BCG Retirement News Roundup

May 2014, Volume 3, Issue 5

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Boomershine Consulting Group (BCG) has launched 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.

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Public Sector/Government Plans

New York state pension ends fiscal year with record assets

New York state's pension fund reached its highest value on record of $176.2 billion at the end of its fiscal year in March as the rate of return on its investments jumped to 13.02 percent, the state comptroller said on Monday.

The public pension fund, the third largest in the country, ended the previous fiscal year with $160.4 billion in assets after its investments returned 10.4 percent.

Investment earnings provide the bulk of public pensions' revenues and last year's rising stock market offered much-needed respite for retirement systems that were hurt by both the financial crisis and states' budget crunches. Public pensions ended 2013 with $3.192 trillion in cash and security holdings, the highest level since 1968, according to the U.S. Census.

The performance of the New York State Common Retirement Fund's assets mirrored the wider market from April 1, 2013 through March 31, 2014. The New York fund's rate of return was nearly double its long-term expected rate of 7.5 percent and the highest since fiscal 2011.

Domestic equities, which make up 37.7 percent of the fund, had returns of 22.3 percent and foreign stocks, representing 13.1 percent of the portfolio, had returns of 13.1 percent. Global equities, an asset class made up of both domestic and foreign stocks which is only a sliver of the allocations, returned 25.1 percent.

The fund's fixed-income investments, 21.4 percent of its total portfolio, had losses of 0.2 percent. Its Treasury Inflation-Protected Securities, representing 5.8 percent of the portfolio, had losses of 6.2 percent.

In recent years, many pensions have branched out into riskier investments in the hope of higher earnings.

The New York retirement fund's "absolute return strategies," or hedge funds, now make up 3.2 percent of its investments and had returns of 9.9 percent last fiscal year. "Opportunistic Alternatives," or investments that offer high risk-adjusted returns, only constitute 0.3 percent of its portfolio and had returns of 7.8 percent.

Baltimore approves moving new city employees to DC or hybrid plan

Baltimore will offer new employees the choice of a defined contribution plan or a hybrid plan under reforms approved Monday by the City Council.

Newly hired workers will contribute 5% of their salaries to either plan. Current workers started contributing 1% last year to the $1.5 billion Baltimore City Employees' Retirement System defined benefit plan. Contributions will increase 1 percentage point over the next four years until they reach the 5% level. Before 2013, employees didn't make contributions. The city will contribute 4%.

The reforms were a compromise between union officials and Mayor Stephanie Rawlings-Blake, who last year proposed putting newly hired city employees into a defined contribution plan.

“Rather than waiting on a fiscal disaster, Baltimore is, again, being proactive in getting our finances in order for the long term by taking decisive action to significantly slow the growth of our unfunded pension liabilities,” Ms. Rawlings-Blake said in a statement.

In 2013, Ms. Rawlings-Blake unveiled a 10-year plan for dealing with a $686 million unfunded liability in the city employees pension fund, and a $765 million unfunded liability in the $2.26 billion Baltimore City Fire & Police Employees' Retirement System.

Ms. Rawlings-Blake will introduce legislation this summer to make similar changes for newly hired police and fire employees, a spokeswoman said.

The effective date of the changes was not available at press time.

Stockton bankruptcy judge to decide if pensions should share losses

The judge presiding over Stockton, California's bankruptcy case on Tuesday said he will question officials from Calpers to determine whether the nation's largest pension fund can be forced to take losses in the case along with other creditors.

Describing the thorny question of whether the California Public Employees' Retirement System should remain whole while other creditors absorb steep losses as a "festering sore," U.S. Bankruptcy Court Judge Christopher Klein said he needed to consider alternatives for the matter. Calpers contends its protected status is guaranteed under law, and Stockton, which declared bankruptcy nearly two years ago, has not tried to impose any losses on the $285.2 billion pension fund.

"We have a festering sore here. We got to get in there and excise it and figure out what the story is. Maybe Calpers is correct, maybe not," Klein said, in a dramatic turn in a trial that began on Monday.

A decision that Calpers could be impaired has wide-ranging implications for public employee pensions across the country and comes as a handful of distressed cities battle their way through insolvency proceedings. In December, U.S. Bankruptcy Court Judge Steven Rhodes ruled Detroit may legally reduce public pension benefits, despite Michigan's constitutional protection of public pensions. In southern California, the city of San Bernardino is currently in mediation with Calpers.

The attorney for Calpers, Michael Gearin, suggested the court should not consider plans other than the one presented by the city, which left pensions untouched.

"There is a bit of the cart before the horse here," said Gearin. "What we are in jeopardy of is embroiling the city in a messy problem that the city does not want to be embroiled in."

But Judge Klein said he would be rubber stamping the city's proposal if he did not consider the alternatives.

Stockton has avoided impairing Calpers, fearing a $1.6 billion termination fee, and "the real and palpable belief that if we take on pensions, we lose employees," said Stockton attorney Marc Levinson.

In the second day of trial to determine if Stockton can exit bankruptcy, proceedings mainly centered around the city's holdout creditor, two funds managed by Franklin Templeton Investments, which is poised to receive less than a penny on the dollar under the city's plan.

Attorneys for Franklin pressed its case that it is being treated unfairly. They refuted the testimony of Stockton Economic Development Advisor Val Toppenberg, who said the golf courses and ice arena it built with money raised from Franklin's $35 million bonds are worthless. Toppenberg conceded the city had reached that conclusion without the assistance of professional appraisers.

"I was able to subtract zero from zero," said Toppenberg, noting that the properties have operated at an aggregate loss for the last eight years.

Franklin highlighted that the city is planning to use public facility fees, revenue that could be used to pay back Franklin's bonds, on other projects and, in part, to pay its bankruptcy lawyers.

"There is room for the city to pay Franklin a heck of a lot more than a penny on the dollar," said James Johnston, attorney for Franklin.

The trial is scheduled to last through Thursday, but Stockton could remain in Chapter 9 protection if the judge does not find the city's plan to exit bankruptcy is fair and feasible.

Judge halts Illinois pension reform law due to lawsuits

An Illinois judge on Wednesday suspended the state's new pension reform law until lawsuits brought by unions, retirees and others challenging the constitutionality of the overhaul of the retirement system are resolved.

"This law is going no place until there is a final resolution on the merits (of the lawsuits)," said Don Craven, an attorney who filed a lawsuit against the law on behalf of the Illinois State Employees Association Retirees.

The law was to have taken effect on June 1. It would reduce retirees' benefits and raise the retirement age to save the state nearly $145 billion over 30 years.

One of the main groups opposing the law is known as the We Are One Illinois labor coalition. The lawsuits claim the reforms violate the Illinois Constitution, which protects public worker pensions from being diminished or impaired.

The coalition applauded Judge John Belz's ruling in Sangamon County Circuit Court.

"This is an important first step in our efforts to overturn this unfair, unconstitutional law and to protect retirement security for working and retired Illinois families," said a statement from Michael Carrigan, president of the Illinois AFL-CIO, on behalf of the coalition.

Maura Possley, a spokeswoman for Illinois Attorney General Lisa Madigan, who is defending the law, said the ruling was under review.

"The goal of the pension reform law is to stabilize the pension systems. Unfortunately, this decision will likely further burden the systems and hurt taxpayers," Possley said.

The law, enacted in December, reduces and suspends cost-of-living increases for pensions, raises retirement ages and limits the salaries on which pensions are based.

Illinois has had the worst-funded pension system among all U.S. states after decades of skipping or skimping on pension payments. As a result, credit rating agencies have slapped Illinois with the lowest ratings among states.

Abdon Pallasch, Illinois' assistant budget director, said the judge's ruling was not unexpected and will not impact the budgets for the current and next fiscal year, which begins July 1.

The law offers workers and retirees some incentives, including a reduction in contributions toward pensions and a method for ensuring the state fully makes its contributions.

Fitch: State pension plans' funding climbs in 2013 despite low contributions

While the funding ratios of U.S. state defined benefit pension plans improved in fiscal year 2013, significant challenges remain, according to a Fitch Ratings report.

The credit rating agency's report reveals that median reported funding ratios of 97 state plans based on actuarial valuations rose to 71.6% in 2013, from 69.1% in 2012. The gains are attributed to strong investment returns that were generally ahead of plan discount rate assumptions.

Despite the gain, actual contributions to plans still run short of actuarially calculated annual required contributions, with only 37 of the 91 state plans that provided this information receiving at least 100% of those required contributions.

Three New Jersey pension funds — the Police & Fireman's Retirement System, Public Employees' Retirement System, and Teachers' Pension & Annuity Fund – received about 28% each of those required contributions, by far the smallest percentage of the 91 plans measured. Assets of those plans total $76.8 billion.

Washington State Law Enforcement Officers and Fire Fighters Retirement System-Plan 1 had the best funding ratio at 135%, followed by Washington State Law Enforcement Officers and Fire Fighters Retirement System-Plan 2 at 113.7%.

Of the 96 plans for which rolling amortization risk was measured, 55 plans assume a rolling, 30-year amortization of unfunded liabilities, which current Governmental

Accounting Standards Board standards allow, but the report states "the re-amortization of liabilities over new 30-year periods means that little meaningful progress is possible toward full funding absent investment gains above the discount rate assumption."
The Kentucky Employees Retirement System-Non-Hazardous reports the worst actuarial funding ratio at 23.2%, followed by the Illinois State Employees Retirement System at 34.2%.

Actuarial valuation dates for the report range from April 1, 2012, to Oct. 1, 2013, depending on the availability of state reports.

Private Sector

Maryland governor creates private-sector retirement task force

Maryland Gov. Martin O'Malley created a retirement security task force to consider ways to expand access for private-sector workers without retirement plans at work.

Mr. O'Malley tapped former Lt. Gov. Kathleen Kennedy Townsend this week to chair the Governor's Task Force to Ensure Retirement Security for All Marylanders. Ms. Townsend is managing director of alternative investment manager The Rock Creek Group and founder of the Center for Retirement Initiatives at Georgetown University. The task force will be looking for "innovative solutions," Ms. Townsend said in a statement. In addition to considering legislative or regulatory changes, the task force will study how other states and countries approach the issue.

The shortfall in retirement savings "poses a significant threat to Maryland's fiscal stability and economic growth," Mr. O'Malley said in his executive order creating the group. "It may be beneficial for private-sector employees in Maryland who have no employer-provided plan to gain access to a professionally managed retirement program that assures reliable retirement income."

In addition to officials from state agencies and the Legislature, task force members will include representatives from labor unions, the financial services industry and retirees. State Treasurer Nancy Kopp, who is chairwoman of the $43 billion Maryland State Retirement & Pension System, Baltimore, will also serve on the task force. The group will submit a report by Dec. 4 and is scheduled to disband by Feb. 5, 2015, unless further study is needed. The schedule for appointments and meetings was not available by press time.

“I understand that a lot of people across Maryland feel anxious about their retirement, and we are taking action to help,” Mr. O'Malley said in a statement.

Marco Rubio’s plan to fix America’s retirement system

Sen. Marco Rubio (R-Fla.), who is considering a presidential bid in 2016, announced a broad plan Tuesday to reform America's retirement system.

During a speech organized by the National Press Club, Rubio proposed raising the retirement age for younger workers, opening up the retirement program used by Congress to non-government workers, and eliminating the payroll tax for people who continue to work after reaching full retirement age. Rubio also proposed scaling back Social Security benefits for wealthy retirees by slowing how quickly benefits will increase for those retirees who may not rely as much on Social Security payments.

Some of Rubio's proposals have been suggested before, and, for obvious reasons, raising the retirement age is rather unpopular with voters. Rubio is trying to work around this by keeping the full retirement age between 65 and 67 for people age 55 or older -- it changes depending on when you were born -- while gradually raising the age for younger workers. But some economists have argued that low-income workers could get stuck with fewer benefits since they typically die younger than higher-earning workers.

Rubio wants to open up the federal Thrift Savings Plan -- which is available to members of Congress and their staff -- to people who don't have access to a retirement plan through their employers. Similar to a 401(k), the thrift plan lets workers contribute up to $17,500 of their pay annually before taxes in a retirement account. The thrift savings plan also comes with lower fees than what most consumers are charged through private defined-contribution plans, Rubio said.

"The twisted irony is that members of Congress – who are employees of the citizens of the United States – have access to a superior savings plan, while many of their employers – the American people – are often left with access to no plan at all," Rubio said during the speech.

Part of the challenge for America's retirement system is broadening access. Only 64 percent of workers said that they or their spouse have retirement savings, according to a report released in March by the Employee Benefit Research Institute, which tracks benefits programs. But those workers haven't saved much. Some 36 percent of workers said they had put away less than $1,000 in retirement savings. And people who don't have access to a retirement savings plan, such as a 401(k), are much less likely to save. Only one in five workers without a retirement plan had saved money for retirement, compared with 90 percent of workers who participated in a savings plan.

People are generally hungry for better retirement savings options. In a survey released last week by Towers Watson, a professional services consulting firm, less than 50 percent of workers said they felt their plans would meet their needs in retirement, and the majority of employees said they would be willing to pay more for guaranteed retirement benefits.

Additional Action Required by Late Filers of Form 5500 (Even Those That Have Already Filed)

Plan administrators who fail to timely file Form 5500 annual reports for their retirement plans may be subject to penalties under both ERISA and the Tax Code. Under previous guidance from the IRS, correcting such a late filing under the Department of Labor's Delinquent Filer Voluntary Compliance ("DFVC") Program could relieve the filer from penalties assessed by both the Department of Labor ("DOL") and the Internal Revenue Service ("IRS"). However, under new guidance from the IRS, relief from its penalties now depends on a separate filing. Moreover, this new IRS requirement will apply retroactively to DFVC Program filings made since 2009.

The Penalties

The DOL may assess civil penalties of up to $1,100 per day against plan administrators who fail to file complete and timely annual reports. The IRS may impose further penalties of $25 per day, up to $15,000 per return, against administrators who fail to file complete and timely annual returns (including actuarial reports).

Penalty Relief

In 1995, the DOL established the DFVC Program to encourage late filers to voluntarily comply with ERISA's reporting requirements. Under that Program, plan administrators may obtain reduced civil penalties for failure to file a timely Form 5500. And in Notice 2002-23, the IRS stated that it would not impose any penalties under the Tax Code for a late Form 5500 on a plan administrator who satisfies the requirements of the DFVC Program. Thus, a successful DOL filing relieved the late filer from penalties under both ERISA and the Tax Code.

The new requirement for relief from the IRS arises from efforts at both agencies to shift from paper to electronic filing. Before the 2009 plan year, plan administrators had to report information regarding terminated participants with vested benefits on Schedule SSA to Form 5500. But as part of the IRS's shift to electronic filing, it replaced Schedule SSA with Form 8955-SSA ("Annual Registration Statement Identifying Separated

Participants with Deferred Vested Benefits"). Form 8955-SSA is filed separately with the IRS, and not the DOL.

In 2013, the DOL revised the DFVC Program to require that all delinquent annual reports be submitted electronically, using its EFAST2 Program. It also announced that late filers would not be permitted to submit Form 8955-SSA (or Schedule SSA) under the DFVC Program, even for 2008 and prior plan years. Thus, information that the IRS requires to be reported on Form 8955-SSA (or, for plan years before 2009, Schedule SSA) may no longer be submitted as part of a DFVC Program correction.

In Notice 2014-32 (the "Notice"), the IRS has addressed this gap by establishing a new procedure for obtaining relief from the late-filing penalties imposed under the Tax Code.

New Requirement for Relief from IRS Penalties

According to the Notice, the IRS will not impose penalties for the late filing of Forms 5500, 5500-SF, or 8955-SSA, or for late actuarial reports, with respect to any year for which such Form is required, if the plan administrator:

is eligible for and satisfies the requirements of the DFVC Program with respect to a delinquent Form 5500 for that year; and files a complete Form 8955-SSA for that year (to the extent that the required information has not already been provided to the IRS) by the later of: (i) 30 calendar days after the filer completes the DFVC Program filing, or (ii) December 1, 2014.

Ironically enough, considering the electronic origins of the problem, any such Form 8955-SSA must be filed on paper. When completing the Form 8955-SSA, the filer must check the box on Line C, Part I (Special Extension) and enter "DFVC" in the space provided on Line C.

According to the Notice, only the Form 8955-SSA is required. In other words, there is no need to file a separate application for penalty relief with the IRS. Instead, the IRS will coordinate with the DOL in determining which late filers are eligible for relief.

ERISA Plans Only

The relief provided under the Notice applies only to retirement plans that are subject to Title I of ERISA. Thus, filers of Forms 5500-EZ and 5500-SF (for non-ERISA plans) are not eligible. However, the IRS has also established a temporary pilot program under which non-ERISA plans may seek penalty relief. (That program is described in in Revenue Procedure 2014-32.)

What Does This Mean for Plan Sponsors?

Plan administrators who have failed to timely file a Form 5500, Schedule SSA, or Form 8955-SSA should understand the new requirements for relief from penalties assessed under the Tax Code and take advantage of this relief before the deadline expires. Administrators who have already obtained relief from the DOL penalties under the DFVC Program must file the appropriate Form 9855-SSA with the IRS before the December 1, 2014, deadline. Those who have not yet completed a filing under the DFVC Program must first do so, and then file Form 8955-SSA with the IRS before the applicable deadline (the later of 30 days after the DFVC filing is complete or December 1, 2014).

Final Rule Issued on Phase-in of PBGC Guarantee for Shutdown Pensions

The Pension Benefit Guaranty Corporation (PBGC) recently issued a final rule (the Rule) on the phase-in of PBGC's guarantee of shutdown pensions and other benefits payable upon the occurrence of unpredictable contingent events.

Background

Shutdown Pensions and the PBGC Guarantee

Shutdown pension benefits – such as "rule of 65" or ''70/80" pensions – are typically collectively-bargained special pensions that allow employees with the right combination of age and service to begin receiving early unreduced pensions if they are terminated due to a layoff or plant closing. For example, 70/80 pensions provide full pensions in the event of a plant closing to employees whose age plus service equals 70 (if at least age 55) or 80 (at any age). Thus, an employee hired at age 18 with 31 years of service would qualify for an unreduced early pension at age 49.

Shutdown benefits often are found in the pension plans of old-line steel, aluminum, automotive and other heavy-manufacturing employers. Some companies provide a version of these special pensions to their salaried employees.

Because the benefit is contingent on the occurrence of an unpredictable event, plan sponsors are not obligated to provide for advance funding of shutdown benefits. Before the Pension Protection Act of 2006 (PPA), shutdown benefits adopted more than five years before the triggering layoffs were fully guaranteed by the PBGC. In many cases, pension plans paying shutdown pensions terminated with unfunded benefit liabilities within a few years of the shutdown, forcing the PBGC to pick up this liability.

Not surprisingly, plant shutdowns often occur when the employer is experiencing financial difficulty and pension funding is jeopardized. Since 1987, PBGC has assumed more than $1 billion of unfunded benefit liabilities from shutdown and similar benefits.

Phase-in of PBGC Guarantee of New Pension Benefits in General

PBGC administers a termination insurance program for single-employer pension plan terminations under Title IV of ERISA. Typically, when an underfunded pension plan subject to Title IV terminates, PBGC is appointed as the trustee of the plan and becomes responsible for paying benefits.

ERISA has a phase-in scheme for PBGC's guarantee of any new pension benefits or benefit increases that a plan sponsor creates. The phase-in of PBGC's guarantee protects PBGC from losses caused by benefit increases made effective shortly before plan termination. The phase-in of the guarantee allows time for the funding of new liabilities before they are fully guaranteed.

Under ERISA Section 4022, PBGC's guarantee is phased in over a five-year period, which begins on the later of the date the new benefit or benefit increase is adopted or the date it is effective. The phase-in is based on the number of full years the new benefit or benefit increase has been in the plan. Generally, 20 percent of a benefit increase is guaranteed after one year, 40 percent after two years and 100 percent after five years. If the amount of the monthly benefit increase is less than $100, the annual rate of phase-in is $20 rather than 20 percent.

Phase-in of PBGC Guarantee of Shutdown Pensions and Other UCEBs

The PPA addressed the problem of unfunded shutdown benefits by adding ERISA Section 4022(b)(8), which changed the phase-in rules for "unpredictable contingent event benefits" (UCEBs) in the case of "unpredictable contingent events" (UCEs) occurring after July 26, 2005. UCEBs are benefits or benefit increases – such as shutdown pensions − that become payable solely by reason of the occurrence of a UCE. Under Section 4022(b)(8), for purposes of the phase-in limit, the date a UCE occurs is treated as the adoption date of the plan provision for the related UCEB. This provides PBGC a greater measure of protection from losses from unfunded UCEBs.

PBGC's Rule Implementing the PBGC Guarantee for Shutdown Pensions and Other UCEBs

The Rule largely adopts the proposed rule PBGC published in 2011 to implement Section 4022(b)(8). Specifically, the Rule (1) incorporates the definition of UCEB that is used under ERISA Section 206(g)(1)(C) and Treasury Regulation Section 1.436-1(j)(9); and (2) provides that PBGC's guarantee of UCEBs is phased-in from the latest of (i) the benefit provision's adoption date; (ii) the provision's effective date; or (iii) the date the UCE occurs.

UCEBs Covered

The Rule incorporates the definition of UCEB used in Section 206(g)(1)(C) and Section 1.436-1(j)(9). These provisions define a UCEB to include benefits payable solely by reason of (1) a plant shutdown or similar event; or (2) an occurrence other than an event, such as the attainment of a certain age or performance of service, that would trigger eligibility for a retirement benefit.

Under the Rule, PBGC will determine whether a benefit is a UCEB based on the facts and circumstances. The substance of the benefit, not what it is called, determines whether it will be considered a UCEB by PBGC. Also, the Rule clarifies that a UCEB does not cease to be a UCEB for phase-in purposes merely because the UCE has already occurred or its occurrence has become reasonably predictable.

Date UCE Occurs

The Rule requires that PBGC determine the date a UCE occurs based on the plan provisions and other facts and circumstances, including the nature and level of activity at a facility that is closing and the permanence of the event. Shutdown pensions are frequently the subject of grievances, arbitrations and court cases, and determinations made by an employer, plan administrator, union, arbitrator or court about the UCE date may be relevant but are not controlling as to the PBGC's determination.

If a plan provides that a UCEB is payable upon the occurrence of more than one UCE, the guarantee will be phased in from the latest date when all such UCEs have occurred. For example, if a UCEB is payable only if a participant is laid off, and the layoff continues for a specified time period, then the phase-in period begins at the end of the specified time period.

The Rule clarifies that plan provisions will determine whether a UCEB phase-in determination applies on a participant-by-participant basis, as opposed to a facility-wide or some other basis. For example, the UCE date of a UCEB triggered by a reduction in force will be determined as to each participant. Therefore, layoffs occurring on different dates will have distinct UCEs. Alternatively, UCEBs triggered by a complete shutdown of an employer's entire operations applies plant-wide. Therefore, the UCE date for all participants will be the same – the shutdown date. Interestingly, a participant-by-participant determination of the UCE date, such as the case with sequential layoffs, may result in participants who are laid off earlier in a shutdown process receiving a greater phase-in percentage than participants laid off later in the process.

Date UCEB Phase-in Begins

The Rule provides that the phase-in period for a UCEB guarantee will begin on the latest of the UCEB provision's adoption date, its effective date, or the date the UCE occurs. Also, if a UCEB becomes payable because a restriction under Code Section 436 is removed − for example, an adequate funding contribution is made − then the effective date of the UCEB for phase-in purposes is determined without regard to the restriction.

Bankruptcy Filings

In general, ERISA Section 4022(g) provides that when an underfunded pension plan terminates while its contributing sponsor is in bankruptcy, the amount of benefits guaranteed by PBGC under Section 4022 will be determined as of the date of the bankruptcy filing rather than the plan's termination date. The Rule clarifies that if a UCE occurs after the bankruptcy filing date, UCEBs arising from the UCE are not guaranteed because the benefits are not nonforfeitable as of the bankruptcy filing date.

Similarly, the Rule clarifies that if a UCE occurs before the bankruptcy filing date, the five-year phase-in period for any resulting UCEBs is measured from the date of the UCE to the bankruptcy filing date, rather than to the plan termination date. For example, if a permanent shutdown occurs three years before the bankruptcy filing date, the guarantee of any resulting UCEBs will be only 60 percent phased in, even if the shutdown was more than five years before the plan's termination date.

3 Approaches to Income-Replacement Ratios in Retirement

A Clear Target

Yesterday's column suggested--courtesy of a paper entitled "American Workers' Retirement Income Security Prospects: A Critique of Recent Assessments (AWR)"--that retirees need less income than is generally believed. Typical advice is to plan for replacing 80% to 85% of preretirement income during the retirement period. That may be too much. In saving for such an amount, investors may be accepting an unnecessarily low lifestyle during their working years.

The key word being "unnecessarily." There's nothing wrong with living better during retirement than while working. That is a personal choice; there's no preferred path for consumption spending. However, the decision should be consciously made, rather than accidentally and, later, with regret.

Morningstar's Jason Stipp writes, "Just do a quick back-of-the-envelope calculation. Imagine you are saving 15% for retirement, another 15% goes to the mortgage, 5% to a 529 plan, and then another 10% for child care. Those are all expenses you can aim to not have by retirement. You're living on 55% of income--not even in the ballpark of the

80% to 85% income-replacement estimates, or worse, the 100% rates that some retirement tools use as their default."

That's the spirit, Jason. Our hypothetical investor probably isn't socking away 15% for retirement while saving for college expenses and funding child care, but then again, some of those other expenses could be higher.

Jason continues, "Now if you want to have a lavish retirement, that's a different story. But I also think people should consider if they want to be 85 and sitting on a giant cash pile, having sacrificed unnecessarily their whole lives. It's a balance. Dying with too much is not an optimal outcome, either--except for the financial-services industry."

Another reader writes, "The right income-replacement ratio is highly dependent on a lot of factors, in particular one's income level. If anywhere the 'one-size-fits-all' label doesn't apply, it's surely here. I know that in my case as a fairly affluent retiree, I am able to live on a higher standard of living on less than a 50% replacement ratio, due to the absence of the cost of funding retirement savings, the elimination of children's expenses (although not quite as much as planned!), and tax reductions (elimination of Social Security/Medicare tax, dividends/capital gains taxed less than ordinary income, etc.)."

It's fruitless to seek the correct income-replacement ratio, as individual circumstances vary broadly. However, one can seek a reasonable starting point. The AWR paper offers three such attempts. While each is calculated and displayed differently, the upshot is broadly similar. Low earners tend to have income-replacement ratios from 70% to 80%, while high earners are mostly from 60% to 70% (with a few lower estimates).

The first study, by John Karl Scholz and Ananth Seshadri, removes the estimated costs associated with raising children and work-related expenses from the retiree's ledger and credits the retiree's lower tax burden. It calculates income-replacement ratios as a percentage of average lifetime wages and as a percentage of the five to nine years before retirement (which are presumed to be the highest-earning years, although that is not always so). Results are given over various income levels.

Scholz and Seshadri: Median Optimal Target Earnings-Replacement Ratios

Lifetime Earnings Percentile	Averaged Over Lifetime	Averaged Over Years 5-9 Prior to Retirement
0%-30%	72%	73%
30%-40%	58%	50%
40%-50%	59%	56%
50%-60%	67%	55%
60%-70%	67%	59%
70%-80%	68%	57%
80%-90%	73%	61%
90%-100%	76%	53%

Sources: John Karl Scholz and Ananth Seshadri.

Setting aside the lowest-earning 30% of workers, the picture is consistent: The income-replacement ratio rises with income when averaged over the lifetime working years, and it declines with income when averaged over the later period. That occurs because higher-income workers substantially grow their wages over time, while lower- and middle-income workers do not. The pattern is a clear warning about creating a single income-replacement rule across a broad salary spectrum.

The Center for Retirement Research shows higher required income-replacement ratios because the Center credits workers for unearned income, such as 401(k) or other investment profits, and for "imputed rent from housing (net of interest paid on mortgage debt)." As these are not consumable items, it's not clear to me (or to AWR's authors) why they should count as preretirement income that needs to be replaced.

Center for Retirement Research (Munnell): Estimated Target Preretirement Income-Replacement Ratios

Household Type	All	Bottom Third	Middle Third	Top Third
All	71%	81%	72%	67%
Couples	73%	81%	72%	67%
One earner	76%	85%	75%	68%
Two earners	72%	77%	71%	67%
Singles	72%	81%	71%	65%
Men	70%	76%	70%	65%
Women	73%	82%	71%	65%

Source: Alicia H. Munnell, Center for Retirement Research.

Even with that conservative feature, though, the Center's estimates are moderately lower than the rule of thumb, landing mostly at 70% to 75%. Again, wealthier workers have the lowest income-replacement ratios.

Finally, AWR's authors offer their own estimates. I've included only their results for retirement at age 65, but they also give targeted replacement-income ratios for those who wish to retire at ages 55 and 60. The good news is that the ratios are quite modest. The bad news is that to retire at such a young age while maintaining the same lifestyle, one must save a great deal while working--which means that consumable income is also modest. In short, the income-replacement target is low because the standard of living was sacrificed during the working years.

Pang and Schieber:
Replacement Rates at Various Retirement Ages to Achieve Preretirement Standards of Living in Retirement

Starting Pay When Savings Begins (2008 Dollars)	Retirement Rate Target—Age 65
$25,000	74%
$35,000	73%
$45,000	72%
$55,000	69%
$65,000	68%
$75,000	67%
$85,000	66%
$95,000	66%
$105,000	65%

Source: Gaobo Pang and Sylvester J. Schieber.

Some read yesterday's column as being advice. It was not. I do not recommend an income-replacement ratio of less than 85%. Nor do I recommend 85% itself, or any figure about 85%. My goal is accomplished if people think twice when hearing the term "retirement crisis" and three times (at least) when thinking about their own financial futures.

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