AUGUST 2012

With Congress in recess for most of the month and much of the rest of official Washington vacationing to escape the city's heat and humidity, August is traditionally the slowest month in the nation's capital. This year was little different, though the presidential campaign kept things occasionally interesting, with Republican candidate Mitt Romney pledging that, if elected, he would undo the two signature legislative achievements of President Obama – health care reform and financial regulations reform.

ISSUES AND EVENTS

Public Pension Assets Surpass 2007 Levels

Public pension assets have recovered the losses they suffered in the market downturn of 2008-09 and now total $2.5 trillion, according to the U.S. Census Bureau.

The 14.6 percent increase in public pension assets in 2011 pushed the funds to a level 2.1 percent higher than they reached in 2007. Funds were hit hard after that point, losing $511.5 billion in 2009 alone.

Obligations also grew, however, and the 3.7 percent increase last year pushed public retirement system liabilities to $3.4 trillion.

Though a $900 billion difference remains between assets and liabilities, the former grew at a faster pace than the latter in 2011, a welcome change in a public pension community that has been assailed by critics over finances.

"To close the pension gap, the rate of growth in assets needs to exceed the rate of growth in liabilities," said Keith Brainard, research director for the National Association of State Retirement Administrators. "And, really, for the last 11 years, due to crummy investment markets, the liabilities, or the obligations, have been growing faster than assets."

Brainard also noted that retirement system funding has been limited by the recent decrease in public payrolls and the slow wage growth for public employees.

Total 2011 revenues increased 32.8 percent to $516.5 billion, with 80 percent of that amount – $410.6 billion – coming from investment earnings. Among the largest investment categories, international securities showed the largest increase, rising 24.1 percent to $446 billion, while domestic stocks grew 13.8 percent to $873.2 billion. Federal government securities returned 7.4 percent and now total $206.6 billion, but corporate bonds dipped 2.1 percent to $349.7 billion. Some smaller investment classes experienced substantial gains, with cash and short-term investments growing 36.4 percent to $107.3 billion, and real property increasing 28.6 percent to $107.1 billion.

Total payments grew 8.5 percent to $189 billion, with benefit payments to 7.3 million people accounting for $176.8 billion of that total.

California had the largest pension fund at $433.3 billion. The state earned $82.4 billion on investments and had $19.1 billion in contributions in 2011, while paying out $27.9 billion, including $26.2 billion in benefits. New York and Texas had the second and third-largest portfolios at $235.4 billion and $165.5 billion, respectively.

Pension Obligation Bond Issuance at Lowest Level Since 2001

The sales of pension obligation bonds (POBs) are at their lowest level since 2001, according to Thomson Reuters.

From January through July of 2012, states and localities issued $604 million in POBs, compared to $4 billion in 2011.

Such bonds can carry a fair amount of risk since sales proceeds are typically invested with the intention of getting a return that exceeds the debt service on the bonds. The use of bonds can result in reduced flexibility and financial losses – Wilshire Associates reported this month that public pension investments have returned just 1.15 percent in the past year – and can be seen by analysts and investors as a sign of financial distress.

"In the past, there was a perception that market returns would make the issuance of pension bonds worthwhile over time," Doug Offerman, an analyst at Fitch, said. "Going forward, it seems less likely that pension investments can provide steady, strong growth."

Nonetheless, Reuters noted that some California cities are considering using such bonds to pay off debts known as side funds to CalPERS.

Jean-Pierre Aubry, assistant director of state and local research at the Center for Retirement Research at Boston College, said that, unless equity valuations drop significantly, "I would not expect to see a flurry of new POB issuance."

"If the economy continues to be steady, pension funds will do better and government revenues will stabilize," Aubry said. "So, there will be less need for many new pension obligation bonds."

Large Public Pensions Increase Alternative Investments

Public pensions with at least $1 billion in assets have a record-high average of 15 percent of their investments in alternative classes such as venture capital and private equity, according to the Wilshire Trust Universe Comparison Service.

The average is up more than 50 percent from the 9.2 percent that was measured a year ago.

Alternative investments provide returns that are unrelated to the performance of the stock market, something that has likely grown more appealing since the market downturn of 2008-09.

CalPERS was found to have 14 percent of its $237 billion portfolio in alternative investments.

“There is a premium that goes with investing in alternative investments because they typically are a little bit riskier, but higher return,” CalPERS spokesman Brad Pacheco said.

GASB Posts New Public Pension Accounting Rules Online

The Governmental Accounting Standards Board has made available on its website the new public pension accounting guidelines it announced in June.

The new rules, for the first time, will require governments that provide defined benefit pensions to employees 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” in calculating their “net pension liability.” Critics of public pensions have pushed to require funds to use a “risk-free” rate of return – as would be expected from Treasury bonds – for the discount rate, which would be about half of the 8 percent return that is now commonly projected.

Funds may continue with the current discount rate method, however, 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.”

GASB Chairman Robert Attmore said in June that the board had considered requiring a risk-free rate to be used in all long-term funding calculations, but the board “decided that it was not appropriate in the government environment.”

Volcker Rule Expected by End of Year

Regulators are reportedly expected to release a final draft of the Volcker rule by the end of the year.

The Volcker rule would prohibit proprietary trading by banks – that is, trading done for the bank's own purposes, not at the direction of a client – and is one of the most controversial parts of the 2010 Dodd-Frank financial regulations reform law.

The Federal Reserve, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Commodity Futures Trading Commission and the Office of the Comptroller of the Currency have been working together to write the rule. They released a 300-page draft in October and have been reviewing 18,000 comments on the proposal that were submitted by the public since then. They've already missed the July 21 deadline for implementation of the rule.

Published reports in late August quoted an unnamed Treasury Department official as saying that "something will get done this year" in order to eliminate the uncertainty that now hangs over financial institutions.

One challenge that regulators have encountered is writing a regulation that bans proprietary trading while allowing legitimate market-making. In addition, Dodd-Frank allows banks to trade for hedging purposes, but it must be determined if the hedging has to be tied to a specific position or can be for an entire portfolio. The latter option would likely result in a fairly weak rule.

Supporters of a tough Volcker rule, primarily Democrats, argue that it is needed to discourage the type of excessive risk-taking that contributed to the market downturn and recession of 2008-09, while critics, mostly Republicans, caution that tight investment restrictions could hamper economic growth.

House Financial Services Committee Chairman Spencer Bachus, R-Ala., who has been one of the sharpest critics of the Volcker Rule and Dodd-Frank, announced on Aug. 7 that his panel will accept "ideas and suggestions on how to formulate a less burdensome legislative alternative" through Sept. 7.

"If regulators implement the Volcker Rule in its current form, the repercussions will be devastating to our economy," Bachus said. It will undermine our nation's ability to compete and make it harder for Main Street businesses to raise capital so they can grow and create jobs. Therefore, we must consider legislative alternatives that will not stifle economic growth and job creation."

Banks will have until July 21, 2014, to comply with the rule.

Dodd-Frank to Cost Banks up to $34 Billion Annually: S&P

The financial regulations in the 2010 Dodd-Frank law will cost the nation's eight largest banks a total of as much as $34 billion annually, according to Standard & Poor's.

Standard & Poor's had previously estimated that Dodd-Frank would reduce pre-tax earnings for Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, PNC Financial Services, U.S. Bancorp and Wells Fargo by $19.5-26 billion, but its latest estimate puts the range at $22-34 billion. The increase largely results from an expectation that regulators will implement a stricter version of the Volcker Rule, which will prohibit banks from engaging in proprietary trading, than had been thought.

The agency noted that, despite the decreased earnings, "we don't believe the financial impact of regulatory reform will, in itself, affect our ratings on the eight large U.S. banks."

Projections Vary Regarding Reform Law's Impact on Employer-Provided Coverage

The Government Accountability Office (GAO) found a wide variation in projections regarding how the health care reform law will affect employer-provided coverage.

The reform law includes several provisions that are expected to have an impact on whether employers provide coverage for their workers, including the individual mandate, the creation of health care exchanges, federal subsidies and penalties assessed on larger employers whose employees receive subsidized coverage.

The GAO reviewed five micro-simulation studies that showed results ranging from a 2.5 percent net decrease to a 2.7 percent net increase in the number of Americans with employer-provided coverage in the next two years. Among 19 surveys of employers reviewed by the GAO, though, 16 projected decreases in coverage ranging from 2 to 20 percent.

Employer-sponsored plans are the most prevalent type in the U.S. health care system, with 59 percent of Americans receiving their health coverage through the workplace. Many Republican critics of the Patient Protection and Affordable Care Act have argued that, notwithstanding the provisions regarding penalties for certain employers who do not cover their workers, the law, on net, will provide economic incentives for companies to drop coverage. The GAO conducted the study at the request of Sen. Michael Enzi of Wyoming, the ranking Republican on the Senate Health, Education, Labor and Pensions Committee and one of the most vehement critics of the law.

Generic Drugs Saved Americans More than $1 Trillion over 10 Years: Study

Generic medicines saved Americans a total of $1.07 trillion during the past 10 years, according to a study released in August by the Generic Pharmaceuticals Association (GPhA).

The study, which was conducted by IMS Research, put the 2011 savings at $193 billion, 22 percent more than in 2010, marking the highest annual increase in more than a decade. About 80 percent of the 4 billion prescriptions written in 2011 were for generic drugs, and total spending on pharmaceuticals last year – both generic and brand-name – totaled $320 billion.

"The remarkable findings demonstrated in this report are a testament not only to the generic industry's tremendous accomplishments over the past decade, but to the even greater achievements that are still to come," GPhA President and CEO Ralph Neas said. "The sustainability of the health care system and the national economy depend in significant measure on the availability of affordable medicines."

The study asserted that the success of generics has not diminished drug innovation, a concern that has been raised by critics. It noted that, "although generic utilization has reached new levels, more new medicines were launched in 2011 than in any other year of the past decade."

"By creating a fair balance between innovation of new medicines and accessibility to lower cost generic medicines," the report concluded, "federal law has established a win-win for providers and American consumers."

California Awarded Third Grant for Insurance Exchange

California and seven other states received grants last week to support the creation of health insurance exchanges, the Department of Health and Human Services (HHS) announced in late August.

Under the 2010 Patient Protection and Affordable Care Act, insurance exchanges are to be created at the state level to provide a place for individuals and small businesses to shop for and enroll in a policy, in some cases while receiving federal subsidies.

"We continue to support states as they move forward building an exchange that works for them," HHS Secretary Kathleen Sebelius said. "Thanks to the health care law, Americans will have more health insurance choices and the ability to compare insurance plans."

California, Hawaii, Iowa, and New York were awarded Level One Exchange Establishment grants, which provide one year of funding to states that have begun the process of building their exchange. Connecticut, Maryland, Nevada and Vermont were awarded Level Two Establishment grants, which are provided to states that are further along in building their exchange and offer funding over multiple years.

California, according to HHS, is to use its grant to:

- Coordinate with state agencies in health coverage programs as well as consumer assistance and insurance oversight.

- Design policies for enrollment and eligibility.
- Refine and begin implementing a public education and outreach program.
- Begin selecting and certifying qualified health plans for participation in the exchanges.
- Submit an exchange blueprint to secure federal certification.
- Develop and execute a plan to evaluate exchange programs.
- Enhance financial management and business operations in the exchange.

California has now received three exchange-related grants totaling $237 million.

Thirty-four states and the District of Columbia have received grants to start building their exchanges, while 15 states have received planning money. Alaska has not applied for a grant. Applications may be submitted through the end of 2014.

RELATED NATIONAL AND INDUSTRY NEWS

Public Sector Groups Note Concerns with Proposed Federal Normal Retirement Age Regulations

A coalition of 13 public sector organizations wrote to the IRS on July 30 to provide comments on proposed regulations regarding the normal retirement age in government retirement plans.

The IRS and the Treasury Department are considering issuing guidance related to the applicability of federal normal retirement age rules to governmental plans.

Noting that "following the issuance of federal normal retirement age regulations in 2007, which were aimed at private sector plans, there has been significant confusion surrounding their application to state and local government retirement plans," the group requested that the IRS and the Treasury Department:

- Issue proposed regulations before finalizing the application of any normal retirement age rules to governmental plans to allow time for public comment.
- Make clear that federal restrictions on governmental plan normal retirement ages pertain to in-service distributions only.
- Treat qualification for an unreduced benefit in a governmental plan to be an acceptable normal retirement age for the purposes of the 2007 regulations.

The groups noted that the unique structures of state and local retirement plans would produce challenges for applying a one-size-fits-all federal standard.

"Many state and/or local statutes may not have a specific normal retirement age, but instead require the satisfaction of one or more age and/or service combinations in order to qualify for an unreduced retirement benefit," they stated in the letter. "In addition, governmental pension plans often provide multiple benefit structures and cover multiple employee groups, which further complicate applying a standardized federal definition in the diverse public sector setting. However, this does not mean that public employees do not have protection for their accrued benefits. State constitutions, state and/or local statutes, and/or case law define when a plan participant is vested in his/or her [sic] benefit and whether future benefits can be modified."

CALIFORNIA CONGRESSIONAL DELEGATION NEWS

CalPERS Urges Congress to Reject Additional Sarbanes-Oxley Exemptions

CalPERS at the end of July urged lawmakers to reject a proposal that would provide additional exemptions from the auditing and internal controls requirements that are at the heart of the 2002 Sarbanes-Oxley Act.

Congress passed Sarbanes-Oxley in the wake of high-profile accounting scandals and bankruptcies at Enron, WorldCom and other companies. CalPERS had a significant role in the drafting of the law, which reformed certain accounting and corporate governance rules for publicly-traded companies.

The law's Section 404 requires an outside auditor to sign off on a company's internal controls. It has long been the most controversial aspect of the law, with Republicans and business groups arguing that it is overly burdensome and impedes job creation. The 2010 Dodd-Frank financial regulations reform law and this year's Jumpstart Our Business Startups (JOBS) Act provided Section 404 exemptions for smaller and "emerging growth" companies, respectively.

Now, Congress is considering a bill from Rep. Michael Fitzpatrick, R-Penn., which would exempt companies with no more than $250 million in publicly-traded shares – the current threshold is $75 million – or with no more than $100 million in annual revenue. CalPERS Senior Portfolio Manager Anne Simpson wrote in a July 30 letter to the chairman and ranking member of the House Financial Services Committee's Capital Markets and Government Sponsored Enterprises Subcommittee that the proposal is "misguided."

"CalPERS and other investors benefit from the assurances provided by independent auditors about issuers' internal controls," Simpson wrote. "Allowing companies to avoid an external audit of their control will undermine investor confidence, and thereby potentially affect companies' ability to attract the long term capital they need for growth."

The Capital Markets Subcommittee, however, voted 18-15 to advance the bill, with all Democrats, including the two from California – Reps. Brad Sherman and Maxine Waters, the panel's ranking member – opposing the measure, and all but one Republican – California's Rep. John Campbell – supporting it. Two other California GOP representatives – Reps. Ed Royce and Kevin McCarthy – backed the legislation.

The subcommittee examined the proposal at a July 26 hearing at which supporters said it would encourage economic growth, while critics expressed concern that it would undermine the accountability goals of Sarbanes-Oxley.