July 2012

For the first time in more than two years, health care reform was a settled issue in July, with the U.S. Supreme Court having ruled in a 5-4 decision on June 28 that the Patient Protection and Affordable Care Act's individual mandate – which, starting in 2014, will require all Americans to have health insurance or pay a penalty – is a valid exercise of Congress' constitutional power to lay and collect taxes. The court did strike down a part of the law that would have revoked all federal Medicaid funding from states that refuse to participate in the planned program expansion. Non-compliant states will now only lose the additional, expansion-related funding. The Republican-controlled House of Representatives voted in July to repeal the law, but that was little more than a symbolic move that had occurred more than 30 times before. The debate over public pensions continued, meanwhile, with new analyses, new accounting rules and new proposals being issued.

Issues and Events

CalPERS Official Defends Dodd-Frank at Congressional Hearing

A CalPERS' senior portfolio manager appeared before a congressional panel on July 10, telling lawmakers that the Dodd-Frank financial regulations reform law "will establish an effective framework for promoting the safety and soundness of capital markets."

At a hearing of the House Financial Services Committee's Capital Markets and Government Sponsored Enterprises Subcommittee, CalPERS' Anne Simpson also described the pension fund's six criteria for "smart regulation":

- Be "complete and coordinated"
- Allow for the proper exercise of roles and responsibilities
- Ensure transparency
- Address "conflicts of interest and perverse incentives"
- Allow for the financing of "legitimate strategies"
- Be proportionate

"We see smart regulation as an investment in [the] safety and soundness of financial markets, which generate the vast bulk of the returns to our fund," Simpson said. "Smart regulation is an investment in the effective functioning of capital markets, which is critical not just to our fund, but to the recovery of the wider economy."

Simpson also offered CalPERS' endorsement of Dodd-Frank's new regulation of derivatives as well as its Volcker Rule, which, when implemented, will prohibit banks from investing with their own money. She referenced the much-publicized trading losses at J.P. Morgan Chase – which the firm recently announced will be at least double the $2 billion that had been initially estimated – in supporting the ban on proprietary trading.

"Although [J.P. Morgan's] CEO has asserted that 'no client, customer or taxpayer money was impacted by this incident,' there is no doubt that clients, customers and taxpayers were exposed to excessive risks due to speculative proprietary trading," Simpson said. "That the losses were borne by shareowners does not detract [from] this crucial point, nor does it diminish the need to effectively implement the Volcker Rule."

Dodd-Frank also includes measures intended to increase shareowner influence within corporations, which Simpson said will provided much-needed accountability.

The Republican-controlled committee held the hearing to examine the "impact of Dodd-Frank on customers, credit and job creators," and while some of the seven witnesses offered criticisms of the law, none raised a hand when asked if any thought that it should be fully repealed.

Thomas Deas, vice president and treasurer of FMC Corporation, appeared on behalf of the National Association of Corporate Treasurers and the U.S. Chamber of Commerce and took aim at, among other things, the Volcker Rule.

"A conservative application of the Volcker Rule could force financial institutions either to raise their fees for [market-making] activities or to become risk adverse and not engage in them at all," Deas said. "This could reduce the flow of capital to Main Street companies while diminishing liquidity in our capital markets. If financial institutions can no longer hold inventory or are unwilling to do so, it will be more difficult for FMC to raise capital. With reduced market liquidity, transaction spreads widen, risks increase and price changes become more volatile. To compensate for these new risks, investors will demand higher rates."

Kenneth Bentsen Jr., executive vice president for public policy and advocacy at the Securities Industry and Financial Markets Association (SIFMA), expressed support for the goals of some parts of Dodd-Frank, including its derivatives regulations, though he cautioned that "rigorous cost-benefit analysis is not only necessary in determining whether a particular rule is on balance beneficial; it is also crucial in evaluating alternative approaches to accomplishing regulatory goals."

Regarding the Volcker Rule, Bentsen's comments were less nuanced, saying the rule as proposed by regulators "may paralyze effective market-making, which is far from the statute's intent. In addition, as an unintended and deleterious side effect, the proposal will severely limit banking entities' abilities to hedge their own risk, thereby increasing rather than decreasing the risk to banking entities and the financial system."

(Dodd-Frank does allow for hedging activities by banks, and some have argued that, depending on how the Volcker Rule is implemented, this could end up allowing for a wide range of investments that are very similar to proprietary trading.)

Bentsen suggested that the rule be revised to allow banks to engage in "customer-focused principal trading."

"To foster customer-oriented business, the [regulatory] agencies' hard-coded criteria should be recast as guidance that helps banking entities to differentiate client-focused business from other business," Bentsen said. "We believe a business should be viewed as customer-focused, and therefore engaged in market making, if it is oriented to meeting customer demand throughout market cycles."

Actuaries Group Challenges GOP Senator's Report on Public Pensions

The American Academy of Actuaries in July challenged some of the arguments in a report by a senior Republican lawmaker that was very critical of public pension plans.

The January report from Sen. Orrin Hatch of Utah, the ranking Republican on the Senate Finance Committee, raised the specter of imminent insolvency of state and local pension funds and stated that "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." It concluded that "a new pension design for public plans" is needed, but it didn't state what that plan should be.

The American Academy of Actuaries wrote to Hatch on July 24 to warn that eliminating public defined benefit plans "comes at a significant cost to participants and taxpayers and is almost certainly an overreaction."

"Pension plans are capable of operating effectively through severe crises," the group stated. "With proper governance and by pooling and managing risk, these plans can provide participants with a secure and steady income through extreme economic conditions. Taxpayers can be well-served by these plans, which deliver this economic security at a reasonable cost when effectively managed."

It warned against an exclusive focus on funding ratios when examining a plan's financial health, saying that several other factors must be considered, and the analysis must look at multi-year trends, not the condition at a given point in time.

The Hatch report cited projections by Republicans on the Joint Economic Committee that 11 states will exhaust their pension plan assets by 2020, but the academy warned in its letter that the paper "uses questionable assumptions and simplistic methods to make this assertion."

"For example, the paper assumes that each plan sponsor would contribute only enough to fund newly accrued benefits, and that none of these funds would be available to pay current benefits," the group stated. "Ten years later the plans are projected to 'run out of money' only because the intervening 10 years' worth of contributions plus income (well over $1 trillion in aggregate) are simply assumed to be unavailable to pay benefits. As the GAO noted, 'The projected exhaustion dates are thus not realistic estimates of when the funds might actually run out of money.'"

As a result, the letter concluded, the paper cited in the Hatch report "should not be used as the basis for assessing the potential threat that state and local government-sponsored pension plans might pose to their sponsors."

Senate Chairman Proposes New Retirement Plans

A Senate committee chairman on July 27 proposed a new model for private pensions that combines aspects of both traditional defined benefit pensions and defined contribution accounts.

In a report that he said he hopes will be "the starting place in an evolving discussion about retirement security," Senate Health, Education, Labor and Pensions Committee Chairman Tom Harkin, D-Iowa, notes studies that have found that half of Americans have less than $10,000 in savings and that there is a retirement income deficit of $6.6 trillion. In addition to the shortfall in savings, he noted that pensions have been in "steady decline," and Social Security was never intended to be the sole source of retirement income.

The report proposes creating "Universal, Secure and Adaptable (USA) Retirement Funds." The portable funds would be privately run and professional managed and investments would be pooled. Participants would receive a defined monthly benefit during retirement that would be based on the total amount of contributions made by them or on their behalf and investment performance.

"Over the coming months, I plan to bring together business and labor leaders, policy experts, advocates and my fellow lawmakers to implement necessary reforms," Harkin said. "The retirement crisis is simply too big to ignore, and it is time for us to roll up our sleeves and get to work."

The new funds, the report notes, would largely eliminate investment risk for employers by spreading the risk across large groups of employees and retirees. Employers that do not already offer a retirement plan with automatic enrollment and a minimum level of employer contributions – defined contribution plans would count as long as they met those two conditions – would be required to withhold a certain amount from employees' pay and contribute it to a USA Retirement Fund. Employees could change their contribution amounts or opt out of the plan at any time.

The report also proposes increasing Social Security benefits and enhancing the program's cost of living allowance (COLA) while phasing out the cap on wages that are subject to Social Security's payroll tax. Taxes paid on wages that exceed the current cap would boost benefits by a limited amount.

President Signs Drug Fee Bill into Law

President Obama on July 9 signed into law a bill that may increase the availability of generic drugs.

The "Food and Drug Administration (FDA) Safety and Innovation Act" (S. 3187), which passed both the House of Representatives and the Senate with bipartisan support in June, would increase the fees that the pharmaceutical industry pays to fund FDA reviews, charging brand-name drug makers $4.1 billion over five years and generic drug makers, which until now have been exempt from user fees, $1.58 billion. Generic companies pushed to be included in the fee program in order to quicken reviews of their products. Companies that make generic versions of biologics – known as biosimilars – are expected to pay $128 million over five years, while medical device manufacturers are to pay $609 million. The total amount of fees from all companies is expected to be $2 billion more than was collected in the previous five years.

"This legislation will drive timely review of new innovator drugs and medical devices, implement the program proposed in the 2013 president's budget to accelerate approval of lower-cost generic drugs and fund the new approval pathway for biosimilar biologics created by the Affordable Care Act," Department of Health and Human Services Secretary Kathleen Sebelius said. "These new programs are important to increasing patient access to affordable medicines."

The legislation, however, does not include CalPERS-supported language that would have prohibited brand name manufacturers from refusing to sell certain tightly controlled medicines to generic companies. Such refusals can make it difficult for generic firms to acquire and duplicate the drugs. CalPERS in June signed on to a letter to lawmakers from the Generic Pharmaceutical Association, AARP, Express Scripts and several insurers that urged lawmakers to support the prohibition, which was in the Senate-passed version of the legislation but did not make it into the final bill.

The new law also directs the FDA to use an expedited review process for drugs intended to treat life-threatening conditions; provides incentives for the development of antibiotics; sets performance goals for the FDA; requires companies to report potential drug shortages to the government; and increases FDA inspections of overseas drug manufacturing facilities while replacing the requirement that the agency inspect domestic facilities every two years with a risk-based approach.

House Votes for Health Care Reform Repeal – Again

In a mostly symbolic vote, the Republican-controlled House of Representatives on July 11 voted to repeal the Patient Protection and Affordable Care Act.

The vote followed the June 28 ruling by the U.S. Supreme Court that upheld most of the law against a constitutional challenge by the National Federation of Independent Businesses (NFIB) and 26 states.

The House voted 244-185, with five Democrats joining all Republicans in backing repeal. The measure is not expected to be brought to a vote in the Senate, where Democrats have a majority.

This was the 33rd time that the House has voted to repeal all or part of the health care reform law.

The court upheld the law's requirement that all Americans have health care insurance or pay a penalty by interpreting the penalty as a tax, one that it found to be constitutional under Congress' power to lay and collect taxes. Republicans have sharply criticized the ruling, arguing that Congress can now impose any requirement on Americans and enforce it by taxing those who are non-compliant.

"How is this different from the government requiring Americans to purchase broccoli or pay a tax for not doing so," House Ways and Means Committee Chairman Dave Camp, R-Mich., asked last week.

Camp's committee on July 10 held a hearing on the "tax ramifications" of the decision at which Carrie Severino, chief counsel and policy director for the Judicial Crisis Network, said that the ruling's "interpretation of the taxing power is simply unprecedented in that it creates a new species of tax with chameleon-like properties."

"Allowing unrestricted taxes on inactivity will open the door to taxes the likes of which this country has never seen," Severino said. "For example, since seatbelts and motorcycle helmets increase road safety, Congress could simply tax those who refuse to wear them. Because 'preventative services' are now required to be covered by all health insurance plans without co-pays, Congress might tax people who fail to take advantage of them. Rather than leaving it to municipalities to incentivize recycling, the federal government could tax those who fail to do so. Legislators could even tax anyone who does not own a gun, citing studies that gun ownership reduces crime. And forget tax incentives for installing solar panels. Congress can now just impose a tax on any American who refuses to buy them. Whether any of these proposals are good or bad public policy is beside the point. The point is that Congress can levy any or all of these taxes in the wake of the *NFIB* decision."

However, Walter Dellinger, a partner at the O'Melveny & Myers law firm in Washington, D.C., and a former acting U.S. solicitor general, said that the ruling was "a relatively routine application of settled precedent and breaks no novel ground."

"The 'shared responsibility payment' is merely a financial incentive for people to have adequate insurance," Dellinger said. "This financial incentive goes hand-in-glove with the provisions ensuring that Americans will be able to obtain health insurance even if they have pre-existing conditions that previously would have allowed insurance companies to reject them. It is a payment that few Americans will ever make or even notice."

Consumer Financial Protection Bureau Challenged in Court

A major component of the 2010 Dodd-Frank financial regulations reform law is now facing a constitutional challenge.

State National Bank, a community bank in Big Spring, Texas, and two conservative groups – the Competitive Enterprise Institute and the 60 Plus Association – have filed a lawsuit arguing that the Consumer Financial Protection Bureau, which oversees mortgages, credit cards, student loans and other consumer financial products, presents "unprecedented violations of 'the basic concept of separation of powers'" and should be struck down.

"No other federal agency or commission operates in such a way that one person can essentially determine who gets a home loan, who can get a credit card and who can get a loan for college," State National Bank CEO Jim Purcell said. "Dodd-Frank effectively gives unlimited regulatory power to this so-called Consumer Financial Protection Board … with a director who is not accountable to Congress, the president or the courts. That is simply unconstitutional."

The arguments echo Republican complaints that the structure of the bureau – which is led by one director and is funded through a process not directly controlled by Congress – makes it too powerful and unaccountable.

The lawsuit, which was filed in U.S. District Court for the District of Columbia, also challenges President Obama's use of a recess appointment in January to make Richard Cordray the bureau's director after Senate Republicans blocked a vote on his nomination in December.

A bureau spokeswoman said that the "lawsuit appears to dredge up old arguments that have already been discredited."

"We're going to keep our focus on the important work Congress created us to do – making markets work for consumers and responsible providers," Jennifer Howard said.

The plaintiffs are also objecting to the Financial Stability Oversight Council, a group of regulators from various agencies that was created by Dodd-Frank to oversee systemic risks in the U.S. financial system, arguing that it has "sweeping power and effectively unbridled discretion" and will raise borrowing costs for smaller banks that are not designated by the council as being "systemically important."

RELATED NATIONAL AND INDUSTRY NEWS

Pew Finds $1.38 Trillion Shortfall in States' Pension, Retiree Health Care Funding

States, in 2010, were $1.38 trillion short of being able to pay for promised pension and retiree health benefits, according to a new study from the Pew Center on the States.

"States continue to lose ground in their efforts to cover the long-term costs of their employees' pensions and retiree health care … due to continued investment losses from the financial crisis of 2008 and states' inability to set aside enough each year to adequately fund their retirement promises," the report stated.

The total shortfall, which was up nearly 9 percent from 2009, included $757 billion in pension commitments and $627 billion in retiree health care promises.

While acknowledging that states "have enough cash to cover retiree benefits in the short term," the report warned that reforms are needed in the long-term.

"Many [states] – even with strong market returns – will not be able to keep up in the long term without some combination of higher contributions from taxpayers and employees, deep benefit cuts, and, in some cases, changes in how retirement plans are structured and benefits are distributed," the report stated.

Pew found that 34 states have pension funding levels below 80 percent, including California, which has funded 78 percent of its $516.3 billion pension liability. Meanwhile, 43 states had funded less than 25 percent of their retiree health care liabilities. Pew reported that California has funded just 0.1 percent of its $77.4 billion in retiree health care commitments. The center found "serious concerns" with the state's management of both liabilities.

Pew compiled the data using state and pension plan financial reports, as well as state actuarial valuations.

Group Estimates Public Pension Funding at 41%, Shortfall at $4.6 Trillion

A right-leaning analysis of public pension finances released in July puts the combined funding shortfall at $4.6 trillion.

The report from State Budget Solutions asserts that "the true state of public sector pension funding is far worse than suggested by official plan disclosures," and that using a "fair market valuation" of funds shows that they are only 41 percent funded. This contrasts with more commonly used 75 percent funding level – and $885 billion shortfall – that the report says is produced by the "more forgiving accounting" that is used by public plans.

The report was written by Andrew Biggs, a resident scholar the American Enterprise Institute, and State Budget Solutions has partnered with conservative and libertarian organizations such as the American Legislative Exchange Council and the Mercatus Center at George Mason University.

The report notes that pensions typically calculate funding levels by factoring in the value of expected investment returns – usually around 8 percent – then states that "there is an emerging consensus" that this approach causes funds to "significantly underestimate the value of public pension liabilities." It argues for using "fair market valuation" in which a "riskless" rate of return is assumed – that is, something like the 3-4 percent annual rate that could be expected from U.S. Treasury bonds – since "the discount rate you apply to a liability should be based on the risk of the liability itself, *not* of any assets used to fund the liability."

"More broadly, the use of a risk-adjusted discount rate captures the value of taxpayers' obligation to make good on benefit promises even if pension investments don't achieve their assumed returns," the report states. "This obligation has legal, political and moral force alongside a significant monetary value."

The Governmental Accounting Standards Board (GASB) in June revised its rules for public pension accounting to require governments to report pension promises as liabilities. The rules will allow funds that are financially healthy to continue to use a discount rate that reflects "the long-term expected rate of return on plan investments" only "as long as the plan net position is projected under specific conditions to be sufficient to pay pensions of current employees and retirees and the pension plan assets are expected to be invested using a strategy to achieve that return." Pensions in poorer fiscal condition must use a discount rate that is more like the riskless rate that critics support, specifically, "a yield or index rate on tax-exempt 20-year, AA-or-higher rated municipal bonds."

The State Budget Solutions report criticizes these reforms, saying they "are even less economically coherent than the current rules" and "may have been designed to placate critics of their current approach without excessively angering public pension administrators, who are effectively GASB's 'customers.'"

The report has better things to say about proposals from the credit ratings agency Moody's, which, earlier this month, suggested using a discount rate based on the returns of high-quality corporate bonds, though the report suggests that even this rate might be too high.

"If public pensions wish to offer less-than-guaranteed benefits to their participants, they are free to discount their liabilities using higher interest rates to represent that risk," the report concludes. "If so, however, pensions should openly state that benefits once thought to be ironclad no longer are so. Alternately, if pensions wish to lower their current contributions by investing in riskier, higher returning assets they also are free to do so. But then they must acknowledge that they are passing a contingent obligation on to future taxpayers to make good on pension benefits if today's investments don't turn out as planned. In other words, they must admit that they're not truly fully funding their future benefits."

NIRS Study Finds Retiree Households with Pensions Much Less Likely to Be Impoverished

Poverty rates in older households without a pension income were nine times higher in 2010 than in households with pensions, according to a report released on July 26 by the National institute on Retirement Security (NIRS).

While in 2010, 15.5 percent of households with residents aged 60 or older with no pensions had income that fell below the federal poverty level, only 1.7 percent of older households that did have pension income were similarly impoverished, according to the report.

The report also found that, without pensions, government spending on public assistance in 2010 would have been $7.9 billion higher, the number of households receiving such assistance would have increased by 1.22 million, and the number of households classified as poor or near-poor would have gone up by 4.7 million.

"This report sounds an alarm bell for policymakers and taxpayers alike," NIRS Executive Director Diane Oakley said. "There is a steep price to pay when older Americans can no longer be self-sufficient in retirement – either as increased public assistance costs to taxpayers or backsliding to a time with elder Americans living in poverty."

In 2010, 9.2 million private sector retirees and 5 million public sector retirees collected pensions averaging $13,301 and $26,199, respectively, according to the report.

AARP Releases Brief Analysis of Social Security Coverage for New Public Hires

AARP has released a short point-counterpoint paper on requiring all newly-hired state and local workers to participate in Social Security.

Virginia Reno, vice president of income security policy at the National Academy of Social Insurance, argued for the proposal, asserting that it would "improve the fairness and predictability of the entire system – Social Security plus the supplemental public pensions."

"All workers would be able to count on Social Security, which is fully portable between jobs and provides a foundation of inflation-protected retirement benefits, life insurance, and disability protection – an umbrella broader than most state and local plans provide." Reno wrote. "And state and local government employers and employees could count on the fact that their employer-provided benefits will be on top of Social Security's basic foundation of income security."

Though Reno acknowledged that states that have large numbers of workers outside of Social Security would face financial challenges, she wrote that including only newly-hired employees "offers state and local governments a manageable way to make the transition."

David John, senior research fellow at The Heritage Foundation, however, argued that the measure would be a "short-term fix that eventually makes Social Security's financial problems worse" and "may cause even greater problems for state and local government employees' pension plans."

John noted that, while the new tax revenues would boost Social Security's financial position in the near-term, the new beneficiaries would later be a drain on the system. By 2065, he wrote,

"Social Security would be paying out more to retiring state and local government workers than it receives in additional revenue from them."

In addition, he stated that a "more immediate problem is the effect on underfunded state and local employees' pension funds."

"Many of these plans have already promised to pay more benefits than they can afford to pay," John wrote. "Adding newly hired state and local government workers to Social Security would do nothing to reduce the cost of those programs since the benefits of current workers would not be affected. However, it could increase the plans' underfunding when those newly hired workers contribute less than they would now. If that happens, Americans in some states would see the temporary improvement in Social Security's finances offset by higher state and local taxes."

CALIFORNIA CONGRESSIONAL DELEGATION NEWS

Calif. Rep. Pushes Again for Hearing on Climate Change

A California congressman is seeking to have Congress hold a hearing "on the recent wildfires and extreme weather events the United States has experienced and the role global climate change played in these events."

In a letter sent to House Energy and Commerce Committee Chairman Fred Upton, R-Mich., on July 13, Reps. Henry Waxman of California, the ranking Democrat on the panel, and Bobby Rush, D-Ill., pointed to wildfires, floods and record-setting heat across the United States and said that, "Scientists are increasingly saying that these events are the climate change consequences they have been anticipating."

Waxman and Rush noted that they have requested that the committee hold a hearing on climate change 14 other times since April 2011 but to no avail.

“Willful ignorance of the science is irresponsible, and it is dangerous,” Waxman and Rush wrote. “According to the National Oceanic and Atmospheric Administration (NOAA), the United States has set more than 40,000 hot temperature records this year. Just this week, NOAA reported that the last 12 months have been the hottest in U.S. history. … Climate change is a grave threat facing our nation and the world, yet you refuse to hold hearings and the Republican-controlled House votes repeatedly to block action to address climate change. … This is a shameful record.”