

TEXPERS OUTLOOK

ISSUES IMPACTING PUBLIC PENSION FUNDS

New Research Studies Effects of Proposed GASB Accounting

As it seems likely that the Governmental Accounting Standards Board's (GASB) proposed rules on public pension plan accounting will soon become final, researchers at Boston College's Center for Retirement Research have released a study saying that the rules will sharply reduce the reported funded levels of public sector plans.

Professor Alicia Munnell and her Boston College team studied the implications of the proposed governmental accounting standards on the reported financial condition and funding status of 126 public pension plans.

The study, "How Would GASB Proposals Affect State and Local Pension Reporting?" contains information on how the accounting changes will alter the funded ratios of state and local plans. It reviews how plans currently value plan assets and employer liabilities and explains GASB's

GASB Accounting continued on next page

TEXPERS Exposes Fallacies in New Report on Public Pensions

TEXPERS is taking issue with a new report by the Laura and John Arnold Foundation in Houston that advocates how to reform public retirement systems.

The report, "Creating a New Public Pension System," is the foundation's first policy paper and touts "effective alternatives to the current pension system."

TEXPERS disagrees with two of the report's main points: 1) that failing to promptly address public pension underfunding would be "economically catastrophic," forcing cities, school systems and even entire state governments into bankruptcy, and 2) that the best way to fix the problem of underfunding is to force public plans to switch from traditional defined benefit (DB) pensions to 401(k)-style defined contribution (DC) plans. In a special report written by TEXPERS, "Debunking Myths about Texas Public Employee Pensions," TEXPERS said it reviewed the Arnold Foundation report and "found numerous examples of exaggeration, hyperbole and questionable fact-

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proposals. It also provides aggregate funded ratios for the 126 plans in the researchers' Public Plans Database. Finally, it discusses some of the implications of the GASB proposals.

"The conclusion is that employers and plan administrators should be prepared for funded ratios reported in their financial statements to decline sharply under the new rules," the study says. "But accounting changes do not alter the underlying fundamentals; \$1,000 owed to a retired teacher in ten years under current standards will remain \$1,000 owed in ten years under the new standards. So policymakers should not let new numbers throw them off the path of sensible reform."

At least one-third of the public plans in the study will not run out of money under the researchers' model and show strong financial capacity beyond the year 2100.

But about one-fifth of the total public pension plans cited in the study have the potential to run out of assets to pay their bills within 25 years, when the model of the new GASB accounting standards is applied.

The study predicts that Texas pension plans will run out of money as follows: Texas County & District, after 2100; Texas ERS, in 2065; Texas LECOS, in 2033; Texas Municipal, after 2100; and Texas Teachers, after 2100.

"It would be unfortunate if the press and politicians characterized these new numbers as evidence of a worsening of the crisis when, in fact, states and localities have already taken numerous steps to put their plans on a more secure footing," the study states. "Reforms need to be done carefully and thoughtfully, remembering that pensions are an important part of the total compensation of public sector workers. Policymakers should not let new numbers throw them off course."

It is still unclear when GASB's proposed accounting standards might take effect. The proposals, outlined in two exposure drafts released for public comment in 2010, encompass a host of reforms pertaining to virtually every aspect of pension accounting.

Three of the main proposals pertain to the valuation of assets and liabilities. First, plan assets would no longer be smoothed but rather valued at market.

Second, liabilities would be discounted by a blended rate that reflects the expected return for the portion of liabilities that are projected to be covered by plan assets and the return on high-grade municipal bonds for the portion that are to be covered by other resources.

Third, the entry age normal/level percentage of payroll would be the sole allocation method used for

reporting purposes.

On the Web at: http://crr.bc.edu/images/stories/Briefs/slp_23_508.pdf.

Meanwhile, Robert Novy-Marx, Assistant Professor of Finance at the University of Rochester, published a paper in November that finds that GASB's methodology for calculating government defined benefit pension liabilities has several features that may obscure plans' true funding status.

"In particular, it is possible that a plan can improve its GASB funding status by literally burning money," he writes in "Logical Implications of GASB's Methodology for Valuing Pension Liabilities."

"GASB also allows a pension system to improve its funding status by reapportioning its assets and liabilities across multiple funds, without altering the true economic nature of either its assets or liabilities," Novy-Marx writes.

"Finally, GASB's methodology is economically equivalent to accounting for pension liabilities in the same manner that states account for their long-term liabilities more generally, but booking stocks at roughly twice their market price, and further crediting a plan an additional dollar for each dollar of stock it intends to buy in the future. These facts make it difficult to interpret a plan's GASB calculated liability."

On the Web at: <http://rnm.simon.rochester.edu/research/LIoGMfVPL.pdf>. 



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finding.” The Arnold Foundation asserts that pension shortfalls nationwide amount to \$3 trillion when using standard private-sector accounting rules. TEXPERS says this figure is “grossly overstated” and that using the currently accepted actual method of accounting put in place by the Governmental Accounting Standards Board (GASB) pegs unfunded liabilities at roughly \$700 million, well within the funding level of about 80 percent that is considered acceptable to many public plans.

TEXPERS also faults the Arnold Foundation report for advocating a switch from DB to DC plans for public employees. “DC plans are simply not good for employees,” TEXPERS says its special report.

The Arnold Foundation report fails to note that DC plans are optional for employees, do not require employees to participate, let employees choose what percentage they want to contribute, and do not require employers to contribute any matching funds to the plan.

In addition, DC plans are more expensive to operate than DB plans, place all risks of investment and inflation in the employees’ hands, and allow employees to liquidate their retirement accounts before they retire, if they choose to pay the penalties.

“DB plans have an infrastructure in place that allows for prudent investing and a secure retirement for its retirees,” TEXPERS says.

The Arnold Foundation report is available on the Web at: <http://www.arnoldfoundation.org/sites/default/files/LJAF-Pension-Solution-Paper.pdf>. TEXPERS Special Report on “debunking myths” in the report is available at: www.Texpers.org/documents/Debunking-the-Arnold-Foundation-Report.pdf.



Global Regulators Open Talks on Regulating OTC Derivatives Markets

Derivatives regulators from across the globe met in Paris in early December and discussed the implementation of new legislation, rules to govern the over-the-counter (OTC) derivatives markets and other cross-border issues, but did not reach any formal agreement, according to a joint statement from the regulators.

At the end of the meeting at the headquarters of the European Securities and Markets Authority in Paris, regulators “agreed to continue bilateral regulatory dialogues and to meet as a group again in early 2012.”

U.S. Commodity Futures Trading Commission Chairman Gary Gensler and Securities and Exchange

Commission Chairwoman Mary Schapiro were among the nine global regulators to attend the meeting. Others came from Canada, the European Union, Hong Kong, Japan and Singapore.

The CFTC and SEC are in the process of finalizing dozens of new rules to implement the derivatives regulatory regime mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

On the Web at: <http://www.sec.gov/news/press/2011/2011-260.htm>.

New Guidance Provides Advice on IRS Plan to Tackle Definition of ‘Governmental Plan’

The Groom Law Group has released guidance covering the Internal Revenue Service’s proposal to define a “governmental plan.”

The definition is “is critically important to defining the obligations of the plan sponsor, and the rights of participants and beneficiaries,” the guidance states.

That’s because governmental pension plans are exempt from the reporting, participation, vesting, and fiduciary standards of ERISA. Similarly, governmental welfare plans are generally exempt from the ERISA rules that privately sponsored welfare plans must satisfy.

But the IRS initiative could change all that. The ERISA exemption for governmental plans primarily reflects congressional policy that the federal government should not dictate the rules for the benefit programs of state and local governments.

Groom’s guidance was published by the Bureau of National Affairs’ Daily Tax Report at: http://www.groom.com/media/publication/1090_New_IRS_Regulation_Project_Tackles_Definition_of_Governmental_Plan.pdf.



Wachovia Settles Charges of Fraudulent Bid Rigging in Municipal Bond Market

Wachovia Bank N.A., today known as Wells Fargo Bank N.A., has settled federal charges of fraudulently engaging in secret arrangements with bidding agents to improperly win business from municipalities and guarantee itself profits in the reinvestment of municipal bond proceeds.

For its role in anticompetitive activity in the municipal bond investments market, the company agreed to pay a total of \$148 million in restitution, penalties and disgorgement to federal and state agencies, according to the U.S. Department of Justice (DOJ) and Securities and Exchange Commission (SEC).

Wachovia admitted to the illegal, anticompetitive conduct by its former employees at its municipal derivatives desk. These employees entered into unlawful agreements to manipulate the bidding process and rig bids on municipal investment and related contracts. These contracts were used to invest the proceeds of, or manage the risks associated with, bond issuances by municipalities and other public entities.

The company generated millions of dollars in illicit gains during an eight-year period (1997-2005) when its employees fraudulently rigged at least 58 municipal bond reinvestment transactions in 25 states and Puerto Rico.

Wachovia won some bids through a practice known as “last looks” in which it obtained information from the bidding agents about competing bids. It also won bids through “set-ups” in which the bidding agent deliberately obtained non-winning bids from other providers in order to rig the field in Wachovia’s favor. Wachovia facilitated some bids rigged for others to win by deliberately submitting non-winning bids.

Wachovia agreed to settle the charges by paying \$46 million to the SEC that will be returned to affected municipalities or conduit borrowers. Wachovia also entered into agreements with DOJ, Office of the Comptroller of the Currency, Internal Revenue Service, and 26 state attorneys general that include the payment of an additional \$102 million.

The settlements arise out of long-standing parallel investigations into widespread corruption in the municipal securities reinvestment industry in which 18 individuals have been criminally charged by DOJ’s Antitrust Division.

As a result of the settlement, Wachovia will avoid prosecution for the manipulation and bid rigging of municipal investment and related contracts, provided that Wachovia satisfies its ongoing obligations under the agreement.

Earlier this year, JPMorgan Chase & Co. and UBS AG also entered into agreements with DOJ and other federal and state agencies to resolve anticompetitive conduct in the municipal bond derivatives market. In July 2011, JPMorgan agreed to pay a total of \$228 million in restitution, penalties and disgorgement to federal and state agencies for its role in the conduct. In May 2011, UBS AG agreed to pay a total of \$160 million in restitution, penalties and disgorgement to federal and state agencies for its participation in the anticompetitive conduct.

On the Web at: <http://www.sec.gov/litigation/litreleases/2011/lr22183.htm>, <http://www.sec.gov/litigation/complaints/2011/comp22183.pdf>, <http://www.sec.gov/litigation/litreleases/2011/lr22183-judgment.pdf>, and <http://www.justice.gov/opa/pr/2011/December/11-at-1597.html>. 

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Government Watchdog Says Medicare Officials Gave Valuable Insider Information to Investors

Federal Medicare officials gave valuable insider information to Wall Street investors in 2009, according to a government watchdog agency, and the information could help investors make decisions about a market worth hundreds of millions of dollars.

The Medicare officials held a private briefing for Wall Street insiders in 2009 on the future of specific medical devices, giving the select group insight on impending agency decisions, according to the Project On Government Oversight (POGO), a nonpartisan independent watchdog that champions good government reforms.

The previously unreported meeting involved the Center for Medicare and Medicaid Services (CMS), and is one of several that POGO cites as recent examples of Wall Street investors winning privileged, insider access to senior Washington officials and possibly to confidential government information.

These examples from Medicare, the U.S. Treasury Department, the Federal Reserve, the Department of Education and the Pentagon all show how “Wall Street investors – hedge funds, private equity executives, mutual fund analysts and others – gain special entrée to Washington’s vast federal bureaucracy,” according to the report.

POGO cited a CMS agency whistleblower who attended the 2009 meeting as saying the briefing focused on whether Medicare would reimburse specific medical devices.

The whistleblower was told by a supervisor that meetings with Wall Street investors are “routine” at CMS. The session prompted the whistleblower to file an ethics complaint with CMS and with the Department of Health and Human Services.

That complaint and others may have caused or contributed to his firing, an action he says he is fighting through legal and administrative channels. CMS confirmed the meeting took place but said it broke no agency rules.

On the Web at: <http://www.pogo.org/pogo-files/alerts/government-corruption/wall-street-in-washington-gc-ii-20111208.html>.

Agencies Seek Comment on Additional Revisions to the Market Risk Capital Rules

The federal bank regulatory agencies are seeking comment on changes to market risk capital rules for banking organizations with significant trading activities.

The amended rules, first proposed in December 2010, would replace credit ratings with alternative standards of creditworthiness to determine the capital requirements for certain debt and securitization positions covered by the market risk capital rules.

The proposed creditworthiness standards include the use of country risk classifications published by the Organization for Economic Cooperation and Development for sovereign positions, company-specific financial information and stock market volatility for corporate debt positions, and a supervisory formula for securitization positions.

The agencies – the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (OCC) – expect to publish a final market risk capital rule after consideration of the public comments, which are due by Feb. 3, 2012.

On the Web at: <http://www.fdic.gov/news/news/press/2011/pr11189a.pdf>.

The proposed OCC rule would remove references to credit ratings in the OCC’s non-capital regulations. It would clarify steps national banks should take to demonstrate that they have properly verified that their investments meet the newly established credit quality standards and steps they and federal savings associations should take to demonstrate they’ve met due diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

On the Web at: <http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-140.html>.



Former Freddie Mac, Fannie Mae Executives Charged with Securities Fraud

The Securities and Exchange Commission (SEC) has charged six former top executives of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) with securities fraud, alleging they knew and approved of misleading statements claiming the companies had minimal holdings of higher-risk mortgage loans, including subprime loans.

Three former Fannie Mae executives – former Chief Executive Officer Daniel H. Mudd, former Chief Risk Officer Enrico Dallavecchia, and former Executive Vice President of Fannie Mae’s Single Family Mortgage business, Thomas A. Lund – were named in the SEC’s complaint filed in U.S. District Court for the Southern District of New York.

The SEC also charged three former Freddie Mac executives – former Chairman of the Board and CEO Richard F. Syron, former Executive Vice President and Chief Business Officer Patricia L. Cook, and former Executive Vice President for the Single Family Guarantee business Donald J. Bisenius – in a separate complaint filed in the same court.

“Fannie Mae and Freddie Mac executives told the world that their subprime exposure was substantially smaller than it really was,” said Robert Khuzami, director of the SEC’s Enforcement Division. “These material misstatements occurred during a time of acute investor interest in financial institutions’ exposure to subprime loans, and misled the market about the amount of risk on the company’s books.”

The SEC is seeking financial penalties, disgorgement of ill-gotten gains with interest, permanent injunctive relief and officer and director bars against Mudd, Dallavecchia, Lund, Syron, Cook, and Bisenius. Both lawsuits allege that the former executives caused the federal mortgage firms to materially misstate their holdings of subprime mortgage loans in periodic and other filings with the Commission, public statements, investor calls, and media interviews.

Fannie Mae and Freddie Mac each entered into a Non-Prosecution Agreement with the Commission in which each company agreed to accept responsibility for its conduct and not dispute, contest, or contradict the contents of an agreed-upon Statement of Facts without admitting nor denying liability. Each also agreed to cooperate with the Commission’s litigation against the former executives.

On the Web at: <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-267-freddie-mac.pdf>, <http://www.sec.gov/litigation/complaints/2011/comp-pr2011-267-fanniemae.pdf>, <http://www.sec.gov/news/press/2011/npa-pr2011-267-freddie-mac.pdf> and <http://www.sec.gov/news/press/2011/npa-pr2011-267-fanniemae.pdf>.



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A pocket watch with a silver case and a white face, resting on a financial chart. The chart shows a line graph with a peak and a subsequent decline, and some text including "Stock Exchange" and "Most active shares".

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CTT Training – Saturday, March 24
TEXPERS Annual Members Meeting – Sunday, March 25


Kansas Public Fund Study Commission Recommends DC Plan for State Workers

The Kansas Public Employees Retirement System (KPERs) Study Commission, set up by the state legislature in May to study pension reform for Kansas state workers, has approved a plan to replace the fund's traditional defined benefit retirement plan with a defined contribution plan for teachers and other government employees.

The proposal would close the state's traditional pension plan to teachers and other state and local government workers hired after July 1, 2013, and instead enroll them in a 401(k)-style plan to which they would contribute 6 percent of their salary. The proposed new retirement accounts would be portable.

Employers, including school districts, local governments and state agencies, would match that amount with a 1 percent contribution paid with state general fund and local tax revenue. The matching contributions would increase to 5 percent over the next eight years, said state Sen. Jeff King, a study commission co-chairman.

The plan would shift investment risk from the state to individual employees. The 13-member commission is working to present the plan to the legislature before the session starts in January. It would help fill an estimated \$8.3 billion gap between the retirement benefits promised to more than 250,000 working and retired KPERs members between now and 2033 and the assets the system will have by then to pay those benefits.

On the Web at: <http://www.statebudgetsolutions.org/publications/detail/retirement-plans-for-states-hires-may-change> and <http://cjonline.com/news/2011-12-07/sweeping-kpers-changes-recommended#.Tu9nIF1vDNg> 

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SUMMER EDUCATIONAL FORUM

Grand Hyatt
San Antonio, Texas
August 4-6, 2013

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Fort Worth, Texas
March 23-26, 2014

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