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Federal Retirement Policy Report for CalPERS Board
September - October 2017

I. Developments in Protecting Public Sector Defined Benefit Plans

CalPERS' 2017 Federal Retirement Security Priorities advocate for the preservation of defined benefit retirement plans and against federal incentives or options to replace defined benefit pension plans and federal intervention in state and local pension plans.

1. New Developments Since Last Report:

- **CBO Report on Federal Retirement System –** The Congressional Budget Office (CBO) published a report analyzing the impact of retirement benefits on the federal budget and on the compensation, recruitment and retention of federal employees. The report explores two broad topics for reform with several options in each topic: (1) modify the current pension plan by either changing the employee contribution rate or changing the benefit formula; and (2) replace the current pension component for new employees with larger contributions from the government to the Thrift Savings Plan.

- **NIRS Reports–** The National Institute on Retirement Security (NIRS) released a new issue brief analyzing the effectiveness of pensions on teacher retention and overall teacher productivity. It found that, compared to defined contribution plans, defined benefit pension plans help recruit high quality teachers and retain productive teachers. Because the cost of teacher turnover is substantial, retention translates into a cost savings for school districts. Read the full issue brief here.

  NIRS also released a new study suggesting the retirement security of low and moderate-income taxpayers could benefit from changes to the federal saver's credit. The report found the incentive is underutilized, but structural and administrative changes could make it less complex and more likely to increase retirement savings. The full report is available here.

- **GAO Report –** The Government Accountability Office (GAO) published a report on the U.S. retirement system. It noted that in 2015, private and public sector employer-sponsored plans and IRAs accounted for 20 percent of income for households where the head of household is 65 or older. Defined benefit plans still remain the predominant type of plan for the public sector available to 93 percent of full-time workers. Research shows state and local pension asset balances have been increasing. The full report is available here. *(Note: Public sector pensions are discussed on pages 82-84.)*

- **Federal Bankruptcy Code –** It's reported that Illinois Governor Bruce Rauner is asking Congress for help in restructuring his state's public pensions. While the proposal has not been specifically identified and is being described as conceptual, signals are that the conservative Republican Governor is advocating a plan first put forward last spring by the conservative-minded Manhattan Institute. The proposal would amend the federal bankruptcy code to allow states to bypass state-based constitutional protections and other legal impediments in order to make changes to their pension funding and benefit structures, provided certain requirements are met. In April 2016, the Manhattan Institute, which interestingly used the Illinois public pension system as its primary justification, released a proposal to create a new section 113 of the U.S. Bankruptcy Code – Proceeding to Protect Essential State Actions. As a candidate, Rauner proposed cutting pension costs by transitioning workers to less generous benefit packages or 401(k)-

style retirement plans. However, the Illinois Constitution stipulates that benefits cannot be "diminished or impaired." Thus far, the state Supreme Court has rejected attempts to reduce pension benefits.

2. CalPERS Implications and Next Steps:

We will closely monitor and advocate against any pension related legislation that proposes PEPTA, the annuity accumulation plan, amended bankruptcy provision for state governments, and/or any proposal that could serve as a vehicle for similar anti-DB pension plan provisions.

3. CalPERS/Federal Representative Actions:

- Your federal representative Tony Roda (Williams & Jensen) briefed the CalPERS board on September 20 on public pension-related issues that are potentially in play as part of Congress's effort to reform the tax code, legislation to repeal the Social Security offset known as the windfall elimination provision, and pending regulatory items.
- Your federal representative Tony Roda (Williams & Jensen) attended a meeting of the public pension network in Washington, D.C. There was a discussion of tax reform and the issues that may be in play as the legislation moves through the legislative process, including the change to mandatory Roth contributions, the Public Employee Pension Transparency Act and the annuity accumulation plan.
  It was also mentioned that the elimination of the federal tax deduction for state and local taxes would lead to political pressure at the state and local level to reduce taxes. It was argued that any tax reductions at the state and local level would, in turn, make it more difficult for states and municipalities to make their employer contributions to public pension plans.
- Your federal representative Tony Roda (Williams & Jensen) attended the NCPERS public safety conference in San Antonio, TX.
- Your federal representative Tom Lussier (The Lussier Group) delivered remarks regarding the state of public employee pension and health benefits at the IPPFA MidAmerican Pension Conference in St. Louis, MO.
- Your federal representative Tom Lussier (The Lussier Group) presented a Federal Update at the annual conference of the National Pension Education Association (NPEA) in Nashville, TN and attended the annual conference of the National Council on Teacher Retirement (NCTR) in Tucson, AZ.
- Your federal representative Tom Lussier (The Lussier Group) participated in the annual CalPERS Education Forum in Rancho Mirage, CA. He highlighted the ongoing threat to State and local public pension plans, discussed the potential impact of tax reform on public workers, and provided an update on the prospects for WEP reform legislation.

4. Recommendations for Next Steps:

There are no specific next steps at this point.

II. Developments in Advancing Retirement Savings and Retirement Security for All Employees

A. The Equal Treatment of Public Servants Act (H.R. 711 – 114th Congress) (Brady-Neal)

1. The Equal Treatment of Public Servants Act - would repeal the current Windfall Elimination Provision (WEP) of the Social Security Act and replace it with a new formula that will fairly account for covered and uncovered employment throughout an individual's career. The legislation will provide relief to current retirees whose Social Security benefits have been arbitrarily reduced by the existing WEP formula and, in general, will result in lower reductions for future retirees through the application of a new formula based on each worker's actual work history.

2. Specific changes/developments since last report:

   There have been no specific developments since the last report. *[NOTE – Based on conversations with staff for Mr. Brady and Mr. Neal, it's likely there won't be any developments on this legislation until late in 2017.]*

3. Implications for CalPERS:

   The passage of the Equal Treatment of Public Servants Act would offer relief to the thousands of CalPERS members who have been – or will be in the future – impacted by the WEP. Current retirees will see their WEP reduction reduced by approximately 15% for the first 10 years and up to 50% thereafter; on average, future retirees will see a reduction approximately 35% less than current law. These benefits have been updated based on a revised SSA actuarial analysis.

4. CalPERS/Federal Representative Actions:

   CalPERS federal representative Tom Lussier (The Lussier Group) met with the Staff Director of the House Ways & Means Social Security Subcommittee to discuss the committee's plans to advance the Brady-Neal WEP reform legislation. Staff confirmed the chairman's commitment to advance his WEP reform this year; however, they remain noncommittal regarding what vehicle will be used to move the legislation. Brady's staff urged CalPERS to work with other coalition partners to secure letters of support from Members of Congress, especially those who previously co-sponsored H.R. 711.

5. Recommendations for Next Steps:

   CalPERS' retirement policy consultants will continue to communicate with staff for Chairman Kevin Brady (R-TX) and Ranking Member Richard Neal (D-MA) to coordinate activity in support for the Equal Treatment of Public Servants Act and will communicate with CalPERS staff to determine when additional engagement is appropriate, including outreach to the California Congressional Delegation in response to Chairman Brady's request for letters of support.

B. Fiduciary Rule –

1. The Department of Labor (DOL) issued a rule that imposes a fiduciary standard on financial firms and advisers providing retirement advice. The rule became effective on June 9, 2017.

2. Specific changes/developments since last report:

   Closely monitor the next steps that DOL takes on this issue.

3. Implications for CalPERS:

   CalPERS has been supportive of the fiduciary rule. As a national and state leader in the retirement security arena, CalPERS has an interest in the full implementation of the rule – especially as it might impact retirement security in California.

4. CalPERS/Federal Representative Actions:

   CalPERS retirement policy consultants will continue to monitor any activity regarding the rule and will communicate with CalPERS staff to determine whether additional engagement is appropriate.

5. Recommendations for Next Steps:

   There are no specific next steps at this point.

C. State-Based Retirement Programs –

1. The Department of Labor (DOL) finalized a rule to facilitate the creation of state and political subdivision-based retirement plans such as California's Secure Choice plan. The rule was intended to enable states to initiate innovative ideas that will boost overall retirement savings. The President signed a resolution (H.J. Res 66) passed by Congress to nullify the DOL rule.

2. New Development Since Last Report:

   - **Seattle Secure Choice -** As part of his budget plan, Seattle Mayor Tim Burgess announced a legislative proposal to establish a city-run, IRA program for private sector workers. Known as secure choice, this program would provide an avenue for retirement savings for many Seattle workers who currently lack access to workplace retirement savings programs. Included in the budget plan, Mayor Burgess proposed $200,000 to conduct a market feasibility study of the retirement program.
   - **NCPERS** SecureChoice 2.0 report provides an overview of cities and states across the U.S. working on similar retirement initiatives.
   - **Oregon Private Sector Retirement Plan –** The ERISA Industry Committee (ERIC) filed a lawsuit alleging federal law bars certain parts of Oregon's retirement savings plan for private sector employees. ERIC has 100 member companies and each has a minimum of 10,000 employees. The lawsuit alleges that the Employee Retirement Income Security Act (ERISA) preempts the Oregon law and its regulations that require employers that sponsor ERISA-governed plan to report on certain plan activities. OregonSaves launched July 1, 2017, making Oregon the first state to launch a program expanding retirement savings to private sector workers. The first pilot program for OregonSaves had 100 participants who saved $30,000 by the end of September. The second phase of the pilot program started October 1.

3. Implications for CalPERS:

   As a leader in the retirement security arena, CalPERS has an interest in efforts that will boost overall retirement savings; especially those that would impact retirement security in California. We will evaluate other opportunities for CalPERS to engage in this important national discussion.

4. CalPERS/Federal Representative Actions:

   CalPERS retirement policy consultants will monitor any activity regarding H.R. 2523 and S. 1035, the PROSPERS Act (legislation that would amend ERISA to specifically exclude from its scope certain IRA-based retirement plans run by state or political subdivisions for private sector workers) and any related regulatory activity and will communicate with CalPERS staff to determine whether engagement is appropriate.

5. Recommendations for Next Steps:

   There are no specific next steps at this point.

D. Other Retirement-Related Legislation/Activity –

- **Tax Reform –** On September 27, the Trump Administration and the Republicans on the House Ways and Means and Senate Finance Committees released a unified framework on tax reform. Regarding retirement policy, the document simply states: The framework retains tax benefits that encourage work, higher education and retirement security. The committees are encouraged to simplify these benefits to improve their efficiency and effectiveness. Tax reform will aim to maintain or raise retirement plan participation of workers and the resources available for retirement.

  House Tax Policy Subcommittee Chairman Peter Roskam (R-IL) said that the search for new sources of revenue includes a review of previous tax reform proposals related to the application of the unrelated business income tax (UBIT) to tax-exempt organizations. Most exempt organizations, including qualified pension plans, are subject to UBIT. However, practitioners continue to argue that governmental pension plans are not subject to UBIT because they perform an essential governmental function. The previous tax reform proposals referred to by Rep. Roskam include a proposal that would clarify that an organization does not fail to be subject to UBIT solely because it meets the essential governmental function test. A separate proposal would require that the UBIT of each unrelated trade or business be calculated separately. The two proposals combined were estimated to increase revenue by $3.3 billion over 10 years.

  The House and Senate have voted to give final approval to a budget resolution. The final budget resolution provides procedural protections (reconciliation instructions) for a tax reform bill to be approved in the House and Senate by a simple majority vote. Republican Congressional leaders are coalescing around the following ambitious timetable: House bill will be released on November 2; Ways and Means Committee markup November 6-8; House floor consideration and Senate Finance Committee markup week of November 13; and Senate floor consideration early in the week of Thanksgiving. Further House action on the Senate-passed bill or a House-Senate conference committee will follow.

- **Joint Tax Committee (JCT) Estimates –** As part of its annual report on tax expenditures, JCT released new revenue loss estimates for defined benefit (DB) and defined contribution (DC) plans. Over the next 10 years, JCT estimates that DB plans will result in deferred tax revenue of approximately $726 billion. DC plans will result in deferred tax revenue of approximately $1.051 trillion. These large amounts of deferred tax revenue have always concerned the retirement savings community. Changes in the law to limit annual contribution amounts or move to Rothification will produce significant revenue that could be used to offset reductions in tax rates.

- **Rothification –** The Tax Foundation, a conservative-leaning think tank, released a paper raising questions on Rothification, the term describing proposals circulating in Congress to require all new contributions to defined contribution plans to be made under Roth-account rules (post-tax). The full paper can be found here.

  Senators Sherrod Brown (D-OH), Ron Wyden (D-OR), Debbie Stabenow (D-MI), Ben Cardin (D-MD) and Bob Casey (D-PA) wrote to the so-called Big Six in opposition to requiring a move to Roth accounts. The Big Six working group is comprised of Treasury Secretary Steve Mnuchin, White House Chief Economic Advisor Gary Cohn, Senate Majority Leader Mitch McConnell (R-KY), House Speaker Paul Ryan (R-WI), Finance Chairman Orrin Hatch (R-UT) and House Ways and Means Chairman Kevin Brady (R-TX).

  House Republicans continue to examine ways in which to curtail pre-tax contributions to defined contribution plans (e.g., IRA, 401(k), 457(b) and 403(b) plans) in order to use that added revenue to offset corporate and individual tax rate reductions. The latest proposal floated was to cap the pre-tax contribution at $2,400 per year. However, President Trump weighed in on the issue saying that, “There will be NO change to your 401(k). This has always been a great and popular middle class tax break that works, and it stays!” On Octber 31, House Ways and Means Committee Chairman Brady said that he did not plan to change the pre-tax contribution rules for defined contribution plans, unless there is broad support from the investment community that a new approach would result in more savings.

Nonetheless, Republicans have dropped from consideration a number of large revenue raising proposals and face increasing pressure to pay for at least a portion of the rate cuts. Because of this most observers believe that Rothification is still very much on the table. The Employee Benefit Research Institute (EBRI) also weighed in on Rothification. They released a paper showing that at the lowest wage levels ($10,000 to $25,000), 58 percent of the contributions from 401(k) contributors would be above the $2,400 cap and, thus, subject to Rothification. For those with more than $100,000 in wages, 80 percent of their contributions would be impacted.

- **Actuarial Standards –** The National Conference on Public Employee Retirement Systems (NCPERS) and the National Council on Teacher Retirement (NCTR) sent a joint letter to the Pension Committee of the Actuarial Standards Board expressing concerns with proposed changes to the Actuarial Standards of Practice relating to pension plans. The Pension Committee is currently drafting proposed modifications that would require actuaries to calculate a market-based alternative liability measurement that must be disclosed for all valuations of pension plans for funding purposes. NCTR and NCPERS object to both the substance of the recommendation and the process by which its implementation is now being pursued. The letter argues that the proposed market-based alternative liability is not useful to public stakeholders or policy makers. NCPERS and NCTR are concerned that plans whose assets do not meet or exceed the measurement will be unjustly deemed “insolvent.” The letter recommends that the Pension Committee hold a public hearing on the recommendations to ensure a more complete discussion.

- **Retirement Security Summit –** On October 2, the Center for State and Local Government Excellence hosted a retirement security summit focused on how state and local governments tackle retirement preparedness and workforce challenges. The summit focused on the challenges of a changing workforce where state and local governments must compete more with other sectors. One panel featured three current and past public employees who shared their perspectives on retirement planning. They discussed the benefits of automatic enrollment and the importance of employee education. Keith Brainard, Research Director for the National Association of State Retirement Administrators, described the recent changes in employee retirement benefits, which have shifted more risks to employees. Such changes include moving to defined contribution plans. The final two panels focused on how to boost benefits for employees through the design of retiree health benefits and ways to encourage employee saving. Rob Wylie, Executive Director of the South Dakota Retirement System, discussed the success of SD’s automatic enrollment and automatic escalation programs, which have increased retiree savings.

III. Other Updates and Information

- **Updated Arnold Foundation Graphic –** The National Council on Teacher Retirement (NCTR) has published an updated graphic on the Laura and John Arnold Foundation. The graphic shows the Arnold Foundation has now spent $53.6 million to undermine state and local governmental pension plans.

- **NCTR Webinar –** NCTR hosted a webinar examining the ancillary benefits of public pension investing. Topics discussed included the differences between and impacts of economically targeted investments (ETI), environmental, social, and governance investing (ESG), and impact investing on public pension funds. Panelists discussed a new report PCV InSight entitled, The Pursuit of Financial Return and Societal Benefit: An Examination of Pension Fund Economically Targeted Investments, which examines how pensions are incorporating impact investing in their investment strategy. The report also provides case studies of current examples of pension fund ETIs.

The discussion also cited the CalPERS for California 2016 Report which, in part, quantifies the impact of ETIs. The report notes that 9.3 percent or $27.3 billion of the CalPERS investment portfolio is invested within California and those investments have resulted in $25.6 billion in economic activity across the state.

- **New GASB Reporting Standards –** The reported calculation of Minnesota's worker retirement system debt increased by $33.4 billion in 2016 because of the implementation of new accounting standards. The Governmental Accounting Standards Board (GASB) now requires governmental plan sponsors to use the yield on a 20-year municipal bond index to determine costs related to the unfunded portion of its pension liabilities. While Minnesota saw the biggest increase in its unfunded liability, 43 states saw their pension's funded status decline in 2016.

- **Good Jobs First Report –** Good Jobs First, a national policy center promoting corporate and government accountability, released a new report that demonstrates that many states could fund annual pension system costs by eliminating corporate subsidies and tax breaks. The report focuses on 12 states where public pensions are in jeopardy and compares pension operating costs to the corporate economic development subsidies offered.

- **Bipartisan Policy Center Report –** The Bipartisan Policy Center (BPC) released a new report analyzing the Social Security and Medicare Trustees' Reports. The report concludes that Social Security and Medicare are facing financing shortfalls that will only grow until corrective legislation is enacted. Further delays in addressing the financing issues will result in making the policy options even more unacceptable to both ends of the political spectrum. The window for repairing Social Security is closing.

- **Municipal Bonds –** The Center for State & Local Government Excellent released a new report entitled, How Have Municipal Bonds Reacted to Pension Reform? The report examines whether state and local borrowing costs have become more sensitive to pensions since the financial crisis. It found that rating agencies have begun to explicitly account for pensions in their methodologies; pension funded status can have a meaningful impact on the borrowing costs for a municipality; and adequate funding, monitoring and management of public pensions should be an important component of fiscal management. The full report is available here.

- **Comparative Analysis of Retirement Readiness –** A recent study examined the global impact of the shift from DB to DC retirement plans on retirement security. The survey of working-age individuals ages 18 to 64 in the U.S., United Kingdom and Australia was commissioned by the American Academy of Actuaries, Australian Actuaries Institute and the Institute and Faculty of Actuaries in the United Kingdom. The results show that many are planning to not retire at all; most are planning to retire gradually rather than fully; many are planning to retire at older ages; and relatively few are expecting a comfortable lifestyle in retirement. The full study can be read here.

- **Kentucky Pension Plan –** The Kentucky Pension Oversight Board's consultants recommended reducing state worker benefits and witching more employees to 401(k) plans. They predicted the state will need to spend about 20 percent of its general budget to save its pension system. They recommended that the state make an additional $2.47 billion in pension contributions annually. Currently, the state's largest pension fund is less than 20 percent funded.

  Kentucky Republican leaders unveiled a pension overhaul plan to make the system solvent over the next 30 years. The plan relies on both funding mandates and switching most employees to a DC plan. The state would be required to fund the plan's annual required contribution likely between $1.2 and $2.7 billion a year. The state estimates total unfunded liabilities across Kentucky's plans have reached $60 billion.

- **Missouri Pension System –** According to the Missouri state treasurer's calculations, the Missouri State Employees' Retirement System is only 60 percent funded and now owes $5.2 billion more than it has in assets. The funding shortfall has increased the amount the state must pay into the system each year to more than 20 percent of the state's total payroll costs. The board has already voted to reduce the assumed rate of investment return from 7.5 percent to 7.05 percent over a period of years. Other proposed measures include reducing benefits that haven't yet accrued and increasing employee contributions.

- **Colorado Pension Board** – The board overseeing Colorado's state pensions recommended higher contributions from employees and employers along with benefit cuts. The Public Employee's Retirement Association's current funded level is 58.1 percent. In December 2015, the funded level was 62.1 percent. The board also recommended cutting the annual cost of living adjustment from 2 percent to 1.5 percent; making 65 the eligible age for full retirement benefits for employees who are hired starting in 2020; increasing employee contributions to 11 percent starting in 2020; and increasing employer payments by 2 percent.

- **Ohio Pension System –** The Ohio Public Employees Retirement System told its members that it is weighing whether to cap the cost-of-living adjustment (COLA) at 1.5 to 2.5 percent. The current COLA is three percent. Trustees are also considering making new retirees wait longer before receiving their first COLA increase. A two page survey was sent to 194,000 current retirees to gauge their support freezing or capping the COLA.

- **Nevada Discount Rate –** A state panel overseeing the $38 billion Nevada public employee pension plan unanimously voted to lower its assumed rate of investment return from 8 percent to 7.5 percent over the next several years. New contribution rates for public employees and employers will be determined in November 2018. It is expected that higher contribution rates will be required to offset lower investment return assumptions.