

Borrowing to Pay Benefits

UI Benefit Financing Seminar

Division of Fiscal and Actuarial Services

U.S. DOL/ETA/OUI

October 23-26, 2018



Borrowing Options

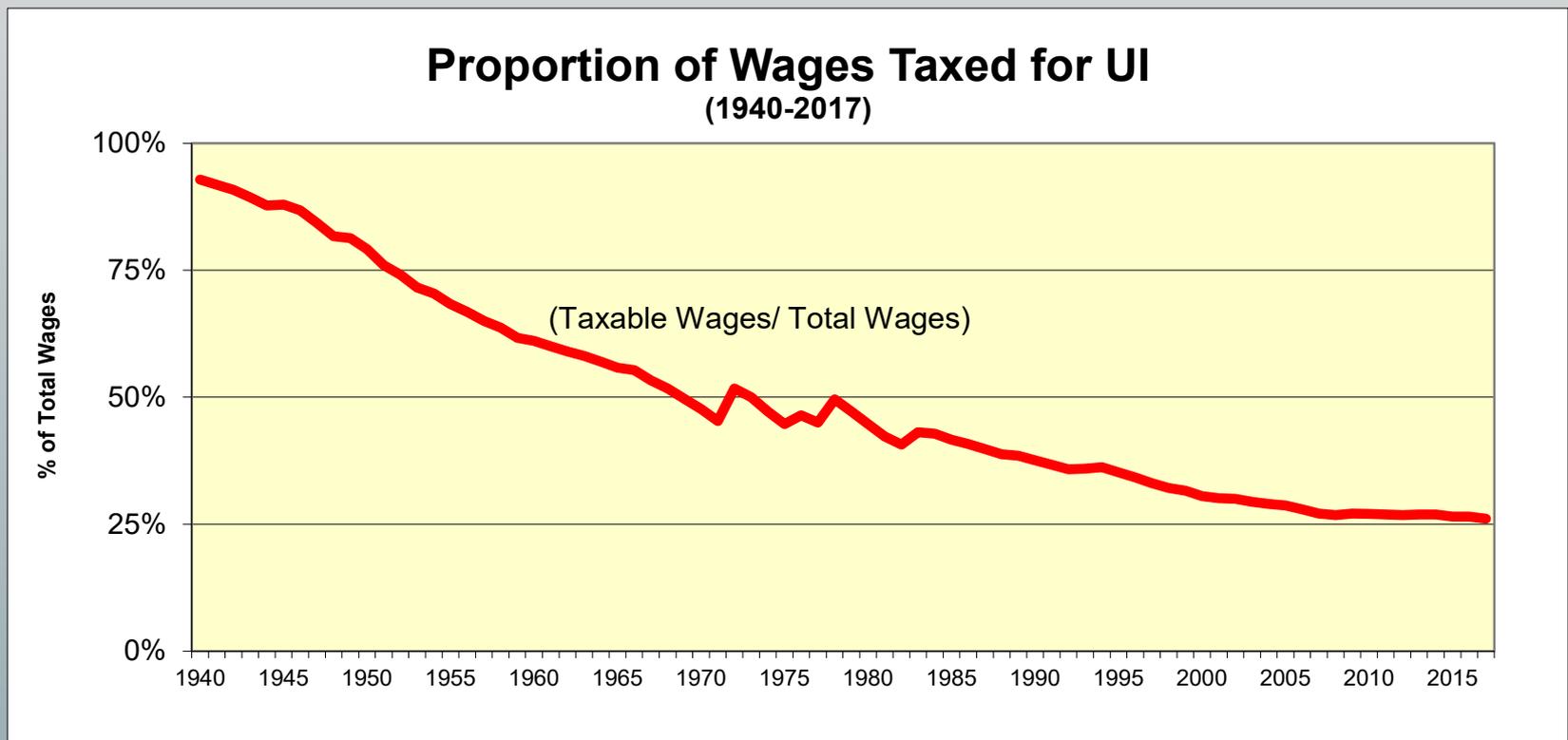
- **FEDERAL GOVERNMENT**
 - Title XII Advances

- **OUTSIDE**
 - Private Capital Market
 - State Government

Factors Contributing to Solvency Problems

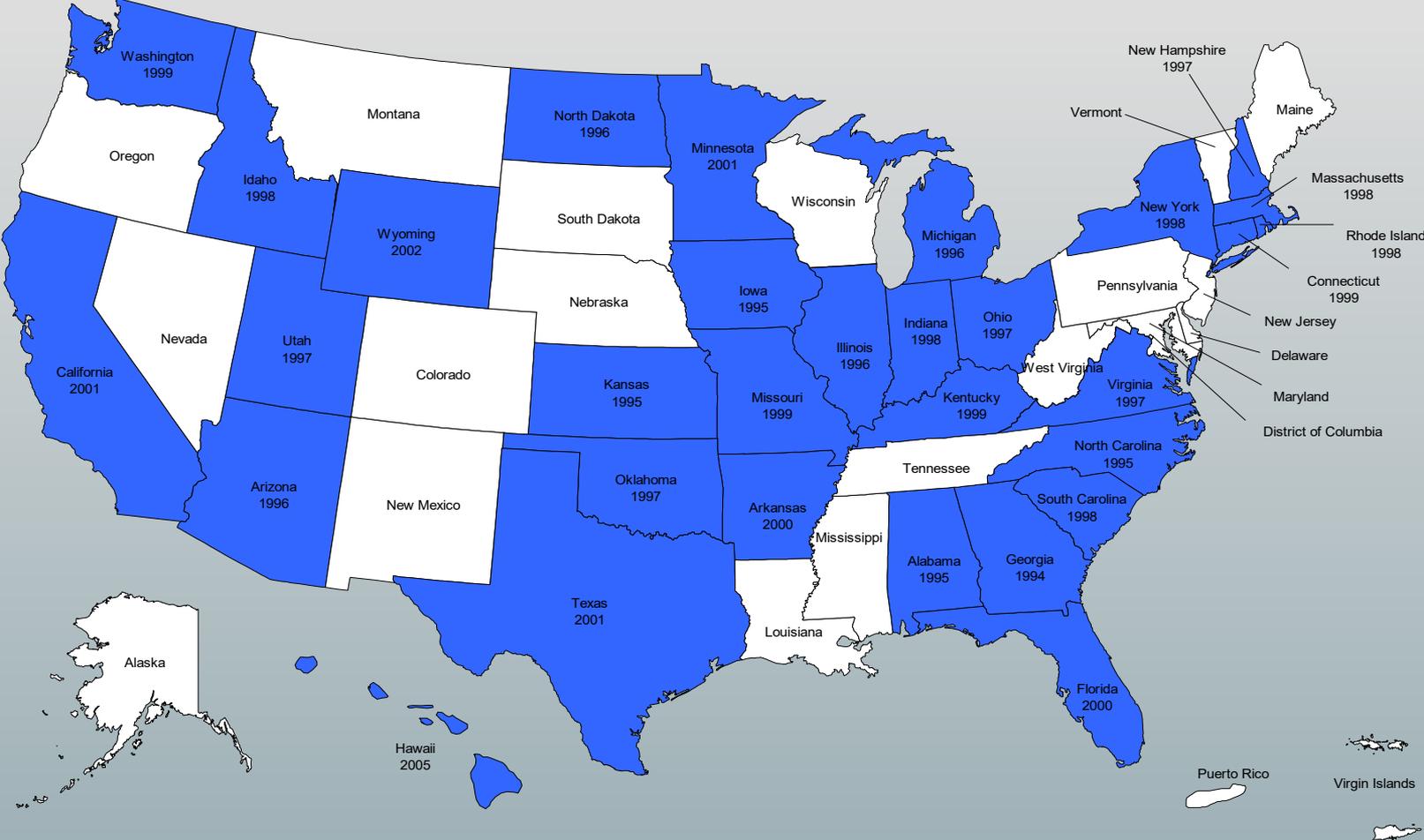
Deterioration in Proportion of Wages that are Taxed for Unemployment Insurance

In 2018 20 States had wage bases at \$12,000 or below - including 5 with the minimum allowable wage base of \$7,000.



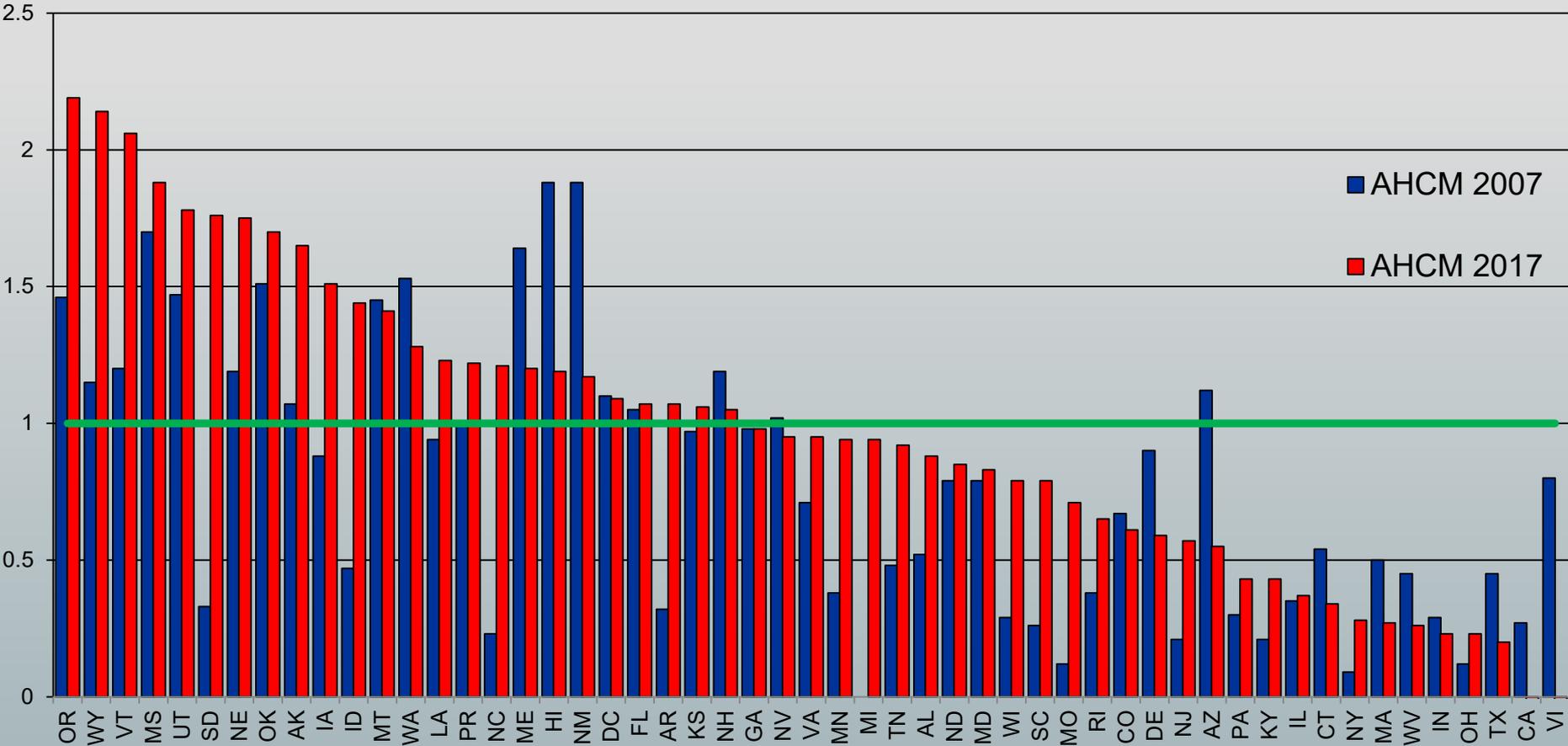
Many States Cut UI Tax Rates in Recent Years

Significant Legislative Reductions in State UI Tax Rates



Solvency Level Before Recession

Average High Cost Multiple, 2007 & 2017



Source: DOL/OUI



Title XII Advances

- Sec. 1201 SSA provides for advances (loans) to states from the Federal Unemployment Account (FUA)
- States make loan requests to USDOL
- No eligibility conditions
- No limit on amounts
- States draw from FUA as needed
- Daily loan balances and accrued interest can be found at:

https://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiesched.htm



Voluntary Repayment

- Sec. 1202 SSA provides for repayment of advances
- States are not required to repay advances, but may make voluntary repayments at any time
- Letter from governor to USDOL submitted through automated Loan And Repayment Application System (LARAS)
- May request specific repayment amounts and dates
- May request transfer of all available account balances (sweep the account) at the end of each business day within a specified period to repay loan

Consequences of Borrowing

- Loans subject to interest payments.
- Pressure to increase revenue and/or cut benefits during recession.
- Media attention.
- FUTA credit reductions.



Interest Payments

1202(b), SSA, 20 CFR Part 606

- Interest rate changes each calendar year – equal to rate earned by UTF the prior Oct.-Dec. – capped at 10%
- Same rate applies to all daily balances in a calendar year – original interest rate doesn't matter
- Interest for the Federal fiscal year is generally due September 30
- Interest cannot be paid directly or indirectly from funds in the state's unemployment fund
- Interest cannot be paid from grant funds or Reed Act funds



Loan Interest

- Loan interest rate equal to rate earned by UTF the prior Oct.-Dec. – capped at 10%

Calendar <u>Year</u>	Loan <u>Rate</u>
2008	4.81%
2009	4.64% (interest waived)
2010	4.36% (interest waived)
2011	4.09%
2012	2.94%
2013	2.58%
2014	2.39%
2015	2.34%
2016	2.23%
2017	2.21%
2018	2.22%



Interest Calculation Example

- A state borrows \$10 million on 11/1/2013 and repays \$10 million on 5/15/2014
- Nov 1-Dec 2013 Interest = $\$10 \text{ M} \times 2.58\%$
 $\times (61 \text{ days} / 365) = \$43,117$
- Jan-May 15 2014 Interest = $\$10 \text{ M} \times 2.39\%$
 $\times (136 \text{ days} / 365) = \$89,051$
- Total Interest Due 9/30/2014 = \$132,168

Failure to Pay Interest Timely

- Section 303(c)(3) of the Social Security Act requires that interest on loans from FUA be paid timely in order for a State to receive administrative funding.
- Section 3304(a)(17) of FUTA requires timely payment of interest on loans from FUA in order for a state's law to be certified: without certification, the FUTA credit is lost.
 - All FUTA receipts then go to Federal accounts in the UTF none to the state's account.
- Both laws require “reasonable notice and opportunity for hearing” before penalty is imposed.

Interest Payment Relief

Interest is due and payable no later than 9/30, with exceptions.

- Cash flow loans.
- May/September delay.
- High insured unemployment rate deferral.
- High total unemployment rate delay.

Cash Flow Loan

- “Cash Flow Loans” applies to funds borrowed from January 1 through September 30.
- No interest will be assessed if the State:
 - Repays all outstanding loan amounts by 9/30.
 - Does not borrow between 10/1 and 12/31 of the same year.
 - Satisfies the funding goal requirement.

Cash Flow Loan

- If a State meets the cash flow loan requirement as of 9/30 but borrows between 10/1 and 12/31, interest that would have been payable on 9/30 is due and payable the day after taking such a loan.

Cash Flow Loan

Funding Goal

In order to qualify for an interest-free advance in 2014 and beyond, the additional Funding Goal criteria require States to meet a solvency target and demonstrate maintenance of tax effort:

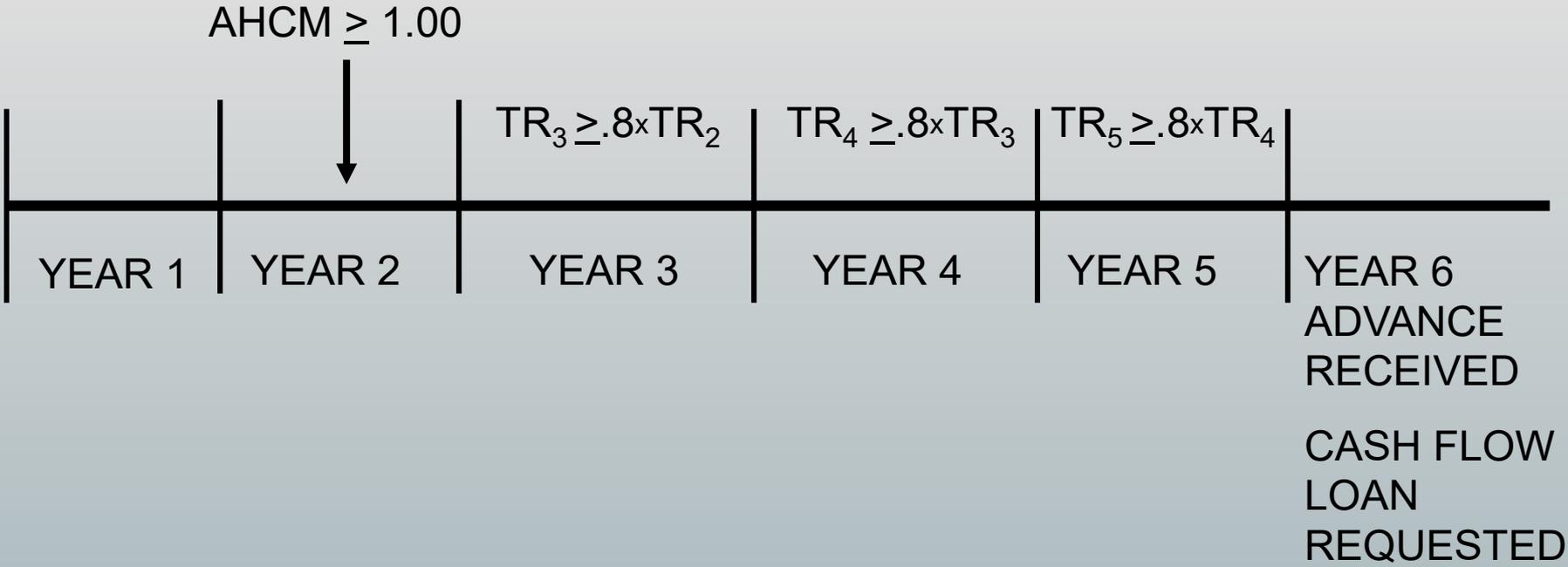
1. The solvency target is an Average High Cost Multiple (AHCM) of at least 1.00 on December 31 in one of the five years prior to the year in which the cash flow loan is requested.

Maintenance of Tax Effort

2. Maintenance of tax effort has two parts that must be satisfied for each year between the year in which the solvency target was last met and the year for which an interest free advance is sought:
 - A. The State's average unemployment tax rate on total wages is at least 80 percent of the prior year's average unemployment tax rate on total wages and
 - B. The State's average unemployment tax rate on total wages is at least 75 percent of the State's average benefit-cost ratio in the prior five years.

Part A

Maintenance of Tax Effort First Criterion



TR_i = Average Tax Rate on Total Wages in Year i

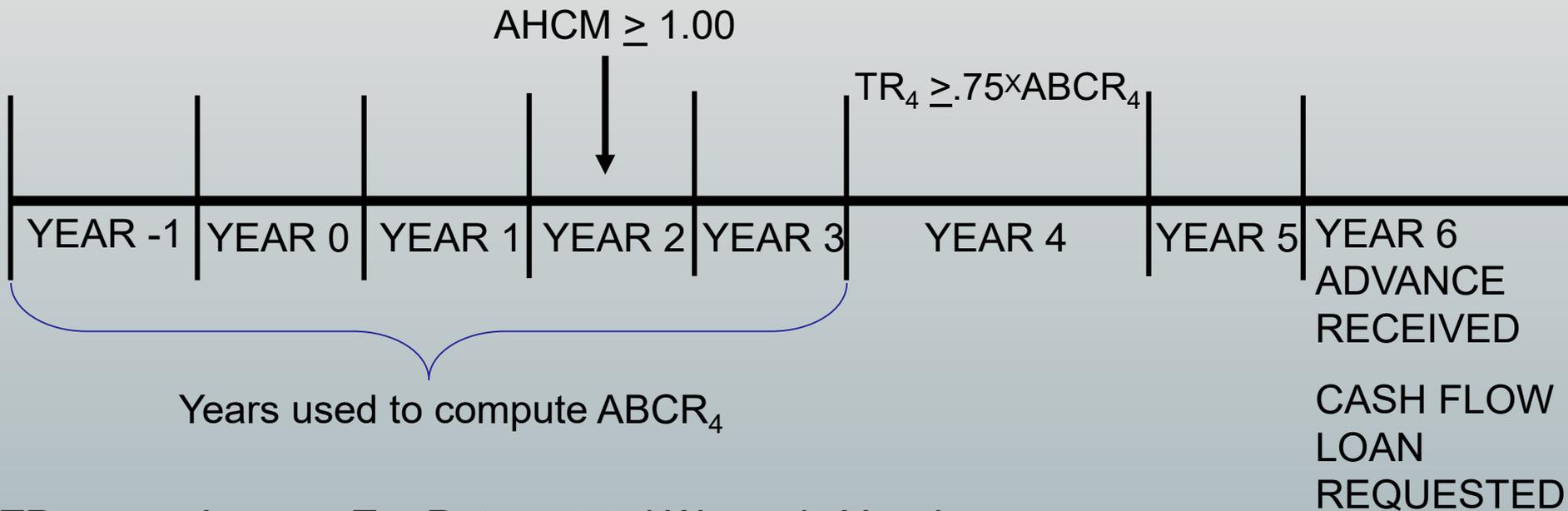
AHCM= Average High Cost Multiple

Part B

- The benefit cost ratio for a year is all UI compensation paid under State law for the year plus interest paid for Title XII advances during the year divided by total wages. (See 20 CFR 606.3(c).)
- The five-year average benefit cost ratio is calculated by dividing the sum of the five benefit cost ratios by five. (See 20 CFR 606.21(d).)

Part B

Maintenance of Tax Effort Second Criterion



- TR_i = Average Tax Rate on total Wages in Year i
- $ABCR_i$ = Average Benefit Cost Ratio
Applicable for Comparison to TR_i
- $AHCM$ = Average High Cost Multiple

Technical Details

- The average unemployment tax rate for a year is determined by dividing the contributions collected for a year by total wages as computed for the Quarterly Census of Employment and Wages. (See 20 CFR 606.3(j) and (l).)
- The average unemployment tax rate is not rounded.
- All other components of the Funding Goal are rounded to two decimal places.

Obtaining a Cash-Flow Loan

- The administrator of the State agency notifies the Secretary of Labor no later than September 10 (see 20 CFR 606.32 (b)) which advances should be interest-free.
- Secretary will determine interest-free status and respond to appropriate parties within 10 business days.
- Methodology is provided here so you can estimate during the year if your State will qualify. UI actuaries will be available for technical assistance.

Interest Payment Relief

May/September Delay

- Payment of interest accrued on loans taken in May through September may be delayed until December 31 of the following calendar year.
 - Interest is due on 9/30 on balances between October 1 of the previous year and April 30 of the current year
 - Interest will accrue on the delayed interest.
 - Governor, or designee, must notify Secretary of Labor of decision to delay such interest payment no later than September 1. (See 20 CFR 606.40)

Interest Payment Relief

High Insured Unemployment Rate Deferral

- State may defer interest payments if IUR equals or exceeds 7.5% for the first six months of the previous calendar year. (See 20 CFR 606.41)
 - State must pay $\frac{1}{4}$ of the interest due at 9/30 and one-third of the remaining interest balance on 9/30 of the 3 years following the 1st payment.

Interest Payment Relief

High Insured Unemployment Rate Deferral

- Governor or designee must request deferral no later than 7/1 of the year for which the deferral is requested.
- State may accelerate the payment schedule.

Interest Payment Relief

High Total Unemployment Rate Delay

- State may request to delay interest payment for nine months after 9/30 if the TUR averaged 13.5% or higher for the most recent 12 months. (See 20 CFR 606.42)
 - State must repay interest in full by 7/1 of following year.
 - No interest accrues on delayed interest.
 - State may accelerate the payment schedule.
 - Governor or designee must apply no later than July 1.

FUTA Tax

- FUTA tax is 6.0% of first \$7,000 earned in covered employment
- Employers get a 5.4% tax credit if state law meets minimum Federal requirements
- Effective tax rate is 0.6% or a maximum of \$42 per covered employee, per year
- Revenues are deposited into the Unemployment Trust Fund maintained by Treasury

FUTA Credit Reduction

- If a State has an outstanding FUA loan balance on two consecutive January firsts, and does not have a zero loan balance on November 10 of the year in which the second January first occurs, employers are subject to a reduction of FUTA credit for that second year and the amount of the credit reduction is due by the following January 31.
- For each additional consecutive January first a State has an outstanding balance and not repaid before Nov 10, the FUTA tax credit is reduced according to a schedule.
- Funds collected as a result of the credit reduction are credited against a State's loan balance.

FUTA Credit Reduction

<u>Year</u>	<u>Basic Reduction</u>	<u>Additional Reduction</u>	<u>FUTA Rate</u>
1	0.0%	0.0%	0.6%
2	0.3	0.0	0.9
3	0.6	2.7 Add-on	1.2 or more
4	0.9	2.7 Add-on	1.5 or more
5	1.2	BCR Add-on	1.8 or more
.	.	.	.
.	.	.	.
19	5.4	BCR Add-on	6.0

$$2.7 \text{ Add-on} = [(2.7\% \times 7000 / \text{US AAW}) - \text{ST ATR}_{\text{tot}}] \times (\text{ST AAW} / 7000)$$

$$\text{BCR Add-on} = (\text{higher of: BCR}_{\text{tax}} \text{ and } 2.7\%) - \text{ATR}_{\text{tax}}$$

where

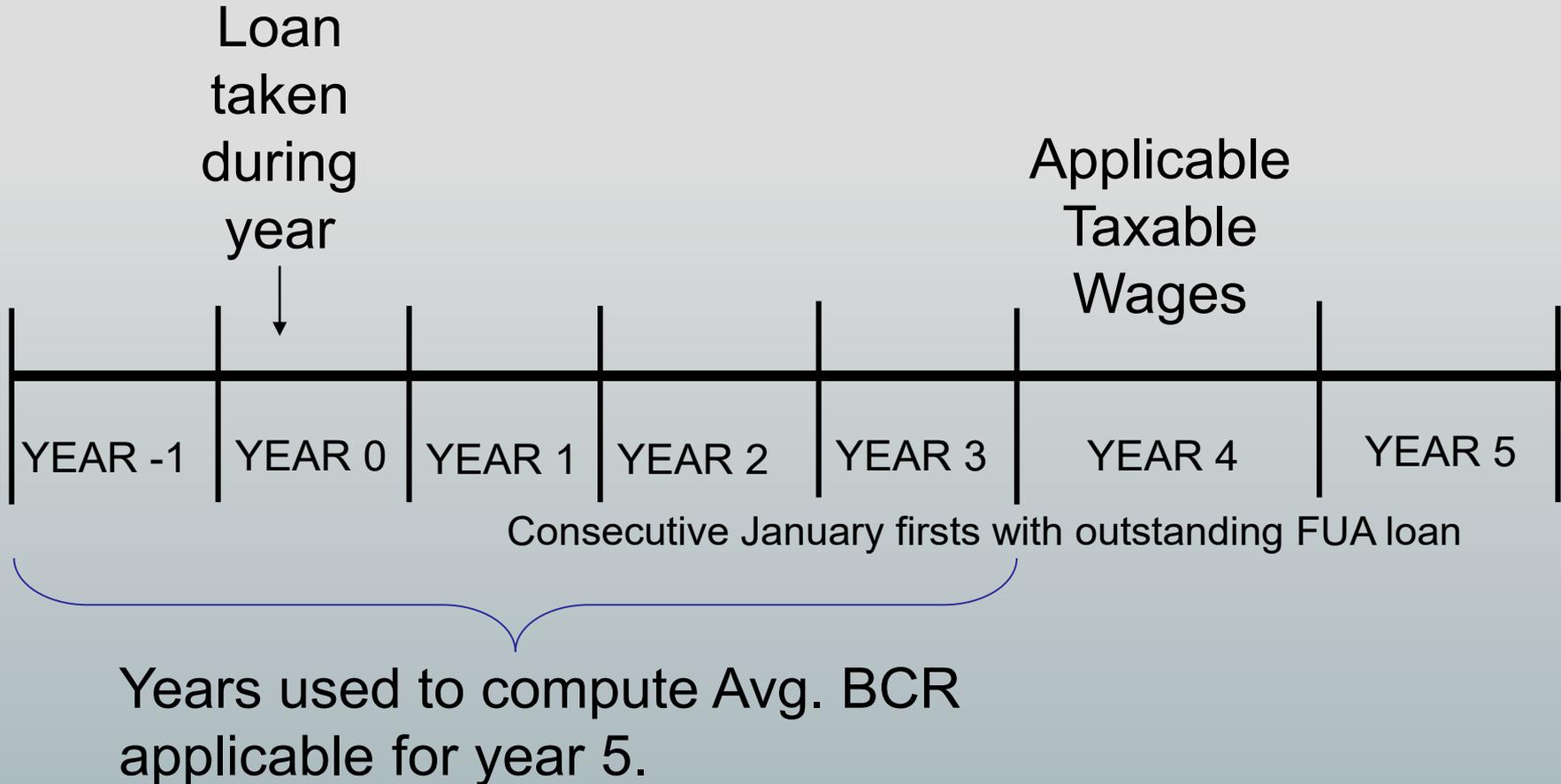
AAW = estimated average annual wage (current year)

ATR_{tot} = average tax rate on total wages (prior year)

ATR_{tax} = average tax rate on taxable wages (prior year)

BCR_{tax} = 5-year average benefit cost (ending second prior year) as a percent of taxable wages (prior year)

Benefit Cost Rate



$$BCR_5 = \text{Avg. Benefit Cost Rate} = \frac{1}{5} * (\text{sum of benefits year -1 through year 3}) / (\text{taxable wages year 4})$$

Credit Reduction Relief

AVOIDANCE

- To avoid a credit reduction for a taxable year, a State must:
 - Have the Governor or designee submit an application to the Secretary of Labor prior to July 1 of the year for which avoidance is sought. (See 20 CFR 606.24)
 - Pay the amount that the credit reduction would produce prior to November 10.
 - Repay all FUA loans received during the one-year period ending November 9 prior to November 10.

Credit Reduction Relief

AVOIDANCE Continued

- To avoid a credit reduction for a taxable year, a State must:
 - Increase solvency for the taxable year through legislative action by an amount equal to or greater than the amount of the FUTA credit reduction.
 - Have the Governor or designee submit prior to Oct. 16 an update to the original submission
 - Not borrow before the next January 31.
 - UI actuaries review application and determine if conditions are met.
 - The year on the consecutive January firsts schedule increments.
 - See 20 CFR 606.23.

Credit Reduction Relief

CAP

- To qualify for a cap on credit reductions, beginning with the second taxable year credit reductions are applicable, a State must:
 - Have the Governor or designee submit an application to the Secretary of Labor prior to July 1 of the year for which a cap is sought.
 - Take no action (legislative, judicial, or administrative) during the 12-month period ending September 30 of the year for which a cap is requested that would reduce taxes or solvency for the period ending September 30.

Credit Reduction Relief

CAP Continued

- To qualify for a cap on credit reductions, beginning with the second taxable year credit reductions are applicable, a State must:
 - Have an average tax rate on total wages for the taxable year that equals or exceeds the average benefit cost ratio for the five years ending with the preceding calendar year (similar to Part B for the maintenance of tax effort for the Funding Goal)
 - The loan balance on September 30 of the taxable year is less than the loan balance on September 30 of the third preceding year.
 - UI actuaries review application and determine if conditions are met.

Credit Reduction Relief

CAP

- A cap is set at the greater of 0.6 percent or the prior year's level.
- Year number on the credit reduction schedule is not incremented.
- See 20 CFR 606.20 and 606.21.

Credit Reduction Relief

Fifth-Year Waiver

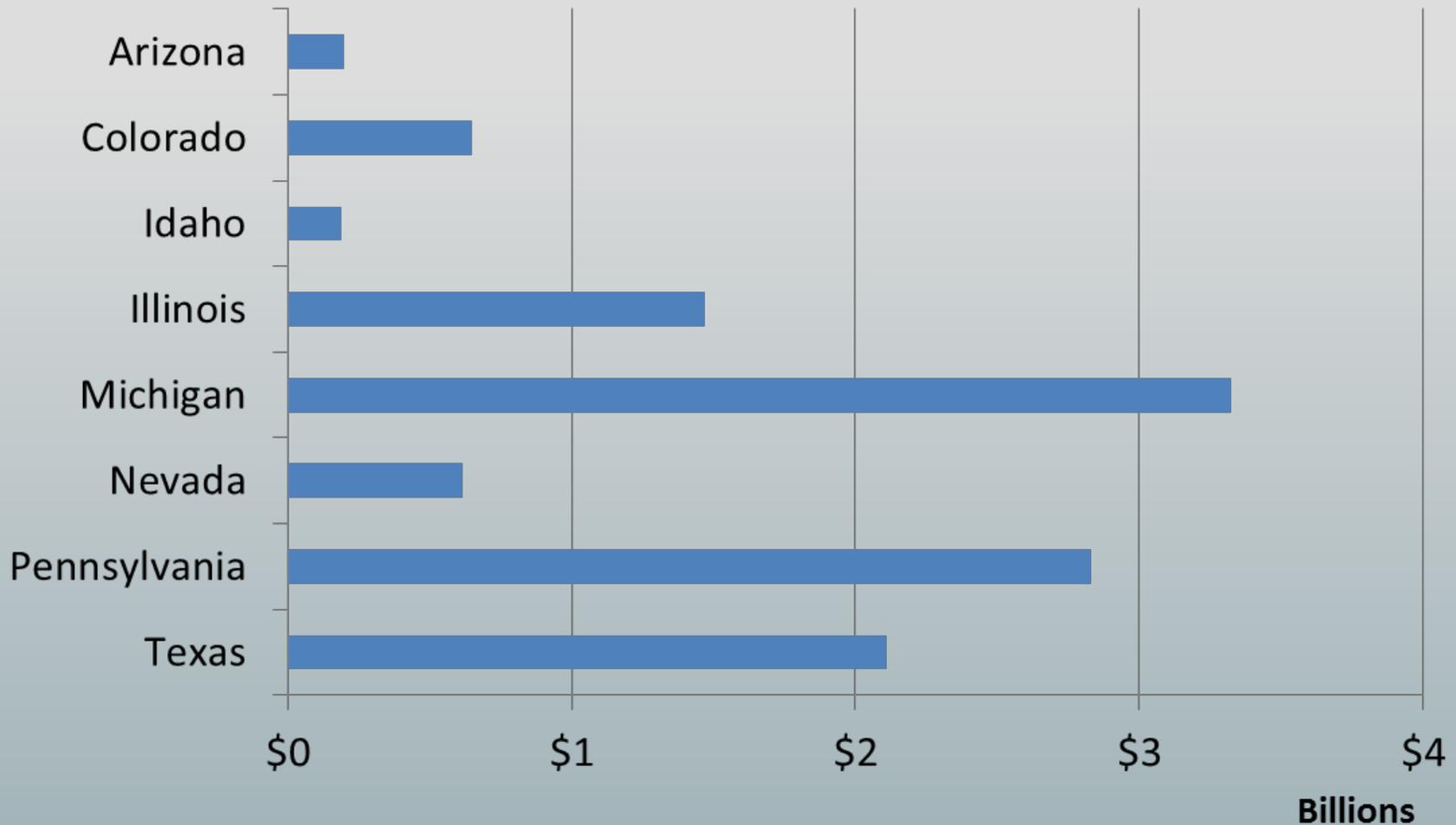
- The Governor or designee must submit an application to the Secretary of Labor prior to July 1 of the year for which the waiver is requested.
- If approved, the Benefit Cost Rate add-on is waived and the 2.7 add-on applies instead (see 20 CFR 606.25).
- Criterion: Take no action (legislative, judicial, or administrative) during the 12-month period ending September 30 of the year for which the waiver is requested that would reduce solvency for the period ending September 30.
- UI actuaries review application and determine if condition is met.



BONDS

- States may issue bonds:
 - To retire Title XII loans
 - To restore UTF reserve
 - To pay future benefits
 - All of the above
- Bonds are issued through regular state bonding authority
- Usually retired through future employer taxes/surcharges

AMOUNT OF FUNDS RAISED FROM BONDS SINCE 2008



BOND FEATURES

- Tax treatment of interest (tax exemption)
- Years to maturity
- Early redemption (callable)
- Fixed or variable interest
- General Obligation or Revenue Bonds



BONDS ADVANTAGES

- Interest rate spreads usually favorable
- State knows total amount of debt incurred
- State controls terms and conditions of debt and debt management
- State can issue fixed-rate debt: Title XII rate not known until the 12/31 UTF yield is computed
- State can use bonds to avoid FUTA credit reduction



BONDS DISADVANTAGES

- Must borrow more than needed
- Interest rate risk
- Credit risk
- Less flexible than Title XII
- Arbitrage risks (IRS Rules): Tax-exempt bond status

BONDS DISADVANTAGES

- Issuance costs
 - Insurance & fees (brokers, bankers, lawyers)
- Redemption costs
 - Costs to call bonds (early redemption)
 - Costs to convert bonds (from variable to fixed rate)
- Administration costs
 - Tax collections
 - Bond administration



ARBITRAGE

- Tax-exempt bond proceeds deposited into UTF account and not expended within 6 months can lead to penalties.
 - Loss of tax-exempt status.
 - Coordinate with IRS
 - <https://www.irs.gov/bonds>

QUESTIONS

- What is source of funds for issuance, administration, and redemption costs?
- Where will proceeds reside so arbitrage rules are not violated?
- How will interest be paid?
- How will principle be paid at maturity?