LGV&A

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MEMORANDUM

TO: Robert U. Glazier

FROM: Thomas R. Lussier Thomas R. Lussier

DATE: October 28, 2013

RE: Update Regarding Federal Threats to State and Local Public Employee Retirement Systems

With the government shutdown behind us and the debt ceiling raised through February 7, 2014, I'd like to provide an update regarding ongoing threats to the independence of State and Local public employee retirement systems. As I've reported to the Board, each of these issues is separate; however, they are easily linked in a narrative that's clearly harmful to public sector defined benefit plans.

"Secure Annuities for Employee (SAFE) Retirement Act" (S. 1270- Sen. Orrin Hatch)

Taken by itself, Senator Hatch's SAFE Retirement Act appears to be a relatively benign attempt to offer municipal employers and employees an option. However, it's important to put Senator Hatch's initiative in perspective. Last year, in a report entitled "State and Local Government Defined Benefit Plans: The Public Pension Debt Crisis that Threatens America," he stated:

"*Many of the legislative proposals and enactments at the state level and federal level are good ideas that would improve the defined benefit pension structure. However, it is becoming increasingly apparent that defined benefit pension plans will never be financially sound enough over the long term for use by state and local governments. The financial risk associated with the defined benefit pension structure may be appropriate in the corporate setting, but it is inherently flawed in the state and local government setting.*"

In his statement on the Senate Floor as he introduced the SAFE Retirement Act, Senator Hatch stated that "*...despite numerous legislative initiatives enacted at the State and local level, the public pension debt crisis has gotten worse, not better.*" He concludes that "*A new public pension design is needed: one that provides cost certainty for state and local taxpayers, retirement income security for* *state and local employees, and does not include an explicit or implicit government guarantee."*

So, while Senator Hatch has introduced an annuity-based option for state and local employers and employees, it's absolutely clear that his goal is far more fundamental. What's also clear is that Senator Hatch, as the Ranking Member of the Senate Finance Committee (and potentially Chairman in the next Congress), is in a significant position to advance his agenda.

While there are a number of obvious flaws with the SAFE Retirement Act, the purpose of this memo is not to analyze the strengths and weaknesses of the legislation[1]. We are continuing to work with representatives of the National Association of State Retirement Administrators (NASRA), the National Council on Teacher Retirement (NCTR), and a number of other national organizations that represent the interests of public retirement systems, public employees and employers, and retiree organizations to develop a consistent message regarding the actual legislation. Rather, my purpose is to suggest that we need to take this legislative proposal very seriously and be prepared to address its faults in conjunction with this larger industry strategy.

As of now, the legislation has no co-sponsors in the Senate and no one has introduced a House companion bill.

Public Employee Pension Transparency Act (PEPTA) H.R. 1628 - Congressmen Nunes, Issa, and Ryan; S. 779 – Sen. Richard Burr)

In a statement issued in conjunction with the re-introduction of his PEPTA legislation, Congressman Nunes offered the following view:

"Often hidden by opaque accounting practices, the costs of public pension funds are driving an increasing number of states and municipalities toward insolvency. This bill will increase the funds' transparency and eliminate deceptive accounting practices that are already shunned in the private sector, giving the American people a clearer understanding of these funds' true fiscal condition."

Working as part of a large and diverse industry coalition, we successfully blocked any serious consideration of the PEPTA legislation in the last Congress. It's also important to note that this year's legislation has secured only ten co-sponsors (including only two other California Congressman) – his 2011 legislation secured over 50 sponsors during the last Congress. The Senate companion has only secured two co-sponsors.

Nevertheless, it's important to note the legislation was considered by House leaders as a pay-for (interesting since we all believe that the legislation will actually be expensive for the Treasury Department to implement) on at least two totally unrelated legislative

[1] To date, most SAFE Act opponents have been reluctant to produce a specific critique of the legislation so as to avoid providing Sen. Hatch's staff with a blueprint to improve the draft.

proposals during 2012. Given Congressman Nunes' increasing seniority on the Ways & Means Committee and the increasing focus on the impact of public pension liabilities on the solvency of State and local governments, we must remain vigilant regarding the viability of this intrusion into State and local governance of public employee retirement systems.

Detroit, Michigan

The Detroit bankruptcy continues to have the potential to be an effective poster-child for the efforts of Senator Hatch and Congressmen Nunes, Issa, and Ryan. On the front page of every major newspaper, in magazine articles, and in media broadcasts across the country, we see the argument that unsustainable and under-reported pension promises have led to the financial ruin of one of America's great cities. Regrettably, we are seeing similar claims in Chicago, Cincinnati, and potentially other major cities. And, closer to home, the California cases remain an important part of this narrative.

Although there are countless explanations for the Detroit bankruptcy that have nothing to do with their public employee pension obligations, the focus on pension costs has placed the question of these "guaranteed" benefits front and center in the debate over the future of Detroit. Clearly, the eventual outcome of current litigation that challenges state-based constitutional guarantees in the context of a Federal bankruptcy would likely have an impact across the country.

Other issues could result from Detroit that would be equally problematic. Any call for a bailout of Detroit would undermine one of our arguments against PEPTA. Our entire coalition has argued that no State of local pension plan is looking to the Federal government for a bailout. We have consistently argued that State and local retirement-related problems -- to the extent they exist -- will be/have been addressed by State and local governments. Also, we could see calls from public sector labor for Federal funding requirements -- something that could look like a public sector ERISA. Such a discussion would divide our coalition and would undermine our arguments regarding the independence of State and local pension plan governance.

Mandatory Social Security Coverage for New State and Local Government Employees

CalPERS has a long history of opposing efforts by the Federal government to mandate Social Security coverage for State and local government employees. As a founding member of the national Coalition to Preserve Retirement Security (CPRS), CalPERS has educated Members of Congress on the unintended consequences of such an unfunded Federal mandate on State and local taxpayers, employers, and employees. A 2011 CPRS study conducted by the Segal Company reports that mandatory coverage would cost states, municipalities and public employees $53.5 billion in its first five years. The cost for California would be $15 billion in the first five years.

The strongest argument against mandatory coverage -- other than the cost of such an unfunded mandate -- has been the security of the public employee defined benefit retirement system. CPRS has long argued that public pensions provide a better benefit for a lower cost -- facts that have been documented by national and state-based studies.

Unfortunately, all of Detroit's public safety workers are outside of the Social Security system. Should the current bankruptcy result in a significant reduction in promised benefits to Detroit retirees and/or current employees, those individuals will be without a safety net and serious questions are likely to be raised regarding their decisions relative to Social Security. While Detroit could voluntarily choose to participate in Social Security for current and future employees, current retirees would experience serious losses.

We are working with other CPRS members (pension plans, public employee and employer organizations, and retiree advocates) to communicate with key Congressional allies and committee staff to reinforce the fundamental arguments against mandatory coverage and to isolate Detroit from the larger public policy discussion.

Municipal Securities Regulation

In July 2012, the U.S. Securities and Exchange Commission (SEC) issued a comprehensive report regarding the municipal securities market which examined a wide range of issues including disclosure and transparency, financial reporting and accounting, and investor protection and education. The Commission offered a series of recommendations to improve the structure of the $3.7 trillion municipal securities market and enhance the disclosures provided to investors.

In its report, the SEC states "*Disclosure regarding pension funding obligations of states and other municipal entities is at the forefront of discussions regarding the municipal securities market. Obligations to provide pension and OPEBs can significantly affect a municipal issuer's financial health and may impact its ability to make debt service payments on municipal securities.*"

While CalPERS would likely support the vast majority of the SEC's recommendations, its discussion regarding pension funding obligations, including the method of calculating appropriate funding levels, has raised a number of issues that concern public plan advocates.

The Detroit bankruptcy will undoubtedly raise questions regarding the accuracy of the city's disclosures regarding its pension obligations. While such questions are entirely appropriate, they are likely to lead to discussions at the SEC and perhaps in Congress regarding the calculation of pension liabilities, including questions regarding the appropriate investment return assumptions. These discussions could fuel calls for Federal standards and could energize support for legislation like PEPTA.

At this point, the questions are – How real are these threats and how might they surface in the current Congress? While the current atmosphere would suggest that the threats may have abated in the aftermath of the universally unpopular government shutdown and the fallout from problems associated with the ongoing implementation of the ACA, there are at least two reasons why I think we need to remain vigilant and proactive.

> First, as is evident from last week's Pew/Arnold/Urban Institute conference in Washington and the Manhattan Institute's conference in New York, our opponents remain deeply committed to destroying the defined benefit pension system in the public sector. Their efforts have been encouraged by the legislative initiatives of Senator Hatch and Congressman Nunes and fueled by Detroit and other municipal solvency debates.
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> Secondly, although none of these issues will ever be front and center on any Congressional agenda, as previously noted, Senator Hatch is uniquely well positioned to insert the SAFE Act or some other anti-defined benefit provision into any tax, entitlement, or deficit-reduction bill that might become the next "must-pass" piece of legislation.

There are several factors that will influence when, how and/or if we'll see any of these threats in play. These include:

- Will the Budget Conference Committee reach an agreement by its mid-December deadline or not? Although unlikely at this point, a "big deal" in the conference could include elements of tax and/or entitlement reforms.

- Government is currently funded through January 15th, how will Congress proceed if the Budget Conference Committee has failed to produce a budget by that deadline?

- Will Senator Baucus and Congressman Camp successfully insert tax reform[2] into the budget conference or future debt ceiling debates? A tax bill remains the most likely vehicle for Senator Hatch to move his SAFE Retirement Act.

- The debt ceiling will need to be addressed again in February. If the borrowing limit isn't addressed in the budget or some subsequent debt-reduction plan, how will Congress avoid another cliffhanger?

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[2] As we've noted in other communication, both Senate Finance Committee Chairman Baucus and House Ways and Means Chairman Dave Camp would like to mark-up tax reform proposals during the current Congress. They both have both personal and political motivations to accomplish this goal – Chairman Baucus will retire at the end of this Congress and Chairman Camp will be required to relinquish his chairmanship due to House term limits.

Each of these situations could create an opportunity for Sen. Hatch and/or Congressman Nunes to advance their proposals as part of a must-pass stopgap measure.

As a result, in addition to working with industry trade associations and the broader based coalition of employer, employee and retiree advocates to support the independence of State and local public employee retirement systems, I think we should consider the following:

1. In addition to CalPERS and CalSTRS, California has a number of public employee pension plans that could/should be more active on these Federal issues. These plans are typically members of SACRS and/or CALAPRS; however, neither of these organizations has an active Federal advocacy agenda. I believe that our efforts within the California Congressional Delegation could be more effective if we could find a way to involve a broader coalition of California public plans. I'm not suggesting a new organization nor am I suggesting that we do anything that would conflict with SACRS or CALAPRS; however, I would like to work with you to develop a communication network and engagement strategy for these plans. [Attachment A offers a suggested approach and a list of potential partners.]

2. We recommend communicating our concerns regarding Senator Hatch's SAFE Retirement Act to Senators Feinstein and Boxer. In addition, we should communicate with likely allies (and potential allies) on the Senate Finance Committee in conjunction with NASRA, NCTR and other DC plan advocates.

3. California has enacted important pension reforms intended to insure the long-term sustainability of the state's retirement systems. In addition, CalPERS has taken (and continues to consider) important administrative and actuarial actions designed to strengthen your plan. In effect, these reforms are all part of the "Why we're not Detroit" story that we need to share with the California Congressional Delegation. It would be very helpful if you could develop a user-friendly summary of these important actions. I suspect that you probably have materials designed to educate members; however, I'm looking for something that would be more useful to a policy-maker. Armed with this information, we'll visit the Delegation with a focus on the health and sustainability of CalPERS and our concerns regard any Federal intervention into state pension policy.

4. Finally, I think we should continue to support industry activities advance by NASRA and NCTR. We will keep you informed regarding the evolution of that strategy.

I hope this is helpful. I look forward to discussing all of this at your convenience.

ATTACHMENT A
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Proposal to Expand the CalPERS Voice

California has a number of public employee pension plans that likely share CalPERS view on Federal issues that threaten the independence of State and local public employee pension plans. While these plans are organized for education and information sharing purposes as members of either the California Association of Public Retirement System (CALAPRS) and/or the State Association of County Retirement Systems (SACRS), there isn't currently a vehicle for this larger California public pension community to speak with a more coordinated voice on these Federal threats or opportunities.

CalPERS is uniquely positioned to facilitate greater communication and action with regard to these important Federal issues.

We're recommending that CalPERS initiate a process by which an ad hoc group of interested California public pension plans could agree to send a letter to Members of Congress on a particular issue of mutual interest. Based on the attached list, there are nearly 40 pension funds which could opt to participate in any given message. The process – which would not require the creation of any new organization or governance structure – would actually be quite simple:

- CalPERS would initiate a draft letter for consideration by the other plans.
- Each plan would be given a specific amount of time to add or not add its name to the letter. Depending on the urgency of the letter, suggested amendments could be considered and re-circulated.
- The letter – with whatever number of signatures the issue garnered – will be sent to the targeted Members of Congress.
- Each plan that signed the letter would be encouraged to forward the letter to their Members of Congress and/or the Members targeted in the letter.

This suggestion is based on a process that works successful for the Public Pension Network (PPN) here in DC. In the case of the PPN, NASRA generally initiates a draft letter for consideration by other retirement, labor, employer, and retiree organizations.

In effect, in any particular instance, the final letter represents a coalition of the willing on any particular issue.

California Public Pension Plans

Alameda County Employees' Retirement Association
Alameda-Contra Costa Transit District Retirement Plan
Bart Investment Plans Committee
California State Teachers Retirement System
Contra Costa County Employees' Retirement Association
East Bay Municipal Utility District Retirement System
Fresno City Employees' Retirement System
Fresno City Fire and Police Retirement System
Fresno County Employees' Retirement Association
Imperial County Employees' Retirement Association
Kern County Employees' Retirement Association
Los Angeles City Employees' Retirement System
Los Angeles County Employees' Retirement Association
Los Angeles Fire and Police Pension System
Los Angeles Water and Power Employees' Retirement Plan
Marin County Employees' Retirement Association
Mendocino County Employees' Retirement Association
Merced County Employees' Retirement Association
Oakland Municipal Employees' Retirement System
Oakland Police and Fire Retirement System
Orange County Employees' Retirement Association
Pasadena Fire and Police Retirement System
Sacramento County Employees' Retirement Association
Sacramento Regional Transit District Retirement Plan
San Bernardino County Employees' Retirement Association
San Diego City Employees' Retirement System
San Francisco City and County Employees' Retirement System
San Diego County Employees' Retirement Association
San Joaquin County Employees' Retirement Association
San Jose Federated City Employees' Retirement System
San Jose Police and Fire Department Retirement Plan
San Luis Obispo County Pension Trust
San Mateo County Employees' Retirement Association
Santa Barbara County Employees' Retirement Association
Santa Clara Valley Transportation Authority/Amalgamated Transit Union Pension Plan
Sonoma County Employees' Retirement Association
Stanislaus County Employees' Retirement Association
Tulare County Employees' Retirement Association
University of California Retirement System
Ventura County Employees' Retirement Association