BCG Retirement News Roundup

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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.

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Municipal Pensions' Funding Up in FY 2013

Wilshire Consulting estimates that the ratio of pension assets to liabilities, or funding ratio, for the city and county pension plans it studied was 73% in 2013, up 4 percentage points from 2012.

The "Wilshire 2014 Report on City and County Retirement Systems: Funding Levels and Asset Allocation" is based upon data gathered by Wilshire from the most recent financial and actuarial reports available and includes 109 city and county retirement systems. Of these, 105 systems reported actuarial values on or after June 30, 2013, and the remaining four systems last reported before June 30, 2013.

"Of the 105 city and county retirement systems which reported actuarial data for 2013, 90% have market value of assets less than pension liabilities or are underfunded," says Russ Walker, vice president, Wilshire Associates, and an author of the report.

For the 105 city and county retirement systems that reported actuarial data on or after June 30, 2013, pension assets increased 11%, or $42.3 billion, from $386.9 billion in 2012 to $428.9 billion in fiscal year 2013, while liabilities grew 5%, or $26.2 billion, from $563.5 billion to $589.7 billion. These 105 plans saw their aggregate shortfall decrease $16.1 billion over fiscal year 2013, from -$176.9 billion to -$160.7 billion.

"City and county pension portfolios have a 62.4% average allocation to equities, including real estate and private equity, and a 37.6% allocation to debt and other assets," Walker notes. "The 62.4% equity allocation is lower than the 63.8% equity allocation five years prior in 2008. Asset allocation varies widely by city and county retirement system. Thirty-four of the 109 retirement systems have total allocations to equity that equal or exceed 70%, and fourteen systems have equity allocations below 50%. The 25th and 75th percentile range for equity allocation is 55% to 72%."

Wilshire forecasts a long-term median return on city and county pension assets equal to 6.6% per annum. This 6.6% estimate, based on beta-only asset class assumptions and excluding active-management alpha, is below the median actuarial interest-rate assumption of 7.75%. One should note that Wilshire's assumptions range over a conservative 10-year or longer time horizon, while pension plan interest-rate assumptions typically project over 20 to 30 years.

Former Pa. pension fund manager says he is "exonerated"

An investigation into an unsuccessful investment by the Pennsylvania State Employees' Retirement System (SERS) has "found no evidence of illegality" by Anthony Clark, the system's former chief investment officer, who persuaded the system to pump $250 million into Tiger Management Advisors as the first step in a planned hedge fund strategy.

"Whether Clark intentionally misled the board by seeking to conceal Tiger's poor performance is open to question," the investigator, former acting state attorney general Walter Cohen, added in his two-page note to the board summarizing his findings.

Clark said Cohen's summary report "exonerated" him and confirmed that he "did nothing illegal, unethical, immoral or against SERS policy" while serving as the top investment picker for the underfunded, $27 billion, taxpayer-backed system.

Despite Tiger's losses, other SERS investments recovered on his watch, Clark added. "I have lost nearly a year of my professional life because of frivolous allegations," he said. "I am eager to resume my career."

In Cohen's more detailed 24-page report, which SERS did not make public but which The Inquirer has reviewed, Cohen wrote it was "appropriate" for the board to accept Clark's resignation last autumn - not because Clark broke any law, but because his hedge fund bet, polarizing leadership, and "failure to command the respect and trust of his staff," made it wiser for the board to seek new leadership.

Cohen's review focused on allegations that Clark failed to properly disclose up to $17 million in short-term losses SERS suffered from Tiger Management Advisors, even as the hedge fund group was paid $11 million in fees. Clark had recommended Tiger as a low-risk, profitable investment; contrary to his predictions, the hedge funds lost money after a manager bet big on gold.

The review also looked at Clark's working hours and personal investing. Cohen said SERS should consider tightening its loose inside-information regulations and work rules, and set limits on investing while at work.

Clark retired early in December after longtime SERS chairman Nicholas Maiale urged him take a leave of absence while the board reviewed complaints about his leadership. Maiale's intervention brought a call for his own resignation from state Treasurer Rob McCord. Gov. Corbett then declined to reappoint Maiale as SERS chairman. Maiale said the Cohen report showed he had been right to hire and support Clark.

"I interpreted it as a complete exoneration," Clark said of Cohen's report. Asked about what Cohen called the "open question" of Clark's Tiger disclosures, he said he saw it as Cohen's acknowledgment that "some board members saw that as an attempt to conceal while others did not."

Clark blamed the "confusion" on changes in SERS reporting methods.

According to Cohen's report, Clark was an aggressive manager who intimidated members of a demoralized staff already reeling from the investment market collapse of 2008.

"My mandate when I was hired was to come in and elevate the stature and capabilities of the investment office and to be a strong leader," Clark said. "I was demanding. I held people accountable, just as I was accountable to the board. I expected people to do their jobs to their best ability."

He added: "In my judgment, the results speak for themselves."

Profits replaced losses as investment markets recovered; SERS benefited from Clark's increased investments in U.S. stocks.

"If I had just accepted the current environment and culture and not rocked the boat, the fund would have continued to experience mediocre performance," Clark said.

Good returns ease public pension fund fears as GASB changes take hold

The first batch of public pension fund financial reports under new accounting standards will be out this fall, and after a bumpy adjustment period, the preliminary results so far are good — or at least not as bad as expected.

Governmental Accounting Standards Board rules for the plans become effective in fiscal 2014 under GASB Statement 67. Those for contributing employers are effective in fiscal 2015 under GASB Statement 68. Both the plans and their sponsors now must report net pension liability, which is based on valuing assets and liabilities on a mark-to-market basis, instead of smoothing.

Until now, public pension plan officials stressed in their reports their actuarially required contribution number, used to set annual pension funding targets. That number — the

ARC — is slipping to the footnotes, and unfunded liability is moving to the balance sheet from the footnotes.

As a result, some underfunded plans are expected to look worse because they might have to use a more conservative discount rate to measure their unfunded liabilities, which will now have a more prominent place on their balance sheets. And for even relatively well-funded plans, the change had officials worried that a more prominent liability figure would add to confusion and misconceptions about public-sector pensions.

Now, thanks to strong investment returns since GASB proposed the rules in 2012, public pension officials are breathing more easily.

“The timing was good for the onset of the new GASB statements because of the markets,” said Keith Brainard, Georgetown, Texas-based director of research for the National Association of State Retirement Administrators. “The stars aligned.”

“A lot of plans are going to be very happy,” said Elizabeth Kellar, president and CEO of the Center for State and Local Government Excellence in Washington.

But Ms. Kellar hasn't stopped worrying. She fears even good GASB numbers could take too much attention away from the bigger decisions about setting annual contribution rates. “The focus should be on what GASB is not doing, which is helping elected officials focus on a funding plan. We may be letting down the taxpayers,” said Ms. Kellar.

It “will create a degree of confusion among many important factions,” said Rachel Barkley, vice president of Loop Capital, Chicago, an investment services firm that tracks public pension funding annually. “GASB will definitely generate significant debate about pensions.”

“For all the people arguing for market rate for liabilities, it's still the wrong concept,” said Jean-Pierre Aubry, assistant director of state and local research at the Center for Retirement Research at Boston College. “For funding purposes, it doesn't really matter. We feel that there's not going to be a huge change because the majority of plans are committed to paying the full ARC.”

On a more optimistic note, Ms. Kellar recalled that GASB disclosure requirements implemented in 1986, although controversial at the time, helped to stimulate better funding practices among many public pension funds. “It had been pay-as-you-go, then people started paying (ahead),” she said. ”

Higher funding levels

Calculations done by the Center for Retirement Research show that for a typical pension plan earning a 7.75% return, a funding level of 76.9% in fiscal 2014 would increase to 80.6% under the new GASB formula based on market assets, and to 82.1% from 79.1% in 2015. “We don't know what the liabilities are today, but we do know the assets. The real story is the pile of assets,” said Mr. Aubry.

One big caveat: Numbers tied to market returns can also go the other way. “People have to understand that this is a more volatile reporting approach,” said Ms. Kellar.

The new net pension liability figure “is now going to become a very volatile number, and next year you could give it all back,” said Robert P. Schultze, director of the $65.2 billion Virginia Retirement System, Richmond. “I would hope that nobody puts too much emphasis on these numbers. These state budgets couldn't take the volatility.”

To help prepare Virginia legislators and local officials for the new numbers, VRS officials did some mock calculations. With an unfunded liability of $21.3 billion, “boy, did we get their attention,” he said, “especially when they could see how some liability from the teacher plan would be allocated to each local government.”

“We've been trying to manage expectations since the GASB rules came out. I am very confident that state legislators and most local officials understand what to expect,” said Mr. Schultze. “We hope these mock calculations will offset some of the sticker shock caused by the new rules.”

When Virginia officially reports its unfunded liability under the new rule this fall, things should look good, thanks to a 9% difference between the market and actuarial value of assets. “That by itself will show that the funded status will probably go up 9%, and unfunded liabilities reduced by about $5 billion,” Mr. Schultze said.

He said he has heard similar predictions from his counterparts at other public pension funds. At a NASRA gathering in August, “the general consensus was that they're feeling comfortable. They are ready,” said Mr. Schultze.

Aside from some significantly underfunded plans, “the dire predictions for all public plans have failed to materialize,” said Bill Hallmark, a public sector expert and consulting actuary with Cheiron Inc. in Portland, Ore. For plans that are not well funded, or do not have a policy in place to get there, the gloom will continue with the GASB rules, which force them to use a more conservative discount rate for measuring their unfunded liabilities.

Combined rate

Until now, projected benefit obligations have been discounted by each plan's long-term assumed rate of return on assets. Under GASB, underfunded plans will use a combined rate that applies the assumed rate of return only to liabilities covered by current assets, while the return for calculating additional liabilities is based on high-grade municipal bond rates, which can be substantially lower.

GASB also gives the pension funds less time to amortize the liability.

“I think it will be a red flag that shows that their funding plan is insufficient,” said Mr. Hallmark. “Those flags could and will pop up.”

The bigger question that won't be answered until statements for fiscal 2015 are prepared is the impact of the new GASB rules on local governments, which for the first time will be reporting their share of pension liabilities on their own financial statements.

Donald Drum, executive director of the $12.9 billion Idaho Public Employee Retirement System, Boise, won't have to deal with the first wave of GASB changes, because the pension fund, which is 94% funded, does not smooth, so assets and liabilities are measured in real time. “It's very useful for us from a planning and political purpose to let legislators really see an impact — if the market dropped, or went up. We can do daily market valuations,” said Mr. Drum.

But the new GASB rules do change the way employers contributing to the pension fund calculate their pension liabilities, so Mr. Drum launched a “GASB state tour,” meeting with employers, calculating their share of unfunded liability and explaining what it will mean when they start reporting in 2015. “I've helped them to understand how to communicate,” said Mr. Drum. “In the end, if everybody understands how it works, it calms down their anxiety.”

Calpers, Nation’s Biggest Pension Fund, to End Hedge Fund Investments

The California Public Employees’ Retirement System, the nation’s largest pension fund, will eliminate all of its hedge fund investments over the next year on concerns that investments are too complicated and expensive.

The pension fund, which oversees $300 billion, said on Monday that it would liquidate its positions in 24 hedge funds and six hedge fund-of-funds — investments that total $4 billion and more than 1 percent of its total investments under management.

The decision, after months of deliberation by the pension fund’s investment committee, comes as public pensions across the United States are beginning to assess their exposure to hedge funds. It is likely to reverberate across the investment community in the United States, where large investment funds look to Calpers as a model because of its size and the sophistication of its investments.

"Hedge funds are certainly a viable strategy for some, but at the end of the day, when judged against their complexity, cost and the lack of ability to scale at Calpers' size," the hedge fund program "doesn't merit a continued role," Ted Eliopoulos, the interim chief investment officer of Calpers, said in a statement.

Calpers oversees investments and retirement benefits for 1.6 million teachers, police officers, firefighters and other public employees. It said it had not decided where it would invest the money it divests.

"I'm a little shocked at what Calpers is doing," Charles J. Gradante, managing principal of the hedge fund advisory firm Hennessee Group. "Hedge funds are the place to be now because people are expecting a major correction. You're looking at a very bumpy stock market over the next five years and that is where hedge funds will prove their mettle."

A growing number of pension funds and institutional investors have expressed concern that the fees that hedge funds charge are too high. While there is a range, hedge funds typically follow a "2 and 20" model where investors pay management fees of 2 percent of the total assets under management and 20 percent of the profit.

These concerns have become more pronounced as performance across the hedge fund industry has disappointed investors. Hedge funds have underperformed the Standard & Poor's 500-stock index for the last five years, a metric that pension funds frequently cite as a comparison. In 2013, for example, the average hedge fund returned just 9.1 percent, according to the data firm HFR. That compares with a 32.4 percent increase in the S.&P. 500.

Calpers said it paid $135 million in hedge fund fees over the financial year that ended on June 30. The hedge fund investments returned just 7.1 percent, adding 0.4 percent to the firm's total returns. For its hedge fund investments to have a material impact, Calpers would have to increase its hedge fund investments to at least 10 percent of its total portfolio, which was not a feasible option, according to Joe DeAnda, a spokesman for Calpers.

Even as some pension funds are reconsidering their investments in hedge funds, the industry has continued to grow to a record $2.8 trillion today, according to HFR.

After the pension funds had their asset values decimated by losses from the financial crisis, many of them flocked to hedge funds, and their promise of high returns, even in years when the broader stock and bond markets were down. Some pension funds vastly increased their hedge fund holdings, with many going from virtually no holdings to allocations of up to 15 percent. The Teachers Retirement System of Texas went so far as to take a stake in the giant hedge fund Bridgewater Associates.

But even as some other pension funds piled into hedge funds, Calpers has long harbored doubts about the value of these investment strategies. Those doubts surfaced last year when Calpers investment staff was surveyed about their broad views on investments. Many members expressed “low conviction” that hedge funds should play an important part of Calpers overall strategy.

On average, hedge funds still make up a relatively small portion of large public pension plan’s investments — about 1.3 percent as of June 30, according to the Wilshire Trust Universe Comparison Service. That share is up from about 1 percent in 2007, but stocks and bonds still make up most of pension investments.

Lately, other pension fund managers in states including Rhode Island and Pennsylvania have expressed similar doubts about whether the hedge funds’ recently spotty track record justifies the high fees.

The Los Angeles Fire and Police Pensions led the charge in May of last year when it announced it would exit its hedge fund positions — which made up a total of 4 percent of their assets under management and 17 percent of the fees the firm paid.

The moves are part of a broader reckoning for public employee pension plans. Facing historically low interest rates, a growing number of city and state pension officials have started lowering their annual investment targets, despite the promises of hedge funds, private equity and other high-priced investment managers to continue delivering high returns.

Some investors dismissed the move by Calpers. “It’s an admission by Calpers that they don’t have the right staff or the right managers,” Anthony Scaramucci, founder and co-managing partner of SkyBridge Capital, a global asset management firm, said.

ANNUAL SURVEY OF STATE-ADMINISTERED DB PLANS

The U.S. Census Bureau has released its “Annual Survey of Public Pensions: State-Administered Defined Benefit Data Summary Report: 2013.” This report is part of a continuing series designed to provide information on the structure, function, employment, and finances of the United States’ over 90,000 state and local governments. Data in this report refer to fiscal years that ended between July 1, 2012, and June 30, 2013, and do not reflect data for the entire calendar year of 2013. This survey covers the following pension system activities: revenues by state (earnings on investments, employee contributions, government contributions); expenditures by state (benefits, withdrawals, other payments); cash and investment holdings by state governmental securities, corporate stocks and bonds, foreign and international securities, etc.); membership information by state (number of pension systems, total membership, beneficiaries receiving periodic payments); and liabilities information by state (covered payroll and pension obligations) for state-administered pension systems only. State-administered pension systems showed positive earnings on investments in 2013. Gains on investments totaled $315.9 billion in 2013, 274.0 percent higher than the 2012 earnings, which totaled $84.5 billion. Total holdings and investments for state-administered pension systems grew by 7.8 percent, from $2.5 trillion in 2012 to $2.7 trillion in 2013. Pension systems have substantial investments in financial markets and, consequently, earnings are dependent on change in market performance. Total holdings and investments consist of cash and short-term investments, governmental securities (e.g., U.S. Treasury), nongovernmental securities (e.g., corporate stocks and bonds, foreign and international securities, mortgages, etc.), and other investments (e.g., real property). The two largest investment categories -- corporate stocks and foreign and international securities –made up over half (56.5 percent) of the total holdings and investments for all state-administered pension systems in 2013. Corporate stocks came to over one-third of the total holdings and investments (36.8 percent) and foreign and international securities comprised approximately one-fifth of the total (19.7 percent). G13-ASPP-ST (August 2014).

Private Sector

Decades-Old DB Benefit Payments Being Questioned

Law firms say they are seeing a growing number of claims for pension benefits that were paid or rolled over decades ago by former employees who either do not recall receiving or rolling over their benefits or who are questioning the amount of benefits they received.

Pat DiCarlo, counsel with Alston & Bird’s ERISA Litigation group in Atlanta, explains that the claims his firm is seeing are brought through defined benefit (DB) plans’ formal administration process and have not yet reached litigation. He tells PLANSPONSOR the trend is new but is becoming more prevalent.

“There are at least three different iterations of the claims,” he says. “Some claim they never received a distribution; some are saying not all their service was credited when calculating benefits. For example, if the employer went through mergers and acquisitions, the individual is saying he should have gotten credit for service with prior employers. And some claimants are spouses of deceased participants, who say they never signed a spousal waiver so the participant should not have received payment as a single life annuity that ended when the participant died.”

According to DiCarlo, a contributing factor to the rise of these claims is the large population of Baby Boomers retiring and the span of time over which records have not been retained or may have been lost. Adding defined benefit plan participation when individuals file for Social Security benefits also boosts the trend. “Along with estimated Social Security benefits, the administration is including notification of plans in which individuals may have participated,” he says. “Participants get this statement and think they’re owed a benefit, but the employer may not even have a record of the individual being a participant.”

David Weiner, a principal at David Weiner Legal in Chicago, also says there seems to be a surge of former participants who are re-engaging with old benefit plans (see “Tips for Fielding Lost Participant Claims”). He says the language of the Social Security notice can be quite misleading, because it tells individuals they “may be entitled to some private pension benefits upon retirement,” depending on whether they have already collected due benefits in the form of a cash distribution. Another sentence in the notice warns pre-retirees, “If you have already received payments from the plan, the amount shown on this notice should be disregarded.”

According to DiCarlo, when an individual makes a claim, the plan sponsor can ask for evidence that he or she was a participant and is owed a benefit. The plan sponsor can also offer evidence showing a payment was made. Most plans provide for an “arbitrary and capricious” review. If the plan sponsor has good evidence it can deny the claim, and it makes it hard for the claimant to file litigation. However, if the plan sponsor doesn’t have good evidence, it can also settle the claim and pay a benefit.

“Obviously, plan sponsors’ first line of defense against such claims is to retain good records, but at this point, that ship has already sailed,” DiCarlo says. “So, plan sponsors should have in place a good administrative process. Require individuals to show proof other than the Social Security notice that they have a claim.

DiCarlo contends plan sponsors may use “pattern and practice” type evidence even if they do not have original documentation showing someone was paid. “If [a plan sponsor] can show its normal procedures somehow document a payment was made, even if it doesn’t have a copy of a canceled check or benefits package anymore, it can say our process results in the record showing if it exists.”

However, plan sponsors can also consider whether it would be a better use of resources to settle or pay the claim. “It can settle with corporate assets and use a confidentiality provision if it is concerned about setting a bad precedent. That way, no one can post on a blog about how they brought a claim and received money.”

IRS Issues Final Regulations Providing Guidance on Hybrid Retirement Plans and Proposed Regulations Providing Anti-Cutback Relief

The Internal Revenue Service (IRS) issued final regulations relating to hybrid retirement plans, including cash balance plans and pension equity plans. The IRS also issued proposed regulations providing anti-cutback relief under IRC Section 411(d)(6) so that plans may be amended to comply with the guidance.

Practical Law Employee Benefits & Executive Compensation

On September 18, 2014, the Internal Revenue Service (IRS) released proposed and final regulations relating to hybrid retirement plans, such as cash balance plans and pension equity plans. The final regulations provide guidance on certain issues under IRC Sections 411(a)(13) and 411(b)(5) that were not addressed in the 2010 final regulations and make other changes to those sections. The proposed regulations issued in connection with the final regulations provide anti-cutback relief under IRC Section 411(d)(6) so that plans may be amended to comply with the guidance without violating the anti-cutback rules.

Hybrid Plans: Background

Hybrid defined benefit plans, such as cash balance plans or pension equity plans (PEP), combine features of both defined contribution and defined benefit plans. In a hybrid plan, the participant's accumulated benefit is usually expressed as:

- The current balance of a hypothetical account maintained for the participant.
- The current value of an accumulated percentage of the participant's final average compensation.

(see Practice Note, Requirements for Qualified Retirement Plans: Hybrid Plans.)

There have been many controversial issues regarding hybrid plans, including whether:

- Lump sums paid from a hybrid plan comply with the minimum present value requirements of IRC Section 417(e), known as the whipsaw issue (see Practice Note, Cash Balance Plans: Whipsaw Effect Background).
- A hybrid plan discriminates against older workers (Practice Note, Cash Balance Plans: Age Discrimination: Background).

- The plan's method of converting from a defined benefit plan to a hybrid plan complies with applicable rules, known as the wear away issue (see Practice Note, Cash Balance Plans, Plan Conversions and Wear-away: Background).

Pension Protection Act (PPA) Changes to Hybrid Plans

The Pension Protection Act of 2006 (PPA) addressed many of these issues by:

- Eliminating the two-step whipsaw calculation (see Practice Note, Cash Balance Plans: Post-PPA: Elimination of the Two-step Whipsaw Calculation).
- Imposing an age discrimination safe harbor which contains a requirement that interest crediting rates cannot be greater than a market rate of return (see Practice Note, Cash Balance Plans: Post-PPA: Age Discrimination Safe Harbor).
- Imposing minimum conversion requirements to address the wear away issue (see Practice Note, Cash Balance Plans: Minimum Conversion Requirements: How the PPA Addresses Wear-Away).

2010 Proposed & Final Hybrid Plan Regulations

In 2010, the IRS issued proposed and final regulations for hybrid plans implementing the changes made to hybrid plans under the PPA. The 2010 proposed regulations provided a list of permissible interest crediting rates that satisfy the market rate of return requirement to include:

- Interest rates based on the actual rate of return on plan assets.
- A fixed 5% rate.
- A rate based on the greater of two interest crediting rates if:
- the plan uses bond-based rates and includes a fixed interest rate floor of no more than 4% annually; and
- the plan uses bond-based or equity-based rates and includes a cumulative interest rate floor of no more than 3%.

(See Practice Note, Cash Balance Plans: Market Rate of Return Rules.)

2014 Final Hybrid Plan Regulations

On September 18, 2014, the IRS issued additional final regulations to provide guidance on certain issues that were not addressed in the 2010 final regulations and make other changes to those sections. These rules are generally effective for plan years that begin on or after January 1, 2016 and provide guidance on:

- The scope of the PEP formula under IRC Section 411(a)(13).
- An increase in the maximum permitted fixed interest credit to 6% from 5%.
- An expanded list of interest crediting rates and combinations of interest crediting rates that satisfy the market rate of return requirement, including:
- unadjusted segment rates; and
- the interest rates permitted under the Moving Ahead for Progress in the 21st Century Act or in the Highway and Transportation Funding Act of 2014, which modify the segment rates to fall within a range of average rates over a 25 year period (see Legal Updates, IRS and PBGC Issue Guidance on Pension Funding Stabilization Issues for Defined Benefit Plans under MAP-21, IRS Issues Guidance on Segment Rates for DB Plans Pursuant to MAP-21, President Obama Signs the Highway and Transportation Funding Act of 2014 with Pension Funding Provisions, IRS Notice 2014-53 Provides Deadlines and Requires Decisions on HAFTA's Pension Funding Provisions).
- Basing interest credits on the return on a subset of plan assets, if certain requirements are met. (The 2010 proposed regulations permitted plans to credit interest based on the actual return on plan assets in the aggregate). Assuming the requirements are met, different groups of participants can have interest credits tied to different subsets of the plan's assets.
- The interest credits used to determine benefits after a plan termination.
- Issues that arose from the 2010 proposed and final regulations on early retirement and optional-form of benefit subsidies.

The final regulations also permit defined benefit plans that adjust benefits using a variable rate that could be negative under the 133 1/3% rule to apply this rule earlier than permitted in the 2010 proposed regulations.

2014 Proposed Hybrid Plan Regulations

The proposed regulations provide transition relief from the anti-cutback rule for plans that use an interest crediting rate that is not permitted under the final regulations. A plan may be amended to change to an interest crediting rate that is permitted before the first day of the first plan year that begins on or after January 1, 2016. (Normally an amendment that reduces the interest crediting rate for benefits that have accrued would be an impermissible cutback that would violate IRC Section 411(d)(6) (see Practice Note, Protected Benefits under IRC Section 411(d)(6)).)

To obtain IRC Section 411(d)(6) relief under the proposed regulations, the amendment must be adopted before and effective no later than the first day of the first plan year that begins on or after January 1, 2016. The amended rate will apply to previously accrued benefits, but only for interest credits for periods after the amendment is adopted, or if later, for periods after the amendment is effective.

Comments on the proposed regulations are due by December 18, 2014. IRS representatives at a recent American Bar Association Section of Taxation meeting indicated that a hearing is scheduled on these proposed regulations in January of 2015 and they anticipate final regulations being issued in the early part of 2015.

Practical Implications

The proposed and final regulations provide some long anticipated guidance by addressing prior concerns from practitioners, including, raising the variable interest rate floor and permitting the crediting of interest rates equal to a subset of plan assets (if certain requirements are met). Plan sponsors may need to make meaningful changes to their plans but have some time for implementation since the IRS provided a January 1, 2016 effective date. Plans sponsors should review the implications of the guidance with their actuaries to determine whether action is needed.

Washington Post announces cuts to employees' retirement benefits

The Washington Post announced large cuts in retirement benefits on Tuesday, declaring that it would eliminate future retirement medical benefits and freeze defined-benefit pensions for nonunion employees.

The company also said that in negotiations that started Tuesday, it will seek to impose the same conditions on employees covered by the union — one of the first indications of how The Post's new owner, Amazon.com founder Jeffrey P. Bezos, will manage relations with the staff of the news organization.

The changes will hit hardest at employees hired before 2009 who could plan on receiving pension payments based on their income and years of service. Each of those employees could see scores — or hundreds — of thousands of dollars less over the course of a retirement. More recent hires do not have traditional pension plans.

The Post will create a new cash balance plan to replace the pensions for nonunion employees and a separate but similar plan for those covered by the union. Those plans provide employees with a lump sum or annuity when they retire. But they do not guarantee a particular level of retirement payments, thus reducing the risk that Bezos would have to add money to the pension if financial markets plunged.

A steady stream of firms have been eliminating pensions over the past decade or so and replacing them with plans that call on employees to bear more of the responsibility for their retirement. The 2008 financial crisis made companies even more wary of promising benefits that they could have trouble funding.

The Post's existing pension plan was about $50 million, or approximately 20 percent overfunded, last Oct. 1 when Bezos bought The Post.

The newspaper said in a letter to employees that it was doing this "with a goal of better positioning The Post for long-term success." The company declined to comment further.

"Sadly, rather than cutting costs by sharing them, some companies instead are giving up on providing pensions at all and dumping the responsibility and risk on employees, who are least prepared to handle it," said Josh Gotbaum, who stepped down last month as the director of the federal Pension Benefit Guaranty Corp.

The letter to employees did not mention changes in company contributions to 401(k) plans, which were cut in a little-noticed section of The Post's contract with Local 32035 of the Newspaper Guild, a union belonging to the Communication Workers of America. Effective Oct. 1, The Post will cut its contributions to 401(k) plans from a maximum of 5 percent to a maximum of 1 percent for workers in jobs covered by the guild contract.

Instead, The Post will create another cash balance plan that will tap the pension surplus. The payments matching employee contributions to their 401(k) plans are paid out of operating expenses.

The Post had made the same changes in 401(k) matches for non-union-covered employees in 2012.

"The Post once again dropped a bomb on the guild at its first day of contract talks," said Fredrick Kunkle, a staff writer and co-chair of the union local. "The last time we went to the table, more than a year ago, we said the publisher might have put forward the most contemptuous proposal in memory. We were wrong. We think this one is as bad, maybe even worse."

PBGC proposes requirement for employers to disclose lump-sum offers

The Pension Benefit Guaranty Corp. disclosed that it intends to require employers to report to the agency offers they make to pension fund participants to convert their monthly annuity to a cash lump-sum benefit.

In a filing published in Tuesday's Federal Register, the agency said it intends to revise 2015 PBGC premium filing procedures to require reporting of such offers, which typically are made to pension fund participants who have terminated employment but are not yet receiving benefits.

Such offers have become one of the biggest defined benefit plan trends.

This week alone, for example, three big employers — American Axle & Manufacturing Holdings Inc., Magnetek Inc. and Newell Rubbermaid Inc. — disclosed such offers, while dozens of other employers over the last few years have made similar offers.

A key appeal of this so-called derisking approach is that when pension fund participants take lump-sum benefits and are no longer covered by a plan, their former employers do not have to worry about how interest rate fluctuations and investment results could affect how much they will have to contribute to their plans to fund future annuity payments.

In addition, when participants take lump sums and move out of the pension fund, employers can reduce certain fixed costs, such as the payment of sharply rising PBGC premiums.

For the PBGC, the approach means its exposure to future losses is reduced since the pension funds it insures will have fewer participants. On the other hand, with fewer participants, employers will pay less in premiums to the PBGC, which the agency uses to help pay promised benefits to participants in failed plans the agency takes over.

Senate Hearing Addresses Retirement System Fixes

A recent U.S. Senate Finance Committee hearing covered numerous retirement-related topics, including proposals to streamline plan-testing requirements and others that could radically change defined contribution (DC) plans.

Those testifying at this week's finance committee hearing, titled "Retirement Savings 2.0: Updating Savings Policy for the Modern Economy," defended many aspects of the current voluntary retirement system, acknowledged some improvements are needed, and cautioned lawmakers against heeding impassioned rhetoric aimed at tearing the DC system down.

"Americans do not face a retirement crisis," stressed Andrew Biggs, resident scholar at American Enterprise Institute (AEI), during his testimony. "But that does not mean we have nothing to worry about."

Biggs sought to refute recent research showing a dire outlook for workplace retirement savers, including a study from the New America Foundation that claims individual retirement accounts (IRAs) and 401(k) plans produce little in the way of sustainable retirement income. For this reason, the foundation advises policymakers to do away with tax preferences for private DC retirement savings and instead double Social Security benefits. Those claims "tend to underestimate the incomes that Americans will have in retirement while overestimating how much [they] will need to maintain their pre-retirement standards of living," Biggs said.

He also pointed to research from the Social Security Administration (SSA) and the U.S. Census Bureau, which paints a more optimistic picture. In fact, Biggs said the Modeling Income in the Near Term (MINT) instrument, an advanced research tool used by the SSA to study income trends, recently projected that many Baby Boomer and Generation X retirees can expect income replacement ratios at or near 100% of average pre-retirement earnings, once all sources of income are factored in.

Others, too, presented more promising statistics to counter—or correct—negative information being widely reported. Brian Reid, chief economist for the Investment Company Institute (ICI), advised "looking below" the commonly cited number of 80.6 million workers who report their employer does not sponsor a retirement plan—a figure from the Current Population Survey (CPS)—and there is "a significantly different picture." Chipping away the federal, state and local workers, the self-employed, part-time employees, and others such as those with a covered spouse, leaves only about 10.2 million private-sector wage and salary employees who would like to have access to a retirement plan but who are currently unable to save and invest at work, he said.

Such assessments distort the reality of DC retirement planning, as do criticisms that focus on one weak component of the system, or account balances only, to define the success of the whole, Reid said. Many of the harshest critics ignore the holistic manner in which most Americans save for retirement—as many participants do not depend on DC accounts alone for retirement income. He cited the importance of home ownership and pension plans, among other factors, in assessing the holistic retirement readiness picture of many Americans.

Reid praised the flexibility of the DC system, which “has led to tremendous innovation in retirement plan design over the past few decades and to continually lower costs for retirement products and services.” He also stressed that changes in policy “should build on the existing system—not put it at risk.”

According to one of the experts, though, the system is indeed already at risk. Vanguard Group founder John Bogle painted a grimmer picture of today’s retirement system, starting with the background. Boasting “many decades of writing extensively on the subject” of retirement plans, he described a layering/compounding of issues over the years, from too much speculation and too little investment to Americans’ rejection of frugality, the costs of mutual fund investing, and other key challenges.

Bogle pushed for a reorienting of the industry toward the shareholders—i.e., participants—rather than the fund managers. To help achieve this, he proposed giving institutional—including mutual—fund managers a mandatory fiduciary status. A federal standard would include, for one, the requirement that these fiduciaries act solely in the long-term interests of their beneficiaries.

Calling DC plans “the only realistic alternative for investors seeking to achieve a comfortable retirement,” Bogle said we must demand significant changes in their structure. The Thrift Savings Plan (TSP) makes a good model, he said.

“It is large, at $385 billion in assets, among the 25 largest pools in institutional money management. It is, well, cheap, with an annual expense ratio of less than 0.03%. It is largely indexed, with 100% of its long-term assets—some $212 billion—composed of four index funds,” Bogle said.

As it is, the defined contribution plan system is “structurally unsound,” he said. The money in accounts is too accessible, through loans and withdrawals, and participation too limited.

Unsound or not, the system works “well for millions of American workers,” said Scott Betts, senior vice president of National Benefits Services LLC, a fee-for-service third-party administrator (TPA) that supports 7,500 retirement and benefit plans in 46 states. Citing data from the Employee Benefit Research Institute (EBRI), he observed that middle-class workers are 15 times more apt to save for their families’ retirement at work than on their own in an IRA.

Still, he conceded, coverage could be enhanced and plan operations simplified. To that end, he said, the American Society of Pension Professionals & Actuaries (ASPPA) has developed a document containing more than 30 legislative proposals to improve the current system. These strategies, some already written into current legislation, would involve only “modest changes to the Internal Revenue Code [IRC] and ERISA,” he said. Eliminating unnecessary paperwork and widening the availability of savings options through simplified small business plans numbered among the ideas.

None of the experts, unsurprisingly, advised removing tax incentives for workplace retirement savings. Noting that tax deferrals should be left out of proposals to cap the value of exclusions and deductions, Reid said, “limiting [their] upfront benefit would impact workers arbitrarily, substantially reducing benefits for those closest to retirement.” In fact, the deferral limit, adjusted for inflation, has already eroded to less than half what it was when established under the Employee Retirement Income Security Act (ERISA) in 1974, he said.

Brigitte Madrian, a professor of public policy and corporate management at the Harvard University Kennedy School of Government, however, downplayed tax incentives’ importance. Armed with 15 years’ experience studying savings behavior, policy interventions and the plan design features that impact retirement plan participant outcomes, she said she has found financial incentives less important than just making things easy for participants. “From a behavioral economics standpoint, the tax code is particularly ill-suited to generating financial incentives to save,” she said.

Our tax system is too complicated for the average taxpayer, Madrian said, noting that even she gave up trying to understand the incentives of the Saver’s Credit for low- and middle-income taxpayers after about 10 minutes. People respond better to immediate, rather than delayed, financial incentives and often do not understand the tax implications of the different types of plans, she said.

The best way to get people to save, she said, agreed upon by essentially all of the experts, is automatic enrollment. It draws in groups known to be poor savers—younger and lower-income employees, she said, adding that “expanding [the DC system’s] reach is the most promising policy step we can take to increase the fraction of Americans who are saving for retirement.”

Biggs agreed, calling the strategy “the single most effective step we could take to increase retirement saving [and] far more effective than other policies, such as contribution matches.”

The crux is to simplify the saving process, Madrian said. Quick enrollment tools and policy initiatives such as auto-IRA proposals and the possibility of multiple employer plans with limited fiduciary liability would also help.

To summarize, she looks to the lessons of behavioral economics research: “If you want individuals to save, make it easy. If you want individuals to save more, make it easy. If you want employers to help their workers save, make it easy. And if you want individuals to spend less [of their retirement assets], make it harder to spend.”