Federal Retirement Policy Report for CalPERS Board
July 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:

- **Federal Employees Retirement System –** The House Budget Resolution, as approved by the Budget Committee, may set in motion major changes to the retirement plans for federal workers. While not affecting state and local governmental pension plans, the provisions are worth noting because they provide an insight into the thinking of the House Republican majority on government retirement plans. While the Budget Resolution is not enacted into law, it is a template for future actions by the committees of jurisdiction.
  - First, the Resolution calls for following the changes included in the President's National Commission on Fiscal Responsibility. The Commission was created by President Obama. It recommended that federal employees pay 50 percent of the cost of their retirement. That would mean an increase to seven percent of payroll. Staggered by date of hire, the current range for employee contributions is no greater than 4.4 percent.
  - Second, the Resolution calls for the elimination of the Social Security supplement, which provides a benefit to bridge the gap for those who retire prior to age 62 up until they reach age 62.
  - Finally, the Resolution includes language recognizing "the need for new federal employees to transition to a defined contribution retirement system…"

- **Discount Rate –** The credit rating agency Fitch announced it is lowering the discount rate for U.S. public pension plan liabilities to six percent from seven percent due to "slower and more incremental" economic growth.

- **State and Local Pension Plans –** The Center for State & Local Government Excellence released an issue brief State and Local Pension Plans Funding Sputters in FY 2016, on state and local pension funding. It found that the aggregate funded status of state and local pension plans declined in fiscal year 2016 because liabilities continued to grow steadily while poor stock market performance led to slow asset growth. The ratio of assets to liabilities for the 170 plans in the Public Plans Database decreased from 73 percent in 2015 to 72 percent in 2016 as measured by the traditional Governmental Accounting Standards Board (GASB) standards; the ratio decreased from 73 percent to 68 percent when measured by the new GASB standard.

  A similar study was recently released by the Society of Actuaries, U.S. Public Pension Plan Contribution Indices, 2006-2014. Their study found unfunded liabilities for 130 large public pension plans increased by about 150 percent from $400 billion in 2006 to nearly $1 trillion in 2014. This occurred despite a 76 percent increase in employer contributions. In addition, the study concluded that only 20 percent of these plans are making contributions to prevent further funding level declines.

- **Defined Benefit Economic Study –** The National Conference on Public Employee Retirement Systems (NCPERS) published a study, Economic Loss: The Hidden Cost of Prevailing Pension Reforms that highlights the costs to the economy that will result by 2025 from the disappearance of defined benefit plans. The study's findings include:
  - Total personal income in the US would decline by about $3.3 trillion by 2025.
  - Economic growth would be reduced to 3.29 percent by 2025, from a potential four percent growth.
  - As various states minimize their defined benefit plans, they are likely to see income inequality rise by 15 percent over a 10-year period. In turn, that will cut into the rate of economic growth by almost 18 percent over the period.
  - Defined benefit plans provide a $1.2 trillion stimulus to economic output, which helps stimulate the economy and provide capital for businesses.

2. CalPERS Implications and Next Steps:

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

3. CalPERS/Federal Representative Actions:

- The National Association of Public Pension Attorneys (NAPPA) held its annual legal education conference from June 27-30. Your federal representative Tony Roda (Williams & Jensen) attended the conference and made a presentation on federal legislative and regulatory issues affecting public pension plans, specifically emphasizing those related to public safety plans.
- The ad hoc public pension network met on June 19; your federal representative Tony Roda (Williams & Jensen) attended the meeting. The discussion centered on updates related to tax reform, infrastructure and Social Security WEP reform. Legislative activity related to tax reform should begin in earnest this fall; infrastructure will follow tax reform, but could easily slip into 2018.
- Following the PPN meeting, a sub-group met with the lead Democratic pension counsel of the Senate Finance Committee who confirmed the timeline above; the group briefed the counsel on the key items for state and local plans in the context of tax reform, namely PEPTA, the annuity accumulation plan and the push to Roth accounts.

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 later 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 percent for the first 10 years and up to 50 percent thereafter; on average, future retirees will see a reduction approximately 35 percent less than current law. These benefits have been updated based on a revised SSA actuarial analysis.

4. CalPERS/Federal Representative Actions:

   Your federal representatives (Tony Roda and Tom Lussier) have both met with staff for House Ways and Means Committee Chairman Kevin Brady (R-TX) and have been assured that WEP reform remains a high priority for the current Congress. Staff is currently crunching numbers in an attempt to develop a transition rule for those who would be exempt from WEP under the current system (substantial earnings exemption) but would be subject to the new proportional formula under H.R. 711 (114th Congress). This concern has been raised primarily by the International Association of Fire Fighters.

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.

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:

   - U.S. Securities and Exchange Commission Chairman Jay Clayton announced that the agency would seek comments on a range of issues related to the fiduciary rule. "An updated assessment of the current regulatory framework, the current state of the market for retail investment advice, and market trends is important to the commission's ability to evaluate the range of potential regulatory actions," Clayton said.
   - President Trump has nominated Hester Peirce to the Securities Exchange Commission (SEC). Peirce is a research fellow at the conservative Mercatus Center at George Mason University in Virginia. She has been a fierce critic of the DOL fiduciary rule. In an April letter to DOL Peirce recommended it work with the SEC, which has a broader understanding of the regulation of financial products and services.
   - The House Financial Services Committee's Subcommittee on Capital Markets, Securities and Investment held a hearing to discuss the DOL fiduciary rule. Republicans and financial service industry representatives advocated delaying the January 1, 2018 full implementation date. They argued that maintaining that the rule actually limits consumer choice and will negatively impact

savers. Democrats and supporters of the rule contended that the rule protects savers by giving them access to unbiased advice.

- On July 19, the House Education and the Workforce Committee approved the Affordable Retirement Advice for Savers Act (H.R. 2823), which was introduced by Rep. Phil Roe (R-TN). H.R. 2823 would repeal the DOL's fiduciary duty rule and establish a statutory definition of investment advice. The Committee favorably reported the bill by a roll call vote of 19-17.

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 resolutions (H.J. Res. 66 and 67) passed by Congress to nullify the DOL rule.

2. New Development Since Last Report:

   - Rep. Suzanne Bonamici (D-OR) introduced H.R. 2523, the companion bill to S. 1035, the Preserve Rights of States and Political Subdivisions to Encourage Retirement Savings Act (PROSPERS Act). The legislation would amend ERISA to specifically exclude from its scope certain IRA-based retirement plans run by state or political subdivisions for private sector workers. However, given the opposition from the financial services community to state and political subdivision--run retirement plans for private sector workers, it is unlikely that this legislation will be considered by the current Congress.
   - Oregon Private Sector Plans – On July 1, Oregon became the first state to launch a retirement savings program for private sector workers, provided the employers do not sponsor retirement plans. The program is similar to those in various stages of implementation in California, Connecticut, Illinois, and Maryland. Eleven Oregon employers have volunteered to register early for the pilot program. They will make transfers from the payroll of 151 employees to professionally-managed, individual retirement accounts established and sponsored by OregonSaves. Employers with 100 or more workers are required to register in the first phase of OregonSaves by November 15; payroll deductions will be made to employee accounts by January 1, 2018.
   - NCPERS published its Secure Choice 2.0: States blazing a path to retirement security for all, report, which focuses on developments in state-facilitated retirement savings. Topics covered include: Updates on state-facilitated retirement savings; best practices; model legislation; and a look at the next stages for state-facilitated retirement.

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, 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 –

- **Hearing on Social Security Payroll Tax Compliance –** On June 29, the House Ways and Means Committee's Subcommittees on Social Security and Oversight held a joint hearing entitled Complexities and Challenges of Social Security Coverage and Payroll Tax Compliance for State and Local Governments. The hearing focused on the administration of section 218 agreements and how the Social Security Administration, Internal Revenue Service, and state governments can communicate better to insure compliance by all public employers. Issues related to the Social Security offsets known as the Windfall Elimination Provision (WEP) and the Government Pension Offset (GPO) as well as proposals to impose mandatory Social Security coverage for all new state and local employees were not discussed at this hearing.

- **Multiemployer Pension Plans –** United Parcel Service (UPS) is working on a proposal focused on maintaining solvency for unionized workers' pensions. The proposal would provide low interest, long-term federal government loans to troubled pension plans to cover their cash flow shortage for five years. Under the proposal, plan participants would see benefit cuts of 20 percent across the board. Plans would be obligated to begin interest-only repayments after five years. Loan repayments would be ensured through the creation of a risk reserve pool funded by employers, participants and unions. UPS has a significant interest in solving the pension crisis because it could liable for up to $4 billion in plan contributions if the Central States (Teamsters) plan becomes insolvent. Legislation has not yet been introduced.

III. Other Updates and Information

- **Retirement Gap Grows –** The World Economic Forum reports that the retirement savings shortfall will reach $400 trillion by the year 2050. That figure is derived from the amount of money government, employers and individuals would need to provide to equal 70 percent of his or her annual earnings before leaving the workforce. The report cites longer life spans and disappointing investment returns among the chief reasons for the growing shortfall. $224 trillion of the gap is attributed to six large pension savings systems: the U.S., U.K., Japan, Netherlands, Canada and Australia. China and India account for the remainder. Some countries have taken steps to reduce the gap. For example, the Netherlands and Canada have collective retirement systems for defined contribution plans, which helps pool risks and reduce fees.

- **FICA Replacement Plans –** At a June 7 meeting, an Internal Revenue Service (IRS) advisory panel recommended that the IRS revise rules defining Federal Insurance Contributions Act (FICA) replacement plans, which are exempt from Social Security taxes. The regulations are 25 years old and becoming obsolete because state and local governments are increasingly creating more and more innovative retirement packages. IRS Commissioner John Koskinen emphasized at the meeting that the tax treatment of FICA

replacement plans was a timely issue, and that he intends to raise the topic with the House Ways and Means Committee staff. The advisory committee's report recommended that the IRS establish consistent terms used to describe the plans. Other recommendations included training for federal, state and local government agents on Social Security coverage laws, and increased enforcement in situations where improper payments have been made.

- **Tax Reform –** An outline of tax reform principles from the Big Six process was released on July 27. The release is only top line and does not contain details. It appears designed to show agreement on only the highest level of policy areas. The Big Six process has been on-going for many weeks. The group is comprised of House Speaker Paul Ryan (R-WI), Ways and Means Chairman Kevin Brady (R-TX), Senate Majority Leader Mitch McConnell (R-KY), Finance Committee Chairman Orrin Hatch (R-UT), National Economic Council Chairman Gary Cohn and Treasury Secretary Steve Mnuchin.

- **Regulatory Reform –** Earlier this year President Trump released an Executive Order that specified that two federal regulations must be eliminated for each new federal regulation issued. Further, the cost of any new regulation must be fully offset. OMB now says that the elimination of agency guidance would count as elimination of a regulation. In the tax area, guidance would include, but not be limited to, revenue rulings, revenue procedures and Treasury notices. Also, OMB has stated that an agency does not have to accomplish the 2-for-1 and the cost offset requirements in each regulatory event. Instead, the 2-for-1 and net neutral cost requirements will be tested at the end of each fiscal year.

- **Treasury-IRS Regulatory Agenda –** Treasury-IRS announced a broad regulatory agenda. According to the outline, they anticipate issuing by the end of this calendar year a proposed rule on the definition of governmental plan under Internal Revenue Code section 414(d) and a final rule on the application of normal retirement age regulations to governmental plans. However, the large number of items on the agenda may mean that several will slip into 2018 and beyond. In addition, on July 24, the Treasury-IRS released Notice 2017-38, which lists eight tax regulations that will be reformed. The range of action is from streamlining the rule to full repeal. The rules slated for reform include a proposed rule from February 2016 regarding the definition of political subdivision for purposes of issuing tax-exempt bonds. This bears monitoring because of its potential implications for the larger regulatory process to define governmental plan under Internal Revenue Code section 414(d).

- **Determination Letter Program –** On June 30, the IRS announced it will be combining its master and prototype (M&P) and volume submitter (VS) programs into a new opinion letter program that will streamline the approval process for tax-qualified retirement plans. The IRS hopes that this change will encourage employers that offer individually-designed plans to convert to a pre-approved format. This change is part of the IRS's continuing shift away from the determination letter program, which plan's previously relied on as assurance that they were qualified under the tax code.

- **Americans Delaying Retirement –** According to the U.S. jobs report released on July 7, 19 percent of people 65 and older are working at least part time. In recent years the percentage of people over 65 in the workforce has steadily increased. Experts cite advances in medicine as the primary reason older Americans are remaining in the workforce longer. However, 61 percent of American retirees say they retired too early and need to continue working for their financial sustainability.

- **myRA Program -** Developed by the Obama Administration, the myRA program provides a simple way to start a portable, auto-contribution, retirement savings plan for people who do not have a retirement plan through their work. Senators Patty Murray (D-WA) and Ron Wyden (D-OR) sent a letter on July 14 to encourage Treasury Secretary Steven Mnuchin to support the program. Currently, 55 million Americans are not covered by an employer-sponsored retirement plan. However, on July 28, the Treasury Department

announced that it will begin to unwind the myRA program because of low demand for investment and high administrative costs to the taxpayers.

- **Louisiana State Pensions –** A new report by the Louisiana Budget Project, Pensions in the Parishes 2017, found that state pension systems serve as key economic drivers across the state, particularly in rural areas where public pension benefits make up a substantial source of personal income and economic activity. The report outlines the combined economic impact of the three largest state retirement systems, LASERS, TRSL and LSPRS, which together account for two percent of all personal income in the state. In rural areas these pension distributions account for as much as four percent of total personal income.

- **Connecticut Retirement Plan –** Connecticut Governor Dannell Malloy released a proposal that would create a hybrid retirement plan for new employees, raise non-hazardous duty employee contributions for current employees, and curb cost-of-living adjustments. The proposal would create a new compensation structure for new hires, by combining a traditional defined benefit plan with a defined contribution plan. The pension portion of the proposal, which includes changes to wage increases and health insurance, would reduce the state's share of pension contributions through fiscal year 2047. The new structure would also include changes to the COLA formula. For retirements occurring after July 1, 2022, the state would match the Social Security COLA index up to a maximum of two percent – down from the current minimum of two percent.

- **Pennsylvania Pension Overhaul –** After many years of controversy and debate, a bipartisan overhaul of the state's employee and teacher pensions has been signed into law. The overhaul shifts risk away from taxpayers and puts the state on track to reduce a $76 billion unfunded pension liability. It will save some $3 billion in investment fees. New members of the State Employees' Retirement System (SERS) and the Public School Employees Retirement System (PSERS) will be allowed to elect one of three retirement saving options: a stand-alone defined contribution plan, or one of two hybrid options that combine both defined benefit and defined contribution features. Existing participants will be given 90 days to elect into one of the new plans.

- **Vermont Multiple Employer Plan –** On June 7, the Georgetown Center for Retirement Initiatives hosted a webinar entitled Small Businesses & Retiree Readiness: Vermont Embraces a Multiple Employer Plan Approach. Vermont Treasurer Beth Pearce described the process to form the multiple employer plan (MEP). She emphasized the guiding principles identified for the plan: simplicity; affordability; ease of access; trustworthy oversight; protection from exploitation; portability; choice; voluntary; financial education; sufficient savings; should be additive, not duplicative; and able to use pre-tax dollars. The MEP will be voluntary and available to employers with 50 employees or less who do not already offer a retirement program. A seven-member board will oversee the MEP.

- **Michigan Teachers' Pension –** On June 15, the Michigan Legislature narrowly passed legislation to create a new hybrid pension system. The bill was pushed through in just two days. Democrats and labor representatives claim that changing the pension laws in an accelerated timeframe is against Michigan law, which requires analysis of the bill seven days prior to changing pension benefits. Republicans claim the issue has been discussed for months before this bill was introduced. Democrats have threatened a lawsuit to prevent enactment of the law citing concerns that the defined benefit program structure is problematic. If the plan becomes underfunded, it would require employees to contribute half the cost of maintaining the new program's debt.

- **New York City Pension –** The Manhattan Institute (MI) issued a new report on the costs of New York City's pension. The report calculates that pension payments currently make up a record high 11 percent of the city's total budget. The report predicts that pension payments will soon displace social security as the largest expense in the budget. MI suggests two possible solutions. One option is to reduce the over-optimistic,

investment-return assumptions. The second is to use reserves set aside for contract settlements to fund the $655 million needed annually for additional pension payments.

- **Chicago Pension Funds –** Mayor Rahm Emanuel has proposed a plan to keep two of the city's pension funds from going insolvent. An ordinance filed June 28 would use Chicago's home-rule powers to allow the city to increase required contributions to the retirement funds for municipal workers and laborers. This step would otherwise require state approval. Without this change, the funds are scheduled to run out of money by 2025 and 2027, respectively.

- **New Jersey Retirement System –** New Jersey will make a $2.5 billion contribution in fiscal year 2018 to the state's retirement system for teachers, police officers and other civil servants. This is the largest contribution in the state's history. However, it is only 50 percent of the actuarially recommended amount. Beginning in 2018, the pension system will also receive approximately $1 billion per year from the state's lottery revenue. The changes are designed to reduce the pension plan's $49 billion unfunded liability by as much as $13.5 billion.