BCG Retirement News Roundup

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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

Detroit emergency manager opts to delay pension freeze

Detroit Emergency Manager Kevyn Orr on Monday delayed a move to freeze the pension fund for some of the city's workers just hours after the order became public, saying a delay would allow for mediation with the city's retirement funds to play out.

Orr had issued the order on Dec. 30, with an effective date the following day, but it did not come to light until Monday when pension officials criticized the move. The document was not posted on a web page where Orr's other executive orders have been since taking over Michigan's biggest city in March.

Despite the delay, Orr said he reserves the right to retroactively freeze the General Retirement Fund, which covers non-public safety workers, retroactive to Jan. 1 if mediation fails to produce an agreement on a $3.5 billion unfunded pension liability the city "cannot afford to pay."

"The city remains in a financial emergency, and to the extent that mediation can assist in finding a way to improve services for all of its 700,000 residents, then it is worth continuing," Orr said in a statement.

He added that "an additional delay without the prospect of a mediated solution threatens to further erode essential services and public safety."

Earlier on Monday, a spokeswoman for Detroit's General Retirement System blasted Orr for ordering the pension freeze in the wake of mediation ordered by a U.S. Bankruptcy Court judge, who is overseeing the city's historic municipal bankruptcy filing.

"This is an outrageous and over-zealous action from the (emergency manager's) office," Tina Bassett, the spokeswoman, said in a statement. "Again the (emergency manager's) office demonstrates a lack of integrity and willingness to make a good faith effort when negotiating with our pension system."

The pension freeze called for closing the pension fund to any new or rehired employees and stopping benefit accruals for current workers. It also stopped worker contributions to the pension and annuity savings funds and ended cost-of-living adjustments for pension payments made to retirees.

As of Jan. 1, the order created a 401(k)-type defined contribution plan for affected workers.

Detroit's pension systems, made up of the general retirement and police and fire funds, are a major factor in the more than $18 billion in debt and other obligations that led to the city's historic municipal bankruptcy filing on July 18. Detroit has approximately 22,000 retirees who currently receive pensions, but only about 9,000 active employees supporting the funds, according to Orr's office.

The pension funds have filed an appeal with the U.S. Court of Appeals for the Sixth Circuit, hoping to overturn Judge Steven Rhodes' Dec. 3 ruling that the city was eligible for Chapter 9 municipal bankruptcy.

Mon Jan 6, 2014 6:28pm EST

United States: Courts Issue Public Pension Decisions

State appeals courts in Louisiana and New Mexico issued decisions this week important to public pension finance.

A Louisiana appeals court held that state law requires the City of New Orleans to contribute pension funding amounts calculated by the pension system actuary. According to the court, the City was not at liberty to put in less than the actuary's calculation of normal cost plus an amortization payment of the unfunded liability. This represents a fiscal challenge for financially-strapped New Orleans says NOLA.com:

> Mayor Mitch Landrieu's administration has suffered another setback in its fight over payments to the pension fund for New Orleans firefighters. An appellate court ruled Wednesday (Dec. 18) that the city is indeed on the hook for $17.5 million that the administration failed to pay into the system in 2012.
>
> A three-judge panel with the 4th Circuit Court of Appeal upheld Civil District Judge Robin Giarusso's ruling in March that the city must immediately pay up. That decision could fall hard on the cash-strapped city's finances as it struggles under the costs of two federal consent decrees meant to overhaul the Police Department and the city jail. You can read the court's entire decision here.
> ***https://app.box.com/s/jq6qu6ciqxhxqmz40lsa***

The New Mexico legislature, in an attempt to improve the funded status of its pension plan and control funding costs, passed a bill which would reduce future cost of living adjustments. The Supreme Court of New Mexico rejected public retirees' challenge to those reductions:

> We hold, therefore, that in the absence of any contrary indication from our Legislature, any future cost-of-living adjustment to a retirement benefit is merely a year-to-year expectation that, until paid, does not create a property right under the Constitution. Once paid, of course, the COLA by statute becomes part of the retirement benefit and a property right subject to those constitutional protections.

Bartlett v. Cameron (N.M., 2013).

We can expect more cases in the future as actuarial projections of future pension costs create a challenge for the treasuries of state and local governments.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Flaws of adopting cost cutting in switching to DC plans

Thinking back to 2007 — before the financial crisis — public pension plans in the aggregate had nearly 90% of the assets on hand required to pay retirement benefits due decades in the future. However, like all investors, public pension funds took a deep hit when the financial markets melted down in 2008. With markets in a downward freefall, pension assets plummeted, unfunded liabilities grew and pressure mounted on state policymakers to enact reforms. Even states with well-funded plans were prudent to closely examine their retirement systems, while policymakers in states that had fallen behind on their contributions prior to the Wall Street crisis faced tough decisions.

Since that time, 48 states have enacted reforms to their pension plans. The overwhelming majority of states acted to ensure the sustainability of their traditional pension structures by adjusting benefits and increasing employee and employer contributions. Specifically, the states enacted one or more reforms: 40 states reduced future pension benefits; 30 states required employees to increase their contributions; 21 states reduced cost-of-living adjustments for retirees; and 11 states statutorily increased the employers' pension contributions.

Now, public pension systems appear poised to emerge stronger than before the financial crisis thanks in large part to state policymakers' resistance to calls for extreme measures, while undertaking prudent state reforms and enjoying economic recovery. Indeed, a recent analysis by the Boston College Center for Retirement Research finds that such substantial reforms have put states on track to closing funding gaps, and many states might eventually reduce their pension costs to levels below what plans paid before 2008.

Although the environment back in 2008 appeared fertile for a wholesale switch to individual defined contribution accounts from defined benefit pensions, it never happened. That begs the question — why did policymakers stick with their defined benefit plans in the face of financial pressure and the corporate trend away from them?

One explanation is that the move away from defined benefit plans in the private sector is rooted in federal regulations that aren't applicable to public systems. These rules create sizable funding volatility and unpredictability for corporate plan sponsors.

Another explanation is that state policymakers heeded the data in actuarial analyses that indicated closing public pensions would not address funding shortfalls. Take for example the experience of West Virginia's pension reform in the 1990s, which now is a cautionary tale for policymakers. West Virginia learned the hard way that a switch to defined contribution accounts from defined benefit plans does nothing to close unfunded pension liabilities, and can leave employees unable to retire.

Here's what happened. To address historical underfunding of the West Virginia Teachers' Retirement System, the state closed the TRS and moved teachers hired after 1991 to 401(k)-type defined contribution accounts. More than a decade later, both the DB plan and the new DC plan faced challenges. The TRS DB plan was less than 20% funded, while teachers with DC accounts found their balances inadequate. Since West Virginia wisely reinstated its pension plan, the TRS DB finances have improved significantly and teachers are better positioned to retire.

While teachers made their required contributions to the TRS DB plan out of every paycheck, until 1991 state policymakers operated the system on an expensive a pay-as-you-go model that built up a significant unfunded liability. West Virginia adopted an actuarially based plan to reach full funding for the liability in the closed pension plan in 1994. But with the plan closed, demographics shifted quickly. By 2005, TRS paid pension benefits to nearly two retired teachers for every active teacher still contributing to TRS. When combined with funding percentage levels in the low 20s, this was a major concern.

Meanwhile, all new teachers made their mandatory 4.5% of pay contribution to the DC plan and employers contributed 7.5% of salary. However, the teachers' investment decisions were conservative and generated lower investment returns. As a consequence, teachers approaching retirement under the DC plan on average had less than $25,000 in their accounts and could not afford to retire, according to a 2005 study.

With these poor results, lawmakers cut their losses in 2005. They closed the 401(k) plan and reopened the pension plan to new teachers. This generated an immediate savings for the state because the “normal cost” for TRS was roughly half of the required employer contribution to the 401(k) plan.

On the demographic front, nearly 36,000 active teachers make the 6% contribution to the DB plan and about 32,000 retirees receive a monthly pension check. Now more sharply focused on the state’s 2034 pension full-funding deadline, West Virginia demonstrated its renewed commitment to catch up on past pension funding payments by using $807 million from its tobacco settlement fund to shore up the TRS plan.

Today, the West Virginia TRS pension plan continues to improve. The system's financial statement as of July 1 reported funding was at 58% of liabilities. That means that in the eight years since reopening the TRS pension, the state narrowed by half what historically was a sizable pension funding gap.

Other states have watched and learned from the West Virginia experience. Ultimately, kicking transition costs and unfunded liabilities down the road can have dire consequence for employees, employers and taxpayers. States have chosen to keep their DB pension model and are taking positive steps to fund their promises rather than embracing theories that there is no cost to switching to a DC plan from a DB plan.

Pension Reforms Push Employees Out the Door in Some States

Former Linn County (Ore.) Sheriff Tim Mueller had eyed this summer as the end of his long career in public safety.

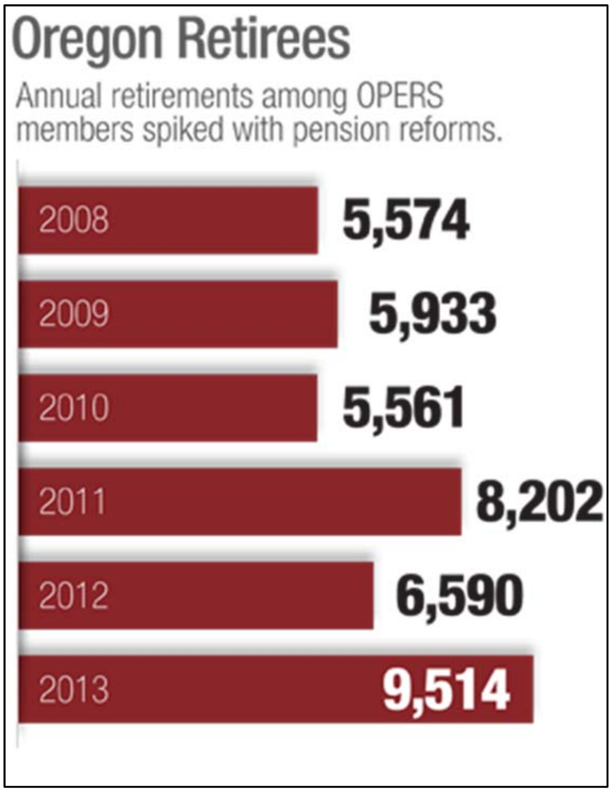
Each annual budget crisis and round of layoffs had begun to wear him out, he said. Then, talks of pension reform in the state legislature escalated last year, and some of his colleagues decided it was time to leave. Not knowing how the eventual reforms would play out was enough to help convince Mueller, 52, to move up his retirement date to December 31. “There was some uncertainty about what’s coming next,” said Mueller, who plans to work as a contractor for a law enforcement training firm. “It was just the last little nudge that I needed.”

More than 9,500 Oregon state employees called it quits last year – a 44 percent increase from 2012 – as they opted to begin drawing checks from the Oregon Public Employee Retirement System (OPERS). Similar scenarios played out elsewhere in recent years as debate over pension reform in state legislatures sparked a corresponding spike in public employee retirements.

A Governing review of data provided by a sample of retirement systems found that recent pension reforms contributed to significantly more workers filing retirement paperwork in at least six states: Georgia, Illinois, New Jersey, Ohio, Oregon and Wisconsin.

Part of the extent to which pension reforms caused public employees to head for the exits hinges on the nature of changes to plans. But in some states, retirements are more driven by the tone of the political rhetoric and cuts put on the table.

When Wisconsin Gov. Scott Walker pushed through controversial changes to collective bargaining and pensions in 2011, retirements nearly doubled. The Illinois State Employees Retirement similarly registered a 47 percent year-over-year surge in 2012 when debate in the legislature began to ramp up. In some other states, reforms had no noticeable effect.



In Oregon, the OPERS board made a change effectively trimming retirement benefits by roughly 2 percent for a portion of long-time state and local workers retiring after Dec. 1, providing them a clear incentive to leave before the cutoff date.

The state legislature also passed its own changes, including reducing cost-of-living-adjustments for OPERS retirees. Although the bill does not yet affect active employees, many still opted to leave. “It’s more of an emotional response to what some people see as a continuing disrespect of public employees,” said Greg Hartman, an attorney representing Oregon’s public employee unions.

OPERS reports that every year the legislature takes up the issue, it prompts a corresponding uptick in retirements.

Legislation in recent years brought drastic reforms in some states, but only minor adjustments in others. In 2012, 10 states overhauled systems with structural changes, such as replacing defined-benefit plans with hybrid or defined-contribution plans. Some states further raised employee contribution rates and cut benefits or cost-of-living-adjustments. Others raised the retirement age.

The majority of states examined that enacted pension reforms did not record notable upticks in retirements, including Montana and New Mexico, which both passed legislation in 2013.

Governing surveyed readers in November and December to gauge the effects of pension reforms. Of the limited number of senior state and local officials who reported pension adjustments were implemented, 46 percent said they caused employees to consider retirement or look for new employment.

By and large, most reforms alter benefits or contribution rates for current employees regardless of when they retire, or make changes for newly-hired workers. But it is clear that when lawmakers or pension boards set cutoff dates for current employees, retirements subsequently spike. The Employees' Retirement System of Georgia, for example, eliminated a tax offset that meant a cut for members retiring after last June. According to state data, 2,060 members retired in the first half of the year before the change, a 52 percent increase from the same period in 2012.

Members of the State Teachers Retirements System of Ohio similarly avoided a five-year cost-of-living benefit adjustment freeze by retiring before August, instead incurring just a one-year freeze. The system reported a small increase in retirements last fiscal year, which spokesman Nick Treneff attributed to the state reforms passed in 2012 along with improving stock portfolios. The Ohio Public Employees Retirement System also reported that it recorded an increase in late 2012.

It's often not so much the reforms actually implemented that push employees to retire as it is the threat of benefit cuts that arise during political debate. Perhaps nowhere was this more evident than Wisconsin, which saw a sharp spike in retirements as public employees occupied the state Capitol to protest the Republican-backed 2011 Act 10 reform bill, which included changes to pensions. "It was all driven by the politics and what employees were seeing and hearing from the capitol," said Marty Beil, executive director of the Wisconsin State Employees Union.

Matt Stohr, an administrator with the Wisconsin Department of Employee Trust Funds, reported call volume nearly doubled after the legislation was introduced. By the end of the year, about 15,600 workers – or 6 percent of active employees – had retired, compared to between 8,000 and 9,000 in a typical year.

Those retiring in 2011 did not gain any pension benefits by not staying on state payrolls. Some of them, like Bob McLinn, who worked 27 years as a state corrections officer, say they accelerated their retirement because of Madison politics. "It pushed me over the edge," McLinn said. "I wanted to protect [my pension] from any takeaways that were being discussed at the time."

A similar story played out in Illinois, where debate in the legislature on how to tackle the state's dire pension woes began heating up in 2012. "Discussions around the legislature in pension reform were a driver for a lot of employees to make this decision to retire," said Ben Winick director of policy and administration for the state Office of Management and Budget. About 4,700 State Retirement System of Illinois members retired that year; there were 3,200 retirements in 2011 and less than 3,000 in 2013.

Retirements among state employees dipped last year, which Winick attributes to a better understanding of reforms as talks progressed and the fact that many had already left in 2012.

The only financial incentive for current employees to retire is for Tier 1 workers age 50 and over, who can avoid seeing their cost-of-living adjustments skipped for one year by retiring before July 1. Tim Blair, executive director of the State Retirement System of Illinois, said he suspects some of those leaving may feel their pensions have more solid legal protections if they're retired.

It's too early to say whether the reforms could push more employees to head for the exits over the next few months, but Blair expects to know soon. "It could be a really busy spring for us," he said.

The New Jersey Public Employees Retirement System (PERS) similarly saw retirements jump by about 3,000 in 2010 and 2011. Chris Santarelli, a spokesman for the Treasury Department, reports public discussion surrounding pension and health benefit changes eventually enacted in June 2011 may have played a role. The past two years, between 8,000 and 9,000 PERS members filed for retirement.

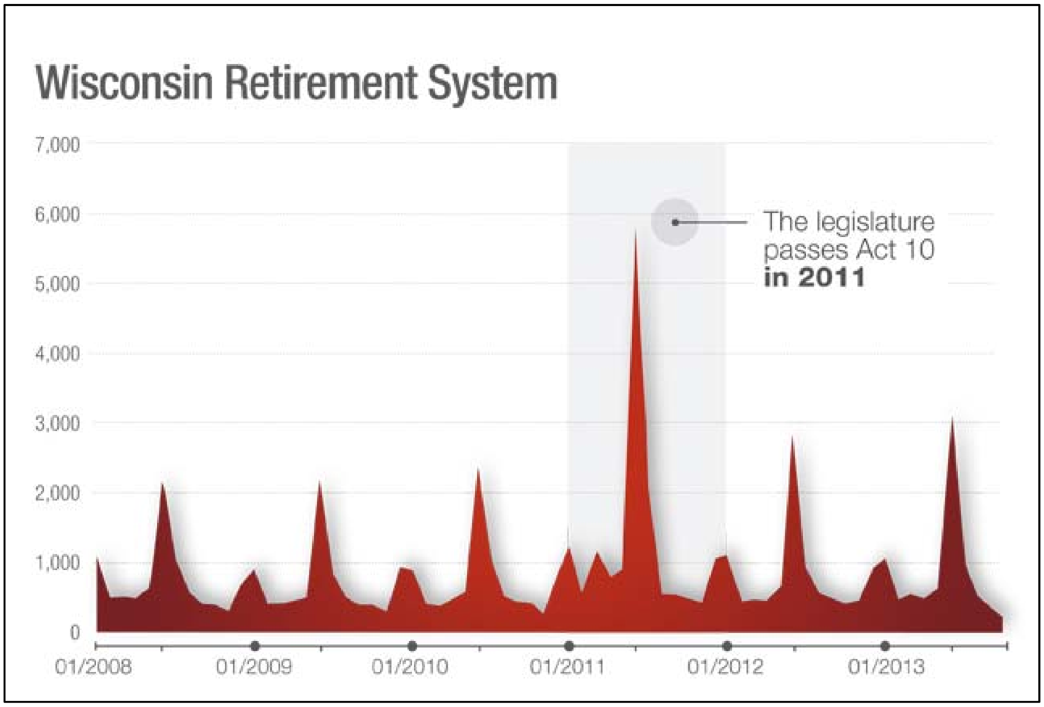
In New Jersey and other states, pension reforms occurred on top of demographic shifts that are already exerting pressure on retirement rates. Many systems project higher levels of retirements for years to come as baby boomers set to exit the workforce. In Oregon, for example, a third of the state employees who participate in OPERS are eligible to retire.

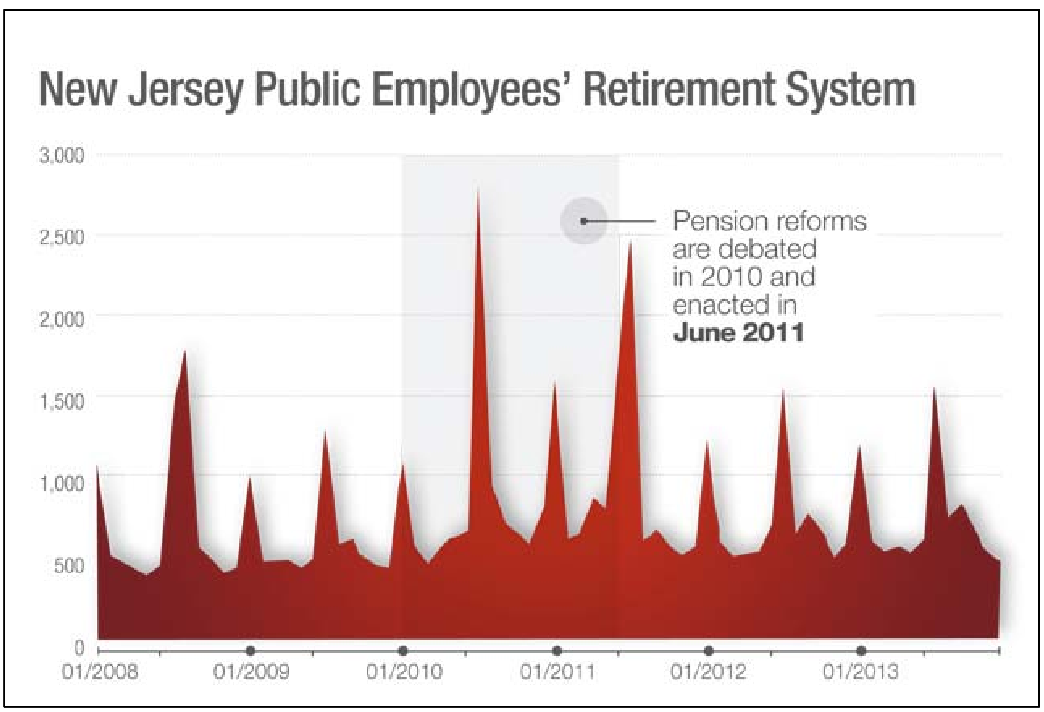
Many boomers delayed retirement during the recession. When they heard talk of tinkering with their pensions, it's likely that many decided it was time to not put it off any longer.

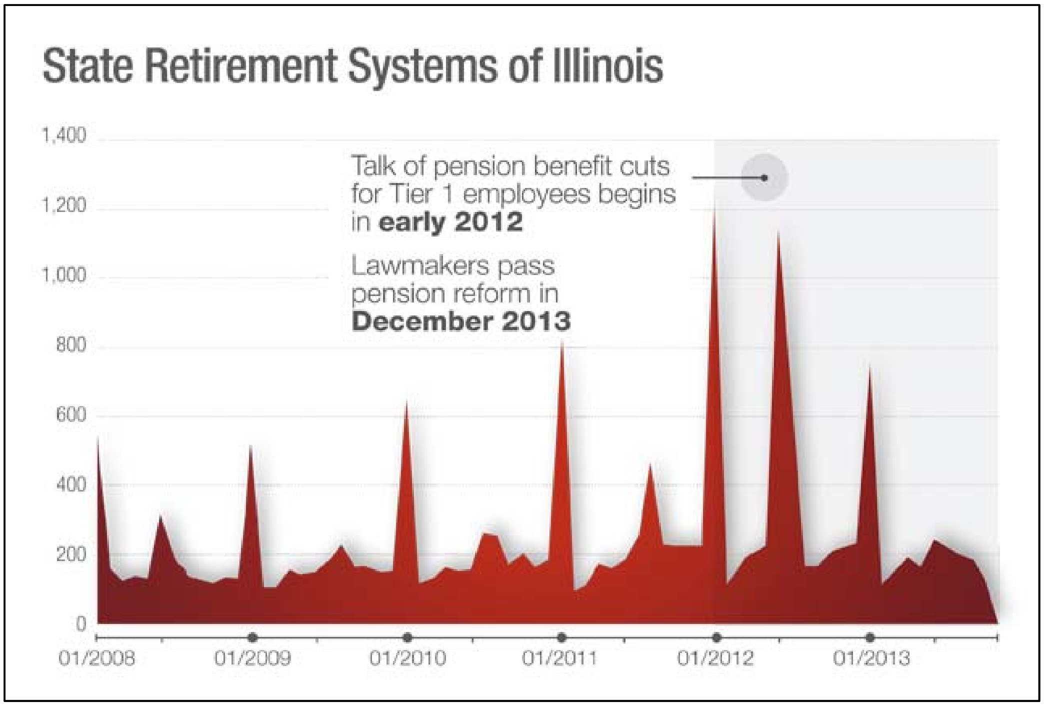
Retirement System Data

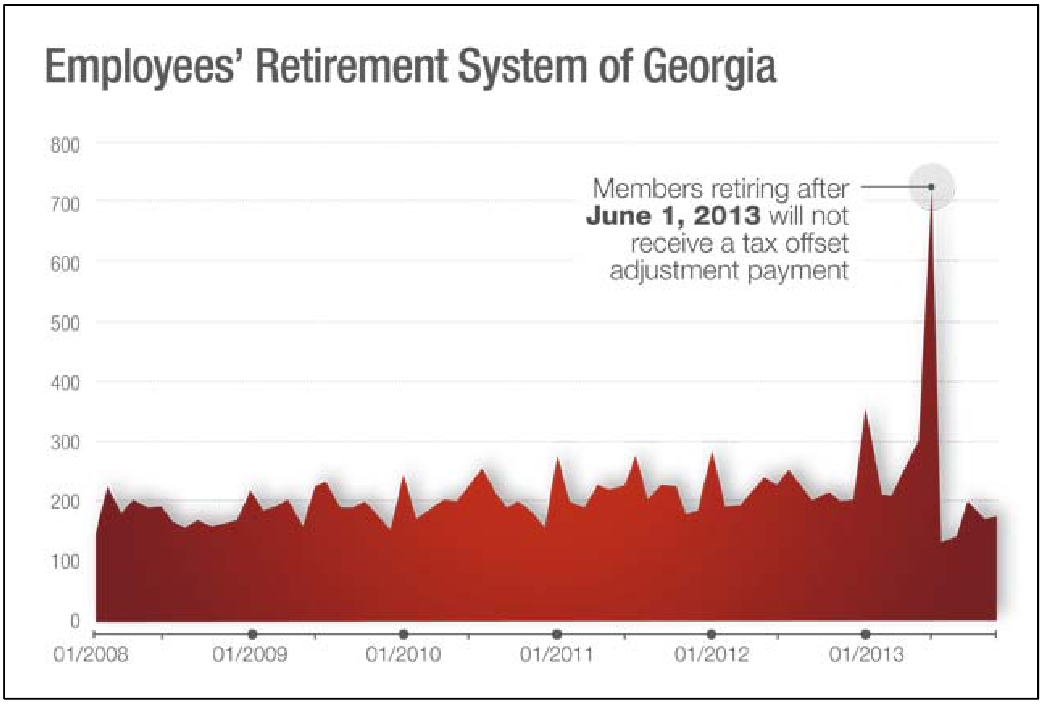
Governing obtained current and historical retirement data from a sample of 15 states implementing adjustments to pensions in recent years. An analysis of data and interviews with state officials indicated pensions reforms contributed to significantly more retirements in the following states reviewed: Georgia, Illinois, New Jersey, Ohio, Oregon and Wisconsin.

The following charts illustrate spikes in employee retirements for systems with available monthly data. Please note that most systems typically experience regular increases near the end of fiscal or school years.






State Retirement Systems of Illinois
1,400
1,200
1,000
800
600
400
200
0
Talk of pension benefit cuts for Tier 1 employees begins in **early 2012**
Lawmakers pass pension reform in **December 2013**
01/2008
01/2009
01/2010
01/2011
01/2012
01/2013


Employees' Retirement System of Georgia
800
700
600
500
400
300
200
100
0
Members retiring after **June 1, 2013** will not receive a tax offset adjustment payment
01/2008
01/2009
01/2010
01/2011
01/2012
01/2013

Where Do Taxpayers Have the Highest Total Unfunded Pension Liability?

Closely-scrutinized unfunded pension liability figures paint a bleak picture in cities' financial statements. But in some cases, local taxpayers are actually on the hook for far greater unfunded liabilities.

That's because there are other overlapping governments often saddled with unfunded pension liabilities of their own. So along with city governments, the same taxpayer base will also need to foot the bill for their state, school district and any other special district's employee pension plans.

In a new report, Morningstar Municipal Credit Research examined all such pension plans and tallied the total unfunded pension burden for residents in the 25 most populous cities and Puerto Rico, arguing state and local pensions shouldn't be examined in a vacuum. In a few localities, adding up pension liabilities revealed a sizable fiscal burden.

"There's got to be some give at some point," said Rachel Barkley, a Morningstar analyst who wrote the report. "Residents can only contribute so much of their income [to pensions]."

The report found the median aggregate unfunded pension liability for the cities examined to be $3,550 per resident.

In no major city was the pension burden greater than Chicago. The city's reported unfunded liability continues to remain high, with an actuarial accrued liability of $19.4 billion, or $7,149 per resident. The state system's pension woes push up the total liability to $14,570 per capita. Factoring in pension systems for Chicago Public Schools and Cook County further raise the total per capita burden to $18,596, according to the Morningstar report.

That total is, by far, the largest of any locality examined, although the figure should dip somewhat with the state legislature's recent pension reforms.

After Chicago, Puerto Rico ($9,987), New York City ($9,842) and Boston ($7,802) recorded the highest per capita unfunded actuarial accrued liabilities in the report.

The following table lists the per capita unfunded actuarial accrued liabilities (UAAL) for the 26 jurisdictions Morningstar examined, with amounts shown for the most recent fiscal year available (mostly fiscal 2012):

City	Per Capita City Pension UAAL	Per Capita Total Pension UAAL
Chicago, IL	$7,149	$18,596
Puerto Rico, PR	$9,987	$9,987
New York, NY	$8,726	$9,842
Boston, MA	$4,465	$7,802
Philadelphia, PA	$3,308	$7,057
Columbus, OH	n/a	$6,814
San Francisco, CA	$2,866	$6,453
Los Angeles, CA	$1,895	$6,426
San Jose, CA	$1,542	$6,014
San Diego, CA	$1,642	$5,973
Denver, CO	$709	$5,356
Detroit, MI	$911	$3,758
Jacksonville, FL	$2,586	$3,675
Indianapolis, IN	$1,011	$3,426
Phoenix, AZ	$1,649	$3,351
Austin, TX	$1,571	$3,009
Dallas, TX	$1,373	$2,733
Houston, TX	$1,196	$2,622
Fort Worth, TX	$986	$2,377
El Paso, TX	$736	$2,149
Seattle, WA	$1,837	$1,997
San Antonio, TX	$251	$1,623
Nashville, TN	$876	$1,291
Memphis, TN	$317	$893
Charlotte, NC	n/a	$585
Washington, DC	-$409	-$409

Source: Morningstar Municipal Credit Research, "Determining the Aggregate Per Capita Pension Liability"

It’s important to note that the figures shown here are not normalized – Morningstar used each individual system’s actuarial methods and interest rate assumptions. And these, of course, can vary greatly from system to system.

Changes in actuarial methods or assumptions often yield major swings in unfunded liabilities. Take New York City, which posted an unfunded actuarial accrued liability of $1,112 per capita in fiscal 2011. Then in 2012, the plan’s actuarial cost method changed to the entry age method and the assumed interest rate dropped from 8 to 7 percent. The two changes ended up raising the city’s per capita liability to $8,472 that year, while the funded ratio fell from 91.9 to 60.1 percent, according to the report.

Morningstar’s Barkley also points out that there are limitations to examining unfunded liabilities on a per capita basis. Some cities, for instance, derive more revenue from commercial properties or businesses than others. The numbers also don’t reflect taxes on nonresidents. Philadelphia’s wage tax, for example, applies to both residents and non-residents working in the city.

by Mike Maciag | January 23, 2014

Private Sector

We no longer have a pension crisis (sort of)

General Electric did something amazing in 1998. A roaring stock market left the pension fund covering its former employees with a huge surplus. In effect, GE had set billions of dollars more than its number-crunchers figured it would need to pay future pensioners. An accounting rule let the company count part of that surplus as profit. Of GE's $13.8 billion profit that year, more than $1 billion came from its pension plan.

These stories sound crazy today. All we've heard about for the last decade is how underfunded corporate pensions are. "More than two-thirds of the companies that make up the S&P 500 have defined-benefit plans, and as of last quarter only 18 of them were fully funded," TIME magazine wrote just a year ago. In December 2012, corporate pensions in the S&P 1500 were underfunded by $557 billion, according to consulting firm Mercer.

But things changed in 2013. A new report by consultants Towers Watson estimates corporate pensions are now 93% funded, on average. In another report, consultants at Mercer said pension plans among S&P 1500 companies are now 95% funded, up from

74% a year ago. The half-trillion deficit a year ago has been reduced by more than 80%, to less than $100 billion.

Two things fueled this turnaround.

Stocks just had their best year since the mid-1990s, up nearly 30%. That was more than enough to offset any decline suffered in bonds. I think we got so used to a decade of dismal returns that a lot of people forecasting the pension crisis forgot this could occur. A year ago, I interviewed Joseph Dear, then chief investment officer of CalPERS, the nation's largest pension fund, who said this about market returns:

It's not been so great for the past ten years, but if you look at big cycles in investment and see 10-year returns from equities relatively low, what we've seen after that is a return to better returns, a reversion to the mean. So I think there is a reasonable basis to be confident.

That's exactly what happened.

Two, and a little more complicated, is that rising interest rates reduced the present value of pension plans' future liabilities. Pensions use a "discount rate" -- an interest rate typically linked to corporate bond yields -- to convert future obligations into a present value. The lower that rate is, the higher a pension's liabilities are. And with interest rates at all-time low in recent years, that discount rate has been incredibly low, pushing up the present value of pension funds' liabilities.

But with interest rates now rising, the present value of future obligations is coming down. Towers Watson says the average discount rate used in corporate pensions rose to 4.8% in 2013, from 3.9% in 2012. When I asked Dear about low discount rates last year, he replied:

In a super-low rate environment like we have today, liabilities are definitely bigger. But are interest rates going to stay low? Is the 10-year Treasury going to stay at 1.6% indefinitely? I doubt it. So it's going to go up and the interest rates will go up and even those who want to do the yield curve will see liabilities coming down.

That, too, is exactly what happened. In June, Mercer estimated that rising corporate bond yields reduced S&P 1500 pension obligations by $150 billion. Yields have increased sharply since then -- the 10-year Treasury bond rose from 2.2% in June to 3% today -- shrinking liabilities even further. If interest rates keep rising this year, and most analysts expect they will, pension funding levels could keep rising.

Is our corporate pension crisis over? Sort of. I think a more accurate observation is that these things constantly move in cycles. Pensions looked underfunded in the early 1990s. Then they were way overfunded in the late 1990s. Then they became strained in the early 2000s. Then they were overfunded again by 2007. Next came the half-a-trillion-dollar shortfall last year, and today, we're back to fairly healthy levels. Funding calculations rely on assumptions. Those assumptions are usually wrong, and they can change dramatically overnight. There's almost never a time when pensions are perfectly funded at just the right level and stay there forever, nor should there be. Any investor it in for the long run has to accept big ups and downs. It's just part of the deal.

So be happy corporate pensions are doing better. But realize we'll be back to Crisisville before long.

U.S. Pensions Enter 2014 in Best Shape in Years

Americans had to be worried about their pension funds until just recently. The status of underfunded pensions was getting out of hand, but the bull market in stocks is helping to fix that issue now. A recent BNY Mellon report shows that the funded status of U.S.-based corporate pensions rose to 95.2% in December. The report shows that pension plans, endowments and foundations have all won from the rise in equity markets.

One word of caution is here, but from a different report this week. A fresh report from TrimTabs showed that bond funds showed record outflows in 2013, but it also warned that only a tiny fraction of the inflows from the past five years has been seen.

This interest rate pressure might seem to hurt pension fund valuations on the surface, although rising interest rates will actually help fund future liabilities not yet on the books. In fact, BNY Mellon did show that rising interest rates lowered liabilities. It said:

The decline in liabilities was due to an eight-basis-point increase in the AA corporate discount rate to 4.93 percent. Plan liabilities are calculated using the yields of long-term investment grade bonds. Higher yields on these bonds result in lower liabilities.

BNY Mellon showed that the funded status of the typical U.S. corporate pension plan in December 2013 rose by 1.3 percentage points to 95.2%. This was the highest level since before the recessionary stock market crush — back to September 2008.

Assets for U.S. corporate plans were up by 0.8%, versus a drop of 0.6% in the liabilities. The funded status of the typical U.S. corporate plan rose by more than 18 percentage points in 2013. A growing number of plan sponsors are said to be reducing their exposure to market volatility.

Even public pensions performed better. The typical defined benefit plan in December saw excess return of 0.4 percent over its annualized 7.5 percent return target; public plan assets must earn at least 0.6% each month to keep pace with the 7.5% annual target.

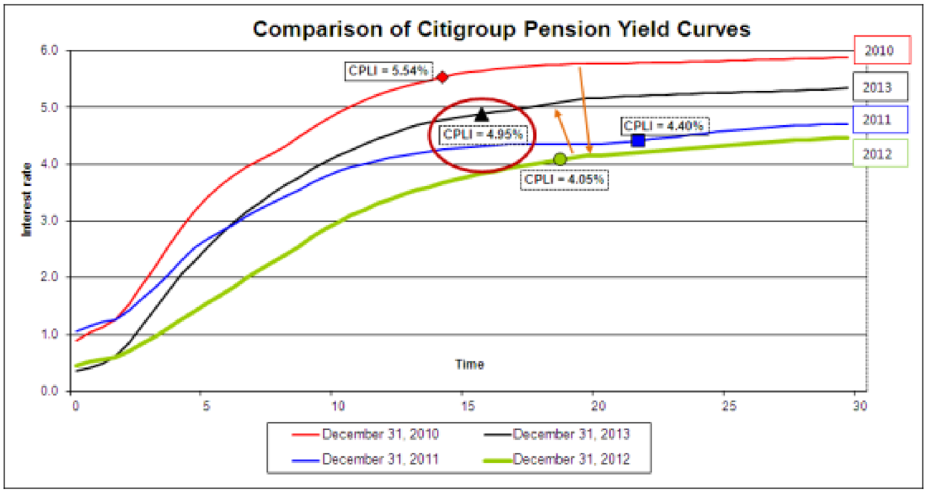
BNY Mellon Investment Management claims some $1.5 trillion in assets under management. It has a keen insight on pension and endowment asset management trends.

Higher Discount Rates Will Help 2013 Pension Disclosures and 2014 Expense

The final results are in and pension plan sponsors should be pleased with final year-end discount rates – at least compared to the FY2012 rates. Using the Citigroup Pension Liability Index (CPLI) and Citigroup Pension Discount Curve (CPDC) as proxies, pension accounting discount rates are up by about 90 basis points this year.

This is great news for pension plan sponsors. The higher discount rates will have a very beneficial effect on pension liabilities. This in turn will affect both the year-end funded status of the plan and also the 2014 pension expense calculation.
Analysis

In the chart below we compare the CPDC at four different measurement dates (12/31 2010 to 2013). We also highlight the CPLI at each measurement date. The CPLI can be thought of as the average discount rate produced by the curve for an average pension plan.



The orange arrows in the chart highlight the trend in yield curve movement and show how rates have increased at almost all points along the spectrum since 2012. This means that pretty much all plans, even closed/frozen plans with shorter durations, should experience the benefit of higher discount rates.

Net Effect on Balance Sheet Liability

Many plans also had strong investment returns during the year. Depending on the starting funded status, the change in pension liabilities and assets can have a leveraging effect on the reported net balance sheet asset/liability.

Below is a simplified illustration for a plan that was 70% funded on 12/31/2012 and we assume a 10% decrease in pension liability during 2013. We then compare the funded status results under two asset scenarios: (1) Assets 5% higher than 12/31/2012 and (2) Assets 15% higher than 12/31/2012.

Illustration of Change in Balance Sheet Liability			
		Liabilities 10% Lower	
		Assets 5% Higher	Assets 15% Higher
	12/31/2012	12/31/2013	12/31/2013
Pension Assets	70,000,000	73,500,000	80,500,000
Pension Liability	100,000,000	90,000,000	90,000,000
Balance Sheet (Liability)/Asset	(30,000,000)	(16,500,000)	(9,500,000)
Funded Percent	70.0%	81.7%	89.4%
Change in Net (Liability)/Asset		-45.0%	-68.3%

In both cases, the funded status of the plan improves measurably. There's also a magnified decrease in the unfunded balance sheet liability because it's such a leveraged result. This amount decreases by 45% and 68%, respectively, in the two sample scenarios.

Conclusions

So, what should plan sponsors be considering over the next few months as we approach year-end? Here are a few ideas.

- Now maybe a good time to consider strategies that lock-in some of this year's investment gains. These could include exploring an LDI strategy to more closely align plan assets and liabilities. Or, offering a lump sum payout window for terminated vested participants early in 2014.

- Additional plan funding (above the IRS minimum requirements) may be appealing in 2014. Not only will it increase the plan's funded status, but it will also help lower your pension plan's PBGC variable rate premiums. These are scheduled to increase significantly starting in 2015 as a result of the Bipartisan Budget Act of 2013.

- Your plan's specific cash flows could have an enormous impact on how much the drop in discount rates affects your pension liability. If you've just used the CPLI in the past, it's worth looking at modeling your own projected cash flows with the CPDC or an alternative index or yield curve to see how it stacks up.

- Even though increased discount rates tend to lower the present value of pension liabilities, your plan may still have an overall liability increase. This could result from active participants continuing to accrue new benefits in the plan, or from the fact that benefits will have one fewer year of interest discount at 12/31/2013 compared to 12/31/2012.

Investment selection and monitoring—It's not monkey business

From time to time, a story will appear in the press describing a stock-picking contest that pits monkeys throwing darts at a newspaper's financial pages against expert money managers. This stems from a line in Burton Malkiel's book A Random Walk Down Wall Street, in which he stated " . . . a blindfolded monkey throwing darts at a newspaper's financial pages could select a portfolio that would do just as well as one carefully selected by experts." The results of these contests have varied over the years (with the monkeys often doing remarkably well).

Regardless of how well the monkeys perform, that process is not likely to satisfy ERISA guidelines for selecting and monitoring a plan's investments, which is fiduciary best practice No. 2. I previously discussed the importance of having a well-designed and efficiently functioning retirement plan committee and documenting the committee's actions (also known as Fiduciary best practice No. 1).

Selecting and monitoring the plan's investments is a vital part of the committee's responsibilities, and when performing this function it's important for committee members to remember that under ERISA, plan fiduciaries are held to a very high standard, sometimes referred to as the "prudent expert" rule.

So what's a committee to do?

Put away your darts and ask yourself the following two questions:

1. Do I and my fellow committee members have the necessary experience and expertise to evaluate the available universe of investments, and then select and monitor the performance of a well-diversified lineup of investment options for our company's retirement plan?
2. 2.Given all of our other corporate duties and responsibilities, can I and my fellow committee members devote the time that's necessary to prudently perform this function?

If the answer to both questions is "yes," then you should be in good shape to proceed. As you do so, remember to engage in a prudent, deliberative process and to carefully document that process and the committee's decisions.

If you're unable to answer both questions with a resounding "yes," take heart—you may still be able to carefully perform this vital function with just a little help from your friends. For example, we'll provide periodic market and economic updates and detailed fund performance analyses from the experts in our Portfolio Review Department for investment committees when needed. Many committees can leverage this great information to make informed decisions regarding their plan's investment lineup without any further outside intervention.

If the answer to either or both of these questions is a definite "no," then the committee could consider retaining the services of a qualified expert to assist them. Depending upon the committee's level of expertise and time available to devote to the investment process, this hired hand could be anyone from a nonfiduciary investment consultant to a fiduciary investment manager. For more information on this, I recommend that you read the commentary entitled "Mitigating fiduciary liability for defined contribution plan investment decisions," which is available on our Institutional website.

Another very important step the committee should take is to adopt an investment policy statement (IPS) with a clearly defined purpose, objectives, and measures of success. The IPS should set forth the plan's investment strategy and describe the performance measures that will be used, how often the performance will be reviewed, and the parameters that will be followed in deciding if and when a particular investment or manager should be eliminated or replaced.

This is not a "set it and forget it" proposition. The IPS should be reviewed periodically to make sure that it continues to reflect the best thinking of the plan committee, and the committee members should make sure that they're following the guidelines that the IPS provides. Not following an IPS or not updating it when needed can have serious consequences. For example, over the past several years, there have been more than three dozen class action lawsuits filed against plan fiduciaries claiming that they caused the plan to pay excessive fees. One of these cases, which has been fully adjudicated at the federal district court level, provides a sobering example of what can happen when a committee doesn't follow their IPS. In that case, the plan fiduciaries did adopt an IPS. However, they failed to follow its provisions in several key areas, including: the process and criteria to use for selecting investments; and the procedures to follow in deciding if and when to replace an investment. Because of these failures, and others, the judge decided that the fiduciaries had caused the plan to pay excessive fees, and the court found the defendants liable for millions in damages. This case is currently being appealed, but should make every ERISA fiduciary sit up and take notice.

Finally, when selecting the investment lineup for your plan, it's important to note that plan fiduciaries are not expected to hit a bull's-eye with every choice. Rather, we've learned from the courts that the committee must be able to demonstrate that a prudent, deliberative process was followed in making the investment selections, and that those investments were regularly monitored to ensure that they continued to fit with the plan's investment strategy and performance measures as outlined in the IPS.

The selection and monitoring of the plan's investments is an important responsibility borne by all investment committee members, but it's one that can be properly managed if the committee has the necessary experience and expertise and devotes sufficient time to the process. For those requiring help with this process, you can get that monkey off your back (at least partially) by hiring a qualified investment professional.

And, remember, whichever course you follow, create a record of prudent fiduciary behavior by documenting what you do.

Note:

- All investing is subject to risk, including the possible loss of the money you invest.

Bonds Captivate $16 Trillion of Pensions

Bond buyers stung by the first losses in more than a decade can look to pension funds from companies such as Ford Motor Co. (F) for a measure of redemption.

Ford's $64 billion pension is piling into bonds to reduce risk and lock in higher interest rates after a surge in yields and the biggest stock gain since 1997 sliced its funding shortfall by about half. The second-largest American automaker, which boosted debt investments to about 70 percent of its U.S. plan assets last year from 55 percent in 2012, is now looking to boost that allocation to 80 percent.

"Companies are now getting on the bandwagon," Ford Treasurer Neil Schloss said in a Jan. 9 telephone interview from the company's headquarters in Dearborn, Michigan.

U.S. pensions, which control $16 trillion, shifted out of equities and into bonds in the third quarter at the fastest rate since 2008, data compiled by the Federal Reserve show. The plans were more willing to own stocks after the Fed dropped its target interest rate close to zero and pushed down yields to record lows with its bond buying to support the U.S. economy crippled by the financial crisis.

After the 30 percent rally in the Standard & Poor's 500 Index brought the biggest corporate pensions on the verge of closing shortfalls for the first time since before the crisis, they're now pouring back into fixed-income assets to lower risk as the Fed's move to taper stimulus causes yields to rise.

Pension Demand

Renewed pension demand may help temper further losses in bonds after debt securities from Treasuries to corporate debentures and emerging-market government notes fell an average of 0.31 percent last year in the first decline since 1999, index data compiled by Bank of America Merrill Lynch show.

Yields on benchmark 10-year Treasuries surged to 3.05 percent this month, the highest since July 2011 and more than double the record low of 1.38 percent set July 2012. The yield fell to 2.84 percent, a three-week low on an intra-day basis, at 12:24 p.m. in New York.

The selloff pushed up yields on the longest-maturing investment-grade company bonds, which pensions buy to fund future liabilities, by 0.82 percentage point last year to 5.33 percent. The annual increase was the first in five years and left yields at the highest level on a year-end basis since 2010.

"It's a very large source of demand" from the pension funds, Jeffrey Gundlach, chief executive officer of DoubleLine Capital LP, which manages $49 billion, said in a telephone interview from Los Angeles. "It puts a ceiling on interest rates, particularly corporate bond rates."

Future Payouts

The cost of future payments to retirees is determined by an estimated interest rate based on corporate bond yields, known as the discount rate. As that rate rises, pension liabilities decrease, and vice versa.

Coupled with the surge in equities that bolstered plan assets, the 100 biggest U.S. corporate pensions narrowed their deficits by a net $319 billion, according to Milliman Inc., a pension advisory firm based in Seattle. The improvement was the biggest since Milliman began releasing the data 13 years ago.

The plans are now 95 percent funded, the highest since 2008. Funding fell as low as 77 percent in 2012 as stocks had yet to fully recover from the financial crisis and the Fed's stimulus caused bond yields to plunge.

The deficit for Ford's pension, which risked forcing the carmaker to seek a federal bailout in 2009, has plummeted to about $10 billion from $18.7 billion at the end of 2012. Ford's shortfall also declined as increasing earnings helped the carmaker to make more cash contributions to its pension.

Risk Off

As companies close those gaps, more of their plans are buying bonds, which allows them to match liabilities and eliminate the risk of potential deficits.

"They're taking more equity risk off the table" with fixed-income securities as their funding status improves, Zorast Wadia, an analyst at Milliman, said in a telephone interview. "Pension plans don't want to give back the gains that essentially took over five years to accumulate."

Public and private pension funds in the U.S. added $117 billion of debt securities in the three months ended in September on an annualized basis and sold $135 billion of equities, according to Fed data released on Dec. 9.

The disparity was the greatest since 2008 when comparing third-quarter data on an annual basis.

About 70 percent of companies with defined-benefit plans, or those that provide workers with retirement income based on employment length or salary level, may increase their share of long-term debt securities and other rate-sensitive investments by 2015, based on a November report by Towers Watson, a New York-based pension advisory firm.

Dumping Stocks

Ryder System Inc. (R), the U.S. truck-leasing company, is increasing the debt allocation in its $1.6 billion pension to about 45 percent this year from about 30 percent, Treasurer Dan Susik said in a Jan. 9 telephone interview.

"This is continuing to play out," said Mark Ruloff, director of asset allocation at Towers Watson. "They didn't switch it all in one day, so it's going to get spread into the next year and perhaps the next couple of years."

Higher rates helped lower pension expenses at St. Paul, Minnesota-based 3M Co. (MMM), which sells products as varied as Scotch tape and dental braces, to as low as $100 million from $534 million in 2012, the company said last month.

After suffering its worst pension deficit in nine years in 2011, 3M's funding status has improved to 93 percent.

Piling In

Deutsche Bank AG forecasts that pensions will sell about $150 billion in equities this year to buy corporate bonds due in 10 years or more. The debt outperformed notes with the shortest maturities last quarter by the most in a year, with the longest-dated bonds returning an extra 1.6 percentage points.

Bank of America, which predicted that investors would start abandoning bonds for stocks last year in what the Charlotte, North Carolina-based bank dubbed the “Great Rotation,” now anticipates investment-grade corporate bonds will return 1.6 percent this year, double its projection in January.

The advance would help restore last year’s 1.5 percent loss, the first decline since 2008, based on the Bank of America Merrill Lynch U.S. Corporate Bond Index. Yields have risen as the Fed pares its monthly debt purchases starting in January to $75 billion from $85 billion.

The central bank will cut buying by $10 billion in each of the next six meetings before ending its stimulus in December at the latest, according to the median forecasts of 42 economists surveyed by Bloomberg on Jan. 10.

Most Expensive

Equities are also the most expensive versus Treasuries since 2011. The earnings yield for S&P 500 companies, measured by profits as a percentage of the index’s price, was 2.9 percentage points higher than the yield for 10-year government notes, the smallest premium since March 2011.

“You’re going to see a significant shift” from pensions into bonds, Rick Rieder, the co-head for Americas fixed income at BlackRock Inc. (BLK), which manages $3.86 trillion, said in an interview at Bloomberg’s headquarters in New York. “It makes a ton of sense. Now that they’re funded, they can buy long-dated bonds” to lock in gains from their equity stakes.

With the longest-dated investment-grade notes already yielding the least relative to U.S. government debt since 2007, pension demand alone won’t be enough to keep bonds from falling out of favor, according to Marc Pinto, the head of corporate-bond strategy at Susquehanna International Group LLP.

Highest Rated

The 1.6 percent return that Bank of America forecasts for notes issued by the highest-rated companies this year wouldn’t even be enough to compensate for a 1.7 percent increase in U.S. living costs that economists estimate in a Bloomberg survey. In 2012, investment-grade bonds surged 10 percent.

"It's going to be difficult to eke out a positive total return in the investment-grade market in 2014," Pinto said in an telephone interview. "The Fed is likely going to increase its tapering efforts and all of this will likely push long-term rates higher. That could pressure long-term returns."

Short-term losses arising from an increase in yields may not deter pension funds as long as they can buy enough bonds to match their obligations as stricter regulations are enforced.

Under the federal Pension Protection Act, which was passed in 2006 and started to take effect in 2008, companies have seven years to fully fund their retirement plans and are required to use a specified, market-based rate of return to compute liabilities rather than their own forecasts.

"We, inherently as it relates to the pension plan, won't care" if yields rise once we've bought a bond to match a specific pension liability, Ford's Schloss said.

Natural Demand

Instead, each 1 percentage-point increase in the discount rate used by Ford's pension would cut its projected U.S. liabilities by $5.2 billion, its regulatory filing shows. Its weighted-average U.S. discount rate stood at 3.84 percent at the end of 2012, its annual filing showed.

Insurers are also poised to step up their bond buying as companies seek to offload plans. MetLife Inc., the largest U.S. life insurer, estimates that pensions have $800 billion in liabilities that may be transferred to insurance companies.

NCR Corp. (NCR), the maker of automated teller machines, moved more than a $1 billion of retirement benefits to Pension Insurance Corp., a U.K. insurer, in November.

The Duluth, Georgia-based company, which started in 1884 by selling mechanical cash registers and now has about 26,000 employees, also shifted almost all its U.S. plan assets into fixed-income securities, according to John Boudreau, NCR's treasurer. As recently as 2010, bonds accounted for as little as 30 percent of the pension's assets.

"There's a lot of natural demand for bonds as rates rise even modestly from here," Ed Keon, who helps oversee more than $100 billion at Prudential Financial Inc.'s Quantitative Management Associates, said in a telephone interview.