BCG Retirement News Roundup

August 2015, Volume 4, Issue 8

Boomershine Consulting Group, 3300 North Ridge Road, Suite 300, Ellicott City, Maryland 21043

www.boomershineconsulting.com 410-418-5525

Boomershine Consulting Group (BCG) provides this monthly news roundup of highlighted significant articles from the retirement industry – for clients and friends. Retirement plan news has become increasingly pertinent for many audiences these days, including:

- Retirement Plan Sponsors – addressing both private and public sector issues
- Employers – dealing with complicated decision making for their plans
- Employees – educating the Boomer generation that is nearing retirement
- Industry Practitioners - helping to understand and resolve today's significant challenges

We review numerous industry news services daily and will include a collection of timely and significant articles each month concerning compliance, actuarial plan costs (including assumption debates), plan design change issues and benefit trends, as well as other related topics. If you would like to discuss any of these issues, please contact us.

Inside This Issue

Public Sector/Government Plans

Private Sector

Public Sector/Government Plans

U.S. Public Pensions Earn 3.4% for Worst Showing Since 2012

U.S. state and local-government pensions are coming off their weakest investment performance in three years, weighed down by losses in international stocks and weak bond returns, according to data from Wilshire Associates Inc.

The pensions logged median increases of about 3.4 percent for the 12 months ended June 30, according to data to be released Tuesday by the Santa Monica, California-based consulting firm.

For the public pensions, which typically target returns of 7 percent or greater, it was the slimmest gain since they earned about 1.5 percent in fiscal 2012. Plans with assets greater than $5 billion performed best, reporting median jumps of 3.6 percent, according to Wilshire's Trust Universe Comparison Service.

"It's been a difficult environment to get quality returns," Robert Waid, a managing director at Wilshire, said in an interview.

Global market turbulence depressed international stocks in the year examined by the Wilshire release. The company cited an MSCI index of international equities that it said lost about 5.3 percent. The Barclays U.S. Aggregate bond index gained almost 2 percent.

A generic portfolio of 60 percent stocks and 40 percent bonds returned 5 percent, according to Waid.

The retirement systems registered returns of almost 17 percent in fiscal 2014 and 12.5 percent in 2013 as asset prices benefited from the Federal Reserve's policy of keeping short-term interest rates near zero and as the economy strengthened. Most U.S. states and many U.S. cities have fiscal years ending June 30.

Typical Target

State and local pensions count on returns of 7 percent to 8.5 percent to pay retirement benefits for teachers, police officers and other civil employees. When pensions don't meet their targets, taxpayers have to make up the difference, leaving less money for services.

Pressure on governments to increase pension contributions has mounted because of investment losses during the recession that ended in 2009, benefit increases, rising retirements and flat or declining public workforces, according to a July 27 Fitch Ratings report.

Governments' unwillingness to fully fund their annual required contributions has also depleted assets. In fiscal 2014, only about 40 percent of public pensions received their full annual required contributions, according to Fitch.

The California Public Employees' Retirement System, the biggest U.S. pension, with $300 billion of assets, reported returns of 2.4 percent for the fiscal year ending June 30, below its assumption of 7.5 percent.

Estimates of the pension-fund deficit facing states and cities vary, depending on the assumptions used to calculate costs over the next several decades. According to Fed figures, the governments have $1.4 trillion less than needed to cover promised benefits.

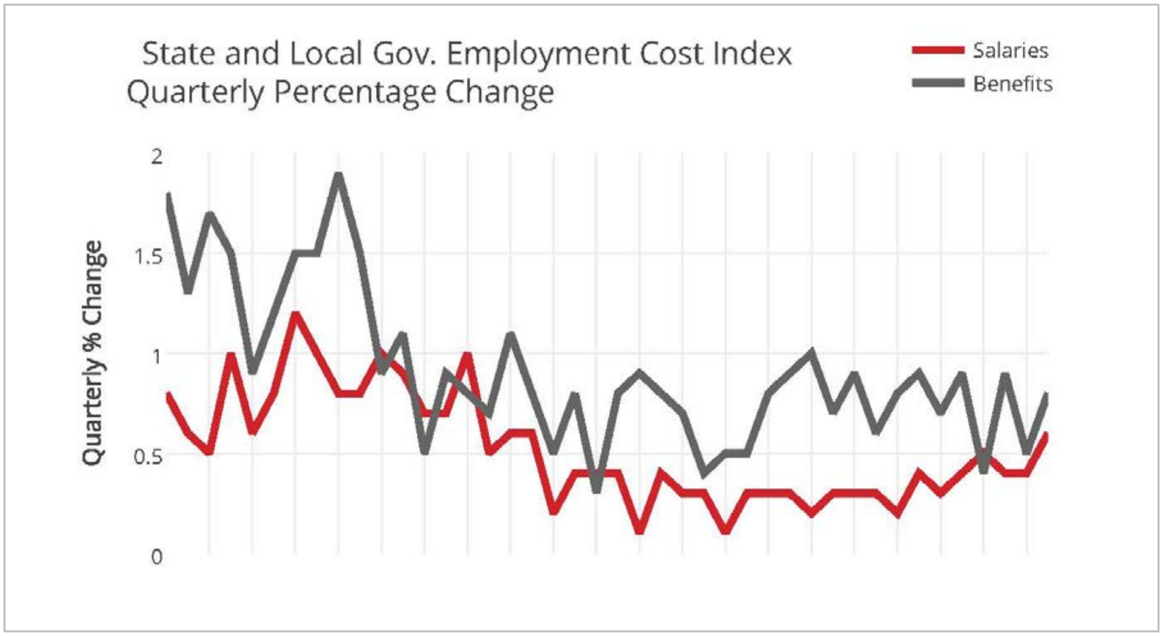
How Government Employment Costs Are Growing

The latest federal data illustrates how benefits are becoming more costly for states and localities.

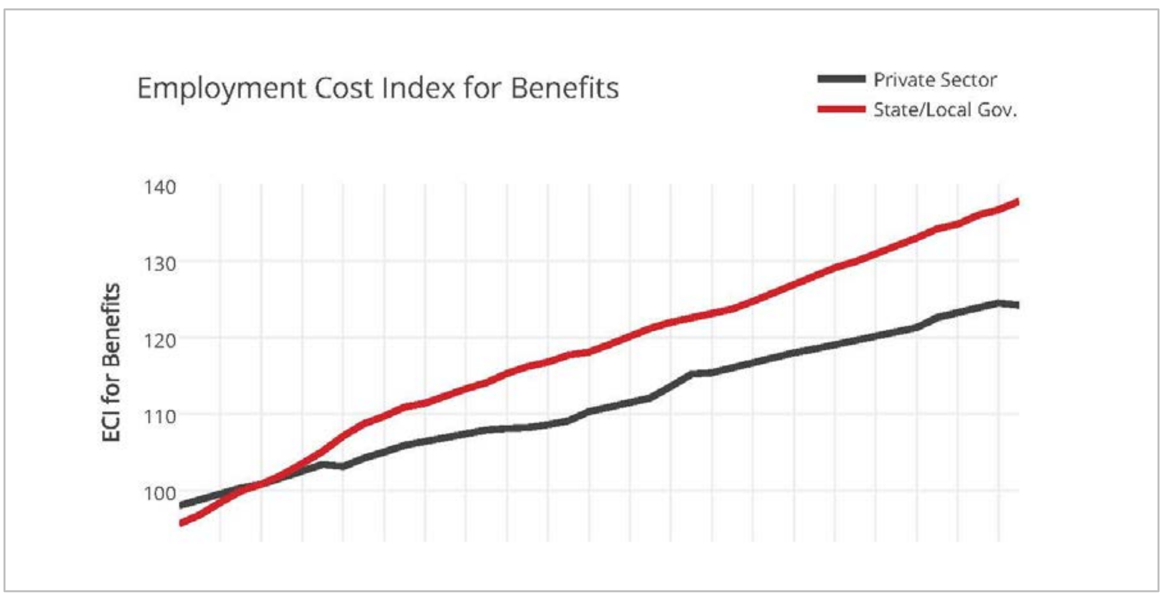
Employee benefit costs have garnered much attention from governments looking to rein in spending. Updated Labor Department data published Friday shows just how much they've increased nationally in recent years.

The latest employment cost index estimates for state and local government workers indicate benefit costs increased 0.8 percent in the second quarter of this year. Over the 12-month period ending in June, benefit expenses have climbed 2.7 percent -- nearly double the rate of the private sector.

The employment cost index, which is not adjusted for inflation, serves as an indicator to track changes in costs for different industries over time. Comparing quarterly changes for state and local governments illustrates that growth in employee benefit costs continues to consistently outpace wage increases:



The gap between benefit costs for states and localities, which includes schools, and that of the private sector also continues to widen:

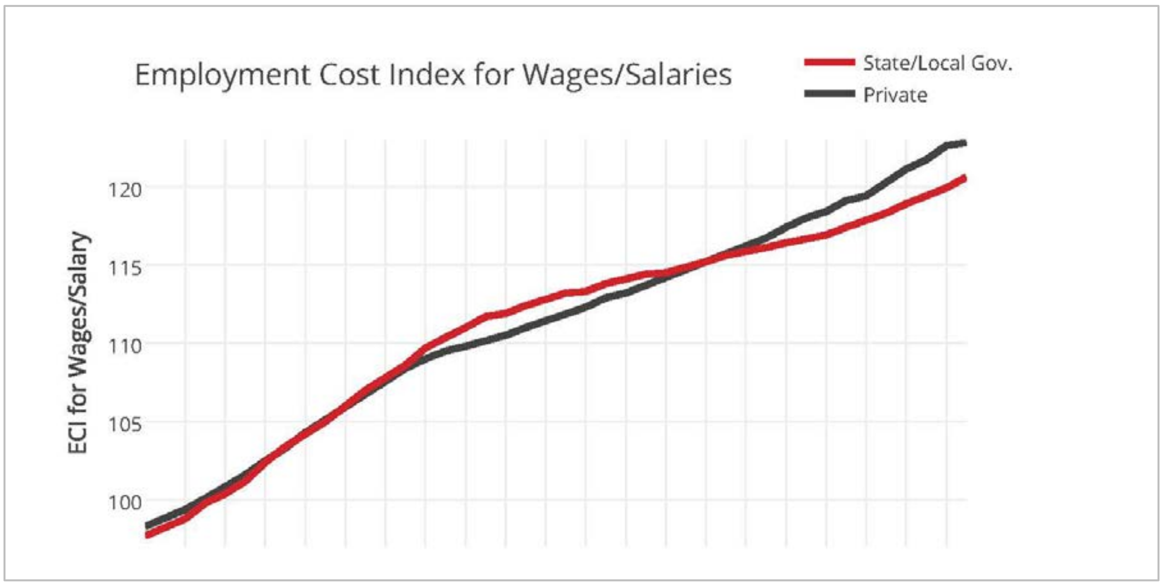


The big news from the report was the extremely lackluster growth in overall compensation -- wages and benefits -- for all sectors of the economy last quarter. Seasonally-adjusted total compensation rose just 0.2 percent over the three-month period ending in June, the lowest recorded tally since the Labor Department began tracking the measure in 1982.

As the economy adds jobs, economists expect the slack in the labor market to lead employers to pay more to attract and retain their employees. The updated data suggests that hasn't yet happened, despite the falling unemployment rate.

Total private sector compensation costs remained flat after increasing 0.7 percent during the first quarter. For state and local governments, overall compensation increased by a healthier 0.6 percent.

Looking back further at wage data, though, tells a much different story. Wage costs initially slowed more in the private sector around the start of the recession, but they've since surpassed public sector wage growth as governments dealt with budget cuts:



Republicans unimpressed with governor's pension proposal

As the Pennsylvania state budget impasse continues through its seventh week, Republican legislative leaders say they are unimpressed with an offer on pension overhaul by Gov. Tom Wolf.

Mr. Wolf, a Democrat, had told legislative leaders he was willing to consider accepting parts of a Republican pension overhaul bill that he vetoed in July, such as an anti-spiking measure for current workers, as well as a limit on the traditional defined-benefit pension for future hires with large salaries.

But Republicans, who control both the Senate and the House, do not seem interested.

"It's an alternative proposal, one that falls far, far short of anything that we would accept," Senate Majority Leader Jake Corman, R-Centre, said Monday. Steve Miskin, spokesman for House Majority Leader Dave Reed, R-Indiana, said Republican members "don't think it goes anywhere near where it should."

Both said a sample proposal from the Wolf administration to limit the defined-benefit retirement plan for future workers to the first $100,000 of salary, with additional earnings accruing a benefit in a defined-contribution plan, would affect too few members of the State Employees' Retirement System and Public School Employees' Retirement System.

As of June 30, 2014, 10,631 of the 263,312 current workers in the school employees system were earning $100,000 or more per year, a spokeswoman said.

The pension bill Mr. Wolf vetoed would have enrolled most future state and public school hires — though not state police or corrections officers — in a defined-contribution retirement plan and an accompanying cash-balance plan, rather than in a traditional pension.

Budget Secretary Randy Albright said in an interview that Mr. Wolf would consider the pension system changes the administration outlined in a memo last week if Republicans agree to increase the main K-12 education funding line in the state budget by $400 million, as Mr. Wolf proposed in his March budget address. He noted that the salary limit on traditional pensions for future workers was meant as an illustration of something the governor could support, not as a definite proposal.

"All of this was in the context that Republicans would move to embrace the education spending proposal that we had been advocating for," Mr. Albright said. "We were trying to say we hear you on pensions being important."

He said the administration expects Republicans to present a counterproposal at a negotiating session scheduled for Wednesday.

Senate Minority Leader Jay Costa, D-Forest Hills, said the governor's pension proposal was a significant offer, and that support from Senate Democrats would require a budget package with sufficient funding for education and human services and a severance tax on natural gas.

"We're not going to support this in isolation," he said. "We would only consider supporting it if it was part of a comprehensive budget deal."

With no state budget in place since the fiscal year began July 1, nonprofit agencies are not being paid to provide services for victims of domestic violence, people with intellectual disabilities and those seeking treatment for drug and alcohol problems.

On Monday, the United Way of Pennsylvania said that about half of the human service providers it surveyed said they would have cash-flow problems by mid-August, with another 25 percent expecting problems by September.

More than a quarter of respondents said they expected to limit services in August.

Judge finds city's changes to pension funds unconstitutional

Mayor Rahm Emanuel's administration said it will appeal a Cook County judge's decision Friday that ruled unconstitutional a state law reducing municipal worker pension benefits in exchange for a city guarantee to fix their underfunded retirement systems.

The 35-page ruling by Judge Rita Novak, slapping down the city's arguments point by point, could have wide-ranging effects if upheld by the Illinois Supreme Court. Her decision appeared to also discredit efforts at the state and Cook County levels to try to curb pension benefits to rein in growing costs that threaten funding for government services.

The issue of underfunded pensions, and how to restore their financial health, is crucial for the city and its taxpayers. The city workers and laborers funds at issue in Friday's ruling are more than $8 billion short of what's needed to meet obligations — and are at risk of going broke within 13 years — after many years of low investment returns fueled by recession and inadequate funding.

Without reducing benefits paid to retired workers, or requiring current workers to pay more, taxpayers could eventually be on the hook for hundreds of millions of dollars more in annual payments to those city funds — before the even worse-funded police and fire retirement accounts are factored into the taxing equation.

Friday's ruling also could further harm the city's rapidly diminishing credit rating. Even before the decision, Moody's Investors Service had downgraded the city's debt rating to junk status based on pension concerns. And after Novak's ruling, Standard & Poor's Ratings Service warned that it would lower the rating on city debt within the next six months without a fix.

Novak's ruling was not unexpected because of a decision in May by the Illinois Supreme Court on a similar pension case. The state's high court unanimously struck down a law changing state pensions, saying the Illinois Constitution's protection against "diminished or impaired" pension benefits for public workers and current retirees was absolute.

City officials had argued that an agreement reached with 28 of 31 labor unions to alter retirement benefits out of the municipal and laborers pension funds — two of the city's four pension plans — was different from the plan struck down by the Supreme Court.

The city argued that it was providing a "net benefit" by coupling the end of annual compounded cost-of-living increases and higher employee contributions with a guarantee of full pension funding over time.

"We continue to strongly believe that the city's pension reform legislation, unlike the state legislation held unconstitutional this past spring, does not diminish or impair pension benefits but rather preserves and protects them," Stephen Patton, the city's corporation counsel, said in announcing a Supreme Court appeal of Novak's ruling.

But in her ruling, Novak said such a trade-off isn't legal. Pension benefits are guaranteed by the state constitution, she said, but any funding scheme to stabilize the pension funds' ability to pay out benefits is not constitutionally guaranteed and could be changed by politicians at any time.

"No 'net' benefit can result where the loss of guaranteed rights are exchanged for legislative funding choices," Novak wrote.

While disappointed by Novak's ruling, the Emanuel administration has always known "that this matter ultimately will be resolved by the Illinois Supreme Court," Patton said.

But officials for the American Federation of State, County and Municipal Employees Council 31 said the city should forgo a costly appeal and pay the promised pension benefits.

"We would urge the city not to waste further time and taxpayer dollars on an appeal," said Anders Lindall, a spokesman for AFSCME, one of the unions that challenged the law.

"The problem with pensions is a funding problem, it's not a benefit problem," Lindall said, adding that the average annual pension payment for a city worker is $32,000. "City employees have always paid their share."

One expert on the Illinois Constitution characterized the city's chances of winning on appeal as futile, given the previous Supreme Court opinion on state pensions.

Ann Lousin, a professor at John Marshall Law School who teaches a course on the state constitution, said she viewed the city's chances of success at "somewhere between zero and a snowball's chance in hell."

As for the city arguments, Lousin said, "There's an old saying among lawyers: creative but not convincing."

In ruling against the city, Novak also appeared to reject a concept being pushed by Springfield politicians as well as Cook County Board President Toni Preckwinkle to try to find ways to reduce pension benefits for current workers in exchange for additional "consideration."

In its May ruling, the Supreme Court noted that benefits may be added in exchange for additional employee contributions or other consideration. Novak said the high court was only reiterating previous findings that benefits could be increased through "consideration," not decreased.

The judge said unions that backed the pension changes sought by the Emanuel administration did so outside of the collective bargaining process. Such a move "does not account for the personal nature of the rights guaranteed by the pension protection clause," she wrote.

"An individual is entitled to challenge statutes that result in a reduction of benefits as a violation of the pension protection clause when applied to his or her own pension," Novak wrote.

In essence, the judge found that any pension fund member could challenge an agreement to change pension benefits, even if backed by a union agreement. At the same time, her ruling would make it all but impossible to reduce benefits since every member of the fund would have to individually comply.

Charles Lomanto, 60, a retired Streets and Sanitation Department employee from Avondale, heralded the ruling. Lomanto said that under Emanuel, his city health care subsidy is being phased out, his annual benefit cost-of-living increases were being reduced and property taxes were increasing.

"We're getting a triple whammy," he said. "We've lived here. We've dedicated our lives to the city. We're willing to sit down and talk. Rahm never came to the retirees."

In Post-Detroit Bankruptcy Era, California Protects Investors Before Pensioners

Before Detroit, many thought general obligation bonds were ironclad. Now they know better.

Starting next year, anyone who buys a general obligation bond from a California locality will stand first in line as a creditor should anything ever happen to cause that locality to restructure its debt. If the law seems redundant to a few people, that's because general obligation debt is supposed to be backed by the full faith and taxing power of the government selling them. In other words, many thought that meant such bonds were unbreakable. So why does California feel the need to clarify that?

The reason goes back to 2013 when Detroit filed for bankruptcy. The city proposed -- and eventually pushed through -- a restructuring plan that placed general obligation (GO) bondholders behind the city's pensioners when it came to who would recover the most of what they were owed. While pensioners averaged a roughly 90 percent recovery rate, GO bondholders recovered about 80 cents on the dollar. "Everything is different after Detroit," said Robert Christmas, a financial restructuring expert at Nixon Peabody. "There were challenges to things that I think people believed were sacrosanct or hadn't thought about."

California, which has had three cities enter Chapter 9 bankruptcy in the last seven years (San Bernardino is the only one still litigating its case), wants to be clear that its local GO bondholders won't be treated the same way. The new law, Senate Bill 222, places a lien on future property taxes to ensure investors will be repaid. By clarifying that the lien created with each GO bond issuance is a statutory one, it "should reduce the ultimate bankruptcy risk of nonrecovery on local GO bonds, and thus potentially improve ratings, interest rates and bond costs," Christmas said.

These liens don't provide total immunity to bondholders. A statutory lien, noted Matt Fabian in an analysis for Municipal Market Analytics, does not preclude a disruption in payment or ensure that the collateral, in this case tax revenue, will be sufficient for full payment. Still, with California accounting for about 20 percent of all bankruptcies since 2000 and almost 30 percent of all city or county bankruptcies since 2007, Fabian predicts "even small reductions in future California bankruptcies can have a market-wide benefit."

Indeed, Moody's Investor's Service has called the new law a credit positive for California localities. Fitch Ratings, however, has said statutory lien laws have no effect on its credit ratings. California isn't the first state to pass a statutory lien for GO debt, although it is the first to do so in the post-Detroit bankruptcy era. Louisiana and Rhode Island already have laws on the books. Nebraska has been considering one.

Rhode Island provides a good, if somewhat sobering, example of how a statutory lien can play out in a bankruptcy case. When Central Falls filed for bankruptcy in 2011, the state enacted an emergency statute that placed a lien on property taxes and pledged them to GO bondholders. There were lots of positives from Wall Street's perspective. During the bankruptcy no creditor challenged the lien, and GO bondholders received full and uninterrupted payment of debt service. The judge in that case highlighted the tactic as one he hoped other cities would follow. Central Falls was in and out of bankruptcy in just 13 months, and so its credit rating also began to recover almost immediately. Its rating was moved out of junk status within a month of exiting bankruptcy.

Still, someone has to take a cut. If not GO bondholders, then who? In Central Falls case, it was retirees who settled for roughly half the pensions they were promised. Labor advocates say the move placed a back-breaking burden on retirees who are now living paycheck to paycheck. In California's bankruptcies, GO bondholders and pensioners have been treated fairly equally. But if ever a locality is forced to choose, the new law makes it clear where the favor now lies.

Private Sector

IRS Issues Mortality Table for Pension Plans for 2016

The IRS in Notice 2015-53 has announced the mortality tables for minimum funding and present value requirements for use in 2016. The IRS issued the notice July 31.

The notice provides updated static mortality tables to be used for defined benefit plans under Internal Revenue Code Section 430(h)(3)(A) Section 303(h)(3)(A) of ERISA. These updated tables, which are being issued using the methodology in the existing final regulations under Section 430(h)(3)(A), apply for purposes of calculating the funding target and other items for valuation dates occurring during calendar year 2016.

The mortality rates in these tables have been developed from the base mortality rates, projection factors, and weighting factors set forth in Treas. Reg. §1.430(h)(3)-1(d), using the blending techniques described in the preamble to those regulations.

The static mortality tables that apply under Section 430(h)(3)(A) for valuation dates occurring during 2016 are set forth in the appendix to the notice.

The static mortality tables that apply under Section 417(e)(3) for distributions with annuity starting dates occurring during stability periods beginning in 2016 also are set forth in the appendix to the notice, in the column labeled "Unisex." These tables were derived from the tables used for Section 430(h)(3)(A) following the procedures set forth in Revenue Ruling 2007-67.

Highway bill would extend health-care option for overfunded DB plans

Sponsors of overfunded defined benefit plans will be able to use excess assets for retiree health care and life insurance, under a highway bill passed by the House late Wednesday. The Senate is expected to take up the proposal this week before the highway trust fund runs out of money Aug. 1.

Internal Revenue Code Section 420(b) allows defined benefit plans whose assets are at least 125% of their funding target to transfer some assets, once per year, to a retiree medical account for the same group of participants. Section 420 was set to expire after 2021 but will be extended through 2025 if the House and Senate agree on a final highway bill.

Section 420 was enacted in 1990 when more pension plans were overfunded. While fewer plans might be in that position today, "they may be able to use it at some point. It's a great opportunity to make sure that retiree health is paid for," said Diann Howland, vice president for legislative affairs with the American Benefits Council in Washington.

Multiple employer plans move out of the shadows and into the spotlight

Out of the shadows; into the spotlight

Not to be confused with the troubled multiemployer sector, MEPs have been around for a long time, but have existed in the shadows of the retirement system, away from the spotlight. Recently, some influential voices—such as the AARP and the Prudential—have thrown their weight behind the MEP idea as a potential way of addressing the retirement coverage gap.

And these voices appear to have been heard. MEPs were the first item identified in a recent report by the Savings and Investment Bipartisan Tax Working Group of the U.S. Senate Committee in Finance on increasing access to retirement plans.

Fiduciary obligations need to be made clear

In a poll of attendees at Russell's recent institutional summit, a majority of respondents came out in favor of this idea. But that support came with strings attached: the most popular response was "I like this idea, but only if we get the right fiduciary reassurance." This underlines the extent to which employers are now on the defensive as regards fiduciary obligations. Significantly wider acceptance of MEPs is unlikely unless employers can be certain that they are able to restrict their fiduciary responsibility to the selection and monitoring of the MEP provider, and no more than that.

The Senate Working Group report highlights some other changes that would likely be required if this sector is to grow. These include making it possible to ring-fence a particular employer in the event of a breach of ERISA (e.g. if nondiscrimination requirements are not met) and resolving the status of open MEPs (i.e. those in which there is no connection between the participating employers.)

If MEPs do emerge as a bigger force in the retirement system, the impact could be significant. The possibility gives rise to questions such as: How would a stronger MEP sector interact with and work alongside existing retirement arrangements? Is there an overlap with state-sponsored initiatives (some of which share many of the features of an open MEP) such as Illinois' Secure Choice program, Washington's small business retirement marketplace and the growing number of other such initiatives?

Let's be deliberate in setting retirement policy

The current structure of the retirement system in the U.S. did not come about by conscious design. Rather we arrived here largely by happenstance, with policy initiatives in several areas and wider societal trends interacting to create the system as we know it today. Today, pressure for change is building, and the growing interest in MEPs is just one example of that. Now is a good time to work out where we want to go.

PBGC looks to reduce reporting waivers for large plans

Fewer large defined benefit plan sponsors will be able to skip Section 4010 reporting under a rule change the PBGC will propose shortly.

Section 4010 of the Employee Retirement Income Security Act requires plan sponsors to report annual financial and actuarial information to the Pension Benefit Guaranty Corp. if a plan is less than 80% funded or has missed more than $1 million in required contributions.

Plans funded more than 80% or underfunded by less than $15 million have been able to obtain waivers that were intended to help smaller plans. Thanks to higher interest rates allowed by MAP-21 that caused many plans' funding levels to increase, some large plan sponsors also have qualified for those waivers in recent years. To curtail that, PBGC officials plan to add a cap of 500 participants or fewer.

PBGC officials estimate that as many as 200 larger plans no longer would qualify for the waiver, but note sponsors also could contribute more to their plans to avoid the less-than-80%-funded trigger.

The 4010 filings provide PBGC "more current and more useful underfunding information than any other source," and are the only way that sponsors report underfunding on a termination basis, the agency wrote in its July 10 report to Congress on 4010 reporting results for 2013. It is also one of the sources of financial information for all pension plans within a corporate control group rather than a single plan sponsor.

“However, in practice, the 4010 reporting criteria fail to properly target plans, resulting in both over- and under-inclusiveness,” the agency said. PBGC officials also recommend Congress consider further changes to make the reporting “better targeted and less burdensome.”
The proposal is scheduled for publication in the Federal Register on July 27. Public comments are due Sept. 25.

Lump-sum windows: thoughts from the GAO

One of the most popular pension derisking strategies for the last few years—which shows no sign of slowing down in 2015—has been offering lump-sum windows (LSWs) to terminated vested participants. (As discussed in an earlier blog post, after the issuance of IRS Notice 2015-49, lump-sum offers to retirees in pay status are no longer permissible, but the vast majority of LSWs have not been extended to retirees in any event.) LSWs offer plan sponsors the opportunity to reduce their pension plan liabilities and headcount, and the associated Pension Benefit Guaranty Corporation (PBGC) premiums and administrative expenses without the premium required to settle liabilities through an annuity purchase (and, in some cases, at a discount to the related balance-sheet liabilities). The knowledge that new updated mortality tables will be required in determining lump-sum amounts (and will increase those amounts by 5–8%) as early as 2016 (although, more likely, in 2017) has added some wind to the lump-sum sails this year.

But, as LSWs have proliferated, so have concerns among the various federal agencies that regulate pension plans. As noted, the IRS has served notice that lump-sum offers can no longer be made to retirees in pay status. The US Department of Labor’s ERISA Advisory Council held hearings in 2013 on derisking, including LSWs, and issued a report that raises a number of concerns, including whether participants understood the risks that they were assuming by taking a lump-sum distribution and whether current disclosure requirements were sufficient. Additionally, the PBGC has recently begun requiring pension plans sponsors to provide reporting to PBGC regarding derisking activities, including LSWs.

Earlier this year, a fourth federal agency weighed in: the Government Accountability Office (GAO) issued a report on February 26 that summarizes its study of 11 LSWs offered by plan sponsors in 2012 and identifies a number of concerns. Its primary concern was that the communications materials provided to potential LSW participants were deficient. The GAO identified a number of major points that it said those communications should cover (see the list below), and it found that most of the communications were missing at least one of those points. In our experience, typical LSW communications do cover all those points, with one possible exception: making clear to participants that their pension is guaranteed both by trust funding and by PBGC insurance, so that they do not take a lump-sum distribution out of concern for their employer's financial viability. It's not clear whether that is a significant motivating factor for many participants in the decision to take a lump sum; nevertheless, the GAO's report serves as a good checklist for LSW communications, and, in an abundance of caution, employers that offer LSWs may want to confirm that their materials cover all these points:

- What benefit options are available
- How the lump sum was calculated
- Relative value of the lump sum compared with a monthly annuity
- Potential ramifications, both positive and negative, for accepting the lump sum
- Tax implications of taking the lump sum
- The PBGC's role and the level of protection that the agency provides
- Instructions for accepting or rejecting the lump-sum offer
- The point of contact for more information or help

The full GAO study and a highlights page are available here.

Despite all this agency activity, for the time being, LSWs remain a viable option for plan sponsors and one that many sponsors that have not already done so may wish to explore before the end of 2015. However, sponsors need to be mindful of this developing set of regulatory concerns, and, in particular, be mindful of the concerns that the GAO raised in designing their communications plan for any LSW that they implement.