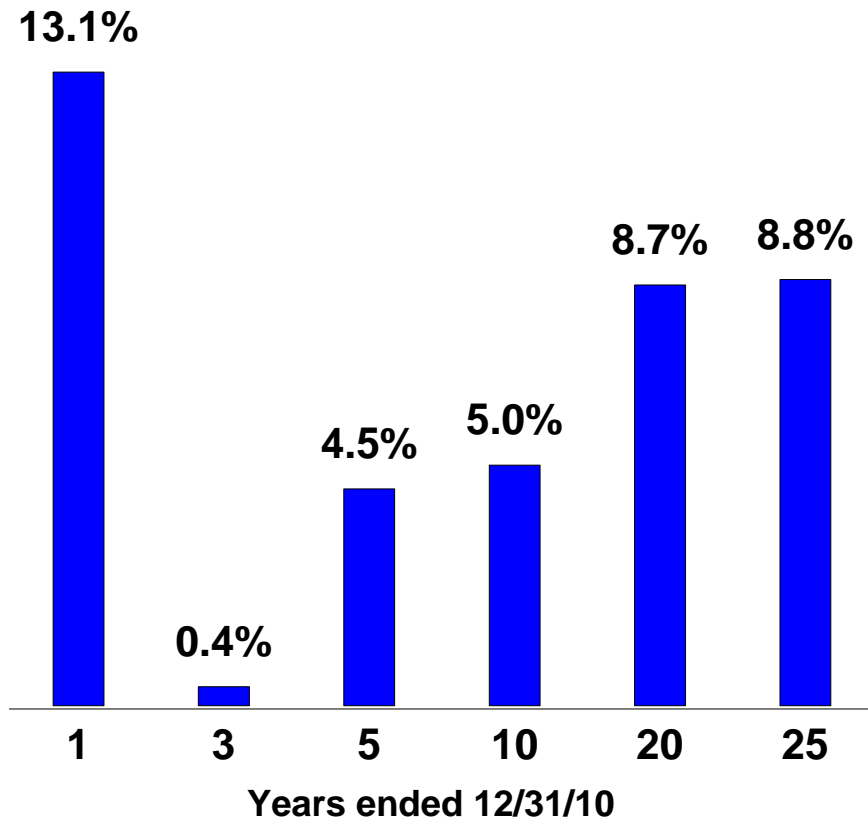
# Aggregate Assets of State and Local Retirement Systems



# Plan Sustainability

- Reports projecting pension exhaustion dates for every state are unfounded:
  - Use market low point to determine asset values
  - Assume no contributions toward unfunded liabilities
- *If the **actual** assets and contributions in public pension trusts earned a relatively modest annual return of 6%, investment earnings alone would be enough to pay for most of the benefits distributed each year; assuming a rate of asset growth consistent with long-term historic market norms, most funds never run out of money.*

# Median public fund returns for periods ended 12/31/10



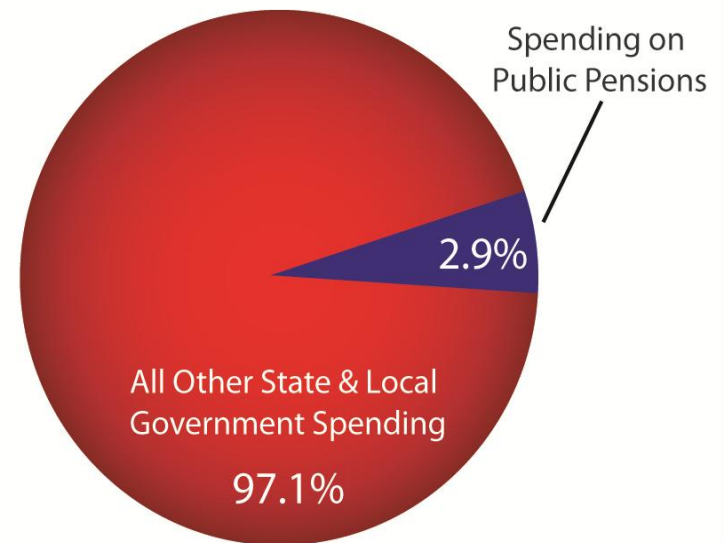
Data: Callan Associates  
Chart: NASRA

# Public Pensions and State/Local Budgets

*“The assertion that public employee pensions are contributing in a meaningful way to state insolvency is simply not supported by the facts”*

- Testimony of Keith Brainard, NASRA research director, before the House Judiciary Subcommittee at a hearing on “The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter”

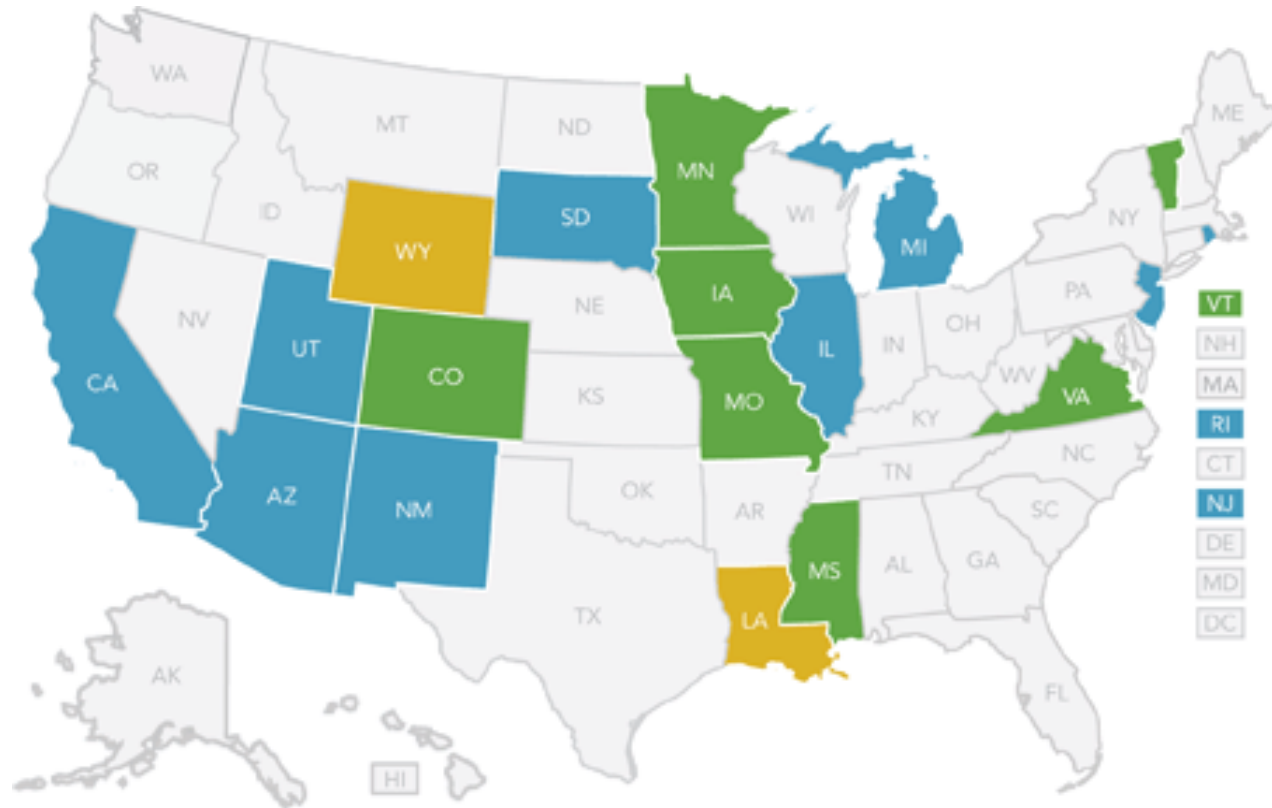
Employer (taxpayer) spending on public pensions as percentage of total state and local governments spending, 2009



# Getting the Facts Out on Plan Governance

- State and local government retirement systems are creatures of state constitutional, statutory and case law and must comply with a vast landscape of state and local requirements, as well as industry accounting and reporting standards.
  - highly transparent and accountable to the legislative and executive branches of the state; overseen by independent boards of trustees that include employee representatives and/or ex-officio elected officials; and ultimately, the taxpaying public
  - Benefits are typically established by constitutional or statutory provisions giving members a contractual or property right to the benefits as promised and are protected by the due process clauses of the U.S. Constitution and all 50 State constitutions.
- In accordance with their fiduciary duty, governing bodies routinely and consistently evaluate plan design, funding and asset allocation to ensure that plans and benefits are sustainable over time (even before recent market downturn)

# Changes in 2010

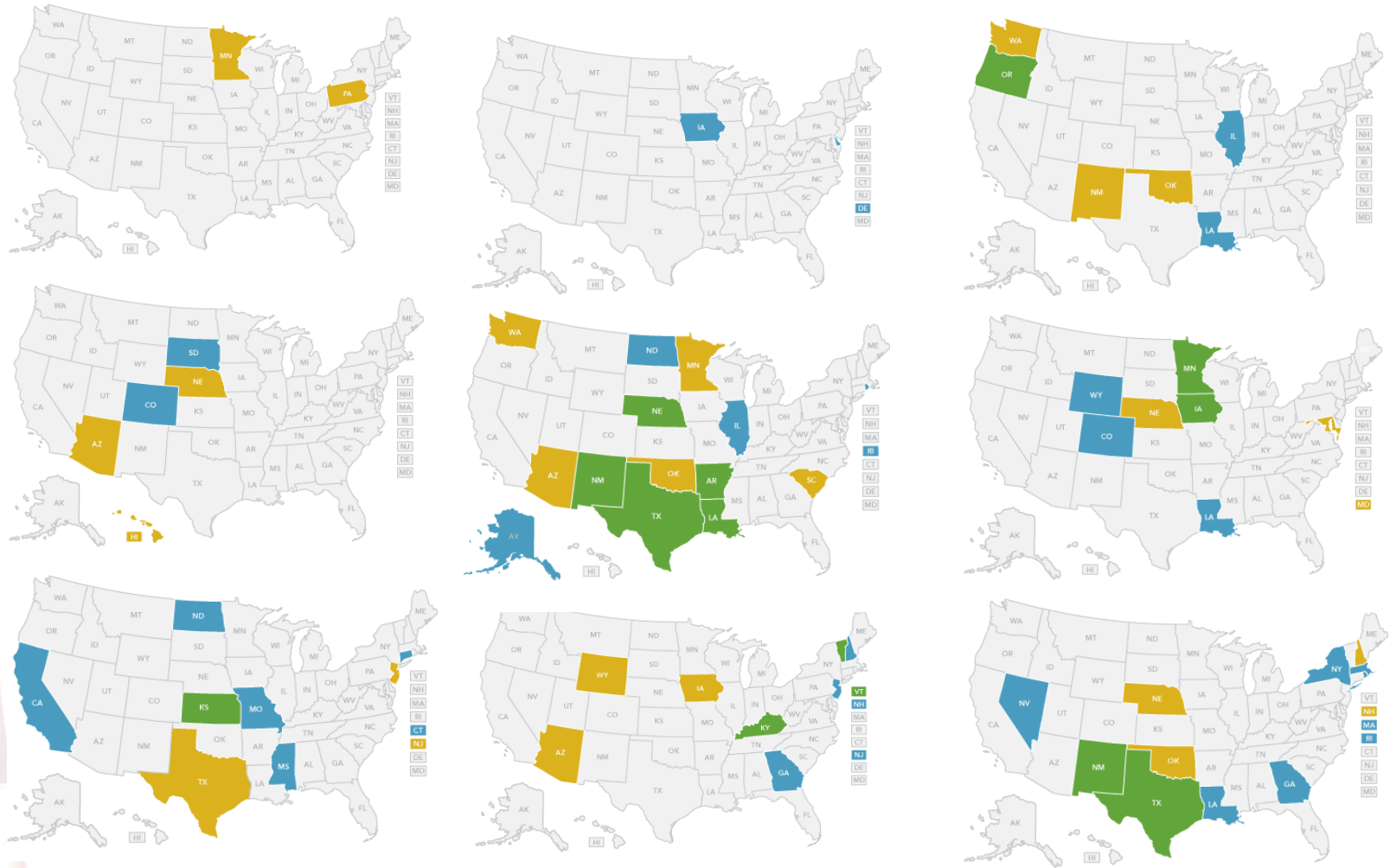


**Reduced benefits**   **Increased employee contributions**   **Both**   **No reforms**

Source: *Pew Center for the States/NCSL*

# Changes in 2001-2009

Source: Pew Center for the States/NCSL

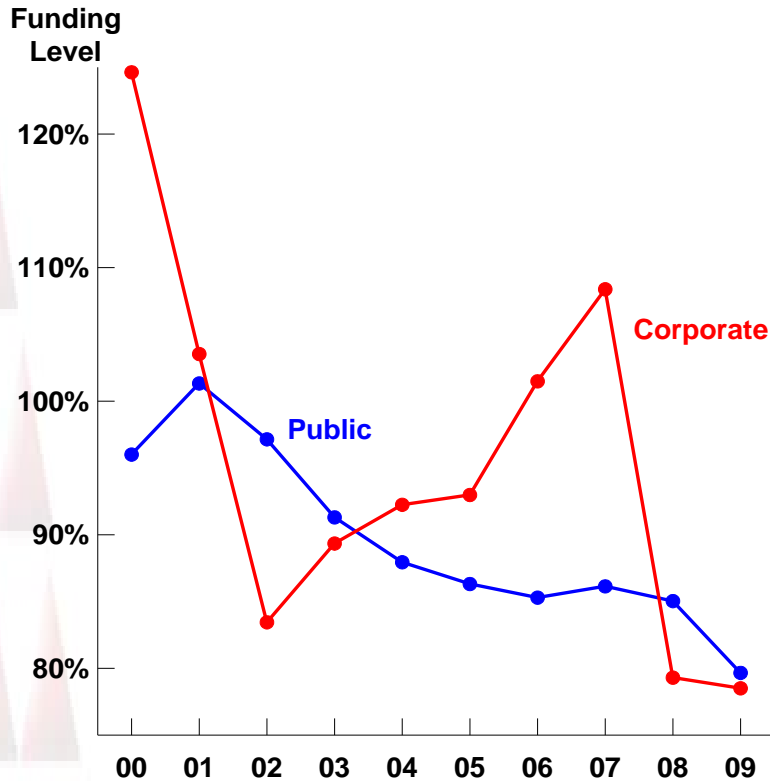


Reduced benefits
  Increased employee contributions
  Both
  No reforms

# **State/Local Government Retirement Systems do not Require, Nor are they Seeking, Federal Financial Assistance**

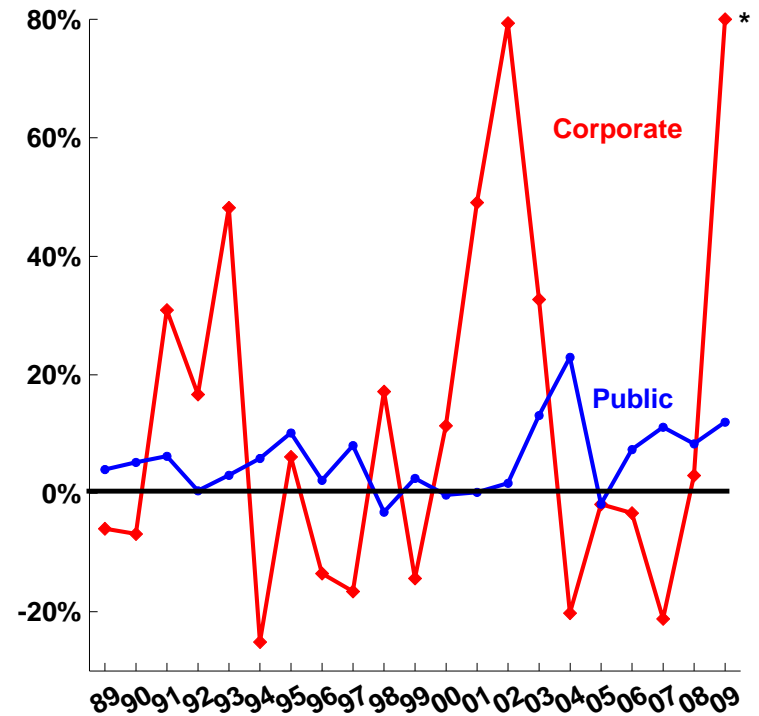
- One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels
- Federal termination liability (“zero risk reserve”) reporting is inappropriate for interminable plans sponsored by State and local governments
  - Congress rejected a similar standard for corporate plans, who cited extremely volatility, cost and irrelevance of such calculations.

## Comparison of corporate and public pension funding levels, FY 00 to FY 09



Wilshire, Milliman, and Public Fund Survey

## Comparison of change from prior year in corporate and public pension contributions, 1989-2009



US Dept of Labor,  
US Census Bureau,  
Milliman

\* Estimate



# Opportunities

- Public pensions are in reasonably good shape, but conditions vary, and some need to take more serious steps than others to bring about long-term solvency
  - Each will require diversified approaches to rebuilding reserves, most have a very long time horizon that allows for a patient and metered response

## ➤ Opportunities:

- Abusive and egregious benefits can/should be addressed
- Policies/governance should promote timely required contributions and analysis of full financial impact of reductions/delays
- Policies/governance should dampen volatility of required contributions, create a more predictable operating budget
- New conversations/appreciation for retirement security and core elements of public pension design that promote retirement security

# Concerns

- Legislating by anecdote/knee-jerk reactions
- Short-sighted policies that encourage a “race to the bottom”
- Removal of the core elements of state and local government retirement systems that are a proven, efficient method for promoting retirement security:
  - Mandatory participation
  - Cost-sharing between employers and employees
  - Pooling of investment and longevity risks
    - Assets professionally/institutionally managed and invested
    - Required annuitization of benefits
    - Integrated survivor/disability benefits